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Client briefing
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More changes to the tax regime of real estate investment funds

Key Issues

Exemption for funds held by eligible investors

New look-through treatment for certain relevant investors

Option to liquidate non-eligible funds

The Italian Government introduced a set of measures – known as "development decree" – that will, among others, reform again the taxation of investors in Italian real estate investment funds (Decree Law 70 of 13 May 2011). The new regime – which would supersede the previous reform even prior to its entry into effect – may be more favourable since it is meant to adversely affect only certain significant investors, rather than the funds themselves. Moreover, the new regime might be less detrimental for foreign investment funds investing directly or indirectly in Italian real estate funds.

It is worth recalling that the regime of real estate funds – traditionally based on full exemption on the income and gains on the funds, coupled with a withholding tax on distribution but with a wide exemption for white listed foreign investors – was first amended in May 2010. The amendments provided that:

- The tightening of the definition of “investment fund”, to contemplate expressly the concepts of "plurality of participants" and of "independence of the management company", thus counteracting captive fund actually managed by the investors;
- The imposition of a substitute tax on funds not meeting the definition and being amended or, if not amended, mandatorily liquidated;
- The tightening of the scope of the exemption for non-residents, making it available only to (i) pension funds and collective investment undertakings established in a jurisdictions allowing a satisfactory exchange of information with Italy (so called "white-list" jurisdictions), (ii) supra-national bodies established under international treaties ratified by Italy, (iii) central banks and other bodies managing the official reserves of a foreign State.

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The highlights of the measure just introduced may be summarised as follows:

- The concepts of "plurality of participants" and of "independence of the management company" – which are essential to the definition of what is an "investment fund" and were meant to serve as a basis to push out of the regime funds that were being used as mere captive investment vehicles – will no longer be defined in any detail and the current consultation process will be dropped;
- Real estate investments funds will continue to enjoy full exemption; however, certain non-eligible investors might be subject to tax on income and gains of the fund under a look-through approach;
- The substitute tax regime provided for funds not meeting the new definition has been reformed.

Save as described below, no significant changes would be introduced on the withholding tax currently applicable on distributions by Italian real estate investment funds and on the (currently rather narrow) scope of the exemption from the same withholding on distributions to foreign participants.

The new legislation is in the form of a decree law, which is immediately effective upon publication on the Official Journal (which took place on Friday 13 May). If not converted into law by the Parliament within sixty days, it will expire and loose effectiveness. In any event, the new legislation will have to be followed by implementing regulations to be issued by the Tax Authorities (*Direttore dell'Agenzia delle Entrate*).

Investment funds held by eligible investors

Under the new legislation, the current regime contemplating the full exemption on income and capital gains and exemption from any substitute tax – and possible taxation only upon distribution – will be applicable in any case only to funds whose participants belong solely to the following categories (the "**Eligible Participants**"), regardless of the respective share of participation:

(a) The State or other public authorities;

(b) Collective investment undertakings;

(c) Social security entities;

(d) Insurance companies, only as to investments made against technical reserves;

(e) Banking and financial intermediaries subject to regulatory supervision;

(f) Foreign entities, bodies and other forms of organisation similar to the ones listed above and established in states or territories allowing an exchange of information which allows the identification of the argument beneficial owners of the income or gains of the (Italian) fund;

(g) Certain Italian philanthropic and non-profit organisations;

(h) Entities with or without legal personality, in which he above persons hold more than 50 per cent..

Hence, real estate investment funds whose participants are all Eligible Participants will as a matter of practice not be affected by the new legislation and will continue to be subject to the existing regime, i.e.:

- Full exemption in the hands of the fund on income and gains derived from investments in real property;
- 20 per cent. withholding tax on distributions, save that the recipient is a:

  - Italian collective investment undertaking;

- Italian social security body;
- Foreign pension fund or collective investment undertaking established in a states or territories allowing an adequate exchange of information; and
- No substitute tax would apply.

In the case of Italian corporate (and other business) investors, or Italian permanent establishment of foreign investors, the withholding tax is not a final tax but is on account of ordinary corporation (or income) tax.

The tax regime of non-eligible investors

Income and gains attributable to participants other than the above (the "**Non-Eligible Participants**") and holding, directly or indirectly through controlled entities, a participation representing more than 5 per cent. of the assets of the fund, will be subject to tax in the hands of the participants regardless of distribution. While in the hands of resident investors such income and gains will be subject to tax at ordinary income and corporate tax rates, income attributable to non-resident holders will be subject to a 20 per cent. final withholding tax upon distribution (possibly subject to mitigation, normally to 10 per cent., under double tax treaties).

Income and gains of the funds taxed in the hands of the participants under the said look-through approach will be sterilised in computing capital gains and losses possibly realised upon disposal of the investment in the fund, by increasing the relevant tax basis by the same amount.

Treatment of existing funds

Under the regime that was introduced prior to this new amendment, but that was never enacted due to the lack of the relevant secondary legislation, investment undertakings not meeting the new definition of "investment fund" and that were not amended to meet the new definition, were meant to be liquidated. This is no longer the case under the newly introduced regime.

Firstly, Non-Eligible Participants holding investments in a fund on 31 December 2010 will have to pay a one-off 5 per cent. substitute tax on the average value of their investment in 2010. The same value will be taken as tax basis of the units of the fund in computing subsequent capital gains or losses.

Moreover, the participants (i.e. not the management company) of investment funds that on 31 December 2010 were participated also by persons other than Eligible Participants, and in which at least one of the non-eligible participants held a participation representing more than 5 per cent. of the assets of the fund, may voluntarily resolve the liquidation of the fund, subject to the application of a 7 per cent. substitute tax on the value of the fund as resulting from the official report as per 31 December 2010. The liquidation must be accomplished within five years and on income and gains realised between 1 January 2011 and completion of the liquidation a 7 per cent. tax will apply. In the case of liquidation of the fund, no withholding tax applies on the distributions and the same distributions shall be exempt in the hands of the participants up to the amount that was subject to the 7 per cent. substitute tax.

Consequences of the new regime

The new regime should make the use of Italian real estate investment funds no longer appealing as purely captive investment vehicles, i.e. in the case where a significant portion of the participants hold more than a 5 per cent. participation, thus not being are Eligible Participants. Should such investors be non-resident of Italy, the tax benefit might survive as the look-through taxation would be replaced by a 20% tax applicable only on distribution. In other words, the new regime should not result in a detrimental tax treatment for non-residents, regardless of whether or not they are Eligible Participants, as in either case in final withholding tax would be applicable only upon distribution. However, it might be argued that, in the case of non-resident non-Eligible Participants, the withholding tax is not a tax on the distribution but a tax tax on the income and gains on real property realised through the participation in the fund, in which case no treaty relief would be available. Hopefully this will be clarified through the relevant secondary legislation..

On the other hand, foreign investors that are Eligible Participants should enjoy a favourable overall regime, being the combination of a full exemption on the income and gains of the fund, combined with a withholding tax (normally reduced to 10% under tax treaties) applicable only upon distribution. All in all, the enactment of the new regime should be welcome by foreign investment funds investing directly or indirectly in Italian real estate funds.