

\* Sabrina Capilupi

## Real Estate Funds

### Fiscal incentives to jump-start the property market

DOI: 10.14609/Ti\_1\_14\_4e

**Keywords:** real estate funds, undertakings for savings collective investment, real estate investments, favourable tax laws.

**Abstract** Real estate funds are a financial instrument enabling investors to transform real estate investments into shares of financial assets, producing liquidity without the investor having to acquire and dispose of property. A strong boost to this type of investment - an alternative to the type of securities - is given by the favourable tax laws that foster the creation, management and participation in real estate funds. This article summarises the main provisions related to tax applicable to funds in this sector.

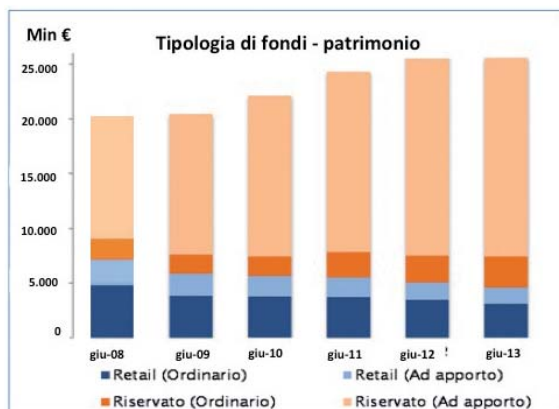
## INTRODUCTION

Growth of the market for real estate funds continues in Italy, where the first fund was established in 1999. It is an investment instrument characterised by favourable and articulated tax concessions that encourages its spread and in which there is a particular interest on the part of authorities and bodies managing public real estate.

Real estate funds are collective investment undertakings (OICR) whose assets, managed by a professional intermediary, are for the most part invested in real estate, real property rights and interests in real estate companies.

The market for Italian real estate funds is equal to 3% of the Italian asset management industry.<sup>1</sup>

Figure 1 Source - Assogestioni - 1<sup>st</sup> half of 2013



\* Head of the Office for Capital and Other Income, Italian Revenue Agency)

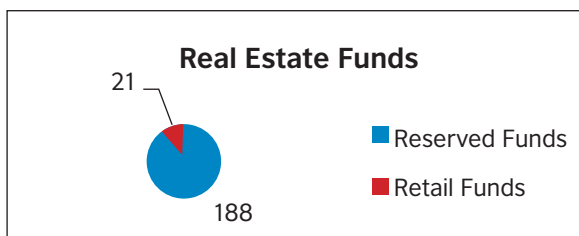
<sup>1</sup> Source: Assogestioni, data contained in the 1st Semi-Annual Report 2013.

The company that manages the fund (asset management company - SGR) provides for the distribution among the participants of the results of transactions arising from investments.

In particular, real estate funds are classified according to the persons at whom they are directed: those intended for all investors can be defined as "retail" and if dedicated exclusively to qualified investors they are referred to as "reserved". In addition, they differ according to the mode of constitution: "ordinary" funds *i.e.*, through the collection for the public of money for investment in real estate or "open-ended" mutual funds that is, through the contribution of private and/or public property (see Figure 1).

In June 2013, the supply of real estate funds is composed of 90% of reserved funds and 10% of retail funds (the total of the funds surveyed by Assogestioni now stands at 209 - see Figure 2). The majority of retail funds is made in an "ordinary" manner, while the mode of formation by the contribution prevails among the reserved funds.

**Figure 2** Composition of real estate funds



Real estate funds are 'closed-end' because, unlike the "open-end" ones in which participants can at any time request a refund of their contribution, the amount of capital and the number of allowances are established upon the creation of funds themselves and the right to repayment of shares is recognised only at predetermined intervals.

## THE TAXATION OF REAL ESTATE FUNDS

Real estate funds have always been recognised as playing an important role for the development of the real estate market and an important role in public and private real estate valorisation and disposal operations.

The favourable tax regime is a demonstration of this having been reserved for them since 2001<sup>2</sup> with provisions encouraging the establishment phase and management of real estate funds, along with provisions to attract investors.

### The tax regime for funds

The proper tax treatment of real estate funds is as follows:

- in relation to direct taxes, the non-occurrence in relation to real estate investment funds of the conditions for the application of income tax and regional tax on productive activities (IRAP);
- in respect of VAT, the attribution of taxable status exclusively by the asset management company that established the fund, with the prediction of provisions to facilitate the recovery of VAT paid by the fund;
- with regard to the contributions in respect of real estate and rights on immovable property, instead of the ordinary tax regime, the possibility to opt for the application of a substitute tax for income tax

<sup>2</sup> Decree Law 351 of 25 September 2001, converted with amendments by Law 410 of 23 November 2001.

and IRAP's rate of 20 per cent;<sup>3</sup>

- special rules for contributions, consisting of a plurality of properties primarily leased at the time of the contribution,<sup>4</sup> which consist in the exclusion of these transactions from the scope of VAT and the application to them of registration, mortgage and cadastre tax on a fixed basis;<sup>5</sup>

- in respect of stamp duty, the non-compulsory nature of the application for the registration of transactions arising out of the establishment of real estate funds, issue and redemption of certificates of participation;

- in respect of mortgage and cadastral taxes, the reduction to half of the rates applicable to the cadastral transfers and transcripts relating to transfers of instrumental real property falling within the scope of VAT if they are part of the same real estate funds.<sup>6</sup>

However, to combat some elusive phenomena, in recent years there have been several changes to the fiscal discipline of real estate funds, most recently with Article 32 of Decree-Law 78 of 31 May 2010<sup>7</sup>, which have especially worked on the taxation of investors.<sup>8</sup>

The performed changes aim, in substance, to curb the formation of real estate funds by a small number of participants created essentially to benefit from the favourable tax regime provided for such funds, thereby circumventing the ordinary regime for taxation of income from land that would apply if the property were held directly by the participants.

This goal was achieved by providing, on the one hand, the strengthening of the statutory requirements that integrate the identification of the real estate funds, on the other, providing a different taxation for participants in real estate funds regarding their nature ("institutional investors" and "non-institutional investors") and the extent of their shareholding.

On the first front, it was stated that the tax regime of the fund may be applied only to those who meet the statutory requirements contained in Article 1, Paragraph 1, letter k) of the Consolidated Law on Finance approved by Decree 58 of 24 February 1998 (TUF).<sup>9</sup> In particular, this standard defines the collective investment entity (including real estate funds), as one whose revenue is collected independently, through one or more issues of shares, among a number of investors with the aim of investing the same on the basis of a predetermined investment policy and collective management, in the interest of the participants and its own autonomy.<sup>10</sup>

<sup>3</sup> See Article 1, Paragraph 140 of Law 296 of 27 December 2006 and Revenue Agency Circular No. 8/E of 31 January 2008, Paragraph 7.3.

<sup>4</sup> See Revenue Agency Circular 22/E of 19 June 2006.

<sup>5</sup> Article 38, Paragraph 11, of Decree-Law 78 of 31 May 2010, with amendments, by Law 122 of 30 July 2010, extended this particular regime, originally planned only for the contributions made by companies, even to those carried out by public and private institutions of compulsory insurance, even if the same are not subject to VAT purposes.

<sup>6</sup> See Article 35, Paragraph 10-ter, of Decree-Law 223 of 04 July 2006, converted into Law 248 of 04 August 2006.

<sup>7</sup> Article 32 of Decree-Law 78 of 31 May 2010 was subsequently amended by Article 8, Paragraph 9 of Decree-Law 70 of 13 May 2011, converted with amendments into Law 106 of 12 July 2011.

<sup>8</sup> Please see Information Circular 2 of 19 April 2012 of the Consorzio Studi e Ricerche fiscali di Intesa Sanpaolo (Tax Studies and Research Consortium of Intesa Sanpaolo) entitled: "Il riassetto del regime fiscale per le imposte dirette dei fondi immobiliari (The Restructuring of the Tax System for the Direct Taxation of Real Estate Funds)".

<sup>9</sup> This definition has recently undergone a makeover as a result of Legislative Decree 44 of 04 March 2014, implementing Directive 2011/61/EC of the European Parliament and of the Council of 08 June 2011 on Alternative Investment Fund Managers, which substantially reproduces the content with the previous letter j).

<sup>10</sup> This definition refers, generally, to all bodies of collective investment. With specific reference to the real estate funds, the statutory legislation that identifies its distinctive characteristics is contained in Article 1, Paragraph 1, d-bis) of the Regulation for the Implementation of the TUF - laying down rules for the establishment of general criteria which the mutual funds must be in accordance with - adopted by the Ministry of the Treasury, Budget and Economic Planning by Decree 228 of 24 May 1999, and subsequently amended several times. This provision specifies the real estate funds as funds that invest exclusively or mainly in real estate, real property rights including those arising from contracts of lease-translational nature and existing concessions, investments in real estate companies, parts of other real estate funds, including foreign ones.

This definition, in line with the EU regulatory framework, highlights the essential characteristics such as the economic function of the fund, *i.e.* the collective management of savings collected from a number of investors, and the autonomy of the management decisions of the asset management company with respect to the influence of the participants.

In this way, redefining the constituent elements of the funds from the point of view of civil<sup>11</sup> law, the rules limit the application of the current tax rules only to those funds that manage widespread savings as well as those aimed at carrying out public interest activities.

With regard to the requirement of the plurality of participants, the norm, given its anti-avoidance purposes, is to identify the minimum requirements that the fund must possess to be an effective management of the spread assets. In this regard, the Revenue Agency, by Resolution 137/E of 04 October 2005 mentioned the existence of the requirement of the plurality of investors by clarifying that "a fund, to be such, requires a plurality of subscribers, unless the sole holder does represent a plurality of interests so as to depict a collective management", which is the case, for example, of pension funds or mutual funds of investment.

The other statutory requirement concerns, however, the managerial autonomy of the SGR with regard to participants that must function to prevent conflicts of interest between members of the asset management company and participants in the funds managed by this company.

Referring the fiscal discipline to the statutory definition of mutual funds of investment, in terms of tax, if an investment body does not meet the requirements of the above mentioned provisions, the same will not benefit from the application of fiscal discipline provided for the real estate collective investment bodies in accordance with the aforementioned Decree-Law 351 of 2001 and these bodies shall be subjected to the ordinary provisions relating to corporate income tax (IRES).

In this regard, it should be noted that, on the basis of Article 73 of the Consolidated Income Tax Law, approved by Decree 917 of the President of the Republic on 22 December 1986, (TUIR - Income Tax Code),<sup>12</sup> collective investment bodies established in the territory of the State (*i.e.* those established therein) are, in general, taxable entities subject to IRES, having been included among the non-commercial entities referred to in Subparagraph c) of Paragraph 1 of the latest provision, although a specific exemption is provided for income obtained by them.

#### *Special provisions for public real estate funds*

Article 14-bis of Law 86 of 25 January 1994 lays down special arrangements for funds established by the contribution of real property or real property rights for at least 51 per cent by the State and other public bodies, regions, local authorities and their associations, as well as wholly-owned subsidiaries, also indirectly, by such entities.

With reference to the contributions made in respect of this particular category of real estate funds, it is expected, for the purposes of income tax, that the transaction occurs in a substantially tax-neutral regime for the benefit of all public and private entities involved in the contribution of goods, provided that, of course, the goods supplied by the said parties have a larger value than the whole of the assets contributed by the private parties.

In essence, the contributions do not give rise to taxable income or deductible losses for the contributor, regardless of the legal nature of the latter and type of activity. In addition, the sha-

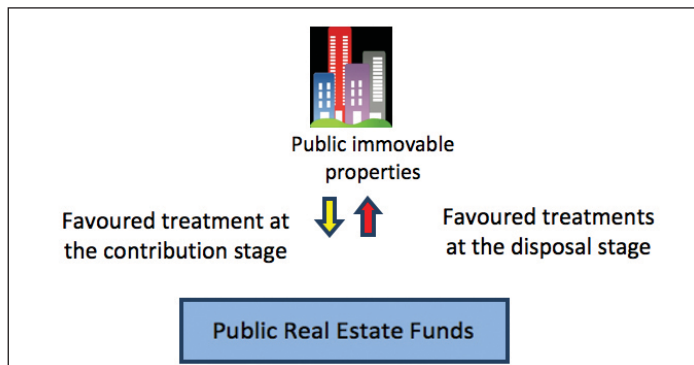
<sup>11</sup> For an overview on the various doctrinal trends that have affected the legal status of the institution in question, please refer to E. Schiavello, *La natura giuridica dei fondi comuni di investimento in una recente sentenza della Cassazione*, in *Strumenti finanziari e fiscalità*, No. 5/2011, Egea, Milano, 111 ss.

<sup>12</sup> See Article 96, Paragraph 1, letter c) of Decree-Law 1 of 24 January 2012, converted with amendments into Law 27 of 24 March 2012.

res received in return for the contribution keep the same taxable value as the goods before the contribution was made.

This neutrality regime was not considered applicable to compulsory social security institutions established as associations or foundations (such as professional funds) taking into account the fact that, according to the recent case law of the Court of Cassation,<sup>13</sup> these institutions are not public bodies.

**Figure 3** Public real estate funds



For the same public funds, for the purpose of indirect taxation, certain benefits have been introduced in order to use the real estate funds as an instrument for the disposal of public property and for a more efficient management. However, it should be noted that these benefits, particularly those relating to indirect taxes, have recently been called into question due to the adoption of measures to suppress, for obvious concerns over revenue, certain exemptions and tax benefits provided with reference to acts of property transfer.<sup>14</sup> This provision is limited only to deeds of transfers of property that were affected by the proportionate registration tax and, therefore, with effect from 01 January 2014, there has been an abrogation of incentives and exemptions provided for the purpose of indirect taxes other than VAT, for transfers and the contributions of residential property exempted from VAT as well as for transfers of residential and instrumental property excluded from the scope of the aforesaid tax as being made by persons lacking taxable status for VAT purposes (private, State, etc.).<sup>15</sup>

### The tax regime for participants

As previously mentioned, another instrument used by the legislature to deal with evasive behaviour consists in introducing a more unfavourable taxation of certain participants in a real estate fund.<sup>16</sup> In particular, Article 32 of Decree-Law 78 of 2010 distinguishes various types of funds providing that the tax regime of real estate funds, contained in Decree-Law 351 of 2001, continues to apply in any

<sup>13</sup> See Court of Cassation, Tax Section, Judgement No. 17961 of 24 July 2013.

<sup>14</sup> See Article 26 of Decree-Law 104 of 12 September 2013 converted, with amendments, into Law 128 of 08 November 2013 and Article 10 of Legislative Decree 23 of 14 March 2011.

<sup>15</sup> See Revenue Agency Circular 2/E on 21 February 2014, paragraphs 8 and 9.6.

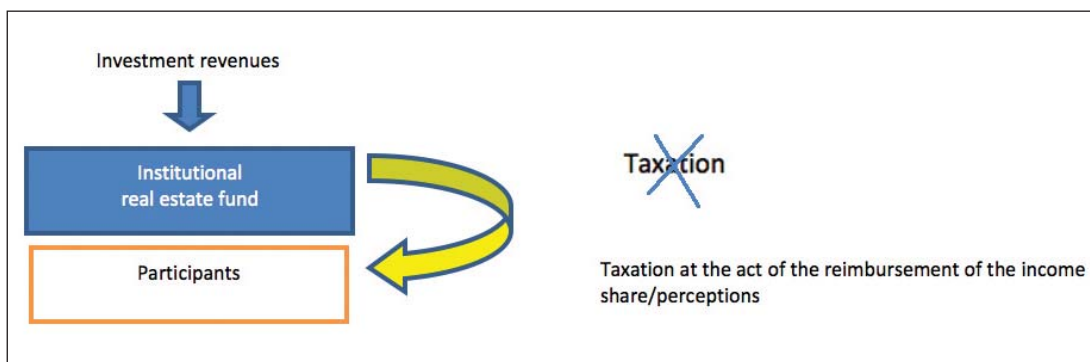
<sup>16</sup> Both capital income and other financial income can derive from participation in OICR estate (Undertaking for Collective Investment). The capital gains consist in the revenues distributed for constant participation as well as the positive difference between the value of redemption or liquidation of the shares and the weighted average cost of the subscription or purchase. Other financial income (positive or negative) derives, however, from the transfer, by payment of the participation fee to the fund, as well as the potential negative difference made by repayment of the share (at the time of redemption or liquidation).

case to funds held, on an exclusive basis, by one or more of institutional investors identified by the same subsection (therefore we speak of "**institutional funds**"), regardless of any further investigation regarding the requirements of operational independence and plurality of the participants as required by the statutory definition (see Table 1 and Figure 4).

**Table 1** Institutional Investors

<b>Institutional Investors</b>
a) The Italian State or Italian public bodies
b) Undertakings for collective investment established in Italy
c) Social security institutions
d) Italian insurance companies, limited to investments intended to cover the technical provisions
e) Italian supervised banking and financial intermediaries
f) Subjects and foreign assets established in white-list Countries
g) Private entities resident in Italy with mutual aims and cooperative companies resident in Italy
h) Vehicles introduced in Italy or white-list Countries being held in the measure of more than 50% from the previous subjects

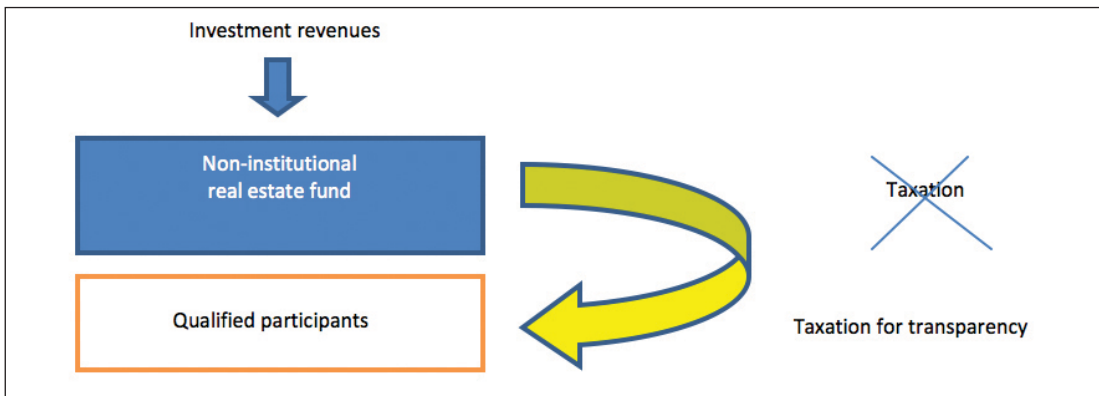
**Figure 4** Taxation participants in institutional funds



For "**non-institutional**" funds, *i.e.* funds that are not exclusively held by qualified investors,<sup>17</sup> the income of the same resulting from the statements of operations is attributed for transparency to non-institutional participants residing in Italy who own shares in excess of 5% (see Figure 5). On disposal, Paragraph 4 of Article 32 of Decree-Law 78 of 2010 assimilates the shares in excess of 5% of the fund's assets to qualified shareholdings in companies and business entities listed in Article 5 of the TUIR. Therefore, the gain realised by an individual who does not hold investments in the exercise of business activities forms the total income in the amount of 49.72 % (Article 68, Paragraph 3, of the TUIR).

<sup>17</sup> As identified in Article 32, Paragraph 3, letter a) to h) of Decree-Law 78 of 2010 (see Figure 4).

Figure 5 Taxation participants in non-institutional funds



For institutional investors and investors who hold a stake in the fund less than or equal to 5% without prejudice to the application of the withholding tax of 20 % on income distributed to constant investment in the fund and the income earned in the redemption or liquidation of shares.<sup>18</sup> As regards the same subjects the capital gains (or losses) obtained on the sale or redemption of the shares, if achieved outside the exercise of a business activity, are subject to withholding tax of 20% in different modes depending on the tax regime chosen by the investor (declaratory, managed and operated scheme).<sup>19</sup>

Table 2 The practice of the Revenue Agency

The practice
Circular 47/E of 08 August 2003
Circular 38/E of 05 August 2004
Circular 22/E of 19 June 2006
Circular 61/E of 03 November 2008
Circular 11/E of 09 March 2011
Circular 2/E of 15 February 2012
Resolution 54/E of 18 July 2013

Conditions of implementing the provisions of the aforementioned Article 32 of Decree-Law 78 of 2010 have been defined by the head of the Revenue Agency on 16 December 2011. In addition, in relation to such discipline important clarifications were provided with Circular 2/E of 15 February 2012 (see Table 2).

*Tax incentives for investments by non-residents*

Finally, as mentioned in the introduction, it should be noted that the regulatory framework under re-

<sup>18</sup> See Article 7 of Decree Law 351 of 2001.

<sup>19</sup> Articles 5, 6 and 7 of Legislative Decree 461 of 21 November 1997.

view also contains some important provisions aimed at attracting foreign investment.<sup>20</sup> Indeed, a regime of non-taxability of income from the investment in real estate funds received from certain foreign institutional investors is provided. And in particular by:

- pension funds and mutual funds located in foreign states and territories on the so-called **white list**;<sup>21</sup>
- international agencies or bodies established in accordance with international agreements ratified in Italy;
- Central banks or organisations which also manage the official reserves of the state, regardless of the country of residence.

The foreign institutional investors who hold a stake of more than 5% shall be subject, however, to substitute taxation of income tax to the extent of 20% at the time of payment of the revenues, never applying the regime of transparency. Moreover, in the case of investors who are resident in countries with which there are agreements in place to avoid double taxation on income, there is still the possibility of requesting the application of any conventional lower rate provided for in Article 11 of the agreements concluded by Italy that conform to the OECD Model Convention.

As regards, however, the tax treatment in respect of non-residents of other financial income arising from trading of shares in real estate funds, the provision of Article 23, Paragraph 1, letter f) of the TUIR is applicable, according to which the capital gains arising from the transfer for consideration of stock certificates are taxable in Italy only if such certificates are not traded on regulated markets and whether they are held in the territory of the State. In addition, Article 5, Paragraph 5 of Legislative Decree 461 of 21 November 1997 provides for a special regime of non-taxability for the aforementioned capital gains realised by individuals residing in "*white list*" states and territories. In any case, the provisions contained in international conventions against double taxation shall apply reserving to the State of residence of the transferor the exclusive imposition of capital gains realised on sold investments.

**Figure 6** Summary of taxation of participants

<b>Taxation of capital gains of participants in a real estate fund</b>		
	Participation ≤ 5%	Participation > 5%
Resident institutional investors	Withholding tax 20%	Withholding tax 20%
Non-resident institutional investors	Withholding tax 20% or conventional rate	Tax transparency
<b>White-list</b> pension funds and OICR International organisations, central banks and sovereign wealth funds	No VAT	No VAT
Other non-resident subjects	Withholding tax 20% or conventional rate	Withholding tax 20% or conventional rate

<sup>20</sup> As regards the tax system of the non-resident participants in the real estate funds, please refer to the contributions of: P. Sella, Il regime fiscale dei partecipanti non residenti dei fondi immobiliari italiani, in *Strumenti finanziari e fiscalità*, n. 6/2012; Egea, Milano, 107 ss; F. Brunelli, Note di commento al regime fiscale dei partecipanti non residenti, in *Bollettino Tributario*, 2011, n. 18, 1371 ss; N. Arquilla, L'Agenzia delle entrate illustra la tassazione dei proventi dei fondi di investimento immobiliari chiusi, in *Corriere tributario*, 2011, n. 15, 1231 ss.

<sup>21</sup> It is about the States and territories present in the list referred to in the Ministerial Decree issued in accordance with Article 168-bis of the TUIR. Pending the issuance of this decree reference should be made to the ministerial decree of 04 September 1996, and its later modifications and additions.



## CONCLUSIONS

Over the years there has been a gradual increase in the market share of contribution funds compared to ordinary funds. With 162 funds, a capital of 19,604 billion euros and a surplus of 33,274 billion euros, this category represented 78% of the total funds, 77% of the total assets and 79% of the total activities in June 2013 (source: Assogestioni). This trend is justified by the favourable law that, from the tax point of view, minimises the form of taxation applicable to contributions made both in the stage of constitution and during the life of the fund.

Therefore, given that real estate funds are an instrument used for the exploitation, processing, management and alienation of property forming part of the public real estate assets owned by local authorities and not, it would be desirable to simplify the tax system in the industry and make the instrumental fund more attractive to the market.

## References

Assogestioni, *1° Rapporto semestrale 2013*.

Arquilla N. (2011), L'Agenzia delle entrate illustra la tassazione dei proventi dei fondi di investimento immobiliari chiusi, in *Corriere tributario*, 2011, n. 15, 1231 ss.

Brunelli F. (2011), Note di commento al regime fiscale dei partecipanti non residenti, in *Bollettino Tributario*, 2011, n. 18, 1371 ss.

Circolare dell'Agenzia delle Entrate n. 47/E dell'8 agosto 2003.

Circolare dell'Agenzia delle Entrate n. 38/E del 5 agosto 2004.

Circolare dell'Agenzia delle Entrate n. 22/E del 19 giugno 2006.

Circolare dell'Agenzia delle Entrate n. 8/E del 31 gennaio 2008, par. 7.3.

Circolare dell'Agenzia delle Entrate n. 61/E del 3 novembre 2008.

Circolare dell'Agenzia delle Entrate n. 11/E del 9 marzo 2011.

Circolare dell'Agenzia delle Entrate n. 2/E del 15 febbraio 2012.

Circolare dell'Agenzia delle Entrate n. 2/E del 21 febbraio 2014, par. 8 e 9.6.

Circolare informativa n. 2 del 19 aprile 2012 del Consorzio Studi e Ricerche fiscali di Intesa Sanpaolo recante: *"Il riassetto del regime fiscale per le imposte dirette dei fondi immobiliari"*.

Decreto del 24 maggio 1999, n. 228 e successivamente più volte modificato.

Decreto legge 25 settembre 2001, n. 351, convertito, con modificazioni, dalla legge 23 novembre 2001, n. 410.

Decreto legge 4 luglio 2006, n. 223, articolo 35, comma 10-ter, convertito dalla legge 4 agosto 2006, n. 248.

Decreto legge 31 maggio 2010, n. 78, articolo 32, modificato dall'articolo 8, comma 9, del decreto legge 13 maggio 2011, n. 70, convertito, con modificazioni, dalla legge 12 luglio 2011, n. 106.

Decreto legge 31 maggio 2010, n. 78, articolo 38, comma 11, convertito, con modificazioni, dalla legge 30 luglio 2010, n. 122.

Decreto legge 24 gennaio 2012, n. 1, articolo 96, comma 1, lettera c), convertito con modificazioni, dalla legge 24 marzo 2012, n. 27.

Decreto legge 12 settembre 2013, n. 104, articolo 26, convertito, con modificazioni, dalla legge 8 novembre 2013, n. 128.

Decreto legislativo 21 novembre 1997, n. 461, articoli 5, 6 e 7.

Decreto legislativo 24 febbraio 1998, n. 58 (TUF).

Decreto legislativo 14 marzo 2011, n. 23, articolo 10.

Decreto legislativo 4 marzo 2014, n. 44, di recepimento della Direttiva 2011/61/UE del Parlamento europeo e del Consiglio dell'8 giugno 2011 sui gestori di fondi di investimento alternativi, che riproduce nella sostanza il contenuto della previgente lettera j).

Legge 25 gennaio 1994, n. 86, articolo 14-bis.

Legge 27 dicembre 2006, n. 296, articolo 1, comma 140.

Provvedimento del Direttore dell'Agenzia delle Entrate del 16 dicembre 2011.

Regolamento di attuazione del TUF, articolo 1, comma 1, lettera d-bis).

Risoluzione dell'Agenzia delle Entrate n. 137/E del 4 ottobre 2005.

Risoluzione n. 54/E del 18 luglio 2013.

Schiavello E. (2011), La natura giuridica dei fondi comuni di investimento in una recente sentenza della Cassazione, in *Strumenti finanziari e fiscalità*, n. 5/2011, Egea, Milano, 111 ss.

Sella P. (2012), Il regime fiscale dei partecipanti non residenti dei fondi immobiliari italiani, in *Strumenti finanziari e fiscalità*, n. 6/2012, Egea, Milano, 107 ss.

Sentenza n. 17961 del 24 luglio 2013 Corte di Cassazione, sezione tributaria.

Testo unico delle imposte sui redditi (TUIR), articolo 5.

TUIR, articolo 23, comma 1, lettera f).

TUIR, articolo 68, comma 3.

TUIR, articolo 73, approvato con decreto del Presidente della Repubblica 22 dicembre 1986, n. 917.

TUIR, art. 168-bis.