

Investment instruments for the Italian Real Estate Sector

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Preface

by *Aldo Mazzocco*

Assoimmobiliare Chairman

An updated version of a document that summarises the characteristics, details and tax regimes of the various real estate investment vehicles that are currently available in Italy is certainly timely and opportune not only because important innovations were introduced in relation to real estate funds and SIIQs (listed real estate investment companies) at the end of 2014, but also as a result of the recent introduction of SICAFs, in implementation of a European directive.

Due to these advances, in large part considered in the “Sblocca Italia” Decree, the Italian real estate market currently, and finally, has a regulatory and tax structure that is among the most modern and flexible in Europe.

With the ability to choose between real estate funds, SIIQs, and SICAFs, as well as ordinary companies, the market can now efficiently and competitively attract the capital and lending resources necessary to re-launch the sector after six long years of contraction.

The availability of a wide range of investment vehicles that are not only competitive in terms of tax regimes, but, most importantly, comparable with those of the best European markets, facilitates the inflow of foreign capital and enables financing of investments with European financial institutions.

The extent to which the “peculiarities” that characterised our civil and tax structure disincentivised capital and debt markets is often underestimated, as these markets have become completely globalised and no longer willing to operate in niches that are perceived negatively in terms of risks and potential.

The unqualified opening to international standards in relation to tax regimes for real estate investment vehicles is a clear sign to foreign investors of our country’s desire to overcome the unwarranted gap that still separates

us from many countries, including, to name a few, France, England, Germany, and even Spain – in terms of attracting real estate investments.

Assoimmobiliare, the association for real estate finance and real estate services, has worked diligently, and continues to do so, to open our market to international institutional operators (as well as Italian). Our real estate infrastructure urgently needs financial resources for the long term in order to be revitalised, and to make it more efficient and suitable for Italy's new requirements. We need more resources than are available from Italian operators after the severe crisis of the last few years.

Real estate funds, SIIQs and SICAFs are essentially transparent vehicles from a tax perspective. They transfer the tax burden to those who reap the benefits of the investments, allowing tax optimisation to each investor, whether Italian or foreign. Moreover, they ensure the revenue agency more visibility of profits due to their simple tax structure. In nearly all countries in which they have been introduced, investment vehicles dedicated to the real estate sector, which aim primarily to rotate the ownership of assets and to provide visibility and consistency in distribution of operating profits, have resulted in significant increases and more stability in tax revenues with respect to the extreme volatility in traditional taxation.

The supervisory duties reserved to Bank of Italy, Borsa Italiana and CONSOB for real estate funds, SIIQs and SICAFs also offer a very important guarantee. Simplification of the tax structure does not correspond to an increase in control risks but rather, on the contrary, to a rigorous monitoring of management practices, whether delegated to internal operating structures or external, as in the case of SGRs (asset management companies).

It is imperative that the market reorganise itself on the offer side by providing impetus to a new generation of modern and efficient vehicles and leaving the old ways of managing real estate investments to the past, when the Italian market was “local”, almost protected, and historically characterised by high rates of inflation and low transparency. In this manner, we will have effective resources to modernise real estate assets in Italy.

Foreword

The regulatory and tax systems as a means to support real estate development and growth in Italy

The economic crisis and stagnation that have plagued Italy for decades have finally successfully managed to push the Italian political class to take action to stimulate the national economy. Some important steps have been taken, but those still to be taken are equally important. Finding a point of balance between reining in public spending while also stimulating the country's economic revival is no easy task.

Economic and industrial operators from various sectors have a duty to help politicians acquire an in-depth understanding of the issues, problems, solutions and stimuli of each industry in the country. Identifying those initiatives and measures which, once implemented, might improve the country's international competitiveness and prestige can help attract more foreign capital which is needed to stimulate growth and investment.

Just as important is to provide clear, positive and objective information both to the Italian and international main economic players and investors, the latter being all too often exposed to a torrent of reports about scandals, corruption, mismanagement and "scoops" that often turn out to be incorrect or exaggerated. These are all negative images that cannot help but have a detrimental impact on the investment choices of international players evaluating whether to "bet" or not on Italy.

Italy has riches that are unimaginable to many other countries, but which are often not managed in the best way. The presence of foreign operators and investors could lead to significant improvements in transparency and in companies managerial skills. This could enable local companies to further increase existing skills and expertise and, through healthy competi-

tion, to stimulate innovation and efficiency, enabling them to provide better products and services to citizens.

The above also applies to the real estate sector which, both for its economics and role, represents a core component of the Italian economy. An economy with a weak and uncompetitive real estate industry could be compared to an individual neglecting to look after its backbone, allowing it to weaken until it can no longer perform its primary supporting function.

With this publication, Assoimmobiliare, as the spokesperson of the real estate industry in Italy, (and the people and businesses who on a voluntary basis have provided their time and resources to manage the content) intends to address two of the thorniest but most important topics for the real estate industry, those of regulation and taxation.

The objective is twofold.

On the one hand, the aim is to help foreign and Italian investors sail an easier course through the “sea of regulations” governing the real estate world, explaining in a clear, detailed and comparative manner all the possibilities available to the investor, also highlighting the new investment tools (i.e. SICAFs) and the important changes recently introduced to the existing vehicles (i.e. Funds and SIIQs).

On the other hand, it also aims to point out to the Italian lawmakers those areas where the regulatory system can be improved through legislative measures increasing the competitiveness of the country’s economic system, simplifying and standardising bureaucratic processes, clarifying grey areas and interpretation doubts, eliminating contradictions currently existing in the Italian legislation, increasing transparency, competition, professionalism and efficiency in the real estate industry. Clear, simple and objective explanations are provided in the various chapters on ideas, requests and suggestions aiming to achieve the above described objectives.

One of the most common complaints from foreign (and national) investors concerns the state of permanent uncertainty of fiscal and regulatory norms. This permeates the Italian legislation (with some changes even having retroactive effects) and prevents professional investors from being able to clearly estimate either the actual investment required or the expected return on investment. This leads many investors, who usually operate in various international markets, to invest in other countries where, under equal conditions, such uncertainty is significantly reduced or non-existent. For other investors this high uncertainty simply turns into a higher country risk, which, according to the economic rules on investment, requires a higher remuneration. The misalignment of the Italian risk profile compared to

those of other neighbouring countries cannot help but have a significantly negative impact on investments in the real economy.

The message is clear: create regulatory and tax systems that are clear, consistent, competitive and stable!

Introduction

1. Fundamental organisation of the system and its evolution over time (tendency to contrast the abuse of the corporate structure)

The aim of this publication is to point the spotlight at the most significant tax profiles within the sphere of “professional” real estate activity (i.e. which is not done for the sole purpose of holding and developing the personal or family-based real estate assets of individuals), in order to emphasize the strengths and weaknesses of the various corporate structures (“ordinary” commercial companies, “Listed Real Estate Investment Companies” – SIIQs – or “Unlisted Real Estate Investment Companies” – SIINQs – and real estate investment trusts and SICAFs) that the current legal system makes available to operators in the performance of such activities.

In order to make this selection of *pros* and *cons* in a systematic way, it is necessary to single out the economic fundamentals of the various areas in which “professional” real estate activities can be performed (that we can summarise as “management”, “trading” and “development”) to be able to check, with reference to each of them, on the treatment reserved by each of the structures used.

Although it may seem obvious, it would be appropriate, nevertheless, to start with the criticism that says that real estate investment, whatever its purpose (management, trading or development) is still an investment for the medium to long term and that the recourse to borrowing is an integral part of the economic cycle it is involved in.

Therefore, the essential elements to be taken into account are the possible correlation between debt servicing (as regards the principal and the interest) and the revenue cycles, and whether they are represented by rents or

proceeds from the sale of assets (revenues or capital gains). If this makes sense in general terms, it does so even more with regard to the activity known as real estate “management”; that is, that activity aimed at the renting out of assets, where, typically, the firms finance most of their activities by resorting to bank loans, often assisted by mortgages levied on property assets. In this case, in fact, it is evident that the structural characteristics and the economic logic of the activity performed essentially revolve around the equilibrium, also in terms of guarantees, of a margin that is adequate and constant over time between the costs of interest charges and the revenues from rents.

In this context, precisely for the significant connection with the timing element, a decisive role is to be played, on the debit side, by the extent and timing of the possible “recovery” of “acquisition” costs (purchase or construction) of the real estate assets, that can be summarised – in relation to the tax profiles – (i) in the actual recovery (via deduction or rebate) of the VAT paid in the “acquisition” phase of the assets, (ii) in the amortisation of the purchase/construction costs (inclusive of any tax charges for “the deed”), and (iii) in the deductibility of *all* the “operating” costs, relating not only to the periodic maintenance and efficiency improvements of the assets, but also to the ownership of the property. On the credit side, however, one can take account of the extent and timing of taxation on the revenues or capital gains realized with respect to the sale of the assets.

These are, after all, the main reasons that have led over time to the adoption of the corporate structure for the structuring of an investment in real estate. But they are certainly not the only ones, given that the use of the corporate screen responds, then, also to the understandable needs of separation of the assets exposed to business risk, from the potential involvement of third-party investors and also to partial sales of the equity investments in question that guarantee reasonable margins of flexibility for the property investment.

However, the opportunities offered by the taxation regime for commercial companies in terms of the possibility of deducting costs (both acquisition and operating costs) and deducting the VAT relating thereto, on the one hand, and of postponing and partly mitigating the taxation on profits, on the other, have led to an improper use (without talking about actual abuse) of the corporate structure by individuals for the management of the real estate business. The reactions of the tax system to these forms of abuse have, over time, extensively modified and worsened the actual regime of real estate companies, with general measures that in addition to sanctioning the exploitation of these forms, have also the effect of jeopardising the

proper and efficient use of the corporate structure by professional operators, who do not want to abuse the actual regime of commercial companies. However, in order to understand the reasons for the current tax system of commercial companies, and the related profiles of inefficiency, it would be appropriate to review briefly the most important reforms adopted in this regard after the adoption of the regulations known as the “70s’ Reform” which designed the current tax system.

In this regard, it is preliminarily worthwhile considering that the national tax system is characterised, historically, by a remarkable, and also increasingly unreasonable distrust in the management of the real estate business, mainly with regard to the management of property rentals. The entire legislative fabric of the last forty years (at least from the tax reform of 1971-1973 up to the present) is imbued with provisions aimed at preventing, or making particularly onerous, the instrumental use by “private individuals” of rules for the analytical determination of business income, in order to try to tax non-entrepreneurial proceeds (yields) according to the lump sum rules of real persons.

The first and most obvious legal provisions in this regard can be traced back to the provisions issued for the purposes of income tax (relating to private individuals, as well as to companies and entities), which tend to exclude rented out assets from the category of *operating* real estate properties, as they are not considered *used directly* in the enterprise’s business activities but described as a mere *object* thereof.

This previous and questionable interpretative position (a reference to it is already found in Ministerial Resolution 9/2086 of 7 March 1977 which thus interprets Article 52 of Italian Presidential Decree No. 597/1973) appears to be based on a preconception (according to which all real estate “management” properties are created for operating requirements, for the management of “private” assets) which is all the more serious because it is likely to lead to entirely unjustified penalising effects on those who – conversely – truly perform their business activities through the renting out of real estate properties, and finds its expression in legislative terms primarily in Articles 43 and 90 of Italian Presidential Decree No. 917/1986 (Consolidated Law on Income Tax). As regards these statutory provisions, in fact, real estate properties *related* to businesses, when they are intended for renting out, constitute *operating* assets that are instrumental to the enterprise only if, from the objective point of view, they are typically *not susceptible to different use without radical changes* (if they are, therefore, properties that are *operating assets “by nature”*); conversely, any properties different from properties defined as operating assets by nature (typically residential