2019 BUDGET LAW[1] AND OTHER TAX NEWS ON REAL ESTATE INVESTMENTS IN ITALY

Hereafter we summarize the main measures that are relevant for the tax planning of real estate investors.

Interest expenses for real estate companies

Under general principle[2], the interest expenses (i.e. interest from loans, bonds issued, notional cash pooling or finance leasing agreements etc.) are not fully deductible for corporate tax purposes, but subject to the general 30% EBITDA threshold.

In particular, interest expenses are: (i) fully tax deductible up to the amount of interest income accrued in the same tax period and (ii) up to 30% of the adjusted EBITDA[3] for the exceeding amount.

2019 Budget Law has excluded from the scope of application of the above interest limitation rule the interest expenses paid on mortgage loans on properties held for renting for companies principally carrying out real estate activity (i.e. "REA"[4]). Therefore, the general 30% EBITDA threshold will not apply to interests related to mortgage loans subscribed by REA.

In this respect it should be noted as follows.

Before ATAD Decree, the Article 1 (36) of Law 244/2007 had provided the establishment of an *ad hoc* study committee for a reform of real estate taxation.

At the time, the rule stated that *"the interests expense related to loans secured by mortgages on property held to be rented"* by REA was fully deductible.

Thereafter ATAD Decree has partially deleted article 1, (36) Law 244/2007 in so far as it provided the full deductibility of such interests.

[1] Law No. 145 of 30 December 2018 ("2019 Budget Law") entered into force as of 1 January 2019.

[2] As amended by legislative decree No. 142 of 28 November, 2018 (and published on the *Official Gazette* 28 December 2018) implementing the European Union (EU) Anti-Tax Avoidance Directive (ATAD Decree).

[3] EBITDA is no longer based on the results of the profit & loss account, rather it is now computed on the basis of corporate income tax (CIT) relevant values.

[4] In order to qualifying as a REA: (i) the majority of the assets (at fair value) is formed by the properties up for lease; (ii) two thirds of company's revenues are made of rents from the lease of properties (or from the lease "property-intensive" going concerns).

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At last 2019 Budget Law (which was published in the Official Gazette after the ATAD Decree) has restored the entire Article 1, paragraph (36) Law 244/2007 without repealing explicitly the amendments introduced by ATAD Decree.

Lack of coordination between the rules could be challenged by the Tax Authorities, although in the technical and financial commentaries to the 2019 Budget Law issued by Parliament it has been clarified that the Article 1 (36) of Law 244/2007, as before the ATAD amendments to such article, is still in force.

A clarification is expected in this regard.

Deductibility of IMU on commercial real estate from IRES tax basis

The municipal tax on real estate (so called "IMU") is a general property tax levied[5], on a yearly basis, by Local Authorities on all property owners, both commercial-property owners and private homeowners.

Starting from FY2019 40 % of IMU relating to operating properties used for business is deductible from IRES (corporate income tax) taxable basis (before the threshold was 20%).

Flat property tax on rental income of commercial properties

Under current law, the taxable income for individual owners renting a property located in Italy is equal to the highest amount between: (i) the cadastral income increased by 5% and (ii) 95% of the rentals referring to the relevant tax period (even if not actually collected, with some exceptions).

Under general principle, the taxable income is subject to a progressive tax rate up to 43% depending on the total aggregate annual taxable income.

In alternative, if the income derives from property rented out for residential use, the taxpayer may opt for a flat property tax (so called "cedolare secca").

In this case, the rental income can be taxed at a flat tax rate equal to 21% (10% in specific cases).

Under 2019 Budget Law, flat property tax also applies to new rental agreement related to commercial immovable properties (belonging to the cadastral category C/1, with an area up to a maximum of 600 square meters).

However, flat tax only applies to rental agreements signed during 2019 (and not later on).

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[5] Except for specific circumstances.

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Step-up of taxable basis of Italian participations

A new window is opened to elect to step-up in the tax basis for participations (i.e., shares, quota and equity rights) in unlisted Italian and foreign companies held as of 1 January 2019.

Revaluation is available only if the owners are resident individuals, non-commercial partnerships or non-resident entities (for a participation not held through a permanent establishment).

Non-resident entities can benefit from stepping up the tax value of a participation only if they are not entitled to take protection under a tax treaty or if the applicable tax treaty provides for the taxation of capital gains on equity instruments in Italy (*i.e.* Italy-US treaty under certain conditions and Italy-France treaty, subject to certain requirements).

The revaluation is recognized upon payment of a substitute tax on the total market value resulting from an appraisal of the company whose shares are stepped up. The tax rate is 10% for a 'non-qualified' participation[6] and 11% for a 'qualified' participation.

The substitute tax can be paid in a single installment by 30 June 2019 or in three equal annual installments[7] – although an annual 3% interest charge will be due on the second and third installments.

Step-up of business assets

A new opportunity has been introduced for Italian companies which have not adopted the International Accounting Standards (*i.e.* ITA GAAP companies) to step up the tax cost of tangible and intangible assets[8] and participations booked in their financial statements as of December 31st, 2017.

The step-up, which can be undertaken by Italian companies and entities subject to corporate tax, must take place in (and be included in the financial statements for) the year following that in progress on calendar year 2017, and must include all the assets belonging to the same asset class.

[6] For unlisted companies, a 'non-qualified' participation is one with no more than 20% of the voting rights in the ordinary shareholders' meeting or no more than 25% of the issued capital.
[7] Please in mind that the step-up is effective upon actual payment of the first instalment. If the taxpayer fails to pay the subsequent instalments, the step – up is still valid. Yet, Tax Authorities will enforce the payment of the residual instalments, adding interest and penalties.
[8] Immovable property held as stock for resale cannot be revalued.

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According to the revaluation rules, Italian companies can step up the relevant category of assets by paying a 'substitute tax' of corporate tax, regional tax and any additional tax. The substitute tax rate is 16% for depreciable assets and 12% for non-depreciable assets.

The equity reserve booked as balance of the asset revaluation is ordinarily taxable on its distribution, unless an additional 10% substitute tax is paid.

For calendar year companies, the increase in tax basis will allow a higher deductible depreciation as of January 1st, 2021 and for capital gains purposes as of January 1st, 2022.

The Law also allows to align tax accounting value of the assets with their book accounting value. The substitute tax and the recognition timing are the same as those provided for the step up with the only exception of immovable properties, for which the higher values are recognized starting from the FY ongoing on December 1st, 2020.

Capital gains from the alienation of shares or interest in entities deriving their value principally from immovable property - Multilateral Convention

Article 9 of the Multilateral Convention to implement tax treaty related measures to prevent base erosion and profit shifting (so called, MLI) incorporates an anti-abuse rule with respect to capital gains realized from the sale of shares of entities deriving their value principally from immovable property.

Article 9 of the MLI contains two substantial provisions in this respect, *i.e.* Article 9(1) and Article 9(4).

Italy has opted to apply Article 9(4) of the MLI, which allows Parties to apply Article 13(4) of the OECD Model Tax Convention as included in the Action 6 final report. More in detail, paragraph 4 of Article 9 introduces a 365-day holding period prior to the alienation of shares, and requires that the shares or comparable interests derive more than 50% of their value directly or indirectly from immovable property[9].

It should be noted that Article 9(4) is an optional provision, which means that it applies only where both the Contracting Jurisdictions have opted in.

It should be additionally noted that MLI has not entered into force in Italy yet, as Italy has not deposited its instrument of ratification/acceptance/approval of the MLI so far.

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[9] The above mentioned provision states that: "*For purposes of a Covered Tax Agreement, gains derived by a resident of a Contracting Jurisdiction from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting Jurisdiction if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property (real property) situated in that other Contracting Jurisdiction*".