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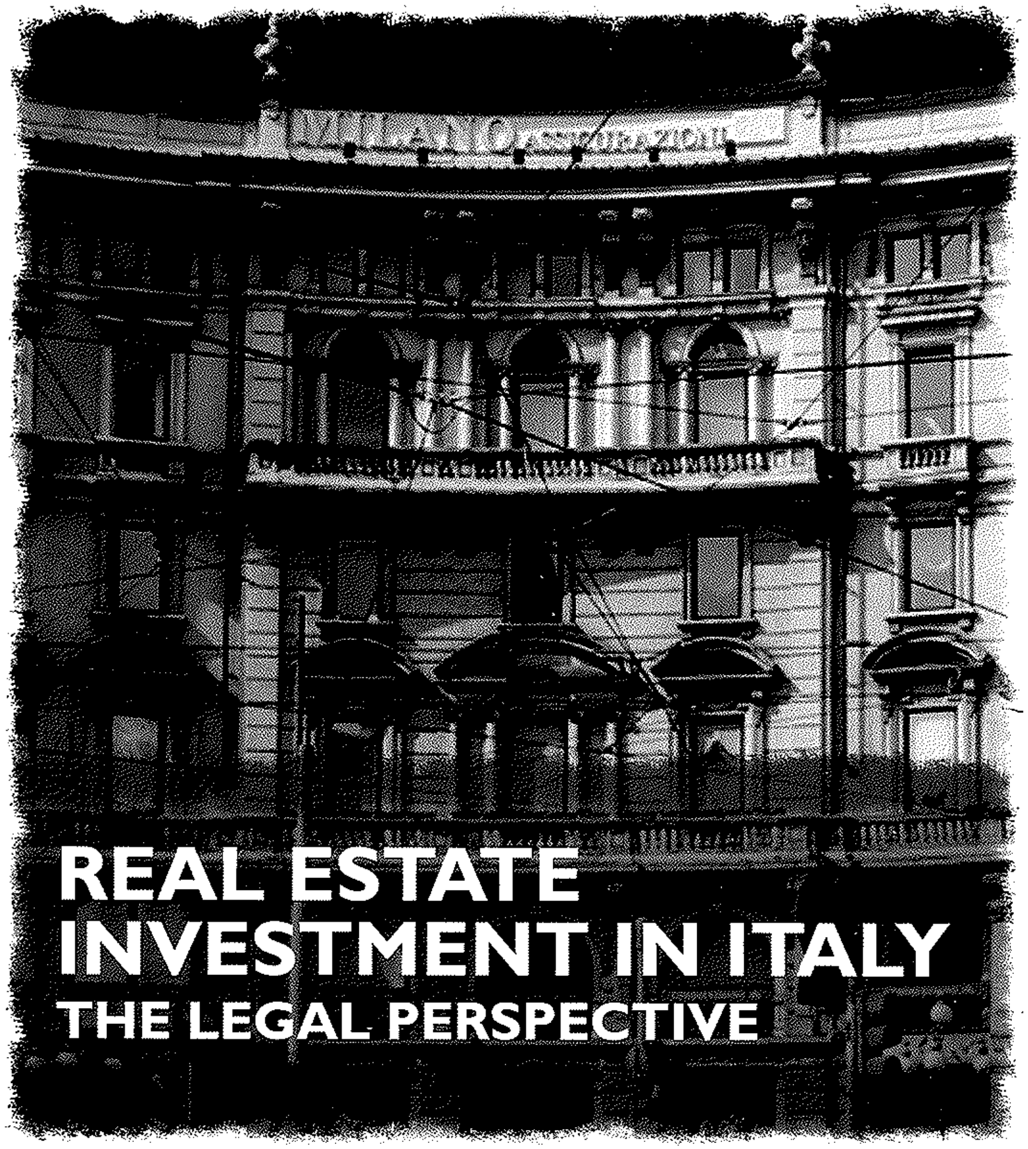

REAL ESTATE INVESTMENT IN ITALY
THE LEGAL PERSPECTIVE

DLA PIPER

EVERYTHING MATTERS

CONTENTS

INTRODUCTION

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Real estate is an important practise area in DLA Piper. We believe that investment in real estate means more than buying valid and unlimited title in real estate property. In our understanding, a good investment in real estate requires the knowledge of all available investment structures and their respective tax implications. The Italian legal and tax framework for real estate investments may appear confusing. In reality it is not. With the present book, we wish to create a comprehensive, but not superficial, guide through the most relevant civil and tax law aspects of real estate investments in Italy. It is our hope that we were able to transform our practical experience into a valuable source for answers to our readers' questions.

The drafting of this book was completed in July 2009. Subsequent changes in law are therefore not taken into account.

A – PURCHASE AND SALE OF COMMERCIAL REAL ESTATE

As in any other country, investments in real estate in Italy can be made in various forms. Letting aside for the time being the tax aspects of real estate investments (see in this regard subsequent section C.), it can be distinguished between two alternative structures:

- acquisition of real estate in the form of an asset deal, and
- acquisition of real estate through the purchase of the corporate vehicle which is owning the real estate, i.e. acquisition of real estate in the form of a share deal.

Under Italian law a further distinction has to be made in the area of asset deals. Based on the legal characteristics of the asset, the asset deal may be structured as

- acquisition of real estate property, or
- acquisition of an ongoing business.

Not always all three structures are actually available for the investor. Often times the vendor has already decided in which form he wants to offer the property to the investor. In other cases, regarding the distinction between an asset deal as purchase of real estate property or as ongoing business, the choice depends on the legal qualification of the object of the intended investment. However, often times the investor still has the possibility to decide upon the best legal structure for his investment. In that case, the tax implications of the available alternatives are of utmost importance, but also civil law consequences, in particular the aspect of liabilities which the investor takes over, are of relevance for the investor.

I. ASSET DEAL

Typically, the preferred choice of an investor is the purchase of the real estate property under the form of an asset deal. The advantages of an asset deal consist in the absence of risks not directly related to the property and the possibility to take over only the real estate without further material or people. While this is true for the straight forward purchase of real estate property, it does not apply to the purchase of an ongoing business. The purchase of an ongoing business, which becomes relevant if the real estate property is part of an organised business and the activities in the property are carried out on the basis of a public law authorization held by the owner/landlord, triggers the application of certain mandatory statutory provisions which force the purchaser to step into existing contractual relationships and to take over certain liabilities.

1. Real Estate

In the area of office building investments, but also of logistic buildings, the typical deal structure is the straight forward purchase of real estate property.

1.1 Real Estate Register, Cadaster Register

Real estate property is recorded in two different registers, the real estate register and the cadaster register.

The real estate register (registro immobiliare) has the function of rendering public (and thereby opposable to third parties, see below) the transfer of title or the creation of rights on the real estate property. In order to ascertain if the vendor has title to the property he is offering or if such property is burdened with third party rights (easements, mortgages, etc.) which may prejudice the use of such property, the investor would typically ask for a title research and such research would be made by investigating the legal status of the property in the real estate register.

The cadaster register has a different function: it contains information regarding the physical extension of the property as well as the so-called cadaster income (rendita catastale) of the property which is the base data for the calculation of the property tax, named ICI. To be precise, there exist two cadaster registers, one for unbuilt land (catasto terreni) and one for buildings (catasto fabbricati). All unbuilt land is recorded in the Land Cadaster. Once this land has been developed and a building (regardless of its nature) has been erected, the owner of the land must register this building in the Building Cadaster by filing detailed floor plans and requesting the attribution of a cadaster income. For somebody who plans to invest in an existing building, all relevant cadaster information will be found in the Building Cadaster.

1.2 Formal Requirements for Transfer of Title to Real Estate Property

Under Italian law (article 1351 of the Italian Civil Code), title to real estate property may be transferred by means of a simple written contract. No further form requirements exist, in particular, no notary deed needs to be signed in order to have a valid transfer of title nor does the transfer of title need to be recorded in the real estate register. The fact that real estate property may be validly transferred without recording such transfer in the real estate register gives rise to a risk: it is conceivable that one owner sells the property more times even though when selling the same property the second time he no longer holds valid title to such property. The solution to such conflict is that under the applicable laws (article 2644 of the Italian Civil Code) the purchaser who is the first to record his title in the real estate register prevails. And this even if he signed his purchase contract after the other purchaser. The existence of this rule can make it advisable to pay the purchase price only once the purchase deed has been recorded and it is thus certain that title has actually been validly transferred to the purchaser. Unfortunately, recording of deeds in the real estate register is not immediate and it can take up to 3 days until the notary receives the confirmation that the deed has been recorded and that no third party has previously recorded other rights on the property. On the other side, no vendor will be willing to sign the purchase deed (and thereby transfer title) without receiving the agreed purchase price. In order to overcome such situation, the parties often times agree to enter into a preliminary purchase contract and to record such preliminary purchase contract in the real estate register. Pursuant to article 2645bis of the Italian Civil Code such recording "blocks" the property for the duration of 3 years, i.e. without the consent of the future purchaser the owner cannot sell the property to third parties or create rights on the property. Once the recording of the preliminary purchase contract has occurred, the purchaser can be certain that he will become owner of the property upon signing of the purchase deed. As a consequence, payment of the purchase price can be made simultaneously with the signing of the purchase deed. In order to record the preliminary purchase contract in the real estate register, the contract must be signed either as an authenticated private deed or a public deed, in either case in front of a notary.

1.3 Typical Acquisition Procedure

Typically, a real estate investment occurs in four phases:

- negotiation and signing of a letter of intent or of heads of terms with an exclusivity provision for the duration of the due diligence,
- legal and technical due diligence,
- negotiation and signing of a preliminary purchase contract which subordinates the execution of the purchase contract to the fulfilment of certain conditions precedent, but already contains all legal and commercial terms at which the property shall be transferred,
- signing of the purchase deed.

In a vendors' market, it is popular to use a tender procedure in order to identify the highest bidder for a property. In such case it may happen that the vendor invites a number of interested investors to carry out a due diligence without having any right of exclusivity and to submit a binding offer for the property based on the results of the due diligence. This forces the investor to incur substantial cost for due diligence without having a reasonable certainty that its bid will be accepted. Many institutional investors refuse to participate in such a tender procedure.

A more reasonable vendor's approach is to invite the investors to do a preliminary due diligence and to present their best non-binding offer. The investor whose offer is accepted is then granted an exclusivity period for thorough due diligence at the end of which a binding offer has to be made.

The signing and recording of a preliminary contract has the above mentioned advantage to "block" the property. But there may also be a disadvantage linked to the request for the signing of a preliminary purchase contract: typically, the vendor requests a down payment of up to 30% of the purchase price at signing of the preliminary purchase contract. This down payment (caparra confirmatoria) has a twofold function. Firstly, it is a down payment which is deducted from the purchase price payable at signing of purchase contract. Secondly, it has the function of a penalty. Should the purchaser not sign the definite purchase contract even though all possibly agreed conditions precedent have been fulfilled, the vendor is entitled to recede from the preliminary purchase contract and to keep the down payment as a form of liquidated damages. Incidentally, this also works the other way around: should the vendor not execute the purchase contract, the purchase may either enforce the preliminary contract or recede from it and ask for payment of liquidated damages over an amount of the down payment. Clearly, the purchaser's position is not as comfortable as the vendor's, because he does not have the down payment in his hands and must sue the vendor for the liquidated damages.

Once the conditions precedent have been fulfilled, the parties meet at the notary's offices (the notary is usually chosen by the purchaser) and execute the purchase deed. As all terms and conditions of the transaction have already been agreed in the preliminary purchase contract, the signing of the purchase deed is normally a mere formality. The only exciting aspect of the closing is the payment of the purchase price. Italian notaries do not accept to receive payments on a fiduciary basis, which means that the payment of the purchase price must be made by wire transfer in the closing. Due to the extremely formal approach of Italian banks, such wire transfers may sometimes become a real organizational challenge and it appears to be advisable to force all parties involved on both sides of the deal into a rigid payment procedure in order to avoid long waiting periods at the notary's office.

1.4 Purchaser's Liabilities

One of the more relevant advantages of the asset deal in the form of a pure real estate purchase is that the investor does not incur the risk of taking over contracts and/or liabilities linked to the property he is buying. The only exceptions are:

- the purchaser must take over the lease contracts regarding the property (article 1599 of the Italian Civil Code),
- the purchaser is the ultimate responsible for soil contamination, insofar as the Italian State may execute in the property if there is soil contamination and the person responsible for such contamination cannot be identified,
- based on certain case law, the purchaser must take over the employment contract with the doorman, provided this is an individual and not a company performing doorman services,
- according to certain case law, the Italian State has a right to execute the property in case the previous owner did not pay all ICI tax owed.

The purchaser is not liable for other debts incurred by the vendor in relation to the property. Likewise, it is the purchaser's discretional decision to take over contracts signed by the vendor with respect to the property (such as property management, utilities, etc.). A special rule exists for insurance policies signed for the building. Such policies are transferred to the purchaser, but both the insurance company and the purchaser are entitled to terminate the contract within 10 days from the next due date for the payment of the insurance premium following the transfer of title to the property (article 1918 of the Italian Civil Code).

1.5 Expenses, Notary Fees

Expenses related to the purchase of real estate property are, in addition to taxes (see in this regard the subsequent section C.), limited to attorney and notary fees. While attorney fees are usually agreed before, it is difficult to obtain a firm offer by a notary. This is partially due to the traditional approach of a notary who defines himself less as a service provider, but more as the guardian of the good principles of law. But even more business orientated notaries find it difficult to make a quote for their fees before they have actually carried out the job. The reason for this lies in the peculiarities of the title research. The responsibility to do the title research typically falls into the notary's competence. Title research, i.e. confirmation of full title to the property and of any third party right burdening on the property, can take little time, but may also be a rather burdensome and time consuming activity. In fact, in order to confirm full title to a property under Italian law, the chain of title transfers must be reconstructed for the last 20 years. As the real estate register is not organized for each property, but recordings are made by individuals (i.e. the parties of the contract to be recorded) the notary must start from the vendor, look for the vendor's seller, then search for the contract by which the vendor's seller has bought the property and so on until the 20 year period is reconstructed. If the vendor holds title for more than 20 years, the research is quickly done, if the notary needs instead to look into 10 different deeds in order to reconstruct the 20 year period, the title research may take up considerable time. This is why a notary is usually reluctant to give a quote on his fees until he has completed the title research.

It appears nevertheless possible to state that the notary fees for a preliminary and for a definite purchase contract should not exceed together 0.05% to 0.2% of the investment value.

2. ONGOING BUSINESS

Under Italian law, some real estate properties are treated as ongoing businesses (azienda). If this is the case, the purchase of such real estate properties is subject to different transfer tax rules (see in this respect the subsequent section C.). From a civil law perspective, the purchase of an ongoing business gives rise to set of problems in relation to the purchaser's liabilities for the activities carried out in the real estate property.

2.1 When is Real Estate an "Ongoing Business"?

The definition of "ongoing business" can be found in Art. 2555 of the Italian Civil Code. An ongoing business is the "complex of assets organized by an entrepreneur for the exercise of an enterprise". As the definition is rather vague it has been interpreted and further specified by case law. As to real estate, the discussion evolved mostly around the distinction between a property lease contract and the contracts regarding the lease of a business. As more in detail illustrated in the following section B.II., the qualification of a lease contract as a lease of a business avoids the application of Law 392/1978, the law for property leases. This law contains numerous mandatory provisions which protect the tenant and reduce the landlord's ability, for example, to enter into short leases or to agree on dynamic rent increases. In short words, a real estate property has to be considered to be an ongoing business if the owner has organized with its own means in the real estate an activity which goes beyond the mere letting of premises. In practical terms, this "more" may consist in trading licences, furniture, goodwill, etc.. If the owner holds title to such additional assets and has leased them temporarily to the tenants on the basis of ongoing business leases, then the purchaser who wants to continue the activities carried out in the real estate, must purchase those further assets together with the building as such. In this case, the real estate must be transferred as "ongoing business" and not as real estate.

The decision as to whether or not qualify a real estate property as an "ongoing business" becomes sometimes relevant if a hotel is the object of the contract to be signed. More often, the distinction becomes relevant in shopping centre investments. In order to open and run a shopping centre, the promoter/owner needs a specific authorization. Even though the implementation legislation for such authorizations has been deferred to the Regions, it may be stated as a general principle in all of Italy's Regions is that such authorization allows the creation of a certain surface for trading activities and, once that surface has been built, constitutes the legal grounds on which the trading activities may be carried out. If the owner decided to keep title to such authorization, it will look for retailers and will temporarily transfer single trading licenses (which are derived from the "umbrella" authorization) to such retailers. The legal instrument to temporarily transfer the trade licence and the premises to the retailer is the above mention contract for the lease of an ongoing business. It becomes obvious that an investor who is interested in purchasing a shopping centre let on the basis of leases of businesses, must accept to purchase, in addition to the shopping centre, also the trade license and the other assets which are let to the tenants.

There are few cases in which a shopping centre may still be bought under the form of a straight forward real estate deal. The first hypothesis is the shopping centre which is let to one single entity on the basis of a so-called over-riding lease contract. The tenant leases the entire shopping centre (hypermarket and shop units in the gallery) and enters into sub-lease contracts with the actual retailers. As in this alternative the tenant of the over-riding lease contract holds title to the trade authorization, the over-riding lease contract must be a regular property lease and, on the other side, the tenant of the over-riding lease is usually sub-letting on the basis of business leases. Another hypothesis is that the vendor is not owner of the trading authorization, because the promoter has definitely transferred the single trade authorizations to the retailers. In this case, the shop units are let as regular property lease contracts to the retailers who carry out their commercial activities on the basis of their own trade licences. In these two cases, the purchase of the shopping centre may be structured as a real estate asset deal and the specific liabilities of the purchase of an ongoing business illustrated in sub-section 2.3 do not apply.

2.2 Formal Requirements for the Transfer of an Ongoing Business

The sale/purchase of an ongoing business must be made by means of an authenticated private deed or by means of a public deed (article 2556 of the Italian Civil Code). In either case, a notary has to participate in the signing of the contract.

2.3 Special Liability for Purchaser of Ongoing Business

The Italian Civil Code contains a number of provisions that regulate the destiny of contracts and of assets and liabilities related to the ongoing business in the case of a sale and purchase of such ongoing business. Some of these rules are mandatory, others may be derogated by express agreement between the parties:

- article 2558: the purchaser of an ongoing business steps into all contracts which the vendor has stipulated with respect to the ongoing business, with the sole exception of those contracts that provide for services which are of personal nature. The parties may derogate from this rule. Should they not derogate, the counterparty of the transferred contract is entitled, within 3 months from the transfer of the ongoing business, to recede from the contract, provided there exists a just cause (giusta causa).
- article 2559: all receivables related to the ongoing business which result from the bookkeeping of the ongoing business are transferred to the purchaser, unless the parties derogate from such rule. No notification of the occurred assignment has to be made to the debtor of the assigned receivable, but should the debtor pay to the former owner and had he not been informed about the occurred transfer, he will be freed from his payment obligation.
- article 2560: all debts related to ongoing business prior to the transfer which result from the bookkeeping of the ongoing business are transferred to the purchaser, who is liable for their fulfilment. However, the vendor remains liable for the fulfilment of such debts, unless the purchaser releases him from such obligation.
- article 2112: the purchaser steps into all employment contracts stipulated with respect to the ongoing business. He also must take over the existing liabilities of the vendor vis-à-vis the employees for payments under their employment contracts, including obligations vis-à-vis the public retirement system. This rule may not be derogated by the parties, which is particularly burdensome for the purchaser in view of the fact that

the transfer of an ongoing business does not constitute a justification for the termination of the employment contract. It is therefore necessary that the vendor makes sure and guarantees that all employment relationships which the purchaser does not want to take over are terminated on a consensual basis before the purchase of the ongoing business.

- art. 14 of Legislative Decree n. 472 of December 18, 1997: the purchaser of an ongoing business is jointly liable with the vendor for the fulfilment of the vendor's tax liabilities incurred in the business year of sale/purchase and the two preceding business years. This liability can be excluded through the request and subsequent release of a certificate by the tax authorities confirming that no tax issues are pending.
- Almost like in the case of the purchase of a company, the purchaser must therefore carefully identify all components of the ongoing business (assets, liabilities, contracts) and agree with the vendor which of such components shall be transferred as part of the ongoing business. With a clear set of warranties and conditions precedent, the additional risks connected to the purchase of an ongoing business should be controllable.

2.4 Expenses, Notary Fees

Other than taxes, there will only be attorney and notary fees. As mentioned above, the contract regarding the sale and purchase of an ongoing business must be signed in front of a notary. The fees for such transfer should be lower that the fees indicated under the preceding section A.I. for the real estate purchase, provided that the notary is not requested to carry out a title research. Should a title research be requested (which appears to be advisable) the notary fees should range again between 0.05% and 0.2% of the investment value.

II. SHARE DEAL

It may happen that the investment in real estate must be made through the acquisition of a corporate vehicle. The reason for this can be that the vendor wants to obtain specific tax benefits by selling the shares of the corporate vehicle instead of selling the property directly. Most double tax treaties signed by Italy exempt the profit derived from the sale of shares from taxation in Italy if the selling shareholder is not tax resident in Italy. It may also be that the corporate vehicle was used for development activities and that the vendor wishes to transfer all liabilities deriving from the development to the purchaser by selling the corporate vehicle as such. In any event, the sale of the corporate vehicle instead of the property itself becomes increasingly popular in the Italian real estate market.

1. Commonly used Corporate Vehicles

As in any other jurisdiction, Italian law provides for different types of corporate vehicles. In the sector of real estate the most used ones are:

- società a responsabilità limitata,
- società per azioni,
- società in accomandita semplice.

1.1 Società a Responsabilità Limitata

The società a responsabilità limitata (s.r.l.) is the preferred vehicle for real estate investments. Shareholders of an s.r.l. are by definition liable for the debts of the company only up to the amount of capital they subscribed. The shares of an s.r.l. cannot be listed and they cannot be represented by marketable certificates. The minimum capital amounts to only €10,000.00. The statutory rules regarding s.r.l. leave the shareholders a wide discretion in determining the corporate governance rules and the management structure and set flexible rules for the procedure of calling and holding shareholders' meetings and taking management decisions. In most cases it will be possible to avoid the obligation to appoint a board of statutory auditors (collegio sindacale), which allows to save costs and simplifies the corporate governance.

90% of the share deals in the real estate market regard s.r.l., exceptions to this rule are made in portfolio acquisitions where the value of the real estate portfolio is such as to justify the more sophisticated legal form of the società per azioni.

1.2 Società per Azioni

The società per azioni (s.p.a.) has a minimum capital requirement of €120,000.00. The capital is represented by share certificates which may be listed at the stock exchange and even if this is not the case are meant to freely circulate on the market. Nevertheless, only few of the companies operating in the real estate sector in the legal form of an s.p.a. are listed (Beni Stabili, Pirelli Real Estate, Aedes, etc.) and these companies should not be up for sale. If an s.p.a. is chosen as vehicle for single real estate operations, the articles of association will usually make sure that the shares cannot be freely transferred and that the corporate governance is assimilated as much as possible to a closed corporation. Both the management structure and the rules for calling and holding shareholders' meetings are rather formal. The appointment of a board of statutory auditors is mandatory.

As to real estate investments, there appear to be no advantages for the use of an s.p.a. over an s.r.l., if not the market perception which considers the s.p.a. a more prestigious corporate vehicle than the s.r.l.

1.3 Società in Accomandita Semplice

Mostly for tax reasons it may occasionally happen that the investor chooses the società in accomandita semplice (s.a.s.) as investment vehicle. The s.a.s. is a partnership with limited partners as well as with at least one partner who is unlimitedly liable for the partnership's obligations. The advantage of the use of the s.a.s. lies in the fact that its profits are taxed – as far as the IRES tax is concerned – directly on the level of the partners. For certain investment structures this may avoid the double taxation under Italian taxes of income on the level of the corporate vehicle and of the partners. Further benefits exist in relation to the possibility to deduct interests on loans (see Part C.III.5.). Since the beginning of 2004 it is possible to have a limited liability company assume the position of the unlimitedly liable partner in a s.a.s. This allows the creation of a partnership with effectively limited liability.

Nevertheless, the s.a.s. remains a partnership and as such is subject to certain mandatory statutory rules which are not ideal for the typical goals in real estate investments through corporate vehicles.

2. Formal Requirements for Transfer of Shares

The sale/purchase of shares in an s.r.l. and in a s.a.s. must be made by means of a written transfer agreement. Shares of the s.p.a. could be transferred only by way of endorsement, but typically a written agreement is signed by the parties. The legal effects of the transfer of the position as shareholder vis-à-vis the company depend on the registration of the new shareholder in the company's shareholder book. This registration may only be effected once the transfer has been recorded in the competent companies' register. As this recording will only be done if the transfer results from a notary deed, the written transfer agreements need to be executed in front of a notary. The same applies to the endorsement of shares of an s.p.a.

Even though the object of the transfer agreement are the shares, the sale and purchase agreement should address, in the representations and warranties section, the typical issues related to risks under a real estate acquisition.

3. Potential Purchaser's Liabilities

Obviously, the major disadvantage (or, from the vendor's perspective, advantage) of the acquisition of a corporate vehicle is that all liabilities related to the activities carried out by the vehicle will stay in the vehicle and thus indirectly pass to the purchaser as new shareholder of the vehicle. Particular importance should therefore be attributed to the legal analysis of the development activities of the vehicle, as well as to its tax position.

4. Corporate Structure

When purchasing a corporate vehicle the investor must be aware that he will need a corporate structure to run the company. This includes the appointment of directors and, at least in the s.p.a., of statutory auditors. The company needs to have its own bookkeeping and to file its own tax declarations. The additional costs triggered by the purchase of a corporate vehicle should be taken into account when comparing the share deal with an asset acquisition.

5. Expenses, Notary Fees

The notary fees for the authentication of a share purchase agreement are typically lower than the ones due in case of transfer of real estate property. However, a corporate deal usually requires a series of further notary activities (such as adaptation of the articles of association) and therefore the overall costs for the notary should range between 0.05% and 0.2% of the investment value.

As to the attorney's fees, the investor should take into account that not only there has to be a more complex legal and tax due diligence, but also will there be the need for implementing a serious of corporate actions (revocation of old management and auditors; appointment of new management and auditors; changes in the articles of association; restructuring of shareholders' loans, etc.), which will typically render the share deal more expensive than the straight forward asset acquisition.

B – LEASE OF COMMERCIAL REAL ESTATE

Regardless of the use destination of a real estate property, the landlord/owner has only two kind of contracts to choose if he wants to let the property to a third party:

- the property lease contract, and
- the business lease contract.

Both contract types are codified legal instruments under which the owner of real estate makes such real estate or portion thereof available for use to a third party against payment of a certain amount of money. The difference between the two contract types lies in the fact that under a business lease the owner/landlord must not only make available to the tenant the premises as such, but an entire business or business branch to which the premises are one crucial, but not the only component.

In both alternatives there are a number of mandatory and not mandatory rules set forth by the statutory law. However, as the statutory rules for business leases grant the landlord more flexibility when agreeing on contract terms (in particular, duration of contract, rent increase, etc.), it is usually perceived as the preferred legal instrument to govern a landlord/tenant relationship. As illustrated more in detail under the following section B.II., the business lease contract can only be used if the landlord is able to actually transfer to the tenant - for the time of the duration of the business lease - a business or a business branch. This is normally impossible in office or logistic leases, and more likely in shopping centre and hotel leases.

I. PROPERTY LEASES

If the object of a lease agreement is nothing else than the premises, the landlord has little choice: he must use a property lease contract for the letting of such premises. Some of the statutory rules which apply to property leases can be found in the Italian Civil Code. Most provisions which govern the relationship between landlord and tenant of a property lease are contained in Law no. 392 of July 27, 1978.

1. Provisions of the Italian Civil Code

Articles 1571 through 1614 of the Italian Civil Code define some basic rights and obligations of the parties of a property lease.

2. Provisions of Law no. 392 of July 27, 1978

Law 392/1978 was initially introduced to set the legal framework for both residential and commercial leases. The legislator's principle intent was to protect the "weak" tenant against the "strong" landlord. Even though the protection of the tenant was felt to be more necessary in the area of residential leases, Law 392/1978 introduced a number of limitations for the landlord also in the area of commercial leases. In the meantime, the provisions for residential leases were transferred into a different statute (law no. 431 of December 9, 1998). What remained is a law which most investors in the real estate market consider to be too restrictive for the landlord and thus not able to satisfy the expectations of a landlord interested in letting and managing its property in accordance with international market standards.

2.1 No Derogation from Mandatory Rules which Protect Tenants

Many of the provisions of Law 392/1978 are mandatory, such as those establishing the duration, the increase of the rent, the rights of the tenant who carries out activities vis-à-vis the public, etc.. They are mandatory in the sense that any derogation from such provisions which has a prejudicial effect on the tenant's legal or commercial position is considered to be void (art. 79 of Law 392). Even the explicit acceptance of a certain clause by the tenant would not be able to render the clause valid. The nullity of a contractual provision however does not trigger the invalidity of the entire lease contract, but the void clause is automatically replaced by the rule under law, i.e. the respective provision of Law 392/1978 (art. 1339 Civil Code).

The invalidity of a clause in the lease agreement may be challenged by the tenant until 6 months from the expiration/ termination of the lease contract. This makes invalid clauses regarding rent increases particularly dangerous: in fact, a tenant who has agreed on a certain rent increase may challenge the validity of such agreement until 6 months from when the contract has expired, i.e. at a point in time he does not incur the risk to harm the good tenant/landlord relationship. Should the tenant be able to demonstrate in front of the court that the rent increase clause was invalid, he is entitled to ask for restitution of any rent paid in excess of the originally agreed rent. And this even if he never complained about the rent before.

2.2 Duration of the Contract

According to Art. 27 of Law 392/1978 a lease contract cannot be signed for less that 6 years. In case of hotels this minimum duration is increased to 9 years. The parties are free to agree on longer periods, but any clause which limits the duration of the lease to less than 6 years (or 9 years for hotels) would be void and automatically replaced by a clause providing for 6 (or 9) years.

After the expiration of 6 (or 9) years, the contract is automatically renewed at the same terms and conditions for other 6 (or 9) years, unless either party notifies its intention not to renew the lease at least 12 (or 18) months before the expiration of the first 6 (or 9) years term. While the tenant may freely decide not to renew the contract, the landlord can do so only in very limited cases. Such case are listed in article 29 Law 392/1978 and can be summarized as follows:

- intention to use the premises by himself or by relatives,
- intention to demolish the building in order to rebuild it,
- intention to refurbish the building in order to bring it in compliance with certain laws.

As most of the above indicated exceptional rules which allow the landlord to deny the tenant's request for renewal do rarely apply, it appears fair to say that the investor should assume that the lease he is signing or has taken over has a duration of 12 (or 18) years, unless the tenant decides to leave after 6 (or 9) years. This rather long duration would not be considered to be bad, if there was not the very restrictive rule regarding rent adjustments of a maximum of 75% of the ISTAT increase (see the subsequent sub-section 2.4).

2.3 Contractual and Statutory Termination Rights

The landlord is not entitled to break the lease during its minimum duration, i.e. 6 (or 9) years, or, if renewed, 12 (or 18) years. Obviously, in case of a material breach of contract by one party, the other party is entitled to terminate the lease.

The parties may agree contractually on a break option in favor of the tenant (art. 27 subsection 7 Law 392/1978). Such break option has to be exercised by the tenant with a 6 months notice to the landlord.

Besides the above mentioned contractually agreed break option, law 392/1978 grants the tenant an extraordinary early termination right in article 27 subsection 8. Such mandatory statutory provision entitles the tenant to break the lease with a prior written notice of 6 months, in case serious and justified reasons (gravi motivi) have occurred. Article 27 subsection 8 of Law 392/1978 does not define what these "serious and justified reasons" are. Hence it was case law which has elaborated over the years some general guidelines as to when "gravi motivi" are given and when not. Bearing in mind that each case needs to be judged on its own facts, in general "gravi motivi" are given if the reasons brought up by the tenant:

- go beyond the tenant's control and do not fall in his sphere of risk,
- were unknown and unpredictable at the time the lease was agreed,
- have a substantially negative impact on the tenant's commercial position, such as to render the continuation of the lease overly burdensome for the tenant.

These parameters are typically not fulfilled if the tenant runs its business bad and does not generate enough revenues to pay the rent or if the tenant decides to restructure its business and after that no longer needs the rented space. They may be present instead when the entire economy in which the tenant is operating goes through unpredictably bad times and the tenant is not able, despite the use of his entrepreneurial capabilities, to save his business. Even though the existence of this statutory break option is a risk for the continuity of the rental income and therefore constitutes a negative aspect under Italian lease law, it should not be forgotten that in most of the cases in which the tenant is able to break the lease on the grounds of "gravi motivi", it is at the brink of bankruptcy and the rental income was any way under risk.

Unfortunately some case law has considered also the unforeseeable business success of a tenant which caused a growth of business such to render the premises no longer big enough as falling in the category of "gravi motivi".

2.4 Adjustment of Rent

According to Art. 32 of Law 372/1978, the rent may be adjusted once a year by a maximum of 75% of a possible increase of the ISTAT index, an index published by a State run body which ascertains the increase of living costs on a daily basis. The limitation to 75% of the real increase of living costs means that the rent is actually being reduced by 25% of the ISTAT increase on an annual basis. This makes the long minimum duration of the property lease actually become, to some extent, a disadvantage to the landlord.

According to the recent amendment introduced by art.41 par.16-duodieces of law 27/2/2009 no.14 converting Law Decree no. 207/2008, the limit of 75% of ISTAT increases applies only to properties lease agreements with a duration of 6 plus 6 years, while for longer contracts this limit has been repealed.

2.5 Determination and Adjustment or Increase of Rent

It is a recognized principle under Italian commercial lease law that the parties are free to agree on the amount of the rent. This should in principle include the right to agree on rent increases. Nevertheless, there is an ongoing, sometimes confusing, discussion about the illegitimacy of contractual agreements which provide for increase of rent during the course of the lease contract. Such discussion takes its origin in article 32 of Law 392/1978. As illustrated before, this statutory provision states that rents may be adjusted only by up to 75% of the possible increase of the ISTAT index, which is an index for the determination of the general cost for living. Even though it appears indisputable that article 32 of Law 392/1978 has the purpose to avoid that inflation becomes stronger because rents are linked to inflation and thereby create themselves inflation, case law and legal authors sustained initially that art. 32 of Law 392/1978 prohibits any form of rent increase. The supporters of this legal position did not see a difference between "rent adjustment" (which is the case regulated by article 32) and a "rent increase". The discussion is still ongoing, but it appears to be possible to state that rent increases which have nothing to do with a compensation of a possible loss of the currency value, are in principle valid. This has been decided for turnover rents, but also for step-up rents where the parties had agreed to increase the rent over time in order to reflect the objectively increasing benefits of a tenant in the use of the let premises. Nevertheless, the discussion in case law and doctrine is not yet at an end and it is therefore strongly recommendable to expressly write the reasons for a rent increase in the lease contract, so that it becomes clear that the increase does not have the purpose of compensating losses due to inflation.

2.6 Maintenance

Prior to the introduction of Law 431/1998, Law 392/1978 provided for some rules in relation to the parties' maintenance obligations under a property lease. Today, the provisions for the allocation between the landlord and the tenant of the responsibility for the maintenance of the premises are set only by articles 1576 and 1609 of the Civil Code. These rules are applicable as far as not expressly derogated by the parties.

Pursuant to article 1576 Civil Code the landlord is in charge for any maintenance which cannot be considered to be "small repairs". According to Art. 1609 c.c. repairs are "small" when related to the use of the premises, with the exclusion of those which are due to wear and tear or force majeure. Therefore the landlord would be in charge for ordinary and extraordinary maintenance of both the building and the plants/installations, unless these plants/installations are owned by the tenant. As this rule does not reflect the commercial standard and since it is allowed to derogate from articles 1576 and 1609 Civil Code, the parties of a property lease usually derogate from the rules of the Code and agree that the tenant takes over the ordinary maintenance of the buildings and its plants/installation, while the landlord is in charge of extraordinary maintenance. There is no legal definition of what is ordinary and what is extraordinary maintenance. Case law has developed a distinction according to which ordinary maintenance usually consists in works which are to be executed on a regular basis (i.e. monthly, quarterly or yearly) in order to maintain the usability of the premises and the installations, whereas extraordinary maintenance regards works which preserve or improve the value of the building or its installations. Such works are typically not executed on a regular basis and/or imply costs which are relatively high compared to the value of the premises. The distinction between the two areas is difficult and this creates a potential for controversies between tenant and landlord. Detailed contractual provisions are therefore recommendable. Sometimes it is possible to agree that the tenants takes over also the extraordinary maintenance of the plants. On the other side, it can be observed that landlords are accepting to be in charge of all ordinary maintenance (and thereby control the quality), asking in return the tenant to pay a certain amount as maintenance fee.

2.7 Expenses

The tenant is usually charged with the so called "operating expenses" which are related to common services organized and initially paid by the landlord, but then reimbursed by the tenant. Pursuant to Art. 9 of Law 392/1978 the following services can be charged back to the tenant:

- cleaning,
- ordinary maintenance of elevators,
- water and electricity supply,
- heating and air conditioning supply,
- sewer cleaning,
- supply of any further common service,
- 90% of costs for doorman.

This list is not considered to be conclusive. It is allowed to add further chargeable expenses. The limit is reached if the landlord uses the reimbursement of expenses to actually increase its income from the letting. There are expenses which are not clearly definable as such: in this case it is advisable to draft specific contract clauses in order to regulate their reimbursement. The classical example is the reimbursement of the landlord's insurance costs. If the insurance covers (also) damages which are typically falling into the owner's sphere of risk, and the landlord wishes to obtain 100% of the insurance costs reimbursed, this should be agreed in a specific contract clause and not in the provision regarding general reimbursement of expenses. The same applies to the reimbursement of the ICI tax. It would be legally valid (even though rather uncommon in practice) to agree that the tenant reimburses the Landlord the cost which the latter has incurred for ICI tax. If the landlord wants to agree on such a clause, he should address the issue in a specific contractual provision in order to avoid that this issue may be considered as a general item of expenses (and therefore not be reimbursable as not being incurred in the tenant's interest).

2.8 Subletting, Assignment of Contract

Save for the case of leases under which the tenant is entitled to carry out activities vis-à-vis the public (see the subsequent sub-section 2.9.4), the tenant may neither sublet nor assign the lease contract to third parties without the prior consent of the landlord.

2.9 Leases which allow Contact with the Public

Special rules are provided for commercial leases under which the tenant is allowed to carry out activities which give rise to a direct contract with the "public of consumers and users". This is typically the case in retail shops and bars/restaurants, but also banks, public offices, etc.. In order to protect and recognize the goodwill created or increased by the tenant in the premises during the lease, such tenant has a number of legal privileges the respect of which, seen from the landlord's perspective, may become rather expensive. Such rights are:

- indemnity for goodwill,
- pre-emptive right in case of sale,
- pre-emptive right in case of new letting,
- sub-letting and contract assignment.

None of these rights may be derogated from, as they are mandatory rights protecting the tenant.

The rules apply only in case the activity which gives rise to the contact with the public prevails over any other activity carried out by the tenant under the contract. The parameter to use in order to ascertain which activity prevails is the surface of the premises used for the respective activities.

2.9.1 Indemnity for Goodwill

The most important rule is provided for under Art. 34 of Law 392/1978: upon termination of the lease the tenant is entitled to receive an indemnification for the loss of goodwill. The amount is equal to 18 times the last monthly rent paid (in case of hotels, the indemnity is equal to 21 times). Moreover, should the premises be subsequently let to a tenant which will carry out the same or similar activities as the former tenant, and this should happen within a year from termination, a further indemnity of the same amount (i.e. 18 or 21 monthly rents) would be payable to the old tenant. The payment of such indemnification to the tenant is a condition precedent for the surrender of the premises to the landlord.

The indemnity is not due in the following cases:

- the tenant decides not to renew the lease contract,
- the tenant decides to use a break option,
- the lease contract is terminated due to the tenant's breach of contract,
- the lease contract is terminated in the context of a winding-up procedure.

It should be noted that the obligation to pay the goodwill indemnification is frequently – from a commercial perspective – off-set by the possibility to request from the incoming tenant a key money for the goodwill it finds in the premises. In a positive market climate, the landlord should not suffer an actual cost, but might even be able to generate an additional profit from the change of the tenants.

2.9.2 Pre-emptive Right in Case of Sale of the Premises

Should the premises be used as a shop or for any other activity which gives rise to contact with the public, the tenant is vested with a pre-emption right under article 38 of Law 392/1978. According to this mandatory provision, the landlord must offer the tenant the purchase of the premises at the same terns and conditions agreed with a potential buyer. The law provides for a term of 60 days from notification of the offer, within which the tenant must decide if he wants to purchase the property or not. Should the landlord not comply with the procedure under law and sell the premises in violation of article 38, the tenant is entitled to claim the property from the new owner within 6 months from the registration of the title in the competent land registry (article 39 of Law 392/1978) by paying the same purchase price indicated in the sale and purchase contract stipulated by the landlord with the third party purchaser.

It should be pointed out that the pre-emptive right only applies in case the let premises and the premises which are up for sale/purchase are identical. In case the let premises are only a part of the building which is up for sale/purchase, the pre-emptive right does not apply.

2.9.3 Pre-emptive Right in Case of New Letting

Similarly to the pre-emptive right in case of sale of the premises, article 40 of Law 392/1978 grants the tenant which carries out activities towards the public a right to let the premises even after his lease contract has expired. As illustrated previously, at the end of the 12 years period (hotels 19 years), i.e. after the first renewal of the lease contract, the landlord is free to terminate the lease and to let the premises to a new tenant. In case of a lease with contact to the public, the landlord must offer the old tenant to sign a new lease at the terms and conditions agreed with the potential new tenant. The landlord must notify the old tenant all terms and conditions upon which a new lease would be granted to a third party and within the following 30 days the old tenant may decide to sign a new lease at such terms and conditions. Different from the pre-emptive right in case of sale, the landlord would have to pay only monetary damages to the old tenant, if he did not respect the provisions under article 40.

2.9.4 Subletting and Assignment of Contract in the Context of a Transfer of Ongoing Business

Special rules are finally set forth in relation to the subletting and the assignment of the contract. As said before, the tenant is usually not allowed to sub-let or to assign the lease without the prior consent of the landlord. In order to grant the tenant more flexibility in carrying out its business, article 36 of Law 392/1978 derogates such general rule and grants the tenant the right to sub-let and to assign the lease without the approval of the landlord when and if the lease is assigned or the premises are sub-let to a third party as part of the ongoing business carried out by the tenant in the premises. In this case the tenant is only under the obligation to communicate to the landlord the transfer or the letting of the ongoing business and the landlord may oppose himself to the transfer of the lease contract or the sub-letting of the premises within 30 days. Such opposition must be based on "serious" reasons, which may regard the new tenant's financial capability or, in rare cases, his reputation. Article 36 of Law 392/1978 grants the landlord in addition to the (limited) right to oppose the assignment of contract, the right to not release the assignor (i.e. the old tenant) from the obligation to respond for any breach of contract by the new tenant. This may become particularly relevant for the obligation to pay the agreed rent. In other words, the assignment of contract in the context of a transfer of an ongoing business does not expose the landlord to additional financial risks.

II. BUSINESS LEASES

Italian law offers a second type of contract under which real estate can be made available to third parties against payment of a rent, the so-called business lease contract (contratto di affitto di azienda). As stated above, the distinction between "property lease" and "business lease" is relevant because the qualification of a lease contract as a business lease allows the landlord to avoid the application of the mandatory rules of Law 392/1978 which apply only to property leases. The main disadvantages of property lease were illustrated in the previous chapter, such as:

- minimum contract duration,
- statutory termination right (gravi motivi),
- rent adjustment only up to 75% of ISTAT,
- discussion about legality of legal rent increases,
- tenant's indemnity for goodwill,
- pre-emptive rights for tenant.

It is obvious that a landlord is interested to avoid the application of such rules, if possible.

1. When can a "Property Lease" be a "Business Lease"?

The distinction between property leases and business leases is based on the nature of the leased object: in case of a property lease, leased object are only the premises. In case of a business lease, the object of the contract is an ongoing concern. Part of that ongoing concern are the premises.

The term "ongoing concern" is defined in art. 2555 of the Italian Civil Code and has been illustrated in detail under the preceding section I.2.1 with respect to the question when an asset has to be sold in the form of an ongoing concern instead of as simple real estate. The criteria to distinguish the two hypotheses in the area of lease are the same. In order to sustain that a lease regards an ongoing business the landlord must be able to let the tenant more than just the premises. This more must inevitably be the trade licence, but should consist in further material and non material assets, such as furniture, equipment or goodwill. Given that by using the business lease contract type the landlord avoids the application of the mandatory rules for commercial leases, the landlord should be able to demonstrate that he made available to the tenant actually more than just the premises. Otherwise he runs the risk that the tenant alleges one day that the contract was in reality a property lease and therefore many of the clauses agreed between the parties are invalid because they derogate from mandatory property lease law.

Leaving aside for a moment the pure legal analysis of the problem, it should be noted that more than 80% of shopping centres in Italy are let on the basis of business leases. This contract type is clearly more apt for the letting and management of retail activities. The operators in the market prefer this contract type, the developers believe that the investors request this contract type. The business lease simply allows a more dynamic letting and centre management. Fact is however that many shopping centres have structured there business leases in a way that there exists more than a theoretical risk that a tenant could successfully claim that his contract was actually a hidden property lease which was only named a business lease to avoid the application of the rules of Law 392/1978.

2. Principle Rules under the Italian Civil Code for Lease of Ongoing Businesses

There is no statutory law regarding business leases as there is for property leases. This makes the business lease the flexible legal instrument which shopping centre managers are looking for. The advantages of the business leases are numerous:

- no minimum contract duration (typically the contracts have a duration of 3 years),
- no limitation on ISTAT adjustment (typically 100% ISTAT increase are agreed),
- no discussion about legality of rent increases (typically step-up rents with a turnover element are agreed),
- no indemnity payment to tenant,
- no pre-emptive rights for tenant,
- no risk of transfer of ongoing business to a third party without landlord's consent (the ongoing concerns belongs to landlord and cannot be transferred without its consent).

On the other hand, there are only a few disadvantages related to the business lease:

- Article 2558: at the expiration of the business lease, the landlord of an ongoing business steps into all contracts which the tenant has stipulated with respect to the ongoing concern, with the sole exception of those contracts that provide for services which are of personal nature. The parties may derogate from this rule. Should they not derogate, the counterparty of the transferred contract is entitled, within 3 months from the transfer of the ongoing concern, to recede from the contract, provided there exists a just cause (giusta causa).
- Article 2112: at the expiration of the business lease, the landlord steps into all employment contracts stipulated by the tenant with respect to the ongoing concern and must take over the existing liabilities of the tenant vis-à-vis the employees for payments under their employment contracts, including obligations vis-a-vis the public retirement system. This rule may not be derogated by the parties, which is particularly burdensome for the landlord in view of the fact that the transfer of an ongoing concern at the end of the lease does not constitute a justification for the termination of the employment contract. It is therefore necessary that the tenant undertakes the obligation to terminate all employment relationships which the landlord does not want to take over on a consensual basis before the restitution of the ongoing business.

The disadvantages of the business lease can be addressed to some extent with appropriate contractual provisions. The tenant must be under the obligation to return the ongoing business without debts and employees. It should be kept however in mind that the obligation to terminate all employment contract has no effect vis-à-vis third parties (i.e. the employees) and if the tenant does not respect this obligation, the landlord would be forced to take over the employees, unless he decides to close down the ongoing business.

C – TAXATION OF REAL ESTATE INVESTMENTS

The full understanding of the tax related aspects of a real estate investment is as crucial for the success of the investment as the evaluation of the investment risk. The following overview about the most relevant principles of taxation in Italian real estate distinguishes between direct taxes (income taxes) and indirect taxes (transactional taxes). In each of these two categories a further distinction shall be made based – as to direct taxes – on the investor's corporate/tax structure in Italy and, as to indirect taxes, following the three different types of investment forms, i.e. asset deal either as real estate acquisition or as acquisition of an ongoing business and share deal.

I. DIRECT TAXES – INCOME TAXES

Under Italian tax law there exist the following two income taxes:

- Imposta sul Reddito delle Società (IRES),
- Imposta sul Reddito sulle Attività Produttive (IRAP).

The IRES tax is levied at the rate of 27.5%, while the IRAP rate is equal to 3.9%. These tax brackets never change under the various available tax structures. What changes is the calculation of the taxable basis and the positive and negative adjustments to the net statutory result. Also, in some cases the IRAP tax does not apply at all. In addition to the IRES and the IRAP tax, the owner of a real estate property has to pay each year the so called Imposta Comunale sugli Immobili (ICI).

ICI (the municipal tax on properties) is not really an income based tax because it is levied independently from the fact that the real estate property actually produces income or not. In fact ICI is a wealth tax related to the possession of real estate and is calculated on the basis of the cadastral income (i.e. "*rendita catastale*") which is set forth by the competent local tax authority in whose jurisdiction the property is located, on the basis of certain legally established parameters. By applying a certain multiplier to the "*rendita catastale*" (which is recorded in the Cadastral Register and hence ascertainable by everybody) one obtains the cadastral value of the property (i.e. "*valore catastale*"). Generally, each Municipality is authorized to set the ICI tax bracket within the range of 0.4% to 0.7%. The annually due ICI tax is the result of the application of such tax bracket to the cadastral value of the property. Typically, the cadastral value is below, sometimes even substantially, the market value of the property. Even in new built properties, the cadastral value hardly ever exceeds 90% of the market value of such property. For the sake of having a reference value in the calculation of the net income of the investment it appears reasonable to allocate 0.4% to 0.5% of the purchase price for ICI tax.

The three mentioned taxes apply, with the exception of IRAP, to any of the available investment structures. Such available investment structures are:

- direct investment without a permanent establishment in Italy,
- direct investment through a permanent establishment in Italy,
- indirect investment through a corporate vehicle,
- indirect investment through a partnership vehicle.

The difference between the four alternatives lies in the way the taxable income is calculated (as to the difference between direct investment with or without permanent establishment) or in the fact that there may be two levels of taxation (as to the difference between direct and indirect investment).

1. Direct Investment without Permanent Establishment in Italy

If the foreign investor does not have a *presence*[1] in Italy, he may decide to simply purchase the property without creating an own structure – directly or outsourced – on the Italian territory. The mere fact of owning a real estate asset in Italy does not give rise to a permanent establishment in Italy. It is, however, clear that the more investments in real estate are made in Italy, the more people will be dedicated to such real estate properties and it will become increasingly difficult to avoid the creation of a permanent establishment in Italy. Nevertheless, as long as the investor does not dispose of an entrepreneurial structure in Italy, he will not have a permanent establishment in Italy just because he owns real estate property located in Italy.

1.1 IRES

In the area of real estate investments there are two main sources of income:

- income from the letting of the property;
- income from the sale of the property.

1.1.1 Taxation of Income from the Letting of the Property

If the investor does not have a permanent establishment in Italy, the income derived from the letting of the property is subject to the 27.5% IRES tax (article 152 sub-section 2 of Presidential Decree n.917 of December 22, 1986, as amended, hereinafter also the "Tax Act"). The basis for the calculation of the taxable income is equal to 85% of the gross revenues derived from the letting (article 37 sub-section 4-bis Tax Act). No depreciation can be made and no specific costs may be deducted for tax purposes. If, for example, the investment is leveraged, the interest will not be deductible for tax purposes.

1.1.2 Taxation of Income from the Sale of the Property

In case of a direct investment without permanent establishment, a possible income deriving from the sale of the real estate asset (the so-called capital gain) would not be subject to the IRES tax, provided the property is sold after 5 years from its

[1] Reference is made to the notion of "permanent establishment" as per the domestic provision n. 162 of the Presidential Decree n. 917/1986, the OECD Guidelines on model tax convention on income and capital and the OECD Model Tax Convention.

acquisition (article 67 sub-section 1, let. b) Tax Act). Should the sale occur before the expiry of such 5 year period, the IRES tax at the rate of 27.5% would apply. It should be noted anyway that, as depreciation of the property is excluded in the absence of a permanent establishment, the taxable income would be limited to a possible difference between acquisition costs at the time of purchase and purchase price agreed for the sale of the property.

Under Italian Law[2], the taxable basis of real estate assets both for direct and indirect tax purposes should be computed with reference to the "normal value", meaning the value that would be agreed between two independent parties in a fair market[3].

1.2 IRAP

In the absence of a permanent establishment in Italy, the income generated by the letting and/or the sale of the real estate asset is not subject to the IRAP tax.

1.3 Tax Treaty

Almost all treaties against double taxation entered into by Italy follow the OECD Model Tax Convention. According to article 6 of the OECD Model Tax Convention, income derived from the letting of real estate is taxed by the country in which the real estate is located. Article 13 sub-section 1 of the OECD Model Tax Convention attributes the right for taxation of profits generated through the sale of real estate property to the country in which the real estate is located. As illustrated hereinbefore, the Italian State has used its right of taxation in both cases, except for the right of taxation of capital gain in case the owner of the real estate asset has no permanent establishment in Italy and the sale occurs more than 5 years from the purchase of the property.

According to article 23 of the OECD Model Tax Convention, two methods to avoid a double taxation of the income which was subject to taxation in the other country are available: either the income is exempt from taxation in the home country or such income forms part of the taxable income in the home country, but the investor is entitled to a tax credit for the taxes already paid abroad.

The following table shows the rules under some of the Tax Treaties signed by Italy. It indicates the country in which the income from letting and the capital gain is taxed and the method chosen for the avoidance of a double taxation.

[2]As amended by the European Law for 2008 already approved by the Italian Parliament but not yet entered in force as of June 30, 2009.

[3]Before the endorsement of the European Law for 2008, the tax authority was able to disregard the agreed price in case the consideration agreed by the parties was lower than the fair market value of the real estate assets sold, determined according to the data and calculation provided by the Real Estate Market Observatory (i.e. "Osservatorio del Mercato Immobiliare") managed by the Land Agency.

Table 1: Taxation of real estate income under Tax Treaties

Country	Income from letting	Capital gain from asset sale	Method for avoidance of double taxation
Austria	Italy	Italy	Exemption
Belgium	Italy	Italy	Exemption
Denmark	Italy	Italy	Tax Credit
Finland	Italy	Italy	Tax Credit
France	Italy	Italy	Tax Credit
Germany	Italy	Italy	Exemption
Luxembourg	Italy	Italy	Exemption
Netherlands	Italy	Italy	Exemption
Norway	Italy	Italy	Exemption
Portugal	Italy	Italy	Tax Credit
Spain	Italy	Italy	Tax Credit
Sweden	Italy	Italy	Tax Credit
United Kingdom	Italy	Italy	Tax Credit
United States of America	Italy	Italy	Tax Credit

1.4 ICI

Even if the investor does not dispose of a permanent establishment in Italy, it must pay the annual ICI tax.

2. Direct Investment through Permanent Establishment in Italy

Typically, a foreign investor tries to avoid that his Italian source activity is carried out through a permanent establishment as the permanent establishment triggers corporate taxation (rather than the so called "taxation of separated income") and implies a value added tax activity which triggers further tax consequences. If it comes to real estate income, the foreign investor's position is different: as it will be shown in this section, the taxation of income deriving from real estate is normally more favourable if such income is generated through a permanent establishment in Italy. It is therefore important to understand the requirements for the establishment of a permanent establishment according to Italian tax law.

2.1 Requirements of a Permanent Establishment

It was said under the previous section that the mere possession of real estate property does not give rise to a permanent establishment. Simply by owning property located in Italy, the investor will not be entitled to apply the rules for taxation of permanent establishments. Something more is required. The Italian tax law has only recently introduced a definition of the term "permanent establishment". Such definition applies, however, only in case the foreign entity involved is resident in a country with which the Italian state has not stipulated a Double Tax Treaty. In case a Double Tax Treaty exists between the two interested countries, the definition of a permanent establishment of such Double Tax Treaty is the standard to be met and domestic law is applicable only to the extent it provides a more favourable treatment for tax payer. Nearly all relevant Double Tax Treaties signed by Italy are based on the OECD Model Tax Convention. Art. 5 of the OECD model has the following wording:

"1. *For the purposes of this Convention, the term »permanent establishment« means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*

2. *The term »permanent establishment« includes especially:*

   a) a place of management;

   b) a branch;

   c) an office;

   d) a factory;

   e) a workshop, and

   f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. *A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.*

4. *Notwithstanding the preceding provisions of this Article, the term »permanent establishment« shall be deemed not to include:*

   a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

   b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

   c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

   e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

   f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. *Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.*

6. *An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.*

7. *The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."*

Leaving aside the specific cases, it may be said that a permanent establishment requires a personal element and a material element. Both elements together must give the foreign investor a presence in Italy from which he takes the entrepreneurial decisions regarding his investment activities in Italy. While it is not necessary that the people who act for the foreign entity in Italy are Italian residents, they should be physically present in Italy when taking the more relevant decisions for the Italian investments. No minimum standards for the material structures are set forth, but it appears that at least a room with the base equipment and infrastructure (telephone, fax, computer, etc.) for office activities should exist. Evidently, such structures create costs. Often times the foreign investor, in particular if he has an institutional background, delegates property and facility management activities, and sometimes even the asset management itself, to third parties, and there is hence no need for an own stable presence in Italy. Nevertheless, should a permanent establishment be created in Italy, it is recommendable to attribute to the latter all necessary means in order to carry out its business activities.

For the sake of completeness it should be noted that Italy, in an official comment to the OECD Model Tax Convention, has stated that, contrary to the official interpretation of Art. 5 of the OECD model, it will consider a permanent establishment as existing if the foreign investor has declared the opening of a so-called "branch office" in Italy, regardless of the fulfilment of the further requirements set forth by Art. 5 (i.e. the carrying out of entrepreneurial activity). The opening of an Italian branch office is a mere formality which requires nothing else than the resolution of the competent body of the foreign investor to open such branch. In such resolution the competent corporate body has to define the activities to be carried out by the branch in Italy, to appoint the legal representative of the branch and to indicate the latter's powers of attorney. Once such resolution is deposited with an Italian notary and filed in the competent companies' register, the branch office exists. In view of Italy's official comment to the OECD interpretation of the definition of a permanent establishment it appears, at first glance, safe to say that the Italian State should not make further inquiries as to whether a permanent establishment actually exists, as long as the foreign investor has recorded a branch office in the companies' register. It should, however, be kept in mind that Italy's comment to the official interpretation of the requirements for a permanent establishment was made with the intention to enlarge the Italian State's right for taxation of income produced by foreign entities in Italy. As to the taxation of real estate income, the loosening up of the requirements for a permanent establishment leads to the contrary effect: the taxable income of the foreign entity in Italy will be reduced as business related expenses become tax deductible and depreciation is allowed, while in the absence of a permanent establishment 85% of the gross income forms the base for income taxation in Italy.

2.2 IRES

Assuming the foreign investor disposes of a permanent establishment in Italy, the net income produced by such permanent establishment is subject to 27.5% IRES tax. The difference existing with the taxation of income generated without permanent establishment lies in the rules regarding the calculation of the taxable income.

2.2.1 Taxation of Income from the Letting of the Property

The taxable income for IRES purposes is given by the excess of revenues over deductible costs as resulting from the annual profit and loss account. With some exceptions specifically set forth by tax law, all costs related to the activities of the permanent establishment can be deducted from the income. This applies in particular to interest payments (for the limitations under the interest-barrier-rules see section III.5). ICI and IRAP taxes cannot be deducted as a cost for IRES purposes. Depreciation of the property is deductible to the extent allowed under the respective laws (see section III.2).

2.2.2 Taxation of Income from the Sale of the Property

A possibly realized profit from the sale of the real estate asset is, regardless of the time period which has elapsed since its acquisition, always subject to the 27.5% IRES tax. The profit to be considered as so-called capital gain income is the difference between the book value of the property relevant for tax purposes when the sale occurs (as reduced through depreciation) and the agreed purchase price.

Under certain conditions it is possible to spread the payment of the capital gain over a period of 5 years.

As far as the taxable basis is concerned, reference is made also to paragraph 1.1.2 above.

2.3 IRAP

The income produced by a permanent establishment is ordinarily subject to IRAP at 3.9%.

2.3.1 Taxation of Income from the Letting of the Property

The taxable income for IRAP purposes is given by the excess of revenues over deductible costs as resulting from the annual profit and loss account. However, different from the IRES tax, not all costs related to the activities of the permanent establishment can be deducted from the income. In particular, (i) interest payments, (ii) cost for employees, (iii) ICI and (iv) IRES are not considered deductible for IRAP purposes. Due, in particular, to the impossibility to deduct interest, there will usually remain taxable income for IRAP purposes. As mentioned above, IRAP tax is a not deductible cost for IRES tax purposes.

2.3.2 Taxation of Income from the Sale of the Property

A possible profit realized from the sale of the property is, as a rule, also subject to IRAP at 3.9%. The profit to be considered is again the difference between the book value of the property relevant for tax purposes at sale (as reduced through depreciation) and the agreed purchase price.

The sale of a real estate asset is always considered a taxable event for IRAP purposes[4], even if the sale of the property is not part of the investor's business activity.

As far as the taxable basis is concerned, reference is made to the above comments at paragraph 1.1.2.

If the real estate asset is part of a going concern (azienda) and the object of the sale is such going concern, the capital gain is not subject to IRAP tax.

2.4 Transfer of Profits to Parent Company

Once the profits of an Italian permanent establishment were taxed in Italy, they can be transferred to the foreign parent company as dividends without further taxation in Italy.

2.5 Tax Treaty

Under article 5 of the OECD Model Tax Convention, income generated through a

[4] As definitely clarified by the Ministerial Circular dated 26 May 2009, n. 27/E.

permanent establishment can be taxed by the State in which the permanent establishment is located. The Italian State has used such right in accordance with the rules illustrated under the preceding sections 2.1 through 2.3. Normally, the country in which the parent company is resident would not tax the income which was taxed in the country of the permanent establishment.

2.6 ICI

Real estate assets related to the Italian permanent establishment are subject to ICI tax. As mentioned before, ICI is not a deductible cost neither for IRAP nor for IRES purposes.

2.7 Taxation upon exit from the Italian investment

The sale of the real estate asset is subject to IRES and IRAP (see par. 2.2.2 and par. 2.3.2 above) at the level of the permanent establishment.

3. Indirect Investment through Corporate Vehicle

The foreign investor may decide to set up a corporate entity in order to subsequently purchase property in Italy. It may also be that the foreign investor is obliged to purchase the property through a share deal (i.e. buying the corporate vehicle which owns the property). In both cases, the income generated by the real estate asset will accrue at the level of the Italian company and a subsequent distribution of the profit to the shareholder will be necessary, unless the investor decides not to distribute but to reinvest the profits at the level of the corporate vehicle.

3.1 Taxation at the level of the Corporate Vehicle

If the corporate vehicle used for the investment is a corporation (i.e. "società di capitali"), the tax treatment of the income is the same as the one provided for the permanent establishment.

3.1.1 IRES

Both income from letting and income from the sale of the real estate asset are subject to IRES at 27.5%. The taxable income is equal to the revenues minus costs, as resulting from the annual profit and loss account to which specific add backs must be made according to the tax rules (see the above section 2.2).

Please note that an Italian corporate vehicle can opt for the application of the tax transparency regime. In such case, the income generated by the company is not subject to IRES at the level of the company, but is taxed at the level of the shareholder, even if not distributed as dividends. The option for the tax transparency can be made also if the shareholder is a foreign resident, to the extent that no withholding tax would have to be applied on dividends paid by the Italian company to such foreign shareholder.

3.1.2 IRAP

Both income from letting and income from sale of the real estate asset are subject to the 3.9% IRAP tax at the level of the company.

3.1.3 ICI

The corporate vehicle has to pay the ICI tax with reference to real estate asset owned by it as in any other alternative investment structure.

3.2 Distribution of Dividends to the Shareholder – Withholding Tax on Dividend Distributions

Once the corporate vehicle has paid the due taxes on letting income, and possibly the capital gain on the sale of the real estate asset, in order to make the profits from the investment available to the investor, the corporate vehicle has to distribute them to the shareholder. If the shareholder is tax resident in Italy, such distribution of dividends may occur without the application of any withholding tax. The tax residence in Italy is given in case the shareholder has its registered office in Italy (i.e. is an Italian entity) or is a foreign entity with a permanent establishment in Italy. In this latter case, the distribution is not subject to any withholding tax only if the participation is actually held through such permanent establishment.

Should the participation in the corporate vehicle be held by an entity resident for tax purposes in an EU Member State or in a country adhering to the European Economic Area included in the White List[5], a withholding tax levied at the rate of 1.375% must be applied by the corporate vehicle at the moment of the distribution of dividends (article 27 Presidential Decree n. 600 of September 29, 1973). Such withholding tax can be reduced to nil under (i) the application of EU Parent Subsidiary Directive if the relevant requirements are met or (ii) the applicable Double Tax Treaty provides for no withholding tax.

Otherwise, dividends paid to non resident entities are subject to a withholding tax equal to 27%, unless a Double Tax Treaty can apply. In this latter case, the withholding tax can be reduced in a range between 15% and 10% depending on the percentage of the participation in the vehicle.

Should a withholding tax be applied on the basis of a Double Tax Treaty, such withholding tax is typically considered a tax credit in the country of residence of the shareholder.

3.3 Taxation at the level of the Shareholder

Should a tax resident shareholder (including a permanent establishment of a foreign entity) receive dividends, such dividends are subject to taxation at the level of such shareholder. In fact, 5% of the distributed dividends are subject to the 27.5% IRES tax, thus giving rise to a second taxation on the 5% of the income on the basis of national tax law (article 89 Tax

[5]Reference is made to the White List currently in force provided by Ministerial Decree dated 04/09/1996. A new White List should be issued by a Decree of the Ministry of Finance, and will include those Countries allowing an exchange of information with Italy. Said new White List will be effective from the fiscal year following the year in which the new list will be officially published.

Act). As the taxation of the dividends occurs at the domestic level, no Treaty protection may be claimed by the resident shareholder and the distributing company.

3.4 Taxation upon exit from the Italian investment

If the shareholder is an IRES entity resident in Italy (including a permanent establishment of a non resident entity), the capital gain realized upon the sale of a participation is subject to IRES at the rate of 27.5%, unless the specific requirements provided for by the participation exemption rules are met. In this latter case, the mentioned rules provide the exemption from taxation of the capital gain for 95% of its amount.

If the Italian shareholder is an individual the capital gain is subject to:

- IRPEF at the marginal rate of the shareholder on 49.72% of the amount of the capital gain, in case the participation is qualified (i.e. if the shareholder holds more than 2% of the voting rights in the shareholders' meeting, in case of a listed company, and 20% in case of a non listed company; or more than 5% of the issued share capital in case of a listed company and 25% in case of a non listed company);
- Substitute tax levied at the rate of 12.5%, in the other cases.

If the shareholder is a non resident subject, the capital gain is subject to taxation at the rate of 27.5% on 49.72% of its amount only if the participation can be considered as qualified as above explained. In the case the participation is not qualified, the capital gain is exempt from taxation to the extent that the foreign subject is resident in a country which allows adequate exchange of information with Italy. Conversely, a substitute tax levied at the rate of 12.5% would be applied.

It should be underlined that art. 13 of the OECD Model, even if it does not provide specific rules for the sale of shares, includes a general provision relating to other properties stating that said capital gains are taxable only in the Country of residence of the alienator. Many of the Double Tax Treaty signed by Italy include this provision. Depending on the relevant Double Tax Treaty the taxation of the capital gain in Italy may thereforebe avoided.

4. Indirect Investment through foreign Partnership

Alternatively to what is mentioned in the preceding paragraph 3 with reference to an Italian corporate entity, the foreign investor may decide to set up a partnership entity in order to subsequently purchase property in Italy through this vehicle. It may also be that the foreign investor is obliged to purchase the property through a share deal (i.e. buying a partnership vehicle which owns the property).

4.1 Taxation at the level of the Partnership Vehicle

4.1.1 IRES

Italian partnerships are transparent entities for IRES purposes. Consequently, the income deriving from the investment is taxed at the level of the partner, even if not distributed as dividend.

As the partnership is not an autonomous IRES taxable entity, some IRES provisions are not applicable at the partnership level. For instance, interest expenses are not subject to the 30% threshold (see below section III, par. 5).

4.1.2 IRAP

Both income from the letting and income from the sale of the property are subject to IRAP at 3.9% at the level of the partnership. As specified by the Tax Authorities[6] every capital gain is excluded from the IRAP taxable basis of a partnership, unless the business activity of the company is the sale of real estate property. In this case, the capital gain would be included in the IRAP taxable basis.

4.1.3 ICI

At the level of the partnership vehicle the ICI tax is due as in any other alternative investment structure.

4.2 Taxation at the level of the Partners

As mentioned above, the annual income of the partnership is attributed to the partners, even if not distributed through dividends. The partnership income is, thus, taxed only at the level of the partners, and the level of taxation depends upon the nature and the residence of the partners.

4.2.1 Taxation at the level of the Italian Partners

Should the partner of the Italian partnership be an Italian individual not acting in the ordinary course of his business, the deemed distribution of the partnership's income would be considered as business income, and subject to personal income tax (i.e. IRPEF) levied at the marginal rate of the partner.

In case the partner is an Italian IRES entity, the deemed distribution of the partnership's income is subject to IRES at the level of the partner, and taxed at the rate of 27.5%.

4.2.2 Taxation at the level of the foreign Partners

If the partner is not resident and has no permanent establishment in Italy, the income is taxed for IRES purposes at the partner level at the rate of 27.5% as business income, if the partner is a company or an entity. Otherwise, if the foreign partner is an

[6] Reference is made to the White List currently in force provided by Ministerial Decree dated 04/09/1996. A new White List should be issued by a Decree of the Ministry of Finance, and will include those Countries allowing an exchange of information with Italy. Said new White List will be effective from the fiscal year following the year in which the new list will be officially published.

individual, the related income is taxed for IRPEF purposes at the marginal rate of the partner (according to the rates provided by art. 11 of the Tax Act).

4.3 Taxation upon completion of the Italian investment

The disposal of an Italian partnership interest in Italy is subject to the same tax treatment provided for the sale of a participation in an Italian corporate vehicle. Please see in this respect paragraph 3.4 above.

5. Comparison of Tax Burden as to Direct Taxes between the Various Investment Structures

If one compares the overall tax burden of the four available structures from the perspective of direct taxes it appears that the direct investment through a permanent establishment and the indirect investment through a corporate vehicle in case of applicability of the EU Parent-Subsidiary Directive or the indirect investment through a limited partnership are preferable over the direct investment without permanent establishment or the indirect investment through a corporate vehicle without applicability of the EU Parent-Subsidiary Directive. Even though the direct investment without permanent establishment appears at first glance the most beneficial structure because there is no IRAP tax and the IRES tax on capital gain may be avoided by selling the property not earlier than 5 years after its purchase, such alternative is usually not attractive due to the way of calculation of the taxable income for IRES tax purposes which assumes 85% of revenues as the basis for levying 27.5% IRES tax. Out of the two indirect investment structures, the partnership route is more attractive when looking at the taxation of running income as it avoids the additional taxation of dividends at the level of the partner. Furthermore, the partnership can deduct 100% of the interest expenses while corporate entities are subject to the 30% EBITDA threshold. Furthermore, capital gain on the disposal of real estate properties of a partnership are not relevant for IRAP purposes if the business activity of the company is not the sale of real estate properties.

Table 2: Comparison of direct taxes under various investment structures

	Direct investment without permanent establishment	**Direct investment with permanent establishment**	**Indirect investment through corporate vehicle held by tax resident shareholder**	**Indirect investment through corporate vehicle held by non tax resident shareholder**	**Indirect investment through partnership held by tax resident partner**	**Indirect investment through partnership held by non tax resident partner**
IRES/IRPEF	27.5% on 85% of revenues	27.5% on taxable profits	27.5% on taxable profits	27.5% on taxable profits	27.5% at level of partners if company; marginal rate IRPEF if individual	27.5% at level of partners if company; marginal rate IRPEF if individual
IRAP	Not applicable	3.9% on taxable profits	3.9% on taxable profits	3.9% on taxable profits	3.9% at partnership level	3.9% at partnership level
ICI	0.4% – 0.7% of cadastral value	0.4% – 0.7% of cadastral value	0.4% – 0.7% of cadastral value	0.4% – 0.7% of cadastral value	0.4% – 0.7% of cadastral value	0.4% – 0.7% of cadastral value
Withholding tax on distribution of dividends	Not applicable	Not applicable	Not applicable	From 27% to 0%	Not applicable	Not applicable
Taxation at the level of the shareholder / partner	Not applicable	Not applicable	5% of net dividends	Depends on foreign jurisdiction	27.5% at level of partners if company; marginal rate IRPEF if individual	27.5% at level of partners if company; marginal rate IRPEF if individual
Capital gain taxation in Italy (on the exit from the investment)	Not applicable if the property is sold after 5 years from the acquisition	27.5% on the capital gain	IRES entity: 27.5% IRES, unless participation exemption applies Individuals: 12.5% if the participation is not qualified; marginal rate on 49.72% of the amount of the capital gain	IRES entity: 27.5% IRES Individuals: 12.5% if the participation is not qualified unless exemption applies (depending on the country of residence); marginal rate on 49.72% of the amount of the capital gain	IRES entity: 27.5% IRES, unless participation exemption applies Individuals: 12.5% if the participation is not qualified marginal rate on 49.72% of the amount of the capital gain	IRES entity: 27.5% IRES Individuals: 12.5% if the participation is not qualified unless exemption applies (depending on the country of residence); marginal rate on 49.72% of the amount of the capital gain DTT may be applied

II. INDIRECT TAXES – TRANSACTIONAL TAXES

In the context of real estate investments the following indirect taxes may apply, depending upon the concrete structure of investment:

- VAT (imposta sul valore aggiunto, IVA),
- Registration Tax (imposta di registro),
- Mortgage Tax (imposta ipotecaria),
- Cadastral Tax (imposta catastale).

Not all taxes apply to all investment structures and when they do, the tax rate varies according to the parties involved and the asset which is object of the transfer.

1. Purchase of Assets

As illustrated in section A., the purchase of real estate property in the form of an asset deal can be made in two different forms: the straight forward purchase of the building as such, or the purchase of the building as part of an ongoing business. There are substantial differences between these two alternatives as regards the indirect taxes levied on the transaction.

1.1 Purchase of Real Estate

The purchase of office or logistic buildings – and in some rare cases of shopping centres and hotels – in the form of an asset deal is structured as a straight forward real estate acquisition in which the only object of the purchase is the building. In such case the following indirect taxes apply:

1.1.1 VAT

a) Transfer of non residential properties

The purchase of properties with non-residential use (so called *"fabbricati strumentali"*) is ordinarily VAT exempt, unless the sale falls within one of the following circumstances:

- the seller is a construction company that built or renovated, even through contracting out to third parties, the relevant property not more than four years prior to the sale;
- the purchaser is a VAT subject with a limited right to deduct VAT, when the percentage is less or equal to 25% (e.g. banks, insurance companies etc.);
- the purchaser is an entity which is not considered to be a VAT subject (entities excluded from the VAT regime as private individuals);
- the seller expressly opted for the taxable VAT regime in the public deed of sale.

In the purchase of non residential properties subject to VAT above listed, VAT is applied under two different and alternative mechanisms. In particular, in the case of the purchases under lett. a) and c) above the seller issues an invoice applying VAT which is recharged to the buyer. In the cases under lett. b) and d), instead, VAT is applied with the so called *reverse charge* mechanism provided by art. 17, (6), lett. a *bis*, DPR n. 633/1972 (see below section III, par. 4).

VAT is charged at the ordinary 20% rate, unless the real estate asset is purchased within 4 years from its completion from the company that carried out refurbishment works. In this case VAT is applied at the rate of 10%.

Generally the taxable basis for VAT purposes is the compensation agreed by the parties. Nevertheless the tax authorities[7] could re-compute the taxable basis of real estate assets both for direct and indirect tax purposes making reference to the "normal value", meaning the value that would be agreed between two independent parties in a fair market[8].

b) Transfer of residential properties

The transfer of residential properties (so called *"fabbricati residenziali"*) is ordinarily exempt from VAT, unless the seller is a construction company that built or renovated, even through third parties, the relevant property not more than four years prior to the sale.

In this latter case the purchase is subject to the application of VAT at the following rates:

- 4% in case the buyer uses the property as principal house (i.e. *"prima casa"*);
- 20% in the event the property is deemed as a luxury home as defined in the Ministerial Decree dated 2 August 1969;
- 10% in all other cases.

Regarding the taxable basis, please see comments above under case (a).

c) Transfer of non completed buildings

As clarified by the Circular Letter dated 1 March 2007, no. 12, sales and contributions of real estate assets, when occurring prior to the termination of their construction, are always subject to VAT. This is because the contributed properties, being "work in progress", are deemed to be goods still within the so-called "production cycle", and consequently they cannot be yet considered as "real estate" under the provisions of art. 10, par. 1, no. 8-bis and 8-ter of Presidential Decree no. 633/1972.

1.1.2 Registration Tax

a) Transfer of non residential properties

The sale of non residential properties is subject to Registration Tax at the fix amount of €168, both in the case the sale is subject to VAT and if it is VAT exempt. Only in the case the purchaser is not a VAT subject, the Registration Tax is levied at the rate of 7%.

b) Transfer of residential properties

If the sale is subject to VAT, Registration Tax is due in an amount of €168. Should the sale not be subject to VAT, the Registration

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[7] As provided by the European Law for 2008 already approved by the Italian Parliament but not yet entered in force as of June 30, 2009.

[8] Before the endorsement of the European Law for 2008, the tax authority was able to disregard the agreed price in case the consideration agreed by the parties was lower than the fair market value of the real estate assets sold, determined according to the data and calculation provided by the Real Estate Market Observatory (i.e. "Osservatorio del Mercato Immobiliare") managed by the Land Agency.

Tax is equal to 7% (or 3% in the event the property is to be used as *"prima casa"*).

c) Transfer of non completed buildings

As the sale is subject to VAT, Registration Tax is applied at the fix amount of €168.

1.1.3 Mortgage Tax

a) Transfer of non residential properties

Mortgage Tax is always levied at the rate of 3%. The rate will be reduced to 1.5% if the purchase involves Italian closed real estate funds or financial leasing companies.

b) Transfer of residential properties

If the sale if subject to VAT, Mortgage Tax is due in an amount of €168. Should the sale not be subject to VAT, the Mortgage Tax is equal to 2% of the value of the real estate. In the event the property is to be used as "prima casa" the Mortgage Tax is due at the fixed amount of €168.

c) Transfer of non completed buildings

The sale is subject to Italian mortgage tax at the fix amount of €168.

1.1.4 Cadastral Tax

a) Transfer of non residential properties

Cadastral Tax is always levied at the rate of 1%. It will be reduced to 0.5% if the purchase involves Italian closed real estate funds or financial leasing companies.

b) Transfer of residential properties

If the sale if subject to VAT, Cadastral Tax is due in an amount of € 168. Should the sale be VAT exempt, the Cadastral Tax is equal to 1% of the purchase price unless the property is used as "prima casa". In this latter case, the Cadastral Tax amounts to €168.

c) Transfer of non completed buildings

The sale is subject to Italian cadastral tax at the fix amount of €168.

1.2 Ongoing Business

Unless the parties agree on the sale/purchase of the corporate vehicle owning the property, the purchase of a shopping centre or of a hotel usually has to be structured as the purchase of a going concern (i.e. *"cessione di azienda"*), where the object of the purchase is not only the building but also the trade license and other tangible and intangible assets which make up the going concern. The purchase of a going concern is subject to the following indirect taxes:

1.2.1 VAT

The operation is not subject to VAT.

1.2.2 Register Tax

The purchase price is subject to Registration Tax in the following amounts:

- real estate: 7% (or 8% for unbuilt land) of the net value of the real estate asset,
- other assets: 3% of their respective net values.

In order to calculate the net value of the single assets pertaining to the ongoing business the parties have to draw up financial statements in which all components of the going concern are listed and properly evaluated. Said financial statements must also indicate the debts included in the going concern to be transferred. Unless such debts are clearly related to single assets (e.g. a mortgage loan which has been entered into for the purposes of financing the construction or acquisition of real estate), they can be proportionally allocated to any of the assets, with the exception of the goodwill which is always gross of any liability. The Registration Tax is computed on the net value of each asset, equal to the difference between each asset's value and the debt value proportionally allocated to it.

The Registration Tax (as well as the Mortgage and Cadastral Taxes dealt with below) are non-recoverable costs and increase the acquisition costs.

1.2.3 Mortgage Tax

The value of the real estate included in the going concern is also subject to a 2% Mortgage Tax.

1.2.4 Cadaster Tax

Finally, the value of the real estate which is part of the going concern is subject to a 1% Cadaster Tax.

2. Purchase of Shares

Should the parties decide to structure the investment as a share deal and therefore not to transfer the title to the real estate asset but to acquire the shares of the corporate vehicle owning the real estate, the operation is not subject to VAT nor to Mortgage or Cadastral Tax and Registration Tax is due at the fix amount of €168.

3. Purchase of Interests

As provided for the purchase of shares, the acquisition of an interest in an Italian partnership owning the going concern is not subject to VAT nor to Mortgage or Cadastral Tax and Registration Tax is due at the fix amount of €168.

4. Comparison of Tax Burden as to Indirect Taxes between the Various Investment Structures

4.1 Transfer of residential properties

A comparison of the available alternatives from the perspective of the indirect taxes shows that the best choice is again the share/interest deal, subject only to Registration Tax at the fix amount of €168. The asset deal is a beneficial structure when the property purchase is subject to VAT or it relates to real estate properties to be used as *"prima casa"*. The VAT paid is only a financial cost (depending on the expected time for recovering the VAT paid) and the Registration, Mortgage and Cadastral Taxes are not significant (€504). If, instead, the asset purchase is VAT exempt, the Registration tax is due on a proportional basis (3% or 7%).

4.2 Transfer of non residential properties

Due to the recent amendments of the indirect tax regime for real estate transfers, the application of transactional taxes depends on variables concerning the seller and the purchaser (i.e. type of activity carried out by the seller, timing of the sale with respect to the completion of the works, etc.), and, as a consequence, the comparison of the various investment structures is influenced by the aforementioned elements. In this respect three different scenarios may be summarized for the case of transfer of non residential property.

4.2.1 Purchase from Construction / Refurbishment Company within 4 years from Completion

In the event the seller is a construction or refurbishment company that sells the real estate asset within 4 years from the completion of the works and the purchaser is either a legal entity or an individual purchasing the asset as part of his/her business activity, the following taxation would be applicable:

	Asset deal real estate	**Asset deal going concern**	**Share deal - corporate vehicle**	**Share deal - partnership vehicle**
VAT	20% (10% for refurbishment works)	Not applicable	Not applicable	Not applicable
Registration Tax	€ 168	7% (or 8%) on net value of the real estate, 3% on net value of other assets	Not applicable	Not applicable
Mortgage Tax	3%	2% on gross value of the real estate	Not applicable	Not applicable
Cadastral Tax	1%	1% on gross value of the real estate	Not applicable	Not applicable

4.2.2 Purchase from Company other than Construction / Refurbishment Company or from Construction/Refurbishment Company which sells later than 4 years from Completion - other case of VAT application

In the event the seller is not a construction/ refurbishment company or is a construction/ refurbishment company which sells the real estate asset later than 4 years from the completion of the works and the purchaser is (i) a VAT subject with a right to reclaim VAT limited to 25% or lower or (ii) an entity which is not a VAT subject or (iii) any other purchaser if the seller opts for the VAT regime, the following taxation would be applied:

	Asset deal real estate	**Asset deal going concern**	**Share deal - corporate vehicle**	**Share deal - partnership vehicle**
VAT	20% (10% for refurbishment works)	Not applicable	Not applicable	Not applicable
Registration Tax	€ 168	7% (or 8%) on net value of the real estate, 3% on net value of other assets	Not applicable	Not applicable
Mortgage Tax	3%	2% on gross value of the real estate	Not applicable	Not applicable
Cadastral Tax	1%	1% on gross value of the real estate	Not applicable	Not applicable

4.2.3 Sale by Company other than Construction / Refurbishment Company or by Construction/Refurbishment Company which sells later than 4 years from Completion - Purchase not subject to VAT

In the event (i) the seller is either an entity different from a construction or refurbishment company or a construction/ refurbishment companies selling the properties later than 4 years from the completion of the works and (ii) the seller does not opt for the VAT regime and (iii) the purchaser is a VAT entity with a right to reclaim VAT higher than 25%, the following taxation would be applied, regardless of the legal nature of the purchaser:

	Asset deal real estate	**Asset deal going concern**	**Share deal - corporate vehicle**	**Share deal - partnership vehicle**
VAT	Exemption	Not applicable	Not applicable	Not applicable
Registration Tax	€ 168	7% (or 8%) on net value of the real estate, 3% on net value of other assets	Not applicable	Not applicable
Mortgage Tax	3%	2% on gross value of the real estate	Not applicable	Not applicable
Cadastral Tax	1%	1% on gross value of the real estate	Not applicable	Not applicable

III. FURTHER TAX ASPECTS

In this last section certain specific aspects of real estate taxation shall be illustrated in more detail.

1. Terms for payment of taxes

1.1 IRES

The IRES tax return has to be filed within the last day of the 9th month following the month in which the company's financial year closed, i.e. ordinarily by September 30th for calendar year's end financial statements. The IRES annual tax is paid in two steps: an advance payment paid in two instalments and a settlement payment. In particular, the advance payment is computed on the basis of 100% of the tax as resulting from the previous year income tax return, net of tax credit and withholding taxes. The settlement payment is equal to the amount of tax as resulting from the income tax return, net of the advance payments already made. In case the financial statements are approved by the shareholders' meeting within the ordinary deadline (i.e. the end of the 4th month after the fiscal year end), the above mentioned payments (i.e. advance payments and settlement payment) are made within the following deadlines:

- within the 16th day of the 6th month after the closing of the financial year, the first instalment of the advance payment, equal to 40% of the previous year tax burden, and the settlement payment of the current year IRES;
- within the end of the 11th month after the closing of the financial year, the second instalment of the advance payment, equal to 60% of the previous year tax burden.

Within certain limits the above payments may be deferred to a subsequent date (in any case not later than one month after the provided deadlines). In this case interest at the rate of 0.4% are due on the deferred payments.

In the case the financial statement is approved by the shareholders' meeting within 6 months after the year end, the payments are made within the 16th day of the month following the one in which the financial statements have been approved.

In case of a permanent establishment, IRES payments shall be made within the same deadlines provided above. Considering that a permanent establishment does not approve official financial statements, the deadlines are computed with reference to the head office's financial year.

1.2 IRAP

IRAP is due within the same term of payment of IRES and with the same computation rules for advance and settlement payments.

1.3 ICI

The ICI tax return must be filed within the deadline set forth for the income tax return only for real estate assets which were subject to variations during the year, like for example in case of real estate transfers, or of creation of real rights on a real estate property.

Starting from 2007, the filing of the ICI return is no longer mandatory for taxpayers, unless the variations have an impact on the computation of ICI and these variations cannot be gathered from the cadastral data bank.

ICI tax is paid in two instalments, each equal to 50% of the overall annual amount due. Payments are made within 16th June and 16th December. If a property is acquired in the course of the year, ICI is due proportionally to the ownership period computed in entire months. In particular, if the real estate is acquired before the 14th day of the month, ICI must be paid by the purchaser for that month, whereas if the property is acquired after the 14th day, ICI will be paid by the seller for the entire month.

1.4 Indirect Taxes

Registration, Mortgage and Cadastral Taxes are paid simultaneously with the event which triggers them. Usually the notary provides for the payment and asks the parties for reimbursement.

The VAT tax return related to one calendar year must be filed within July 31st of the following year.

VAT payments are ordinarily made on a monthly basis. In the case annual revenues are lower than €309,874.14 (for service providers) or €516,456.90 (for all other activities), VAT payments may be made on a quarterly basis.

Italian VAT Law provides for an advance payment to be made within December 27th of each year. The amount of the advance payment is calculated according to different parameters depending upon the kind of activities carried out and the chosen payment method (ordinarily the advance payment is equal to 88% of the VAT debt of the last month/quarter of the previous year). The yearly settlement payment (if due) has to be made within March 16th of the following year.

Table 4: Due dates for tax declarations and tax payments

Tax	Return	Payment
IRES	9th month from end of financial year	– 40% first advance payment: 16th day of 6th month from end of financial year – 60% second advance payment: within 11 months from end of financial year – settlement payment: 16th day of 6th month from end of financial year
IRAP	9th month from end of financial year	– 40% first advance payment: 16th day of 6th month from end of financial year – 60% second advance payment: within 11 months from end of financial year – settlement payment: 16th day of 6th month from end of financial year
ICI	7th month from end of financial year (only one time, unless cadastral value of property changes)	– 50% by 16th June – 50% by 16th December
VAT	30th September	– monthly or quarterly – advance payment December 27th – settlement March 16th
Registration, Mortgage, Cadastral Taxes	At sale/purchase	At sale/purchase

2. Depreciation

The depreciation rate of real estate property is ordinarily equal to 3% per annum and must be applied on a linear basis. If the real estate asset is a building used for the so-called large distribution (i.e. "*grande distribuzione*"), the depreciation rate is increased to 6% per annum. Typically, shopping centres, out-lets and other building destined for sales activities on large surfaces are included in this latter category. No anticipated or accelerated depreciations are allowed. On the contrary, the tax payer is allowed to reduce the depreciation rates in case they do not reflect the effective utilization of the properties.

Land depreciation is not allowed neither for statutory nor for tax purposes. The Law Decree no. 223 of 4 July 2006 (the so called "Bersani Decree") expressly provided that the value of the land must be separated from the value of the total property, in order to correctly compute the depreciation only of the amount related to the buildings. A specific rule is introduced to calculate the land value according to which the value of the land is the higher between (i) the value recorded in the owner's accounting books prior to the entering into force of the provision at stake and (ii) 20% of the total value (increased to 30% for industrial buildings), unless the deed of purchase provided separate prices for lands and buildings. In this case, the value of the land must be in any case higher than 20% or 30% (depending on the nature of the building) of the value of the building.

3. Off-setting and Refund of VAT

If the investor purchases a property in the form of an asset deal (and the asset cannot be considered as a going concern), under specific circumstances the purchase price can be subject to 20% VAT (see above chapter III.). No question that such VAT may be recovered by the investor if the latter is registered in Italy as a VAT entity. However, the VAT refund procedure may be quite long and on the other side the investor's possibility to set-off input VAT with output VAT is typically limited. Moreover, VAT refund cannot be claimed on the amount referable to the not depreciable land value, computed as mentioned in the above par. 2. As a consequence, if the price of the land is not separately indicated in the deed of purchase, VAT could be claimed back only for the 80% (or 70% in case of industrial buildings) of the VAT paid. Nevertheless, the residual amount of VAT not refundable can be off set against output VAT or against other taxes, within the limit of € 516,456.90 per year.

VAT thus may becomes an issue: even if it is not an effective cost at the level of the investor, the delay in refunding the VAT credit may give rise to a financing cost which must be taken into consideration when calculating the return of the investment.

All the above being stated, the taxpayer has three ways to recover the VAT credit:

- off-setting it with output VAT (for example VAT on rental income),
- off-setting it with other taxes, within the limit of €516,456.90,
- filing a claim for refund.

In principle, all recovering methods, different from ordinary setting-off with output VAT, presuppose that the paid VAT has been included in the annual VAT return, and consequently it has become a "VAT credit".

3.1 Off-setting with Incoming VAT

The VAT credit may be used by the taxpayer to off-set the output VAT (i.e. the VAT collected on issued invoices starting from the first month/quarter following the acquisition date). The off-set can be made on a monthly or on a quarterly basis, upon the VAT payments. If the investor's income in Italy is limited to rental income, this off-setting method usually takes considerable time. However, from a tax law perspective, neither time limits nor limits on the amounts exist for this kind of off-setting procedure.

3.2 Off-setting with Other Taxes

The VAT credit may also be used to off-set other Italian taxes owed by the investor, such as IRES, IRAP or withholding taxes. From a practical point of view, the off-set is done through the payment form called "F24", when the other taxes become due. The off-set procedure with other taxes is limited to a maximum amount equal to €516,456.90 per year.

3.3 Refund of VAT

As far as the refund procedure is concerned, three different refund procedures are currently available:

- the ordinary annual refund, for an amount up to € 516,456.90,
- the ordinary annual refund, for an amount exceeding € 516,456.90, and
- the quarterly refund.

3.3.1 Ordinary Annual Refund up to € 516,456.90

The request for refund (made through the filing of the "VR Model") can be presented in the period between 1st February and October 31st of the year following the year in which the VAT credit arose. The VR Model shall be filed with the Tax Collector Office (i.e. "*concessionario della riscossione*") competent for the city where the taxpayer has its registered office. For non resident entities, the competent Tax Collector Office is located in Pescara. The maximum amount which may be asked for refund under this procedure per year is €516,456.90. Within 40 days from the filing of the request, generally the Tax Collector Office will ask the investor to grant a suitable bank guarantee to cover the amount requested, plus the interest due, up to 31 December of the fourth year following the one to which the repayment pertains (to cover the assessment period). Within further 20 days, the Tax Collector Office should transfer the amount requested for refund on the investor's bank account. Should this time limit not be respected, the investor is entitled to receive interest of 2.75%[9] p.a. on the requested amount. Based on current experience, reimbursement of VAT takes between 2 and 12 months.

[9] The interest rate will be reduced to 2% starting from 1 January 2010.

In order to calculate the maximum limit of €516,456.90 for this ordinary refund method, any VAT used to off-set other taxes (different from with VAT) must be taken into consideration.

3.3.2 Ordinary Annual Refund Exceeding € 516,456.90

The request for refund of an amount exceeding the above mentioned threshold of €516,456.90 has to be filed with the Tax Authority (i.e. "*Agenzia delle Entrate*"). The procedure for the request is identical to the one described above, except for the duration of the procedure: typically, the refund is granted after two to four years. After a 90 day period has elapsed from the filing of the VAT tax return, the investor is entitled to receive interests on the requested amount equal to 2.75[10]% p.a.. Before the refund is granted, the investor must present a bank or insurance guarantee over the amount requested for refund and with a duration of three years or, if lower, of the remaining tax assessment period.

3.3.3 Quarterly Refund

The quarterly refund procedure can be used to request the refund of VAT paid in the preceding quarter if certain conditions are met. In order to qualify for the quarterly refund method, for instance, the investor must have made in such quarter purchases of fixed (i.e. depreciable) assets for at least 2/3 of the total purchases of such quarter. This is typically the case when real estate property is bought. It should be noted that the quarterly refund cannot be asked for VAT paid in the last quarter of the calendar year. The request must be filed with the Tax Authority (i.e. "*Agenzia delle Entrate*") within the following dates:

- 30th April for the first quarter,
- 31st July for the second quarter,
- 31st October for the third quarter.

The payment of the requested refund must be made within 20 days of the second month following the end of the quarter to which the refund request relates. If payment does not occur on such date, interest at an annual rate of 2.75[11]% accrues. As in the case of the annual refund, the investor must present a bank or insurance guarantee over the amount requested for refund with a duration equal to the remaining assessment period, but in no case of more than three years. The quarterly refund procedure is not subject to the threshold of €516,456.90.

The total cost for the insurance/bank guarantee is usually between 0.8% and 1.5% of the amount requested for refund, including any possible interest.

[10]The interest rate will be reduced to 2% starting from 1 January 2010.

[11]The interest rate will be reduced to 2% starting from 1 January 2010.

Table 5: Methods for VAT recovery

Method	Timing	Limits	Duration	Bank guarantee
Offset with output VAT	From the 1st month/quarter after purchase	No	Immediately effective	No
Offset with other taxes	When other taxes become due (starting from 1st January of the following year)	Up to €516,456.90	Immediately effective	No
Ordinary annual refund from Tax Collector Office	February 1st to October 31st of year after purchase	Up to €516.456.90	2–12 months	Yes
Ordinary annual refund from Tax Agency	From February 1st of year after purchase	No	2–4 years	Yes
Quarterly refund	From the quarter after purchase	No	3–6 months	Yes

4. Reverse Charge Mechanism

Under the "*reverse charge*" mechanism, the tax fulfilments related to the VAT application, ordinarily due by the seller, are transferred to the purchaser if VAT registered.

The reverse charge mechanism has been introduced to avoid fraudulent behaviour that can lead to the VAT misapplication, in order to avoid that the seller would charge VAT without paying it, and the purchaser would correctly deduct the VAT. From a practical point of view, the seller will issue an invoice without charging VAT and the purchaser will integrate the invoice received by the seller charging VAT and registering such invoice in both VAT registers (i.e. sales register and purchases register).

The reverse charge mechanism is applicable to sales of non residential real estate properties if the seller expressly opted in the deed of sale for the VAT application. Furthermore, starting from 1 March 2008, it is applicable also to sales of non residential real estate properties carried out towards a VAT subject having a limited right to reclaim VAT.

5. Interest Barrier Rules

Significant changes have been introduced by the Financial Bill for 2008 with regard to the tax regime of interest expenses for industrial and commercial companies. In particular, the rules on thin capitalization (4:1 debt equity ratio) and equity pro-rata have been repealed and replaced by a new interest deductibility limitation. According to such new rule, any excess of interest expenses over interest income is deductible up to the threshold equal to 30% of "gross operating income" (EBITDA), calculated as the difference between (i) revenues and (ii) costs, excluding depreciation, amortization and financial leasing instalments, as resulting from the profit and loss accounts[12].

Any excess of interest expenses over the above threshold (i.e. 30% of EBITDA) may be carried forward in the following tax periods, provided that the net interest expenses accrued are lower than 30% of EBITDA, in each relevant year. Starting from 2010, if 30% of EBITDA of the relevant year exceeds the interest expenses, the exceeding portion may be carried forward to increase the relevant EBITDA of the following tax periods.

In case a company joins the domestic tax consolidation regime, any interest expenses exceeding 30% of EBITDA may be offset with the taxable income of another company within the fiscal unity, provided that the latter company fulfils the EBITDA threshold.

In case of indirect investment through a corporate vehicle, the aforementioned restrictions are applicable at the level of the Company. In case of indirect investment through a limited liability partnership, the interest expenses restrictions are not applicable. Therefore, the interest expenses can be deducted from the taxable basis of the partnership for 100% of their amount (provided the general "business related" requirement of any cost is met).

The Financial Bill for 2008 provided for an exemption pursuant to which the above mentioned limits on interest deductibility are not applicable on interest due on loan entered into for the acquisition or construction of a real estate property that is going to be leased, when the loan is secured by a mortgage on the same real estate property.. Please note that this rule could be repealed by the Commission already appointed by the Minister of Finance to review the rules of taxation of real estate income.

6. Participation Exemption

Pursuant to article 87 of the Tax Act, under certain conditions, 95% of the capital gain generated by the sale of participations in Italian companies is exempt from IRES, provided that the following specific requirements are met.

- the sold participation must have been booked as financial fixed assets (i.e. "*immobilizzazioni finanziarie*") in the first financial statement of the holding;
- the company whose participations are transferred must carry out an actual commercial activity;
- the holding company must not be resident in a Black Listed jurisdictions (so called "*tax havens*");
- the participations must be held uninterruptedly from the first day of the 12th month prior to the disposal (minimum holding period).

The participation exemption rules have little relevance for corporate transactions in the real estate sector, due to the requirement provided under the above lett b). Normally, companies holding real estate assets and whose business activity is the construction or trade activity are not considered to be carrying out "commercial activities", therefore the capital gain on share disposal would be entirely taxable. Real estate companies who are owning and actively managing shopping centres or other retail activities may instead qualify for the participation exemption.

7. Step-up from Book Value to Market Value in Case of Share Deal

In case of a share deal, the book value of the real estate asset is usually lower than the market value of the property. This is particularly the case in development projects: if the company which is up for sale is the vehicle used by the developer/vendor to carry out the development, the property is usually recorded in the books of the vehicle at construction cost. The developer's profit is not reflected in the book value of the real estate asset. This causes two disadvantages for the purchaser:

- the depreciation basis of the property in the vehicle is lower and as a consequence, the vehicle will pay more annual income taxes;
- there is a latent capital gain tax in the vehicle: should the vehicle sell the property, it will have to pay a higher income tax because it will be taxed on the difference between the (lower) book value and the purchase price.

The parties have to agree how to eliminate or at least reduce the negative effects of the lower book value of the property for the purchaser. From a purely mathematical perspective it is clear how this can be accomplished: as the latent capital gain tax is equal to 31.4% (IRES +IRAP) of the difference between book value of the property relevant for tax purposes and the agreed market price for the property, such amount could simply be deducted from the purchase price for the corporate vehicle. This would create a cost for the vendor equal to the tax burden he would have had in case of an asset deal.

Under Italian law in case of tax neutral transactions (contributions of going concerns, mergers or de-mergers), the related higher value of tangible (including real estate properties) and intangible assets can be stepped up for fiscal purposes.

In particular, an optional substitutive tax can be paid to align the tax values of real estate properties up to their higher book

[12]Please note that a specific rule is provided for the interest deductibility of financial entities (i.e. banks, insurance companies, financial companies, parent companies of banking and insurance groups). In particular, passive interest are deductible up to 96% of their total amount (97% for the first year of application, i.e. for the fiscal year following the one in course at December 31, 2007). The remaining 4% (3% for the first year) is definitely not deductible.

values resulting form the transaction. The substitute tax is applicable at different rates depending upon the step-up amounts:

- 12% (up to €5m)
- 14% (from €5m to €10m)
- 16% (above €10m)

The stepped up value is relevant starting from the same fiscal year in which the transaction and the step up took place. The tax benefits are recaptured if the stepped-up real estate properties are disposed within 4 fiscal years after the one in which the step-up is carried on. The substitute tax shall be paid in 3 annual instalments starting from the fiscal year following the one in which the transaction took place.

8. The Convenient Company tax regime and recent amendments impacting on real estate investments

The Financial Bill 2008 has significantly changed the tax regime relating to the so-called "convenient companies" or "dummy companies" (i.e. "*società di comodo*") ruled by Law no. 724 of 1994. The main purpose of the law regarding convenient companies was (and is) to prevent private individuals from using corporate vehicles to hold real estate only in order to benefit from the depreciation rules applicable to the assets and the deduction of VAT paid on the services acquired (e.g. maintenance services). The recent amendments made in 2007 have widened the definition of tax payers to whom the regime may be applied and, as a consequence, introduced potential additional tax burdens for real estate investments.

8.1 Corporate income taxes (IRES and IRAP) under the Convenient Company Tax regime

The process to ascertain if a company falls within the rules of the "*società di comodo*" regime is complex and cannot be illustrated in detail in this context. In summary, the tax payer must compute a figurative income - deriving from the application of certain rates to the tangible and intangible assets values as recorded in the yearly financial statement, and compare it with the effective income deriving from the business activity. In the event the figurative income is lower than the effective income, the tax payer must apply different rates to the same tangible and intangible assets in order to calculate a presumptive taxable basis on which the ordinary corporate income taxes (IRES and IRAP) are levied.

The mentioned rules are applicable to companies and partnerships incorporated under Italian law and to any Italian permanent establishment of a non resident company.

Some exceptions are foreseen for the following entities, to which the convenient company tax regime is not applicable:

- companies with more than 50 shareholders;
- listed companies and their directly or indirectly controlling or controlled companies;
- companies that in the previous two tax periods have had at least 10 employees;
- companies which have registered in their profit and loss account a "value of production" (i.e. revenues, variations in stocks, variations in works in progress, increase of fixed assets for work carried out by the undertaking for its own purposes and other income) which is higher than the total amount of assets registered in the balance sheet;
- companies which are consistent with the presumptions of profit making provided by the so called "Sector Studies";
- companies which demonstrate, within the context of a specific tax ruling procedure, that there existed objective reasons which made it impossible to generate an income exceeding the minimum thresholds;
- companies having any other objective reasons identified by the Director of the Tax Agency which avoid the applicability of the CCT regime.

8.2 VAT and the Convenient Company Tax regime

If a company falls under the convenient companies tax regime, this will trigger adverse consequences with regard also to the excess of input VAT. In particular, the excess of input VAT, resulting from the annual VAT return, cannot be (i) refunded or compensated with other tax payments due; or (ii) assigned to third parties. Furthermore, in case no relevant VAT transactions are carried out by the entity falling within the Convenient Company Tax regime for 3 consecutive fiscal years and for an amount higher than the minimum presumptive income, the excess of input VAT cannot be compensated and becomes a cost.

This consequence may have a relevant impact on the overall yield calculated on the investment as the excess of input VAT may turn out to be an additional cost of the investment due to the definitive loss of the right for the refund.

9. Tax Consolidation

A domestic tax consolidation regime is available in the case of a control relationship equal to, directly or indirectly, more than 50% of the capital and more than 50% of the entitlement to the profits (Art. 117 et seq. TUIR). The control relationship has to be in existence at least from the beginning of any financial year for which the controlling company and the controlled company make use of the option for tax consolidation. Only legal entities (not partnerships) are allowed to participate in the tax consolidation.

The top controlling entity must be an Italian resident, or a foreign entity (i) resident in a treaty country and (ii) with a permanent establishment in Italy in whose books the shareholding is recorded. The option will be irrevocable for 3 years and must be made jointly by the controlling company and the participating companies; if the control ceases within 3 years, consequences apply).

The consolidated taxable base is the algebraic sum of 100% of the taxable income/loss of each participating company, regardless of whether the participation actually amounts to 100%. The controlling company is responsible for computing and paying the tax and, jointly and severally, for penalties imposed for own violations of the participants. Each participating company is (i) jointly and severally liable with the controlling company for higher taxes and interest assessed as a consequence of a violation of the participant and (ii) directly liable for all penalties due in relation to their own share of consolidated taxable income. If the algebraic sum is negative, the controlling entity is entitled to carry the loss forward; tax losses suffered before the entry into the consolidation can be used only by the company that suffered the loss. Excess tax credits generated before the entry into the consolidation may be used alternatively by the company that generated them or by the controlling company.

From tax year 2008, certain benefits deriving from tax consolidation have been repealed. In particular:

- dividends paid by companies within the consolidation group are no longer fully exempt (i.e. 5% of their amount is included in the taxable income of the receiving company); and
- the transfer of capital assets between companies within the same group is no longer neutral for tax purposes.

However, with regard to the interest deduction, starting from tax year 2008, if a company joins a domestic consolidation, any interest expenses exceeding 30% of EBITDA limit may be offset against the taxable income of another company within the consolidation group, provided that the latter company has not reached 30% of EBITDA limit itself. The offset is available only with regard to the interest expenses accrued after the inclusion in the consolidation group. The same rules apply with respect to the carry-forward regime of excess interest.

For the purposes of the Italian consolidated tax return rules, a controlled foreign (i.e., non-Italian) corporation cannot be included in an Italian consolidated group, but, importantly, as a general rule the adjusted EBITDA of such controlled foreign corporation can be "virtually" included within the adjusted EBITDA of an Italian consolidated group, so long as the controlled foreign corporation's statutory financial statements are audited and conditions set forth for Italian fiscal unit are met.