



Proposed new Italian real estate VAT regime



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Introduction

Italy's value added tax (VAT) regime for real estate is amended in a new law decree.

Decree 223/2006 came into force on 4 July 2006. As a law decree it will no longer remain in force, with retroactive effect, unless converted into law within 60 days of that date.

This guide provides some very preliminary comments on the following aspects of Decree 223/2006:

- the VAT and transfer tax regime for the leasing and transfer of certain real estate properties;
- the recoverability of existing and future VAT credits; and
- the impact of the new rules on Italian real estate funds.

The guide considers only transactions carried out by businesses registered for VAT purposes in Italy. It does not provide an exhaustive analysis of the implications of Decree 223/2006 but rather a preliminary overview of the aspects highlighted above. Given the novelty of the new rules and the absence of related guidelines from the tax authorities, it reflects only our interpretation of the new provisions and we cannot exclude the possibility that a different view could be taken by the tax authorities.

VAT regime for the leasing and transfer of real estate

The regime before 4 July 2006 (the old regime) for the sale of real estate

Articles 10(1)(8-*bis*) of the presidential decree of 22 October 1972, no. 633 (Decree 633/1972) provided the following.

- The sale of commercial buildings¹ was subject to VAT at the standard 20 per cent rate, provided that the seller was entitled to recover the VAT, if any, levied on the purchase of the same buildings (the Input VAT)². In such a case registration tax, cadastral tax and mortgage tax were due on the sale at the fixed rate of €168 each.
- The sale of residential buildings³ was generally VAT exempt (with the exception considered in the third bullet below) and subject to registration tax (generally levied at a rate of 7 per cent on the sale price) and to mortgage tax and cadastral tax (generally levied at a rate of 2 per cent and 1 per cent, respectively, on the sale price).
- The sale of residential buildings was subject to VAT (at a rate of 10 per cent or 20 per cent⁴ depending on the nature of the building and of the purchaser)⁵, when executed by one of the following entities: (i) the developer of the building; (ii) the entity that carried out the restoration activities provided for by article 31, paragraph 1, letters c), d) and e), of the law of 5 August 1978, no. 457 (law 457/1978); or (iii) the entity trading in such buildings on a prevailing or exclusive basis. In such circumstances, registration tax, cadastral tax and mortgage tax were due on the sale at the fixed rate of €168 each.

According to an *a contrariis* reading of article 2(3)(c) and 10(1)(8) of Decree 633/1972, the sale of pieces of land eligible for building permits (*terreni suscettibili di utilizzazione edificatoria a norma delle vigenti disposizioni*) was subject to VAT at the standard 20 per cent rate. In such a case registration tax, cadastral tax and mortgage tax were due on the sale at the fixed rate of €168 each.

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- ¹ Defined as commercial buildings of the cadastral class A10 and the cadastral categories from B to E.
 - ² If the business were not entitled to recover the Input VAT levied on the acquisition of the commercial building, the sale of the building would be VAT exempt under article 10(1)(27-*quinquies*) of Decree 633/1972.
 - ³ Defined as residential buildings of the cadastral classes from A1 to A11, with the exception of A10.
 - ⁴ A rate of 4 per cent applies when the purchaser is an individual entitled to the so-called *prima casa* benefits.
 - ⁵ Again, under the assumption that the seller was entitled to recover the Input VAT (if any) levied on the acquisition of the residential building (otherwise, the sale would be VAT exempt under article 10(1)(27-*quinquies*) of Decree 633/1972).

The old regime for the leasing of real estate

Article 10(1)(8) of Decree 633/1972 provided the following.

- Rental income from leases of commercial buildings was subject to VAT at the standard 20 per cent rate and, as such, to a fixed registration tax of €168⁶.
- Rental income from leases of residential buildings was generally VAT exempt (with the exception considered in the third bullet below), with registration tax levied at a rate of 2 per cent on the rental income due for the entire duration of the relevant contract, under article 5 of the tariff, part I, attached to the Italian presidential decree of 26 April 1986, no. 131 (Decree 131/1986).
- Rental income from leases of residential buildings was subject to VAT at a rate of 10 per cent rate when the lessor was the entity that developed the building with a view to selling it, according to the version of article 127-ter of schedule A, part III, attached to Decree 633/1972. In such circumstances, the fixed registration tax of €168 was due⁷.

The regime applicable on or after 4 July 2006 (the new regime) for the transfer of real estate

Article 35(5) of Decree 223/2006 has changed the provisions in article 10(1) (8-bis) of Decree 633/1972 referred to above. Under the new wording of article 10(1)(8-bis):

- the sale of commercial and residential buildings is generally VAT exempt (with the exception considered in the next bullet below) and subject to registration tax (generally levied at a rate of 7 per cent on the sale price) and to mortgage and cadastral tax (generally levied at rates of 2 per cent and 1 per cent, respectively, on the sale price); and
- the sale of commercial and residential buildings is subject to VAT at a rate of 10 per cent or 20 per cent⁸, depending on the nature of the building and of the purchaser⁹, when the seller is (i) the developer of the building, provided that the sale occurs within five years of completion of construction; or (ii) the entity that has carried out the restoration activities set out by article 31, paragraph 1, letters c), d) and e), of law 457/1978, provided that the sale occurs within five years of completion of

⁶ The registration tax is due where the agreement is executed by public deed (*atto pubblico/scrittura privata autenticata*).

⁷ The registration tax is due where the agreement is executed by public deed (*atto pubblico/scrittura privata autenticata*).

⁸ A rate of 4 per cent applies when the purchaser is an individual entitled to the so-called *prima casa* benefits.

⁹ Again, under the assumption that the seller was entitled to recover the Input VAT (if any) levied on the acquisition of the building (otherwise, the sale would be VAT exempt under article 10(1)(27-quinquies) of Decree 633/1972).

such restoration activities. In such circumstances, registration tax, cadastral tax and mortgage tax are due on the sale at the fixed rate of €168 each.

The sale of pieces of land eligible for building permits (*terreni suscettibili di utilizzazione edificatoria a norma delle vigenti disposizioni*) is still subject to VAT at the standard 20 per cent rate. Article 36(2) of Decree 223/2006 sets out a new broad concept of ‘pieces of land eligible for building permits’, defining them as those pieces of land that are eligible for building permits according to the general town plan approved by the relevant municipality, even absent (i) the approval of such plan by the region and (ii) the adoption of the relevant enacting measures (*utilizzabile a scopo edificatorio in base allo strumento urbanistico generale adottato dal comune, indipendentemente dall’approvazione delle regioni e dall’adozione di strumenti attuativi del medesimo*). In such a case registration tax, cadastral tax and mortgage tax apply on the sale at the fixed rate of €168 each.

The new regime for the leasing of real estate

Article 35(5) of Decree 223/2006 has changed the provisions contained in article 10(1)(8) of Decree 633/1972 referred to above. Under the new wording of article 10(1)(8) rental income from leases, including financial leases (*locazioni finanziarie*), of commercial and residential buildings is VAT exempt under all circumstances. Any invoice for rent issued on or after 4 July 2006 will be VAT exempt.

Under article 40 of Decree 131/1986, as amended by article 35(10) of Decree 223/2006, and article 5 of the tariff, part I, attached to Decree 131/1986:

- lease agreements, other than financial leases, for commercial and residential buildings are subject to registration tax, levied at a rate of 2 per cent on the rental income due for the entire duration of the lease agreement, with the possibility to pay the registration tax on an annual basis. Any lease agreements in place at present will have to be registered and the relevant registration tax paid within 30 days of 4 July 2006 (ie by 3 August 2006)¹⁰; and
- financial leases for real estate are not subject to the 2 per cent registration tax, even though they are VAT exempt. Only the fixed registration tax (€168) is due¹¹.

¹⁰ The new provisions do not affect lease agreements that were already VAT exempt (and, therefore subject to the 2 per cent registration tax) under the old rules. Such agreements had to be registered (with the payment of the 2 per cent registration tax) at the time of their execution.

¹¹ The registration tax is due where the agreement is executed by public deed (*atto pubblico/scrittura privata autenticata*).

Impact of the new regime on VAT credits

Future VAT credits

Based on the new regime, as of the enactment of Decree 223/2006 a purchase of real estate is subject to VAT only under the following circumstances:

- in case of purchase of a commercial or residential building from a seller that is either the developer of the building or the entity that carried out the restoration activities set out in law 457/1978 (under the condition that the purchase occurs within five years of completion of the construction or restoration activity); or
- in case of purchase of pieces of land eligible for building permits.

The Input VAT levied in the above circumstances (and the Input VAT paid on fees or other costs, such as maintenance or advisory fees) will no longer be recoverable (*detraibile*) by the purchaser under article 19(2) of Decree 633/1972 to the extent that the purchaser's main business activity is to lease and/or trade in buildings. The lease and sale of buildings would generate VAT exempt revenues (except for the case in which the purchaser carries out the construction or restoration activities as above and sells the building within five years) and the Input VAT would relate to assets that generate VAT exempt revenues with the consequence that it would not be recoverable.

The unrecoverable Input VAT cannot be claimed as a refund or used to set off any output VAT or other tax liabilities. It represents an additional transaction cost of the assets to which it relates and, where it relates to a building, can be amortised for corporate income tax and local income tax over the life of the building.

Existing VAT credits

The changes to the VAT regime for the sale and leasing of buildings, as per the provisions of Decree 223/2006, apply as from 4 July 2006. However, such amendments may have a retroactive effect that generates an Additional VAT Liability for taxpayers (the Additional VAT Liability).

This potential retroactive effect derives from the application of the adjustment procedure set forth by article 19-*bis*(2) of Decree 633/1972. This requires taxpayers to adjust their VAT balance (upwards or downwards, as applicable) in various circumstances. In particular, under article 19-*bis*(2)(3) of Decree 633/1972¹² this adjustment applies when there is a change that affects the recoverability of the Input VAT in the VAT regime of

¹² We assume that the business in question does not determine the recoverability of Input VAT according to article 19(5) of Decree 633/1972 (pro rata method); in this case it would probably not apply paragraph 3 of article 19-*bis*-2(3) but paragraph 4 of the same article with the consequence that an Additional VAT Liability (or less likely a VAT additional credit) would be determined according to different rules.

supplies made by a taxpayer (as in Decree 223/2006, which shifts all leases and most of the sales of buildings to the VAT exempt regime, affecting the recoverability of Input VAT).

The provisions of Decree 223/2006, combined with the adjustment procedure under article 19-*bis*(2)(3), generate an Additional VAT Liability for taxpayers in connection with any Input VAT levied (and recovered) on buildings purchased or built (even if through a third-party subcontractor) on or after 1 January 1998¹³ and still owned upon the enactment of Decree 223/2006¹⁴.

The Additional VAT Liability is determined as follows:

- the amount of the Input VAT levied and recovered previously on the relevant buildings purchase (the Recovered Amount) is recalculated on the basis of the new rules (as if the new rules applied at the time of the purchase);
- the negative difference (the Difference) is spread over a prescribed period of 10 years, which represents the ‘safeguard’ period over which the adjustment of the Input VAT may be considered; and
- one-tenth of the Difference is multiplied by the number of years that must elapse before the building is owned for 10 years – the result of this calculation is the Additional VAT Liability.

The following example may help to clarify how the Additional VAT Liability is determined. We assume that:

- company A purchased a commercial building in 2002 for a price of 100 plus 20 as Input VAT;
- company A considered 20 as the Recovered Amount in 2002, as the rental income and sale proceeds for such commercial buildings were subject to VAT;
- with the enactment of the new regime after 4 July 2006 the redetermined amount is zero, as the rental income and sales proceeds for such building are at present VAT exempt – the Difference is 20; and
- one-tenth of the Difference is equal to 2. As the building has been owned for 4.5 years, 5.5 years must elapse before the full period of 10 years is complete – Additional VAT Liability will be 2 x 5.5, which gives 11.

¹³ The date of 1 January 1998 derives from the fact that the rule in article 19-*bis*(2) was originally enacted as from 1 January 1998 by Decree 313/1997.

¹⁴ The adjustment procedure under article 19-*bis*(2)(3) applies also to any Input VAT on: (i) goods purchased and still owned upon the enactment of Decree 223/2006; and (ii) services purchased and still not used upon the enactment of Decree 223/2006.

The Additional VAT Liability does not affect the availability of any VAT credits (Existing VAT Credits) accrued before the enactment of Decree 223/2006 (including the VAT credits generated by the Input VAT levied on purchases of buildings captured by the adjustment procedure described above). This applies where refunds of such Existing VAT Credits have been requested or they have been carried forward. As explained below, any existing VAT credit carried forward (ie where a refund is not requested) can be used to offset the payment of the Additional VAT Liability (to the extent such credit is still available). On the other hand, where a refund claim is filed for an existing VAT credit, the occurrence of an Additional VAT Liability does not affect the right to collect the refund (nor does it accelerate the collection of it), although the taxpayer will have to settle the Additional VAT Liability in cash (under the conditions considered below).

According to article 36(8) of Decree 223/2006, the Additional VAT Liability arising from the adjustment procedure contained in article 19-*bis*(2) of Decree 633/1972, as outlined above, must be paid in three yearly instalments within the term of the payment of annual VAT advance payments (the first instalment falling due on 27 December 2006 and the other two roughly on the same day of 2007 and 2008)¹⁵. Such payment can be made (i) in cash; (ii) by offsetting non-VAT credits according to article 17 of the legislative decree of 9 July 1997, no. 241 (Decree 241/1997)¹⁶; or (iii) by offsetting any available VAT credits (including any Existing VAT Credits not requested in refund and not otherwise already used). Failure to pay such Additional VAT Liability incurs a 30 per cent penalty¹⁷.

It must be noted that under article 19-*bis*(2)(7) of Decree 633/1972, where depreciable assets (such as commercial buildings) are transferred between businesses in reorganisations such as mergers, de-mergers, sales or contributions of going concerns, the recipient inherits from the transferor the obligation to adjust its VAT balance as set out above for the acquired assets. In particular, in the case of a contribution of a going concern including buildings, the 10 years' safeguard period starts with the recipient on the date on which the building is acquired by the transferor.

¹⁵ According to certain tax commentators the adjustment of the VAT balance by way of the Additional VAT Liability, determined as a lump sum, although payable in three yearly installments, may be considered in conflict with previous decisions of the European Court of Justice.

¹⁶ Within a ceiling of €516,000 concurrent with other amounts offset under article 17 of Decree 241/1997 and any tax refunds requested to be processed directly by the tax collecting agent (*Concessionario*).

¹⁷ With reference to the example illustrated above. The Additional VAT Liability of 11 shall be paid in three equal instalments of roughly 3.6 each. The payment can be made by offsetting any existing VAT credit generated by the Recovered Amount of 30 to the extent that such credit has not been requested in refund or otherwise used.

Real estate funds

The sale and lease of real estate properties by an Italian real estate fund and the recoverability of VAT credits available to the fund are subject to the rules outlined in the two relevant sections above.

The rules governing the contribution of multiple, primarily leased properties (the contribution) to the fund are still governed by article 8(1-*bis*) of the law decree of 25 September 2001 no. 351 (Decree 351/2001).

However, as article 8(1-*bis*) of Decree 351/2001 stipulates that the contribution is qualified for VAT purposes as a contribution of a going concern, there is a risk that the rule of article 19-*bis*(2)(7), which applies, *inter alia*, to the contribution of a going concern, would also apply to the fund. Based on the above, the fund would inherit from the transferor the obligation to adjust its VAT balance in relation to the contributed properties as described in the section 'Existing VAT credits' above, including the obligation to pay the Additional VAT Liability, if any.

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