Corporate Buildings

in the Italian Tax Law

Analysis of the real estate fiscal categories and impact of this classification on business' income formation

1 The real estate fiscal categories

For tax purposes, companies' real estate property are divided into:

- instrumental properties, by nature or destination;
- properties whose production or exchange is the core business of the company (real estate goods/inventories);
- estate assets, namely those that do not fall into the above categories since acquired by companies as an investment.

Art. 43, co. 2, TUIR (Italian Income Tax General Law) considers instrumental

- Buildings used exclusively by the owner for the exercise of the art or profession or commercial enterprise (real estate instrumental by destination);
- Buildings relating to commercial enterprises which due to their nature are not susceptible to a different use, without radical changes, even if leased or loaned (real estate instrumental by nature).

Instrumental buildings are those belonging to "B" category (property units for use in collective housing), C (property units for ordinary commercial activities and other), D (special purpose properties), E (particular use buildings) and A/10 (offices and private practices) under the condition that the latter classification appears in their building's permit.

These buildings maintain the instrumentality requirement even if they granted to third parties for loan or lease.

Instrumental buildings, however, are those which, regardless of their classification in the Land Register, are used exclusively by the entrepreneur as assets for the business activity.

The exclusive use for business purposes is crucial, if the building is leased or used in promiscuous mode it can no longer be regarded as instrumental.

In this category are also included residential buildings that are used as offices by companies owner.

Instrumental buildings by nature or by destination

Tax Agency Circular 57/2001 (§ 1.2)

It is believed that the above mentioned building should be included in the category of instrumental buildings by destination. This because the use of a building already instrumental by nature as head office of the owner (company) causes a further specification of its status as asset and a different utility for the enterprise's purpose.

Furthermore, due to the combined provisions of Article 43, paragraph 2, last sentence, TUIR and Article 95, paragraph 2, second and third period, TUIR, buildings granted in use to employees who have transferred for business their residence in the same municipality where they work are considered instrumental. In this case, the instrumental nature of the building is recognized, provisionally, for the tax period in which the transfer occurred and for the next two periods.

The transitional period

Tax Agency Resolution 214/2002

The rule does not provide for a minimum staying period and therefore, if by the expiration of three years period the employee leaves the rented building unit, from that moment on it can no longer be considered instrumental.

Buildings as goods

Are those whose production or trade is directed the company's activities; the purpose of typical activity of the company must be estate transactions or construction and subsequent sale of those buildings.

Buildings as assets

The real estate assets, finally, are those buildings that can not be traced to the other two categories instrumentals and goods (article 90, paragraph 1, TUIR).

Those are lands and buildings, as a residual, by the company for investment and not to be used as capital assets for business purposes.

It should be stressed that this buildings' fiscal classification is relevant also with respect to pure property management companies for which, as clarified by the Tax Administration, **an house building although leased to a third party can't be considered instrumental, despite the company's objects.**

Buildings' fiscal categories

Instrumental buildings

- By nature: buildings belonging to A/10, B, C, D and E categories;
- By destination: buildings that, regardless of classification, are used exclusively by the entrepreneur as assets for the business;
- Pro-tempore: buildings granted in use to employees who have transferred their residence for business in the municipality in which they work. The building's nature is recognized as instrumental for the tax period in which the transfer occurred and for the following two.

Real estate goods

Buildings whose production or trade is directed the company's business;

Buildings that do not fall into the above categories since acquired by companies as an investment.

2. The identification of buildings related to enterprises

Article 65, TUIR defines the following cases for company's relating assets:

- Sole entrepreneur;
- Commercial partnerships;
- Companies in facts.

2.1. The building of the sole entrepreneur

For sole entrepreneurs, are considered related to the enterprise:

- Buildings whose production or exchange is the core business (so-called "goods-buildings"), and their sales is regarded as producing revenues under Article 85,paragraph 1, letter a) TUIR;
- Instrumental buildings (by nature and destination) and property assets, under condition of being included in the inventory required by Article 2217, Italian Civil Code, or, in case of simplified ledger for individuals, in the Register of depreciable assets (or in the manner provided for in article 13, of the Presidential Decree 435/2001 and article 2, paragraph 1, of Presidential Decree 695 / 1996).

Buildings instrumental by destination acquired before January 1st 1992 and for which no option has been exercised for their facilitated ouster, are considered related to the company even if not registered in the register of inventory or depreciable assets.

2.2. Corporate buildings

According to Article 65, paragraph 2, TUIR as irrefutable presumption all the buildings belonging to a general partnership and to a limited partnership shall be deemed related to the company, except in those cases foreseen for companies in fact.

This presumption is also applicable with regard to limited liability companies, given the provisions of Article 81, paragraph 1, TUIR, which provides that the total income of companies and commercial entities, despite of the source they come from, is always considered business' income.

Therefore, on the basis of the above provisions, all the buildings that fall within the legal and asset's sphere of the companies are considered related to the company.

With particular reference to companies in fact are considered related to the company:

- Buildings whose production or trade the company is directly focused;
- Building considered instrumental for the company's activity, including those enrolled in public records on behalf of the shareholders used only as assets for the company activity.

Buildings serving the enterprise activity

Sole entrepreneur:

- Buildings whose production or exchange is the core business of the entrepreneur (real estate goods);
- Instrumental Buildings (by nature and destination) and real estate assets, included in the inventory required under Article 2217, of the Italian Civil Code, or, for subjects with simplified ledger, in the register of depreciable assets;
- Instrumental Buildings by destination purchased before January 1st 1992 and for which no option has been exercised for the ouster easier, though not in the register of members in the inventory or depreciable assets

Limited Liability Companies and General Partnerships

- Buildings that fall within the legal-capital sphere of the company

Companies in facts

- Buildings whose production or exchange is the company's core business (real estate goods)
- Instrumental Buildings to the business pursuit, including those enrolled in public records on behalf of the shareholders used only as instruments for the corporate activity.

3. The impact of instrumental buildings on business's income

Although buildings held by companies under various capacities are, however, productive of enterprise income, their classification affects the way the positive and negative values, arising from them, bear to formation of the taxable income.

With respect to instrumental buildings, both by nature and destination, the taxable income arises from the difference between revenues and operating income (direct and indirect) related to the buildings, and the connected costs, which deductibility depends on the rules of any other specific company's asset.

From a statutory point of view, instrumental buildings are inscribed as tangible fixed assets in the balance sheet and they are systematically amortized over their remaining using life.

From a fiscal point of view, all the capital gains arising from their sale and any income from their lease are taxable, and, in accordance with the limitations and conditions provided by the tax law, depreciations (or the capital amount of leasing expenditures) and other charges, such as, for example, interest expenses and maintenance costs are deductable.

3.1 The fiscal cost of instrumental buildings

Instrumental buildings' fiscal management is primarily focused on the depreciation/amortization process to the tax cost recognized.

Article 110, TUIR establishes procedures for determining the cost of goods as part of the base business's income. In particular, the Article 110, letter a) first period and the letter b) paragraph 1,

provides that the relevant assets' tax cost is the one paid for their acquisition taken before the already deducted depreciation; you can also include in the cost directly attributable ancillary charges, that means those costs associated with the asset with consequential link, of cause and effect, excluding interests and overhead expense.

On this point, however, the same letter b), in the second and third period, provides that:

- for tangible and intangible fixed assets instrumental for corporate business interest payments are included in the cost, as cost's increase, inscribed in the balance sheet due to law's prescriptions;
- To the manufacturing cost can be added, using the same criteria, also costs other than those directly attributable to the product.

2.1.1 Maintenance costs

Among the possible building's capex should be further developed those relating to maintenance costs. The Italian General Accepted Accounting Standard Nr. 16 states that **maintenance costs can be capitalized if those costs increase the tangible productivity or asset's life.**

If they meet the above requirements costs that may therefore be capitalized are those costs directed to expansion, modernization or improvement of the structural elements of immobilization, including modifications and alterations carried out to increase their responsiveness to the purposes for which it was acquired.

In the event that such costs do not produce any of these effects they are to be considered routine maintenance and are therefore charged to the income statement (P&L).

The TUIR doesn't provide specific criteria for distinguishing between ordinary and extraordinary maintenance. The tax treatment of such costs is closely related to the accounting policy conduct adopted by the taxpayer.

There are, in fact, different rules in relation to the fact that expenses are charged to the income statement or to increase the cost of the tangible assets which they relate.

The latter are not subject to the rules contained in Article 102, paragraph 6, of the TUIR (to which reference should be made in case of maintenance costs charged to the income statement) and their deduction from income is connected, due to the capitalization effect, to assets' depreciation related to the costs.

3.2 When the instrumental building leaves the company

Under the general provisions of Article 86, paragraph 1, of the TUIR, capital gains on corporate buildings, different from those specified in paragraph 1, Article 85 (real estate goods), combine to form the income:

- if they are sold;
- if they are implemented through compensation, even in the form of insurance for loss or damage;
- if the assets are allocated to shareholders or for purposes not connected with the company.

In such situation, therefore, instrumental buildings produce a taxable capital gain, determined as follows:

- in case of transfer by sale or compensation the capital gain is set by the difference between the price or compensation awarded, less any directly attributable ancillary charges and the not amortized cost;
- in case of allocation to shareholders or for other company's purposes, the capital gain is set by the difference between the market value of the property at the date of the assignment and the not amortized cost.

Those capital gains contribute to form the income in their total amount in the year they were realized.

However, if these are made with reference to buildings held for a three years exceeding period, they can contribute to the generation of income, as an option to the taxpayer, for the full amount in the same year they were made and the following ones but no later than the fourth.

The article 101, paragraph 1, of TUIR provides that if a capital loss occurs, instead of a capital gain, it shall be determined by the same criteria established for the determination of the gains.

However, the same capital loss will be deductible from income only if it comes from sale or compensation, even in the form of insurance, loss or damage.

Therefore the capital loss will be undeductible if it comes from building's allocation to shareholders or if the same is intended for purposes not connected with the company's activity.

Capital gains and capital losses

Capital gains tax:

- if they come from sales
- if they are implemented through compensation, even in the form of insurance for loss or damage
- if the assets are allocated to shareholders or for purposes not connected with the enterprise's activity.

Deductible losses:

- if effected by assignment for value
- if implemented through compensation, even in the form of insurance for loss or damage of goods

Tax Agency's Circular 11/2007, clarified that the sale of the land including the building generates just one capital gain (or loss) equal to the difference between the price paid and the fiscal cost (without depreciations) including the building. The rules in question, in fact, consider the need to separate the value of the land and that of the building in order to determine the part of the land pertaining to the building, that can be depreciated, and not connectible to the capital gain (or capital loss).

For the Regional Tax (IRAP), finally, the provisions in force predict that gains and losses relating to buildings not arising from transfer of a business (asset deal) contribute to the tax base, regardless of their classification in the P&L statement .

4. Buildings as goods

As already noted, a "building-goods" means properties whose production or trade is the core business of the compnay. In other words, these are properties sold by real estate companies, engaged for buying and selling buildings, or constructor / renovator companies for buildings' subsequent sale.

Unlike the case for instrumental buildings registered as fixed assets, real estate goods do not undergo any systematic depreciation procedure, since they will contribute to the income's formation according to the mechanism of costs, revenues and inventories.

More specifically, real estate goods bear to the corporate revenue through:

- acquisition's or construction's cost;
- inventories' variation;
- sales' revenues;
- revenues from temporary location.

In particular, the sale of real estate good generate significant income tax under Article 85, paragraph 1, letter a) of the TUIR.

Buildings not completed or transferred at the end of the year participate to income's formation as variation of inventories' final value.

With reference to real estate goods fiscal treatment further consideration are needed upon the their temporary rental.

4.1 Real estate goods leased

Constructors, Renovators and Real Estate Companies must carefully monitor those buildings that, waiting to be sold, are meanwhile leased.

Indeed, all the operators ask themselves whether it is correct to continue to classify these properties in the inventories or whether they must be placed as current assets and are therefore subject to the housing provisions of Article 90, of the TUIR. In this regard, the financial administration has provided interesting explanations.

Real estate goods temporary rental

Ministry of Finances Resolution, 12.07.1982, prot. 9 / 1730

Companies engaged in mixed activities related to property's management and construction and sale usually do a complex activity that does not allow a clear distinction between real estate that can be considered goods and properties held not for sale but for their profitability. Therefore, an analysis from time to time on individual cases has to be done for the purpose of identifying the category in which the single good has to be set.

Tax Agency Resolution 15/12/2004 No 152

The several years and ongoing duration of leasing contracts and the simultaneous absence of any sale deal to consider the lease as the main activity of the company and not a subsidiary one, typical of a property management company, although the formal classification of the business is as builder.

These facts show that the relevant factor in determining whether a leased building market can retain its status, is the leasing contract duration. In other words, the renting of the building does not change its destination (for sale), if the leasing contract is a temporary one.

However, is not easy to define the concept of "temporary rental".

In this regard, some assumptions have been made: the solar year time could be considered the limit beyond which the location changes from occasional/accidental activity to typical activity; another solution would be to consider a three-year horizon as a reference:Article.8, Law 504/1992 lays down in 3 years the upper limit for entitlement ICI reduction (Building's Local Tax) contemplated by Municipalities for the benefit of real estate company on unsold properties (assuming that the three years period is an appropriate time to proceed with the sale of the purchased or constructed building).

5. Real estate assets fiscal treatment

Real estate assets are those not instrumental buildings and those buildings not related company's production ore trade.

Therefore, **they are all the residential land and buildings purchased by companies as an investment and not to be used, or considered as assets involved in the company's enterprise**.

According to Article 90, paragraph 1, of the TUIR, those real estate assets/investments do not contribute to income's formation on the basis of related costs and revenues but on the basis of the amount determined under the **land's income** rules.

Regarding, however, the tax treatment of gains and losses resulting from their sale, the rules described in the section regarding instrumental buildings are applied, to which we refer.

5.1. Income's determination for real estate assets

The real estate assets located in Italy, owned by companies, bear to the taxable income in the amount determined in accordance with the provisions of Chapter II of Title I TUIR that are those specific for land's income.

Therefore, in general, the taxable income derived from such buildings is equal to **the greater between assigned Land's Registry income revalued by 5% and the rent income, reduced up to a maximum 15% of the documented maintenance costs**.

In this regard, note that under the effects of changes made by Article 7, paragraph 1, lett. a) of the Law Decree No 203/2005, for enterprises the flat-rate deduction of 15% on the leasing income has been changed to an **analytic deduction bound to a ceiling of 15% of the rent fee**.

With reference to the above mentioned "ordinary maintenance costs", those are only the documented, supported and effectively retained expenses mentioned in letter a) paragraph 1, of

Article 3, Presidential Law Decree No 380/2001, namely those construction measures related to repairing, renovation and replacement of buildings' parts and those required to integrate or maintain the efficiency of existing technological systems.

The following list is given an exemplification of the construction measures that are considered of ordinary maintenance, taken from the Ministry of Finance's Circular 24/02/1998 No 57 (§ 3.4).

Maintenance building interventions (CM 57/1998)

- Replace all or part of the floor and the finishing works and conservation
- Repair of facilities for ancillary services (plumbing, water disposal plant for the white and black)
- Coverings and painting of external perspective without modification of existing objects, ornaments, materials and colors
- Renovation and plaster interior painting
- Remaking external paving and covering mantles without changes to the materials
- Replacing of damaged tiles and other ancillary parts for water disposal, renewal of waterproofing
- Repairs of balconies and terraces and pavements
- Repair of fences
- Replacement of elements of technological systems

- Replacing window frames, doors and windows with shutters or blinds, without changing the type of fixture

However, the expenditure's amounts incurred on building projects not connected to the letter a) paragraph 1, Article 3, Presidential Law Decree No 380/2001, such as planned maintenance, restoration and rehabilitation (Tax Agency Circular 13/03/2006, No. 10), can't be considered for rent's reduction.

5.1.1 Undeductible costs

The main consequence of determining the real estate assets income under the terms of land's revenue is that the company is unable to deduct from business income most of the costs related to the same buildings.

Article 90, paragraph 2, of the TUIR, provides that costs and other negative components related to the above mentioned buildings are not allowed as deductions. In this regard, the Inland Revenue in its Circular 13/02/2006 No 6 (§ 7.5), has clarified that this provision is a special one and derogates from the general principle of the inherent negative income components. This rule has, in fact, an absolute prohibition on the deductibility of all the negative components for buildings, even including interest expense associated with them, both operational and funding.

However, that for property management companies is not so easy to distinguish the costs related to the property, which must be considered undeductible, from those who have no direct connection with the assets of the company and that, therefore, follow general principles of deductibility.

To this end, we can refer to the conclusions reached by the Association of Chartered Accountants in Milan with the rule of behavior No 156, which states that for costs other than repair and maintenance each type of expenditure must be checked in detail if any link can be made to characteristics set by Article 90, paragraph 2, of the TUIR.

In particular, the Milan's Chartered Accountants Association maintained that all corporate expenses are fully deductible for those companies, as there is no correlation between this category of expenditure and fixed assets; those expenses relate to the company structure and not to a particular activity or enterprise.

In particular, the standard of conduct states that these expenses include, for example:

- Accounts and bookkeeping costs;
- Financial Statement's drafting and deposit costs and other corporate compliance;
- Corporate and tax advice costs and completion of related formalities;
- Remuneration for the Auditors, if any;
- Board of Directors compensation charges, with the exception of the specific compensation for the building's management delegated to one of the directors.

As regards, however, to the personnel costs, the standard of conduct reaches the following conclusions:

- Personnel's costs providing care services or concierge, maintenance of buildings or dedicated to the administration and management of the buildings, as related to current profitability of the property, are not deductible;

- The cost of administrative personnel, the latter being not specifically related to the buildings, are fully deductible.

5.1.2. Regional Tax (IRAP) implications

With effect from tax year 2008, the share-capital (IRES) entities, sole proprietorships and partnerships obliged to maintain ordinary accounting, even if by option, determine the IRAP tax on the basis of financial statement's information, saved only by undeductibility rules laid by Law No 446/1997 (IRAP Decree).

From this arises a clear benefit for the property management companies, renting their assets, which can compute the IRAP payable according to the data of the financial statement, regardless of relevance increases set for IRPEF / IRES. Therefore, for those companies, the tax base will be calculated as the difference between the rents and costs (aggregate "A" less aggregate "B" of financial statement) with the exception of those that are undeductible on the basis of specific rules provided for the tax itself (personnel costs, interests, depreciations, etc.)

6. Domestic taxation for real estate properties owned in Italy by foreign entities

Article 152 paragraph 2 of Presidential Decree 917/86 (TUIR) provides that the income produced in Italy by non-residents entities without permanent establishment in our country are taxed according to the provisions for different categories of income (land, capital, other) as if it were individuals . Based on article 153 paragraph 2 of Income Taxes Law (Italian TUIR) the foreign company will be

taxed on the received rent according to the same criteria applied to individuals and, therefore, limited to 85% of its amount.

A statutory definition of permanent establishment has been introduced for the first time into our law system by Art. 162, paragraph 4 of Presidential Decree 917/86. In particular, it expressly provides that "a fixed place of business is not, however, considered a permanent establishment if:

a. The company uses the installment solely for the purpose of goods, belonging to the company, storage, display, delivery or merchandise,

b. the goods or merchandise belonging to the enterprise are stored solely for the purpose of storage, display or delivery;

c. the goods or merchandise belonging to the enterprise are stored solely for the purpose of being processed by another enterprise;

d. the installment is a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise.

The law's content

The rule does not expressly mention the case in which the property is rented, but the Ministerial Resolution of 13 December 1989 (No. 460196) clarified that in such a case, "The real estate structure does not seem to realize ... a permanent establishment, since it is an asset without a separate organization and a separate accounting system from the foreign parent company. It is therefore not possible to identify a chief task activity of the structure in Italy for the production of income, as it is in fact produced by a complex organization that operates outside the state. " The

Ministry, in fact, further explains that "for the existence of a permanent establishment there must exists the actual establishment of a national structure organizational and functional independent from the foreign company. The independence should be manifested both from a managerial and accounting point of view, and from a business perspective it should be an economic entity with operational management autonomy, being not sufficient that the installment nevertheless does some activities for the parent company. "

The taxation system:

The fact that the leased or rent property does not constitute a permanent establishment leads to a altogether singular taxation system. Thus, Article 152 paragraph 2 of Presidential Decree 917/86 provides that the income produced in Italy by non-residents without permanent establishment in our country are taxed according to the provisions set for different income's categories (land's , capital's, others', incomes) as if it were produced by an individual. Based on article 153 paragraph 2 of TUIR, the income produced in the State is the income specified in Article 23, which includes income from land. The foreign company, therefore, must fill out the Income Tax Return (Modello Unico) for non-commercial entities, and tax the rent according to the criteria set for natural persons, normally only 85 per cent of its amount.

Instructions to the Income Tax Return (Modello Unico):

The instructions to the RB framework of Income Tax Return of non-commercial entities provide on page 25 that "... This framework must be completed by non-resident companies of any type without a permanent establishment in Italy who hold buildings for property, usufruct or other real rights title

in the territory of the State which are or shall be enrolled in the Land Register with a related assigned income. "

In addition, as for individuals, the Tax Return's instructions state that " In case of usufruct or other real rights titles the holder of the "bare ownership" should not declare incomes for the building".

Conventions against double taxation

The rules contained in the conventions against double taxation do not provide in principle a different system of taxation from the one set by the internal rules. Article 6 of the OECD Convention Model provides for taxation's liability for the real estate's income both in the State of building's location , whether in the owner's State of residence.

Cassano d'Adda, Milan, November 2009.

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