

## **Italian Taxation of Collective Investment Vehicles and Treaty Benefits**

Mutual funds give investors a way to acquire diversified investment holdings and access to professional management with a relatively small investment.

The Italian tax treatment of domestic mutual funds is designed to provide portfolio investors with the same tax treatment they would be subject to if they owned directly the stocks and bonds that are held by the fund.

Under Italian law, when an Italian resident individual invests in portfolio stocks or bonds she is subject to tax at a flat rate of 12.5% on the dividends or interests received or the capital gains realized from the investment.

If the investment is carried out through a Italian mutual fund, the tax rate of 12.5% is charged upon the fund. The tax is computed on the increase of the net asset value of the fund at the end of the tax year. No tax applies to investors upon distribution of income from the fund or redemption of fund's shares.

If the investment is carried out through a foreign fund that is established and managed in accordance with the EU rules and regulations ("EU regulated fund"), the 12.5% tax rate applies to the Italian investor upon receipt of income from the fund or redemption of fund's shares.

If the investment is carried out through a foreign unregulated offshore fund, income from the fund is included in the investor's income tax return when received (through distribution or redemption of fund's shares) and subject to tax at the investor's marginal tax rate.

In case of investment in foreign stocks or bonds, usually the dividends, interest and gains from the investment are subject to withholding tax in the foreign country of source, but the foreign withholding tax rate is either reduced or eliminated under the tax treaty in effect between the foreign country and the investor's country of residence. The Italian investor is then subject to tax on the net amount received at the flat rate of 12.5% with no credit for the foreign withholding tax.<sup>1</sup>

The same treaty benefits should apply whenever an investment is held through a domestic or foreign fund. However, the application of treaty benefits in that case may be controversial whenever an investor, by carrying out the investment through a fund, is able to defer that tax on the income from the investment in her country of residence or change the character of the income and benefit from a reduced tax.

As a result, the application of the treaty benefits to mutual funds depends to a great extent on the way in which the fund and its investors are treated in country of organization of the fund or the investors' country of residence.

We provide below a brief overview of tax treatment of mutual funds under Italian law as a way to offer a background for a possible discussion of the issue from the perspective of Italian law.

### ***Italian mutual funds***

Italian mutual funds can be organized either as a contractual arrangement among investors who decide to aggregate their investments in a pool of assets to be managed by a separate managing company, or as a separate investment company which is a legal person under Italian company law.

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<sup>1</sup> Italian Unified Code of Income Taxes ("TUIR") Art.16 bis.

In either case, the fund needs to be registered and approved and is subject to special rules about the registration, offering and marketing of fund's shares and managements of fund's assets. Typically the fund can invest only in certain allowed financial investments (stock, bonds and other securities) that would generate financial income taxed at the preferential rate of 12.5% had they been held by the fund investors directly.

Italy operates a special tax regime for Italian investment funds, which provides that the funds are not subject to the regular income tax but they are subject to a substitute tax on the result accrued at the end of the fiscal year.

The tax regime of the fund is based on the accrual method instead of being based on the usual realization method. That means that the substitute tax charged on the funds it is not applied on the single gain or income realized through the management of the fund but on the overall result of the management accrued at the end of each tax period.

The substitute tax is charged at fixed rate of 12.5% on the net result accrued by the management of the fund at year end and it is paid by the management company. If there is not enough cash to pay the substitute tax, the managers of the funds are allowed to free part of the investment unless the investors give to the fund the money needed to pay the tax. The tax of 12,5% is due on February 28 of each year and it is calculated on the difference between the net asset value of the fund at the beginning of the year and the net asset value of the fund at the end of the year, such tax is levied on the net gain of the fund.<sup>2</sup>

If there is a loss in the result accrued from the fund, such loss can be used to offset future gain, i.e. carried forward, or it can be used to offset a positive result of other open-end funds managed by the same company.<sup>3</sup>

The tax treatment of distributions to investors in mutual funds treats differently resident investors and non-resident investors.

When the investor is an Italian individual, the proceeds derived from the investments in mutual funds are not included in the investor's income, therefore they are not reported in the annual tax return of the investor. Investors are exempt from taxation because the income is taxed at the fund's level.<sup>4</sup>

This taxation regime does not apply for the gain derived by the sale or transfer of interests in the fund exceeding the increase of the net asset value of the fund subject to tax upon the fund. Such gain is subject to tax at the rate of 12.5%. The tax is paid through a withholding from the Italian financial intermediary, usually the manager of the fund, at the time of the sale of the fund's shares.

In case of a distribution from a domestic Italian mutual fund to a non-resident investor, the law exempts the taxation of the distribution of the investor that is a resident of a country included in the "white list" of Italy. In such case, the investor will be entitled to a tax reimbursement for an amount equal to 15% of the net profits received from the fund,<sup>5</sup> capped by the amount of tax owed by the fund. The reimbursement eliminates the Italian tax of 12.5% charged on the mutual fund. The residents of country that are not in the Italian "white list" are not eligible for the refund.

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<sup>2</sup> Art. 9 of Law 77/1983

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> Art.9 of Legislative Decree 461/1997

In the latter case the non-resident investor will receive distribution from the funds net of the tax of 12.5% paid by the fund to the Italian Government.<sup>6</sup>

Italian law also provides special rules for domestic mutual funds just offered exclusively to non-residents. These funds are totally exempt from tax,<sup>7</sup> therefore the fund will not be taxed and the non-resident will not be taxed when he receives distributions from the fund.

### ***Foreign mutual funds***

Taxation of foreign mutual funds is different from the taxation of an Italian mutual fund in one important respect.

No tax is levied on the foreign mutual fund by the Italian Government, since Italy does not have jurisdiction on the foreign fund. However, the tax is levied upon the Italian investors in the fund upon receipt of the profits from the fund in the form of either a distribution from the fund or redemption of fund's shares.

The profits received by an Italian investor from a EU regulated fund are subject tax at the rate of 12.5%<sup>8</sup>. The tax is withheld by the Italian intermediary bank that receives the income on behalf of the investor or computed and paid separately by the investor upon filing of her annual income tax return.

Instead, the profits received from an unregulated off-shore fund are reported and taxed as ordinary income at the investor's marginal rate, with the top rate currently assessed at 43%.<sup>9</sup> Also in this case the tax is paid by the investor upon filing of her annual income tax return.

### ***Application of the treaty benefits to Italian mutual funds.***

The application of an income tax treaty to Italian mutual funds that pay dividends or interest presents several issues. The first issue is to determine whether a mutual fund can be considered a "person" under the treaty. Once determined that the fund qualifies as a "person" under the treaty, the application of the treaty benefits requires that the fund be treated as resident of Italy, which means that the fund be "liable to tax" in Italy as the beneficial owner of the income.

On 31 May 2010 the OECD Committee on Fiscal Affairs released a Report on "The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles". The Report contains proposed changes to the Commentary on the OECD Model Tax Convention to address the extent to which either collective investment vehicles ("CIVs") or their investors are entitled to treaty benefits on income received by the CIVs.

The report analyzes the technical questions of whether a CIV should be considered a "person", a "resident of a Contracting State" and the "beneficial owner" of the income it receives under treaties that, like the OECD Model Tax Convention, do not include a specific provision dealing with CIVs.

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<sup>6</sup> Art. 6 of Legislative Decree No.239/1996

<sup>7</sup> Art. 9 par. 1 of Legislative Decree No. 461/1997

<sup>8</sup> TUIR Art. 18

<sup>9</sup> Art.10-ter par. 5 of Law 77/1983.

The OECD in its report commented that if a common investment vehicle is not treated as a legal person under the tax law of the State in which it is formed but only as a pure joint ownership it could not be considered as person for Treaty purposes.

Once a CIV has been found to be a “person” for treaty purposes, the second question to answer is if the CIV is resident of a Contracting State. The OECD report states is that the determination of whether a CIV is resident of a contracting state depends on the tax treatment of such CIV in the Contracting State. If the Contracting State see the CIV as “opaque”, i.e. an entity interposed between the investors and the investments, such CIV will be considered resident of the Contracting State and liable to tax even if the specific income received by the CIV is exempt from taxation in the fund’s country of organization.

In order to be eligible to treaty benefic a CIV must also be the beneficial owner of the income received. The term “beneficial owner” is not defined in the Model Treaty, therefore the definition should be determined under the internal law of the country that imposes the tax. As clarified in the technical explanation of the OECD Model Treaty Convention the beneficial owner is the person to whom the dividend or the interest income is attributable for tax purposes under the law of the sourcing State.

The Report takes the view that a widely-held CIV should be treated as beneficial owner of the income it receives as long as the managers of the CIV have discretionary powers to manage the assets held by the CIV. The Report explains that the investors have no right to the underlying assets held by the CIV, therefore they can not be considered beneficial owners of the income.

Some CIV may qualify under the principles set under the OECD Report, for example Italian SICAV (“Italian investment companies with variable capital”), and might be eligible for treaty benefits.

However, other contractual forms of CIV might fail to qualify as a “person” under treaty or to meet the requirements for the application of treaty benefits. In this case the question is whether the treat benefits should apply to the individual investors in the fund.

With respect to existing treaties, the Report concludes that, if a CIV is not entitled to claim benefits in its own right, its investors should in principle be able to claim those benefits. The Report, however, highlights that administrative difficulties in many cases effectively prevent individual claims by investors. Accordingly it suggests that countries should adopt procedures to allow a CIV to make the claim on behalf of investors.

With respect to future treaties, the Report’s recommendation is to expand the Commentary on Article 1 of the Model Tax Convention in order to include a number of optional provisions for countries to consider in their future treaty negotiations. Inclusion of one or more of these provisions in bilateral treaties would provide certainty to CIVs, investors and intermediaries regarding the application of treaty benefits. The favored approach for such a provision would treat a CIV as a resident of a Contracting State and the beneficial owner of its income, at least to the extent that its investors would themselves be eligible for treaty benefits from the source country.

However different views were expressed on the issue of whether treaty-eligible residents of third countries should be taken into account in determining the extent to which the income of a CIV should be entitled to treaty benefits. For this reason the proposed Commentary, under the Report’s suggestions, should include alternative provisions that adopt different approaches with respect to the treatment of treaty-eligible residents of third countries.

The proposed Commentary should also include an alternative provision that would adopt a full look-through approach, under which the CIV would make claims on behalf of its investors rather than in its own name. The look-through approach would be appropriate in cases where the

investors, such as pension funds, would have been eligible for a lower, or zero, rate of withholding had they invested directly in the underlying securities.