Real Estate Focus Team

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TAX Treatment of REOCOs: some clarifications from the Italian Tax Authority

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Last week the Italian tax authority ("**ITA**") replied to a ruling request we submitted on behalf of a client, concerning the accounting and tax ramifications for ReoCos incorporated under the new Article 7.1 of the Securitisation Law (Law No. 130 of 30 April 1999, as amended in 2017)[1].

The ruling is expected to be published soon, but in the meantime, here is a summary of the matter and some **insights** on the possible implications for businesses involved in the securitisation market.

Background

ReoCos are real estate companies, set up by investors in Italian mortgage-backed non-performing receivables, in order to promote a more efficient management and sale of the relevant mortgaged assets.

The ReoCo Agreement

Under a traditional ReoCo structure:

- an Italian securitisation SPV (the "**SPV 130**") would acquire the mortgage-backed receivables and finance such acquisition through the issuance of securitisation notes (the "**Notes**");
- the investors in the securitisation would set up a real estate company (the "**ReoCo**");
- the ReoCo would take part in the auctions of selected mortgaged assets and, in case of successful bid, would: (i) pay the quota of purchase price to be distributed to persons other than the SPV 130, and (ii) for the remaining part, assume a corresponding amount of the original mortgage-backed debt vis-à-vis the SPV 130; and

[1] On 15 June 2017, parliament approved the Conversion Law of Decree No. 50 of 25 April 2017, which introduced significant changes to the legal framework for securitization transactions. The aim of the Conversion Law is to attract new investment and facilitate the disposal of distressed claims (*crediti deteriorati*) (including nonperforming, unlikely to pay, and forborne claims) and financial lease receivables (and their residual value component) by Italian banks and financial intermediaries.

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- the ReoCo would then: (i) manage and sell the mortgaged assets, and (ii) repay the assumed debt vis-a-vis the SPV 130, limited recourse on the net proceeds of such activities.

The new Article 7.1 of the Securitisation Law has provided that, in the context of securitisations of distressed receivables sold by banks and financial intermediaries registered under Article 106 of the Italian Banking Act: (a) ReoCos may be incorporated for the sole corporate purpose of assuming the task of purchasing, managing and selling, in the exclusive interest of the securitisation, real estate and other assets and rights that secure the securitised receivables, and (b) the proceeds of the ownership, management or sale of such assets and rights (due to the SPV) are considered as payments made by the assigned debtors and exclusively destined to cover securitisation costs and to make payments on the Notes.

Under such new provisions, a ReoCo scheme had been implemented, whereby:

- the ReoCo would purchase, manage, develop and dispose of selected mortgaged real estate assets, according to individual business plans agreed with the SPV 130 before their acquisition;
- the SPV 130 would:
    - allow the ReoCo to satisfy its obligation to pay the quota of purchase price to be distributed to the SPV 130, through the assumption of a corresponding amount of the original mortgage-backed debt;
    - provide the ReoCo with the necessary funds to complete the acquisition of the real estate assets and carry out the management, insurance, renovation and disposal of the real estate assets, in accordance with the relevant individual business plans; and
    - pay the ReoCo a fee for the services provided;
- the ReoCo would: (i) manage and sell the assets in accordance with the relevant business plans, and (ii) periodically transfer all net proceeds of such activities to the SPV 130; and
- the ReoCo would use the proceeds from its business to cover its general corporate expenses and any extraordinary expenses it incurs (i.e. those not covered by the business plan and not arising because of fraud or gross negligence by the ReoCo) to comply

with its corporate purpose and law.

The ITA's ruling

The ITA noted that Art. 3.2 of the Securitisation Law states that any assets and liabilities of an SPV 130 constitutes a **cover pool** (*patrimonio separato*) that is segregated, for all intents and purposes, from the rest of the business and from any other securitisation transactions carried out by the SPV 130.

Back in 2003, the ITA concluded that, based on Art. 3.2, any profits and losses from the cover pool legally owned by the SPV 130 are for the exclusive benefit or detriment of the holders of the Notes and that, therefore, they are not taxable or deductible in the hands of the SPV. In substance, any cash derived from the pool of receivables acquired by the SPV 130 flows through the SPV directly to the noteholders, without any direct tax leakage at the level of the SPV.

Since the new provisions on ReoCos do not expressly state that Art. 3.2 also applies to real estate owned by ReoCos, the ITA concluded that:

(a) assets purchased by the ReoCo do not constitute a cover pool, and, consequently

(b) ReoCo's profits and losses are subject to ordinary corporate taxes (IRES at 24% and IRAP at approx. 4%).

As to **VAT**, the ITA agreed with us that any sums advanced by the SPV 130 to the ReoCo to enable it to purchase, manage and dispose of real estate assets are not subject to VAT. The ITA also confirmed that this applies equally to all sums paid by the ReoCo to the SPV in performance of the ReoCo Agreement. Only the fees due by the SPV 130 to the ReoCo for its services are subject to VAT at ordinary rates.

Finally, the ITA confirmed that real estate sales and purchases by the ReoCo are subject to the same rules applicable to any Italian company, i.e., they are subject to indirect taxes at the ordinary rates (VAT, registration tax, cadastral and mortgage tax).

Comments

The ITA's position on VAT resolves many doubts raised by practitioners.

Indeed, the ReoCo Agreement could have been construed as an undisclosed agency mandate (*mandato senza rappresentanza*) to purchase and resell real estate that, under VAT rules, is treated as two transactions, each individually subject to VAT (to the extent applicable) i.e.: (a) in the case of purchases by a ReoCo from a third party, the ReoCo immediately resells the asset to the SPV 130; whereas (b) in the case of sales to a third party by a ReoCo, the ReoCo purchases the asset from the SPV 130 and immediately resells it to the third party. The ruling clarifies that this is not the case.

The ITA's position on the corporate tax regime for ReoCos **is very unsatisfactory**.

First, the ruling states that ReoCos are "ordinarily" subject to corporate taxes but does not clarify how their taxable base should be determined. In various parts, the ITA acknowledges that the law and the ReoCo Agreement explicitly oblige the ReoCo to transfer to the SPV 130 any net proceeds from the sale of real estate. Thus, any such payments should be considered deductible costs for the ReoCo, so its taxable base should include only the commissions received, net of any business costs incurred in providing its services. The ITA does not take any view on this in the ruling.

Second, the ITA's analysis ignores the fact that the new Article 7.1 of the Securitisation Law has expressly: (i) assimilated the net proceeds of the Reoco's activities to the payments received from the securitised debtors, and (ii) extended to them the principle (so-called "destination principle") that the same must be exclusively destined to cover securitisation costs and to make payments on the Notes.

In addition, the text of the revised Securitisation Law makes it clear that the new rules on ReoCos apply in addition to (not in substitution of) the general rules on securitisation transactions, including Art. 3(2).

The ruling neglected to address these two issues.

Concluding remarks

The market expects that the Securitization Law would be further amended, as there are several important issues that need to be addressed by Parliament.

In the meantime, Reocos Agreements should be **carefully drafted** in order to cope with the albeit unsatisfactory clarification from the ITA.

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