

AN OVERVIEW OF THE NEW ITALIAN CLOSED-END FUNDS

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New legislation was enacted in August 1993 which introduced in Italy closed-end funds ("Fondi Chiusi"). Other fund structures were already available but they were not suitable for investments in principally unquoted companies. As their name suggests, closed-end funds are funds which have a limited life. The requirements regarding their duration are considered below.

The new legislation appears to be capable of playing a very important role in view of the structure of the Italian capital market and the large number of unquoted companies in existence.

The following notes consider the main features of closed-end funds against the background of the Italian tax system.

The Legal Structure of the Fund

The Italian Fondi Chiusi legal structure possesses extensive similarities to the French Fonds Communs de Placement à Risque. The fund itself has no legal personality; it acts, therefore, through a management company to be set up according to specific rules to be authorised by the Bank of Italy.

The management company must in fact conform to certain requirements, namely:

- (a) its exclusive purpose must be the running of open and/or closed-end funds;
- (b) its legal structure must be the form of an Italian Società per Azioni (SpA), a limited liability company;

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- (c) its minimum capital, fully subscribed and paid up, must be:
 - 5 billion lira if it only manages closed-end funds
 - 7 billion lira if open and closed-end funds are managed;
- (d) its administrative offices must be located in Italy;
- (e) the largest part of the board of directors must have an extensive (at least three years') experience as directors of a bank, a financial or an insurance company.

The fund is set up by the management company and must comply with a Regulation which represents the agreement according to which the investors deliver their resources to the management company for the purposes of the fund.

The assets of each fund are distinct from those of the management company, of the participants in the management company, of the investors in the fund and in each other fund managed by the same management company. Consequently, creditors of the management company cannot make any claim against the fund and creditors of individuals holding units in the fund can only make claims in respect of the shares of the specific unit holder.

The investment policy which the management company is entitled to choose must conform to the following requirements:

- (a) at least 40% - but not more than 80% - of the fund must be invested in shares or convertible bonds issued by unquoted companies within three years of closing;
- (b) not more than 20% of its assets may be invested in Italian or foreign treasury bonds;
- (c) not more than 20% of its assets may be invested in bonds or shares issued by quoted companies.

So far as the investments in companies are concerned, the fund is prohibited from holding more than 5% of the equity of a quoted company or more than 30% of an unquoted company. Funds may, however, overcome those limits by owning also a majority participation in a portfolio company, in which case the shares must be held by at least three funds, managed by three distinct management companies, belonging to three different groups.

Both institutional and non-institutional investors can acquire units in a closed-end fund. For the purpose of the closed-end funds' legislation, pension funds, insurance companies, banks, duly authorised financial companies and management

companies of closed-end funds are considered institutional investors. Foreign institutional investors can be admitted if they are similar to those described above and when they are subject to a form of control regarding the "duration" of their activity (the meaning of this requirement is somewhat unclear).

The liability of investors is limited to the amount of capital they have individually subscribed in the fund.

The fund's life must have a duration not exceeding, originally, ten years. An extension of three years is available, subject to approval by the Bank of Italy. Within three years of the fund's closing the management company must apply to the CONSOB (the Italian financial market authority) for the fund's units to be listed on the main market of the Italian Stock Exchange or in another regulated stock exchange, unless all the fund's unit holders are institutional investors.

Taxation of the Fund

The fund itself is not subject to income taxes or VAT.

It is subject to a so-called substitutive annual duty based on its worth. The taxable base is determined according to the average of the semestral valuation of the fund's assets which the management company is obliged to disclose. The duty's rate is 0.25% which might be reduced to 0.10% when the fund's assets are invested, as to more than 50% in small to medium sized enterprises. A firm is classified as small or medium sized if it meets either of the following conditions:

- (i) if it is engaged in industrial activities, has a net asset value not exceeding 20 billion lira and has no more than 200 employees;
- (ii) if it is engaged in trading or services activities, has a net asset value not exceeding 7.5 billion lira and has no more than 75 employees.

Withholding taxes applied on interest and dividends paid to the fund cannot be recovered. The same is true for VAT paid by the fund. Nevertheless, although the fund is not subject to income taxes or VAT, it is not clear that it is not a taxpayer or a "person" for Italian tax purposes (and tax treaties as well). The exclusion from income taxes is in fact stated in parallel with the application of the substitutive duty, and the liability of dividends and interest to irrecoverable withholding taxes does not allow one to consider the fund as not a person at all. The system of taxation referred to the unit holders, extensively examined below, which differentiates the appropriate treatment according to the nature of the unit holder, appears an additional reason for backing the view of the fund as a person or taxpayer and, therefore, for denying its transparency.

The revenues deriving from the participation in the fund may assume different technical characteristics: they may derive from (i) an interim distribution of the profit made during the period of the fund's existence; from (ii) the first distribution of the same; a final distribution of the ultimate gains or losses deriving from (iii) the disposal of the units possessed. Notwithstanding their different nature, however, the sums deriving from the participation into the fund are considered "fund's proceeds" for Italian tax purposes: no matter, then, their source or the nature of the operation by the fund or by the unit's holder which generated them.

The fund's proceeds are subject to different treatment according to the investor's nature and this has to be divided in four categories:

- (a) private individuals (resident or non-resident)
- (b) non-profit-making organisations (resident or non-resident)
- (c) resident entrepreneurs
- (d) non-resident entrepreneurs
 - (i) Private individuals are fully exempt from income tax on all proceeds received from the fund. In view of the extended concept of "fund's proceeds", the exemption also relates to any possible gain on the disposal of the fund's units possessed by the private individual. The exemption is subject only to a condition as to the size of the individual's investment, which must be not greater than 2% of the fund.
 - (ii) The tax regime for non-profit-making organisations is just the same as for private individuals (i.e., there is a full exemption). Non-profit-making organisations may, however, be constituted by pension funds, which are considered institutional investors. In this case the maximum permitted investment size is greater. Full exemption is given in respect of investments not greater than 10 per cent of the fund.
 - (iii) Resident entrepreneurs are, on the other hand, fully taxable on every sort of the fund's proceeds (the inclusive income taxes rate being 52.2%). Taxation only arises, though, when distributions are actually received or a disposal of the fund's units is actually made. A 25% tax credit is available provided that both the following conditions are met:
 - (aa) a continuous interest in the fund has been maintained for more than three years before the fund's proceeds are received; and

- (bb) the stake in the fund has not exceeded 2% in the case of non-institutional investors or 10% in the case of institutional investors.

- (iv) The regime for non-resident entrepreneurs is determined in accordance with the existence of a business presence in Italy. Should a non-resident entrepreneur have a permanent establishment in Italy - owning the fund's units directly or indirectly - he or she is fully taxable just like a resident entrepreneur. However, should no permanent establishment exist, the fund's proceeds are not subject to any tax charge or withholding tax when sums are received and transferred abroad.

In relation to those non-residents who do not meet the requirements to be considered institutional investors, consideration has to be given to the limitations on investment size which must be complied with in order to benefit from the favourable tax regime. The limitation on the capital stake in companies may be regarded as a possible reduction of risk but it is also an additional element of rigidity having regard to the limited marketability of a minority shareholding.

Conclusion

In conclusion, the Fondi Chiusi structure appears certainly suitable for private individuals, either resident or not. It seems rather burdensome for other investors.