PRACTITIONERS' CORNER

Italian Supreme Court: No Gift Tax On Transfers of Property to a Trust

by Marco Rossi

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In this article, the author discusses Italy's Supreme Court ruling regarding the application of Italian gift tax on the transfer of property to a trust.

In Ruling No. 21614 of October 26, 2016, the Italian Supreme Court considered whether the Italian gift tax applies to the transfer of property to a trust.

The issue arises under the provisions of Law No. 262 of October 3, 2006, which reinstated the gift tax. Article 2, in paragraphs 47 and 49, while addressing the scope of the newly reinstated gift tax refers to "legal arrangements having the effect of creating constraints or limitation on the use, enjoyment and disposition of property."

One interpretation of the statute is that the language of article 2 of Law 262 clarifies, but does not extend, the scope of the gift tax, which continues to apply solely to a straightforward gift — namely, the transfer of property from a person, the grantor, to another person, the beneficiary, for no consideration, whereby the beneficiary obtains the immediate legal title as well as the beneficial enjoyment, use, and economic value of the transferred property (made with the intent to enrich the recipient of the property).

According to that interpretation, no gift tax applies at the time of the transfer of a property to a trust, when the ultimate beneficiary still does not acquire the direct legal ownership and full right of use, enjoyment, and disposition of the transferred property. Instead, the gift tax will apply at the time of the ultimate and final distribution of the property, from the trust to the beneficiary.

Another interpretation of the statute is that the language of article 2 of Law 262 intended to extend the scope of the gift tax, from a straightforward gift to any legal arrangement by means of which a person places some of his assets in a separate fund, not part of his estate, to be used and disposed of for the benefit of another person or for a specified purpose. Under that interpretation, the gift tax would apply on the transfer of property to a trust, while no gift tax would apply at the time of the actual, final distribution of the property from the trust to the beneficiary.

The fifth department of the Court refused to construe the new statute as if it instituted a new tax separately from and in addition to the old gift tax. It affirmed its previous rulings, according to which the gift tax applies solely to a direct transfer of property to the beneficiary, as a result of which the beneficiary is enriched and has a direct and full right to the use, enjoyment, and disposition of the property.

It also held that Law 262 only reinstated the old gift tax, without instituting any new tax, and that the reference to "legal arrangements instituting limits or constraints to the use, enjoyment or disposition of a property" is only aimed at preventing the possible avoidance of the gift tax in cases in which legal schemes may be used that deviate from a straightforward gift of the property to the intended beneficiary while reaching the same result (that is, enriching the beneficiary with unlimited use, enjoyment, and disposition of the property).

According to the Court, Law 262 — by referring to the Gift Tax Act — simply reinstated the gift tax, which requires the actual transfer of and receipt of the full beneficial ownership and value of the property, with resulting enrichment of the beneficiary. In case of transfer of properties to trusts, the beneficiary is not immediately enriched, and does not receive the full value of the property unless and until the property is transferred from the trust to the beneficiary (at which time the gift tax would apply). The Court pointed out inconsistencies that would arise if the opposite interpretation were adopted, including the need to put the liability for the tax on the trustee, which is in contrast with the provisions of the Gift Tax Act, which puts the liability for the tax on the beneficiary and recipient of the gift.

The Supreme Court is split on this issue and ruling 21614 of the fifth department is in direct contrast with other rulings from the sixth department of the Supreme Court on the same issue. Lower courts have consistently ruled against the application of the gift tax, and the Italian tax agency has filed appeals against those rulings, as a result of which more decisions are expected from the Supreme Court in the near future.

If the interpretation of the fifth department prevails, it would have extremely important and potentially disruptive effects on cross-border estate and trust planning arrangements with connections to Italy.

For instance, Americans with assets located in Italy and held in U.S. trusts would be liable for the Italian gift tax at the time those assets are distributed to the beneficiaries of the trust, while no U.S. tax would apply when the original transfer of the assets to the trust was a full and final gift under U.S. tax law.

Similarly, for Americans who were domiciled in Italy at the time of their death, the distribution of their assets from their U.S. trusts to their beneficiaries would be subject to the Italian gift tax, regardless of whether the assets are located abroad and are held in U.S. trusts, while no U.S. tax would apply at that time, when the original transfer of the assets into the trusts was a full and final gift under U.S. tax law.

Below is a review of the statute, the position of Italy's tax administration, the most recent rulings issued by the Supreme Court, and the position of lower courts.

2006 Law Reinstating the Gift Tax

Law Decree 262 of October 3, 2006, reinstated the gift and estate taxes introduced and governed by Legislative Decree 346 of 1990 and repealed in 2001. (Prior coverage: *Tax Notes Int'l*, Dec. 11, 2006, p. 833.)

In reinstating the estate and gift tax, Law 262 (article 2, paragraphs 47 to 49) refers to the following transactions:

- gifts;
- transfers of property at death;
- transfers of property for no consideration; and
- other instruments or deeds having the effect of separating or segregating some assets from all other assets of the grantor and subjecting them to restriction on use, enjoyment, and disposition.

For the purpose of determining the tax base and tax rates, Law 262 refers to the Gift Tax Act. The tax base for the gift and estate tax includes the net market value of all transferred assets, with only the exception of state and municipal bonds, which are excluded (but only for estate tax purposes). Different rates and exemptions apply, depending on the family relationships between the parties, as follows:

- 4 percent for spouses and lineal relatives, with an exemption of €1 million for each beneficiary;
- 6 percent for siblings, with an exemption of €100,000 for each beneficiary;
- 6 percent, with no exemption, for other family members within the fourth level; and
- 8 percent, with no exemption, in all other cases.

The gift tax applies for gifts granted from October 3, 2006. The estate tax applies to transfers at death occurred from November 28, 2006.

One interpretation of Law 262 reinstating the gift is that, by referring specifically to instruments segregating certain assets and subjecting them to restrictions on use, enjoyment, or disposition, it intended to extend the scope of the gift tax, with the result that the newly reinstated gift tax would apply both to actual gifts or donations (namely, transfers of property to a beneficiary made with the intent to enrich the transferee, and with the transferee having immediate and full control, enjoyment, and disposition of the property), as well as to any other transfers of assets for no consideration and, in particular, to any arrangement or transaction that separates the transferred assets from all of the other assets of the grantor and limits their use or disposition (article 2, paragraph 47).

Under this interpretation of Law 262, the transfer of property to a trust would fall under the last category and would be within the scope of the new estate and gift tax. Two related issues would be at what rate and with what exemptions the tax should apply, and whether the subsequent transfer of the same assets from the trust to the beneficiaries should be taxed again.

Some commentators argued that the scope of the original gift tax was not expanded, and no tax should apply on transfer of assets to trusts, because the transfer is only temporary and the trust is used as a vehicle for a transfer of the assets to the final beneficiaries, so that only one tax should apply at the time of the actual and final transfer of the assets from the trust to the beneficiaries.

Another opinion distinguished between fixed nondiscretionary trusts with named beneficiaries and other types of discretionary trusts with beneficiaries not identified in the trust agreement. In the former case, the gift tax should apply as if the transfer were made to the beneficiaries directly (that is, at the time of the transfer of assets to the trust, and at the rate and with the exemptions that apply to the named beneficiaries). In the second case, two taxes might actually apply.

Interpretation and Administrative Guidance

Initially, the tax administration asserted that the gift tax would apply first on a transfer of assets to a trust, and then on the subsequent transfer of trust assets to the beneficiaries. For the transfer to a trust, the tax would apply at the full rate (8 percent) and with no exemptions. For the transfer to the beneficiaries, the tax would apply with the rates and exemptions based on the relationship between the beneficiary and the settler. According to this interpretation, the use of trusts for individual tax planning would be at risk and potentially subject to adverse consequences.

Circular 48/E issued on August 8, 2007, provided important clarifications that partially rectify the initial determination of the tax administration. According to the tax administration, Law 262 of 2006, in reinstating the gift tax, actually extended the scope of the tax and made it applicable to legal arrangements that segregate the assets and subject them to restrictions on their use or disposition. Such arrangements include trusts, foundations, and other similar legal structures, whereby one party transfers the legal title to assets to another party (fiduciary) and puts them under fiduciary administration for the benefit of other parties (beneficial owners).

The tax applies with the exemptions and rates provided for in the statute, when the beneficiaries of the assets of the trust are identified in the trust agreement. This can be at the time of formation of the trust, for nondiscretionary, irrevocable trusts with named beneficiaries, or at a later time when the trustee designates the beneficiaries under her powers as granted in the trust agreement. Exemption and rates are determined in accordance with the status of the beneficiaries and their relationship with the grantor. For charitable trusts or trusts with no clearly identifiable single beneficiaries, the gift tax applies at the time of transfer of the assets to the trust, at the full rate and with no exemption. No second tax applies at the time of the distribution of the assets from the trust to the final beneficiaries.

By way of Circular No. 3/E issued on January 22, 2008, the tax administration confirmed its interpretation of Law 262 and provided further guidance on the application of the reinstated gift tax. Circular 3/E confirms that the gift tax applies at the time of the transfer of the assets to the trust, and no second tax applies at the time of the transfer of the assets from the trust to the beneficiaries, on the theory of the extension of the scope of the tax and its application to arrangements having the effect to segregate the assets and put them under restrictions as to their use, enjoyment, and destination. It also clarifies that whenever the provisions of the trust do not identify the final beneficiaries of the assets of the trust with sufficient certainty, the exemptions and reduced tax rates cannot apply, and the tax is charged at the full rate of 8 percent with no exemptions. The party liable for the tax is the trustee acting on behalf of the trust.

Supreme Court's Case Law

The Supreme Court is split on the application of the gift tax to the transfer of properties to a trust.

The sixth department, which is also the tax division of the Court, has issued four decisions holding that the tax applies to the transfer of property to a trust, following the tax administration's interpretation of Law 262 of 2006. The ruling numbers are:

- 3735 of February 24, 2015;
- 3737 of February 24, 2015;
- 3886 of February 25, 2015; and
- 4482 of March 7, 2016.

In its rulings, the sixth department held that Law 262, article 2, paragraph 47 instituted a completely new tax, which applies to legal arrangements or transactions having the effect of segregating assets and subjecting them to constraints or limitations about their use, enjoyment, or disposition.

For the application of the new tax, Law 262 refers to the Gift Tax Act (Presidential Decree No. 346 of 2000). However, the new tax also applies to transactions that were not originally within the scope of the once-repealed and now-reinstated tax.

According to the Court, the transfer of a property to a trust is a transaction that has the effect of segregating assets and subjecting them to constraints or limitations about their use, enjoyment, or disposition, and as such, it is subject to the new tax under the new statute. Indeed, by setting up a trust and transferring a property to the trust, the grantor transfers the legal title to the property to the trustee, and limits the use, enjoyment, and disposition of the property, under the terms and provisions of the trust.

The fifth department of the Supreme Court has issued four decisions holding that no tax applies to the transfer of property to a trust. The ruling numbers are:

- 25478 of December 18, 2015;
- 25479 of December 18, 2015;
- 25480 of December 18, 2015; and
- 21614 of October 26, 2016.

In rulings 25478 and 25479, the Supreme Court considered the issue of the application of the gift tax to the transfer of property to a trust under the Gift Tax Act and before the reinstatement of the gift tax under Law 262. The Court held that the gift tax did not apply before, or in the absence of, a definite and final transfer of the property to and the enrichment of the beneficiary, who enjoys the full power to use, benefit from, and dispose of the property.

In ruling 21614 of October 26, 2016, the Supreme Court considered the same issue under the new provisions of Law 262, article 2, paragraphs 47-49 reinstating the gift tax and extending it to arrangements that segregate and create legal constraints on the use, enjoyment, and disposition of property. The sixth department refused to construe the new statute as if it instituted a new tax, separately from and in addition to the old gift tax. It affirmed its previous rulings, according to which the gift tax applies solely to a direct transfer of property to the beneficiary, as a result of which the beneficiary is enriched and has a direct and full right to the use, enjoyment, and disposition of the property.

It also held that Law 262 only reinstated the old gift tax without instituting any new tax, and that the reference to ''legal arrangements instituting limits to the use, enjoyment or disposition of a property'' is only aimed at preventing the possible avoidance of the gift tax in cases in which legal schemes may be used that deviate from a straightforward gift of the property to the intended beneficiary, while reaching the same result (enriching the beneficiary with unlimited use, enjoyment, and disposition of the property).

According to the Court, Law 262 — by referring to the Gift Tax Act — simply reinstated the gift tax, which requires the actual transfer of and receipt of the full value of the property, with resulting enrichment of the beneficiary, for the gift tax to apply. In case of transfer of properties to trusts, that occurs only when the property is transferred from the trust to the beneficiary, and the gift tax should apply solely at that time. The Court pointed out inconsistencies that would arise if the opposite interpretation were adopted, including the need to hold the trustee liable for the tax, which is in contrast with the provisions of the Gift Tax Act, which puts the liability on the beneficiary and recipient of the gift.

Lower Courts' Case Law

Lower tax courts throughout the country (both trial courts and appellate courts) have unanimously held that no gift tax applies at the time of the transfer of property to the trust, and no new tax has ever been instituted by Law 262 that should apply in lieu of the gift tax under those circumstances. The reasons in support of those rulings mirror those elaborated by the Supreme Court in ruling 21614. The author has examined more than 30 decisions issued in the last 10 years, which consistently ruled in favor of the nonapplication of the tax.

It is reasonable to expect additional decisions from the Supreme Court in the coming months, as it decides cases decided by appellate courts in favor of taxpayers, which have been appealed by the tax administration.

Considering the status of the case law, both from the Supreme Court (which is split on the issue) and from the lower courts (which are unanimously in favor of the nonapplication of the tax), there appears to be substantial authority and reasonable basis for taking the position that no tax applies to the transfer of the property to the trusts.

It should be noted that the Italian tax code provides complete relief from penalties for failure to pay a tax due in the event that a split of authorities exists on a particular tax issue, or objective conditions exist regarding the correct interpretation and application of the law that could justify the taxpayer's decision not to pay the tax. ◆