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Italy Clarifies Domestic Trust Provisions

by Marco Rossi

Italy's 2007 Budget Law (Law 296 of December 27, 2006) introduced, for the first time in Italy's history, domestic provisions on the tax treatment of trusts. (For prior coverage, see *Tax Notes Int'l*, Apr. 23, 2007, p. 391, *Doc 2007-8253*, or *2007 WTD 82-7*.) The provisions, which establish general principles on the tax classification and treatment of trusts in Italy for income tax purposes, have significant cross-border implications.

On August 6 Italy's tax administration issued Circular 48/E, which provides administrative guidance on the interpretation and application of the new trust tax provisions. The circular clarifies the tax treatment of trusts both for income tax and transfer tax purposes. (For prior coverage, see *Tax Notes Int'l*, Aug. 13, 2007, p. 650, *Doc 2007-18438*, or *2007 WTD 154-3*.)

As a general rule, trusts are classified as separate taxable entities and are taxed as corporations. However, trusts with income beneficiaries that are identified and named in the trust agreement are treated as fiscally transparent entities — that is, income is attributed to the beneficiaries as provided for in the trust agreement, regardless of how the trust distributes its funds, and the beneficiaries are taxed directly on their share of the trust's income. This fiscally transparent treatment also applies when the trustee determines the income beneficiaries of the trust in accordance with the authority granted in the trust agreement.

A trust is resident in Italy for tax purposes if its place of management or place of activity is located in Italy. Trusts formed in jurisdictions that do not allow exchange of information with Italy are treated as residents and are subject to worldwide taxation in Italy, if some connections with Italy exist (for example, if any grantor or beneficiary is Italian), unless taxpayers provide sufficient evidence that they are resident (that is, effectively managed) outside of Italy.

Trusts must keep tax books to compute their taxable income (taxed on the trust in the case of fiscally nontransparent trusts, or passed through and taxed in the hands of the beneficiaries in the case of fiscally transparent trusts).

A transfer of assets to a trust is subject to gift or estate tax. The tax is charged at reduced rates (4 percent and 6 percent) if the beneficiaries named in the trust agreement or determined by the trustee are close family members. The regular rate for trusts with no identified beneficiaries or beneficiaries that are not close family members or a charitable trust is 8 percent.

Following is an overview of the trust tax provisions as clarified and implemented by Circular 48/E.

Tax Classifications of Trusts

Italian Tax Code article 73, which lists entities that are classified as corporations for tax purposes, has been amended and now includes trusts. Therefore, the default rule is that trusts are separate taxable entities subject to corporate income tax.

Resident trusts are subject to corporate income tax on their worldwide income. Nonresident trusts are subject to tax on their Italian-source passive income and on business income attributable to a permanent establishment in Italy through which they carry on a trade or business there.

A trust can be either a business trust or a nonbusiness trust, depending on whether it is engaged in a trade or business as its exclusive or principal activity. Circular 48/E clarifies that trusts subject to tax in Italy can be classified as:

- resident trusts whose principal or exclusive object is to carry on a trade or business (business trusts), which are subject to tax in Italy on their worldwide income;
- resident trusts whose exclusive or principal object is not to carry on a trade or business

(nonbusiness trusts), which are subject to tax on their worldwide income; and
- nonresident (foreign) trusts, which are taxable in Italy only on their Italian-source income.

As mentioned above, there is a major exception to the treatment of trusts as separate taxable entities. If a trust's income beneficiaries are named in the trust agreement, the trust is treated as fiscally transparent, so its income is attributed to the income beneficiaries regardless of its distribution for tax purposes and its beneficiaries are taxed directly on their share of the trust's income.

Similarly, if the trust agreement grants the trustee the power to identify the beneficiaries of the income of the trust, once the trustee has made that determination, the trust is treated as a fiscally transparent trust.

Circular 48/E clarifies that a trust can be partly fiscally nontransparent and partly fiscally transparent (a hybrid trust). This happens when the trust agreement, or the trustee under the powers granted in the trust agreement, attributes to named beneficiaries only part of the trust income. In that event, the trustee computes the total taxable income of the trust, and the portion of the trust's income that is attributed to the named beneficiaries in the trust agreement (or by the trustee under the authority granted in the trust agreement) is taxed directly in the hands of the beneficiaries, while the portion of the trust's income that is not attributed to named beneficiaries in the trust agreement is subject to corporate income tax on the trust. Therefore, the new rules provide tremendous flexibility in structuring a trust for tax purposes.

The tax regime of a trust can change from fiscal transparency to fiscal nontransparency to hybrid treatment from one tax year to another as the result of an amendment to the trust agreement or depending on how and when the trustee exercises the authority to determine the beneficiary of the trust's income during the life of the trust.

Neither the statutory provisions nor Circular 48/E clarifies whether losses also flow through to the beneficiaries of fiscally transparent (business) trusts. However, that should be a natural consequence of the transparent nature of a trust, which — in the case of business trusts — should be treated like a partnership. (In other words, partnership tax rules should apply by way of analogy.)

The special rule on the tax transparency of trusts also applies to nonresident trusts — that is, nonresident business trusts with named beneficiaries are fiscally transparent and are treated like partnerships for Italian tax purposes.

This is a major change in the Italian tax system. Previously, all foreign entities — regardless of their legal form and tax classification under foreign law — were treated as separate taxable entities for Italian tax purposes. As a consequence, the combination of foreign and domestic income/losses and any tax planning through the use of foreign hybrid entities was severely limited.

Now, as a result of the new rules, a foreign entity organized as a trust can be treated as a fiscally transparent business trust for Italian tax purposes, and its income/losses will flow through to its Italian beneficiaries. In short, the new rules on the classification of resident (domestic) and nonresident (foreign) trusts create new planning opportunities for well-advised taxpayers.

Tax Residency of Trusts

The new provisions contain no specific rules on the tax residency of trusts (except for antiabuse rules that will be described below). Therefore, the general rules on corporate tax residency apply. Those rules establish tax residency (both for corporations and partnerships) in the place where an entity has maintained its legal seat, place of administration (effective management), or principal business for the majority of the tax year (more than183 days).

Circular 48/E clarifies that the place of administration test applies for trusts that operate through a specific organization (with offices and staff) and establish tax residence in the place where the organization is located. In all other cases, the place of administration is the domicile of the trustee. In the case of passive trusts, the place of business is the place where the trust's assets are located. For example, for real estate or investment trusts, the place of business test establishes the tax residency of the trust in the country where most of its real estate assets or investments are located. In the case of trusts with movable assets or different types of activities, reference is made to the actual and main business or activity carried out by the trust.

A special antiabuse rule provides that if a trust is formed in a low-tax jurisdiction that is not included in the list of countries that allow exchange of information with Italy (the so-called white list), and at least one of its settlors or beneficiaries is an Italian resident person, the trust is presumed to be resident in Italy and is subject to worldwide taxation there.[1]

[1]The tax residency of individuals is established under three alternative criteria: registration in the list of Italian resident persons, residence for civil law purposes (meaning the place where a person habitually lives with the intention of staying there for an indefinite period), or domicile for civil law purposes (meaning the main center or a person's personal, professional, and economic interests and affairs).

Circular 48/E clarifies that, for purposes of the antiabuse rule, the tax residency of a settlor is tested at the time of formation of the trust. Therefore, if at the time of formation of the trust any settlor was an Italian resident person, the antiabuse rule applies, even if the settlor becomes a nonresident person at a later stage. For beneficiaries, tax residency is tested in each tax period during the life of the trust. Therefore, if any trust's beneficiary at any time in any tax year is an Italian resident person, the antiabuse rule applies and the trust is presumed to be resident in Italy for Italian tax purposes.

The taxpayer can rebut the presumption by providing evidence that the trust is nonresident in Italy according to the general rules (meaning that the trust's place of effective management or place of business is outside of Italy).[2]

The antiabuse rule applies when the trust is formed in a nonqualified jurisdiction. The place of formation of the trust is the place where the trust agreement is signed and executed. Circular 48/E also refers to the place where the formal residence or seat of the trust is located. Because the choice of the place of execution of the trust agreement or of the seat of the trust generally is under the taxpayer's control, the effectiveness of the rules may be questionable. However, the rule can be a trap for the unwary. It is important that taxpayers know the rule and check any situations that may trigger its application.

A trust is also considered to be resident in Italy when, after its formation, an Italian resident person transfers to the trust full or limited ownership rights on real property. From the statutory language, it is not entirely clear whether taxpayers can rebut that presumption by providing evidence of the trust's foreign tax residency under the general rules.

Finally, Circular 48/E clarifies that the corporate anti-inversion rules also apply to trusts. As a consequence, if Italian resident persons own or control an Italian entity through a foreign trust, the trust is deemed to be resident in Italy unless the taxpayer proves that it is effectively managed in a foreign country.

[2]A comment issued by the tax administration draws a parallel with the new anti-inversion corporate residency rules, according to which a foreign entity (that is, an entity formed and having its legal seat in a foreign country) that is controlled by Italian resident shareholders or for which the majority of its directors (or its sole director) are Italian residents is presumed to be resident in Italy for tax purposes, and subject to Italian worldwide taxation, unless it provides evidence that it is resident abroad under the place of management or place of business test.

The tax residency tests for trusts are factual and revolve around the place of management or place of business of the trust. The antiabuse rules are linked to the tax residency of individuals who are either settlors or beneficiaries of the trust, which in turn is determined under the residence and domicile tests.

As a consequence, every time a trust has any connections with Italy, its tax residency should be tested under the above-mentioned rules to make sure that the trust is not treated as resident in Italy and subject to tax in Italy on its worldwide income. Foreign counselors should be aware of that and seek proper advice to avoid unexpected tax consequences.

Tax Treaties

Circular 48/E also provides some interesting comments on the application of tax treaties to trusts.

Cross-border issues in the taxation of trusts arise when a trust organized in one country has assets or activities in another country that generate income from source within that country or when a trust's settlors or beneficiaries are resident in foreign countries other than the resident country of the trust.

A trust that is treated as a corporation according to the tax classification rules discussed above and that is subject to tax in its home jurisdiction qualifies as a person resident in the treaty partner country for treaty purposes. Therefore, treaty benefits would apply to fiscally nontransparent trusts.

However, fiscally transparent trusts that are not subject to tax on their income in their home jurisdiction fail the residency test and cannot get access to treaty benefits.

Tax Treatment of Trusts

Computation and Reporting of Taxable Income

Circular 48/E clarifies that a trust (either fiscally transparent or fiscally nontransparent) computes and reports its income according to the rules that apply to corporations. Therefore, the trustee must file a tax return within the deadline provided for corporate income tax returns.

Trusts that are not engaged in a trade or business generally are subject to a gross-basis withholding tax on their income. The tax levied at source is final, and the trust is not required to report any income.

Trusts that are engaged in a trade or business must keep financial books and records and file financial statements like corporations.

If the same entity acts as trustee for more than one trust, it must file separate income tax returns and keep separate books for each trust.

Fiscally Nontransparent Trusts

Although the new tax provisions on trusts have no specific rules related to fiscally nontransparent trusts, their tax treatment should be relatively straightforward. As noted above, fiscally nontransparent trusts are treated as corporations and are taxed on their worldwide income if they are resident in Italy, or on their Italian-source income or business income attributable to a PE in Italy if they are nonresident.

The taxable income of a fiscally nontransparent trust is computed according to the same rules that apply to corporations, including the participation exemption rules for dividends and capital gains. Those rules exempt 84 percent of the gain from sales of stock that qualify for the exemption and 95 percent of dividends (except for dividends coming from tax haven jurisdictions).

Resident trusts qualify as resident in Italy for tax treaty purposes; therefore, they should be eligible for treaty benefits. However, they are not eligible for the benefits of the EU tax directives because they are not organized in one of the legal forms indicated in the annexes to the directives (joint stock companies, limited liability companies, or partnerships with stock divided by shares).

As clarified below, distributions of trust income that have already been taxed on the trust are nontaxable to the trust's beneficiaries

This is a major departure from the corporate tax model, in which dividends are partially taxed in the hands of the shareholders (at graduated rates of 5 percent of the amount of the dividend in the case of corporate shareholders; 40 percent of the amount of the dividend in the case of shareholders who own the stock in connection with their trade or business or own qualified stock; and at a 12.5 percent gross-basis tax rate on the entire amount of the dividend for individual portfolio shareholders).

The result is that a fiscally nontransparent trust is subject to tax only at the entity level, at corporate rates, with no taxation at the level of the income beneficiaries.

Fiscally Transparent Trusts

The new provisions contain a rule on the taxation of fiscally transparent trusts that states that the income of the trust is passed through to the trust's beneficiaries and taxed in their hands, regardless of distribution, in proportion to the beneficiaries' shares of trust income as determined in the trust agreement or, in the absence of such a determination, by equal shares.

Circular 48/E clarifies that income is passed through according to the amount of the income that is attributed to the beneficiaries in the trust agreement or by the trustee in accordance with the powers granted to him by the trust agreement.

Income is passed through for the amounts, and to those persons who are beneficiaries, on the last day of the trust's tax year.

Neither Circular 48/E nor the statutory provisions address the consequences if the income beneficiaries or amount of income change near the end of the tax year.

The beneficiaries' share of the trust income is characterized as income from capital. In a brief comment on the rules, the tax administration said the characterization of a trust's income as income from capital applies only for individual beneficiaries who receive income from the trust outside the context of carrying on a trade or business. The comment suggests that for corporate beneficiaries and individual beneficiaries engaged in a trade or business, the trust income should be recharacterized as business income and taxed on an accrual basis. Circular 48/E confirmed that assumption.

Source of Trust's Income

The new provisions do not contain any rules on the source of income derived from fiscally transparent trusts or the treatment of trust losses.

The closest comparison is with partnerships. The general rules on sources of income provide that a partner's share of a domestic partnership's income is Italian-source income, regardless of the source of the income in the hands of the partnership. In other words, the source of the partnership's income does not pass through, and it is determined at the partner level. However, no similar rules apply to trusts. Furthermore, Italian law does not contain any rule that attributes the Italian PE of a trust (or a partnership) to its beneficiaries for the purpose of taxing the beneficiaries on Italian-source business income from the trust (or partnership).

Because the source of income in the hands of the trust does not pass through to the beneficiaries, and (unlike a partner's distributive share of partnership income) because there is no rule that expressly recharacterizes the beneficiaries' share of trust income as Italian-source income, establishing the exact legal basis for the current taxation of nonresident beneficiaries of Italian fiscally transparent trusts may be problematic. Indeed, income from an Italian fiscally transparent trust may be treated as non-Italian-source income and escape taxation in Italy. More importantly, that income may also be treated as "other income" and be sheltered from tax under the "other income" article of a tax treaty.

At the same time, taxing nonresident beneficiaries on the distribution of income from the trust does not seem feasible because, in principle, the tax applies on a look-through basis when the income is realized and because distributions from fiscally transparent entities are nontaxable in the hands of the entity's members. Circular 48/E has confirmed that distributions from fiscally nontransparent trusts are nontaxable in the hands of the beneficiaries; therefore, outbound distributions of a trust's income are not subject to Italian withholding tax at source.

This is also an area where there may be interesting planning opportunities for foreigners investing in Italy through domestic trusts.

Treatment of Trust Losses

Neither the statute nor Circular 48/E provides any useful clarifications on the tax treatment of trust losses. A comment issued by the tax administration on the treatment of fiscally transparent trusts makes a general reference to the rules on the taxation of companies that elect to be treated as partnerships under Tax Code articles 115 and 166 (the Italian check-the-box rules). By analogy to those rules, trust losses should also pass through to the beneficiaries.

However, it is not clear whether the check-the-box rules for companies (or partnerships) should apply by way of analogy to trusts across the board. Further clarifications from the tax administration on this issue are badly needed.

If losses pass through, because nonresident trusts are treated like resident trusts for fiscal transparency purposes (unlike nonresident partnerships, which are always separate entities regardless of their tax treatment under foreign law), nonresident fiscally transparent business trusts would allow the passthrough of foreign losses to Italian beneficiaries, who could use them in Italy to offset other Italian taxable income.

That would be a major exception to the general rule, under which nonresident entities are always treated as separate entities for Italian tax purposes, regardless of their tax classification under foreign law, so that foreign losses can never be used in Italy unless taxpayers operate in branch form or are able to consolidate foreign subsidiaries under Italian worldwide consolidation rules (or use other elaborated joint venture schemes).

Indeed, the rules may, for the first time, create a foreign entity that could be treated as a fiscally transparent entity for Italian tax purposes. In that case, the use of nonresident fiscally transparent trusts would offer resident taxpayers interesting tax planning opportunities for outbound investments.

Tax Treatment of Beneficiaries

The income of fiscally transparent trusts passes through to the beneficiaries on the last day of the tax year of the trust, regardless of how the trust actually distributes it to the beneficiaries, and is taxed in the hands of the beneficiaries at graduated rates. For those purposes, beneficiaries and the income assigned to them must be clearly identified in the trust agreement or by the trustee in accordance with the powers granted to him in the trust agreement. Distributions of a trust's funds to the beneficiary are fiscally irrelevant.

Income taxed on a fiscally nontransparent trust is also nontaxable when distributed to the trust beneficiaries.

A foreign tax credit for foreign income taxes paid by the trust is granted to the trust, if fiscally nontransparent, or is passed through to the income beneficiaries of the trust, if fiscally transparent. In the case of hybrid trusts, the credit is allocated pro rata.

Trust income is characterized as income from capital in the hands of the beneficiary.

As capital income derived from a resident entity, the trust income is characterized as Italian-source income for nonresident beneficiaries. The taxation of capital income from a trust can be sheltered under the "other income" article in tax treaties.

Circular 48/E does not provide any clarification on the character and source of trust income. If the trust is a resident fiscally transparent trust carrying on a trade or business in Italy, it may be argued that the income is Italian source by analogy with the source rule that applies to distributive shares of a domestic partnership's income. However, the absence of a direct rule on source of income and any authority that attributes the PE to the trust's beneficiaries may create troubles in identifying the correct legal ground for the taxation of trust income in Italy. Also, taxation in Italy may be sheltered under the other income article in tax treaties.

For foreign trusts deriving passive income from Italian sources, the income would be subject to withholding tax at source, charged at domestic statutory rates reduced under any treaty between Italy and the country of residence of the trust or the beneficiaries, depending on whether the trust is transparent or nontransparent.

And for foreign trusts doing business in Italy through a PE, Italian tax would apply to the income attributable to the PE on a net basis on the trust or its beneficiaries, depending on whether the trust is transparent or nontransparent.

Transfer of Assets to and From Trusts

The contribution of business assets to a trust triggers a taxable gain or loss for the transferor. Circular 48/E treats the contribution as a transfer of assets outside of corporate solution, which is a taxable event. The transfer to a trust of a business as a going concern is also a taxable event.

The nonrecognition rules — which are confined to transfers of a business as a going concern to a corporate transferee in exchange for transferee stock — do not apply.

If a business is transferred by gift or inheritance, taxation of the gain or loss is deferred and the trust takes a carryover basis in the transferred assets.

Circular 48/E clarifies that a transfer of stock (or other participating financial instrument treated as stock for tax purposes) is a nontaxable event. In that case, the trust takes a carryover basis in the transferred stock and taxation is deferred to the time the trust disposes of the stock in a taxable transaction.

Transfers of assets from the trust are subject to the general rules. Business assets may trigger a taxable gain. Nonbusiness assets may be taxable or nontaxable, depending on the type of assets and the transaction.

Trusts for Indirect Tax Purposes

The New Estate and Gifts Tax

The tax act (Law Decree 262 of October 3, 2006) related to the 2007 Budget Law reinstated the gift and estate taxes introduced and governed by Legislative Decree 346 of 1990 and repealed in 2001.

Those taxes apply to gifts, transfers at death, and other transfers for no consideration that have the effect of separating or segregating some assets from all other assets of the grantor to subject them to a special purpose, use, or destination.

Therefore, gratuitous transfers to trusts (including self-settled trusts) and the subsequent transfers from the trusts to the beneficiaries are each subject to the gift tax. The tax base includes the net market value of all transferred assets, with 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 immediate family members by blood (parents, children, grandparents, and grandchildren), with an exemption of €1 million for each beneficiary;
- 6 percent for brothers and sisters, with an exemption of €100,000 for each beneficiary;
- 6 percent, with no exemption, for other family members up to 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 occurring from November 28, 2006.

Gifts and transfers at death also are subject to mortgage and cadastral taxes at a combined rate of 3 percent. Therefore, the total tax burden on gifts and transfers at death can be as high as 11 percent.

Transfer of Assets to Trusts

Unlike under the previous regime, the newly reinstated estate and gift tax applies not only to donations (defined as transfers made with the intent to enrich the transferee), but also to any other transfers of assets for no consideration that separate the transferred assets from the other assets of the grantor and subject them to a special use or destination.

Therefore, transfers of assets to a trust fall within the scope of the new estate and gift tax. Two issues that had not been resolved concerned which rates and exemptions 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 no tax should apply on transfers 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 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 estate and 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.

Initially, the tax administration took the position that the estate and 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. In the case of the transfer to a trust, the tax would apply at the full rate (8 percent) with no exemptions.

According to that interpretation, the use of trusts for individual tax planning would be at risk and potentially subject to very adverse consequences.

Circular 48/E provides important clarifications that partially rectify the initial position taken by the tax administration.

The estate and gift tax applies when the beneficiaries of the trust assets are identified. This can be at the time of formation of the trust in the case of nondiscretionary irrevocable trusts with named beneficiaries, or at a later time when the trustee designates the beneficiaries in accordance with his powers as granted in the trust agreement. The application of the tax can be significantly deferred by appropriately drafting the clauses of the trust agreement. The exemptions and rates are determined in accordance with the status of the beneficiaries.

For charitable trusts or trusts with no clearly identifiable single beneficiaries, the tax applies at the time of formation, at the full rate and with no exemptions.

Cross-Border Considerations

In a cross-border context, Italian residents are subject to the estate and gift tax on their worldwide assets, while nonresidents are subject to the tax on their assets located in Italy.

The law does not contain any special definition of the term "resident" for estate and gift tax purposes; therefore, the general income tax residency rules should apply.

Nonresidents transferring Italian assets to a trust must be aware that, even though the trust is administered outside of Italy and is subject to foreign law and has no other connections with Italy, the transfer is now subject to tax in Italy at the combined rate of 11 percent.

According to the source rules for the application of the estate and gift tax to nonresidents, the following assets are deemed to be located in Italy:

- assets registered in Italy;
- stock or equity interests in Italian resident entities;
- bonds, notes, or other financial instruments issued by Italian resident entities;
- negotiable instruments representing goods located in Italy;
- checks, promissory notes, and any other claims for which the issuer or debtor is an Italian resident;
- claims secured by assets located in Italy (up to the value of the asset used as collateral); and
- goods in transit in foreign countries whose final destination is Italy.

A nonresident subject to gift or estate tax must file a tax return in Italy and compute and pay the tax due. Stiff penalties apply for noncompliance.

A tax credit for the taxes paid in Italy may be granted to the nonresident in accordance with estate and gift tax treaties.

Conclusion

Italy's new rules for trusts fill a gap in the Italian tax system. They are far from comprehensive and still leave some gray areas, but the guidance issued by the tax administration with Circular 48/E is useful in clarifying many open issues.

The rules on the classification and tax treatment of trusts create planning opportunities. However, the provisions and antiabuse rules on the tax residency of trusts are potentially dangerous and may be a trap for the unwary. They should be checked every time a trust has any connection with Italy.

In general, the tax treatment of trusts is an area of Italian tax law that still needs further attention.◆

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