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COUNTRY DIGEST

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Tax Authority Rules on Change of Residency During Tax Year

Italy's tax administration on December 4 issued Ruling 471/E, stating that foreign individuals with Italian tax residency who return to their home country and terminate their residency in Italy during the second half of a year continue to be tax resident in Italy and subject to tax on their worldwide income until the end of that year.

The ruling also clarifies that the potential double taxation that arises in those circumstances cannot be resolved by dividing the taxpayer's tax residency for that year between Italy and the taxpayer's home country so that the taxpayer is treated as partly resident and partly nonresident in Italy for the second part of the year in which she moved back to her home country under the tiebreaker rules of an income tax treaty between Italy and the taxpayer's home country unless that treaty contains specific provisions that provide for the part-time residency. The only remedy to double taxation might be to claim the foreign tax credit granted in Italy for the tax assessed in the home country on income from sources within that country.

Ruling 471/E highlights the need for careful planning before moving from Italy to a foreign country during a tax year if one is to avoid continued liability to Italian taxation.

Italian Tax Residency Tests for Individuals

Under Italian law, individual taxpayers are treated as resident in Italy for tax purposes and subject to tax in Italy on their worldwide income if they meet one of three alternative tests:

(1) they are registered in the official register of Italian residents;

(2) they maintain their residence in Italy; or

(3) they maintain their domicile in Italy.

For the purposes of test 2, residence is defined as the place where a person habitually lives. For the purposes of test 3, domicile is defined as the main center of an individual's interests and affairs, which include personal, social, business, and economic interests. Either test must be met for at least 183 days during a tax year.

First and Last Day of Tax Residency Rules

Taxpayers who move to Italy during the first half of a year and satisfy a residency test for that year are treated as resident in Italy for tax purposes from the first day of the year. Conversely, taxpayers who move to Italy in the second half of a year are treated as resident in Italy for tax purposes from the first day of the following tax year if they satisfy a residency test in that year.

If an Italian resident taxpayer moves to a foreign country during the first half of a year, his Italian tax residency terminates (and he is treated as a nonresident of Italy for tax purposes) from the first day of that year. If an Italian resident taxpayer moves to a foreign country during the second half of a year, his tax residency terminates (and he is treated as a nonresident of Italy for tax purposes) starting from the first day of the following year.

In other words, the starting date of Italian tax residency is retroactive to the first day of the year or is postponed to the beginning of the next year depending on whether the taxpayer moves to Italy in the first or second half of a year; conversely, the termination date of Italian tax residency is retroactive to the first day of the year or postponed to the last day of the year, depending on whether the taxpayer leaves Italy in the first or second half of the year.

The first and last day of residency rules create a planning opportunity but also traps for the unwary.

Individuals who arrive in Italy on July 1 of year 1 and leave Italy on June 30 of year 2 will not be considered resident in Italy for tax purposes at any time in year 1 or year 2. Conversely, individuals who arrive in Italy on June 30 of year 1 and leave Italy on July 1 of

year 2 will be considered resident in Italy for tax purposes for the entire duration of years 1 and 2.[1]

Treaty Tiebreaker Rules

Under the typical article 4 of a tax treaty, individuals who are resident of both contracting states under the national rules of each state have their tax residency attributed to the contracting state in which they have their permanent home, main center of vital interests, or place of habitual abode (or to the country of which the taxpayer is a national under a last resort rule). If a taxpayer lived partly in one country and partly in the other country during a year, the tax residency can be split between the two countries during a single year according to the above criteria.[2]

Facts of the Case

In 2002 a Swedish national individual moved with his family to Italy, where he started working as an employee of an Italian subsidiary of a Swedish company. He registered as resident in Italy and was treated as resident in Italy for tax purposes and subject to tax in Italy on his worldwide income. In 2007 the taxpayer's employment with the Italian subsidiary terminated, and on July 10, 2007, he removed himself from the register of Italian residents and moved back to Sweden. When filing for 2007, the taxpayer argued that under article 4, paragraphs 1 and 2 of the Italy-Sweden tax treaty, he should be treated for that year as resident in Italy for the period from January 1 to July 10 and as resident in Sweden for the period from July 11 and December 31 and that as a nonresident in Italy, he was not subject to tax in Italy on his Swedish income earned in the second part of the year.

Ruling

The Italian tax administration clarified that under Italian law, because the taxpayer moved back to Sweden in the second half of 2007, his Italian tax residency continued through the end of 2007.

Regarding the tax treaty issue, the Italian tax administration noted that some Italian tax treaties contain an express provision that provides for an allocation of the tax residency between Italy and the other contracting state under the treaties' tiebreaker rules for any period of a tax year in which an individual lived partly in Italy and partly abroad. That is the case, for example, in article 4, paragraph 4 of the tax treaty with Switzerland[3] and article 3 of the protocol to the tax treaty with Germany.[4]

According to the tax administration, when a similar provision is not included in a tax treaty, it means Italy has not agreed to waive the application of its ''once a resident, always a resident'' residency rule that extends the Italian tax residency of a taxpayer to the last day of the year when the taxpayer left Italy in the second half of the year. It also means Italy is not bound by the general interpretation of article 4, paragraph 2 of the OECD model treaty as suggested in the commentary to the OECD model treaty.

The Italy-Sweden treaty does not contain a provision for the change of residency during the tax year. Therefore, according to the Italian tax administration, the Italian internal rule applies and the taxpayer is also subject to tax in Italy on his income earned from services performed in Sweden in the second half of 2007, and the only remedy against double taxation is the foreign tax credit.

Had the taxpayer moved to Sweden on June 30, 2007, his Italian tax residency would have terminated on January 1, 2007; as a nonresident, he would not have been taxed in Italy on his Swedish income for the period from July 1, 2007, to December 31, 2007, and would have been taxed as a nonresident on his Italian-source income for the period from January 1, 2007, to June 30, 2007.

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[1]Circular 304 of December 2, 1997, provides general guidance on the rules governing the tax residency of individuals.

[2]*See* paragraph 10 of the commentary to article 4, paragraph 2 of the OECD model convention, which states:

> the facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.

[3]''4. An individual who has definitely transferred his domicile from one Contracting State to the other Contracting State shall cease to be subject in the first-mentioned State to the taxes which are determined by domicile at the end of the day on which such transfer is completed. At the same time tax liability shall, to the extent that it is determined by residence, begin in the other State.''

[4]''3. With reference to Article 4 If an individual is deemed a resident of a Contracting State in the sense of Article 4 for only part of the year and a resident of the other Contracting State for the remainder of that year (change of residence), his tax liability in the first-mentioned State, as far as it is determined by his residence, shall cease at the end of the day on which the change of residence takes place. His tax liability in the other State, as far as it is determined by his residence, shall begin on the day following that of the change of residence.''

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Conclusion

The major implication of the ruling is that Italy does not apply any partial-year residence rule under a tax treaty by way of general interpretation of article 4 of the OECD model treaty; there must be an express provision allowing for such treatment within the treaty.

Under Italian internal law, there is no part-time residence rule. Instead, an all-exclusive or all-inclusive rule applies under which a taxpayer is either resident in Italy for the entire year or not resident for any part of the year. ◆

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