

ITALY: NEW CLARIFICATIONS CONCERNING THE TAXATION OF TRUSTS AND BENEFICIARIES

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INTRODUCTION

A trust is an instrument having extreme flexibility and adaptability. For those reasons, it is becoming more and more common in the field of estate and succession planning as a simple and effective solution to protect an individual's assets from uncertain events. It is customarily used in generational transfers of family assets and businesses, the achievement of charitable purposes, and the protection of vulnerable individuals.

Italy does not have proper civil rules regulating trusts, but the use of trusts has been recognized in Italy through the ratification of the Hague Convention of July 1, 1985 (enforced with the Law n. 364/89 and came into force since January 1, 1992). Nonetheless, the increasing use of trusts in Italy has raised several questions about tax treatment for trusts, settlors, and beneficiaries.

In this context, the Italian tax authorities released Circular Letter No. 34/E on October 20, 2022, providing guidance on several key issues surrounding trusts. It provides many important clarifications making trusts even more attractive for individuals resident in Italy and international families having one or more beneficiaries resident in Italy or wishing to relocate to Italy. By way of example, capital distributions involving assets located outside of Italy can be totally exempt from taxation in Italy when made by an irrevocable, discretionary trust established by a settlor resident abroad.

This article examines the principal provisions of Circular Letter No. 34/E and provides a comprehensive view of the tax treatment of trusts in Italy. Several practical examples are discussed.¹

TAX TREATMENT OF TRUSTS, SETTLORS, AND BENEFICIARIES

The tax treatment of trusts, settlors, and beneficiaries varies depending on (i) the type of trust from an Italian tax perspective (*i.e.* opaque, transparent, or disregarded), (ii) the nature of the trust based on actual activity carried out (*i.e.* commercial or non-commercial trust), and (iii) the residence of the trust for tax purposes.

¹

The examples provided are based on the interpretation of recent clarifications provided by the Italian tax authorities. Because some points remain unclarified, the examples may need to be revised in the event additional clarifications are issued by the Italian tax authorities.

Type of Trusts

- **Disregarded Trust.** To be treated as a disregarded trust, a trust must be (i) a revocable trust or (ii) a trust where the settlor or the beneficiaries have a power or *de facto* control or influence to manage the trust assets or dispose of either the assets held in trust or the income from such assets.

With Circular Letter 61/E/2010, the Italian tax authority listed some cases in which a trust should be considered a disregarded entity for tax purposes:

- Trusts where the settlor or the beneficiaries can terminate the trust at will.
 - Trusts where the settlor can, at any time appoint himself or herself as beneficiary.
 - Trusts where the trustee cannot administer the trust without the prior consent of the settlor or of the beneficiaries.
 - Trusts where the settlor has the power to revoke the trust assigning trust assets to himself or herself or to other beneficiaries.
 - Trusts where the beneficiaries have the right to receive an anticipated attribution of the trust assets during the life of the trust.
 - Trusts where the trustee must follow the directions provided by the settlor with reference to the management of the trust assets and the trust income.
 - Trusts where the settlor has the power to modify the list of beneficiaries during the life of the trust.
 - Trusts where the settlor can appoint income or assets, or provide loans, to persons appointed by the settlor.
 - Trusts where the administrative and dispositive powers of the trustee are limited, or can be affected, by the settlor or by the beneficiaries
- **Transparent Trust.** To be treated as a transparent trust, a trust must be a fixed-interest trust or another trust where the beneficiaries are identified. According to the interpretation of the tax authorities, a beneficiary is identified when he is not only named as a beneficiary, but also has an enforceable right to the payment of his share of the trust's income.
 - **Opaque Trust.** To be treated as an opaque trust, a trust must be irrevocable and discretionary, meaning that the trustee has a discretionary power to appoint income and capital to beneficiaries.

Nature of Trusts

- **Commercial Trust.** To be treated as a commercial trust, the exclusive or principal object of the trust must have a commercial nature, meaning that the activity performed results in the generation of business income pursuant to Art. 55 Italian Income Tax Code, ("I.T.C.").

- **Noncommercial Trust.** This category is a residual category. To be treated as a noncommercial trust, a trust must not be a commercial trust.

Tax Residence of Trusts

- **Resident Trust.** To be treated as a resident trust, the place of administration of the trust must be located in Italy or its principal business must be carried out in Italy.

The Italian tax legislation provides two anti-tax avoidance presumptions for a trust to be considered fiscal resident in Italy, even if none of the listed conditions are met.

- The first provides that a trust is presumed to be resident in Italy if (i) a trust is established in a jurisdiction not included in the white list of countries that allow exchanges of information with Italy and (ii) at least one of its settlors and one of its beneficiaries is an Italian resident person. Circular 48/E/2007 clarifies that, for the purposes of this rule, the tax residency of the settlor is tested at the time of establishment of the trust. Therefore, if at the time of formation of the trust any settlor was an Italian resident person, the anti-abuse rule applies, even though the settlor becomes nonresident at a later stage. For beneficiaries, tax residence is tested in each taxable period during the life of the trust. The taxpayer can rebut the presumption by providing evidence that the trust is considered to be nonresident in Italy according to the general rules. This means that the trust's place of effective management or place of business is located outside Italy.
 - The second addresses the addition of Italian situs real property by a resident person to a trust settled in a State that is not a white-list State. In that fact pattern, the trust is considered to be resident in Italy when, after its formation, an Italian resident person transfers to the trust full or limited ownership rights to Italian real property. Also in this case, the taxpayer can rebut the presumption by providing evidence that the trust is considered to be nonresident in Italy under general rules.
- **Nonresident Trust.** To be treated as a nonresident trust, the place of administration of the trust must be located outside of Italy and its principal business must not be carried on in Italy.

DIRECT TAX PROVISIONS

Italian Resident Opaque Trusts

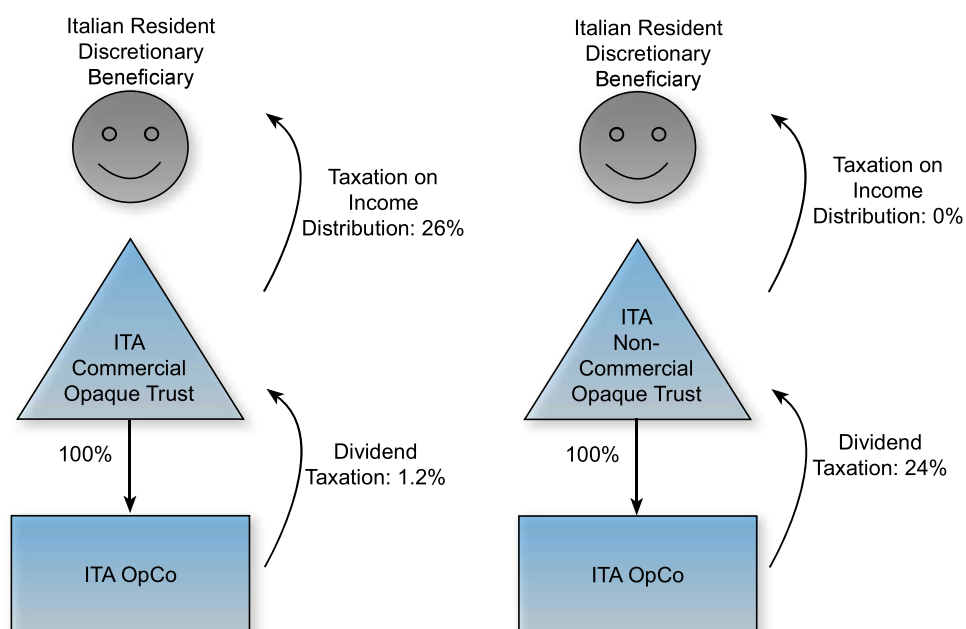
According to Italian tax law, resident opaque trusts are treated as taxable persons for corporate income tax purposes. Taxation of worldwide income occurs at the trust level.

Within the category of opaque trusts, a distinction must be made between opaque commercial trusts and opaque noncommercial trusts.

“According to Italian tax law, resident opaque trusts are treated as taxable persons for corporate income tax purposes.”

- For a commercial trust, income must be determined under the rules applicable to business income,² including the rules exempting capital gains³ and dividends from tax.⁴ Income is subject to corporate income tax (I.R.E.S.), levied at a rate of 24%. A subsequent income distribution to a discretionary beneficiary is subject to a withholding tax imposed at a rate of 26%. In addition, profits reserves of the commercial trust are considered to be distributed to beneficiaries before capital reserves,⁵ regardless of the nature of the reserve to which the trustee has allocated the amounts distributed to the beneficiaries.
- For a noncommercial trust, income must be determined by applying the same rules which apply to individuals. By way of example, capital gains that are derived from the sale of a property held for over five years is not subject to taxation. Once income is determined, it generally is subject to I.R.E.S., levied at a rate of 24%, except for certain financial income⁶ that is subject to the substitute tax, levied at a rate of 26%. Subsequent income distributions to a discretionary beneficiary are not subject to additional taxation.

The following diagram illustrates the differences in taxation of dividend income paid by an Italian operating company to an Italian resident commercial opaque trust and an Italian resident noncommercial opaque trust and distributed by the trust to a beneficiary that is an Italian resident individual.



² Article 81 and following provisions of the I.T.C.

³ Article 87, regulating the participation exemption regime.

⁴ Article 89, I.T.C. which provides for an exclusion from taxable base of 95% of the gross dividend.

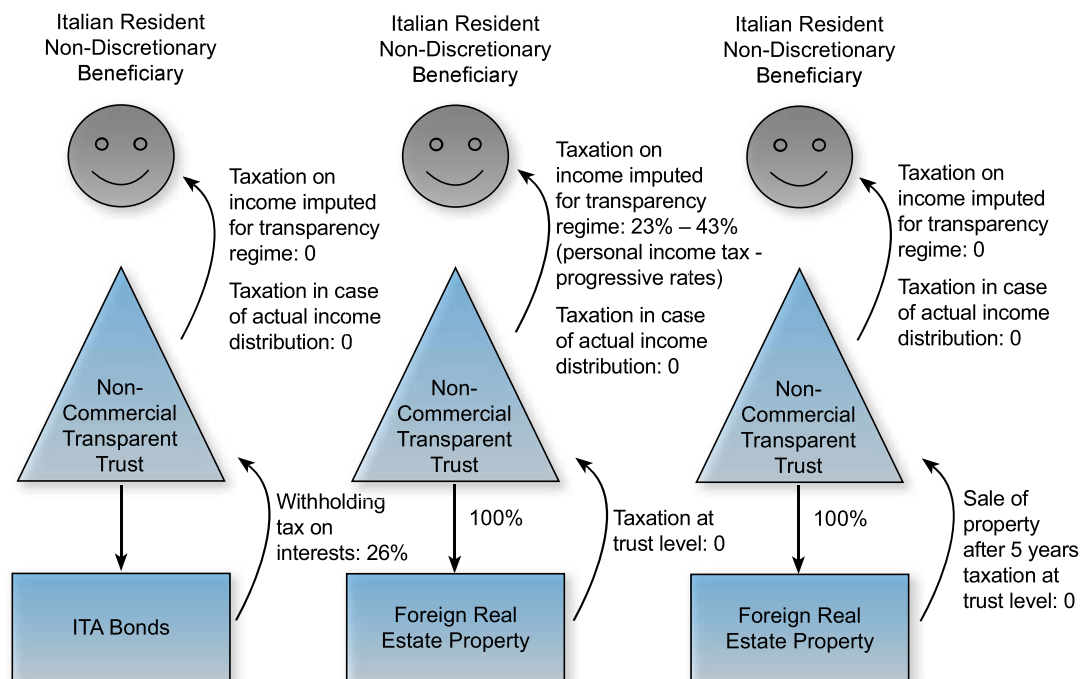
⁵ Article 47 (1), I.T.C.

⁶ Dividends are not subject to 26% withholding/substitute tax but at 24% corporate income tax.

Transparent Trusts

Whether resident or nonresident, a transparent trust is not considered to be a taxable entity. As a result, the worldwide income of the trust is subject to taxation on an accrual basis at the level of Italian resident beneficiary. Where the beneficiary is an individual, the income imputed to him is added to his taxable income, and taxed at progressive tax rates that range from 23% up to 43%. Where the trust income has already been subjected to a final withholding tax or a substitute tax in Italy, no further tax is due at the level of the beneficiary. Either way, no further tax is due at the time of an actual distribution to an Italian resident beneficiary.

The following diagram illustrates taxation in three different fact patterns involving income received by a noncommercial transparent trust. In one fact pattern, the trust receives interest income derived from Italian bonds held with an Italian financial institution. In the second fact pattern, the trust receives rental income from real estate located outside of Italy. In the third fact pattern, the trust realizes a capital gain from real estate held for more than five years.



Foreign Opaque Trusts

As a general rule, foreign trusts are treated as taxable persons for corporate income tax purposes and subject to taxation in Italy in respect of income produced in Italy only. Where a trust is a foreign opaque trust, the taxation of an Italian resident beneficiary on eventual income distributions will vary depending on whether the trust is established in a low-tax jurisdiction described in Article 47-bis I.T.C.

Income distributions from a foreign opaque trust established in a low-tax jurisdiction are treated as taxable income for an Italian resident beneficiary. If the beneficiary is an individual, progressive tax rates apply, ranging from 23% to 43% on the amount received. Where the trust receives Italian source income on which Italian tax has

been paid at the trust level, no additional Italian tax is imposed on an Italian resident beneficiary when that Italian source income is distributed.

In the case of a foreign opaque trust established in a low-tax jurisdiction, where it is not feasible to differentiate contributed capital from income generated by the trust, the entire amount distributed to a Italian resident beneficiary resident is presumed to be income for Italian tax purposes. This all-or-nothing characterization may be rebutted by accurate and complete accounting records prepared by the trustee or other documentation such as bank and financial account statements. In all instances, Italian tax rules will be applied in identifying income and capital. An accounting method applied by a trustee according to the rules of its country of residence or the country of residence of the trust will not be determinative for Italian tax purposes.

In order to understand if income distributions from a foreign opaque trust is established in a low-tax jurisdiction several factors must be evaluated. The first is the nominal rate of tax imposed on the trust. An opaque trust is deemed to be established in a low tax jurisdiction where the nominal level of tax in its country of residence is less than 12%, which amounts to 50% of the Italian corporate income tax of 24%. If the trust exclusively generates income of a financial nature, the nominal rate of tax must be less than 13%, which amounts to 50% of the Italian substitute tax on financial income, currently 26%. For this comparison, special tax regimes that directly affect tax rates or that provide exemptions or reductions in the tax base affect the nominal rate in the foreign country. The comparison between the foreign nominal level of taxation and the Italian one must be made at the time the income is generated by the trust.

The second is the place of establishment. A trust is established in a low-tax jurisdiction by reference to its place of tax residence at the moment of the distribution of income to an Italian resident beneficiary (provided that the income distributed was subject to taxation, at the time of its generation, in compliance with the minimum level of taxation provided for by the aforementioned Article 47-bis of the ITC). Where a trust has more than one trustee and can be viewed to have residence in more than one jurisdiction, the state of residence is the state where the trust is actually taxed. In the event that the trust is not considered to be tax resident in any state based on relevant local criteria so that no tax is imposed on the trust or its Italian resident beneficiary, a trust is considered to be established in the state where the trust's administration activity is predominantly carried out.⁷ Finally, a trust established in an E.U. or E.E.A. Member State may be considered as established in a low tax jurisdiction if it benefits from a tax exemption regime provided for offshore trusts.

If a foreign opaque trust is considered to be established in a jurisdiction other than a low tax jurisdiction, Italy will impose tax only on income generated in Italy. Distributions of income to a discretionary beneficiary residing in Italy are not taxed.

Disregarded Trusts

If a trust is a disregarded trust, its income is imputed directly to the settlor or a beneficiary based which party has *de jure* power or *de facto* power to (i) control or influence the management of trust assets or (ii) dispose of trust assets or income. In other words, the trust is deemed not to exist for Italian tax purposes.

⁷ These trusts are referred to as resident but not domiciled trusts.



INDIRECT TAX PROVISIONS

Time of Payment of Inheritance and Gift Tax

Prior to the release of Circular Letter 34/E, the position of the Italian tax authorities was that a settlor's transfer of assets to a trust (*atto dispositivo*) constituted an immediate gratuitous transfer subject to inheritance and gift tax ("I.H.G.T."). The Italian Supreme Court expressed a different view in several recent cases. It adopted a clear rule that the transfer of assets in favor of a trustee is a temporary transfer. The effective transfer by the settlor occurs at a later stage, at the time of distribution of assets to beneficiaries.

The Italian tax authorities have now aligned their position to the approach of the case law. The addition of assets into trusts represents a non-taxable event for I.H.G.T. purposes. Consequently, I.H.G.T. will be applied only upon the enrichment of the beneficiary which occurs (a) upon distribution of the capital to the beneficiaries or earlier (b) in case of beneficiaries acquiring a vested interest over the trust's assets.

Distributions of income are not instead subject to I.H.G.T. but rather to income tax, in the manner described above.

In applying its new position, the Italian tax authorities have adopted a grandfather rule. For settlements effected in earlier years where I.H.G.T. was paid at the time of contribution of assets to a trust, Circular 34/E provides that that no additional I.H.G.T. will be due upon capital distribution to the beneficiaries. The grandfather rule applies only where assets that have been transferred to the trust and the beneficiaries have not changed. Where the final transfer of assets is made to a different beneficiary or relates to assets or rights other than those transferred and taxed at the moment of the contribution of assets to the trust, I.H.G.T. previously paid at the time of contribution can be credited against the I.H.G.T. due when assets are transferred to beneficiaries. Alternatively, taxpayers may claim a refund of I.H.G.T. provided that the three-year statute of limitations from the date of payment has not elapsed.

"Distributions of income are not instead subject to I.H.G.T. but rather to income tax . . ."

Tax Rates and Tax Base

I.H.G.T. is levied on the worldwide assets transferred by an Italian resident transferor. It is also imposed on the transfer of Italian-situs assets transferred by a nonresident transferor. I.H.G.T. tax rates range from 4% to 8% subject to exemptions of up to €1.0 million depending on the degree of kinship between the transferor and the transferee. The degree of kinship, the computation of the tax base, and the rate of I.H.G.T. applicable to a transfer is determined at the moment of the transfer of assets to a beneficiary. The resident or nonresident status of the settlor is determined at the time assets are contributed to the trust. Finally, assets held in a disregarded trust are subject to I.H.G.T. at the time of the death of the settlor.

Examples of Application

The following examples illustrate the way I.H.G.T. will now be applied.

Example 1

A trust was established by a nonresident with regard to Italy many years ago by means of a contribution of foreign financial assets into a foreign resident trust. The

trust is not disregarded from an Italian tax perspective. Mr. X is a beneficiary. At the time the trust was funded, Mr. X was a tax resident in a country other than Italy. At some point thereafter, Mr. X became a tax resident of Italy. He is subject to the ordinary regime for residents. After his relocation to Italy, Mr. X receives a capital distribution from the trust.

The capital distribution is not subject to Italian I.H.G.T., and as a capital distribution, it is not subject to any income tax. The residency of the trust in a white list jurisdiction or a low tax jurisdiction has no effect on Mr. X's Italian tax position with regard to the capital distribution, with one possible exception. If the trust is an opaque trust resident in a low tax jurisdiction the trustee's accounting records, supported by bank account statements and financial account statements must clearly document that the distribution is a capital distribution legally and in substance. That determination is made according to Italian tax rules applicable to trusts.

Example 2

Ms. Y is a tax resident of a country other than Italy. She establishes a revocable trust to which she contributes Italian real property. After five years, Ms. Y meets an untimely death. At the conclusion of her life, Ms. Y continued to be a tax resident of the same country.

No I.H.G.T. is due at the moment of contribution of the Italian real property to the revocable trust. However, at the conclusion of her life, the Italian real estate property is subject to Italian I.H.G.T.

TAX REPORTING OBLIGATIONS AND WEALTH TAXES

The Italian tax authorities clarified that the current legislation concerning tax reporting obligations applies to individuals who qualify as "beneficial owners" of assets held in trust. It does not matter that the legislation makes no explicit reference to trusts. The reporting obligations may be summarized as follows:

- Italian tax reporting obligations that are typically made on Form RW of the Italian tax return are not extended to the trustee or the protector. In addition, the obligation is not extended to the settlor, provided the trust is not deemed to be disregarded for Italian tax purposes.
- Regarding Italian resident noncommercial opaque trusts, the Italian tax reporting obligations fall upon the trust, itself.
- Italian tax resident beneficiaries of nondiscretionary trusts are required to fulfil the Italian tax reporting obligations disclosing the value of the foreign investments and financial assets held by the trust, as well as their share in the trust's assets.
- Regarding foreign opaque trusts, resident beneficiaries are required to comply with Italian tax reporting obligations, provided that (i) the beneficiaries are identified, or can be easily identified, pursuant to the trust deed and to the related documentation and (ii) such beneficiaries have available information; for example, where the trustee communicates a trust decision to attribute the income or capital of the trust fund to a resident beneficiary.

- No tax reporting obligations arise for second degree beneficiaries, meaning individuals who only have a right to income or assets of the trust after the primary beneficiaries ceases to hold such interest; note that a different conclusion is possible if the relevant provisions of the trust provides that a purported second degree beneficiary has at least a potential right to receive a distribution from the trust during the lifetime of the primary beneficiaries.

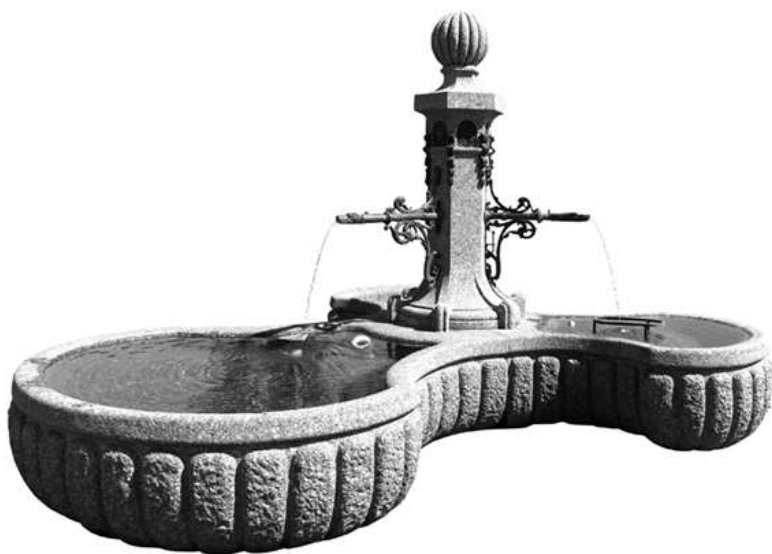
WEALTH TAX

Beginning with the 2020 tax period, noncommercial trusts that are resident in Italy are subject to wealth taxes on real property and financial assets held abroad (respectively, “I.V.I.E.” and “I.V.A.F.E.”).

In very general terms, wealth taxes apply to noncommercial trusts at the following rates:

- Financial assets held abroad are subject to an annual tax at the rate of 0.2%.⁸ The tax is capped at €14,000. The tax base is the fair market value for listed assets and nominal value for unlisted assets.
- Real estate located abroad are subject to an annual tax at the rate of 0.76%. The tax base is the original purchase price, except for real estate located in an E.U. or E.E.A. Member State. If exchange of information programs are in place with an E.U. or E.E.A. Member State, the tax base is the value resulting from foreign cadastral registers or other deemed value relevant to foreign income, wealth or transfer taxes.

Lastly, Italian tax resident beneficiaries of a trust that is not a disregarded trust are not subject to Italian wealth taxes.



⁸ For bank accounts, I.V.A.F.E. applies at a fixed amount of €100.