

Italy's substitute tax regime: features, benefits and requirements for qualification

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INTRODUCTION

A special new tax regime was introduced in Italy under the 2017 Italian Budget Law (Substitute Tax Regime) to attract high net worth individuals into the jurisdiction. The Substitute Tax Regime provides for:

- A substitute tax on foreign-source income and gains, whereby an individual's foreign-source income and gains will be subject to a fixed amount annual tax of EUR100,000.
- Additional benefits in relation to reporting obligations, wealth taxes and inheritance and gift tax.

The Substitute Tax Regime is available to individuals (both Italian or foreign nationals) who acquire Italian tax residence, provided:

- The individual taxpayer has been a non-resident of Italy for income tax purposes for (as a minimum) nine of the ten years prior to the first year of bringing the option to use the Substitute Tax Regime into effect.
- The individual taxpayer exercises the option to use the Regime within the prescribed timeframes.
- The individual taxpayer pays the substitute tax within the prescribed timeframes.

The option to use the Substitute Tax Regime can be exercised with or without an advance ruling request made to the Revenue Agency (see below, *Qualifying for the regime: Ruling from Italian tax authorities*).

On 8 March 2017, the Italian Revenue Agency issued implementing regulations to supplement the Substitute Tax Regime (Implementing Decree). On 23 May 2017, the Revenue Agency issued a circular letter (Circular Letter) to address a number of interpretative issues raised by the Substitute Tax Regime.

This article provides a summary of the features/benefits of the Substitute Tax Regime, the requirements for qualifying for the regime, the duration of the regime, and how the regime can be applied to family members and the effect of applicable tax treaties.

FEATURES/BENEFITS OF THE REGIME

Substitute tax on foreign-source income and gains

If an individual chooses to use the Substitute Tax Regime, all of his/her foreign-source income and gains will be subject to a substitute tax equal to EUR100,000 per year (subject to any specific exclusions, see below, *Exception: substantial shareholdings and Optional exclusion: foreign jurisdictions*). This tax will apply to the individual in place of his/her usual levy of income tax under the general rules, irrespective of the amount of foreign-source income and gains. The income and gains within the scope of the substitute tax are not subject to any additional income taxation, even if remitted to Italy.

The Italian tax authorities have provided useful guidance on how the regime would apply. In particular, they have taken the view that:

- For income or gains owned by an individual that are subject to the Substitute Tax Regime through a disregarded company (or

trust or other entity), the income and gains of that company must be imputed to the individual and can qualify for the Substitute Tax Regime under the ordinary conditions (that is, provided they are foreign-source and are not capital gains from the sale of a substantial shareholding). Obtaining confirmation that a company (such as a personal holding company) or trust is to be disregarded can be helpful to rule out any issue of Italian tax residence or existence of an Italian permanent establishment.

- The transfer into Italy of an individual who manages a (not disregarded) company (or trust or other entity) and is subject to the Substitute Tax Regime is not per se sufficient to attract the tax residence of such company into Italy.
- Controlled foreign corporation (CFC) rules do not apply to individual subjects of the Substitute Tax Regime.

Exception: substantial shareholdings

A general exception to the EUR100,000 per year substitution is that capital gains (and losses) on substantial shareholdings realised during the first five years of tax residence in Italy are excluded from the scope of the substitute tax. Such gains/losses will therefore be subject to income tax under general rules.

In general terms, a disposal of a "substantial shareholding" arises if the shares sold in the last 12 months represented more than either:

- 2% of the voting rights of a company listed on a stock exchange or more than 20% of voting rights of other companies.
- 5% of the share capital of a company with shares listed on a stock exchange or more than 25% of the share capital of other companies.

It should also be noted that during this five-year period, substantial shareholdings are subject to reporting obligations on foreign-held assets (see below, *Additional benefits*).

However, the tax authorities can rule that the exemption will not apply if the taxpayer can prove that they are not carrying out the abusive behaviour that the exception is meant to counteract (which requires an assessment of the specific facts and circumstances). If the disapplication is confirmed, capital gains on substantial shareholdings will fall within the scope of the substitute tax and the substantial shareholdings will not be subject to reporting obligations.

Optional exclusion: foreign jurisdictions

The taxpayer individual can opt for all income and gains sourced in one or more foreign states to be excluded from the scope of the substitute tax and therefore be subject to income tax under general rules. The selection of foreign states that will be excluded from the scope of the substitute tax can, at the individual's discretion, be broadened over time.

Depending on any specific tax treaty provisions and their interpretation in the foreign jurisdiction, the exclusion may allow the individual to benefit from reduced taxation in the jurisdiction where the income and gains are sourced.



It should be noted that that assets held in the excluded jurisdictions are subject to reporting obligations on foreign-held assets and to quasi-wealth taxes, and assets situated in the excluded jurisdictions are within the scope of inheritance and gift tax (see *below, Additional benefits*).

Additional benefits

Opting for the Substitute Tax Regime triggers additional benefits, in addition to the levy of the substitute tax on all foreign-source income and gains. These additional benefits include:

- **Benefits in relation to reporting obligations on foreign-held assets.** Resident individuals are generally subject to reporting obligations on foreign-held assets that are either owned, beneficially owned, or in any case at their disposal. However, during the years of effect of the Substitute Tax Regime, the individual is not subject to such reporting obligations (subject to any specific exclusions, see above, *Exception: substantial shareholdings* and *Optional exclusion: foreign jurisdictions*).
- **Exemption from wealth taxes on foreign-held financial products and foreign real estate.** Resident individuals are also subject to quasi-wealth taxes (IVAFE at 0.2% at and IVIE at 0.76%) on the foreign-held financial products and foreign real estate that they own. However, during the years of effect of the Substitute Tax Regime, foreign-held financial products and foreign real estate are exempt from wealth taxes (save for the exclusion set out above in *Optional exclusion: foreign jurisdictions*).
- **Exemption from inheritance and gift tax on foreign-situs assets.** During the years of effect of the Substitute Tax Regime, foreign-situs assets (save for the exclusion set out above in *Optional exclusion: foreign jurisdictions*) are not within the scope of inheritance and gift tax (which generally applies to world-wide assets if the deceased or donor is resident of Italy). The Italian tax authorities have clarified that the exclusion from gift tax also applies to the settlement of assets into trusts, as well as to gifts.

QUALIFYING FOR THE REGIME

Non-residence in at least nine of the previous ten years

For income tax purposes, an individual will be regarded as a resident of Italy if at least one of the following conditions (Connecting Factors) is fulfilled for most of the year (the tax period coincides with the calendar year):

- The individual is registered with the Italian Official Register of the resident population (*anagrafe della popolazione residente*).
- The individual has his/her residence in Italy for civil law purposes. The term "residence" is defined by the Civil Code as the place where the person has his/her habitual abode.
- The individual has his/her domicile in Italy for civil law purposes. The term "domicile" is defined by the Civil Code as the place in which a person established the main seat of his/her business and interests.

Therefore, if the individual does not meet any of the Connecting Factors listed above for the majority of the year, he/she will be considered non-resident for that year.

To help individuals assess whether they satisfy any of the Connecting Factors, the Italian Revenue Agency has issued a checklist that allows them to make a preliminary assessment of whether they would be eligible.

Exercising the option

If the individual satisfies one of the Connecting Factors and decides to exercise his/her option to use the Substitute Tax Regime, he/she must include a request in his/her income tax return for the year in which the Regime is due to start. The income tax return must generally be filed by 30 September of the subsequent year.

The option for the Substitute Tax Regime is exercised by either:

- Filing the tax return for the tax period in which the individual moved tax residence in Italy.
- Filing the tax return for the tax period following the period in which the individual moved his/her tax residence to Italy (for example, individuals who acquired tax residence in Italy in 2016 can apply for the Substitute Tax Regime as from the tax year 2017 by exercising the option within September 2018).

When exercising the option, the individual must provide:

- Personal data, their Italian social security number, and the residence address in Italy (if already resident).
- A declaration of their non-resident status in Italy, which must have been for (as a minimum) a period of at least nine of the ten years prior to the first year of effect of the Substitute Tax Regime.
- Details of the last jurisdiction(s) where the taxpayer was resident for tax purposes prior to the first year of effect of the option for the Substitute Tax Regime.
- Details of the foreign jurisdictions/territories that the individual intends to exclude from the scope of the Substitute Tax Regime (see above, *Optional exclusion: foreign jurisdictions*).

Ruling from Italian tax authorities

Getting a ruling from the Italian tax authorities is optional and not mandatory, and individuals can opt for the Substitute Tax Regime without the need for prior assessment.

However, a ruling from the tax authorities may be helpful in obtaining confirmation that, for example, the individual was a non-resident of Italy in at least nine of the ten years prior to the first year of effect of the option, that income or gains have foreign-source, and/or whether or not a company or trust is to be disregarded.

In relation to the timing, the tax authorities must reply to the ruling request within 120 days (if additional information and documentation are required, a new deadline of 60 days starts from the submission of the such additional information and documentation).

The Implementing Decree now allows for a checklist to be attached to the ruling request that provides preliminary assessment from the Revenue Agency on the individual's eligibility for the Substitute Tax Regime. If the ruling is not requested, the taxpayer individual must compile the checklist upon the filing of his/her tax return.

The ruling request can be filed, and the ruling may be obtained, prior to the individual's (possible) transfer of tax residence to Italy.

DURATION OF THE REGIME

The Substitute Tax Regime is effective for up to a maximum period of 15 years. The option is automatically renewed every year. However, the effects of the option will cease when either:

- There is a lack or partial payment of the substitute tax (the substitute tax must be paid, for every tax period covered by the Substitute Tax Regime, within the deadline for the payment of the income tax balance).
- The tax residence of the individual is moved abroad.

The option can be revoked by the individual, but, if revoked, it will no longer be available as an option. Therefore, cherry picking the regime (that is, revoking the regime and then using it again) is not permitted throughout the 15 years.

If the taxpayer individual dies, the heirs can revoke the option in relation to the year of demise on the deceased's behalf. This will trigger the application of Italian ordinary taxation (income tax, wealth taxes, inheritance and gift tax and tax reporting obligations) in relation to that year. Such revocation may be beneficial because, depending on the provisions of the inheritance tax treaty, the ordinary application of Italian inheritance tax (levied at rates ranging

from 4% to 8%) may allow the heirs to benefit from reduced foreign inheritance/estate taxes under the relevant tax treaties.

In case of loss or revocation of the option, the effects of the Substitute Tax Regime remain valid in relation to previous tax periods.

FAMILY MEMBERS

The Substitute Tax Regime can be extended to one or more qualifying family members, provided that they fulfil the nine out of ten years non-residence condition, against the payment of a further annual substitute tax of EUR25,000 (rather than EUR100,000) per each family member benefitting from the regime. Therefore, if, for example, two spouses transfer their tax residence to Italy and both of them wish to benefit from the regime, the overall annual substitute tax would be limited to EUR125,000. If the individual subject to the EUR100,000 substitute tax revokes the option, then the substitute tax regime automatically ceases to apply also to the

qualifying family members. However, in such cases, the qualifying family member is entitled to exercise an autonomous option by paying the EUR100,000 substitute tax with effects only for the remaining tax years up to a total of 15 years (taking into account the years during which the family member benefitted from the Substitute Tax Regime in the capacity of family member).

The extension of the Substitute Tax Regime to qualifying family members can be revoked without affecting the application of the regime to the individual subject to the EUR100,000 substitute tax.

TREATY APPLICATION

In the Circular Letter, the Italian tax authorities took the position that individuals benefitting from the Substitute Tax Regime generally qualify as residents of Italy for income tax treaty purposes unless a specific treaty contains ad hoc provisions that may apply to individuals benefitting from privileged tax regimes (for example, the 1976 income tax treaty between Switzerland and Italy).

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