SPECIAL REPORTS

Overview of Italy's Tax Provisions on Trusts

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Italy does not have domestic rules on trusts. However, trusts created under foreign law are recognized and enforceable in Italy under the provisions of the 1985 Hague Convention on the Law Applicable to Trusts and on Their Recognition, which has been ratified and implemented and is fully effective in Italy.

The Hague Convention was signed on July 1, 1985, and ratified in Italy with law No. 364 of October 16, 1989, and entered into force on January 1, 1992. It harmonizes the private international laws of the contracting states relating to trusts, provides that each contracting state recognizes the existence and validity of trusts created by a written trust instrument, and sets out the general characteristics of a trust and establishes rules for determining the governing law of trusts with cross-border elements.

According to the convention, as implemented in Italy, a trust created under and governed by the law of a country that has provisions governing trusts is recognized and valid in Italy, subject only to the overarching limitation of Italian public order principles. Purely internal trusts, with Italian grantors, Italian beneficiaries, and assets located in Italy, are also recognized.

In the 2007 Finance Bill Italy enacted for the first time specific provisions dictating the tax treatment of trusts for Italian tax purposes.[1] They establish general principles on tax classification and treatment of trusts in Italy for income and indirect tax purposes and have significant cross-border implications.

On August 6, 2007, Italy's tax administration issued Circular 48/E, which provides administrative guidance on the interpretation and application of the new tax provisions on trusts. Circular 48/E clarifies the tax treatment of trusts both for income tax and transfer (indirect) tax purposes. Subsequently, Italy's tax administration issued additional interpretative guidance in Circular 61/E (December 27, 2010).

Generally, for a trust to exist as a legal and tax entity separate from the grantor, the trustee, and its beneficiaries, there must be a real and effective legal separation of the trust's assets from both the estate of the grantor and the beneficiaries of the trust and the trustee must be granted with real powers of administration of the trust, acting independently from and not being under the direct or indirect control of the grantor or beneficiaries of the trust.

Once it is established that a trust actually exists, generally for income tax purposes trusts are classified as separate taxable entities and 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 whether and how the trust distributes its funds, and the beneficiaries are taxed directly on their share of trust's income. This fiscally transparent treatment also applies if after the initial creation of the trust, the trustee determines the income beneficiaries of the trust under the authority granted in the trust agreement.

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[1]Article 1, paras. 74 to 76 of Law No. 296 of Dec. 27, 2006.

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 subject to worldwide taxation in Italy, if specific 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 Italy.

Trusts must keep tax books to compute their taxable income (taxed upon the trust for fiscally nontransparent trusts, or passed through to and taxed upon the beneficiaries for fiscally transparent trusts).

A gratuitous 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 beneficiaries named in the trust agreement or determined by the trustee at any time thereafter are close family members. Otherwise, the regular rate for trusts with no identified beneficiaries or beneficiaries that are not close family members or charitable trust is 8 percent.

I. Legal and Tax Recognition

For a trust to exist as a separate legal and tax entity the following requirements must be met:

- there must be a real separation of the assets of the trust from the estate of the grantor, the trustee, and the beneficiaries;
- the trustee must hold the legal title to the assets of the trust; and
- the trustee must be vested with the power and duty to administer, manage, and dispose of the assets of the trust according to the applicable law and provisions of the trust.

Particularly important is the actual power of the trustee to administer and dispose of the assets of the trust independently from the grantor and beneficiaries. The grantor cannot retain control over the trust's assets in a way that may limit or interfere to any meaningful extent with the trustee's actual management and disposition powers as provided for under the terms of the trust agreement and applicable law.

When the power to manage and dispose of the assets of the trust is wholly or partly retained by the grantor, the trust is disregarded and the grantor is treated as the owner of the assets and income of the trust for income tax purposes. The determination of whether the grantor has retained sufficient power of control over the management and disposition of the trust is made by taking into consideration the terms and conditions of the trust as well as all of the facts and circumstances of the particular case.

A trust that operates as a conduit or intermediary with no meaningful life of its own is disregarded.

Circular 61/E of 2010 has extended and illustrated the list of situations in which a trust would be disregarded for income tax purposes:

- the grantor (or beneficiary) can terminate the trust at any moment, to his own benefit or to the benefit of third parties;
- the grantor can appoint at any time himself as beneficiary;
- the grantor (or beneficiary) holds, under the terms of the trust or otherwise, specific powers under which the trustee, despite being vested with discretionary power to manage and administer the trust, cannot carry out those powers without the consent of the grantor;
- the grantor can declare an earlier termination of the trust, appointing himself or another as a beneficiary;
- beneficiary has the right to receive distribution of assets from the corpus of the trust;
- the trustee is required to take into account the instructions of the grantor regarding the management of the assets and income of the trust;
- the grantor can change the beneficiaries of the trust during the life of the trust;
- the grantor has the power to assign income or assets of the trust to individuals he may designate; and
- any other case in which the trustee's powers to manage and dispose of the assets of the trust, as granted under the trust agreement or applicable law, is to any extent limited or conditioned by the will of the grantor or beneficiaries.

II. Tax Classifications of Trusts

Article 73 of the Italian Tax Code, which sets forth the entities that are classified as corporations for tax purposes, was amended and now includes trusts. Consequently, 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 only on their Italian-source passive income and 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 the trusts subject to tax in Italy can be classified as follows:

- 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.

There is a major exception to the treatment of trusts as separate taxable entities. If the beneficiaries of the trust's income are identified and named in the trust agreement, the trust is treated as fiscally transparent, its income is attributed to the beneficiaries regardless of its distribution for tax purposes, and the trust's 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 this 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 (hybrid trust).

That 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 this case, the trustee computes the total taxable income of the trust, and then the portion of the trust's income that is attributed to named beneficiaries in the trust agreement (or by the trustee under the authority granted in the trust agreement) is taxed directly upon 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 upon the trust.

The tax regime of a trust can change, from fiscal transparency to nonfiscal transparency to hybrid treatment, from tax year to tax year, as a result of amending the trust agreement or depending on how and when the trustee exercises his authority to determine the beneficiaries of the trust's income during the life of the trust.

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

The special rule on tax transparency of trusts also applies to nonresident trusts. Nonresident business trusts with named beneficiaries are fiscally transparent and 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 above 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 would flow through to its Italian beneficiaries.

III. Tax Residency of Trusts

The new provisions have no specific rules on tax residency of trusts (except for the antiabuse rules described below).

As a result, the general rules on corporate tax residency apply. Those rules establish tax residency 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 (greater than 183 days).[2]

Therefore the alternative tests to establish tax residency of a trust are as follows:

- legal seat;
- place of administration (that is, place where the office of administration of the trust is located and trust administration is actually carried out or domicile of the trustee); and
- principal place of business.

Circular 48/E clarifies that the place of administration test applies for trusts that operate through a specific organization (offices and staff), and it establishes tax residence in the place where that organization is located. In all other cases, the place of administration will be the domicile of the trustee.

For 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. For 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, not included in the list of countries that allow exchange of information with Italy (the 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.[3]

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[2]The legal seat, place of management, and principal place of business tests apply for the purpose of determining the tax residency of both corporations and partnerships.

[3]Tax residency of individuals is established under three alternative criteria: registration in the list of Italian resident persons (formal criteria), residence for civil law purposes (the place where a person habitually lives with the intention of staying there for an indefinite period of time), or domicile for civil law

(Footnote continued on next page.)

Circular 48/E clarifies that for the purposes of the above rule, the tax residency of the grantor is tested at the time of formation of the trust. Therefore, if at the time of formation of the trust any grantor was an Italian resident person, the antiabuse rule applies, even though the grantor 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 (that is, the trust's place of effective management or place of business are outside of Italy).[4]

The antiabuse rule applies when the trust is formed in a nonqualified jurisdiction. The rule refers to the place where the trust is formed. 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. Since the choice of the place of execution of the trust agreement or of the seat of the trust is generally 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 this 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.

As it appears from the above, the tax residency tests for trusts are highly factual and turn on 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 facts and circumstances residence and domicile tests.

Every time a trust has any connections with Italy, its tax residency should be tested under the rules noted above 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 seek proper advice to avoid unexpected tax consequences.

IV. Tax Treatment of Trusts

A. Computation and Reporting of Taxable Income

Circular 48/E clarifies that a trust (whether 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 according to and within the deadline provided for corporate income tax returns.

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

B. Fiscally Nontransparent Trusts

Although the new tax provisions on trusts have no specific rules in this respect, the tax treatment of fiscally nontransparent trusts should be relatively straightforward.

As noted above, fiscally nontransparent trusts are treated as corporations and taxed on their worldwide income, if they are resident trusts, or on their Italian-source income or business income attributable to an Italian PE, if they are nonresident trusts.

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 sale of stock that qualifies for the exemption, and 95 percent of dividends (except for dividend coming from tax haven jurisdictions).

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

purposes (the main center of a person's personal, professional, and economic interests and affairs).

[4]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) is presumed to be resident in Italy for tax purposes, and subject to Italian worldwide taxation, unless the taxpayer provides evidence that it is resident abroad under the place of management or place of business test, when the entity is controlled by Italian resident shareholders or the majority of its directors (or its sole director) are Italian residents.

As clarified in Section V below, distributions of a trust's income that has already been taxed upon the trust is nontaxable to the trust's beneficiaries.

This is a major departure from the corporate tax model, in which dividends are partially taxed upon shareholders (at graduated rates on 5 percent of the amount of the dividend for corporate shareholders, and 40 percent of the amount of the dividend for shareholders who own the stock in connection with their trade or business or own qualified stock, and at 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.

C. Fiscally Transparent Trusts

The new provisions contain a rule on taxation of fiscally transparent trusts that states that the income of the trust is allocated to the trust's beneficiaries and taxed upon them, 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 allocated according to the amount of income that is attributed to the beneficiaries in the trust agreement or by the trustee under the powers granted to him by the trust agreement.

Income is allocated for the amounts and to those persons who are beneficiaries on the last day of the trust's tax year. The statutory provisions and Circular 48/E are silent on what to do when income beneficiaries or amount of income changes close to the year-end. Beneficiaries' share of trust's income is characterized as income from capital.

In a brief comment on the rules, the tax administration said that characterization of a trust's income as income from capital applies only for individual beneficiaries receiving the income from the trust outside the carrying out of a trade or business.

The comment suggests that for individual beneficiaries engaged in a trade or business, or corporate beneficiaries, the trust income should be recharacterized as business income and taxed on an accrual basis.

Circular 48/E confirmed this assumption.

D. Source of Trust Income

The new statutory provisions do not contain any rule on the source of the income derived from fiscally transparent trusts and 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. Also, 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 tax treaties.

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

However, Circular 61/E of 2010 expressly treated this issue and clarified that income of a fiscally transparent Italian trust allocated to trust beneficiaries under the fiscal transparency system is always characterized as Italian-source income, because it flows through an Italian resident trust, regardless of the source of the underlying items of income of the trust. To clarify, if a trust earns rental income from the lease of rental real estate located in a foreign country, that same income (which in the hands of the trust is foreign-source business income), once allocated to the trust beneficiaries based on their share of the trust's income as determined under the provisions of the trust, will be characterized as Italian-source income from capital. The change in character would bring with it a change in tax (from taxation on a net basis at graduate rates to taxation at a flat rate of 20 percent).

As a result, foreign-source income of an Italian resident trust that is allocated to foreign beneficiaries of the trust is Italian-source income taxable upon the foreign beneficiaries.

E. Treatment of Trust Losses

The statute is silent and Circular 48/E does not provide 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 taxation of companies that elect to be treated as partnerships under articles 115 and 166 of the Italian Tax Code (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 rules on check-the-box companies (or partnerships) should apply by way of analogy to trusts across the board. Further clarification from the tax administration on this issue is badly needed.

If losses pass through, because nonresident trusts are treated like resident trusts for fiscal transparency purposes (contrary to nonresident partnerships, which are always separate entities regardless of their tax treatment under foreign law), then nonresident fiscally transparent business trusts would allow 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 for the first time may 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.

V. Tax Treatment of Beneficiaries

Income of fiscally transparent trusts is allocated to the beneficiaries of the trust on the last day of the tax year of the trust, regardless of how the trust actually distributes its income to the beneficiaries, and is taxed upon the beneficiaries at graduated rates. For this purpose, beneficiaries and the income attributed to them must be clearly identified in the trust agreement or by the trustee under the powers granted to him in the trust agreement. Distributions of the trust's funds to the beneficiary are fiscally irrelevant.

Income taxed upon 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 passed through to the income beneficiaries of the trust, if fiscally transparent. For hybrid trusts, the credit is allocated pro rata.

Trust income is characterized as income from capital in the hands of the beneficiary. For nonresident beneficiaries, as capital income derived from a resident entity, it is characterized as Italian-source income and subject to withholding tax. Taxation of capital income from trusts can be sheltered under the other income article of tax treaties.

Circular 48/E does not provide any clarification on the character and source of trust income.

If it is a resident fiscally transparent trust carrying on a trade or business in Italy, it may be argued that 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 taxation of trust income in Italy. Also, taxation in Italy may be sheltered under the tax treaty's other income article.

In the case of foreign trusts deriving passive income from Italian sources, income would be subject to withholding tax at source and 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.

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

VI. Cross-Border Aspects and Implications

A. Inadvertent Italian Resident Trusts

A U.S. trust under U.S. rules may inadvertently become an Italian trust under Italian rules, as a result of any of the three alternative tax residency tests illustrated above (legal seat, place of administration/residency of the trustee, place of business/location of main assets or activities).

In particular, the U.S. trust might inadvertently become an Italian trust because its trustee has inadvertently become an Italian resident individual under Italian tax residency rules,[5] or because the trustee, while never becoming an Italian resident person under Italian tax residency rules, actually administered the trust out of an office in Italy, or because the trust's main or principal assets activities are located or carried out in Italy.

If treated as fiscally nontransparent for Italian tax purposes, all of a sudden that inadvertent Italian trust would be an Italian taxpaying entity subject to tax on its worldwide income in Italy, including U.S.-source income originating from U.S. investments, assets, or activities.

[5]Italian tax residency rules for individuals use subjective and highly factual tests regarding whether the individual's main center of interest is located in Italy or abroad, which themselves may trigger inadvertent Italian tax residency at the level of the individual involved, with ripple effect at the level of the trust.

If treated as fiscally transparent, all of its income — including foreign-source income originating from investments, assets, or activities in the United States — would be attributed to its foreign beneficiaries and treated as Italian-source income taxable in Italy upon the beneficiaries of the trust, regardless of the source of the trust's underlying income.

Also, beneficiaries would be determined under Italian tax law and may not necessarily coincide with those who are treated as beneficiaries under U.S. tax rules.

B. Italian Trusts With Foreign Beneficiaries

Italian nontransparent trusts would be subject to corporate income tax in Italy (27.5 percent) on all of their income from all sources. No other tax would apply to either the trust or its foreign beneficiaries at the time of the distribution of the trust's income.

Italian transparent trusts allocate their income to their foreign beneficiaries, who are taxable on their share of the trust's income, which is treated as Italian source regardless of the source of the income in the hands of the trust.

The income attributed to the trust's beneficiaries is characterized as income from capital and is subject to Italian withholding tax at the rate of 20 percent. However, the Italian tax could be eliminated under the residual other income article of the tax treaty.

C. Italian Beneficiaries of Foreign Trusts

The foreign trust would be classified as either fiscally transparent or fiscally nontransparent under Italian tax rules, regardless of its tax classification and treatment under foreign law.

For a fiscally transparent foreign trust, Italian beneficiaries would be taxed on the share of the trust's income that is allocated to them under Italian rules. Circular 61/E of 2010 states that Italian beneficiaries are taxed on their allocated share of the foreign trust's income, regardless of whether that income is from Italian or foreign source.

For a fiscally nontransparent foreign trust, the income of the trust is not attributed to its beneficiaries. Rather, it is attributed to the trust and treated as taxable to the trust. As a result, no tax applies in Italy, either to the foreign trust at the time the income is earned by the trust or to the trust's beneficiaries at the time the income is distributed from the trust to the beneficiaries.

VII. Transfer of Assets to and From Trusts

Contribution of business assets to a trust triggers taxable gain or loss to the transferor.

Circular 48/E treats the contribution as a taxable event. The transfer to a trust of a business as going concern is also a taxable event.

Nonrecognition rules, which are confined to transfers of a business as 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 gain or loss is deferred and the trust takes a carryover basis in the transferred assets.

Circular 48/E clarifies that transfer of stock (or other participating financial instruments 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 of gain 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 taxable gain. Nonbusiness assets may be taxable or nontaxable depending on the type of assets and transaction.

VIII. Indirect Tax Purposes

A. The Italian Estate and Gift Tax

The Tax Act (Law Decree 262 of October 3, 2006) related to the Finance Bill of 2007 reinstated the gift and estate taxes introduced and governed by Legislative Decree No. 346 of 1990 and repealed in 2001.

The Tax Act applies to gifts, transfers at death, and other transfers for no consideration that have the effect of separating or segregating certain 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 trust to the beneficiaries are each subject to the gift tax.

The tax base 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 immediate family members by blood (parents-children and grandparents-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 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.

Gifts and transfers at death are also subject to the 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.

B. Transfer of Assets to Trusts

Contrary to the previous regime, the newly reinstated gift tax applies to not only 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 are 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 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 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 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.

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 provides important clarifications that partially rectify the initial determination of the tax administration.

The tax applies when the beneficiaries of the trust assets are identified. 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. By appropriately drafting the clauses of the trust agreement, the application of the tax can be significantly deferred.

Exemption and rates are determined in accordance with the status of the beneficiaries.

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

C. Cross-Border Considerations

In a cross-border context, Italian residents are subject to estate and gift taxes on their worldwide assets, while nonresidents are subject to the Italian estate and gift taxes 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 Italy and subject to foreign law and has no other connections with Italy, the transfer is now subject to tax in Italy at the rate of 8 percent or, for real estate, at the combined rate of 11 percent.

According to the source rules for the application of the 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 under estate and gift tax treaties.

IX. Reporting of Foreign Assets

Italian resident individual taxpayers are required to report their foreign assets to the Italian Tax Agency. Reporting is accomplished by filing Form RW, which is part of the Italian tax return and serves a purpose similar of that of the foreign bank account report in the United States.

Recently, the scope of international tax reporting of foreign assets for Italian resident individuals has changed as a result of new rules being enacted that partially replace the previous statute. Under the new rules, a taxpayer is subject to a reporting obligation whenever he is the beneficial owner of the assets, even if an intermediate entity owns the legal title to those assets.

For trusts, individuals who are identified as the final beneficiaries of the distribution of the assets of the trust under the trust agreement are considered to be the beneficial owners of the trust for tax reporting purposes.

Problems may arise when the right to distribution of trust assets is not certain or may change, subject to conditions or future events, or is to any extent subject to discretion of the trustee. Eventually, the way in which the terms of the trust agreement are drafted will determine exactly if there is an obligation to report, who is obliged to report, and to what extent there is an obligation to report the underlying assets of the trust.

X. Conclusion

Italy's new rules on trusts fill a gap in the Italian tax system and provide important guidelines about the tax treatment of trusts organized under foreign law.

They are far from comprehensive and still leave some gray areas, although the guidance issued by the tax administration with Circular 48/E of 2007 and further clarified by Circular 61/E of 2010 is useful in explaining many open issues.

The provisions and antiabuse rules on tax residency of trusts are potentially dangerous and may be a trap for the unwary. They need to be checked every time a trust has any connection with Italy, because one of the following situations may apply:

- some of the assets, activities, or investments of the trust are located in Italy;
- the trustee has contacts with or spends significant time in Italy and may be considered an Italian resident under Italian law; or
- the trust is actually administered from Italy.

Also, foreign trusts are classified and treated (either as fiscally transparent or fiscally nontransparent) under Italian tax rules, regardless of their classification and treatment under foreign law, and Italian beneficiaries are taxed accordingly.

Finally, foreign beneficiaries of Italian trusts are taxed in Italy based on the tax classification and treatment of the trust under Italian law, regardless of how the same trust is classified and treated under the beneficiaries' own law.

In light of the above, extreme caution should be exercised in drafting and administering a trust, whenever the trust has point of contacts with Italy, either because its grantor, trustee(s), or beneficiaries are Italian resident, or because any of the assets of the trust is located in Italy. In particular, it should always be considered whether the trust may be treated as an Italian resident trust, as a result of the trustee being Italian resident or part of the trust's assets and activities being located or carried out in Italy, and how the trust or its grantor and beneficiaries would be treated under Italian law whenever any of the trust's assets or activities are located in Italy. ◆