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by Marco Rossi

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Recent Italian Supreme Court Decisions on Individual Tax Residency

by Marco Rossi

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The author reviews Italian tax rules on individual tax residency as interpreted and applied in light of new case law from the Italian Supreme Court.

The Italian Supreme Court in decision no. 6501 of March 31, 2015, dealt with the case of an Italian citizen who had most of his personal and family connections in Italy but moved to Switzerland to work, where he had most of his economic and financial interests. The court ruled that the taxpayer's economic and financial connections should prevail over the taxpayer's personal and family connections under the center of vital interests test of the Italy-Switzerland income tax treaty and concluded that the taxpayer's tax residency had to be allocated to Switzerland under that treaty.

The above decision is the latest in a series of recent Italian tax court rulings supporting the conclusion that economic ties to a country are more important than personal or family ties to another country in determining an individual's tax residency. The Supreme Court's holding goes against older case law and has important ramifications.

I refer, in particular, to the frequent cases of U.S. citizens who transfer money from the United States to Italy, purchase and own valuable homes in Italy, and spend significant time there, together with their family. Those people usually pass the test for establishing tax residency in Italy under Italian domestic tax law.

In many cases, the Italian tax administration, which relies on an extensive database detecting U.S. transfers of money to Italy and purchase and ownership of Italian homes, sends audit letters to inquire about the tax status of foreign citizens in Italy, considering that they usually are unaware of the problem and have never filed an Italian income tax return.

The recent case law offers a valuable opportunity to avoid unintended tax consequences arising from inadvertent Italian tax residency so that taxpayers in those cases can still argue that their tax residency remained in the United States whenever sufficient economic and financial interests are still located there, while physical presence and personal and family connections have shifted to Italy.

Below is an overview of Italian tax rules on individual tax residency as interpreted and applied in light of the new case law noted above.

Tax Residency Tests in Italy

Italy applies three alternative tests to determine Italian tax residency for individual taxpayers: the registration test, the residence test, and the domicile test. Tax residency must be tested for each relevant tax year and is triggered when, in any given year, one of the three tax residency tests is met for more than 183 days within the year.

The registration test is a mechanical test. The residence (habitual abode) and domicile tests are facts and circumstances tests and require a thorough review of all of the facts of the case.

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Below are some initial comments in anticipation and preparation of a more careful and in-depth discussion of that issue in light of the information and documents that will be collected and examined during the course of the work.

Registration Test

The registration test applies whenever an individual is listed in the Italian register of residential individuals in the local municipal office of the town or city in which the individual has his primary home address in Italy. If the listing continues for more than six months during a calendar year, tax residency begins from the first day of that year.

Residence (Habitual Abode) Test

The first component of the residence test is an objective element consisting of the taxpayer's physical presence in Italy, which must be regular and continuous, as opposed to sporadic and occasional. When the taxpayer spends time both in Italy and abroad, the periods of presence in Italy must be computed and compared with the periods of presence abroad in any given year.[1]

The second component of the residence test is a subjective element consisting of the taxpayer's intention to stay and live in Italy for the foreseeable future. In order to determine the taxpayer's intention to move to and live in Italy for the undefined future, reference is made to the taxpayer's overall conduct, social and personal habits, working relationships, family relationships, business and personal activities, and so forth. The taxpayer's intention can be ascertained retroactively and exists even before the required minimum physical presence is satisfied.

Overall, physical presence in Italy and all of the factors considered in order to determine the taxpayer's subjective intention to establish his stable place of living in Italy must be prevalent compared to the physical presence abroad and any other factors considered to determine intent.

A regular and continuous presence in Italy exists when the taxpayer frequently travels abroad, even for long periods of time, if it is proved (by referring to all other circumstances of the particular case) that the taxpayer maintains his home in Italy, returns to Italy as soon as he has a chance, and maintains in Italy the center of his social and family relations, therefore showing the intention to treat Italy as his home indefinitely.[2]

[1]Supreme Court, United Sections, issued Dec. 28, 1985, no. 5292.

[2]Supreme Court Mar. 14, 1986, no. 1738; Supreme Court June 12, 1987, no. 5194; Supreme Court, 1983, no. 5584), Circular 304/E of 1997.

The same analysis should apply, for example, to foreign individuals who spend significant time in Italy but maintain their home and economic, social, and family relations in their country of origin and return to their home country when they have a chance.

The two components of the residency test must be met for more than six months during a tax year to establish tax residency in Italy.

The Domicile Test

Domicile is defined as the main center of an individual's interests and affairs. For this purpose, interests include personal, social, moral, familial, economic, financial, professional, and business interests and relationships.

The test can be met regardless of the actual time spent or physical presence in Italy. Unlike the residence test, the domicile test is not based on the physical presence and time spent in Italy; rather, it revolves around the taxpayer's intention to establish the main center of his relations and interests in Italy, and it is based on the nature, extent, and quality of the connections between the taxpayer and Italy, compared with the taxpayer's connections with any other country.[3] As a result, a taxpayer who lives primarily abroad, but maintains in Italy the principal center of his interests, satisfies the test.[4]

The test requires a careful and comparative evaluation and balancing of all the facts of the taxpayer and his business or personal relationships that are connected with Italy compared to those connected with other countries.

The Supreme Court has referred to a decision of the Court of Justice of the European Union on a nontax matter, for the purposes of concluding that in case multiple relations are connected with different countries so that the location of the main center of that person's interest cannot be easily determined, a prevalent consideration should be given to the personal relations.[5]

In more recent decisions, however, the Supreme Court assigned more relevance to the taxpayer's center of economic, business, or financial interests over the location of the taxpayer's close family members[6] in order to establish the taxpayer's tax residency in Italy. Those decisions are discussed in more detail below.

[3]Supreme Court May 22, 1963, no. 1342; Supreme Court Feb. 12, 1973, no. 435; Supreme Court May 5, 1980, no. 2963.

[4]Supreme Court, Dec. 29, 1960, no. 3322; Supreme Court Mar. 21, 1968, no. 884.

[5]CJEU, C-262/99, *Paraskevas Louloudakis v. Elliniko Dimosio* (July 12, 2001); Supreme Court, Nov. 7, 2001, no. 13803.

[6]*See* Marco Rossi, "Italy's Supreme Court Rules on Establishing Tax Residency," *Tax Notes Int'l*, Feb. 10, 2014, p. 557.

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Administrative Guidance on Domicile Test

The tax administration has issued specific guidance on the application of the domicile test in determining the Italian tax residency of individual taxpayers according to Circular no. 304/E of December 2, 1997.

Circular 304 provides instructions for the tax agency's control and audit activities, which should include the following:

- collecting all information in the tax agency database system;
- collecting copies of all public documents concerning purchases of real estate, gifts, formation of companies and entities, and capital contributions to companies and entities;
- collecting information on transfers of money from or to foreign countries;
- reviewing the taxpayer's family relations in Italy;
- reviewing the taxpayer's economic interests in Italy; and
- ascertaining the taxpayer's intention to remain and live permanently in Italy according to public statements or any other available information.

Recent Italian Case Law on Domicile Test

The most recent decisions from Italy's tax courts and Supreme Court support the principle that economic relations prevail over personal connections to determine an individual taxpayer's domicile (and center of vital interests) for Italy's tax residency purposes.

Decision no. 49 of November 11, 2006, of the Regional Tax Commission (appellate court) of Florence deals with the case of an Italian resident individual who had purportedly transferred his tax residency to Monaco. Under the facts of the case, it was stipulated that the taxpayer had been living regularly in Monaco with his family. However, it was also found that he maintained significant economic and business relations with Italy, in the form of executive positions in various Italian companies, bank accounts, and other income-generating investments. The court focused on those economic and business connections and concluded that despite his clear personal ties with Monaco, the taxpayer's main center of interests and tax residency under the domicile test had remained in Italy.

Decision no. 87 dated July 13, 2012, of the Regional Tax Commission of Genoa (appellate court) dealt with the case of another Italian individual claiming to have established his residency in Monaco. Also in this case, the fact that the taxpayer actually lives regularly in Monaco is stipulated and not an issue. However, the court concluded that the economic interests that the taxpayer maintained in Italy prevail over his personal connections to his new country of residence and have the effect of keeping the taxpayer's residency in Italy under the domicile test.

The Supreme Court's decision no. 5382 of April 4, 2012, affirmed the Regional Tax Commission of Tuscany-Florence's decision no. 49 of November 11, 2006 (noted above). The Supreme Court affirmed the principle of law according to which the taxpayer's economic and business connections to a country prevail over his personal and family affairs in determining the taxpayer's domicile and therefore his tax residency in that country under the domicile test.

Ultimately, the Supreme Court in decision no. 6501 of March 31, 2015, in which the taxpayer had most of his personal and family connections with one country (Italy) and most of his economic and financial interest in another country (Switzerland), ruled that the economic and financial connections prevail over the personal and family connections under the center of vital interests test of the Italy-Switzerland treaty (and concluded that the taxpayer's residency had to be allocated to Switzerland under the treaty).

Under the facts of the case, the taxpayer was an Italian citizen who moved to Switzerland, where he registered as a Swiss resident and started working for a local employer. His family continued to live in Italy. The tax administration took the position that the taxpayer should be considered an Italian tax resident based on his personal and family interests located in Italy. The Supreme Court affirmed the lower tax courts' rulings in favor of the taxpayer, holding that the taxpayer's tax residency had to be assigned to Switzerland because of the taxpayer's professional and economic interests located there, and prevailing over his personal interests located in Italy.

The decision does not provide any direct authority in cases in which the economic interests in another country are of a different nature, namely financial interests linked to passive investments as opposed to active business interests connected with a job or an active business operated and actively managed in the foreign country. However, it clearly constitutes an important precedent, supporting the conclusion that whenever meaningful economic and financial interests are located abroad, while a taxpayer's personal and family ties are in Italy, Italian tax residency may still be excluded under the center of vital interest tiebreaker provision of the applicable tax treaty.

Residence Tests in the Italy-U.S. Treaty

If the taxpayer's Italian tax residency is established according to any of the tax residency tests provided for under Italian internal law, as described above, reference can be made to the tiebreaker provisions of article 4 of the Italy-U.S. tax treaty to break the dual tax residency situation in favor of the United States.

It is unclear whether an individual taxpayer who is resident in Italy under Italian internal tax laws but is treated as a resident of a foreign country under the tiebreaker provisions of any applicable Italian tax treaty is exempt from the international tax reporting

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obligations of Law Decree 167. Under U.S. tax law, tax treaties apply only for the purposes of determining the U.S. tax due, but for any other purpose a taxpayer who is a resident of the United States under U.S. internal law is treated as a U.S. resident and remains subject to U.S. tax reporting obligations. There is no such provision under Italian tax laws.

When a taxpayer has permanent homes both in Italy and the United States, the test to apply under the treaty would be the center of vital interests test, which is the equivalent of the domicile test under Italian internal tax law.

If taxpayer residency cannot be determined under the center of vital interests test, the next test to apply would be the place of habitual abode test. If residency cannot be determined under the place of habitual abode test, the final test to apply would be the nationality (citizenship) test.

As noted above, the center of vital interests test of the treaty is similar to the domicile test applied under Italian internal tax laws. The place of habitual abode test of the treaty is similar to the residence test applied under Italian internal tax laws.

Italian tax agencies often make reference to Italian case law regarding the Italian domicile and residence test in order to interpret and apply the center of vital interest and place of habitual abode tests of tax treaties.

Permanent Home

The first test under the treaty is ''permanent home.'' The OECD commentaries define a permanent home as a permanent place of abode. A home could simply be a furnished room, but to qualify as a permanent home it should be available to the individual at all times continuously and not occasionally for the purposes of a stay for a short duration.

The OECD commentary states:

> As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.)[7]

An individual will be considered resident in the country where the individual has his permanent home. It is possible that the individual has a permanent home in both places or in neither place; in those cases, residency will have to be determined based on one of the other tests below.

'Center of Vital Interests' Test

''Center of vital interests'' is defined as the country with which an individual's personal and economic relations are closer.

The center of vital interests test involves evaluating an individual's personal and economic ties to determine to which country they are closer. The OECD commentary notes that this test should include an examination of the individual's family and social relations; his occupation(s); his political, cultural, or other activities; his place of business; and the place from which he administers his property. This test can be fairly objective, and the factors listed above may occur in both countries.

The OECD commentary states:

> If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it would be nevertheless obvious that considerations based on the personal aspects of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his center of vital interests in the first State.[8]

Thus, as observed in the commentary, an individual's center of vital interests does not shift easily from one country to another.

'Place of Habitual Abode' Test

If residency cannot be resolved based on either the permanent home or center of vital interests test, then residency is determined based on the individual's place of habitual abode. An individual's habitual abode is the state where the individual spent the most time. According to the OECD commentary, the comparison must cover a sufficient length of time for it to be possible to determine whether the residence in either of the two states is habitual and to establish the intervals at which the stays took place.

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[7] *See* OECD commentary of article 4 of the OECD Model Tax Convention on Income and Capital, para. 13.

[8] *Id.* at para. 15.

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The Italy-U.S. treaty in article 4, paragraph 2(c) says clearly that ''if he has an habitual abode in *both* states . . . he shall be deemed to be a resident of the state of which he is a national'' (emphasis added). Therefore, the treaty clearly contemplates a situation in which a person could have a habitual abode in *both* states. So, an American with houses in both the United States and Italy could have a habitual abode in the United States where he spends most of his time *when he is in the United States*. At the same time he could have a habitual abode in Italy, where he spends most of his time *when he is in Italy*. If habitual abode simply means the place where he spends most time *overall*, then the language of the treaty would make no sense.

'Citizenship' Test

If a habitual abode exists in both countries, or in neither of them, residence is then determined by the country of which the individual is a citizen. If the individual is a citizen of both states, or of neither, the determination of residence will normally be settled by the competent authorities by mutual agreement.

Conclusion

Italian tax residency for foreign citizens living in Italy is a hot tax issue, given the frequent case of foreign citizens transferring money from the United States to bank accounts in Italy, purchasing and owning valuable homes there, and spending significant time in Italy, coupled with the extreme active approach taken by the Italian tax authority in starting audits based on available public records and information flowing in its own extensive database.

Advance planning is always recommended in those situations; however, the latest trend in Italian case law offers a ray of hope for those taxpayers who are caught by surprise and need to deal with the issue after the fact. ◆

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