

ITALIAN INTERNATIONAL TAX REPORTING RULES
FOR INDIVIDUAL TAXPAYERS

I. INTRODUCTION.

Italian resident taxpayers are required to report to the Italian tax administration their foreign financial investments and assets, which can generate foreign-source income subject to tax in Italy.

Italian taxpayers report their foreign investments by filling out a special part of their annual income tax return referred to as form RW. Taxpayers who are not otherwise required to file an income tax return (e.g., those who earn only salary income reported on form 730 equivalent to form W-2 in the United States) must file a full return just for the purpose of reporting their foreign investments on Part RW.

Italian international tax reporting through form RW is very extensive in scope and accompanied by very harsh penalties with very limited opportunities to rectify past mistakes or failures. It includes personal assets other than financial investments (e.g. personal residences, boats, jewelry, artworks). One section of form RW is used to report the value of the reportable assets at the end of the taxable year. Two separate sections are used to report outbound, inbound and foreign transfers of money or other assets relating to foreign assets subject to reporting (i.e. additional investments and disinvestments through purchases, sales or transfers of reportable assets).

Reporting may be particularly complicated when foreign assets are held through trusts or other foreign entities. Depending on the tax classification and treatment of the entity or trust the taxpayer may be exempt from reporting, required to report his or her own interest in the

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trust or entity, or required to report his or her own undivided ownership interest in the underlying assets held through the entity or trust, with totally different results.

The duty to report revolves around several fundamental tax concepts: tax residency of the taxpayer, ownership of the asset, and tax nature of the asset and associated income.

Italian tax residency rules are far reaching and often based on technical and heavily factual tests. As a result, many non-Italian nationals who spend significant time in Italy for personal or business purposes or have personal, investments or business interests in Italy should act very carefully, especially now that the Italian tax agency is stepping up its enforcement actions in the effort of collecting additional revenue.

Indeed, if it turns out that they should be treated as resident of Italy for Italian tax purposes, they would automatically face the issue of not having reported their non-Italian assets, with all potential penalties associated with it, in addition to the main issue of having failed to file their tax returns and pay any taxes due.

International tax reporting rules are very technical and complex to administer. Italy's tax administration issued a general guidance on international tax reporting of foreign assets and investments with Circular n. 45 of September 13, 2010.

II. STATUTORY FRAMEWORK.

1. Law Decree n. 167 of 1990: reporting of foreign financial assets and investments and related transfers.
 - a. Article 4, paragraph 1: Reporting of Foreign Investments and Foreign Financial Assets.

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Individuals, noncommercial (non business) entities¹, simple companies and other organizations classified as simple companies for Italian tax income tax purposes pursuant to article 5 of the Italian unified code on income taxes (“TUIR”)², which are resident in Italy for tax purposes and hold, at the end of the tax year, foreign investments or foreign financial assets through which they can derive foreign source income subject to tax in Italy, must report those foreign investments and foreign financial assets on their Italian income tax return.

The reporting requirement applies if the aggregate value of the assets exceeds euro 10,000 at the end of the tax year.

b. Article 4, paragraph 2: Reporting of Transfers Relating to Reportable Foreign Investments and Foreign Financial Assets.

The amount of any outbound (from Italy to abroad), inbound (from abroad to Italy), and foreign (between foreign countries or within a foreign country) transfers made during a tax year, and relating to the reportable foreign investments and foreign financial assets referred to under paragraph 1, must also be reported on the Italian income tax return.

In this case, the reporting requirement applies if the aggregate amount of the transfers during a tax year exceeds euro 10,000.

¹ As are referred to under article 73, paragraph 1, letter c) of TUIR. They include private and public entities and organizations (other than corporations, companies and partnerships), and trusts, which do not have as their exclusive or principal purpose the carrying out of business activities for profit.

² Simple companies are companies that can only carry out noncommercial profit activities as defined in the civil code i.e. agricultural activities as defined in the civil code.

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Each individual transfer must be classified and reported on form RW of the Italian tax return.

2. Taxpayers not subject to reporting.

The following taxpayers are not subject to reporting obligations:

- a. Nonresident individuals.
- b. Nonresident entities and trusts
- c. Domestic (resident) business entities (companies, partnerships, corporations) and business trusts.

3. Taxpayers subject to reporting.

The following taxpayers are subject to reporting obligations:

- a. Tax Resident Individuals.
- b. Tax Resident Noncommercial Entities.

Trusts that are not engaged in a trade or business as their main or exclusive activity are classified as noncommercial entities under article 73, paragraph 1, letter c) of TUIR.

As a consequence, resident noncommercial (nonbusiness) trusts owning foreign assets and investments are subject to the reporting obligations of DL 167 of 1990.

On the contrary, Italian resident commercial (business) entities, including Italian resident commercial (business) trusts, are not subject to reporting obligations.

4. Tax Residency Requirement.

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a. Tax residency tests for individuals.

For individual taxpayers, Italian tax residency is established when any one of the following three criteria is satisfied for a period of more than 183 days during any tax year:

1. The individual is registered on the register of Italian resident individuals,
2. The individual has his or her place habitual abode (main place of living)³ in Italy,
3. The individual has his or her domicile (main center of the individual's family, personal, business and professional affairs and interest)⁴ in Italy.

b. Tax residency tests for trusts.

For trusts, Italian tax residency is established when any one of the following two alternative criteria is met for a period of more than 183 days in a tax year:

1. The place of administration (management) of the trust is located in Italy⁵;

³ The residence or place of habitual abode test requires both the predominant or habitual physical presence in Italy (objective requirement) and the taxpayer's subjective intention of living there for an indefinite period of time (subjective requirement).

⁴ Domicile in Italy may exist as a result of the taxpayer's personal and economic connections with Italy, regardless of taxpayer's presence in the country during the tax year.

⁵ For the purposes of determining the place of administration of the trust, reference is made to the place where the trust offices, personnel and staff are located and the actual management of the trust is carried

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2. The principal activities of the trusts are located or carried out in Italy⁶.

Therefore, a U.S. whose main assets are located in Italy could be considered an Italian resident trust and could be required to reports its remaining non Italian assets on its Italian income tax return.

5. Assets subject to reporting.

Assets subject to reporting are defined in the statute as follows:

- a. Foreign financial investments.
- b. Foreign financial assets.

Following are examples of foreign financial assets and investments subject to reporting:

- Leisure assets such as boats, art works, jewelry, paintings, and real estate assets (homes, apartments), located abroad;
- Securities (stocks, bonds, options) that are issued by foreign persons or are held or located at places outside of Italy;
- Ownership interests in foreign companies or foreign partnerships;
- Banking or deposit accounts with foreign banks or financial institutions;

out; however, when the location of the trust's offices, personnel and management activities cannot be easily determined, reference is made to the residence or domicile of the trustee.

⁶ For the purpose of determining the place of business of the trust, reference is made to the location of the trust's assets or the place in which the activities and investments of the trust are actually carried out.

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- Units or shares of foreign funds or of Italian funds but held with foreign depositories;
- Foreign currencies;
- Precious metals and currencies held abroad;
- Financial arrangements or contracts (derivative contracts, forwards, futures, repos, insurance contracts) that are entered into with foreign counterparts;
- Pension and retirements plans issued by or with foreign entities.

As clarified by the Italian tax administration, reporting extends to personal assets that do not generate at present any foreign source taxable income but may generate it in the future in case of future sale and disposition of same. The classic example is a personal residence held for use or investment and not rented.

The fair market value of the assets or investments as existing at the end of the tax years must be reported on the section II of form RW of the Italian tax return.

6. Transfers Subject to Reporting.

Any cross border (outbound, inbound, and foreign) transfer of money or other values that is connected with reportable foreign financial assets or investments, is subject to reporting.

Reportable transfers include additional investments (e.g. transfers of money from Italy to a foreign country to purchase additional shares of foreign stock), a partial or total liquidation of an existing asset or investment (e.g., transfer of money from abroad to Italy or between

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foreign countries, or within the same foreign country, resulting from the sale of shares of foreign stock), repatriation of money from a foreign bank account, etc.

Collection of income derived from foreign reportable assets or investments (e.g. interest or dividends from foreign bonds or shares of stock that are paid and credited on a foreign bank account) does not constitute a reportable transfer.

The amount of each individual reportable transfer must be disclosed on section III of form RW of the tax return.

7. Ownership Requirement.

A taxpayer is subject to reporting only when he or she owns the reportable foreign financial assets or investment.

The ownership requirement is satisfied when the taxpayer:

- Is the legal owner of the asset, alone, or co-owner pro quota with other persons,
- Owns some partial or limited rights (e.g. life estate) on the asset, alone, or as co-owner with other persons;
- Is the beneficial owner of the assets with power of disposition and enjoyment of the asset regardless of the ownership of legal title,
- Owns an asset indirectly through an agent or nominee or a conduit or other fictitious entity,
- Has signatory authority on a bank account or other financial arrangements.

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Assets owned through a trust that is disregarded for tax purposes (e.g. a revocable grantor trust) must be reported by the actual owner of the assets, namely either the grantor or beneficiaries depending on the terms of the trust.

In other terms, the grantor or a beneficiary of a trust must report any assets formally owned (titled to) by the trust, when it appears from the terms of the trust or the facts of the case that either the grantor or that beneficiary has enough power of direct disposition and enjoyment of the assets that he or she qualifies as the actual beneficial owner of the assets.

Examples of disregarded trusts are illustrated in Circular 43/E of October 10, 2009 (paragraph 1).

8. Foreign Source Taxable Income Requirement.

For the reporting obligation to apply, the reportable assets must be capable of producing foreign source income taxable in Italy. The provisions of article 23 of TUIR apply to determine the notion of foreign source income for international tax reporting purposes.

The tax administration with the Circular n. 45/E of 9/15/2010 clarified that the foreign source income requirement is met whenever the asset are may possibly generate foreign source taxable income in the future, also through its sale or disposition, even though it does not currently generate any income.

As a consequence, a foreign real estate property that is held as personal residency or investment property and does not currently generate any rental income is nevertheless a reportable asset.

9. Statutory Penalties for Failure to Report.

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Separate penalties apply to the failure to report the value of the foreign financial assets and investments held at the end of the tax year on section II, and to the failure to report the amount of the transfers relating to foreign financial assets and investments that occurred during the tax year on section III.

The amount of the penalties is the following:

- 10 to 50 percent of the unreported amount, effective from August 5, 2009,
- 5 to 25 percent of unreported amount, effective before August 8, 2009.

10. Possible Grounds for Penalty Relief.

Law decree n. 167 of 1990 does not contain any specific penalty relief provisions. As a result, an investigation has been started and is under way before the European Commission to determine whether the Italian statute is in breach of the general EU principle of proportionality in administering tax penalties or unlawfully discriminates against a taxpayer's freedom to invest or move funds outside of Italy.

However, the general statutory provisions on tax penalties as briefly described below could be used to mitigate penalties associated to failure to report:

- a. Article 10, paragraph 3 of the law n. 212 of July 27, 2000 (so called taxpayer's statute) provides that no tax penalties apply whenever a conduct amounts to a formal breach of the law with no taxes due and no obstacles to normal tax audit activities.
- b. Article 5, paragraph 1 of Legislative Decree n. 472 of November 18, 1997 provides that for the tax penalties to apply the conduct amounting to a breach of the law must be conscious and voluntary, and can be either intentional or negligent. Lack of consciousness of the violation may lead to the complete forgiveness of penalties.
- c. Article 6 of Legislative Decree n. 472 also provides as follows:

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- i. Paragraph 1: In case of breach due to error on the facts, the author of the breach is not subject to penalties when the mistake is not due to negligence.
 - ii. Paragraph 2: no penalty applies when a breach is due to objective conditions of uncertainty about the meaning and scope of the applicable tax provisions.
 - iii. Paragraph 4: the ignorance of the applicable tax provisions does not excuse, unless it is unavoidable ignorance.
 - iv. Paragraph 5: no penalties apply in case of a breach that does not adversely affect the exercise of control actions (audit) and does not affect the computation of the tax base, the amount of the tax due and tax payments.
- d. Finally, article 7, paragraph 4 of Legislative decree n. 472 of 1997 provides that when exceptional circumstances concur which make manifest the disproportion between the amount of the tax to which the violation relates and the amount of the penalty, the penalty can be reduced up to one half.

III. OVERVIEW OF RELEVANT TAX CONCEPTS FOR ITALIAN INTERNATIONAL TAX REPORTING PURPOSES.

1. Italian Tax Residency for Individual Taxpayers.

Tax residency must be tested for each relevant tax year and for each year either of the three tax residency tests (see above, section II, paragraph 4(a)) must be met for more than 183 days of that year.

The registration test is a bright line test.

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The residence (habitual abode) and domicile tests are (heavily) facts and circumstances tests and require a thorough review of all of the facts of a particular case.

a. The Residence (Habitual Abode) test.

Residence has the same meaning as defined in the Italian civil code for general law purposes and indicates a person's habitual abode or regular place of living.

The first component of the residence (habitual abode) test is the 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 in Italy⁷.

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

Overall, the physical presence in Italy and all of the factors considered in order to determine the taxpayer's intention to establish his stable place of living in Italy, must be prevalent compared the presence and the factors located in a foreign country.

The regular and continuous presence in Italy exists when the taxpayer travels frequently abroad, even for long periods of time, if it is proved that the taxpayer maintains his

⁷ Supreme Court ruling n. 5392 issued on December 28, 1985.

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home in Italy, returns to Italy as soon as he has a chance, and maintains in Italy the center of his social and family relations⁸.

The above clarification should hold true also in the opposite case. As a result, when a foreign person spends significant time in Italy, but he or she maintains his or her contacts with a foreign country, and from all of the facts and circumstances of his or her periods of stay in Italy it appears or can be reasonably argued that he or she does intend to live in Italy for his or her indefinite future, that person would not have his or her residency in Italy for the purposes of the residency test used to determine her possible Italian tax residency.

b. The Domicile Test.

Domicile is defined as the place in which a person has established the head quarter of his or her business and interests. For this purpose, interests include personal, social, moral, familiar, economic, 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

⁸ Supreme Court ruling n. 1738 issued on 3/14/1986; Supreme Court ruling n. 5194 issued on 6/12/1987; Supreme Court ruling n. 5584 of 1983, Circular 304/E of 1997.

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connections with any other country⁹. As a result, a taxpayer who lives primarily abroad, but maintains in Italy the principal center of his or her interests, satisfies the test¹⁰.

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

i. Administrative Guidance on The Domicile Test.

The tax administration has issued specific guidance on the application of the domicile test for the purposes of determining the Italian tax residency of individual taxpayers by way of the Circular n. 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 contained in the tax agency data base system;
- Collecting copies of all public documents concerning purchases of real estate, gifts, formation of companies and entities; 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,

⁹ Supreme Court ruling n. 1342 issued on 5/22/1963; Supreme Court ruling n. 435 issued on 2/12/1973; Supreme Court ruling n. 2963 issued on 5/5/1980.

¹⁰ Supreme Court ruling n. 3322 issued on 12/29/1960; Supreme Court ruling n. 884 issued on 3/21/1968.

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- Reviewing the taxpayer's economic interests in Italy;
 - Ascertaining the taxpayer's intention to remain and live permanently in Italy as appearing from public statements or any other available information.
- ii. Recent case law on the tax domicile test.

The Italian Supreme Court referred to a decision of the European Court of Justice on a non tax matter, for the purposes of concluding that in the event a taxpayer has several contacts and interest in more than one country, and the exact location the taxpayer's interest cannot be easily determined, a prevalent consideration should be given to the relations of personal nature over those of economic nature¹¹.

More recent decisions have come to a different conclusion and have emphasized economic ties over personal ties.

In particular, Supreme Court Ruling n. 5382 of April 4, 2012 upheld the decision of the tax Court of Appeal of Florence n. 49 issued of November 21, 2006 and ruling that the taxpayer's domicile was located in Italy, where the taxpayer had most of his economic interests, instead of Monaco, where the taxpayer actually lived with his family (wife and children). The taxpayer had provided sufficient evidence that he actually lived and spent most of his time in Monaco, where he was a registered resident together with his wife, his children went to school and he was active member of various local associations and social clubs. However,

¹¹ European Court of Justice (ECJ) 7/12/1991 in Case C262/99 referred to in Italian Supreme Court, judgment n. 13803 issued on 11/7/2001.

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the taxpayer, originally from Italy, had maintained significant interest in numerous family companies for which he served as director. The court concluded that his economic ties with Italy were prevalent and more significant than his personal contacts with Monaco and his tax residency had ultimately to be located in Italy.

The Tax Court of Appeal of Liguria in its decision n. 87 of January 23, 2012 applied the same principle in a very similar and held that economic interests in Italy prevail over the personal residency of the taxpayer abroad and are sufficient to establish the taxpayer tax residency in Italy under the domicile or center of vital interests test.

iii. Role of Tax Treaties.

A taxpayer who is resident in Italy under Italian internal tax laws but is treated as resident of a foreign country under the tie breaker provisions of any applicable Italian tax treaty, is exempt from the international tax reporting obligations of Law Decree 167.

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

For the most part, the Italian domicile test is interpreted and applied in the same way as the tax treaty center of vital interests test of treaty article 4, paragraph 2(b).

Under the theory of the prevalence of the economic interests over personal ties, as recently applied Italian courts (see sub paragraph ii) above) a taxpayer may be able to successfully argue that despite living in Italy with his or her family, he or

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she may still have his or her center of vital interests in a foreign country in which he or she maintained the most part of economic interests relating to his or her family of origin.

2. Ownership Requirement For Assets Held in Foreign Trust or Entities.

As discussed (see above section I, paragraph 7) For a foreign asset or transfer to be subject to reporting on form RW in Italy, it is necessary that an Italian resident taxpayer owns the foreign assets to which the transfer relate.

In case of assets held in a foreign trust, a determination about the tax character of the trust and tax and ownership of the trust assets must be made in order to determine whether any Italian resident taxpayer having any interest in or legal relationship with the trust must report the trust assets or trust transfers in Italy.

Italian tax law classifies trusts as transparent or opaque depending on whether the trust, as opposed to the trust grantor or the trust beneficiaries, has the power of enjoyment and disposition of trust assets, regardless of legal title. In case of revocable trust, the grantor is the owner of the trust assets and, if the grantor is a tax resident of Italy, the grantor must report the trust assets under form RW. In the event that the trust beneficiaries are entitled to enjoy and benefit from trust assets or receive distributions from the corpus of the trust during the life of the trust, and those distributions are not at the discretion of the trustee or subject to objective standards beyond the beneficiaries' control, then the beneficiaries are treated as owners of the trust assets to the extent that they have direct access to those assets or the trust corpus based on the terms of the trust¹².

¹² Italy's tax administration issued general guidance and clarifications on Italian tax rules on trusts with Circular n. 48 of August 6, 2008.

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On the contrary, in case of irrevocable discretionary trusts in which the grantor makes a final and definite transfer of the assets to the trusts and the beneficiaries do not hold a direct and enforceable right over the trust assets before a distribution event occurs, the trust is treated as the owner of the assets and no reporting is due for the trust assets.

In case of ownership of assets through a foreign entity, the Italian owner is required to report his or her undivided interest in the entity's underlying assets to the extent that the entity is a mere agent, nominee or conduit or should be disregarded because it is not engaged in any active business but it serves the sole purpose of holding the legal title to the assets. In any other case an Italian owner or shareholder must report his or her interest in the entity.

3. Foreign Source Taxable Income Requirement.

As discussed (see above, section I, paragraph 8), a reporting obligation may exist in respect of foreign financial assets and investments (and transfers relating thereto), only if those assets and investment are capable of generating foreign source income subject to tax in Italy.

This in turn requires that any income from those assets must be allocated to an Italian resident taxpayer for Italian tax law purposes.

Therefore, in case of investments and assets held in a foreign trust, when on the basis of the terms of the trust agreement the income of the trust is allocated to beneficiaries who are not Italian resident taxpayers, there should be no obligations to report the trust assets in Italy even though those assets are treated as "owned" by an Italian individual (who is either the grantor or a beneficiary of the assets of the trust).

4. Tax Residency of Trusts.

As noted (see above section I, paragraph 4(b)), under Italian law the tax residency of a trust is determined based on two alternative criteria: the trust's place of administration or the main place of trust's activities.

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The residency or domicile of the trustee is deemed to be trust's place of administration unless the taxpayer proves otherwise. Similarly, the location of trust's assets is deemed to be the trust's place of business unless the taxpayer proves otherwise.

The governing law of the trust places no role in this respect.

A nonresident trust is not subject to reporting obligations. A resident trust with foreign (non Italian) assets is required to report those assets on form RW.

IV. CONCLUSIONS.

Italy's tax administration is increasing its enforcement activities in the area of international tax law and is using banking information about inbound and outbound international transfers of money as starting point to begin audits on international taxpayers.

Audits usually begin with questions about the nature and source of the transfers, taxpayer's tax status and reasons for not reporting them when the transfers do not show up on taxpayer's tax returns.

Enforcement of reporting obligations is particularly strict since the enactment of the third version of Italian international tax amnesty in 2009-2010 (after the first of 2001-2022) specifically aimed at repatriation of foreign unreported investments.

In the light of the above, taxpayers must pay specific attention to their reporting obligations through form RW of their tax returns. Foreign taxpayers with (personal and business) activities, interests and contacts in Italy must use extra caution in determining whether the extent of their presence and contacts in Italy may be such that they may be considered resident of Italy for Italian tax purposes.

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In the latter case, they would be subject to Italian tax reporting obligations independently from and in addition to their obligations to report their income and pay their taxes to Italy, with potential harsh penalties for any past failure to report and very limited possibilities to remedy the past failure and mitigate their penalty exposure.

Form RW reporting requires extensive study for taxpayers who use trusts and entities to hold and manage their investments portfolio or business interests.

Any effort is essential to avoid or minimize the risks of being exposed to unexpected tax duties for which going back in compliance may prove to be not practically possible or particularly painful.

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