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Trusts in Prime Jurisdictions

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STEP
ADVISING FAMILIES ACROSS GENERATIONS

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Table of contents

Volume II

Italy

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Maisto e Associati

1. Introduction

Italy is a civil law jurisdiction. The fundamental concepts of Italian law are rooted in Roman law. However, the increase in international transactions has encouraged the use of institutions developed in common law countries – including trusts, which are used in Italy for many purposes, such as estate planning. Although the trust is not comprehensively regulated by the domestic civil law, foreign law trusts are recognised in Italy due to Italy's ratification of the Hague Convention on the Law Applicable to Trusts and on their Recognition. In addition, Italian tax law includes specific provisions on the taxation of trusts and the tax authorities have issued extensive guidelines on the taxation of trusts. Furthermore, a statute (Law 112 of 22 June 2016) deals with trusts established in favour of disabled individuals.

2. Trusts under the Italian law and recognition of trusts in Italy

The Italian Civil Code does not comprehensively regulate trusts, but trusts regulated by foreign laws are recognised in Italy pursuant to the Hague Convention. Therefore, the applicable law may be elected voluntarily by the settlor from among those foreign jurisdictions that provide for trusts (eg, England and Wales, Jersey). However, a trust, whether set up *inter vivos* or *mortis causa*, will be recognised in Italy to the extent that it is set up in compliance with the governing foreign law and complies with the requirements laid down by the Hague Convention.

Pursuant to Article 2(1) of the Hague Convention the trust assets must be "placed under the control of the trustee". This condition is sometimes referred to in the Italian case law in order to argue that trusts giving very intrusive powers to the settlor are not to be recognised pursuant to the Hague Convention and therefore are *tamquam non esset* (eg, see Tribunal of Reggio Emilia, Decision 531 of 2 April 2019, dealing with a Jersey trust whereby the settlor retained the power to vary the trust).

In other cases, Italian courts have refused to recognise trusts by making reference to the concept of a 'sham trust' (eg, see Supreme Court, Criminal Chamber, Decision 36801 of 25 July 2017).

In accordance with Article 15 of the Hague Convention, the recognition of trusts cannot affect the application of Italian mandatory rules including (to the extent that Italian succession law is applicable) forced heirship rules. The settlement of assets in a trust is regarded as a gift from a succession law perspective, and is thus relevant to the calculation of the value of the estate of the deceased for the purpose of calculating the reserved quota of forced heirs. Whether the use of the trust may affect forced heirship rights depends on the specific facts and circumstances, including the weight of the value of the trust assets as compared to the whole estate of the settlor/deceased. Furthermore, in relation to foreign nationals living in Italy, Italian succession law may not apply due to the election for the foreign succession law of nationality. A legislative proposal for the reform of Italian succession law is pending: it is hoped that this reform will lead to increased use of trusts in Italy.

3. Most frequent uses of trusts in Italy

The use of trusts has dramatically increased in Italy in recent years, thanks to the increased certainty regarding their legal and tax ramifications and extensive administrative tax guidelines.

By virtue of their flexibility, trusts are effective tools that allow individuals to achieve goals that would not otherwise be available through Italian legal entities or traditional institutions. They may be used for multiple purposes, such as:

- managing and protecting family assets from family events or frictions between relatives;
- protecting minors, incapacitated individuals or disabled person;
- structuring a successful generational transfer of a business; and
- serving as a guarantee fund instrument (eg, as an alternative to a mortgage or pledge).

With specific reference to the use of trust in the generational transfer of a business, trusts are often used to:

- ensure professional management where the descendants are not prepared to take over the business;
- ensure that only those descendants who have the desire and the capabilities will be involved in the management of the business;
- avoid the descendants receiving too much money too soon;
- avoid the fragmentation of the controlling shareholding, preventing impasse situations;
- prevent the transfer of shares to non-blood relatives;
- protect the descendants' interests from creditors and ex-spouses; and
- ensure stable ownership even if the descendant becomes legally incapable.

Trusts are also used as a tax-efficient vehicle to hold private assets, such as real estate. From an income tax perspective, the trust is generally not subject to anti-abuse provisions that apply to companies (ie, anti-shell companies legislation), whereby a minimum income is imputed to the company on the basis of the value of the assets, or to provisions deeming a benefit in kind for shareholders and related parties that enjoy the assets of the company without paying a fair market value charge. Furthermore, the computation of the income of trusts follows the same rules as apply to individuals; therefore, beneficial regimes applicable to individuals – such as the exemption from capital gains on real estate held for at least five years – also apply to trusts.

Finally, trusts may be helpful to optimise the inheritance and gift tax regime. For instance, given the potential for increases in inheritance and gift tax rates, trusts have been used (as an alternative to the typical gift of bare ownership with reservation of usufruct) to freeze the current inheritance and gift tax regime. As explained below, according to the tax authorities, the transfer to the trustee is a taxable event for inheritance and gift tax purposes; and once the assets are within the trust structure, they are not exposed to inheritance tax.

4. Tax treatment of trusts

From an Italian tax standpoint, the main taxes of relevance with regard to trusts are:

- inheritance and gift tax; and
- income tax (which applies to income and gains).

4.1 Inheritance and gift tax regime of trusts

Inheritance and gift tax is levied on worldwide assets if the deceased or donor had his or her habitual abode in Italy on the date of demise or gift; otherwise, it applies only to Italian-situs assets.

Transfers upon death and gifts are subject to inheritance and gift tax at the following rates and with the following allowances:

- 4% if the transfer is made in favour of spouses and direct descendants or ancestors; here, the transfer is subject to tax on the value exceeding €1 million (this allowance applies to each beneficiary);
- 6% if the transfer is made to brothers and sisters; here, the transfer is subject to tax on the value exceeding €100,000 (this allowance applies to each beneficiary);
- 6% if the transfer is made to relatives up to the fourth degree, to persons related by direct affinity as well as to persons related by collateral affinity up to the third degree; and
- 8% in all other cases.

There are no specific provisions dealing with the taxation of trusts in the

Inheritance and Gift Tax Act. The tax authorities, in Circular Letters 48 dated 6 August 2007 and 3 dated 22 January 2008, have held that the addition to the trust fund must be regarded as a taxable event from an inheritance and gift tax perspective (on the other hand, from an income tax perspective, the addition of assets to the trust fund is not a taxable event and the tax basis upon the settlor is rolled over to the trustee). The tax authorities have taken the view that this approach also applies to revocable trusts (which are disregarded for income tax purposes).

In particular, the tax authorities have pointed out that inheritance and gift tax will be due by the trustee at the time of the addition of the assets to the trust fund, and that the applicable rate and the possible allowances will be computed based on the degree of kinship between the settlor and the beneficiaries. The benefit of the favourable rates and allowances may be lost if the trust deed is not properly structured. For instance, in case of a discretionary trust with a class of beneficiaries comprising individuals not belonging to the family of the settlor, the highest rate with no exempt amount will apply (as the capital may be wholly distributed to the beneficiary not belonging to the family of the settlor). Furthermore, to the extent that the settlor is among the beneficiaries (or the trust is revocable), the 8% rate with no allowance will apply.

The tax authorities have further stated that the distributions from the trustee to the beneficiaries will not be a taxable event for gift tax purposes, since inheritance and gift tax is applied at the time the addition to the trust fund is made. Furthermore, the trust assets do not belong to the estate of the settlor and of the beneficiaries and, accordingly, are not exposed to inheritance tax until they are held within the trust structure.

The case law on the tax regime applicable to the addition of the trust fund is inconsistent. In particular, in some cases the Supreme Court has upheld the position of the tax authorities and ruled in favour of the levy of the tax upon the addition to the trust fund; while in others it has ruled that the tax should not be levied upon the addition of the assets to the trust fund, but only at the later stage of distribution to the beneficiaries. However, the tax authorities have not changed their approach and continue to consider the addition of assets into a trust fund as a taxable event for inheritance and gift tax purposes (eg, see the recent Ruling 371 of 2019, in which the tax authorities held that the creation of a *mortis causa* trust by way of will is a taxable event for inheritance tax purposes).

Finally, in relation to trusts settled prior to the reintroduction of inheritance and gift tax in 2006, in light of the case law of the Supreme Court (see Judgments 25478 of 18 December 2015 and 975 of 17 January 2018), it seems that the distributions from the trustee to the beneficiaries should be a taxable event for inheritance and gift tax purposes.

4.2 Income tax regime of trusts

(a) Trusts as a taxable person (versus disregarded trusts)

Trusts are expressly included by tax law (Article 73(1) of the Income Tax Act) among the taxable persons that are subject to corporate income tax.

However, a trust is a taxable person provided that the trust itself – rather than, for example, the settlor or the beneficiaries – is regarded (in light of general tax principles) as the person 'owning' the income from the trust fund. Such a condition is not met for:

- revocable trusts, which are disregarded for corporate income tax purposes. In fact, the right of the settlor to call back the income and capital of the trust (by revoking the trust) triggers the imputation of the income from the trust assets directly to the settlor (rather than to the trust as a taxable person) in accordance with general principles; and
- irrevocable trusts that are disregarded, under general principles, because the overall analysis shows that either the settlor or the beneficiaries have power, or *de facto* influence, to manage the trust assets and/or dispose of either the assets held in trust or the income from such assets.

In such cases the income from the trust assets is imputed directly to the settlor and/or beneficiaries, depending on the circumstances, and keeps its original characterisation. Accordingly, the distributions from the trustee to the beneficiaries are not relevant for income tax purposes.

In particular, in Circular Letter 61/E of 27 December 2010, the tax authorities listed examples of disregarded trusts by including, among others:

- trusts where the settlor (or the beneficiary) has the power to terminate the trust at any time, for his or her own benefit or for the benefit of others;
- trusts where the settlor (or the beneficiary) has significant veto powers so that he or she can limit the exercise of the discretionary powers of the trustee;
- trusts where the settlor has the power to change the beneficiaries; and
- more generally, trusts where the discretionary powers of the trustee are limited or somehow influenced by the will of the settlor and/or of the beneficiaries.

This list of the tax authorities is not exhaustive and the tax authorities will carefully verify on a case-by-case basis whether the settlor or the beneficiaries have the power, or *de facto* influence, to manage the trust assets and/or dispose of either the assets held in trust or the income from such assets. The interposition of a trust is a question of fact and depends on the analysis, also *ex post*, of the specific facts and circumstances, not only of the provisions of the deed of trust. In this regard, communications between the settlor and the trustee tend to be interpreted by the tax authorities as being instructions from the former to the latter. This is particularly the case where the settlor is among the beneficiaries.

(b) Transparent trusts

Income tax provisions (Article 73(2) of the Income Tax Act) lay down a transparency regime for trusts that, although considered as taxable persons, have 'identified beneficiaries'.

In such case the income from the trust assets (other than the income subject to a final withholding tax or a substitute tax at the level of the trust) is computed under the rules applicable to the trust, but imputed to the identified beneficiaries (accordingly, the distributions from the trustee to the identified beneficiaries are not relevant for income tax purposes). The income so imputed is therefore subject to income tax at progressive tax rates (assuming that the beneficiary is an individual).

According to the tax authorities, a beneficiary qualifies as 'identified beneficiary' to the extent that he or she holds a 'current unconditional right' to claim a share of the income generated by the assets held in trust (eg, the whole income of the trust, a percentage of the income of the trust or the income from certain assets held in trust) by virtue of the trust deed or any other enforceable instrument. Accordingly, a beneficiary of a discretionary trust, lacking a right to receive any income, does not qualify as identified beneficiary.

Circular Letter 61/2010 provided clarifications on the application of the territoriality rules to transparent trusts. The tax authorities clarified that resident beneficiaries of non-resident transparent trusts shall be taxed in Italy on the income from the trust assets wherever sourced (ie, not only on Italian-source income). Furthermore, the tax authorities held that income realised by resident transparent trusts and imputed to non-resident beneficiaries is considered to be sourced within the Italian territory, further to the application of the general territoriality rules provided for by Italian tax law.

(c) Residence of trusts

According to general rules, companies and entities, including trusts, are resident of Italy if, "for the greatest part of the tax period, they have their legal seat or seat of management or main object within the territory of the State" (Article 73(3) of the Income Tax Act).

First, in Circular Letter 48/2007, the tax authorities clarified that this criterion of the legal seat is not relevant to trusts (as it applies only to corporate bodies).

Second, in Circular Letter 48/2007, the tax authorities provided clarification on the notion of the seat of management, which is similar to the treaty notion of place of effective management and points to the place where key decisions to pursue the purpose of the trust are effectively taken. In particular, the tax authorities took the view that the seat of management:

- for trusts that are endowed with an autonomous organisational structure (eg, premises, employees), will be located where this structure is situated; and
- for other trusts, will tend to coincide with the place where the trustee is 'fiscally domiciled'.

Therefore, for such other trusts, the tax authorities tend to look at the tax residence of the trustee in order to determine the seat of management of the trust. However, since the seat of management test is not a formal test, one will first need to ascertain the place where, in substance, the key decisions concerning the trust fund are taken. Whenever the activity of more than one person is relevant to the determination of the seat of management (including where there is more than one trustee), due attention must be paid to the actual decision-making process to determine where key decisions are effectively taken.

Third, the seat of management is determined based on the entity's day-to-day activity, rather than the highest management functions. In Circular Letter 48/2007, the tax authorities took the view that if a trust holds only real estate and that real estate is mainly located in Italy, the main object of such trust is located in Italy.

The Finance Bill 2007 added two presumptions of residence of trusts. Both apply only to certain trusts that are formally resident in a non-whitelisted country (ie, in a state which is not included in the official list of states providing for effective exchange of information with Italy), and are rebuttable (Circular Letter 48/2007).

According to the first presumption, trusts settled in non-whitelisted states are deemed to be resident if "at least one of the settlors and at least one of the beneficiaries are residents". For the purpose of this presumption, the residence of the settlor must be assessed at the time of the addition of the assets to the trust, while the residence of the beneficiaries must be assessed on an annual basis (Circular Letter 48/2007).

The second presumption applies in case of settlement of Italian-situs real estate by a resident settlor (Circular Letter 48/2007). The residence of the transferor should be assessed upon the addition of the real estate to the trust fund, consistently with the timing of the assessment of the residence of the settlor under the first presumption.

(d) Distribution of income from trusts

Distributions of income from trusts to beneficiaries are not relevant for income tax purposes, to the extent that the trust is either disregarded or subject to the transparency regime.

The position is more complex in relation to other trusts. Assuming that the income from the trust assets was subject to Italian income tax (either corporate income tax or final withholding taxes or substitute taxes) at the trust level – since either the trust was resident or the income from the trust assets was sourced in Italy – distributions of income from the trust to the beneficiaries are not taxable (see Circular Letters 48/2007 and 61/2010). There is more debate concerning the income tax regime for distributions of income from non-resident trusts with foreign source income to resident beneficiaries, given also that the administrative guidelines are unclear in this regard. Indeed, different interpretations have been put forward by scholars, ranging from no taxation to taxation at progressive tax rates. In a number of tax audits, the tax authorities have taken the view that distributions from non-resident trusts of foreign source income not subject to Italian tax to resident beneficiaries qualified as income subject to progressive tax rates upon the beneficiaries.

5. Conclusion

Trusts regulated by foreign law are recognised in Italy pursuant to the Hague Convention and are widely used for estate planning purposes. The tax regime has been clarified by specific legislation as well as extensive guidelines of the tax authorities. It is hoped that the pending legislative proposal for the reform of the Italian succession law will further increase the use of foreign law trusts in Italy.

This chapter 'Italy' by Nicola Saccardo is from the title *Trusts in Prime Jurisdictions, Fifth Edition*, published by Globe Law and Business.

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