Understanding Taxation

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Summer School «Personal income Tax in the EU»

Lesson 01

Introducing the Speaker

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… and the Place I am from

- University of Ferrara, Italy.





Introducing the Class …

- Personal Income Tax in Italy:
  1. The Italian Model of Taxation;
  2. The Connection with the Constitution;
  3. The Policy choices;
  4. The latest developments.

The Enduring Paradox

- Income to be taxed on a personal basis:
  - All income owned by an individual;
  - No matter the source of it;
  - Progressive taxation;
- Yet ...
  - Progressive expansions of taxation at source;
  - Carve out from the taxable base of selected items;
- Conclusion: a system based on rules and derogations;
  - The Mario Draghi's government attempt of reform did not succeeded entirely.

The Constitutional Framework

- Italian Constitution Art.2,
  - The Republic recognises and guarantees the inviolable rights of the person, both as an individual and in the social groups where human personality is expressed.
  - The Republic expects that the fundamental duties of political economic and social solidarity be fulfilled.
- Italian Constitution Art.53,
  - Every person shall contribute to public expenditure in accordance with their capability (*Ability to pay principle*);
  - The tax system shall be progressive.

Personal Income Tax

- Outline of a system born in the seventies (1971 – 1973) (Act n. 825 October 9th 1971);
- One person, one tax: convergence of all revenues into one single taxable base, charged with a progressive tax;
- Policy:
  - Link of the individual with the territory and the community he/she belongs to.
  - Necessity to adjust the actual tax to the overall economic capacity;
  - Refusal of a comprehensive Wealth Tax.

What is income anyway ?

- Personal Income:
- Any revenue generated in the framework of a specific activity or in a case as defined by the law;
- A comprehensive law dictating when a kind of income is taxable;
- Consequence:
  - Legal / formalistic approach to Revenue / Income for tax purposes:
  - Taxable Income is only that (income) which is defined as taxable under the law;
  - No Law, No Tax.

Theoretical consequences

- Over formalistic approach entails two sets of consequences:
- Legal certainty:
  - Tax is charged exclusively in cases ruled for by the law;
  - *In dubio contra fiscum* ? (In doubtful cases the interpretation against the tax administration should be upheld)
- Leeway for aggressive tax planning:
  - Possibility to circumvent the law as general anti avoidance rules (GAAR) have been introduced only recently.

The Taxpayer

- Personal Income Tax is a person-based system;
- No relevance to family ties as for the calculation of the taxable base;
  - Constitutional Court decision n. 176/1976: to sum up income of spouses for tax purposes is unconstitutional;
  - Husband and wife must be different taxpayers although the tax return may be filled jointly.
- Few exceptions to the personal based taxation:
  - Inheritance / inherited assets not yet transferred to the heirs.

Citizenship and Taxation

- Citizenship plays no role in defining tax liability for income tax purposes;
  - Complicated procedures to achieve it;
- Personal income tax in Italy is a **residence-based system** where income taxable is calculated according to the so called world-wide principle of income taxation;
- Few derogations because of EU Law and special attraction regimes as recently introduced.

Residence in Italy

- Majority of the tax period residence is to be in the state (6 months plus one day);
- Definition of residence depending on:
- Formal criteria:
  - Registration to the registry / Log of the individual resident in the country (link with the welfare services);
- Substantial criteria:
  - Residence according to the Civil Code (Article 43);
  - Domicile according to the Civil Code (article 43).

Claw back provisions

- Article 2, § 2 Income Tax Act (Act 917 passed in 1986):
- An Italian is deemed to be resident in the country if:
  - He/she transfer his/her residence in a Tax haven as defined by the ministry of finance;
  - He/she does not give evidence of the actual transfer of residence in the other state:
- It's a rebuttable presumption;
  - Currently some problems might arise with Switzerland.

Dual residence and Tie Break rules

- Article 4 OECD Model
- For the purposes of the Convention, the term "Resident of a Contracting State" means any person who, under the law of that State, is **liable to taxation therein** by reason of his **domicile**, **residence**, **place of management** or **any criterion** of a similar nature.
  - … But this term does not include any person who is liable to tax in that Contracting State in respect only of income from sources in that State or capital situated therein.
  - Tie break rules: (1) Permanent home; (2) Center of vital interests, (3) Habitual abode, (4) Nationality, (5) Mutual agreement by the two tax administration.

The new progressive tax system

Taxable income (EUR)		Tax on excess (%)
Over	**Not over**	
0	15,000	23
15,001	28,000	25
28,001	50,000	35
55,001		43

What about non resident individuals ?

- Non-resident individuals are subject to PIT only on ‘income produced’ in Italy (i.e. employment income related to the work activity performed in Italy);
- Foreign income is not relevant to the purposes of taxation in Italy.
    - The law rules when a specific kind of income is produced in the territory.

What income is Taxable ?

- The Italian tax system provides the six following categories of income:
  1. Employment income.
  2. Business income.
  3. Self-employment income.
  4. Real estate income.
  5. Investment income.
  6. Capital gains.
- The gross taxable income is determined by the sum of the taxable income of the above categories subject to ordinary taxation.
  - Some kinds of income (interest, dividends, and capital gains) could be subject to a flat tax rate provided that conditions established by the Italian tax law are met (in most of the case tax rate is set at 26%).

Employment income

- Employment gross taxable income includes all compensation (cash or benefits in kind) received by the employee in relation to their employment relationship, including: bonuses, stock options, interest free loans, overseas adjustments, cost of living allowance, tax reimbursements, car allowance, etc.
- As a general rule, 100% of compensation paid in cash is subject to tax (exceptions apply), and compensation paid as fringe benefits (such as housing, loans, company car granted for personal and business use) are taxed on the base of the ‘normal value’ or on a lump-sum basis.
  - Normal value is defined in Article 9 of the Italian Tax Act, as the price generally applied to similar goods and services on the market.
    - In particular, for shares, bonds, and other securities listed on stock exchange or traded over-the-counter, the normal value shall be determined on the basis of the average closing price during the preceding month.

Business income

- Business income arises from the performance of commercial activities and is subject to corporate income tax. Unless the case is for a *solo* entrepreneur or *partnerships*;
- Generally, it is calculated on an accrual basis as the difference between proceeds and expenses relating to the commercial activity. Business income is also subject to IRAP (Regional tax on productivity).
  - Non-resident individuals are required to declare only Italian source business income. Income derived by a foreign entity from a business carried on through a PE in Italy is assumed to be Italian source.

Self employment income

- Self-employment income refers to incomes produced by self-employed professionals (self-employee VAT number holder);
- Self-employment income is subject to Income tax (Personal).
  - The income derived from services rendered by professionals is calculated as the difference between fees collected and business expenses.
  - Documented expenses refunded for travelling, boarding, and lodging expenses incurred in rendering services outside the tax domicile are not taxable income.
- Income from self-employment could also be subject to IRAP (Regional tax on productivity).
- Self-employment income is also subject to VAT (see class tomorrow).
- Professionals are required to keep accounting records, but directors and statutory auditors do not have to keep such records.
- Non-residents who are self-employed are subject to a 30% final withholding tax (WHT) unless otherwise provided by DTCs.
  - In this case, they are not required to file an income tax return.

Real Estate Income

- Since Fiscal year 2013, a principal abode is no longer subject to Immovable Property Tax and is subject to PIT, and has to be reported in the tax return.
- **Principal abode**
  - The taxable income deriving from the ownership of a principal abode is calculated on the basis of its *adjusted* 'cadastral value', which corresponds to the 'ordinary'/'average' income deemed to be derived from such properties, determined by the Cadastral Office in consideration of their characteristics.
- The taxable value for principal abode can be deducted by the gross taxable income.

Continued …

- **Real estate at disposal**
  - Immovable Property Tax has substituted PIT for real estate at disposal, but it has to be reported on a tax return in any case, and no taxable income arises. An exception is provided for real estate at disposal located in the same municipality in which is located the principal abode, which constitutes taxable income in the measure of 50% of the adjusted cadastral value.
- **Real estate rented**
  - Taxed at a progressive tax rate
  - In case of rented real estate located in Italy, the taxable income generally corresponds to the highest amount between:
    1. The cadastral income increased by 5% and
    2. 95% of the rentals referring to the relevant tax period (even if not actually collected, with some exceptions).
  - For leased buildings, the law admits a 5% flat rate reduction of rentals in consideration of eventual managing and maintenance expenses incurred by the owner.
  - As a result, related expenses actually incurred are not relevant for tax purposes.
  - The taxable income, as determined above, is subject to a progressive tax rate.

Special regimes

- **Tax at a flat tax rate**
- As of Fiscal year 2011, a new tax regime, called in Italian cedolare secca (*Tax at Source*) , has been introduced.
- It is a voluntary and optional tax regime in respect to the ordinary one. In this case, the rental income can be taxed at a fixed tax rate equal to 21% or 10%, provided some conditions are met.
- This taxation replaces:
  1. The incomes tax (national, regional, and municipal)
  2. The registration tax
  3. The stamp duty, and
  4. Other taxes.
- The taxable income is 100% of the rental income.

Investment Income

- Investment income is generally defined as income arising from the use of capital, typically interest and dividends.
- **Shareholdings**
  - The dividends distributed by a foreign entity that are not paid through an Italian resident broker shall be included (gross of foreign taxes withheld) in the individual's tax return and taxed at a 26% flat rate.
  - In this case, no foreign tax credit can be claimed.
  - Dividends distributed by a foreign entity and paid through an Italian resident broker are subject to tax at a 26% flat rate (net of foreign taxes withheld). In this case, no further action will be required.
- **Interest income**
  - Interests are subject to a flat tax rate of 26% to be applied at source.
  - For specific interests stated by the tax law (e.g. government bonds and other bonds issued by public entities mentioned in Article 31 of D.P.R. 29 September 1973, no. 601 and similar financial instruments), the tax rate remains at 12.5%.

Capital gains

- For individuals, capital gains are generally taxable, even if they do not arise from speculative intent or from a business.
- Qualified shareholdings
  - The capital gains earned by the sale of qualified shareholdings is taxed as follows:
    - Capital gains made before 31 December 2017: 49.72% of capital gains is included in the individual annual gross income (income taxed applying progressive tax rates).
    - Capital gains made between 1 January 2018 and 31 December 2018: 58.14% of capital gains is included in the individual annual gross (income taxed applying progressive tax rates).
    - Capital gains made as of January 2019 will be taxed applying a flat tax rate of 26% on the whole capital gains amount. The 2018 Italian Financial Bill introduced a final WHT at 26% both to tax resident and non-tax resident individuals for capital gains deriving from a qualified and a non-qualified shareholding (starting from 1 January 2019).
- Non-qualified shareholdings
  - The capital gains earned by the sale of non-qualified shareholdings is taxed applying a flat tax rate of 26%.

Continued

- Capital gains tax on the sale of a real estate
  - The taxable base of the real estate capital gains is the difference between the sale price and the original cost of real estate together with the sum of all the additional purchase costs (notary fees, taxes, etc.).
  - The capital gain on the sale of real estate is taxed at progressive tax rates or with a substitutive flat tax of 26% under certain conditions.
  - There are some exemptions, however, and such are applicable on capital gains deriving from the following sales:
    - The sale of a real estate if owned for more than five years.
    - The sale of a real estate, even if owned for less than five years, if it has been used as primary residence for most of the period of ownership (even if owned for less than five years).

Concluding remarks

1. Progressivity of the system has been eroded through years via ana array of special, tailor made rules;
2. Constant tension between constitutional principles and the law;
3. Necessity to regulate PIT consistently with the EU fundamental principles;
4. Duty of reporting automatized.

End of Day 1

- Credits: PwC Italy.