Private Pension Taxation Under the New Italy-U.S. Income Tax Treaty

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The United States and Italy signed a new income tax treaty on 25 August 1999. The U.S. Senate ratified the treaty with reservations on the "main purpose" test, one of the antiabuse rules contained in the treaty. However, the ratification process in Italy is yet to begin. Therefore, the new treaty is not yet in force and the 1984 Italy-U.S. treaty is still in effect. (For the full text of the treaty, see *1999 WTD 202-31* or *Doc 1999-33613 (65 original pages)*.) This article analyses the provisions in article 18 on pensions of the 1999 treaty.

Overview

Under the 1984 treaty, pensions and other similar remuneration beneficially derived by a resident of one country in consideration of past employment are taxable only in the country of residence.[1] As a general rule, the 1999 treaty reproduces identical provisions that are subject, however, to a change-of-residence exception for lump sum or severance payments. Also, the 1999 treaty removes a barrier to labor mobility by providing for the reciprocal recognition by the two countries of contributions made to private pension plans that qualify for tax benefits under the laws of the home country, as discussed further below.

The tax treatment of public pensions — that is, pensions paid from the public funds of one of the states (or a political subdivision or a local authority) to an individual for services rendered to that state (or subdivision or authority) — is dealt with in article 19 of both the 1984 and the 1999 treaties, and is not part of the analysis that follows.

[1]The Italian tax authorities have addressed cases regarding the taxation of U.S. pensions under the 1984 treaty in *Risoluzione Ministeriale*, No. 226/E of 27 July 1995, issued by the Ministry of Finance, and in Decision no. 19, published on 12 October 1995, issued by the *Commissione Tributaria, I grado, Catanzaro*.

Lump Sum or Severance Payments After a Change of Residence

In general, the U.S. authorities view the provisions of article 18 as intended to apply to both periodic and lump sum payments, as stated in the technical explanation of the 1999 treaty. The U. S. Internal Revenue Service also expressed that view on the 1984 Italy-U.S. treaty in Private Letter Ruling 8904036. The case discussed in the ruling involved lump sum distributions from U.S. qualified retirement plans that were temporarily deposited into a U.S. rollover individual retirement account and then withdrawn by the beneficiary after he had established his new residency in Italy.

The above U.S. interpretation, however, clashes with the position taken in the past by the Italian tax authorities. In fact, the Italian minister of finance,[2] interpreting the Italy-Switzerland treaty, has ruled that lump sum past-employment remuneration paid from an Italian employer to a nonresident individual is not exempt under article 18 (pensions) of the treaty and, therefore, is subject to Italian tax. The rationale underlying the Ministry's interpretation is that lump sum past-employment payments, unlike pensions, are not periodic payments. That conclusion, on the scope of article 18 of the Italy-Switzerland treaty, is likely to be reproduced by the Italian tax authorities in interpreting similar provisions in other treaties signed by Italy, including the Italy-U.S. 1984 treaty, which is currently in force. Accordingly, as of today, it has been common practice by Italian withholding agents to deduct and withhold Italian tax from lump sum past-employment payments to U.S. residents for the portion pertaining to services that were performed in Italy.

While the 1999 Italy-U.S. treaty provisions may not resolve the conflicting views of the U.S. and Italian tax authorities on the issue of similarity between lump sum past-employment payments and pension payments, they will finally address the issue of assignment of taxation rights for

[2]*Risoluzione Ministeriale* no. 12/1226 of 11 July 1980.

those payments. The new provisions state that lump sum or severance payments received after a change of residency for employment exercised in the original country of residence are taxable only in the original country of residence. Those provisions are intended to prevent theoretical change-of-residence tax-planning techniques, which may otherwise find stimulus in the effective personal income tax rate differentials between the two countries.

> *Example:* Mr. X is a resident of Italy, where he has worked for the past 30 years. On retirement, Mr. X moves to Florida and becomes a resident of the United States. Under the 1999 treaty's change-of-residence exception, any lump sum or severance payment received in reference to Mr. X's past employment in Italy would be taxable only in Italy.

Annuities, Alimony, and Child Support

Under the 1999 treaty, annuities — that is, sums that are paid periodically for life or for a specified number of years — are taxable only in the country of residence.

The 1999 treaty also provides a general rule according to which payments for alimony and/or child support are taxable only in the country of residence of the recipient. Nevertheless, if the payors are not entitled to a deduction in their country of residence, the amount will not be taxable to the beneficiary.

Social Security Benefits

Payments made by one country under the provisions of its Social Security system (or similar legislation) to a resident of the other country are taxable only in the country of residence.

Social Security benefits in the United States consist of old age (that is, retirement), survivorship, and disability benefits (OASDI) and are paid by the Social Security Administration. However, the Italian tax authorities, relying on the OECD model commentary, recently have expressed a narrow interpretation of the term "social security payments" as to include only social welfare payments (for example, unemployment, sickness, or industrial injury benefits).[3] The competent authorities, under article 25(3) of the treaty, should address any conflict arising from the different interpretation of the term.

Normally, the United States retains the sole right to tax U.S. Social Security payments it makes to U.S. citizens. In both the protocols of the 1984 and the 1999 treaties, the United States waives its right to tax U.S. Social Security payments it makes to U.S. citizens who are Italian residents and have dual U.S.-Italian nationality. The uniqueness of that treaty provision is that it waives all the U.S. right to tax when the United States has both a source claim and a citizenship claim to tax the income.

Pension Plan Contributions

While the 1984 treaty did not address issues on contributions to pension plans, the 1999 treaty provides for a reciprocal recognition of qualified pension plan contributions of employees who are assigned to work outside their home country for purposes of determining deductibility and exclusion from gross income. The new rules follow somewhat the provisions set forth by the 1996 U.S. model and the OECD model that seek not to discourage employees from taking overseas assignments.

The U.S. Treasury Department Technical Explanation provides detailed guidance on criteria that must be met and specific plans that qualify for treaty benefits under U.S. law. (For the full text, see *1999 WTD 211-22* or *Doc 1999-34700 (105 original pages)*.) ✦

[3] *Circolare Ministeriale* n. 41/E of 21 July 2003. (For prior coverage, see *Tax Notes Int'l,* 11 Aug. 2003, p. 521, *2003 WTD 149-10,* or *Doc 2003-17825 (3 original pages)*; and *2003 WTD 152-6* or *Doc 2003-18257 (3 original pages)*.)