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News Analysis: The Fine Print in Italy's New Flat Tax on Rental Income

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As of April 7,[1] Italian taxpayers may elect to be taxed at a flat rate on their gross rental income. The flat tax is imposed at a rate of 21 percent (19 percent for income derived from some rent-controlled housing) of the annual lease payments.

The flat tax is an alternative to the tax otherwise applicable on income from real estate. Under the general rule of article 37 of Italy's Consolidated Tax Act (Testo Unico delle Imposte sui Redditi, or TUIR), the tax on real estate income is levied, for buildings, at regular, graduated tax rates on the greater of either the phantom income attributed by the Italian authorities or the rental income less a flat 15 percent deduction (25 percent for buildings located in Venice and in Giudecca, Murano, and Burano Isles).

A taxpayer with income from Italian real estate will therefore have to decide which tax regime produces the lowest tax in Italy. For example, if a taxpayer has €100,000 of gross rental income, the effective tax rate of the regular tax is approximately €30,000. Under this scenario, the elective 21 percent flat tax would save the hypothetical investor €9,000 (€30,000 - €21,000).

The new tax law raises two issues regarding cross-border investment in real estate. First, the election does not appear to be available for rental income from non-Italian real estate. Unlike U.S. law, Italian tax law does not have an all-inclusive definition of income. Rather, income is included in gross income only if it falls into one of the specific categories provided for by the statute. The term ''income'' is defined under TUIR article 6 as the following:

- income from real estate;
- investment income;
- income from dependent personal services;
- self-employment income;
- business income; and
- ''other income.''

Despite the terminology, ''other income'' is not a catchall category. Rather, under TUIR article 67, this category includes only some sources of income, including, but not limited to, rental income from non-Italian real estate. The new legislation does not seem to apply to this ''other income.'' It follows that Italian investors may not elect to be taxed on a flat basis on their income from foreign real estate.

A second, and possibly more contentious, issue is the creditability of the flat tax paid by foreign investors in their country of residence. In the United States, for example, the ''predominant character'' of a foreign tax must be ''that of an income tax in the U.S. sense'' in order to qualify as creditable foreign income tax.[2]

The predominant character condition is met if several requirements are satisfied under the U.S. Treasury regulations. One test is whether the tax is likely to reach net income. Italy's new tax does not provide for recovery of the significant costs and expenses attributable to the gross receipts included in the tax base.

Also, the new tax law does not allow reductions of the tax base under a method that is likely to produce an amount that approximates, or is greater than, the recovery of such significant costs and expenses. Finally, the new tax does not provide allowances that effectively compensate for non-recovery of one or more significant costs or expenses. Accordingly, it seems that the new tax would fail the U.S. net income requirement.

Even if it fails the net income requirement, the flat tax may still be treated as an income tax if it is imposed in lieu of a tax on income generally imposed by Italy. The most common type of tax in lieu of an income tax is a foreign tax analogous to the withholding taxes imposed by the United States on nonbusiness income of nonresident aliens and foreign corporations.

[1]Through the introduction of article 3 of Legislative Decree No. 23 of March 14, 2011.

[2]U.S. Treas. reg. section 1.901-2.

While U.S. gross withholding taxes do not always satisfy the net income requirement, they have nevertheless always been considered income taxes as a matter of administrative convenience, because it would be an arduous task to verify the expenses of foreign persons with no U.S. trade or business. By the same token, the U.S. reasoning is that foreign gross withholding taxes imposed by foreign countries in similar circumstances should also be considered income taxes.

Italy's elective flat tax on rental income, however, does not have the character of a withholding tax, because it applies to Italian resident investors as well as nonresident investors in real estate. Therefore, one may conclude that the tax is not creditable in the United States.

Thus, in addition to requiring an annual analysis to decide which tax is more beneficial in Italy, U.S. investors with Italian rental income also must consider the U.S. foreign tax credit implications of the elective tax.

Under article 2(3) of the Italy-U.S. income tax treaty currently in force, the competent authorities of the two countries will notify each other of significant changes in their tax laws or of other laws that affect their obligations under the treaty. Ideally, the Italian competent authority will thus notify its U.S. counterpart and some light will be shed to the taxpayers' benefit. ◆

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