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Residence and Tie-Breaker Provisions Under the Pending Italy-U.S. Tax Treaty

by Alessandro Adelchi Rossi

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by Alessandro Adelchi Rossi

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Generally, the benefits of the U.S.-Italy income tax treaty[1] are only available to a resident of one of the treaty countries. Article 4 provides rules for determining whether a person is a resident of Italy or the United States for treaty purposes.[2]

Under article 4, as a general rule, a person is a resident of the country in which the person is resident under domestic law. If a person is resident in both Italy and the United States under their respective domestic tax laws, the article proceeds, where possible, to use tie-breaker rules to assign a single country of residence to the person for treaty purposes.

U.S. Domestic Law

Individuals

As a general rule,[3] an individual is a resident for U.S. tax purposes under either the "lawful permanent resident test," commonly referred to as the "green card test," the "substantial presence test," or if the individual so elects.

The substantial presence test is satisfied when an individual: is present in the United States for at least 31 days during the calendar year; and satisfies the 183-day test for the current and two preceding calendar years.

The 183-day test is satisfied when the sum of the number of days that the individual is present in the United States during the current year, plus 1/3 of the number of days present in the first preceding year and 1/6 of the number of days present in the second preceding year, equals or exceeds 183 days.[4]

Corporations

For corporations, the term "resident" is replaced with the term "domestic." The statute[5] defines a domestic corporation as one created or organized in the United States or under the law of the United States or any U.S. state.

Italian Domestic Law

Individuals

Under Italian tax law, residents are subject to tax on their worldwide income, while nonresident individuals are subject to tax only on income from Italian sources.[6] Individuals are residents of Italy if any of the following three conditions are met for the greater part of the tax period:

- they are registered with the Office of Records of the Resident Population;
- their domicile, within the meaning given to this term by the Italian Civil Code, is in Italy; or
- their residence, within the meaning given to this term by the Italian Civil Code, is in Italy.[7]

The Italian Civil Code defines domicile as the center of an individual's vital interests and residence as the location in which an individual has an habitual abode.[8]

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[1]The United States and Italy signed a new income tax treaty and protocol (the 1999 treaty) on 25 August 1999. This will replace the current treaty and protocol, which entered into force on 20 December 1985. The 1999 treaty must be ratified by both countries and will enter into force when the instruments of ratification are exchanged.

[2]The fact that a person is determined to be a resident of Italy or the United States under article 4 does not necessarily entitle the person to the benefits of the treaty, because that person must also qualify under the limitation on benefits provision contained in article 2 of the protocol to the current treaty.

[3]*See* Internal Revenue Code (IRC) section 7701(b)(1)(A).

[4]IRC section 7701(b)(3)(B) provides an exception to the substantial presence test. An individual who meets the substantial presence test may nevertheless be treated as not meeting the test for a calendar year if the individual:

a) Is present in the United States for fewer than 183 days during the current calendar year;

b) Maintains a tax home in a foreign country during the current calendar year; and

c) Has a closer connection to the foreign country in which the "tax home" is maintained than to the United States.

Generally, an individual's tax home is considered to be located at the individual's regular or principal place of business. An individual has a closer connection to a foreign country rather than to the United States if the individual shows that he has maintained more significant contacts with the foreign country than with the United States. This exception is unavailable to an individual who has an application pending for adjustment of status during the current calendar year.

[5]*See* IRC section 7701(a)(4).

[6]*See* article 3(1) of *DPR* 917/86 *Testo Unico Imposte sui Redditi* (TUIR).

[7]*See* TUIR article 1(2).

[8]*See* article 43 of the Civil Code.

Corporations

In determining whether a corporation is a resident[9] of Italy, Italian tax law classifies corporations not only by citizenship (where they are incorporated), but also by the nature of their physical activities in Italy, including management, control, and assets. A corporation is therefore resident in Italy if either its registered office,[10] its main activity, or its effective place of management is in Italy for 183 days or more during a tax year.[11]

In comparison to the U.S. concept of residence, Italy has additional and more substantive tests. The United States only asserts full residence jurisdiction over the income of corporations incorporated under domestic law. While the U.S. incorporation test has the advantage of certainty, the Italian management test has the advantage of economic reality.

Exceptions to the 'Resident' Rule

As a general rule, only Italian and U.S. residents may claim treaty benefits. Article 4 provides for two exceptions to the general rule.

Under the first exception, a person who is liable to tax in either Italy or the United States only on income from sources within that country will not be treated as a resident of that country for treaty purposes.[12]

Example 1

An Italian government official who is posted to the United States, and who may be subject to U.S. tax only on U.S.-source investment income,[13] would not be considered a resident of the United States for purposes of the treaty.

Example 2

A U.S. corporation with a permanent establishment in Italy is not, by virtue of that PE, a resident of Italy. Generally, the U.S. corporation is only subject to Italian tax on income attributable to the Italian PE, and not on its worldwide income, unlike an Italian resident.[14]

The second exception relates to entities that are not subject to tax at the entity level.[15] The U.S. treasury explanation[16] clarifies that in addition to partnerships and trusts, this provision also applies to U.S. limited liability companies (LLCs) that are treated as partnerships for U.S. tax purposes. Under this exception, an item of income derived by a flow-through

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entity will be considered to be received by an Italian or U.S. resident if that person is treated, under the domestic laws of the country where the person is resident, as receiving the item of income.

Example 3

An Italian corporation distributes a dividend to an LLC that is treated as a flow-through entity for U.S. tax purposes. Thus, under U.S. tax law, the members of the LLC are treated as receiving the dividend income. The dividend will be considered to be received by a U.S. resident only to the extent that the members of the LLC are U.S. residents.[17]

Conversely, if the members of the LLC are not U.S. residents for U.S. tax purposes, they may not claim a benefit under the treaty for the dividend paid to the entity because they are not U.S. residents for purposes of the treaty. If, however, they are treated as residents of a third country under the provisions of an income tax treaty which the third country has with Italy, they may be entitled to claim a benefit under the third country convention.

Example 4

The facts are the same as in Example 3 except that the LLC is treated as a corporation for U.S. tax purposes. The dividends will be considered to

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[9] For an analysis from an Italian perspective of the different international concepts of residence, *see* G. Marino in *Corso di Diritto Tributario Internazionale*, pp. 220- 231, CEDAM, Padova, 1999.

[10] While for tax purposes Italy applies the registered office test, Italian corporate law applies the "law of incorporation" test. Thus, a corporation organized under Italian law that moves its registered office abroad is still subject to Italian law. *See* M. Piazza in *Guida alla fiscalità internazionale*, pp. 5-8; 17-19, Il Sole24-Ore, Milano, 2001.

[11] TUIR article 87(3).

[12] *See* article 4(1)(a).

[13] Because under IRC section 7701(b)(5)(A) a foreign government-related individual is an "exempt individual," that is an individual treated as not being present in the United States on any day, he may not be taxable in the United States on non-U.S.-source income.

[14] *See* paragraph 50 of the U.S. Treasury technical explanation of the 1999 treaty.

[15] *See* article 4(1)(b).

[16] *See* paragraph 55.

[17] The residence status of the members of the LLC is determined, for this purpose, under U.S. tax laws.

be received by a U.S. resident, and thus entitled to the benefits of the treaty, because U.S. domestic law treats a corporation as a U.S. resident and as receiving the income.

'Tie-Breaker' Provisions for Individuals

Paragraph 2 provides a series of tie-breaker rules to determine a single country of residence for an individual in the event that, under the laws of Italy and the United States, the individual is deemed to be a resident of both countries.[18] The tie-breaker rules establish a number of tests — to be applied in the order in which they are stated — that look at the personal connections between the individual and the two countries, as follows:

- An individual is deemed to be a resident of the country in which the individual has an available permanent home;
- If a permanent home is available in both Italy and the United States, the individual is deemed to be a resident of the country with which the individual has closer personal and economic relations (center of vital interests);
- If the center of vital interests cannot be determined, or if the individual does not have an available permanent home in either country, the individual is deemed to be a resident of the country in which the individual has an habitual abode (the country where the individual spends more time);
- If the individual has a habitual abode in both countries or in neither country, the individual is deemed to be a resident of the country of which he is a national; and
- If the individual is a national of both countries, or of neither country, the U.S. and Italian competent authorities will settle the question by mutual agreement.

Example 5

Mr. X is an Italian citizen. X is registered with the Office of Records of the Resident Population in Italy, the country where he was born and raised. During 2002 he was on the payroll of a U.S. corporation and spent 250 days in the United States, thus satisfying the substantial presence test for 2002. X is deemed to be a resident of both countries.

Because, under the laws of Italy and the United States, X is deemed to be a resident of both countries, a single country of residence must be determined under the tie-breaker rules.

First, it must be ascertained whether the individual has a permanent home available to him or her in either the United States or Italy, or in both countries, during the years at issue.

Permanent Home

First, it must be ascertained whether the individual has a permanent home available to him or her in either the United States or Italy, or in both countries, during the years at issue.

The OECD Commentary to article 4[19] of the model treaty describes the term "permanent home" as the place that an "individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration."[20]

Whether the place is owned or rented is irrelevant, but the permanence of the home is the essential factor. The individual must have arranged to have the dwelling available to him at all times, and not just occasionally for the purposes of a stay which, because of the reasons for the stay, is of short duration (travel for pleasure, business travel, attending a course at a school, and so on).[21]

If an individual has a permanent home available in both Italy and the United States, the next tie-breaker rule (center of his vital interests) is applied.

Conversely, as discussed below, when an individual does not have a permanent home available in either country, the center of vital interests test is skipped and the next tie-breaker rule is applied.

[18]The tie-breaker notwithstanding, an Italian resident who is also a U.S. resident alien will be treated as a U.S. resident for all U.S. federal tax purposes other than the computation of the individual's U.S. federal income tax liability. For example, an Italian and U.S. resident alien individual would be treated as a U.S. resident for purposes of determining whether a foreign corporation is a U.S.-controlled foreign corporation or foreign personal holding company. *See* Treas. reg. 301.7701(b)- 7(a)(3). The Italian statute does not provide for a similar provision.

[19]Courts have often used the commentary to interpret U.S. income tax treaties. *See United States v. A.L. Burbank & Co.*, 525 F.2d 9, 15 [36 AFTR 2d 75-6227] (2d Cir. 1975); *North W. Life Assurance Co. of Canada v. Commissioner*, 107 T.C. 363 (1996); see also *Taisei Fire & Marine Ins. Co. v. Commissioner*, 104 T.C. 535, 546 (1995), and *Stephen D. Podd, et al. v. Commissioner*, T.C. Memo 1998-418.

[20]*See* paragraph 12 of the OECD commentary to article 4 of the OECD model treaty.

[21]*See* paragraph 13 of the OECD commentary on article 4 of the OECD model treaty.

Center of Vital Interests

The proper test is to determine, on balance, the country in which the individual has deeper roots, taking into account their personal and economic interests.[22]

As a practical matter, based on the treaty,[23] and U.S. and Italian domestic provisions,[24] all the facts and circumstances should be considered in determining whether an individual has his center of vital interests in a foreign country. The United States in particular will consider the:

- location of the individual's family;
- location of personal belongings owned by the individual and the individual's family, including automobiles and furniture;
- location of social, political, cultural, and religious organizations with which the individual has a current relationship;
- location of the individual's personal bank accounts;
- individual's driver's license;
- country of residence designated by the individual on forms and documents;
- official forms and documents filed by the individual, including IRS Form 1078 (Certificate of Alien Claiming Residence in the United States) and IRS Form W-9 (Request for Taxpayer Identification Number and Certification);
- jurisdiction where the individual votes;
- individual's regular place of business; and
- place from which the individual manages their property.

Example 6

The facts are the same as in Example 5. In addition, X rents an apartment in Italy and an apartment in the United States. He maintains checking and savings accounts at Italian banks, and his wife is an Italian citizen who may not legally work in the United States.

X is a member of the board of directors of a closely held Italian corporation in which he is heavily involved and for which he does not perform any services in the United States. His personal belongings are predominantly located in Italy, he has Italian health insurance, is attended by an Italian doctor and dentist, and maintains his religion in Italy. He holds an Italian driver's license, votes in Italy, and his parents and other relatives are in Italy.

At the same time, during the year at issue, X also had connections with the United States: X reported for work in the United States every day, and maintained checking and savings accounts at U.S. banks, as well as investments in U.S. securities. His daughters also attended a school in the United States.

The preponderance of evidence seems to show that on balance, during 2002, X had closer ties to Italy and, therefore, that his center of vital interests was in Italy,[25] not only because of the number of connections, but also because of their depth.[26]

> When the center of vital interests cannot be determined, article 4, as well as the U.S. courts, tip the balance toward the country where the taxpayer stays most often.

The determination for a particular year should be made regardless of the individual's residence status for the following years.[27] This seems to be the proper interpretation, because taxation, and therefore, residency, is an annual affair.[28]

The OECD suggests that a person who starts with his center of vital interests in one country will not easily lose that center unless there is a clear shift to the

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[22]*See* paragraph 15 of the OECD commentary on article 4 of the OECD model treaty ("circumstances must be examined as a whole").

[23]*See* the OECD commentary on article 4 of the OECD model treaty.

[24]In the case of the United States, *see* Treas. reg. section 301.7701(b)-2(d). In the case of Italy, *see Circolare Ministeriale* 140/E 1999 and *Circolare Ministeriale* 304/E 1997.

[25]*See* the cases referred to in Klaus Vogel, *Double Tax Conventions*, (3rd ed. 1997), at p. 250.

[26]It is generally accepted that one must not only count the number of connecting factors in each country, but also must attempt to weigh their depth by which it can be meant their importance to the individual. *See*, for example, *Hertel v. The Minister of National Revenue*, 93 DTC 721 (TCC), a case decided by a Canadian court, discussed in Joel Nitikman, "Current Tax Treaty Cases of Interest," *Tax Notes Int'l*, 20 Sept. 1999, p. 1089, at 1100.

[27]For example, in *Stephen D. Podd, et al. v. Commissioner*, T.C. Memo 1998-418, the court does not appear to have believed that the taxpayer's admission that he was a U.S. resident under the U.S.-Canada treaty for 1991 had any bearing on his residency under the treaty for 1990.

[28]*See* Nitikman, "Current Tax Treaty Cases of Interest," *Tax Notes Int'l,* 20 Sept. 1999, p. 1089, at 1103, *1999 WTD 181-8*, or *Doc 1999-30444 (21 original pages)*.

other country.[29] Generally, it seems that more weight is given to personal ties than to economic interests.[30]

If an individual's personal and economic interests are equally split between Italy and the United States, then the residence issue turns on which country is the more significant to the individual.

Finally, that test does not apply when an individual does not have a permanent home available to him in either country, the theory being that it is unlikely for an individual to have the center of his vital interests in a country where he does not have a permanent home. Accordingly, in such circumstances, the center of vital interests test is skipped and reference must be made to the next tie-breaker rule.

Habitual Abode

Because the "tie-breaker" rules are intensely factual in nature, when the facts are ambiguous and there are doubts as to where an individual has his center of vital interests, it is necessary to look to the next tie-breaker rule,[31] under which a taxpayer "shall be deemed to be a resident of the country in which he has an habitual abode" — the country where he spends more time.

Thus, when the center of vital interests cannot be determined, article 4, as well as the U.S. courts,[32] tip the balance toward the country where the taxpayer stays most often.

Special Rule for Certain U.S. Citizens and 'Green Card' Holders

The 1999 treaty[33] provides that Italy will treat a U.S. citizen or alien lawfully admitted for permanent residence (a "green card" holder) as a U.S. resident entitled to treaty benefits, only if he has a substantial presence, permanent home, or habitual abode in the United States.

This provision intends to prevent a resident of the United States, who is not a resident of Italy and who has stronger ties to a third country, from benefiting from the Italy-U.S. treaty when his relationship with the United States, compared to that of a third country, is very tenuous.

Example 7

An individual resident of Mexico who is a U.S. citizen by birth, or who is a Mexican citizen and holds a U.S. green card, but who, in either case, has never lived in the United States, would not be entitled to Italian benefits under the 1999 treaty.[34]

Example 8

A U.S. citizen employed by a U.S. corporation who is transferred to Mexico for two years, but who maintains a permanent home or habitual abode in the United States, is entitled to treaty benefits.[35]

If, however, such a person is a resident both of the United States and Italy, whether he is treated as a resident of the United States for treaty purposes is still determined by the tie-breaker rules discussed above.

Dual-Resident Corporations

The treaty currently in force (the 1984 treaty) does not provide a tie-breaker rule for a corporation that is a resident of both Italy and the United States. Instead, the current treaty provides that Italy and the United States can tax their residents without regard to the treaty.[36]

Accordingly, double taxation of dual-resident corporations (for example, a company incorporated in the United States but effectively managed and controlled in Italy) is permissible under the current treaty.

Under the 1999 treaty, conversely, dual residents other than individuals (such as companies, trusts, or estates) are addressed by paragraph 4. If such a person is found to be a resident in both Italy and the United States, the competent authorities shall seek to determine a single country of residence for purposes of the treaty. The 1999 treaty, however, is silent with respect to the consequences of failure by the competent authorities to agree on a single country of residence. ✦

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[29] *See* paragraph 15 of the 1992 OECD commentary on article 4 ("If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, together with other elements, go to demonstrate that he has retained his center of vital interests in the first State").

[30] In the case of Italy, *see Risoluzione Ministeriale* No. 8/1329 of 14 October 1988 and *Risoluzione Ministeriale* No. 17/E of 10 February 1999.

[31] *See* paragraph 17 of the OECD commentary on article 4.

[32] *See*, for example, *Stephen D. Podd, et al., supra.*

[33] *See* article 1(5)(c) of the protocol.

[34] *See* paragraph 48 of the U.S. Treasury technical explanation of the 1999 treaty.

[35] *Id.*

[36] *See* article 1(2)(a).