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The Saving Clause of Pending U.S.-Italy Tax Treaty

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The tax treaty between the United States and Italy[1] contains a "saving clause" that authorizes either country to tax its residents (including corporations and other entities) and its citizens as if the treaty did not exist.[2]

Treaties generally give that right to either country on a bilateral basis. In the pending U.S.-Italy treaty, the inclusion of the saving clause was a requirement of the United States. That is because unlike Italy, which asserts full taxing jurisdiction only on the basis of Italian residence,[3] the United States asserts full taxing jurisdiction on the basis of U.S. residence, as well as on the basis of U.S. citizenship.

Therefore, the purpose of the saving clause — which is found only in treaties to which the United States is a party — is mainly to preserve, with certain specific exceptions, the United States' right to tax on the basis of citizenship even when the treaty would otherwise impose a limit on U.S. taxation.

Effects of the Saving Clause for U.S. Citizens and Residents

As a practical matter, the effect of the saving clause is to prevent U.S. citizens and residents from obtaining a U.S. tax benefit under the treaty.[4] In other words, the treaty makes no change in the U.S. tax liability of U.S. citizens and residents, and it protects them only from certain Italian taxes.[5]

The saving clause might seem like an undue restriction to the application of the treaty. However, its advocates argue that — in countries which, like the U.S. and Italy, have a system based on worldwide taxation and treaties that adopted the credit method (as opposed to the exemption method) as the method to avoid double taxation — a treaty's function is only to limit the taxing jurisdiction of the country where a given type of income is generated. Under that view, a treaty should not reduce the taxing powers of the country where the recipient of that income is resident any more than is necessary to eliminate double taxation of that taxpayer's foreign-source income.

The following example illustrates the consequences that the saving clause can have for a taxpayer:

Example 1

Mr. X is a U.S. citizen and an Italian resident. Mr. X spends all of his time in Italy and derives all of his income from services performed in Italy in an independent capacity.[6] Being a U.S. citizen, Mr. X cannot benefit from the provision of article 14 (independent personal services) of the treaty, under which that income would be taxable only in Italy.

Rather, in addition to filing and paying taxes in Italy, Mr. X also will have to report the income in the United States and pay any tax in

[1]On 25 August 1999, the United States and Italy signed a new income tax treaty and protocol (the treaty) that will replace the current treaty and protocol, which entered into force on 20 December 1985. The treaty has to be ratified by both countries and will enter into force once the instruments of ratification are exchanged. (For the full text, see *1999 WTD 202-31* or *Doc 1999-33613 (65 original pages)*.)

[2]See treaty art. 1(2). The OECD Model Income Tax Treaty (OECD model) does not contain any provision comparable to the saving clause. The United States has entered a reservation to article 1 of the OECD model, under which it claims the right to tax its citizens and residents without regard to the treaty.

[3]See article 2 of Decreto del Presidente della Repubblica (DPR) 917/86 Testo Unico Imposte sui Redditi (TUIR).

[4]*See* generally *Filler v. Commissioner*, 74 T.C. at 410; *Marie G. Crerar*, 26 T.C. 702 (1956); Rev. Rul. 72-330, 1972-2 CB 444, 445; Rev. Rul. 79-152, 1979-1 CB 237.

[5]In *Irene Vavasour Elder Perkins*, 40 T.C. 330 (1963), a decision rendered in connection with the 1955 tax treaty between Italy and the United States, the court denied the attempt of a U.S. citizen who resided in Italy to exclude from U.S. taxation an amount received from a U.S. trust because the treaty provisions were not applicable to U.S. citizens.

[6]For the purpose of that example, the impact of the Internal Revenue Code (IRC) section 911 exclusion is ignored.

excess of that paid in Italy that can be credited against U.S. tax.[7]

Recourse to the Tie-Breaker Provisions for Dual Residents

Unlike U.S. citizens, U.S. residents can avoid the application of the saving clause by means of the "dual residents" provisions discussed in the analysis of article 4 below.[8] In those cases, the country with which a taxpayer has stronger ties under the "tie-breaker" provisions[9] is accorded the status of the country of residence for treaty purposes.[10]

> ***Unlike U.S. citizens, U.S. residents can avoid the application of the saving clause by means of the 'dual residents' provisions.***

Therefore, for an Italian citizen, becoming a U.S. resident may prevent him from using treaty benefits to avoid U.S. taxes, unless he also retains his Italian residence for tax purposes and can benefit from the "tie-breaker" test under the residence article.

Example 2

The facts are the same as in Example 1, except that Mr. X is an Italian citizen and resident and also is deemed to be a U.S. resident because of the amount of time he spends in the United States each year.

Being only a resident (and not a citizen) of the United States, the "tie-breaker"[11] test could make Mr. X resident only in Italy to avoid the application of the saving clause and the U.S. tax consequences.

With only the foreign tax credit to rely on, U.S. citizens residing in Italy might be unable to obtain any benefit from tax-advantageous transactions in either country.

For example, while the United States offers a rate of tax for capital gains that — in certain cases — is lower than that of Italy,[12] the United States taxes capital gains, which are exempt under Italian law.[13]

The saving clause, in combination with those inconsistencies between the two systems, may have the consequence illustrated in the example below:

Example 3

Mr. X is a U.S. citizen and an Italian resident. During the year 2000, Mr. X inherits from his father an apartment in Italy, which he sells two years later at a $30,000 gain. Along with the apartment, Mr. X sold at a $10,000 gain 100 shares — representing 50 percent of Alpha SPA's common stock — purchased in 1999.

While the $30,000 gain is not subject to Italian income tax,[14] because of Mr. X's U.S. citizenship, it will be taxed in the United States.[15]

On the other hand, the $10,000 gain from the sale of the stock is subject to the higher Italian fixed tax rate of 27 percent.[16] The lower U.S. tax at graduated rates, which Mr. X would have otherwise enjoyed had he not been an Italian resident, is completely offset by the credit for the tax paid in Italy.

As a result, a U.S. citizen who is resident in Italy might pay Italian capital gains tax at Italy's higher

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[7]Double taxation may arise anyway as a consequence of the U.S. alternative minimum tax provisions. *See* analysis of treaty art. 23, below.

[8]*See* treaty art. 1(2)(a). That is one of the few differences between a U.S. citizen and a U.S. resident alien from a U.S. tax viewpoint. Another difference is that — unlike U.S. citizens — U.S. resident aliens, while taxed on their worldwide income, may take credits for taxes paid to foreign countries but not to U.S. possessions. *See* IRC section 901(b)(1) and (3).

[9]*See* treaty art. 4(2).

[10]In the case of the United States, an individual who is a U.S. resident under domestic law, but who is deemed to be a resident of Italy under the tie-breaker rules of article 4 (resident), would be subject to U.S. tax only to the extent permitted by the treaty. However, individuals would be treated as U.S. residents for U.S. tax purposes other than determining their U.S. tax liability. For example, in determining whether a foreign corporation is a controlled foreign corporation for U.S. tax purposes, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be U.S. shareholders of a controlled foreign corporation subject to current inclusion of subpart F income recognized by the corporation. *See* Treas. reg. section 301.7701(b)-7(a)(3).

[11]*See* treaty art. 4(2).

[12]As a general rule, in the case of individuals, the maximum U.S. tax rate for capital gains is 20 percent, while Italy applies a "special" 27 percent or 12.5 percent tax in lieu of the regular income tax.

[13]For example, in Italy gains from the disposal of personal property, as well as gains from the disposal of real and personal property inherited and real property held for longer than five years, are generally not subject to income taxation. *See* TUIR article 81.

[14]TUIR art. 81(1)(b).

[15]In addition, for U.S. tax purposes, if Mr. X financed the purchase of his Italian residence with a mortgage denominated in euros, he also should take into account the provisions of IRC section 988. Those provisions would prevent Mr. X from offsetting the gain (or loss) realized from the sale of his personal residence with a loss (or gain) realized on the repayment of a mortgage denominated in euros. *See also* Rev. Rul. 90-79, 1990-2 CB 187.

[16]*See* D.Lgs. No. 461/1997, art. 5(1).

rate on those gains that are not exempt under Italian law, and U.S. capital gains tax on gains that are exempt from Italian tax.

In other words, a U.S. citizen in a situation similar to Mr. X in Example 3 above, obtains the benefits of neither system's taxation of capital gains.

Exceptions to the Saving Clause

In addition to the possibility for dual residents to claim the application of the "tie-breaker" rule, treaty benefits are unaffected[17] for U.S. residents and citizens for the following:

- alimony and child support payments;[18]
- Social Security payments;[19]
- foreign tax credit provisions;[20]
- the nondiscrimination provisions;[21]
- the right to use the mutual agreement procedure;[22] and
- the tax benefits conferred to an individual for government services, to teachers, to students, and to diplomatic agents.[23]

Relief for U.S. Partners Resident in Italy

Finally, the saving clause will not affect the benefits conferred by Italy to a U.S. citizen who is an Italian resident and a partner of a U.S. partnership.[24] In that case, Italy foregoes full residence-based taxation and allows a refundable credit against that individual's personal income tax equal to the corporation income tax that Italy imposed on the U.S. partnership for the same period.

Example 4

Mr. X is a U.S. citizen and an Italian resident.

Mr. X is a partner of Alpha Partnership, a U.S. law firm, and he is in charge of the Alpha Partnership office in Italy.

The Italian office of the Alpha Partnership generates income that is subject to the Italian corporate income tax. Also, Mr. X is subject to the Italian individual tax on his share of the profits.[25]

Mr. X is not entitled to the credit against individual income tax otherwise available under Italian law for profits distributed by certain Italian resident entities.[26] However, Mr. X can benefit from the special relief of the treaty under which he can credit against his Italian individual income tax his pro rata portion of the corporation income tax imposed in that year on Alpha Partnership.

The provision creates a dichotomy between the partners of a non-Italian resident partnership who are both Italian residents and U.S. citizens, and those who are either Italian residents but not U.S. citizens, or U.S. citizens but not Italian residents.

Example 5

Mr. Y is an Italian citizen and resident.

Mr. Y is a partner of Beta Partnership, a U.S. law firm, and he is in charge of the Beta Partnership office in Italy.

The Italian office of Beta Partnership generates income that is subject to the Italian corporate income tax. Also, Mr. Y is subject to the Italian individual tax on his share of the profits.[27]

Mr. Y is not entitled to the credit against individual income tax otherwise available under Italian law for profits distributed by certain Italian resident entities.[28]

In addition, Mr. Y cannot benefit from the special relief of the treaty because he is not a U.S. citizen.

Example 6

Mr. Z is a U.S. citizen and resident.

Mr. Z is a partner of Gamma Partnership, a U.S. law firm with an office in Italy. Gamma Partnership is deemed to have a permanent establishment in Italy.

[17] *See* treaty art. 1(3)(a) and (b).

[18] *See* treaty art. 18(5).

[19] *See* art. 1(2)(a) of the protocol.

[20] *See* treaty art. 23.

[21] *See* treaty art. 24.

[22] *See* treaty art. 25.

[23] *See* treaty arts. 19, 20, 21, and 27.

[24] *See* protocol arts. 1(2)(b) and 4. The protocol contains provisions that the U.S. and Italian authorities deem less important or that only affect one contracting party or that should be distinguished from the main text for other reasons. Those provisions complete — and sometimes even alter — the text of the treaty. Legally, however, they are part of the treaty and their binding force is equal to that of the main text. *See* Klaus Vogel, *Double Tax Conventions*, Kluwer Law International, 3rd ed. 1997, at pp. 22 and 32.

[25] Mr. X's share of profits is taxed as income from capital investments under TUIR art. 42.

[26] *See* TUIR art. 14, which grants a credit only for profits distributed by the Italian resident entities described in TUIR art. 87(1)(*a*) and (*b*).

[27] Mr. X's share of profits is taxed as income from capital investments under TUIR art. 42.

[28] *See* TUIR art. 14, which grants a credit only for profits distributed by the Italian resident entities described in TUIR art. 87(1)(*a*) and (*b*).

The Italian office of Gamma Partnership generates income that is subject to the Italian corporate income tax. Under Italian law, Mr. Z is subject to the Italian individual tax on his share of the profits from Italian sources.[29]

Mr. Z is not entitled to the credit against individual income tax, otherwise available under Italian law for profits distributed by certain Italian resident entities.[30]

In addition, Mr. Z cannot benefit from the special relief of the treaty because he is not an Italian resident.

Former U.S. Citizens and Long-Term Residents

In line with the U.S. expatriate rules,[31] the treaty includes language that permits the United States to apply the saving clause not only to U.S. citizens, but also to former U.S. citizens and former long-term residents whose loss of that status had as one of its principal purposes the avoidance of tax.[32]

That provision applies for 10 years following an individual's loss of citizen or long-term resident status.

Effects of the Saving Clause for Italian Citizens and Residents

The saving clause is for the benefit of the United States, which is virtually unique among the major countries in taxing its citizens, wherever resident, on their worldwide income solely by reason of their citizenship. The Italian government's report on the treaty clarifies that Italy, which asserts income tax jurisdiction only on the basis of residence, will not invoke the "saving clause" for Italian citizens even if under the treaty it has the right to do so.

Italy is not geared to enforce a provision that is inconsistent with its domestic income tax legislation, as well as its normal treaty obligations. In addition, under an internationally accepted principle, a treaty can limit, but never amplify, a country's tax jurisdiction. Income taxation of Italian citizens solely by reason of their citizenship, therefore, would unduly expand that jurisdiction. ✦

[29]*See* TUIR art. 20(1)(*b*).

[30]*See* TUIR art. 14, which grants a credit only for profits distributed by the Italian resident entities described in TUIR art. 87(1)(*a*) and (*b*).

[31]IRC section 877 generally provides that a citizen who loses U.S. citizenship or a U.S. long-term resident who ceases to be taxed as a lawful permanent resident, that is, individuals who expatriate, within the 10-year period immediately preceding the close of the taxable year will be taxed under section 877(b) and the special rules of section 877(d) for that taxable year, unless the loss did not have the avoidance of U.S. taxes as one of its principal purposes. Under IRC section 877(c) a taxpayer can request a ruling as to whether the loss of long-term resident status does not have as one of its principal purposes the avoidance of U.S. taxes. For a ruling favorable to taxpayer on an expatriation to avoid tax case, see LTR 200035032.

[32]*See* protocol art. 1(1).