TAXATION OF PENSIONS IN ITALY

by

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The Italian pension system may be described as a “two-pillar” system, consisting of a public compulsory scheme, and of a private pension system. All employees must adhere to the public pension scheme, whereas the private pension system is mainly based upon collective bargaining and participation is entirely voluntary.

The public pension system is a defined benefit system, guaranteeing at least a minimum pension regardless of the amounts of the contributions paid by the employee or by the employer. It operates as a “pay-as-you-go” system: current pensions are financed by the contributions of current workers; any deficit is covered by public expenditure.

The private pension system, on the other hand, is a defined contribution system, operating through funding coming from the employees and, generally, from the employers as well. Within the private pension system, we should also include individual pension plans, which enjoy the same tax treatment as collective pension schemes.

The tax frameworks under which the public pension system and the private pension system operate in Italy respond to quite similar principles.

The public pension system is taxed under a pure E-E-T system.

- Contributions (both the employer’s and the employee’s) are totally exempt from taxation.
- The public pension schemes are not subject to any taxation.
- The payment of pensions envisages income for the pension recipients, subject to the personal income tax.

The private pension system may instead be described as a E-R-TE system.

- Contributions are exempt from taxation: they are totally deductible for the employer, they are deductible up to a set ceiling for the employee.
- Returns on the investments of the private pension schemes are taxed at a reduced rate compared to the rate of taxation of similar financial investments.
The payment of pensions is subject to personal income tax for the pension recipients, except that the component of the pension corresponding to the financial returns, which were already taxed (at a reduced rate) when accumulating with the pension scheme, is exempt from any further taxation.

The differences existing between tax treatment of public and private pension systems may be explained on the following bases:

- Total tax relief for contributions to public pension schemes vs. limited tax relief for contributions to private pension schemes: contributions to public pension schemes are mandatory, whereas contributions to private pension schemes are voluntary.

- Total tax exemption for public pension schemes vs. taxation (although at a reduced rate) for private pension schemes: public pension schemes operate as “pay-as-you-go” systems, whereas private pension schemes are “funded” systems. In “pay-as-you-go” systems there is no financial component in the formation of the pension position and this accounts for the non taxation of the pension scheme. Indeed, it is to be considered that, since the financial returns on funded private pension schemes are taxed at a reduced rate (compared to taxation of any other financial investment) and are not any more subject to taxation when they are paid out as pension to the pension recipient, the system of taxation of private pensions may, in this respect, turn out to be more favorable than the system of taxation of public pensions. In fact, when public pensions are paid out, the whole amount will be subject to progressive personal income taxation. In this view, if, as envisaged, the public pension system is to be transformed into a “funded” system (capitalization of defined contributions), the same mechanisms that today are applied to private pension schemes should be applied.

It is also to be considered that public pension schemes and private pension schemes are quite similar also in terms of pension vesting. Both systems envisage either “old-age” pensions, to be received at the achievement of the final retirement age (generally, 65 for men
and 60 for women), or “elderness” pensions, to be received when fulfilling set requirements in terms of age and in terms of years of participation to the pension scheme (for example, for public pensions, the requirement is met, generally, when the age of the future pension recipient plus the years of participation adds up to no less than 90; for private pensions, the requirement is met when the age of the future pension recipient is no less than 10 years younger than the “old-age” pension age, concurring with at least 15 years of participation to the pension scheme).

Both public pensions and private pensions are perfectly portable, substantially and tax-wise, at least from a domestic point of view.

The public pension system is run by public entities operating under the supervision of the Ministry of Labor.

Private pension schemes may be “collective” or “individual”.

Collective pension schemes arise out of collective bargaining, which may take place at a national level, at a regional level or at the firm level. They are generally set up as private associations, whose members are the participating employees and employers (if the latter were part of the collective bargaining). The management of the collective pension scheme is entrusted to a board of directors that must be formed by an equal number of representatives of the employees and of the employers.

Individual pension schemes may be set up through collective investment schemes promoted and managed by banks, asset managers or insurance companies, or through special insurance contracts. Tax-wise, individual pension schemes are treated as collective pension schemes.

Following is some greater detail as to the tax regulation of public and private pension schemes.

**Tax treatment of contributions**
Employees’ contributions to the public pension system are totally exempt from taxation.

Employees’ contributions to private pension funds are exempt from taxation as well, within a maximum amount. Such maximum amount is equal to 12% of the employee’s income up to a limit of 10 million Liras (Euro 5,164.57). Whenever a collective pension scheme exists to which the employee may participate, the above said tax relief is granted only if, under the collective agreement setting up the pension fund, it is established that a portion of the so called “liquidation bonus”\(^1\) is paid out as further contribution to the pension fund.

Employers’ contributions, both to public schemes and to private schemes, are always to be considered as costs for the employer and hence they can be treated as a deduction in calculating the employer’s business income. However, the employer’s contributions to private pension funds is regarded as part of the employee’s income for tax purposes: they will be summed up to the employee’s contributions and, together with such contributions, their tax relief will be subject to the above described limits. Hence, if the total amount of contributions paid to the pension fund (including both the employer’s and the employee’s) exceeds the limit of 12% of total income (up to 10 million Liras), any surplus shall be taxable income for the employee.

**Tax treatment of accumulation**

Since the public pension system is “unfunded”, there is no investment of resources and, consequently, no financial income and returns in composing the pension position accruing to the employee. The accumulation stage is, therefore, exempt from any income taxation.

\(^{1}\) This so called “liquidation bonus” is deferred remuneration accruing every year (about 7% of the annual salary for each year of employment), which will only be paid out to the employee when his/ her employment contract is terminated, for whatever reason.
On the other hand, as anticipated earlier, private pension schemes are “funded” systems and operate on the basis of the capitalization of the resources collected through the employees’ and employers’ contributions. Private pension schemes may only invest such resources in financial instruments, and the financial returns thus gained are subject to taxation at a rate of 11%. Such rate is lower than the one generally applicable to financial income, which currently is 12.50%. The justification for such lower rate is generally deemed to be based upon the longer time constraint to which pension savings are subject to. There is quite a lively discussion to urge Parliament to further lower the tax rate for pension schemes investment.

**Tax treatment of pensions**

The payment of pensions always constitutes income for the pension recipient, and it is therefore subject to personal income taxation.

Public pensions are always paid as annuities and, hence, they are subject to progressive taxation for their entire amount.

Private pension schemes may allow the pension recipient to opt for a partial payment of the pension as a lump-sum, whereas the remaining part (at least half of the total pension position) must be paid out as annuity.

The underlying principle for taxation of pensions is that they should be taxed only limited to the amounts corresponding to the contributions that enjoyed tax relief when they were paid in, thus avoiding any economic double taxation of income. According to this principle, annuities will be subject to progressive taxation but the component of the annuity corresponding to the financial returns accumulated by the pension fund or to the contributions that exceeded the tax relief threshold shall be excluded from any further taxation. By the same token, taxation of the lump-sum pension payments shall follow a similar structure: the lump sum payment, however, shall not be subject to progressive taxation, but to separate taxation at a rate which, ultimately, is equal to the average rate of taxation of the pension recipient in the preceding five years. Taxation of lump sum pension payments becomes harsher (also subjecting to taxation the amount of the payment...
corresponding to the financial returns accumulated by the pension fund) when the amount paid out as lump sum exceeds one third of the total pension position accumulated by the pension recipient. It is a clear example of the use of the tax regime to enhance the pension function of the accumulation of savings, favoring the payment of pensions in the form of annuities.

Cross border pension provisions

As for taxation of cross border pension provisions, it is to be considered that Italian domestic legislation is subject to any existing Convention against double taxation. In this respect, existing Conventions to which Italy is a party generally follow the directives of the OECD Model Convention, hence stating that pensions are taxed in the State where the pension recipient is a resident.

Where no double taxation convention is in place, the general rule is that both public and private pensions are taxed in the State where the pension scheme (be it public or private) is resident, regardless of the residence of the pension recipient.

Greater restrictions are in place, however, when it comes to tax treatment of cross border contributions or cross border portability of pension positions, with regard to private pension schemes.

As a matter of fact, contributions to private pension schemes enjoy tax relief only if the pension scheme is Italian (an exception is only made for individual retirement plans through insurance contracts, offered by EC insurance companies). This limitation to tax relief, however, is only suffered by employees, whereas contributions paid by employers, even if to a foreign pension fund, should anyhow be considered labor costs and hence be deductible from profits for tax purposes.

Moreover, there is no cross border portability of the pension position, since the transfer of the position to (or from) a foreign private pension scheme is, tax-wise, deemed to be receipt of a lump-sum and hence subject to taxation accordingly: tax neutrality of transfers from one pension scheme to another is only envisaged for domestic transfers.
In conclusion, it should be considered that the rigidity envisaged for cross border pension provisions, in terms of contributions and portability, does have a rational justification that must be taken into account, in order to find a proper balance with the freedoms established by the EC Treaties. The rationale underlying the tax favor in place towards pension schemes is based upon the assumption that “today’s relief” shall become “tomorrow’s taxation”. In principle, this assumption only works if the system is a closed system: when a person that has enjoyed tax relief in one State moves to another State, if the transfer of the pension position is neutral tax-wise, then the relief granted from the original State becomes a “gift”. From a domestic point of view, a unilateral solution to this, allowing for free and exempt transferability of pension position to foreign schemes, may be founded upon a reciprocity regime, thus allowing the exemption if the other country equally allows exemption for transfers from its system to the other system.
Essential Bibliography

Laws, regulations and practices concerning private pension funds may be found on the internet website of the Pension Fund Authority (Covip), at www.covip.it


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