

HR & Tax Alert

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Italy – change in the tax treatment of redundancy payments

July 2006

Executive summary

A new tax decree has recently been passed which eliminates some elements of the favourable treatment of certain termination payments in Italy. The decree is expected to be passed into law shortly, and will apply to all termination payments agreed on or after 4th July 2006.

Background

Termination payments made to employees can be made up of the mandatory termination payment under Italian law, the ‘TFR’ (Trattamento di Fine Rapporto), and an additional voluntary payment from the company or ‘incentive to leave the company’ payment. Both such payments are subject to a special TFR withholding tax rate. However the final income tax rate due on both the mandatory and voluntary termination payment is then calculated by reference to the taxpayer’s average tax rate over the last five years, which can differ from the TFR rate withheld by the employer. This adjustment is made by December 31st of the 4th year following the filing of the employer’s withholding tax return for the year of payment, meaning that the adjustment could be made some years after payment was actually received.

Under current legislation, a 50% reduction was given in both the TFR withholding rate and the final applicable tax rate for additional voluntary termination payments made to women over the age of 50 and men over the age of 55.

New Decree

With effect from 4 July 2006, any additional voluntary termination payments made to individuals over the ages outlined above will no longer receive the 50% reduction in withholding and final tax rates. However such payments will still be subject to separate taxation (i.e. will not be assessed as part of the total annual income) and will ultimately be assessed by the tax authorities at the average tax rate of the last 5 years. This regime is still more favorable than ordinary taxation at progressive tax rates for the majority of taxpayers, and is consistent with the taxation of mandatory termination payments which is unchanged by the new decree.

A transitional provision was passed by the Italian government on 25th July 2006 which would allow individuals whose termination conditions were agreed prior to 4th July 2006 to be taxed in accordance with the previous legislation. This provision must now be approved by the Chamber of Deputies and is then likely to be incorporated into the law.

Next steps

Companies should ensure that they are withholding tax on termination payments at the appropriate rate under the new decree. Planning opportunities on termination have been restricted but not cancelled by this new decree and Ernst & Young can assist in drafting and reviewing termination agreements to ensure that separate taxation will be applicable where possible, albeit at a higher tax rate than previously. We will continue to update you of any further developments in future Alerts.

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