ITALY

The New Tax Credit Regime on Dividends: Effects on Existing Treaties

Dr Piergiorgio Valente and Dr Marco Magenta

Piergiorgio Valente is Director of International Tax Planning at Studio Associato Legale Tributario (associated with Ernst & Young International) in Milan.

Marco Magenta is Manager at Studio Associato Legale Tributario (associated with Ernst & Young International) in Milan.

I. INTRODUCTION

The aim of this article is to outline the provisions introduced in Italy by the Legislative Decree No. 467 of 8 December 1997, concerning the abolition of the equalization tax and the reform of the dividend tax credit. In particular, the effects of the Decree on treaty provisions providing for the refund of the equalization tax and/or the dividend tax credit to certain non-resident shareholders will be examined.

II. THE DIVIDEND TAX CREDIT AND THE EQUALIZATION TAX

The Italian taxation of dividends follows the imputation model. The tax credit is granted only to resident shareholders and to foreign companies having a permanent establishment in Italy.[1] Indeed, according to the "force of attraction" of the permanent establishment, pursuant to Article 112, paragraph 2, of the Italian Income Tax Act (ITA), the profits distributed to the head office are considered to have been received by the same permanent establishment; consequently, they are subject to the tax regime established for profits distributed to resident shareholders.

The tax credit is equal to a portion of the distributed dividends and is computed on the basis of the Corporate Income Tax (IRPEG) rate in order to provide the resident shareholder with credit for the IRPEG paid by the distributing company.

The amount of the old tax credit,[2] equal to 9/16 (56.25 per cent) of the distributed dividends, was determined on the basis of a 36 per cent IRPEG rate as follows: 36/(100 – 36) = 36/64 = 9/16.[3]

Since 1995, the IRPEG rate was increased to 37 per cent; consequently, the new regulations contained in the Legislative Decree No. 467/1997 set forth an increase of the tax credit from 56.25 per cent to 58.73 per cent, calculated as follows: 37/(100 – 37) = 37/63 = 58.73 per cent. For the purposes of the calculation of the tax due, the tax credit to which the shareholder is entitled must first be added to the dividend received (gross of the withholding tax applied, if any) in such a way as to determine the taxable income and must thereafter be subtracted from the gross tax due.[4]

A correct functioning of the tax credit mechanism presupposes that the profit from which the dividend derives has been subject to a tax, at the distributing company's level, which is (at least) equal to the tax credit granted to the shareholder. Where this was not the case, the old rules applied an "equalization tax", for the purpose of balancing the tax liability which was as a whole applied to the profit distributed in relation to the tax credit granted to the shareholder.[5]

If the profit for the year was not immediately distributed but allocated to reserves, a calculation of its amount was required which, in case of subsequent distribution, would have been subject to the equalization tax, thus highlighting the subsequent allocation of the reserves set aside either in the tax return or in the explanatory notes of the financial statements for civil law purposes.

III. ABOLITION OF THE EQUALIZATION TAX AND CHANGES RELATING TO THE TAX CREDIT

Legislative Decree No. 467/1997 abolishes the equalization tax and modifies the dividend tax credit with the aim of creating a relation between the tax credit granted to the share-

1. Conversely, the profits distributed to non-resident shareholders with no permanent establishment in Italy are subject to a 27 per cent withholding tax as of 1 July 1998, or to the lower applicable treaty rate, with no tax credit granted to the recipients. Up to 4/9 of the withholding tax can be refunded to the non-resident shareholder, if he shows that he has paid taxes on those dividends in his country of residence.
2. As per Law No. 904/1977 as modified by Law No. 649/1983.
3. In accordance with what was provided for by the EU directive proposal of 23 July 1975, concerning the harmonization of systems of company taxation and of withholding tax on dividends (cf. *O.J.E.C.*, 23 July 1975 No. C 253), if we refer to a as the tax rate applied to the income produced by the company (that we presume to be amounting to 100), the portion of net profit which may be distributed is equal to $(100 - a)$, while the ratio tax paid-profit distributed is equal to $[a/(100 - a)]$. Therefore, the tax credit coefficient which is to be applied to the dividend, can be calculated through the same formula.
4. The 10 per cent withholding tax has been repealed under the new system.
5. The equalization tax was applied where the dividend distributed, less the portion assigned to savings shares, exceeded 64 per cent of the taxable income, gross of the carried forward tax losses. In this event, the equalization tax due by the distributing company was equal to 9/16 of the excess amount, i.e. of an amount equal to the tax credit attributed to said excess.

holder and the tax paid by the company on the distributed profits.

After the new provisions come into effect in the second financial year subsequent to that in progress at 31 December 1996 (i.e. where the financial year closes at 31 December starting from the financial statements relating to 1998), all profits will be freely distributable and it will no longer be necessary to calculate the portion of the accounting profits subject to an equalization tax, in case of distribution.

Notwithstanding the abolition of the equalization tax, however, the new rules do not modify the principle on the basis of which a relation was established between the tax paid by the distributing company and the tax credit granted to the shareholder. In the absence of the equalization tax, this relation is achieved through a limitation of the tax credit on dividends deriving from profits which have not been subject to taxation, at an ordinary rate, at the distributing company's level.

Therefore, the distributed dividends may:
- entitle the shareholder to a full tax credit amounting to 58.73 per cent of the gross dividend received; or
- entitle the shareholder to a limited tax credit; or
- not entitle the shareholder to any tax credit.

In order to determine the tax credit attached to the distributed dividends, when filing their own tax return, companies must take into consideration:
- the IRPEG paid at the full rate, imputed to "Basket A", which allows the shareholders to benefit from a full tax credit; and
- the IRPEG amount which, even if not actually paid, is considered as notionally paid, and is imputed to "Basket B", entitling shareholders to a limited tax credit.

In particular, the types of income which fall within *Basket B* are the following:
- capital gains and other positive income components, subject to substitute taxation, deriving from extraordinary operations of company reorganization;[6]
- the portion of the total taxable income subject to a lower taxation when compared to the ordinary tax rate as a result of the provisions relating to the *dual income tax*;[7]
- the non-taxable portion, equal to 95 per cent or to 60 per cent, of the dividends received by resident companies respectively from EU "subsidiaries" or by foreign affiliated companies;[8]
- income, benefiting from tax relief, produced in Southern Italy;
- foreign source income which benefits from the "matching credit" under the applicable treaty.

IV. THE LIMITED TAX CREDIT

The limited tax credit is also equal to 58.73 per cent (37/63) of the gross dividend received by the shareholder, but differs from the full tax credit in that:
- it cannot be refunded or carried forward to subsequent financial years, and
- it can be deducted only from the tax referring to the dividends from which it originates, which is calculated on the basis of the following formula:
  - *(dividends with a limited tax credit + limited tax credit)/ (total taxable income, gross of the tax credit and tax losses carried forward, if any) X total gross tax.*

The limited tax credit must be used by the shareholder before the full tax credit, which, unlike the limited credit, may be carried forward to following years without any time limit.

The limited tax credit may be used only to offset the taxes on dividends to which it is attributed, so as to preserve the benefits of tax reliefs or exemptions granted at the level of the distributing company. On the other hand, the non-deductibility from taxes referring to other income is justified since the notional taxes were never actually paid by the distributing company.

V. SUBSTITUTE TAX FOR THE MANDATORY RELEASE OF RESERVES SUBJECT TO THE EQUALIZATION TAX

The reserves subject to the equalization tax disclosed in the financial statements relating to the fiscal year subsequent to that in progress at 31 December 1996 (i.e. where the fiscal year closes at 31 December, in the financial statements relating to 1997[9]), must be mandatorily released through the payment of a substitute tax – not deductible for income tax purposes and imputable to reserves or to the corporate capital – which is equal to:
- 5.6 per cent of the amount of reserves subject to the 56.25 per cent full equalization tax;
- 2.2 per cent of the reserves subject to equalization tax at the reduced rate of 15 per cent.

The amount of the reserves subject to the substitute tax is reduced by the amount of the possible tax-free allowance as resulting from the tax return relating to the fiscal year subsequent to that in progress at 31 December 1996. Where the tax-free allowance is higher than the amount of the reserves subject to the equalization tax, the excess amount may be imputed to the above-mentioned *Basket A* as the IRPEG paid at the full rate, in equal instalments in the same financial year and in the nine subsequent ones.

The substitute tax has to be calculated in the tax return relating to the 1997 financial year and must be paid in three instalments:
- 9 per cent within the filing date of the tax return relating to the year 1997 (filed in 1998);
- 50 per cent within the filing date of the tax return relating to the year 1998 (filed in 1999);

6. See Legislative Decree No. 358 of 8 October 1997, effective from 8 November 1997.
7. See Legislative Decree No. 466 of 18 December 1997, effective from the fiscal year subsequent to the one in progress on 30 September 1996.
8. See Art. 96 and 96-*bis* of ITA.
9. Therefore the 1996 profits distributed during 1997 and the 1997 profits, although not distributed, are not subject to the substitute tax.

– 41 per cent within the filing date of the tax return relating to the year 1999 (filed in 2000).

VI. DOUBLE TAX TREATIES AND ABOLITION OF THE EQUALIZATION TAX

This section analyses the consequences for the French, German and Dutch shareholders of Italian companies resulting from the abolition of the equalization tax and of the mandatory release of the reserves subject to it through payment of the above-analysed substitute tax.

The treaties concluded between Italy and France,[10] Germany,[11] and the Netherlands[12] grant the shareholder residing in these countries the right to obtain the refund – subject to dividend withholding tax at treaty rates[13] – of the equalization tax due by the Italian company on the dividends distributed.

The refund is claimed by means of the Italian distributing company which acts in the name and on behalf of the non-resident shareholder. If certain formal procedures are fulfilled, the refund may be obtained through the distributing company itself, so that the shareholder will directly receive the whole amount and will save on (financial) costs otherwise incurred in connection with refunds from the Italian tax authorities.

Following the mandatory release of the reserves subject to the equalization tax, what must be established is whether the above-mentioned treaties entitle the non-resident shareholders to the refund of the substitute tax applied in order to obtain such release. The substitute tax, if not refundable, implies a decrease in the net worth pertaining to non-resident shareholders in that it reduces the distributable net amount of the reserves to which this substitute tax is imputed or, in any event, in the case where it is imputed to the profit and loss account, it reduces the net profit of the Italian company distributable to the shareholders. Where it is refundable, the substitute tax would not generate any additional charge for non-resident shareholders.[14]

From this perspective, it is necessary to ascertain whether the substitute tax is included in the scope of the treaties in question. According to Article 2, the treaties apply:
- to individuals' income tax (IRPEF);
- to corporate entities' income tax (IRPEG);
- to local income tax (ILOR);[15]
- to any identical or substantially similar taxes, imposed after the signature of the treaty in addition to or in place of the above-mentioned taxes. For this purpose, the competent authorities of the contracting states must notify each other of any substantial changes in their respective tax legislation.

That being stated, the wording of the domestic provision instituting the equalization tax established that: the IRPEG is subject to an increase by an amount which is equal to the "equalization tax";[16] therefore, it seems possible to surmise that the equalization tax is neither a levy which differs from the income taxes generally existing in Italy (IRPEG, IRPEF and ILOR), nor is it a withholding tax on the distributed profit. It is in fact an additional rate of the IRPEG owed by the distributing company.

Besides being expressly mentioned in Article 10 which covers dividends, the equalization tax seems to be included in the scope of the treaty pursuant to Article 2, in that it may be considered as a portion of the IRPEG due, explicitly mentioned in that article.

According to this approach, the substitute tax applied to obtain the mandatory release of reserves should also be included in the scope of the treaty since it is destined to replace the equalization tax. Accordingly, the non-resident shareholder would be granted the right to receive the substitute tax refund subject to the same conditions and procedures established for the equalization tax refund. In effect, the difference between the basis of the equalization tax (i.e. to be applied upon distribution of profits or reserves subject to it) and the basis of the substitute tax (i.e. upon release of the reserves subject to the equalization tax and irrespective of their distribution) is not likely to justify the exclusion of the substitute tax from the scope of the treaty provisions.

However, pursuant to the above-mentioned treaties, entitlement to the equalization tax refund is subject to the profit or reserves distribution on which the equalization tax is applied. No other rule being provided, it does not seem possible to deviate from this principle and, consequently, the substitute tax refund could nevertheless be claimed at the time of the distribution of the reserves on which the tax is applied. According to this approach, no claim could be made following the mere application of the substitute tax to the reserves which are not to be distributed. The said refund should rather be claimed at the time of the distribution of such reserves,

10. The 1989 Italy–France treaty grants to the French shareholders who are not entitled to receive the refund of the tax credit established by the same treaty, the right to a refund of an amount corresponding to the equalization tax due by the Italian distributing company, provided that: (i) they are the beneficial owners of the dividends at the date of the resolution for the distribution and, in the case where the dividends are paid to companies (in the sense established by the treaty) which are entitled to the application of the 5 per cent withholding tax or which benefit from the "*régime des sociétés mères et filiales*" provided for by the domestic French law, (ii) they owned the participation without any interruption for a 12-month period prior to the date of said resolution.

11. The 1989 Italy–Germany treaty grants to the German corporate shareholders the refund of an amount corresponding to the equalization tax due by the Italian distributing company, provided that: (i) they are the beneficial owners of the dividends at the date of the resolution of distribution, (ii) they own a direct participation in the capital of the Italian distributing company equal to at least 25 per cent and (iii) they owned the qualified participation without any interruption for a 12-month period prior to the date of said resolution.

12. The 1990 Italy–Netherlands treaty grants to Dutch shareholders the refund of the equalization tax due by the Italian distributing company, provided that: (i) they are the beneficial owners of the dividends at the date of the resolution of distribution, (ii) they owned the participation without any interruption for a 12-month period prior to the date of said resolution and (iii), in the case of companies (in the sense established by the treaty) are entitled to the 5 per cent withholding tax, and which held more than 50 per cent of the voting right in the course of the same period.

13. Cf. Circular issued by the Ministry of Finances of 18 August 1994, No. 151/E-14/658, which authorizes the non-application of the withholding tax in case of refunds of the equalization tax to shareholders residing in France and Germany.

14. This is similar to the case of the refund of the equalization tax.

15. Note that ILOR was abolished as of 1998 by Art. 36 of Legislative Decree No. 446 of 15 December 1997.

16. See the former Art. 105, para. 1, of ITCT.

even if the distribution is subsequent to the application of the substitute tax.

As is the case for the equalization tax refund, the substitute tax refund should also be claimed through the Italian distributing company which should operate in the name and on behalf of the non-resident shareholder.

More specifically, the procedure by which the substitute tax would be directly refunded by the Italian distributing company should not be adopted in the absence of a provision, or at least of a ministerial interpretation which explicitly provides the possibility for the Italian distributing company to make the direct refund and deduct the refunded tax from its income tax liability. The foreign shareholder should rather file, through the Italian distributing company, a specific request for the refund with the competent Italian authorities, and in case of denial, appeal to litigation.

VII. DOUBLE TAX TREATIES AND THE NEW TAX CREDIT REGIME

The relationship between the new provisions and those granting the refund of the dividend tax credit to non-resident shareholders, set forth in the treaties concluded with France[17] and the United Kingdom,[18] may be summarized as follows.

While there should be no doubt that the new provisions do not imply any change in the refund rights concerning the full tax credit – the only change being an increase in the amount of the tax credit from 56.25 per cent to 58.73 per cent – the refund of the limited tax credit, as defined above, is a more delicate matter since the relevant treaties include the following conditions:

- the treaty with France provides that the refund is granted only on dividends which would involve a tax credit if they were distributed to an Italian resident shareholder;
- the treaty with the United Kingdom provides that the refund would be granted to the same extent that it would be granted to an Italian individual receiving the same dividends.

As already stated, the limited tax credit on dividends received by resident shareholders (or permanent establishments in Italy of non-resident shareholders) is subject to two different restrictions:

- it may not be refunded or carried forward to the following financial years; and
- it may be deducted only from the tax relating to the dividends to which the credit relates.

With reference to the latter condition, it must be verified whether the tax relating to the dividends only takes into account the Italian tax payable or if it also includes the tax due by the shareholder in its country of residence on the dividends received. The first interpretation should be adopted for the following reasons.

It must be pointed out that the possibility to take into consideration the taxes paid by the shareholder in his state of residence in order to compute the amount of the tax credit, is not based on the wording of the treaty provisions and it may be, in the absence of specific provisions on this matter determining the procedure to be adopted, difficult to maintain and to put into practice.

Further, the limited tax credit refers to the profits which were not subject to taxation at the distributing company's level, with the result that if such profits are subject to taxation at the shareholder's level, no double taxation occurs. The granting of a (limited) tax credit to the resident shareholder aims at ensuring that the taxation of the distributed dividend does not cancel the effects of the tax benefits granted to the distributing company. Nevertheless, this reason does not seem to be the rationale of the tax credit refund established by the treaty provisions which are intended to reduce double taxation rather than extending the tax benefits granted by a contracting state to its resident companies to the shareholders residing in the other contracting state.

From a different perspective, with regard to the tax paid in Italy, it may be noted that a non-resident shareholder without a permanent establishment in Italy does not owe any tax in Italy on the dividends received, with the exception of the dividend withholding tax. One could therefore argue that the British or French shareholder may benefit from the refund only within the limits of the same withholding tax. Conversely, the excess amount could not (in any way) be used since, pursuant to domestic rules, it cannot be refunded or carried forward or set off against taxes due on other income.

It must be noted, however, that the deduction of the tax credit from the withholding tax is not consistent with treaty provisions, according to which the tax credit refund must also be subject to withholding tax, together with the dividend to which it is related. Moreover, the withholding tax applied to non-resident shareholders has to be considered as a substitute tax for ordinary income taxes, which does not allow any deduction or credit which would otherwise be available if ordinary taxation rules were applicable.

In the light of the foregoing, one may conclude that, while the refund of the full tax credit, pursuant to the above-mentioned treaty provisions, is not modified by the new domestic tax rules, the refund of the limited tax credit seems no longer possible since it exceeds the Italian tax due by the foreign shareholder on the dividends received.

17. The Italy–France treaty grants to the French shareholders the right to the refund, subject to withholding tax, of an amount corresponding (i) to the tax credit in the event that the dividends are paid to an individual or a company (in the sense established by the treaty) which is not entitled to the 5 per cent withholding tax and does not benefit from the *régime des sociétés mères et filiales* provided for by domestic French law, or rather (ii) to half of the tax credit in the case where the dividends are paid to a company (in the sense established by the treaty) which is entitled to the 5 per cent withholding tax or may benefit from the *régime des sociétés mères et filiales* established by French domestic law.

18. The 1990 Italy–United Kingdom treaty grants to UK shareholders the refund – subject to withholding tax – of an amount corresponding to the tax credit, in the same amount due to Italian shareholders. Moreover, the refund is limited to the 50 per cent of the tax credit in the case where the shareholder receiving the dividend is a company which controls directly or indirectly through or together with other related companies (in the sense established by the treaty) at least 10 per cent of the voting rights of the distributing company.