# ITALIAN SUPREME COURT ISSUES A LANDMARK DECISION ON THE ENTITLEMENT TO THE FOREIGN TAX CREDIT

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## INTRODUCTION

In a recent case regarding distributions from the U.S., the Italian Supreme Court stated a general principle recognizing that, on the basis of double tax treaty provisions, Italian resident individuals are entitled to the foreign tax credit in respect of foreign taxes imposed on non-Italian source dividends.[1]

The decision is particularly relevant because it resolved a conflict between the Italian domestic rule and double tax treaty provisions. The Italian domestic rule denies the application of the foreign tax credit in a fact pattern involving foreign dividends that are subject to a reduced separate taxation in Italy, reasoning that the foreign tax credit applies solely to ordinary income subject to individual income taxes at the standard progressive rates. In comparison, the relevant tax treaty provision grants double tax relief in the form of a foreign tax credit that may be claimed by Italian resident individuals. The Italian Supreme Court ruled in favor of the clear meaning of the treaty provision.

Significant practical implications derive from this court decision as it provides grounds to Italian resident individuals to claim the refund of the income taxes paid in Italy without computing the foreign tax credit.

This article provides an overview of (i) the application of the foreign tax credit in respect of foreign source dividends received by Italian resident individuals and (ii) the main consequences that may result from the decision of the Italian Supreme Court.

## TAXATION OF FOREIGN SOURCE DIVIDENDS

Under Italian domestic rules, dividends received by Italian resident individuals are not included in the ordinary income subject to individual income tax at progressive rates (up to 43%) and are instead subjected to "separate" taxation at the rate of 26%.[2]

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1 Decision of the Italian Supreme Court of Cassation No. 25698 of 1 September 2022.

2 Until December 31, 2017, a different tax treatment applied on dividends depending on whether the shareholding qualified as substantial (more than 2% of the voting rights or 5% of the equity in listed companies, or more than 20% of the voting rights or 25% of the equity in non-listed companies) or non-substantial. Dividends from substantial participations were subject to ordinary income taxation on 58.14% (49.72% until 2016) of the dividend payment. The remaining 41.86% (50.28% until 2016) was exempt. Dividends from non-substantial participations were subject to separate taxation at the reduced rate of 26% by way of final withholding tax or substitutive tax. The tax rate was originally equal to 12.5% until 2011. It was increased to 20% in the period from 2012 to June 30, 2014, and to 26% starting from July 1, 2014. As of 2018, the distinction between substantial and non-substantial participation eliminated. All dividends are subject to separate taxation at the rate

In those cases, the recipient does not have the option to include the dividends in the ordinary income and separate taxation applies on a mandatory basis.[3]

The 26% taxation is applied either by way of withholding tax levied by an authorized financial intermediary[4] or through a substitutive tax to be paid by the recipient, if there is no financial intermediary intervening in the payment. Under the official interpretation of the Italian Revenue Agency,[5] different tax consequences result from an Italian perspective depending on whether separate taxation of foreign-sourced dividends is applied by way of withholding tax or substitutive tax.

If an authorized financial intermediary intervenes in the payment, the 26% withholding tax is applied on the amount of the dividends received net of the foreign taxes applied on those dividends. Example 1 illustrates the application of Italian tax collected by withholding.

| **Example 1 – Italian Withholding Tax** | | |
|---|---|---|
| A | Gross Dividend | 100 |
| B | Foreign Tax (15%) | 15 |
| C | Amount Subject to Italian W.H.T. (A – B) | 85 |
| D | Italian W.H.T. (C x 26%) | 22.1 |
| E | Foreign Tax Credit | 0 |
| F | Net Dividend (A – B – D) | 62.9 |
| G | Effective Tax Rate | 37.1% |

of 26%. Grandfathering rules apply in respect of dividends on substantial participations paid out of profits realized by a company up to December 31, 2017, and paid between January 1, 2018, and December 31, 2022. In particular, the taxable amount of the dividends to be included in the ordinary income subject to individual income tax is as follows: (i) 40% for dividends paid out of profits realized before 2008; (ii) 49.72% for dividends paid out of profits realized in the period from 2008 to 2016; and (iii) 58.14% for dividends paid out of profits realized in years 2016 and 2017.

3 It should be specified that the foregoing tax treatment does not apply to dividends directly or indirectly distributed by a company resident in a State with a privileged tax system. Those dividends are fully taxable in the hands of Italian resident individuals, unless previously taxed in the hands of the individuals under Italian domestic Controlled Foreign Corporation rules.

4 The category of authorized financial intermediaries includes Italian resident banks (including permanent establishments of non-Italian resident banks), Italian securities investment firms, Italian trust companies, Poste Italiane S.p.A., Italian stockbrokers and asset management companies authorized to provide individual asset management services.

5 Ruling No. 111/2020 of the Italian Revenue Agency.

If no authorized financial intermediary intervenes in the payment because, for example, the dividends are directly received by the Italian resident individual, the recipient must declare the dividends received in the individual income tax return and pay a substitutive tax at the rate of 26% on the amount of the dividends gross of foreign taxes. Example 2 illustrates the application of the Italian substitutive tax.

| **Example 2 – Italian Subsititutive Tax** | | |
|---|---|---|
| A | Gross Dividend | 100 |
| B | Foreign Tax (20%) | 15 |
| C | Amount Subject to Italian Substitutive Tax (= A) | 100 |
| D | Italian Substitutive Tax (C x 26%) | 26 |
| E | Foreign Tax Credit | 0 |
| F | Net Dividend (A – B – D) | 59 |
| G | Effective Tax Rate | 41.0% |

As shown in Example 2, when foreign dividends are subject to Italian substitutive tax, overall taxation is heavier than when Italian withholding tax is imposed on foreign dividends because the latter is collected after deduction of foreign taxes. No rational explanation exists for the difference; the two cases are identical, but for method of tax collection, and should lead to the same result. In neither case is a foreign tax credit allowed in Italy.

## FOREIGN TAX CREDIT APPLIES TO ORDINARY INCOME, ONLY

According to Italian domestic rules, the foreign tax credit is granted, subject to certain conditions, exclusively with respect to foreign source income included in the taxpayer's ordinary income and is limited to the lower of the foreign tax paid or the Italian tax that relates to the foreign income. If the foreign source income is not included in the ordinary income subject to Italian individual income tax at progressive rates, the recipient is not entitled to benefit from any foreign tax credit.[6] That is the case of foreign source dividends received by individuals which, as described above, are subject to separate taxation and are not included in the ordinary income.

6 As confirmed by the Italian Revenue Agency in Circular Letter No. 9/E of 2015, the rationale is that separate taxation is typically lower than ordinary taxation. Consequently, there is limited need for the application of methods to avoid double taxation, because the final result leads to a level taxation considered to be bearable. However, what was true when the rate for Italian taxation of dividends and certain other income of financial nature was 12.5%, is not necessarily valid when the rate of Italian tax is 26% with no relief for foreign tax.

In certain cases, the recipient may elect to treat certain financial income as ordinary income instead, which precludes application of the separate tax regime. In such a case, the recipient would be entitled to the foreign tax credit. However, this option is not applicable for foreign source dividends. Such dividends are never allowed to be included in ordinary income subject to individual income tax at progressive rates.

***"The domestic foreign tax credit provision conflicts with the double tax relief provisions of the income tax treaties entered into by Italy, which generally provide double tax relief by means of a foreign tax credit."***

In light of the framework described, foreign dividends suffer double taxation as they are taxed twice: first, at source, in the residence State of the foreign company and then, separately, in Italy in the hands of the recipients. The effect of double taxation is even heavier when the foreign dividends are not received through an authorized financial intermediary. As illustrated in Example 2, when the Italian substitutive tax is applied, the tax base is the amount of the gross foreign dividend computed without any reduction for foreign withholding taxes.

## DOUBLE TAX RELIEF UNDER ITALIAN INCOME TAX TREATIES

The domestic foreign tax credit provision conflicts with the double tax relief provisions of the income tax treaties entered into by Italy, which generally provide double tax relief by means of a foreign tax credit.

In general, the method chosen by Italy to provide double tax relief is the ordinary credit method based on Article 23 B of the O.E.C.D. Model Tax Convention on Income and on Capital. Under the credit method, where an Italian tax resident derives income which may be taxed in the other contracting State in accordance with the provisions of the double tax treaty, Italy is obligated to allow a deduction from the tax – *viz.*, a credit – in an amount equal to the income tax paid in that other State. The credit is subject to a limitation, preventing it from exceeding the portion of Italian income tax that is attributable to the income arising in the other State. In broad terms, the Italian tax is multiplied by a fraction in which the numerator is the income that is derived from sources in the other state and the denominator is the total income of the Italian company.

Most double tax treaties entered into by Italy (87 out of 103) contain a clause allowing Italy to deny the foreign tax credit in the event that a particular item of foreign source income is taxed in Italy separately by way of a final withholding tax applied at the request of the Italian resident recipient. Examples appear in the income tax treaties with the U.S., France, Germany, Luxembourg, the Netherlands, Spain, and the U.K.[7] Consequently, if an item of foreign income is subject to separate taxation by way of withholding tax or substitutive tax on a mandatory basis rather than upon request of the Italian resident recipient, Italy should be required to allow the foreign tax credit.

In the most recent tax treaties, Italy introduced a different clause that denies the foreign tax credit where the final withholding tax is applied "also by request of" the Italian tax resident recipient. (Examples include income tax treaties between Italy and Malta, Cyprus, and Hong Kong. Other tax treaties expressly deny the foreign

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[7] See for example Art. 23, paragraph 3, third sentence, of the Italy-U.S. Income Tax Treaty, which provides that "[n]o deduction will be granted if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law."

tax credit “whether at the request of the recipient or otherwise” Examples include income tax treaties between Italy and Chile, Jamaica and Colombia). Under the relevant clauses in those treaties, no foreign tax credit would be granted if foreign income is subject to separate taxation in Italy, whether the separate taxation is mandatory by law or upon request by the recipient.

In light of the above, the current Italian tax treatment of foreign source dividends can be summarized as follows:

- Foreign source dividends are subject to separate taxation in Italy either by way of withholding tax or substitutive tax.
- No foreign tax credit is allowed under Italian domestic rules because it only applies to items of income included in the ordinary income.
- An Italian resident individual who receives a dividend does not have the option to treat the dividends as ordinary income.
- Under most income tax treaties entered into by Italy, the foreign tax credit can be denied in Italy solely if the income is subject to separate taxation at the request of the recipient.
- The Italian Revenue Agency has traditionally taken the position that the Italian tax system does not allow any foreign tax credit in relation to income subjected to separate taxation.

## DECISION NO. 25698/2022 OF THE ITALIAN SUPREME COURT

The recent decision of the Italian Supreme Court addressed this matter. The facts were straightforward. An Italian tax resident individual directly received distributions from a US partnership without the involvement of any authorized financial intermediary. Under Italian domestic rules, foreign entities (including partnerships) are regarded as tax opaque (*i.e.*, non-transparent) entities, regardless of the actual tax treatment in their country of residence or establishment. Consequently, from an Italian perspective, distributions from foreign entities are treated as dividends provided that certain conditions are met.[8]

In the case, the Italian recipient reported in his individual income tax return the distributions from the U.S. partnership as dividends subject to substitutive tax and used the foreign tax credit, by deducting the U.S. taxes from the Italian taxes on the U.S. income. The Italian Revenue Agency claimed that the individual omitted to pay the substitutive tax on the dividends from the U.S. partnership, arguing that no foreign tax credit was available with respect to the dividends as they were subject to “separate” taxation.

The Italian resident individual filed an appeal before the tax court of first instance, claiming that he was entitled to the foreign tax credit according to Paragraph 3 of

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[8] Distributions from shares and equity-like financial instruments issued by non-Italian entities are treated as dividend income for Italian income tax purposes provided that such remuneration: (i) is fully participating; and (ii) is not deductible from the taxable income of the issuer in its State of residence.

Article 23 (Relief from Double Taxation) of the Italy-U.S. Income Tax Treaty. Those dividends were not subject to separate taxation at his request but were applied on a mandatory basis by operation of law.

The tax court of first instance and the tax court of second instance ruled in favor of the Italian resident individual. The Italian Revenue Agency filed an appeal before the Italian Supreme Court.

The Italian Supreme Court rejected the appeal of the Italian Revenue Agency on several grounds. First, it acknowledged that Paragraph 3 of Article 23 of the Italy-U.S. Income Tax Treaty prevails over any Italian domestic tax rules. As a result, Italy can deny the foreign tax credit only if "if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income in accordance with Italian law." Second, it argued that the article must be construed according to its plain meaning. Consequently, when an item of foreign income, such as foreign dividends, are received by Italian resident individuals other than within the course of a business, and for that reason are subject to separate taxation on a mandatory basis the treaty limitation that prevents the individual from claiming foreign tax credits does not apply. The U.S. taxes may be claimed as a credit against the Italian income taxes due on the U.S. source income.

As support for its interpretation, the Italian Supreme Court pointed to the different wording adopted in other income tax treaties entered into by Italy. Under those treaties, Italy can deny the foreign tax credit the request of the recipient or otherwise, meaning under a provision of Italian domestic law.

Based on the above, the Italian Supreme Court ruled that the Italian resident individual was entitled to the benefit of a foreign tax credit on U.S. source dividends based on a straightforward reading of Paragraph 3 of Article 23 (Relief from Double Taxation) of the Italy-U.S. Income Tax Treaty. It clearly states that Italy can deny the foreign tax credit only if the item of income is subjected in Italy to a final withholding tax by request of the recipient in accordance with Italian law.

The principle stated by the Italian Supreme Court should apply not only to foreign dividends taxed by way of a substitutive tax paid by the individual, but also when such dividends are received through an authorized financial intermediary which applies final withholding tax.

## PATH FORWARD

In light of decision No. 25698/2022 of the Italian Supreme Court, recipients of foreign source dividends should be able to claim foreign tax credit in respect of the foreign taxes applied on the dividends provided that (i) a tax treaty between Italy and the country of the company paying the dividends is applicable and (ii) according to such treaty Italy can deny the foreign tax credit solely with respect to items of income subject to withholding tax upon request of the recipient.

In moving forward, several additional considerations should be taken into account.

Italian domestic rules provide for conditions and limitations that are not envisaged in the tax treaties and the question arises as to whether those conditions and limitations apply when the foreign tax credit is granted on the basis of an applicable tax treaty.

Moreover, from a practical perspective it is not clear what remedies are available in order to claim the foreign tax credit.

In relation to past years, for which the Italian taxes have already been paid, the only available instrument is to file a refund request with the Italian Revenue Agency, claiming a refund of the Italian taxes that would have not been paid had the foreign tax credit been applied. Under the Italian statute of limitations, refund requests must be filed within 48 months from the date of payment. In case the Italian Revenue Agency denies the refund outright or because the failure to answer a refund claim within 90 days is deemed to be a denial, it would then be necessary to appeal the denial before a tax court.

As far as dividends subject to Italian withholding tax are concerned, given that the dividends are not reported in the tax return of the recipient, it is technically not possible to claim the foreign tax credit in the tax return. Perhaps the withholding tax agent could consider adjusting the Italian withholding tax so that it is net of the foreign tax credit. However, lacking a specific rule, the withholding tax agent would likely be exposed to penalties.

If there is no authorized financial intermediary intervening in the payment, the dividends must be reported in the tax return by the Italian resident recipient and be subjected to substitutive tax. However, the tax return does not plainly allow to use the foreign tax credit against the substitutive tax on dividends.

On a go-forward basis in the absence of legislation, a prudent solution taking into account the risk of penalties is to pay the Italian taxes by way of withholding tax or substitutive tax without using the foreign tax credit and then to file a refund request to recover the higher taxes that have been paid.

The principle stated by the Italian Supreme Court is not limited to foreign source dividends. It should apply to any other items of income that are subject to separate taxation with no option covering inclusion in ordinary income. In particular, it applies to capital gains on shares in non-Italian resident companies realized by Italian resident individuals, to the extent that the applicable tax treaty allows the source country to tax the capital gain.