4th Joint Seminar

Tax assessment in the field of transfer pricing

A comparison between Italy and Germany

Scuola di Polizia Tributaria
Ostia Lido, Roma

Subtopic 1 – Corresponding adjustments between Italy and Germany:

domestic tax law, relevant treaties and mutual agreement procedures:

THE DOUBLE TAXATION TREATY BETWEEN ITALY AND GERMANY: ARE CHANGES NEEDED?

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A. GENERAL ON ITALIAN TAX TREATY-POLICY

- CONVENTIONS FOR AVOIDANCE OF DOUBLE TAXATION (CDT) STIPULATED BY ITALY ARE BASED ON THE OECD-MODEL (WITH INDUSTRIALIZED COUNTRIES) AND PARTIALLY ON THE UN-MODEL (WITH DEVELOPING COUNTRIES)
- IN RECENT YEARS: SIGNIFICANT GIURISPRUDENCE ON CDT-ISSUES
- CDT PREVAIL OVER NATIONAL TAX LAW. NO TREATY OVERRIDE BY NATIONAL LAWS

- INTERNATIONAL TREATIES MUST BE RATIFIED BY THE PARLIAMENT TROUGH A RATIFICATION LAW. THE ENTRY INTO FORCE OF A CDT IS SUBJECT TO THE EXCHANGE OF THE INSTRUMENTS OF RATIFICATION, A NOTICE OF WHICH IS PUBLISHED IN THE OFFICIAL GAZZETTE BY THE MINISTRY OF FOREIGN AFFAIRS
- METHODS FOR AVOIDANCE DOUBLE TAXATION WITHIN A CDT: UNTIL THE 70IES ITALY ADOPTED THE EXEMPTION METHOD, AFTERWORDS ONLY THE "CREDIT METHOD"
- WE HAVE, THEREFORE, TREATIES IN WHICH ITALY AS RESIDENT-COUNTRY APPLIES THE CREDIT METHOD WHILE THE OTHER COUNTRY APPLIES THE EXEMPTION METHOD (FOR ITS RESIDENTS). AT LEAST FOR SOME IMPORTANT INCOME ITEMS (FROM REAL ESTATE, FROM PERMANENT ESTABLISHMENT ETC.). THIS IS EXACTLY THE CASE WITHIN THE ITALY-GERMANY TREATY.

- SINCE ITALY CAN BE CONSIDERED AS A HIGH TAX COUNTRY (AVERAGE TAX BURDEN OF COMPANIES BETWEEN 30 AND 40%), THE CREDIT METHOD ALSO WITHIN THE TREATIES MAY IMPLY NEGATIVE CONSEQUENCES IN TERMS OF COMPETITIVENESS FOR ITALIAN COMPANIES HAVING A PE IN A FOREIGN COUNTRY WITH LOWER TAXATION (WHILE THE COMPETITORS MAY BENEFIT FROM THE EXEMPTION METHOD IN THEIR HOME COUNTRIES (LIKE GERMANY)

- A FURTHER PECULIARITY OF THE ITALIAN TREATY POLICY - AS SOURCE STATE – CONCERNS A HIGH WITHHOLDING TAX ON INTEREST (EXAMPLE: INTEREST ON LOANS). THIS WITHHOLDING TAX (20% UNDER NATIONAL LAW IS REDUCED GENERALLY BY A TREATY ONLY TO 10% ON THE GROSS INTEREST AMOUNT, WHICH MAY NOT BE FULLY CREDITABLE ABROAD IN CASE OF REFINANCING ABROAD).

- AS REGARDS THE EXCHANGE OF INFORMATION, THE ITALIAN TREATIES FOLLOW THE PROVISION OF ART. 26 OF THE OECD MODEL. MOREOVER ITALY STIPULATED SPECIAL AGREEMENTS ON THE EXCHANGE OF INFORMATION ALSO WITH NON-TREATY-COUNTRIES (FOR INCLUSION OF THOSE COUNTRIES IN THE SO-CALLED “WHITE LIST”)

- THE LIMITED EXCHANGE OF INFORMATION CLAUSE WITHIN THE TREATY ITALY-SWITZERLAND IS EXACTLY THE REASON OF THE CRITICAL TAX RELATIONSHIP BETWEEN ITALY AND SWITZERLAND. THE EXCHANGE OF INFORMATION IS LIMITED TO INFORMATION “AS IT IS NECESSARY FOR CARRYING OUT THE PROVISIONS OF THIS CONVENTION” AND NOT ALSO TO SUCH INFORMATION “AS IT IS NECESSARY FOR CARRYING OUT THE PROVISION OF THE CONVENTION OR OF THE DOMESTIC LAWS OF THE CONTRACTING STATES CONCERNING TAXES COVERED BY THE CONVENTION

... AND TO PREVENT TAX EVASION". CURRENTLY ITALY AND SWITZERLAND ARE NEGOTIATING A NEW CDT WITH AN INFORMATION CLAUSE BASED ON ART. 26 OECD-MODEL.

- AS REGARDS THE COMPATIBILITY OF NATIONAL ANTI-ABUSE-LAWS WITH THE CDT (FOR EXAMPLE CFC-LEGISLATION), ITALY - LIKE THE OECD-COMMENTARY – DOES NOT SEE ANY PROBLEM. IN ANY CASE THE ITALY-GERMANY TREATY CONTAINS A SPECIFIC RESERVATION FOR THE VALIDITY OF THE CFC-LEGISLATION WITHIN THE TREATY. ANOTHER ITALIAN ANTI-ABUSE PROVISION - INDEDUCTIBILITY OF COSTS IN ECONOMIC RELATIONSHIPS WITH BLACK LIST COUNTRIES OUTSIDE EU, UNLESS CERTAIN CONDITIONS ARE PROVED – MAY BE IN CONTRAST WITH THE "NON DISCRIMINATION RULE" PROVIDED BY ART. 24 OF THE OECD-MODEL.

- ITALY, AS STATE OF SOURCE, ALLOWS TO APPLY THE REDUCED OR ZERO WITHHOLDING TAX OF THE TREATY ALREADY AT THE MOMENT OF THE PAYMENT OF THE RELEVANT INCOME ITEM, IF THE RECIPIENT OF SUCH INCOME PROVIDES TO THE ITALIAN DEBTOR ALL EVIDENCES REQUIRED FOR SUCH TREATY-REDUCTION.

- ONLY VERY FEW CDT INCLUDE EXPLIT LOB-PROVISIONS (LIMITATION ON BENEFIT). THIS IS THE CASE OF ITALY-USA TREATY WITH EXTENSIVE LOB-PROVISIONS BUT NOT IN A SUCH COMPLICATED MANNER AS IN THE CASE, FOR EXAMPLE, OF THE TREATY USA-GERMANY OR USA-NETHERLANDS.

B. SOME RULES AND PECULIARITIES IN THE ITALY-GERMANY CDT

1. GENERAL

- THE MORE THAN 20 YEARS OLD TREATY ENTERED INTO FORCE ON DECEMBER 26, 1992. HOWEVER IN THE LAST 20 YEARS SEVERAL SUBSTANTIAL TAX REFORMS HAVE OCCURRED IN BOTH COUNTRIES AND IMPORTANT DEVELOPMENTS HAVE OCCURRED IN THESE YEARS AT OECD-MODEL LEVEL

- SOME SIGNIFICANT JUDGMENTS BY THE SUPREME COURT DEALT WITH THE ITALY-GERMANY TAX TREATY IN FORCE. THE MOST FAMOUS JUDMENT CONCERNS A GERMAN COMPANY BELONGING TO THE PHILIP MORRIS GROUP WITH A DEEMED PE IN ITALY. THIS COURT CASE REPRESENTED THE REASON FOR THE 2005 AMENDMENT OF THE COMMETARY TO ART. 5 OECD-MODEL.

FURTHER COURT CASES REFERRED TO WITHHOLDING TAXES ON INTEREST AND ON REMUNERATIONS FOR MUSICAL PERFORMANCES AS WELL AS ON THE PLACE OF EFFECTIVE MANAGEMENT OF A COMPANY INCORPORATED IN GERMANY.

- MOREOVER, ALSO THE ITALIAN TAX AUTHORITY HAVE ISSUED SEVERAL ADMINISTRATIVE RULINGS REGARDING, AMONG OTHER, ROYALTIES; RECOGNITION OF THE GERMAN EXIT VALUE OF A PARTICIPATION AS ACQUISITION – COSTS FOR ITALIAN TAX PURPOSES IN CASE OF EMIGRATION OF THE SHAREHOLDERS FROM GERMANY TO ITALY; TAXATION OF PENSIONS AND OTHER INCOME FROM A SPORTSMAN ACTIVITY IN ITALY.

- ANOTHER IMPORTANT RULING, EVEN NOT STRICTLY RELATED TO THE CDT, DEALT WITH THE FISCAL CONSEQUENCES IN ITALY (FOR THE PE) OF THE FOLLOWING GERMAN RESTRUCTURING MEASURE:

  TWO GERMAN COMPANIES, WHERE THE INCORPORATED COMPANY HAD A PE IN ITALY, WERE MERGED IN GERMANY AND THE QUESTION WAS IF THE MERGER TRIGGERED A TAX CONSEQUENCE FOR THE PE IN ITALY. THE ANSWER OF THE ITALIAN MINISTERY WAS NEGATIVE (NO TAX CONSEQUENCES) IF THE MERGER IN GERMANY SHOWS THE FEATURES OF A MERGER ACCORDING TO ITALIAN COMMERCIAL LAW – “OVERALL SUCCESSION”).

2. TAXES COVERED BY THE TREATY

THE CONVENTION STILL REFERS TO THE OLD LOCAL INCOME TAX (ILOR) ABOLISHED IN 1997 AND REPLACED BY THE SO CALLED IRAP IN 1998.

AN ITALIAN INTERNAL PROVISION STATES THAT FOR TREATY PURPOSES IRAP IS TREATED EQUALLY TO THE PREVIOUS ILOR. TREREFORE THE TREATY COVERS ALSO THIS TAX (IN ITALY AS STATE OF SOURCE). THE PROBLEM IS WHETHER GERMANY RECOGNIZES THIS TAX AS INCOME TAX FOR THE FOREIGN TAX CREDIT MECHANISM (BECAUSE IRAP CAN NOT BE CONSIDERED AS A REAL INCOME TAX). FOR EXAMPLE, THE UNITED STATES RECOGNIZES ONLY PART OF THIS TAX AS CREDITABLE INCOME TAX IN THE US (AS TAX COVERED BY THE TREATY). A SIMILAR WORDING IS USED IN THE ITALY-GERMANY-TREATY WITH RESPECT TO THE RECOGNITION IN ITALY OF GERMAN TRADE TAX: "... INCLUDING, IF APPLICABLE, THE TRADE TAX INSOFAR AS LEVIED ON PROFITS".

3. PARTNERSHIPS AND THE SWITCH OVER CLAUSE

- WITHIN THE TREATY ITALY-GERMANY THE PARTNERSHIP IS TREATED NOT ONLY AS "PERSON" IN THE MEANING OF THE CONVENTION, BUT ALSO AS "RESIDENT PERSON" OF A STATE ACCORDING TO ART. 4 OF THE TREATY (IF ESTABLISHED IN ACCORDANCE WITH THE LAW OF THAT STATE OR IF THE MAIN OBJECT OF ITS ACTIVITIES IS IN THAT STATE) – PAR. 2 PROT.

- HOWEVER THE LIMITATION TO THE RIGHT TO TAX OF THE OTHER CONTRACTING STATE AS PROVIDED IN ART. 6 TO ART. 23 APPLY ONLY INSOFAR AS THE INCOME DERIVED FROM THAT STATE IS SUBJECT TO TAX IN THE FIRST-MENTIONED STATE" – PAR. 2 PROT.

- THEREFORE, EVEN IF THE GERMAN PARTNERSHIP HAS A JAPANESE PARTNER, THE PARTNERSHIP CAN BENEFIT FROM LIMITATIONS OF TAXATION IN ITALY AS STATE OF SOURCE PROVIDED BY ART. 6 TO 23, IF THAT ITEM OF INCOME IS SUBJECT TO TAX IN GERMANY (IN THE HANDS OF THE JAPANESE PARTNER BECAUSE THE GERMAN PARTNERSHIP IS FISICALLY TRANSPARENT).

- WHILE THE TAXATION OF THE CURRENT INCOME OF A PARTNERSHIP FOLLOWS THE SAME PRINCIPLE IN GERMANY AND IN ITALY (TRANSPARENT TAXATION IN THE HANDS OF THE PARTNER) A DIFFERNT APPROACH BETWEEN THE TWO TAX LEGISLATIONS REFERS TO THE TAXATION OF THE CAPITAL GAIN ON DISPOSAL OF THE PARTICIPATION IN A PARTNERSHIP.

THE ITALIAN TAX LAWS TREATS THE GAIN FROM THE SALE OF A PARTICIPATION IN AN ITALIAN OR FOREIGN PARTNERSHIP IN THE SAME WAY AS THE GAINS FROM A SALE OF A PARTICIPATION IN A CORPORATION.

- THUS, IF A FOREIGN PARTNER (FOR EXAMPLE: GERMAN PARTNER) OF AN ITALIAN PARTNERSHIP SELLS THE QUOTAS OF AN ITALIAN PARTERNSHIP, THE ALIENATION IS NOT TREATED AS ALIENATION OF A PERMANENT ESTABLISHMENT IN ITALY (LIKE GERMANY DOES) BUT AS ALIENATION OF A PARTICIPATION AND THEREFORE SUBJECT TO THE CAPITAL GAIN TAX (UNDER THE NATIONAL LAW).

FOR TREATY PURPOSE, ITALY DOES NOT APPLY THE PARAGRAPH CONCERNING THE GAIN FROM ALIENATION OF A PERMANENT ESTABLISHMENT (ART. 13, PAR. 2) BUT PAR. 4 OF THE SAME ARTICLE (APPLICABLE ON THE CAPITAL GAIN ON THE SALE OF A PARTICIPATION IN A CORPORATION). THEREFORE, THE GAIN IS NOT TAXABLE IN ITALY, BECAUSE PAR. 4 ATTRIBUTES THE EXCLUSIVE RIGHT OF TAXATION TO THE RESIDENT STATE OF THE ALIENATOR.

- GERMANY, INSTEAD, QUALIFIES THIS GAIN AS A GAIN FROM THE ALIENATION OF A PE ACCORDING TO PAR. 2 OF ART. 13 WHICH ALLOWS THE TAXATION IN ITALY AND GERMANY WOULD APPLY THE EXEMPTION METHOD FOR SUCH GAIN. SINCE ITALY DOES NOT TAX THIS GAIN THE EXEMPTION METHOD IN GERMANY WOULD LEAD TO A DOUBLE NON TAXATION.

BUT THE SWITCH OVER CLAUSE IN PAR. 18, SUBPARAGRAPH B) OF THE PROTOCOL PROVIDES, IN THIS CASE, THAT GERMANY SHALL NOT GRANT THE EXEMPTION BUT SWITCH TO THE CREDIT METHOD. THAT MEANS THAT THE GAIN IS FULLY TAXABLE IN GERMANY.

- THE REAL "LOSER" DUE TO THIS DIFFERENT QUALIFIATION OF THIS INCOME ITEM IS ITALY BECAUSE IN THE CASE MENTIONED ITALY CANNOT TAX (BECAUSE OF THE TREATY) WHILE IN THE OPPOSITE CASE (IF AN ITALIAN RESIDENT SELLS THE PARTICIPATION IN AN GERMAN PARTNERSHIP) GERMANY AS SOURCE STATE TAXES THIS GAIN AS GAIN FROM THE ALIENATION OF A PERMANENT ESTABLISHMENT IN GERMANY, AGAIN ALLOWED BY THE TREATY.

- GERMANY TAXES, THEREFORE, IN BOTH CASES, WHILE ITALY DOES NOT TAX IN THE FIRST CASE AND CAN ONLY CREDIT THE GERMAN TAX IN THE SECOND CASE (WITH NO OR VERY SMALL ITALIAN TAX AMOUNTS)
- CONSIDERING THESE NEGATIVE EFFECTS FOR THE ITALIAN STATE A NEW ITALIAN APPROACH RELATED TO THE FISCAL TREATMENT OF GAINS FROM ALIENATION OF A PARTICIPATION IN ITALIAN PARTNERSHIP IS ADVISABLE.

4. PERMANENT ESTABLISHMENT

- RECENTLY TAX ASSESSMENTS IN ITALY HAVE BEEN FOCUSED ON EXISTING OR HIDDEN PERMANENT ESTABLISHMENTS (ALSO TOWARDS GERMAN COMPANIES). THEREFORE A MORE PRECISE DEFINITION OF PE WITHIN A NEW TREATY AS WELL AS NEW PROVISIONS RULING THE PROFIT ALLOCATION IN THE LIGHT OF THE RECENT OECD DEVELOPMENTS ARE NEEDED. MOREOVER, FURTHER CLARIFICATION ESPECIALLY IN RELATION TO THE DEFINITION – AND DETERMINATION OF THE PROFIT – OF CONSTRUCTION OR ASSEMBLY PROJECTS ARE NEEDED.

5. ASSOCIATED ENTERPRISES – TRANSFER PRICING

AS PROVIDED BY PARAGRAPH 7 OF THE PROTOCOL TO THE "CDT G-I", "*WHERE A REDETERMINATION OF THE PROFITS OF AN ENTERPRISE HAS BEEN MADE BY A CONTRACTING STATE, THE OTHER CONTRACTING STATE SHALL [...] MAKE A CORRESPONDING ADJUSTMENT TO THE PROFITS OF THE ASSOCIATED ENTERPRISE OF THAT OTHER CONTRACTING STATE.*" HOWEVER EXPERIENCE HAS SHOWN THAT THIS MUTUAL AGREEMENT PROCEDURE DOES NOT SATISFY THE TAX PAYER. THE EXAMPLE OF ART. 25, PARAGRAPH 5 OF THE OECD-MODEL SHOULD BE TAKEN INSTEAD (AS WITHIN THE NEW CDT BETWEEN USA AND GERMANY), WHERE THE CASE SHALL BE SUBMITTED TO A COMPULSORY ARBITRATION PROCEEDING IF THE COMPETENT AUTHORITIES ARE UNABLE TO REACH AN AGREEMENT WITHIN A CERTAIN TIME. CONSIDERING THE INCREASING TAX ASSESSMENTS IN ITALY ON INTERNATIONAL TRANSFER PRICES, THIS TOPIC RELATED TO THE AVOIDANCE OF DOUBLE TAXATION IS VERY SIGNIFICANT FOR THE FUTURE. BETWEEN ITALY AND GERMANY, HOWEVER, ALSO THE EUROPEAN ARBITRATION CONVENTION 90/436/CE OF JULY 23, 1990 IS APPLICABLE.

6. DIVIDENDS

AS REGARDS DIVIDEND TAXATION - FOR RESIDENT AND NOT RESIDENT - SUBSTANTIAL REFORMS HAVE OCCURRRED IN GERMANY AND ITALY AFTER 1992.

THEREFORE CERTAIN PROVISIONS IN THE ARTICLE REFERRING TO DIVIDENDS HAVE BECOME MEANINGSLESS (FOR EXAMPLE REIMBURSEMENT OF THE EQUALIZATION TAX)

A REDUCED WITHHOLDING TAX AT SOURCE - FOR CASES WHICH DO NOT FALL UNDER THE PARENT-SUBSIDIARY-DIRECTIVE - IS VERY IMPORTANT FOR ITALY AS RESIDENT STATE BECAUSE THE DIVIDENDS (FOR CORPORATIONS) ARE TAXED ONLY ON 5% OF THE GROSS AMOUNT BUT THE CREDITABLE FOREIGN WITHHOLDING TAX IS ALSO REDUCED TO 5% OF THE WITHHOLDING TAX APPLIED.

7. ROYALTIES

THE LIMITATION OF TAXATION IN ITALY PROVIDED BY THE "CDT G-I" IN FORCE (5 % – COMPARED TO THE WITHHOLDING TAX OF 30 % ACCORDING TO NATIONAL LAW) CAN BE CONSIDERED MORE FAVORABLE THAN IN OTHER CDT SIGNED BY ITALY.

THE BENEFIT CONSISTS IN THE LOW CDT-RATE AS WELL AS IN THE FULL EXEMPTION FROM WITHHOLDING TAX OF CERTAIN CATEGORIES OF ROYALTIES. "*PAYMENTS RECEIVED FOR THE USE OF INDUSTRIAL, COMMERCIAL OR SCIENTIFIC EQUIPMENT*", FALLING WITHIN THE CDT IN FORCE UNDER THE DEFINITION OF "ROYALTIES", SHOULD BE ASSIGNED BY A NEW CDT TO "BUSINESS PROFITS" (ART. 7 OF "CDT G-I"), IN ORDER TO AVOID ANY WITHHOLDING TAX IN ITALY (30 % ON INDUSTRIAL GOODS RENTAL, AS PER NATIONAL LAW AND 5% WITHIN THE TREATY).

8. INTEREST

IT IS UNLIKELY THAT THE LIMITATION OF WITHHOLDING TAX (10 %) PROVIDED BY THE “CDT G-I” IN FORCE WILL BE FURTHER REDUCED BY A NEW CDT. ITALY AS THE “STATE OF SOURCE” CONFIRMS ALSO IN OTHER CONVENTIONS WITH IMPORTANT COMMERCIAL PARTNERS A WITHHOLDING TAX OF 10% (FOR EXAMPLE CDT ITALY-USA, BUT NO WITHHOLDING TAX UNDER THE CDT ITALY-HUNGARY). HOWEVER SPECIFIC CASES FALL WITHIN THE “INTEREST DIRECTIVE”, SO THAT NO WITHHOLDING TAX IN ITALY IS APPLIED. A WITHHOLDING TAX OF 10 % OF THE GROSS AMOUNT OF INTEREST COULD OFTEN IMPLY NEGATIVE EFFECTS ON REFINANCING OPERATIONS ABROAD, WHEN THE ITALIAN WITHHOLDING TAX CANNOT BE FULLY CREDITED IN THE FOREIGN STATE.

9. SUBJECT TO TAX CLAUSE

A FURTHER PECULIARITY OF THE "CDT G-I" IN FORCE IS THE SO-CALLED "*SUBJECT-TO-TAX CLAUSE*" PROVIDED BY PARAGRAPH 16, SUBPARAGRAPH D) OF THE PROTOCOL. THIS CLAUSE APPLIES ONLY TO GERMAN TAX PAYERS RECEIVING INCOME FROM ITALIAN SOURCES, BUT NOT TO ITALIAN RESIDENTS FOR INCOME FROM GERMANY, BECAUSE ITALY ALWAYS APPLIES THE "CREDIT METHOD".

THIS CLAUSE COMPLIES WITH THE PREVIOUS **GERMAN** TREATY POLICY; HOWEVER IN CERTAIN CASES A "DOUBLE NON-TAXATION" – IF NOT ORIGINATED BY A CONFLICT OF DEFINITIONS – IS "TOLERATED" EVEN BY THE COMMENTARY TO THE OECD-MODEL. THE "CDT G-I" IN FORCE PROVIDES THAT ITALY AS "STATE OF SOURCE" MAINTAINS THE RIGHT TO LEVY TAX ON SPECIFIC ITEMS OF INCOME, HOWEVER IT CANNOT EXERCISE THIS RIGHT ACCORDING TO NATIONAL LAW (FOR EXAMPLE IN CASE OF GAINS FROM THE ALIENATION OF REAL ESTATE, UNDER CERTAIN CONDITIONS).

GERMANY DOES NOT GRANT THE EXEMPTION, SINCE "*THIS ITEM OF INCOME IS NOT CONSIDERED AS DERIVED FROM ITALY*"; FOR EXEMPTION PURPOSES IT IS REQUIRED THAT ITALY **EFFECTIVELY TAXES** THAT ITEM OF INCOME ACCORDINGLY TO THE CONVENTION. THUS, THE EXEMPTION IN GERMANY FOR SPECIFIC ITEMS OF INCOME FROM ITALY, WHICH CAN BE TAXED IN ITALY AS PER CDT, BUT CANNOT BE TAXED ACCORDING TO NATIONAL LAW, IS PRACTICALLY ELIMINATED.

10. ELIMINATION OF DOUBLE TAXATION

WITHIN THE "CDT G-I" IN FORCE, THE CONTRACTING STATES AS "STATE OF RESIDENCE" APPLY DIFFERENT METHODS: GERMANY APPLIES THE SO-CALLED "*EXEMPTION-WITH-PROGRESSION METHOD*" ON THE MAJORITY OF ITEMS OF INCOME (IMMOVABLE PROPERTY, PERMANENT ESTABLISHMENT, PARTNERSHIP PROFITS ETC.), WHILE FOR THE RESIDUAL INCOME (INTEREST, ROYALTIES ETC.) THE "CREDIT METHOD" IS APPLIED. ITALY APPLIES **THE "CREDIT METHOD"**, WITH THE ONLY EXCEPTION FOR SPECIFIC TYPES OF DIVIDENDS (ART. 24, PARAGRAPH 2, SUBPARAGRAPH B) OF "CDT G-I"). ALSO WITHIN A NEW CDT, ITALY WILL MOST PROBABLY CONFIRM THE "CREDIT METHOD", AS IT COMPLIES WITH THE GENERAL TREATY POLICY OF ITALY. WHETHER GERMANY WOULD CONFIRM THE "*SUBJECT-TO TAX*" AND "*SWITCH-OVER*" CLAUSES WITHIN A NEW CDT WITH ITALY, IS QUESTIONABLE.

AS REGARDS THE “CREDIT METHOD”, THERE IS A SPECIFIC PROBLEM RELATED TO THE DEDUCTION OF GERMAN TAX, IF INCOME DERIVED FROM GERMANY IS SUBJECT TO **FINAL** TAXATION IN ITALY (SUBSTITUTE TAX). THIS IS FOR EXAMPLE THE CASE IF THE INCOME FROM A GERMAN **PARTNERSHIP**, OWNED BY AN INDIVIDUAL (NOT ENTREPRENEUR) WITH A PARTICIPATION NOT EXCEEDING 25 %, IS “**COMPULSORILY**” SUBJECT TO THE SUBSTITUTE TAX OF 20% IN ITALY; IN THIS CASE THIS ITEM OF INCOME FALLS WITHIN THE DEFINITION OF “DIVIDENDS”. ON THE OTHER HAND, A GERMAN **WITHHOLDING TAX** (AS IT IS THE CASE WITH RESPECT TO DIVIDENDS OF A GERMAN CORPORATION) COULD BE DEDUCTED FROM THE **TAXABLE BASIS** FOR THE ITALIAN SUBSTITUTE TAX (RATE OF 20%).

HOWEVER THE SUBSTITUTE TAX ACCORDING TO NATIONAL LAW DOES **NOT** ALLOW A TAX CREDIT FOR THE FOREIGN TAX. THIS IS THE REASON WHY AN ITALIAN TAX PAYER INTERPRETED THE CDT WORDING AS AN OPTION FOR DEDUCTION. THIS WORDING ACTUALLY EXCLUDES THE DEDUCTION OF THE GERMAN TAX *"IF THE ITEM OF INCOME IS SUBJECT IN THE ITALIAN REPUBLIC, ACCORDING TO ITALIAN LAW AND UPON REQUEST OF THE RECIPIENT OF THAT INCOME, TO TAXATION BY WAY OF WITHHOLDING AT SOURCE"* (ART. 24, PARAGRAPH 2, LAST SENTENCE). HOWEVER, THE NON-DEDUCTIBILITY SEEMS TO BE CONDITIONED BY THE TAX PAYER'S OPTION FOR A FINAL TAXATION ("APPLICATION"). SUCH AN OPTION, TO BE EXERCISED BY INDIVIDUALS, WAS ABROGATED IN 2004 WITH REGARD TO DIVIDEND INCOME, AND THE AFOREMENTIONED **COMPULSORY** FINAL SUBSTITUTE TAX WAS INTRODUCED.

THIS COULD LEAD TO THE INTERPRETATION THAT THE DEDUCTION IS ADMITTED WITHIN THE TREATY. HOWEVER THIS INTERPRETATION HAS BEEN DENIED BY ITALIAN TAX AUTHORITIES BY MEANS OF A RULING. THE FACT THAT THE CDT-WORDING STILL LEAVES THESE DOUBTS IS CONFIRMED BY THE AMENDED WORDING IN THE NEW CDT (AND RELATED PROTOCOL) BETWEEN ITALY AND CYPRUS, WHICH CLARIFIES THAT **FUNDAMENTALLY** NO DEDUCTION IN CASE OF A FINAL SUBSTITUTE TAX IS ADMITTED, NOT EVEN IF THIS TAXATION IS UPON REQUEST OF THE TAX PAYER. THEREBY THE PROBLEM OF A JURIDICAL DOUBLE TAXATION, WHICH SHOULD ACTUALLY BE COMPLETELY SOLVED BY MEANS OF A CONVENTION, DOES NOT DISAPPEAR.