Tax Management International Forum

Comparative Tax Law for the International Practitioner

Lack of Source Country-Residence Country Tax Coordination and Double Taxation

Although the mitigation or elimination of international double taxation of income is a core principle of most countries' international tax policy, many factors—some practical and some policy—result in lack of coordination between a source country's taxation of income items and a residence country's provision of unilateral and tax treaty relief. The result is that double taxation of cross-border income flows remains stubbornly resistant to elimination.

In this issue of the International Forum, leading experts from 18 countries and the European Union examine outbound and inbound treatment of some common kinds of passive income (in particular dividends), and discuss inconsistencies that result in double taxation, with a particular focus on efforts to eliminate double taxation through domestic law or tax treaties.

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THE TAX MANAGEMENT INTERNATIONAL FORUM is designed to present a comparative study of typical international tax law problems by FORUM members who are distinguished practitioners in major industrial countries. Their scholarly discussions focus on the operational questions posed by a fact pattern under the statutory and decisional laws of their respective FORUM country, with practical recommendations whenever appropriate.

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Lack of Source Country-Residence Country Tax Coordination and Double Taxation

Background

Although the mitigation or elimination of international double taxation of income is a core principle of most countries' international tax policy, many factors—some practical and some policy—result in lack of coordination between a source country's taxation of income items and a residence country's provision of unilateral and tax treaty relief. The result is that double taxation of cross-border income flows remains stubbornly resistant to elimination.

This issue examines countries' outbound and inbound treatment of some common kinds of passive income (in particular dividends), and inconsistencies between their treatments of these items that result in double taxation.

The study focuses on the elimination of double taxation, by domestic law or by treaties under a country's normal tax treaty policy (i.e., it does not address special rules relating, for example, to the existence of specific matching credits). The study focuses on regular, plain vanilla situations involving cross-border income flows between corporations (partnerships will not be discussed). These "regular" situations also exclude cases involving rules that depart from the normal as a result of BEPS considerations (for example, it does not discuss special rules dealing with payments to tax havens, or the definition of "effective beneficiary").

Questions

I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

2. How is a "dividend" defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law

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context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

C. Royalties:

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

IV. Conclusion

ARGENTINA: Source-Residence Country Coordination

Manuel M. Benites
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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Argentina imposes a withholding tax on the amount of dividends paid to nonresidents. For dividends paid during 2018 and 2019, the withholding rate is 7%; for subsequent years, the rate is 13%.

Most of Argentina's tax treaties allow a maximum withholding rate of 10% if the recipient of the dividends is a resident of the other Contracting State and is the beneficial owner of the dividends. The Argentina-France and Argentina-Germany tax treaties allow a maximum withholding tax rate of 15% in all cases.

Argentina also applies an "equalization tax" when the amount of a distribution exceeds the taxable profits accumulated at the close of the previous taxable year. This tax is also collected by way of withholding, at a rate of 35%. A recent tax reform repealed the equalization tax with respect to profits accruing in taxable years beginning on or after January 1, 2018.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

There is no specific definition of "dividend" in Argentine tax law. Under the Argentine business entities law, an entity is allowed to pay dividends to shareholders or members only out of profits that are liquid and realized, resulting from a balance sheet prepared in accordance with accepted accounting principles.

A dividend may also be embedded in a redemption of stock, if the entity concerned has liquid, realized profits. In such a case, the dividend component of the stock redemption is the excess of the amount paid to the shareholder over the amount of the net worth of the entity as of the close of the previous taxable year attributable to the shares that are redeemed.

Stock dividends distributed as a result of the capitalization of liquid, realized profits are not subject to tax, but the cost basis of such shares is zero. Dividends in kind are taxable, the taxable amount being determined by reference to the fair market value of the property concerned on the date of distribution.

There are a number of circumstances in which dividends are deemed to be distributed to shareholders. A dividend is deemed to be distributed by a company to its shareholder where the company has realized, liquid undistributed profits as of the close of the previous taxable year and:

- The shareholder withdraws funds from the corporation: the amount of the deemed dividend is the amount of the withdrawal;
- The company allows the shareholder to use an asset of the company: the amount of the deemed dividend is 8% of the market value of the asset if the assets is real estate, and 20% of the market value of the asset in the case of any other type of asset;
- Any asset of the company is provided as collateral for a debt owed by the shareholder and the collateral is forfeited: the amount of the deemed dividend is

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equal to the fair market value of the asset, up to the amount of the guarantee;

- Any asset of the company is sold to or purchased from the shareholder at a value that is, respectively, lower or higher than the fair market value of the asset: the amount of the deemed dividend is the difference between the fair market value of the asset and the amount received or paid, as the case may be;
- Any expense met by the company in favor of the shareholder, if the expense is not incurred in the interest of the company: the amount of the deemed dividend is the amount of the expense; or
- Amounts received by the shareholder by way of salary, fees or other remuneration where it cannot be proved that: the shareholder effectively performed services for the company; the remuneration was appropriate to the nature of the services performed; and the remuneration was not in excess of what an independent third party would have paid for the services.

The presumption that a deemed dividend has been distributed also applies when any of the above takes place with respect to a spouse or live-in partner of a shareholder. In all the above cases, the amount of the deemed dividend is limited to the amount of the undistributed accumulated profits of the company as of the close of the previous taxable year.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

The tax applies to the net income but, instead of allowing deductions, the law in most cases makes a presumption as to what percentage of any payment of income to a nonresident is net income. In the case of income derived from the leasing, renting or sale of assets located in Argentina, including the sale of shares, bonds, etc., the law allows the adjusted basis of the assets, as well as other expenses related to the income concerned, to be deducted in computing the net income.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Argentine tax law neither allows nonresidents to deduct other tax losses from taxable dividend income nor provides any other mechanism for compensating other tax losses.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Argentina does not allow any tax deductions or exemptions to account for potential incomplete double tax protection in the residence country.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

A distribution of dividends to a foreign holding company is taxable at the rates and in accordance with the rules described in I.A.1., above.

Argentine law does not allow foreign tax credits to be set off against withholding tax on outbound dividends.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Interest paid to nonresidents is taxable by means of a withholding effected by the payor of the interest. The law applies different withholding rates to different type of interest.

In general, interest paid to a nonresident that is a regulated financial institution and is not resident in a non-cooperative or low-tax jurisdiction is subject to a 15.05% withholding tax, while other interest is taxed at a 35% rate.

Interest on time deposits, public or private bonds, quotas of common investment funds, bonds issued by financial trust and similar contracts in Argentine currency without indexation clauses is taxed at a rate of 5%. In the case of instruments that have an indexation clause or are 0denominated in a foreign currency, the rate is 15%

Interest is not specifically defined. It comprises remuneration for the use of money lent and includes any original issue discount.

The law contains a rebuttable presumption with respect to interest that may apply to nonresidents. Section 48 of the Income Tax Las provides that it is presumed that all debts arising from money lent, from the sale of real estate, etc. carry interest at a specified rate.

Argentina's tax treaties usually provide for reduced rates of withholding tax on interest that, if they are lower than those that apply under Argentine domestic law, will apply to payments of interest made to residents of the other Contracting State, provided such residents also qualify as beneficial owners of the interest concerned.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Under Argentine domestic law, the term "royalty" is defined to mean the compensation received for the transfer, use, or license of a right, the amount of which is determined based on a unit of production or sales, exploitation, etc. Argentina's tax treaties contain a broader definition of royalty than the domestic law definition, in line with the provisions of the OECD Model Convention. It should be noted, however, that certain items that do not qualify as royalties under Argentine law but are from Argentine sources are also taxed in Argentina (for example, payments for the use of news, payments for technical assistance, etc.).

In all cases, the method of taxation is withholding at source.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

Royalties are also subject to the net income presumptions of Argentine domestic law. Section 93 a) of the Income Tax Law provides that the presumed net income is: (1) 60% of fees paid for the provision of technical assistance, engineering or consulting services duly registered in Argentina; and (2) 80% of amounts paid for the assignment of rights or licenses for the exploitation of patents and other items not covered by (1). In cases not falling within the scope of Section 93 a), the law presumes that net income is 90% of the amount paid.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Argentina's unilateral method of relieving double taxation is to allow a foreign tax credit. In general, a foreign tax credit is allowed with respect to foreign-source income for similar taxes paid in a foreign jurisdiction. A "similar tax" is a tax that taxes net income or allows the recovery of costs and significant expenses incurred to obtain the income.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

The foreign tax credit is limited to the amount by which the income tax of the Argentine resident is increased as a result of the inclusion of foreign income. This is a general limitation, as opposed to a per-country or per-transaction limitation.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

If, in a given taxable year, the foreign tax credit attributable to that year cannot be deducted in full as a result of the limitation described in II.A.2., above, the excess amount may be carried forward and deducted from the tax attributable to foreign income in the following five taxable years.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

No relief is provided by Argentine law in these circumstances: the Argentine resident will deduct the overall loss against the foreign income (assuming the overall loss does not qualify as a "ring fenced" loss) and no tax will be determined for the taxable year. In such circumstances, the law does not allow the computation of a foreign tax credit because there is no Argentine tax on the foreign income.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The answers would be the same as those given in relation to dividends in II.A., above.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The answers would be the same as those given in relation to dividends in II.A., above.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Under Argentine constitutional law, international treaties to which Argentina is a party prevail over Argentine domestic laws. Article 5, paragraph 22 of the Argentine Constitution provides as follows: "Treaties and concordats have a higher hierarchy than laws." This rule not only resolves any conflict in favor of the provisions of international treaties, but also prevents the application or interpretation of local laws in a way contrary to a provision of an applicable treaty.

Thus if, in a particular case, an international treaty applies and there is an inconsistency between a provision of the treaty applicable to the case at hand and a provision of Argentine domestic law, the treaty provision is to be applied.

On the other hand, if there is a difference between the way in which a treaty is applied in each of the Contracting States, this is not an issue of hierarchy, but simply a matter of interpretation of the treaty concerned. Argentine law does not provide any relief or remedy to address this situation, other than the mutual agreement procedure (MAP) provided for in most of Argentina's tax treaties.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

The short answer is "no." Argentina's tax treaties only impose limits on Argentina's taxing powers; they do not create or increase liability to its taxes. For example, if an applicable tax treaty allows Argentina to impose a tax burden with respect to a particular item of income that is higher than that which is imposed under Argentine domestic law, the lower domestic law tax burden will apply.

IV. Conclusion

The Argentine tax system is very simple in its approach to the taxation of a nonresident that does not have an Argentine permanent establishment (PE). The tax is imposed by means of withholding at source on net taxable income, and the law makes a presumption as to what portion of the amount of the income paid is net taxable income and thus does not allow the deduction of actual expenses (some exceptions are provided for with respect to income derived from the leasing, renting or sale of assets located in Argentina). The tax applies on the event of each payment of Argentine source-income to a nonresident and no loss compensation is allowed. This system may give rise to some inconsistencies with the tax position in the nonresident's country of residence, in particular when the income presumed by Argentine law to have been derived by the nonresident is higher or lower than the actual income determined in accordance with the tax law of the nonresident's country of residence. Such inconsistency may also have the effect of limiting the availability of a tax credit in the residence country for income taxes withheld in Argentina.

With respect to Argentine residents obtaining income abroad, Argentina's unilateral measures, i.e., the computation of foreign tax credits for similar taxes paid abroad, are generally sufficient to prevent double taxation. There are, however, some circumstances in which double taxation does actually arise. For instance, many countries apply a withholding tax on fees for services provided from Argentina such withholding tax does not qualify for foreign tax credit relief in Argentina, because, under the Argentine Income Tax Law, such fees are considered to be derived from sources within Argentina.

AUSTRALIA: Source-Residence Country Coordination

Grant Wardell-Johnson and Julian Humphrey
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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Australia operates a dividend imputation system whereby dividends can carry credits (referred to as "franking credits") for the underlying Australian corporate tax paid on the profits the dividends represent.

Where a company does not, or cannot, frank its dividend, the dividend is known as an "unfranked dividend." Unfranked dividends paid to non-residents are generally subject to withholding tax at the rate of 30% under Australian domestic law.

The rate of withholding tax is reduced to 15% under most of Australia's tax treaties. In some cases a treaty may reduce the withholding tax rate to as low as 5% where the shareholder has a participation interest of 10% or more. Further, some treaties (for example, the Australia-Germany, -United Kingdom and -United States tax treaties) allow for exemption from withholding tax where the shareholder owns 80% or more of the shares in the Australian company and satisfies certain other criteria.

Franked dividends paid to non-residents are not subject to withholding tax.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Australia has comprehensive rules for the purposes of classifying arrangements as either debt or equity for tax purposes. Returns sourced from profits paid on ordinary shares will be treated as dividends. However, returns on certain preference shares may be classified as interest while returns on certain notes may be a frankable dividend.

Further, certain integrity measures can treat an amount paid by a company in substitution for a dividend as a dividend for tax purposes.

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3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

It is not possible under Australian domestic law to reduce the taxable amount of an unfranked dividend for the purpose of calculating the non-resident withholding tax payable. However, as noted in I.A.1., above, a bilateral tax treaty may apply to reduce the withholding tax to as low as zero in certain circumstances.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

There is no coordination between the withholding tax requirement and whether the foreign resident has losses of any kind.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

There are no such reductions or exemptions with respect to the non-resident withholding tax, other than those provided for in Australia's tax treaties.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

The domestic law provides an exemption from withholding tax on the unfranked portion of a dividend paid to a non-resident shareholder, to the extent that the dividend relates to certain foreign-sourced income of the Australian issuer.

Such income could include, for example, active business income derived from a foreign branch, and dividends from the Australian issuer's foreign subsidiary (in which the issuer has at least a 10% participation interest).

The issuer must declare the amount to be "conduit foreign income" in the distribution statement that it provides to the non-resident shareholder.

Additionally, certain of Australia's tax treaties allow an exemption from withholding tax where the shareholder has at least an 80% ownership interest and satisfies certain other criteria. These criteria can include being listed on an authorized securities exchange.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends?

Where an Australian resident entity makes a payment of interest to a non-resident, a withholding tax of 10% applies under Australian domestic law. A number of Australia's tax treaties provide for the withholding tax to be reduced to zero in certain circumstances, where the recipient is a financial institution resident in the treaty partner country.

Subsection 6(1) ITAA36 defines interest as including:

income consisting of interest, or a payment in the nature of interest, in respect of:
(a) money lent, advanced or deposited; or
(b) credit given; or
(c) any other form of debt or liability

Certain interest payments made by a designated offshore banking unit may be exempt from withholding tax. An exemption may also apply for interest paid by Australian companies or trusts on debentures or other interest-bearing securities that meet certain public offer requirements.

There is no ability to reduce the withholding tax on account of deductions or losses that the recipient may have incurred in generating the interest income. Other than under the treaty provisions mentioned above, there is no opportunity to mitigate any double taxation that may arise due to the imposition of the withholding tax.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

ITAA36 defines "royalty" very widely. The definition includes payments for:

- The use of, or right to use, any copyright, patent, scientific or industrial equipment;
- The supply of scientific, industrial, or commercial knowledge;
- The reception and transmission of broadcast images or sound;
- The right to use motion picture, video, and sound recordings; and
- Any total or partial forbearance with respect to making the above materials available.

The rate of withholding tax on all types of royalty income is 30%.

Where Australia has a tax treaty that contains a different definition of "royalty" that differs from the domestic law definition, the definition in the tax treaty is adopted for the purposes of the domestic withholding tax provisions.

Australia's tax treaties generally provide for a reduction in the withholding tax rate in certain circumstances. The reduced rate can be as low as 5% (for example under the Australia-Germany, -United Kingdom and -United States tax treaties).

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

The withholding tax on a royalty is not able to be reduced on account of possible costs incurred by the recipient with respect to the property giving rise to the royalty.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Where an Australian resident corporate taxpayer has a participation interest of at least 10% in a foreign corporation, dividends received from that foreign corporation are exempt from Australian income tax. In such a case, the Australian taxpayer would not be entitled to any foreign income tax offset (FITO) with respect to foreign withholding tax on the dividend.

In other cases, an Australian resident taxpayer is generally assessed on the dividend received and entitled to a FITO with respect to foreign withholding tax deducted from dividend payments (subject to a cap equal to the Australian tax payable on the income).

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

A taxpayer's annual FITO entitlement is subject to a cap broadly equal to the Australian tax payable on the foreign income. The cap is the difference between:

- The income tax payable for the year (disregarding any tax offsets, including FITO); and
- The income tax that would be payable (disregarding all tax offsets) if the taxpayer excluded from the calculation all foreign-sourced income, and all deductions relating to that foreign income (other than debt deductions).

The FITO is claimable in the year in which the taxpayer derives the income, rather than the year in which the foreign tax is paid.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in II.A.2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

There is no ability to carry forward an excess FITO. The excess amount is not able to be claimed as an income tax deduction.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

There is no credit or other relief available in these circumstances. Where a resident has brought forward tax losses, the resident can elect not to utilize those losses to the extent the FITO is available for foreign income in that year.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The operation of the FITO rules in relation to foreign withholding tax deducted from interest income is the same as that described in II.A., above

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C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The operation of the FITO rules in relation to foreign withholding tax deducted from royalty income is the same as that described in II.A., above.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Australia's tax treaties are incorporated into the taxation law by the International Tax Agreements Act 1953.

Consequently, a treaty may modify what would otherwise generally be the position under the Australian taxation law.

Where Australia's interpretation of a treaty is different from that of the treaty partner country (for example, regarding the classification of a payment as interest or as a dividend), the treaty would generally provide for a mutual agreement procedure (MAP) to be followed in order to resolve the matter.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

There is nothing in the Australian tax law that expressly prevents this. It would, however, be highly unlikely to occur in the context of dividend, interest, and royalty payments.

IV. Conclusion

Australia's system of franking (or imputation) of dividends is unusual when compared to the systems of the great majority of developed countries. This means that a foreign investor can have different tax outcomes depending on whether or not a dividend is franked.

Australian companies do not need to withhold tax from dividends that they pay out of their tax-exempt foreign-sourced income. Such income would include dividends received from foreign subsidiaries. This is important for Australia's ability to attract regional headquarters companies to locate in the country.

For Australian resident companies, the calculation of FITO availability for foreign taxes on dividend, interest, and royalty income is consistent.

BELGIUM: Source–Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Under Belgian domestic tax law dividends, whether paid to residents or nonresidents, are in principle subject to a dividend withholding tax (DWT) to be retained at source. The current DWT base rate is 30%. Belgian tax legislation generously derogates from this principle by providing for various reduced rates and exemptions that apply in a number of situations, subject to specific conditions.[1] This paper will not address all of these, but the most relevant exemptions for dividends paid to nonresident holding companies are dealt with in I.A.6., below.

Belgium's tax treaties usually provide for a general reduction of the DWT rate to 15% and a further reduced rate, ranging from 0 to 10%, for dividends paid to a qualifying holding company.

A feature peculiar to Belgium is that from 2014 to 2018 a special "fairness tax" levied in the form of a 5.15% addition to the ordinary corporate tax, was imposed on large companies that distributed dividends, having reduced their ordinary corporate tax base by making use of Belgium's notional interest deduction and/or a carryforward of tax losses.[2] As the imposition of the fairness tax was triggered by a dividend distribution (in combination with the use of certain deductions from the ordinary corporate tax base), taxpayers argued that the fairness tax constituted a withholding tax on dividends within the meaning of Article 5 of the Parent-Subsidiary Directive (PSD) and was therefore prohibited by the PSD with respect to dividends falling within its scope of application. In its decision of May 17, 2017, the Court of Justice of the European Union (CJEU) held that the fairness tax does not constitute such a (prohibited) withholding tax.[3]

As a logical consequence of this characterization, the fairness tax is to be considered a form of additional corporate tax levied on, and borne by, the distributing company and the CJEU indeed held that the fairness tax therefore conflicts with Article 4 of the PSD to the extent it is applied to a dividend distribution that derives from an earlier dividend *received* that qualified under the PSD and already underwent Belgium's (then applicable) 95% dividends-received deduction (DRD) regime. A conflict with the PSD arises because the combination of the 95% DRD regime and the fairness tax due on re-distribution of the received dividend exceeds the maximum 5% tax base allowed under Article 4 (3) of the PSD. The CJEU also held that the fairness tax could conflict with the EU freedom of establishment principle to the extent its application modalities result in Belgian branches being treated less favorably than Belgian resident companies. Notwithstanding this rather mild judgment of the CJEU, the fairness tax legislation was subsequently repealed in its entirety by the Belgian Constitutional Court (which had referred the case to the CJEU) based on substantial violations of Belgium's own domestic constitutional fiscal principles of non-discrimination and legality. The Constitutional Court, however, also decided that—except as regards situations in which the

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fairness tax is found to conflict with the PSD according to the earlier CJEU decision—the repeal only applies prospectively, not retrospectively (i.e., the fairness tax legislation is upheld for tax assessment years 2014 to 2018).[4]

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

The ITC defines the term "dividend" in a very broad manner as "any advantage granted by a company with respect to (profit) shares, regardless of the grounds on which and the form in which the advantage is received."[5] The scope of the term also extends to the retained earnings component of liquidation distributions, share redemptions, and capital reimbursements.[6]

Regarding capital reimbursements, it used to be possible to avoid DWT by formally imputing the reimbursement by priority to actual paid-up fiscal capital (rather than to retained earnings formally incorporated into the capital or assimilated issue premium account). With effect from January 1, 2018, the ITC provides for the mandatory apportionment of a capital reimbursement between: (1) the company's actual paid-up capital (and assimilated issue premium); and (2) the company's taxed reserves plus its untaxed reserves that have been incorporated in its formal capital. The latter portion of a capital reimbursement is henceforward treated as a dividend distribution for tax purposes and is also subject to Belgian DWT (unless an exemption applies).[7]

Certain interest payments are also explicitly assimilated to dividends for DWT tax purposes. These include interest payments on loans granted by a person (whether an individual taxpayer or a legal entity) exercising a mandate as director or an equivalent mandate in the borrowing company to the extent the interest rate on the loans exceeds an "arm's length" rate, as well as to the extent the amount of the loans exceeds the equity of the borrowing company (equity being defined as the borrowing company's taxed reserves existing at the beginning of the relevant taxable period and its paid-up fiscal capital at the end of that taxable period).[8] The ITC excludes loans granted to the borrowing company by another Belgian resident company from this assimilation-to-dividend rule but not loans granted by a nonresident company.[9] In *Lammers & Van Cleeff*,[10] the CJEU held that this difference in tax treatment between resident and nonresident companies is contrary to the EU freedom of establishment principle. Based on this decision, the assimilation-to-dividend rule should no longer be applied to interest on loans granted by a company that is tax resident in a country that is a member of the European Economic Area (EEA).[11]

The Dividend Article in most of Belgium's tax treaties contains a very broad definition of "dividend" and includes a reference to the dividend definition in the domestic law of the source country, which allows interest assimilated to dividends under the domestic rule described above to be caught.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Belgian DWT is computed on the gross amount of a distributed dividend. Belgian domestic tax law currently does not provide for the ability to reduce this tax base by expenses or other deductions that the shareholder has incurred with a view to obtaining the dividend income or acquiring the shareholding that generated the income.[12]

Following the CJEU's *Brisal* decision[13] (which is discussed in more detail in I.B., below), Belgian legal scholars have taken the position that Belgian domestic tax law may also not be in line with EU law on this point with regard to dividends paid on shares that are part of the shareholders' business activity.[14] Thus far, however, the Belgian tax administration appears not to have initiated concrete legislative action or issued an administrative position in this respect.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Belgian domestic tax law does not provide for an adaptation of the dividend (withholding) tax on Belgian-source dividends distributed to a nonresident shareholder (that does not have a Belgian permanent establishment (PE)) to account for the fact that the nonresident shareholder may have tax losses or may be in an overall loss position in its country of residence.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Belgian domestic tax law does not as such provide for a reduction of, or an exemption from, the Belgian DWT on Belgian-source dividends paid to nonresident shareholders to account for the possibility of incomplete double tax protection of the recipient in its country of residence.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

The following basic rules are relevant for purposes of comparing the Belgian tax burden between a resident and a nonresident corporate taxpayer on a Belgian-source dividend that it receives:

- For a nonresident corporate shareholder (with no PE in Belgium), the Belgian DWT is the final (Belgian) tax;
- A Belgian corporate shareholder (that is subject to ordinary corporate tax) can fully credit the Belgian DWT withheld at source against its own corporate tax liability and any excess credit is reimbursable; and
- A Belgian corporate shareholder must include the full amount of the dividend received in its own corporate tax base (without being allowed any tax credit for the corporate tax due at the level of the distributing company) except where the Belgian participation exemption (i.e., the DRD) applies.

It follows that (disregarding the fact that an ordinary resident corporate taxpayer can in principle deduct current year expenses and tax loss carryforwards from its overall tax base) the imposition of Belgian DWT will be particularly discriminating against a nonresident corporate shareholder if applied to dividends that are eligible for Belgium's DRD. This is, however, remedied by two distinct DWT exemptions, which are discussed below.

First, there is the exemption available under Belgium's implementation of the PSD. It is worth noting that Belgium does not limit this exemption to intra-EU dividend distributions but has extended it to holding companies situated in qualifying tax treaty countries outside the European Union.[15]

The exemption is subject to the following conditions:

- The foreign holding company is established in an EU Member State or in a country with which Belgium has concluded a tax treaty, if the treaty, or any other convention entered into with that country, provides for the exchange of information that is not limited to information for purposes of the application of the tax treaty but also covers information for purposes of the application of the domestic laws of the treaty countries;
- The foreign holding company has held or will hold a shareholding representing at least 10% of the Belgian subsidiary's share capital for an uninterrupted period of at least one year;[16]
- Both the foreign holding company and the Belgian subsidiary have a qualifying legal form, i.e., a legal form provided for in the Annex to the PSD or, if the foreign holding company is established outside the European Union, a company form that is substantially comparable thereto;
- The foreign holding company and the Belgian subsidiary are treated as tax residents of their respective countries of residence (both for domestic corporate tax purposes and for purposes of such countries' tax treaties); and
- The foreign holding company and the Belgian subsidiary are subject to the ordinary corporate income tax regimes in their respective tax jurisdictions.

Application of the exemption requires the foreign holding company to provide the Belgian subsidiary with a special affidavit confirming that all requirements for the exemption are met.[17]

The above 10% shareholding condition for DWT exemption purposes does not fully match the corresponding shareholding condition under Belgium's domestic 95% (recently increased to 100%) DRD regime. The latter shareholding condition is more generous in the sense that it requires a shareholding either of at least 10% or with an acquisition value of at least 2.5 million euros.[18] A shareholding of less than 10% but with an acquisition value of at least 2.5 million euros qualifies for Belgium's domestic DRD regime but does not qualify for the DWT exemption described above.

In 2012, the CJEU held in *Tate & Lyle Investments*[19] that this situation constitutes a discrimination against a foreign investor (which must bear the full cost of Belgium's DWT on a dividend without being able to recuperate this in Belgium) compared to a corresponding Belgian corporate investor (which can limit its tax cost on a dividend to corporate tax on 5% of the dividend received by recuperating the excess DWT applied at source) and that such discrimination violates the EU free movement of capital principle unless Belgium's tax treaty with the residence country of the foreign investor provides appropriate relief against such a difference in tax cost for the foreign investor concerned.

To remedy this situation, the Belgian legislature introduced a special reduced DWT rate of 1.6995% (which percentage corresponded to the tax cost of a comparable Belgian resident corporate shareholder, i.e., 33.99% corporate tax rate on 5% of the gross dividend).[20] Given the recent increase in Belgium's DRD from 95% to a full 100% deduction introduced by the corporate tax reform law of December 25, 2017, this special 1.6995% DWT rate has now been replaced by a full exemption from DWT.

The new DWT exemption (which applies with respect to dividend distributions made on or after January 1, 2018) is subject to the following conditions:[21]

- At the time of the dividend distribution, the foreign shareholder holds a shareholding in the Belgian distributing company that represents less than 10% of the latter's share capital but the acquisition value of which amounts to at least 2.5 million euros, and has held or will hold the shareholding in full ownership for an uninterrupted period of at least one year;
- The foreign shareholder is established in either an EEA Member State or a country with which Belgium has concluded a tax treaty, provided this treaty, or any other convention, provides for the exchange of information that is not limited to information for purposes of the application of the treaty but also covers information for purposes of the application of the domestic laws of the treaty partner countries;
- The foreign shareholder is established in either an EEA Member State or a country with which Belgium has concluded a tax treaty, provided this treaty, or any other convention, provides for the exchange of information that is not limited to information for purposes of the application of the treaty but also covers information for purposes of the application of the domestic laws of the treaty partner countries;
- Both the Belgian distributing company and the foreign shareholder have a company form listed in the Annex to the PSD or, if the foreign shareholder is not established in the European Union, a company form that is substantially comparable thereto; and
- The foreign shareholder and the Belgian dividend distributing company are both subject to the ordi-

nary corporate income tax regimes in their respective tax jurisdictions.

Even where all the above conditions are fulfilled, the exemption is only available if and to the extent that the foreign shareholder concerned would not be entitled in its home country to a foreign tax credit, or other method of relief, in relation to the Belgian DWT hypothetically due if the exemption were not applied.

Here again, the application of the exemption requires the foreign shareholder to provide the Belgian distributing company with a special affidavit confirming that all the requirements for the exemption are met, including the absence of any available tax credit or other relief as noted above.[22]

Belgian domestic tax law does not provide for foreign tax credits to be set off against the Belgian DWT on outbound dividends when such foreign tax credits cannot otherwise be used because inbound dividends are exempt.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends?

Like dividends, Belgian-source interest payments are, in principle, also subject to a 30% withholding tax.

The tax base for this source tax is the gross amount of the interest. Belgian tax law currently does not provide for the deduction of expenses borne by the beneficiary in order to acquire the relevant interest payments.[23]

This position is, of course, in sharp contrast to the net basis taxation applying to a Belgian corporate taxpayer subject to ordinary corporate tax. In *Brisal*,[24] the CJEU held that domestic tax law that imposes tax at source on interest earned by a nonresident financial institution without allowing the deduction of business expenses directly related to the activity in question, when such a deduction is allowed to resident financial institutions, constitutes a discrimination prohibited by EU law. Based on *Brisal* and related CJEU decisions, legal scholars have argued that Belgian tax law is also in breach of EU law in not allowing corporations resident in other EU Member States to deduct business expenses that are directly related to the relevant interest income (including travel and accommodation expenses, expenses of legal or tax advice, financial costs, etc.).[25] So far, however, the Belgian tax administration seems not to have initiated any concrete legislative action in this respect.

> “Belgian-source interest payments are, in principle, also subject to 30% withholding.”

The relative calm persisting in Belgium in this respect may be attributable to the fact that the burden represented by a 30% gross basis source tax is very often mitigated by one of the large number of available exemptions from such source taxation. A number of these exemptions will be addressed below. For now, it may be worth noting by way of example that, in Belgium, a foreign regulated credit institution, such as that in *Brisal*, would have benefitted from the full DWT exemption for foreign regulated credit institutions (see further below).

The relief available under Belgium's tax treaties varies from treaty to treaty. Although most such treaties provide only for a reduction of the applicable rate (to 15%, 10% or 5%) a number of the treaties provide for a full exemption, subject to specific conditions.

Also of importance in this context is the Belgian implementation of the EU Interest and Royalties Directive,[26] which covers interest paid between associated companies under a wide range of financing forms, including bonds and similar securities, as well as contractual debt-claims and loans.[27] In essence, Belgium has adopted the standard application conditions set by the Directive[28] but is more generous in defining the scope of eligible “associated companies.” The beneficiary of the income and the Belgian debtor company qualify as associated companies if:

- One of them holds, for an uninterrupted minimum holding period of one year, a *direct or indirect* shareholding of at least 25% in the capital of the other; or
- A third company that is an EU resident holds, for an uninterrupted minimum holding period of one year, a direct or indirect participation of at least 25% of the capital of both companies.

This domestic association definition is broader and more flexible than the corresponding Directive definition in that: (1) both direct and indirect participations can be taken into account; and (2) with regard to indirect participation under the second bullet above, it suffices that the top holding company and the actual recipient are EU resident companies without requiring that all intermediary companies in the shareholding chain should be resident in the European Union.

Another important exemption is the exemption for interest payments on ordinary loans (not represented by securities) made by Belgian corporate borrowers to qualifying foreign credit institutions.[29] To qualify for this exemption, the foreign credit institution must be tax resident in a country that is a member of the EEA or in a tax treaty partner country (it is not necessary for the relevant treaty itself to provide for an exemption from source country taxation of interest) and must be appropriately licensed in its home jurisdiction as a regulated credit institution. Its licensed activities must include both: (1) the collection of funds from the public; and (2) the granting of credit, and the institution must be subject to supervision under an appropriate local regulatory system.

With regard to interest on bonds, there is a widely used exemption regime for bonds traded through Belgium's X/N clearing system organized by the National Bank of Belgium. Trading through the X/N clearing system requires bonds to be issued in tradable dematerialized form. An automatic exemption from withholding tax applies to interest payments made on such bonds that are held on "X-accounts" within the X/N clearing system. The range of investors admitted to hold bonds on such X-accounts is very broad. Belgian resident individuals and certain types of Belgian legal entities are the main excluded categories. Foreign corporate entities are admitted (regardless of whether they have PEs in Belgium).[30]

With regard to interest on registered bonds (which by their very nature cannot be held and traded through the X/N clearing system), there is an exemption for interest payable to a nonresident corporate investor, subject to certain conditions (for example, the foreign investor must pass a subject to tax test in its home jurisdiction and must not be majority-held by Belgian residents).[31]

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Like dividends and interest, Belgian-source royalties (which, for Belgian domestic tax purposes, are defined very broadly as "income derived from the putting at disposal, use or concession of movable goods") are in principle subject to a 30% withholding tax.[32] Again, this burden can often be mitigated by one of a number of treaty-based or domestic exemptions.

In line with the OECD Model Convention, Belgium's tax treaties often provide an exemption from source country taxation on royalties. The Belgian implementation of the EU Interest and Royalties Directive[33] provides another important exemption. The conditions for its application are to a very large extent identical to the conditions for the application of Belgium's implementation of the Directive with regard to interest payments (see I.B. above).

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

In contrast to the tax base for the source taxation of dividends and interest, in principle, the tax base for royalties is the net royalty income, i.e., after the deduction of the actual costs incurred with a view to generating or maintaining the relevant royalty income.[34] There is no exhaustive list of costs that can be taken into account for these purposes, but the position of the tax administration seems to be that only costs that are directly linked to the relevant royalty income can be deducted. No deduction, however, is allowed for interest costs.[35]

Certain Belgian legal scholars have taken the position that the decision of the CJEU in *Brisal* should also apply to royalty payments, which might extend the range of costs to be allowed as deductions in determining the net royalty amount (for example, to encompass financing costs).[36]

Absent sufficient proof of the actual costs incurred by the beneficiary, the deductible expenses are determined on a lump sum basis as a percentage of the gross amount. The base cost percentage is 15%,[37] but higher cost percentages ranging from 50% to even 85% apply to certain specific types of royalty income, for example, income from the granting of film and television distribution rights.[38]

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

a. Belgian corporate shareholders

In general, the only double taxation relief available to an ordinary Belgian resident corporate shareholder with regard to dividends is the Belgian participation exemption regime or DRD (see I.A., above).[39] Under the DRD regime, a qualifying dividend, whether domestic or foreign-source, is first included in the corporate tax base and can subsequently be deducted from the aggregate tax base. The deduction under the regime used to be limited to 95% of the dividend, but this was increased to 100% by the corporate tax reform law of December 25, 2017 (which is generally applicable for financial years commencing on or after January 1, 2018).

For many years, the deduction was only allowed to be taken from the current year taxable base with no carryforward of any excess deduction, so that any excess deduction was irreversibly lost. In 2009, the CJEU held that this was contrary to the PSD (because excess DRD deductions were treated less favorably than ordinary excess current year losses, for which a carryforward is available).[40] Following this CJEU case law, Belgium amended its ITC to provide for the carryforward of excess DRD deductions for dividends from subsidiaries resident in the EEA.[41] The Belgian tax administration also grants such a carryforward for dividends from subsidiaries resident in treaty countries outside the EEA (provided the relevant treaty contains an appropriate non-discrimination clause).[42] In the case of dividends received from other countries, the Belgian tax administration is only willing to consider allowing the carryforward of excess DRD deductions based on the EU free movement of capital principle (provided for in Article 63 of the Treaty on the Functioning of the European Union (TFEU)) if the Belgian shareholder concerned is able to demonstrate convincingly that it is in a situation in which this principle can be invoked (which, as a matter of principle, requires that it does not have influential control over the foreign distributing company).[43]

To be eligible for the DRD, the parent company must, on the date of the dividend distribution, hold a shareholding of at least 10% in the capital of the sub-

> “Dividends that are not eligible for the DRD as a rule do not qualify for any other form of relief from double taxation.”

sidiary or (alternatively) with an acquisition value of at least 2.5 million euros. The shareholding must be held in full ownership for an uninterrupted period of at least 12 months. If a dividend is received before the end of this minimum holding period, the participation exemption applies on a provisional basis if the (recipient) Belgian company undertakes to maintain its holding until the expiration of the minimum holding period.[44] The subsidiary must also meet a “subject to tax” requirement. Derogations from the above requirements apply to dividends received from or by certain investment companies.[45]

Dividends that are not eligible for the DRD as a rule do not qualify for any other form of relief from double taxation under domestic Belgian tax law.[46]

Belgium’s tax treaties generally do not provide any further foreign tax credit relief for dividends received from treaty partner countries by Belgian resident corporate shareholders, as they tend simply to refer to the relief available under Belgian domestic tax law. This situation, however, is subject to change. Indeed, Belgium’s recent treaties (as well as the current “model convention,” which the Belgian tax administration is supposed to use as the basis for current and future treaty negotiations) provide for more extensive double taxation relief with regard to dividends received by a Belgian resident corporate shareholder from a company resident in the other treaty country, as follows:

- The base provision states that such a dividend is exempted from Belgian tax subject to the conditions and within the limitations established by Belgian domestic tax law. This merely represents a reference to Belgium’s domestic DRD regime discussed above and is nothing new.
- A first (new) additional provision states that if the distributing company is engaged in the active conduct of a business in the other (source) country and the dividend distributed by it derives from the profits from such activity, Belgium is to grant an exemption for the dividend, subject to the conditions and limitations established by Belgian domestic law but without having regard to the eligibility conditions relating to the tax regime applicable in the source country to the distributing company or its profits. This rule obliges Belgium to disregard its “subject to tax” requirements in applying its DRD regime.[47]
- A second (new) additional provision states that if such a dividend still does not qualify for exemption in Belgium under either of the preceding rules, Belgium is to grant a credit for the treaty-compliant (source country) tax levied by the other treaty country (although the creditable amount may not exceed the portion of the Belgian corporate tax due that relates to the dividend income concerned).[48]

This new style of treaty tax relief provision is a relatively recent phenomenon for Belgium and will only gradually find its way into actually applicable tax treaties. The “new style” relief can already be found in existing tax treaties with the United States and Uruguay, and also in the recently signed (but not yet in force) treaties with Japan and Norway.

b. Belgian private individuals

Belgian private individuals receiving foreign-source dividends are often subject to double taxation (source country tax plus Belgian (resident country) tax, generally at the flat rate of 30%, on the net dividend received). The foreign-source tax can be deducted from the tax base in Belgium but cannot be credited against the Belgian tax due.

Until 1988, Belgian domestic tax law granted foreign tax credit relief to private individuals but the Law of December 7, 1988, eliminated this benefit by excluding income from privately held assets from the relief. The fact that a number of Belgium’s tax treaties included a foreign tax credit relief provision that was also available to private individuals was of no avail because, generally, this provision confined itself merely to referring to Belgium’s foreign tax credit regime subject to the conditions and within the limitation(s) established by Belgian domestic tax law. Notwithstanding the (undisputed) principle that treaty law prevails over domestic tax law (see III.A., below), the explicit reference made in these tax treaties to the conditions and limitations established by Belgian domestic tax law with respect to its foreign tax credit regime was considered not to prevent Belgium from amending, restricting or even abolishing its foreign tax credit regime.

For almost 30 years, Belgian resident individuals deployed many efforts to remedy this situation before the courts. Attempts made before the CJEU to have Belgium, as the residence country, compelled to grant relief for source country taxation based on EU law failed because the CJEU held that, given the current absence of uniform EU law on the allocation of taxing powers between the source country and the residence country, Belgium (as the residence country) could not be required to grant relief for the source country tax if this was not provided for in the applicable tax treaty.[49] Belgian residents were more successful in obtaining exemption from source country taxation where France was the source country (see the decision of the French *Conseil d’Etat* of May 7, 2014, discussed in the French contribution to this issue of the Forum).

Recently, however, a Belgian private individual achieved a breakthrough victory before the Belgian Supreme Court based on the specific foreign tax credit provision contained in the Belgium-France tax treaty. In a decision of June 16, 2017, the Supreme Court held that, since that provision does not merely refer to the conditions for the application of Belgium’s domestic law foreign tax credit regime but also specifies that the foreign tax credit should not be lower than 15% of the net dividend received, it requires Belgium to ensure that such minimum 15% foreign tax credit remains effectively in place for Belgian residents entitled to invoke this treaty provision (i.e., the new conditions for the application of the credit that result in its being disallowed, or limited to below the stated 15% minimum, should be disregarded on their behalf).[50]

The effect of this Supreme Court decision on the foreign tax credit climate in Belgium has still to be determined. While the Belgian tax administration is apparently persisting in its refusal to accept the position of the Supreme Court, it is unlikely that it will succeed in maintaining this attitude. This, of course, holds true for only as long as the current Belgium-France tax treaty remains in effect. The treaty has for some time reportedly been in the process of being thoroughly renegotiated by the Belgian and French tax authorities. These negotiations appear to be both difficult and protracted but, in due course, a new tax treaty with France will enter into force. The Belgian negotiators may be expected to ensure that the existing foreign tax credit clause will not be retained in the new treaty, but until the new treaty enters into effect, the Supreme Court's 2017 position should prevail. As to its potential scope of application, it may be noted that the treaty clause concerned applies not only to Belgian resident private individuals but also to Belgian (not-for-profit) legal entities subject to Belgium's legal entities tax rather than ordinary corporate tax. The clause does not, however, apply to ordinary Belgian resident companies. Arguably, it should cover not only dividends but also interest. A number of questions relating to the interface between the minimum 15% credit provided for in the treaty clause and the Belgian domestic calculation rules remain to be answered.[51] It is important to note that the Supreme Court decision is based on the very specific wording of the relevant foreign tax credit clause in the current Belgium-France tax treaty (which only applies to French-source income). The decision should definitely not be seen as generally applicable to other Belgian treaties. There are only a few other Belgian treaties that appear to contain similar or sufficiently comparable provisions that would allow the Supreme Court's decision also to be invoked with respect to income from the relevant source countries.[52]

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

In view of the analysis set out in II.A.1., above, no further comments are provided in relation to this question.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in II.A.2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

In view of the analysis set out in II.A.1., above, no further comments are provided in relation to this question.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

In view of the analysis set out in II.A.1., above, no further comments are provided in relation to this question.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

a. Belgian corporate shareholders

In Belgium, relief for source country taxation of foreign-source interest payments received by Belgian resident corporate beneficiaries is granted by means of Belgium's foreign tax credit mechanism, known as the "*Quotité Forfaitaire d'Impôt Etranger*" or Lump-sum Foreign Tax Credit (LFTC).[53] The LFTC is available only with respect to income related to a business activity and is, as a rule, only available with respect to foreign-source interest payments and royalties.

Eligibility for the LFTC is conditional on the income concerned being subject to effective taxation in the source country.[54]

In the case of foreign-source interest, the creditable amount of the LFTC is based on the actual amount of withholding tax levied in the source country (subject to a maximum rate of 15%) and is further reduced by a special debt-financing factor (that compares the amount of the taxpayer's interest and royalty expenses to its total ordinary income).[55] If the taxpayer did not hold the interest-generating asset in full ownership for the entire taxable period, a corresponding time-related proportional reduction also applies.[56]

The LFTC computation comprises two steps: first, the creditable amount is added to the corporate tax base of the Belgian recipient (the "gross-up"); second, this amount may then be credited against the corporate tax due on the aggregate tax base.[57] Any excess credit is not refundable and cannot be carried forward.[58]

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Apart from the LFTC, relief from the double taxation of interest payments is generally not available because the double taxation relief provisions of most of Belgium's tax treaties refer to Belgian domestic law, which does not provide for any other form of double taxation relief in relation to interest payments.

Most of Belgium's tax treaties simply refer to the domestic Belgian LFTC regime described above, with its own conditions and limitations.[59] Some treaties, however, deviate from this in a variety of ways, providing for either: (1) a specified minimum foreign tax credit;[60] (2) a foreign tax credit with a minimum rate equal to the actual foreign source country tax imposed;[61] or (3) a foreign tax credit corresponding to the credit available under the Belgian domestic tax regime in place at the time the relevant treaty was signed.[62]

b. Belgian private individuals

Belgian resident private individuals are generally not entitled to a foreign tax credit or any other relief for source country taxation with regard to foreign-source interest payments (because, since 1988, Belgium has excluded income from privately held assets from its domestic foreign tax credit provisions — see II.A., above).

As to the possibility of bypassing this restriction by claiming foreign tax credit relief based on EU law or one of Belgium's tax treaties, see the discussion in II.A., above (in particular the fact that legal scholars are of the opinion that the Belgian Supreme Court decision of June 16, 2017 with respect to French-source dividends can also be invoked with regard to interest payments sourced in France or in other source countries that have treaties with Belgium containing similar or sufficiently comparable foreign tax credit clauses).[63]

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The treatment set out in II.B., above with regard to interest payments generally also applies with regard to royalty payments.

The main difference in treatment between interest and royalty payments is the way in which the creditable amount of the LFTC is calculated. While, in the case of interest payments, the creditable amount is based on the actual amount of the applicable foreign source taxation (subject to a maximum rate of 15%), in the case of royalties, the creditable amount is generally[64] a fixed 15/85 of the net foreign income received, regardless of whether the effective rate of the foreign source tax is higher or lower than that fixed rate (it should be noted, however, that it is a condition for eligibility for the LFTC that some foreign source tax, however little, must have been paid).

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Given the complexity and open-ended nature of the questions raised, the discussion below confines itself to setting out a few of the major principles.

The Belgian Supreme Court[65] long ago firmly established the rule that (once ratified[66] and in force) treaty law provisions prevail over domestic tax law, even subsequent domestic tax law. Thus, the Belgian (tax) legislator cannot override an existing tax treaty provision. Should this nevertheless happen, the taxpayer can continue to invoke the direct effect of the (overridden) treaty provisions against the tax administration and before the courts. If Belgium wishes to cancel, or derogate from, an existing tax treaty provision that is no longer considered desirable, it must negotiate a new or amended treaty with the treaty partner country, or resort to terminating the existing treaty.[67]

In classifying an item of income for purposes of applying the relevant tax treaty, the principle is that the income definition in the treaty overrides the definition in domestic law. Where the applicable treaty does not provide a clear definition, however, Belgium's tax treaties will (in line with the OECD Model Convention) generally allow each Contracting State to refer to its domestic law except "where the (treaty) context requires otherwise."[68] The general view in Belgium is that the (treaty) context includes the (updated) Commentary on the OECD Model Convention.[69]

Where reference to Belgian national law is allowed, this should be understood as referring, as a matter of priority, to (the definitions in) domestic tax law and not civil law, or other segments of domestic law. The general view is also that, unless otherwise specified in the relevant tax treaty provision, reference should be made to current domestic law (not the historical domestic law that was in place at the time the relevant treaty was signed).[70]

Where, in accordance with the above rules, the classification of an item of income under a tax treaty has to be resolved by referring to domestic (tax) law, each treaty country will refer to its own domestic (tax) law, which may lead to a conflict of classification between the source country and the residence country. In this situation, where Belgium is the residence country, the Belgian tax administration adheres to the OECD view that the source country qualification prevails for purposes of determining whether the income concerned may be taxed by the source country under the treaty.[71]

The predominance accorded in the situation considered above to the domestic income classification applied by the (other) source country is limited to the application of the treaty rules determining whether the source country has the power to tax the income concerned. Once this is established, Belgium (as the residence country) will follow its own domestic income classification to determine under which income category the income is to be taxed in Belgium and also which type of double taxation relief is to be granted under the treaty.[72]

This may be illustrated by the following example. A lease payment made by a foreign company to a Belgian resident company (the lessor) was classified by the source country as a royalty payment falling, in its entirety, within the scope of the Royalty Article of that country's tax treaty with Belgium. Accordingly, source country tax was imposed on the full amount of the lease payment. Under Belgium's domestic tax law, the lease payment is classified partly as a reimbursement of the invested principal (which is not included as a profit in the P&L account of the Belgian lessor and consequently is not treated as an income item and is not subject to tax in Belgium) and partly as an interest payment (which is included in the taxable profits of the Belgian lessor). The Belgian tax administration granted foreign tax credit relief only with respect to the portion of the lease payment that is classified as an income item under Belgian law. This was based on the view that Belgium can apply this domestic classification for purposes of deciding the amount with respect to which it is to grant foreign tax credit relief under the Double Taxation Relief Article of the applicable tax treaty. This relief provision states that Belgium is to grant an exemption for income taxable (and effectively taxed) in the source country with the exception of dividends, interest or royalty income, for which foreign tax credit relief is to be granted. Accordingly, Belgium fulfills its obligations under the treaty relief provision with respect to the part of the lease payment that is not classified as (interest) income for Belgian domestic tax purposes by abstaining from imposing tax on this payment. In a decision of January 22, 2010, the Belgian Supreme Court held in favor of this interpretation of the treaty concerned.[73]

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

The principle that tax treaty law prevails over domestic tax law (see II.A., above) does not imply that tax treaties can by themselves constitute a basis for taxation in Belgium. This follows from the content of tax treaty provisions, which, in essence, provide for the redistribution of taxing rights between the source country and the residence country and establish what double taxation relief is to be granted by the residence country. The fact that a tax treaty provides that a given item of income can be taxed by Belgium, does not by itself constitute a legal basis for Belgium to effectively tax such income. For this reason, when new versions of the OECD Model Tax Convention have been introduced that attribute to the source country the right to tax additional items of income, the Belgian tax legislator has had to extend Belgium's ITC provisions on the taxation of nonresidents to safeguard Belgium's right (as the source country) to effectively levy tax on the income concerned once Belgium's treaties begin to incorporate such extended source country taxing rights.[74]

It seems to follow from the above that, in principle, the application of a tax treaty should not result in a higher tax burden than would result from the direct application of the relevant domestic tax law. Theoretically, there is the potential for a higher tax burden to arise as a result of a tax treaty, where the treaty grants an extended foreign tax credit in accordance with Belgium's domestic foreign tax credit rules. These rules provide that, in principle, the first step is to add the available foreign tax credit to the tax base (the "gross-up"). The second step is for the available foreign tax credit to be credited against the Belgian income tax due on this grossed-up tax base. Where the taxpayer cannot apply the actual credit in the second step because it has insufficient taxable income to absorb the credit as a result of the fact that it is in a loss position, the unused excess credit is lost (it can neither be reimbursed nor carried forward to subsequent tax years). In such circumstances, the addition of the tax credit to the tax base in the first step described above may lead to a reduction of the taxpayer's tax loss carryforward without this disadvantage being compensated by the allowance of a matching effective tax credit in the second step. This theoretical risk seems to have been removed, however, by a decision handed down by the Belgian Constitutional Court on January 29, 2014,[75] in which the Court held that the requirement that a foreign tax credit be added to the tax base (i.e., the first step above) is contrary to Belgium's constitutional equal treatment principle to the extent the foreign tax credit cannot be effectively set off against any income tax due. As a result of the decision, going forward, taxpayers can limit the gross-up to be applied in the first step to the amount of the tax credit that can be effectively credited in the second step.

IV. Conclusion

With regard to the stubbornly persisting double taxation of cross-border income flows, Belgium is best known on the EU scene as the brave little country that for some considerable time fiercely resisted repeated attempts launched by taxpayers to oblige it, as a residence country, to grant relief for taxation levied in another, source country. Initially, taxpayers' attempts before the CJEU (based on EU law principles) as well as their attempts before the national courts (based on tax treaty interpretation or Belgian constitutional principles) were unsuccessful. For a long time, Belgium has also been spared severe criticism of its source taxation of outbound income flows (partly because of its generous range of exemptions from such taxation).

As the above analysis may help to illustrate, in Belgium too, the debate over double taxation is in full swing and far from being at a standstill. Belgium has already had to adapt its (source) taxation regimes to take account of CJEU case law and is bound to face further challenges based on further recent breakthroughs in his regard. This multi-country review of the problems involved is thus both appropriate and timely. Current and upcoming developments will need to be monitored carefully and proactively.

NOTES

[1] *See, e.g.,* the exemption for dividends paid to qualifying foreign tax-exempt pension funds under the Royal Decree

implementing the Belgian Income Tax Code (ITC), Art. 106, § 2 and § 4 and the exemption for dividends distributed by certain types of Belgian investment companies under the Royal Decree implementing ITC, Art. 106, § 7 and § 9.

[2] The very technical calculation formula used by the fairness tax is set forth in ITC, Art. 219*ter*.

[3] Case C-68/15, *X. vs. Ministerraad* (CJEU May 17, 2017). In dismissing the characterization of the fairness tax as a (prohibited) withholding tax, the CJEU followed the criteria for such characterization it had already upheld in Case C-284/06, *Burda* (CJEU June 16, 2008).

[4] Case C-24/2018 (Constitutional Court March 1, 2018).

[5] ITC, Art. 18, 1°.

[6] ITC, Art. 18, 2°, 2°*bis* and 2°*ter*.

[7] ITC, Art. 18, §§ 2 to 7, introduced by the Corporate Tax Reform Law of Dec. 25, 2017.

[8] ITC, Art. 18, § 8, 3°.

[9] ITC, Art. 18, §§ 2 to 7, introduced by the Corporate Tax Reform Law of Dec. 25, 2017.

[10] Case C-105/07, *Lammers & Van Cleeff* (CJEU Jan. 17, 2008).

[11] P. Smet, "Herkwalificatie interesten: strijdig met vrijheid van vestiging," *Fiscoloog* 2008, ed. 1100, p. 1.

[12] ITC, Art. 22, § 1 and 2.

[13] Case C-18/15, *Brisal – Auto Estradas do Litoral SA* (CJEU July 13, 2016).

[14] E.g., O. Hermand, P. Delacroix and M. Protin, "Bronheffing op nettobasis: naar een 'notionele' vaste inrichting?", *Fiscoloog Internationaal* 2016, ed. 394, 1.

[15] Royal Decree implementing ITC, Art. 106, § 5.

[16] If the one-year holding period has not already been achieved at the time of the dividend distribution, the distributing company must provisionally retain the amount of Belgian withholding tax that would otherwise be due, but can release this retained amount to the shareholder if and when the relevant one year 10% holding requirement is met (Royal Decree implementing ITC, Art. 117, § 15).

[17] Royal Decree implementing ITC, Art. 117, § 4.

[18] ITC, Art. 202, § 2.

[19] Case C-384/11, *Tate & Lyle Investments* (CJEU July 12, 2012).

[20] Former ITC, Art. 269/1.

[21] ITC, Art. 264/1, § 1.

[22] ITC, Art. 264/1, § 2.

[23] ITC, Art. 22, § 1 and § 2.

[24] Case C-18/15, *Brisal – Auto Estradas do Litoral SA* (CJEU July 13, 2016).

[25] O. Hermand, P. Delacroix and M. Protin, "Bronheffing op nettobasis: naar een 'notionele' vaste inrichting?," *Fiscoloog Internationaal* 2016, ed. 394, 1; C. Buysse, "Roerende inkomen aan niet-inwoners: bronheffing op nettobasis?," *Fiscoloog* 2016, ed. 1494, p. 8; K. Morbee, "Het einde van een tijdperk: bronheffing op netto-inkomen!," *TFR* 2016, p. 679.

[26] Royal Decree implementing ITC, Art. 107, § 6.

[27] In the case of "real estate certificates," the exemption applies only with respect to ordinary periodic income distributions and not to distributions corresponding to disposals of the underlying real property assets.

[28] The beneficiary of the income must be tax resident in an EU Member State (also for purposes of that Member State's tax treaties with non-EU countries); must be subject to the corporate income tax regime of that Member State; and must have adopted a legal form listed in the Annex to the Directive. The beneficiary must also have held full legal ownership of the assets giving rise to the interest payments for the entire relevant interest period and may not have attributed those assets at any time during that period to a PE situated outside the European Union. For the exemption to apply, the foreign payee must provide the Belgian payor with a special affidavit confirming that all the requirements for exemption are met (Royal Decree implementing ITC, Art.117, § 6*bis*).

[29] Royal Decree implementing ITC, Art. 107, § 2, 5°, a), second dash.

[30] Royal Decree of May 26, 1994, on the deduction and indemnification of withholding tax, Art. 4.

[31] Royal Decree implementing ITC, Art. 107, § 2, 10°. For this exemption to apply, the foreign investor must provide the Belgian payor with a special affidavit confirming that all the requirements for exemption are met (Royal Decree implementing ITC, Art. 118, § 1, 1°).

[32] ITC, Arts. 17, § 1, 3° and 269, § 1, 1°.

[33] Royal Decree implementing ITC, Arts. 111 and 117, § 6*bis*.

[34] ITC, Art. 22, § 3.

[35] ITC, Art. 22, § 2.

[36] O. Hermand, P. Delacroix and M. Protin, "Bronheffing op nettobasis: naar een 'notionele' vaste inrichting?," *Fiscoloog Internationaal* 2016, ed. 394, 1.

[37] Royal Decree implementing ITC, Art. 3.

[38] Royal Decree implementing ITC, Arts. 4 and 5.

[39] ITC, Arts. 202 and 203.

[40] Case C-138/07, *N.V. Cobelfret* (CJEU Feb. 12, 2009); Cases C-439/07 and C-499/07, *KBC Bank NV* and *Beleggen, Risicokapitaal, Beheer NV* (CJEU June 4, 2009, joined cases).

[41] ITC, Art. 205, § 3. It is worth noting that the Corporate Tax Reform Law of Dec. 25, 2017, introduced an annual cap on the effective use of a number of carryforwards including the carryforward for excess DRD deductions (effective for taxable periods commencing on or after Jan. 1, 2018). The annual cap is set at 100% of the first 1 million euro tranche of the tax base for the year in which the deduction is claimed and 70% of the excess tax base. The portion of the carryforwards that cannot be used as a result of this cap is not lost but can be carried forward without time limitation (ITC, new Art. 207, fifth indent).

[42] Circular letter AFZ/INTERN.IB.2006/0549 of Oct. 12, 2009.

[43] On Oct. 11, 2012, the Constitutional Court held that the non-application of the carryforward to third countries with which Belgium has not concluded a tax treaty containing a non-discrimination clause does not violate Belgium's constitutional equality principle (Constitutional Court Oct. 11, 2012, case no. 5259, *Agfa-Gevaert v. Belgian State*).

[44] Cf. Cases C-283/94, C-291/94 and C-292/94, *Denkavit* (CJEU Oct. 17, 1996).

[45] ITC, Art. 202, § 2 third indent and Art. 203.

[46] Apart from a special look-through rule for dividends from certain investment companies (ITC, Art. 285, second indent).

[47] Belgian model tax convention of June 2010, Art. 22, § 2(e).

[48] Belgian model tax convention of June 2010, Art. 22, § 2(f).

[49] *See* Case C-513/04, *Kerckhaert-Morres* (CJEU Nov. 14, 2006); Case C-128/08, *Damseaux* (CJEU July 16, 2009); Case C-540/11, *Levy and Sebbag* (CJEU Sept. 19, 2012).

[50] Supreme Court Decision of June 16, 2017; D. Scornos and N. Bammens, "FBB op buitenlandse dividenden: DBV met Frankrijk bevat volgens cassatie een autonome verrekeningsverplichting," *TFR* 2017, ed. 531, 898-902.

[51] S. Gnedasj, "Cassatie gebiedt toch verrekening van Franse dividend- en interestbelasting op privébeleggingen, maar wat met FBB en andere verdragen?," *Fisc. Act.* 2017, ed. 28, p. 1.

[52] Tax treaties potentially qualifying for a similar position include the Belgium- Australia, Hungary, Israel, Italy and Ivory Coast tax treaties.

[53] This regime is laid down in ITC, Arts. 285 to 289. Administrative circular N° Ci.RH.421/457.115 of May, 1995, describes its application modalities.

[54] ITC, Art. 285, first indent. Taxation in the source country does not necessarily have to be incurred prior to claiming the LFTC (Circ. N°. 421/470.197 of Feb. 2, 1996).

[55] ITC, Art. 287.

[56] ITC, Art. 288. See also the anti-abuse rule in ITC, Art. 289 directed at channeling situations.

[57] ITC, Art. 37, third indent. If there is insufficient taxable base for the available creditable amount to be effectively fully utilized, only the effectively credited amount has to be added to the taxable base in the gross-up step (Constitutional Court Jan. 29, 2014, C-14/2014; M. Isenbaert, "FBB-overschotten zijn volgens GwH geen verworpen uitgaven", *Fiscoloog* 2014, ed. 1372, p. 1).

[58] ITC, Art. 292, first indent.

[59] Certain tax treaties (e.g., the Belgium-Bangladesh, Brazil, Malaysia, Malta, Pakistan and Tunisia tax treaties) contain "tax sparing" clauses. Since tax sparing is available only in very specific situations and subject to specific conditions, it is not further addressed.

[60] E.g., the Belgium-France and Belgium-Israel tax treaties.

[61] E.g., the Belgium-Australia and Belgium-Italy tax treaties.

[62] E.g., the Belgium-Ireland tax treaty.

[63] S. Gnedasj, "Cassatie gebiedt toch verrekening van Franse dividend- en interestbelasting op privébeleggingen, maar wat met FBB en andere verdragen?," *Fisc. Act.* 2017, ed. 28, p.1.

[64] Specific derogating rules apply to royalties that qualify for Belgium's innovation income deduction (under ITC, Arts. 205/1 to 205/4) or for Belgium's patent income deduction and provide that the creditable amount is to be calculated based on the actual foreign source country tax imposed and can only be credited against the corporate income tax due in relation to such innovation or patent income (ITC, Art. 286, second and third indent).

[65] Cass., May 27, 1971, *Fromagerie Franco-Suisse "Le Ski,"Pas*. 1971, I, 886. The only exception to this predominance of treaty law over domestic law is where treaty provisions would conflict with principles laid down in the Belgian constitution, such as the equal treatment and non-discrimination principles (Circular N° AFZ/2004/0053 on tax treaties of Jan. 16, 2004 (the "Tax Treaty Circular"), I.7.

[66] It may be noted that, as a result of Belgium's partial "regionalization" of income taxes between the federal state and the regions, the ratification of a tax treaty by Belgium is currently considered to require the endorsement of both the federal Parliament and each of Belgium's regional parliaments (which involves the risk of a protracted parliamentary process).

[67] A special situation occurs where one of Belgium's tax treaties provides for foreign tax credit relief subject to the conditions and within the limitations set by Belgian domestic tax law. Where such a treaty provision does not itself define the minimum ("treaty-guaranteed") foreign tax credit to be granted and does not specify that reference is made to the Belgian domestic tax law in place at the time the treaty is signed, this is considered a "free card" handed by the treaty to the Belgian national tax legislator to change or amend the applicable foreign tax credit provisions at any time (see the discussion in II.A.1. with regard to Belgian private individuals). This should not be regarded as a violation of the principle that a treaty predominates since it is the treaty itself that allows such an "override" by Belgian domestic law.

[68] Cf. OECD Model Convention, Art 3(2).

[69] Tax Treaty Circular, III. 3(a) and IV.2(a).

[70] Tax Treaty Circular, III.3(b).

[71] Tax Treaty Circular, IV.4. A good example of this approach is afforded by the share of income earned by a Belgian resident partner in a commercial partnership with legal personality situated in another, source country that treats such a partnership as tax transparent under its domestic tax law. Under its own domestic tax law, Belgium would treat the partnership as non-transparent and accordingly, the Belgian partner would not be considered to be directly taxable in the source country on his share of income from the partnership. But if the source country, in accordance with its own domestic tax law, treats the partnership as tax-transparent and accordingly, taxes the Belgian resident partner on his share of the partnership income, Belgium will accept that the source country correctly interprets the tax treaty as conferring on it the right to tax the Belgian resident partner. As a consequence, Belgium will consider that it is obliged under the treaty to grant the Belgian resident partner treaty relief with respect to income taxable in the source country.

[72] Under Belgium's tax treaties, treaty relief to be granted by Belgium as the residence country generally takes the form of an exemption (with a progressivity reserve) for income that is "taxable" (or in the more modern tax treaties "(effectively) taxed") in the source country except for income classified under the treaty articles on dividends, interest or royalties, with respect to which Belgium is to apply its domestic dividend deduction or foreign tax credit regimes, sometimes with extended foreign tax credit provisions being provided by the treaty concerned.

[73] Belgian Supreme Court, Jan. 22, 2010, no. 8/0100.

[74] *See, e.g.,* the "catch-all" provision in ITC, Art. 228, § 3, whose main purpose is to ensure that Belgium can exercise its taxing rights based on its domestic tax rules in situations in which the applicable tax treaty allocates the taxing rights to Belgium.

[75] Case no. 14/2014 (Constitutional Court, Jan. 29, 2014); M. Isenbaert, "FBB-overschotten zijn volgens GwH geen verworpen uitgaven," *Fiscoloog*, 2014, ed. 1372, p. 1.

BRAZIL: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Dividends paid by a Brazilian company to its shareholders, be they individuals or legal entities, are tax-exempt as a matter of Brazilian domestic law, even if the shareholders concerned are nonresidents (and regardless of their country of residence).[1] For this reason, a nonresident would not need to resort to a tax treaty with Brazil in order to obtain a more favorable tax treatment for dividends paid to it by a Brazilian company.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Dividend treatment is only afforded with respect to distributions that are formally and legally made out of profits earned and accumulated by a legal entity. This derives from the fact that dividends are generally understood as the positive outcome of having an equity interest in a legal entity. While, on the one hand, the stakeholders in an entity intend to earn profits, on the other, they bear the risks that are inherent in the business activities engaged in for purposes of earning those profits. That is to say, investors have no guarantee as to the yield they are going to achieve, and, at the same time, there is no limit on their potential returns (should the investee prosper) and, if the investee is liquidated, the investors will share in the investee's latent capital gains.[2] Dividends are thus the product of uncertainty: a legal entity that does not have accumulated earnings or profit reserves is unable to pay out dividends.[3]

In the view of the authors, this line of reasoning justifies, for example, the tax-exempt dividend treatment of amounts paid out to holders of preferential shares, even if such amounts are pre-determined (i.e., known at the time the preferential shares are issued). Nonetheless, the authors believe that this treatment should be contingent on the existence of accumulated earnings or profit reserves that justify the payments of dividends. In other words, although the holders of preferential shares may enjoy economic advantages, they should still be "at risk," like any other ordinary shareholders.

It is worth noting that Brazilian legal entities are allowed to make other distributions on shareholders' equity, i.e., "interest on shareholders' equity" (*Juros sobre Capital Próprio* or JCP). JCP can be included, at their net value, as part of any mandatory dividend. However, such payments are treated as interest for tax purposes,[4] are subject to withholding income tax (WHT) (and thus taxable at the level of the recipient), and treated as a deductible expense for a Brazilian payer.[5]

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

This question has no relevance in a Brazilian context since, as discussed in I.A.1, above, dividends paid out by a Brazilian payer are tax-exempt as a matter of Brazilian domestic law.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Again, this question has no relevance in a Brazilian context since, as discussed in I.A.1, above, dividends paid out by a Brazilian payer are tax-exempt as a matter of Brazilian domestic law. Nor is any rule in place in Brazil that would provide such coordination.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Again, this question has no relevance in a Brazilian context since, as discussed in I.A.1, above, dividends paid out by a Brazilian payer are tax-exempt as a matter of Brazilian domestic law.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

As discussed in I.A.1, above, dividend distributions are exempt from WHT, regardless of whether the recipient of the dividends is a local shareholder or a foreign holding company.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Interest is regarded in Brazilian tax doctrine as fixed and determinable income. While investing in stock generally entails risk (i.e., the legal entity invested in may not accumulate earnings, and, thus, may not be able to pay dividends), making a loan or investing in bonds/notes does not generally entail such risk,[6] since interest is calculated over time based on a fixed (principal) amount (the debtor must calculate and pay the interest when it becomes due).[7]

Interest payable to a nonresident beneficiary is generally subject to WHT at the rate of 15% if the nonresident is *not* located in a tax haven.[8] Where interest is payable to a beneficiary resident in a tax haven, WHT is generally levied at an increased rate of 25%.[9]

Even though Brazil is not a member of the Organisation for Economic Cooperation and Development (OECD), Brazil's tax treaties[10] follow, at least to some extent, the various versions of the OECD Model Convention. That being said, Brazil's treaties depart from the OECD Model Convention guidelines in that Brazil retains source-country taxation rights with respect to a number of types of gross income, usually at rates as high as 15% (which is the general WHT rate applicable to income paid to nonresidents under Brazil's domestic law). The consequence of this is that a nonresident will probably not obtain any significant benefit by resorting to the terms of one of Brazil's treaties, as Brazil's domestic tax laws generally establish a tax regime that is either comparable to, or more advantageous than, that agreed to by Brazil in its treaties.

It is only in a narrow set of circumstances that a foreign resident will enjoy extra tax benefits if its country of residence has a tax treaty with Brazil. For example, the Brazil-Japan tax treaty provides that Brazilian-source interest paid to a resident of Japan is to be subject to WHT at a (lower) rate of 12.5%.[11]

It should be noted that an applicable tax treaty would also potentially reduce the WHT rate on interest payments made to beneficiaries resident in tax haven jurisdictions from 25% to the 15% level referred to above, but Brazil has not yet signed any tax treaties with tax havens.

There are currently no Brazilian domestic tax rules that would allow a nonresident without a Brazilian permanent establishment (PE) or other local establishment to reduce the taxable amount of an interest payment by any expense or allowance to reflect the fact that only a net amount might be taxable in the residence country. Nor are there any provisions that would: (1) relieve taxation imposed on a nonresident that may have losses; or (2) guarantee any modification of Brazilian WHT to account for incomplete double tax protection in the country of residence of the recipient of Brazilian-source interest.

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C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

As a matter of Brazilian domestic law,[12] royalties correspond to income derived from the use, enjoyment or exploitation of rights, such as the right to extract natural resources, or to exploit inventions, production processes, trademarks and copyrights (except when the author of the work derives income in connection with his/her own work). According to Brazilian legal doctrine,[13] the law only affords "examples" of royalty payments. In this sense, any amounts due with respect to the exploitation of rights not explicitly listed in the relevant provision will also be characterized as royalties.

Article 12 of Brazil's tax treaties states that the term "royalties" includes payments in consideration for information concerning industrial, commercial or scientific experience (know-how).[14] In addition, there are interpretative protocols to a number of treaties indicating that the term "royalties" also includes payments in consideration for technical assistance or technical services. In any event, whenever Federal Law no. 4,506/64 employs the term "royalties," it does so in accordance with the concept contained in Article 22 of that Law, and therefore does not include payments for know-how or technical services/assistance. The extension of the royalty concept to encompass such payments is therefore restricted to transactions involving residents of treaty partner countries.[15]

> "Any amounts due with respect to the exploitation of rights not explicitly listed in the relevant provision will also be characterized as royalties."

Royalties payable to a nonresident beneficiary are generally subject to WHT at the rate of 15% if the nonresident is *not* located in a tax haven. Where royalties are payable to a beneficiary resident in a tax haven, WHT is generally levied at an increased rate of 25%.[16]

As noted in I.B., above in connection with interest, a nonresident will probably not obtain any relevant benefit by resorting to the terms of one of Brazil's tax treaties, as Brazil's domestic tax laws generally establish a tax regime that is either comparable to, or more advantageous than, that agreed to by Brazil in its treaties with regard to royalties.

In addition to being subject to WHT, royalty payments are also subject to taxation in Brazil by way of a special additional contribution on intervention in the economic domain (*Contribuição de Intervenção no Domínio Econômico* or CIDE), which is levied at the rate of 10%.[17] The economic burden of this tax is generally borne not by the foreign beneficiary of the royalty payments, but by the local (Brazilian) exploiter of the rights with respect to which the royalties are paid. Royalty payments are thus taxable in Brazil at rates that may reach as high as 25% (or even 35% if the foreign beneficiary is resident in a tax haven jurisdiction), the portion relating to the CIDE not being subject to any treaty protection.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

No category of royalty is reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs. Brazil generally retains source-country taxation rights with regard to *gross* income, i.e., there are no rules that would provide for any royalty to be taxable in a reduced amount, grant any allowances or otherwise account for the recognition of possible costs associated with earning royalties.

II. Residence Country Taxation

A. Dividends and Similar Payments

Before addressing the issue of whether Brazilian tax law protects Brazilian residents from economic or juridical double taxation resulting from the imposition of source country tax, it is worth commenting on how foreign-source items of income are taxed in Brazil.

Until December 31, 1995, foreign-source income (i.e., profits and capital gains) derived by Brazilian corporate taxpayers, either directly or through branches, or controlled or associated entities (*sociedades controladas ou coligadas*), were not subject to Brazilian corporate income tax (CIT).[18] In addition, investments held in related entities (whether foreign or domestic) had to be accounted for using the Equity Method of Accounting (*Método de Equivalência Patrimonial* or EMA) and the profits or losses derived therefrom (the "EMA results") were not included in the Brazilian controlling entity's taxable income.[19]

As from January 1, 1996, however, a number of changes were implemented with the purpose of making foreign-source income and capital gains taxable. A number of statutory provisions were enacted one after another, ranging from provisions that recognized that profits derived by a foreign related entity would only be taxable if "made available" (i.e., upon payment, credit, delivery, use or remittance of the foreign-source profits) to its Brazilian controlling entity, to provisions that determined that profits derived by a foreign related entity would become taxable in Brazil "as if" they had been made available to its Brazilian controlling entity (i.e., it would suffice for taxability in Brazil that the profits derived by the foreign related entity were accounted for by its Brazilian controlling entity – whether or not there had been an effective distribution of profits). The statutory provisions on the taxation of foreign-source income have evolved over time and Federal Law no. 12,973, of May 13, 2014[20] currently contains the applicable rules.

In general terms, in the case of controlled companies (*sociedades controladas*), the provisions apply to each directly or indirectly controlled entity. Any investment in such a controlled foreign company (CFC) must be adjusted yearly to reflect the change in the value of the investment that corresponds to the profits or losses of the (directly and/or indirectly) CFC. The change in the value of the investment must be recognized in proportion to the Brazilian parent's participation in the CFC's equity, so that the portion of the parent's EMA results relating to the profits earned by the CFC, calculated in accordance with the local accounting standards of the jurisdiction in which the CFC is located, is subject to Brazilian CIT.

In the case of affiliated companies (*sociedades coligadas*), the law generally does not take into account the Brazilian entity's EMA results relating to the profits earned by the affiliated company, but rather focuses on the profits distributed (credited or paid out) by the affiliate. As such, any profits earned by a Brazilian entity through a foreign affiliate will generally only be taxable in Brazil on December 31 of the year in which they were actually distributed to the Brazilian entity.

While, on the one hand, a Brazilian resident company is taxed on its worldwide income, on the other, the company may take foreign tax credits against its Brazilian CIT liability for taxes paid abroad on the profits, income and capital gains that it earns. This will be explained in further detail below.

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Brazil generally allows foreign tax credits to be taken for taxes levied and paid in other countries.

The relevant statutory provisions apply to income earned abroad either: (1) directly by a Brazilian corporate taxpayer (royalties, interest, capital gains, etc.);[21] or (2) indirectly through branches, or controlled or associated entities (profits).[22] With regard to (2), foreign tax credits may be available not only with respect to the foreign WHT levied by the source country (the "Direct foreign tax credit"), but also with respect to the CIT paid by the CFC in its country of residence (the "Indirect foreign tax credit").

The "Direct foreign tax credit" is available if and when dividends are paid out by a foreign investee, be it a CFC or an associated entity. In this context, a Brazilian parent may claim a credit against the foreign WHT imposed by the source country.

The "Indirect foreign tax credit" is available only in connection with the CIT paid by a *CFC*. The credit is not necessarily available at the time the CFC pays out dividends, but rather when the Brazilian parent becomes liable to tax on the portion of its EMA results relating to profits earned by the CFC (i.e., on December 31 of each fiscal year).

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

Brazil does not have a set of rules for determining the source of a particular item of income for purposes of imposing a foreign tax credit limitation. Indeed, the foreign tax credit limitation is *not* computed separately for passive and general income.

The foreign tax credit may not exceed the difference between: (1) the Brazilian CIT calculated by the Brazilian parent without including foreign income; and (2) the Brazilian CIT calculated on a taxable basis that includes foreign income (i.e., the amount of the foreign tax credit may not exceed the amount of tax that Brazil imposes on the foreign income).[23]

Domestic CIT is imposed on foreign income at the same rate as that at which it is imposed on other types of (domestic) income, so there is no rule requiring any reduction of the foreign tax credit amount on the grounds of any rate differential.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Any excess foreign tax credit resulting from the calculation described in II.A.2., above cannot be carried forward for set off in subsequent years.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

Any excess credit derived from the fact that the Brazilian resident company concerned has an overall loss *can* be carried forward for set off in subsequent years.[24]

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

See the general principles described in II.A.1, above, without regard to the comments made in relation to the CFC rules.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

See the general principles described in II.A.1, above, without regard to the comments made in relation to the CFC rules. There are no categories of royalties that are treated differently from others.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

The authors believe that conflicts of income classification between a tax treaty and domestic law should be resolved in accordance with the classification of the income adopted by the treaty Contracting State that is the source country with respect to the income concerned.

According to Brazilian domestic civil law, the law applicable to an agreement is the law of the place where the agreement was executed, i.e., where the relevant obligation was established.[25] Furthermore, the Brazilian tax authorities have already confirmed the view expressed by the OECD by giving priority to the classification of income adopted by the source country.[26]

In addition, there are precedents and rulings in which the classification of income adopted by Brazil (as the source country) has prevailed, irrespective of the interpretation adopted by the residence country.[27]

In short, when applying a tax treaty, Brazil will have the right to determine the classification of income in accordance with its domestic tax law when it is the source country; conversely, when it is the residence country, Brazil will have to accept the classification adopted by the source country and respect the corresponding tax treatment (and grant the applicable exemption or credit).

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Brazil generally follows the view expressed in the international tax doctrine to the effect that the application of a tax treaty should never result in a higher tax burden than would result from the direct application of the relevant domestic law.

Brazilian scholars have endorsed this view and indicated that tax treaties neither expand the scope of domestic law nor create a claim that otherwise would not exist as a matter of domestic law. In other words, treaties do not perform a "positive function" by allowing countries to impose tax on a particular item of income, but rather perform the "negative function" of limiting the taxing powers of the Contracting States founded on their respective domestic laws.[28]

IV. Conclusion

In considering situations in which Brazil is the source country, the issue of double taxation should not be a concern with regard to Brazilian-source dividend payments, as these are currently exempt from WHT as a matter of Brazilian domestic law, regardless of the nature of the beneficiary (i.e., whether an individual or a legal entity) and its country of residence.

As regards Brazilian-source interest and royalties, such payments are currently taxed by Brazil at the rate of 15%, which is generally within the limit established by Brazil's tax treaties; such payments are only subject to WHT at a higher rate (of 25%) when the beneficiary is resident in a tax haven jurisdiction (a tax treaty would potentially reduce the WHT on payments made to residents in tax haven jurisdictions, from 25% to the general 15% rate, but Brazil has not yet signed any tax treaties with tax havens).

Specifically with regard to royalty payments, Brazil levies an additional tax, known as the CIDE, at the rate of 10%, the economic burden of which generally falls on the local (Brazilian) exploiter of the rights giving rise to the royalty payments (and not on the foreign beneficiary of the payments). This additional tax can represent a genuine extra liability, since the CIDE is not within the scope of the taxes covered by Brazil's tax treaties and consequently cannot give rise to any tax credit in the country of residence of the royalty recipient.

When it is the residence country, Brazil generally imposes its CIT on foreign income at the same rate as on other types of (domestic) income, whether the income is earned abroad directly by a Brazilian corporate taxpayer (royalties, interest, capital gains, etc.) or indirectly through a branch, or a controlled or an associated entity (profits). No rate differentiation applies in relation to any particular item or source (domestic or foreign) of income, i.e., CIT is levied at the regular combined rate of 34% on all income.

Double taxation relief is provided by means of foreign tax credits for taxes paid in the source country—not only the foreign WHT levied by the source country (the "Direct foreign tax credit"), but also the CIT paid by a CFC in its foreign country of residence (the "Indirect foreign tax credit"). Nor is there any rate differentiation when computing the foreign tax credits that may be taken in relation to different items of income.

The amount of the foreign tax credit may not exceed the amount of tax that Brazil generally imposes on the relevant foreign income and there is no carryforward of excess credits in that regard. Carryforwards to subsequent years are only allowed in the event the taxpayer has an overall loss in a particular year.

By way of a final remark, the authors believe that conflicts of income classification between treaties and domestic law should be resolved in accordance with the classification of the income adopted by the treaty Contracting State that is the source country and that tax treaties should not result in a higher tax burden than would result from the direct application of the relevant domestic law.

NOTES

[1] Federal Law no. 9,249, of Dec. 26, 1995, Art. 10. The tax exemption is granted to the extent dividends are paid out of profits generated on or after Jan. 1, 1996.

[2] Brigagão, Gustavo; Pepe, Flavia Cavalcanti. Neutralizing Hybrid Financial Instruments – Selected Tax Policy Issues. In: *Estudos de tributação internacional*. Rio de Janeiro: Lumen Juris, 2017.

[3] Mosquera, Roberto Quiroga. O Regime Jurídico-tributário das Participações Societárias – Ganho de Capital, Juros sobre o Capital Próprio e Dividendos. In: *O Direito Tributário e o Mercado Financeiro e de Capitais*. São Paulo: Dialética, 2009, p. 427.

[4] Although there is some discussion among Brazilian scholars as to whether JCP should be regarded as interest or dividends for purposes of the application of Brazil's tax treaties. See, e.g., Xavier, Alberto. Direito Tributário Internacional do Brasil, 8th Ed. Rio de Janeiro: Forense, 2015, pp. 716-717.

[5] Federal Law no. 9,249/95, art. 9.

[6] Other than the credit risk associated with any lender, at any given time.

[7] Comparato, Fábio Konder. Direito Empresarial: Estudos e Pareceres. São Paulo: Saraiva, 1990, p. 164; Mosquera, Roberto Quiroga, *op. cit*.

[8] The term "tax haven" (*jurisdição com tributação favorecida*) is defined in Federal Law no. 9,430/96, Art. 24, and Ordinance (*Portaria*) no. 488, issued by the Brazilian Ministry of Finance on Nov. 28, 2014.

"Tax havens" include countries: (1) that do not impose income tax or impose income tax at a rate lower than 17%; and (2) whose legislation does not allow access to information relating to companies' shareholding structures, to persons holding shareholder's rights or to the identity of the beneficial ownership of income attributable to nonresidents.

[9] Decree no. 3,000, of Mar. 26, 1999 (the current Income Tax Regulations – ITR), arts. 682 and 685, I and II.

[10] Brazil currently has income tax treaties with the following 33 countries: Argentina, Austria, Belgium, Canada, Chile, China (PRC), Czech Republic, Denmark, Ecuador, Finland, France, Hungary, India, Israel, Italy, Japan, Korea (ROK), Luxembourg, Mexico, the Netherlands, Norway, Peru, the Philippines, Portugal, Russia, Slovakia, South Africa, Spain, Sweden, Trinidad and Tobago, Turkey, Ukraine and Venezuela. Brazil had a tax treaty with Germany that was terminated in 2006.

On May 3, 2018, Brazil was set to sign a tax treaty in Switzerland, the text of which would subsequently be subject to the internal ratification process in the Brazilian Legislative branch.

[11] *See* Brazil-Japan tax treaty, Art. 10(2) and corresponding Protocol, Art. 2.

[12] Federal Law no. 4,506, of Nov. 30, 1964, Art. 22.

[13] See, e.g., Leonardos, Gabriel Francisco. Tributação da Transferência de Tecnologia, Rio de Janeiro: Ed. Forense, 1997, p. 107.

[14] Art. 12(2) of Brazil's tax treaties generally reads as follows:

2. The term "royalties" as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

(. . .)

[15] Be that as it may, the authors would like to emphasize that the discussion as to the extension of the concept of "royalties" does not generally arise in a cross-border context, but only in a domestic context in relation to determining the deductibility of the corresponding expenses for the Brazilian payer of the royalties.

The relevant rules are consolidated in ITC, Arts. 351 to 355, the scope of which is narrower, as they only limit the deductibility of royalties paid in connection with the use of (or the right to use) patents, processes or formulae, as well as payments for technical assistance. The deductibility of the relevant costs/expenses is limited to certain percentages, depending on the type of industry or trade involved.

Hence, payments in consideration for technical services would arguably not be subject to the above limitations, their deductibility still being determined by reference to the general standards laid down in ITR, Art. 299 (such payments must be: (1) necessary and required for the activities of the company/payer and for the maintenance of its productive sources of income; and (2) usual or normal, given the kind of transactions carried out by the company/payer).

[16] ITR, Arts. 682 and 685, I and II.

[17] Federal Law no. 10,168, of Dec. 29, 2000, Art. 2.

[18] Generally understood as encompassing both the *Imposto de Renda da Pessoa Jurídica* (IRPJ) and the *Contribuição Social sobre o Lucro Líquido* (CSLL), levied at the combined rate of 34% on a Brazilian resident company's taxable income.

[19] Federal Law no. 6,404, of Dec. 15, 1976, Art. 248; Decree-Law no. 1,598, of Dec. 26, 1977, Art. 23, sole para.; Decree-Law no. 1,648, of Dec. 18, 1978, Art. 1, IV.

[20] Federal Law no. 12,973, of May 13, 2014, Arts. 76 *et seq*.

[21] Federal Law no. 9,249/95, Art. 26; ITR, Art. 395. Supplemental provisions are contained in Normative Instruction no. 213, of Oct. 7, 2002. Normative Instruction no. 213/02, paras. 1 to 15 of art. 14, provide details on the rules and procedures to be followed by Brazilian legal entities for the enjoyment of FTCs. In addition, such paragraphs provide a few requirements/limitations which were not expressly provided by Federal Law no. 9,249/95.

[22] Federal Law no. 12,973/14, Arts. 87 and 88; Normative Instruction no. 1,520, of Dec. 04, 2014, Arts. 25 to 29.

[23] Normative Instruction no. 213/02, Art. 14, paras. 10 and 11. Normative Instruction no. 1,520/14, Arts. 25, 26 and 30, paras. 8 to 11.

[24] Normative Instruction no. 213/02, Art. 14, para. 15. Normative Instruction no. 1,520/14, Art. 30, para. 14.

[25] Decree-Law no. 4,657, of Sept. 04, 1942 (the Introductory Law to the rules of Brazilian law), as amended, Art.

9. In the original wording: "*Art. 9. Para qualificar e reger as obrigações, aplicar-se-á a lei do país em que se constituírem*."

[26] The position adopted by the OECD is based on the analysis of OECD Model Convention, Arts. 3(2), 23A and 23B.

In general terms, Art. 23A deals with the Exemption Method, which states that whenever the source State is able to tax income of a resident of the other Contracting State *in accordance with the provisions of the Convention*, the residence State must exempt such income from tax. In turn, Art. 23B deals with the Credit Method, according to which whenever the source State is able to tax income of a resident of the other Contracting State *in accordance with the provisions of the Convention*, the residence State must allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State.

The highlighted expression is key to understanding the OECD line of argument, in the sense that, whenever the source State applies a tax treaty based on its own domestic law according to Art. 3(2) – and thus taxes income – such State is exercising its taxing rights "in accordance with the provisions of the Convention." In this case, the residence State, in applying Article 23, would allow an exemption or a credit, regardless of whether it agrees with the classification of the income concerned adopted by the source State. In other words, the mechanics behind the exemption and credit methods lead to the conclusion that the source State has precedence with regard to the classification of income, leaving the residence State no room for re-discussing the nature of the relevant payment, but rather only with providing the exemption/credit availed of by its resident under the treaty.

[27] See, e.g., Private Letter Ruling no. 31, of March 4, 2002. Be that as it may, the authors have been unable to locate any precedent in which Brazil was acting as the residence State.

[28] See, e.g., quoting renowned scholars such as Philip Baker and Klaus Vogel, Xavier, Alberto. *op. cit.*, p. 128.

CANADA: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

An actual or deemed dividend paid or credited by a corporation resident in Canada (CRIC) to a nonresident will be subject to 25% Canadian withholding tax on the gross amount of the dividend, unless a lower treaty rate applies.[1]

Canada's bilateral income tax treaties generally provide lower rates of withholding tax where the payee is a resident of the other treaty country and entitled to full benefits under the relevant treaty. While those rates vary by treaty, in general they are:

- 5% if the payee is a corporation that beneficially owns the dividend and holds at least 10% of the voting stock of the CRIC; and
- 15% in any other case.

The CRIC will generally be required to withhold the applicable withholding tax from the actual or deemed dividend payment and remit it to the Canada Revenue Agency (CRA) for the payee's account.[2] Directors of the CRIC can be personally liable for any unremitted tax, plus penalties, for non-compliance by the CRIC.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

For Canadian income tax purposes, a dividend generally has its common law meaning of "any distribution by a corporation of its income or capital made *pro rata* among its shareholders"[3] other than, presumably, a return of capital.

The Canadian Tax Act also defines a "dividend" to include "a stock dividend (other than a stock dividend that is paid to a corporation or to a mutual fund trust by a nonresident corporation)."[4] Certain other amounts or payments are also deemed to be dividends for withholding tax purposes, including, in particular:

- any interest payment by a CRIC to a nonresident in excess of Canadian thin-capitalization limits;[5]
- any increase in the "paid-up capital" with respect to a share of the capital stock of a CRIC in excess of any corresponding increase in the CRIC's net assets, or reduction of its net liabilities or contributed surplus;
- any amount distributed or otherwise appropriated to, or for the benefit of, the holders of a class of shares in the capital stock of a CRIC on the winding up, discontinuance, or reorganization of the CRIC's business in excess of any reduction of the paid-up capital of that class on the distribution or appropriation;[7]
- any amount paid by a CRIC on the redemption, cancellation or acquisition of a share of its capital stock in excess of the paid-up capital of that share;[8] and
- any amount paid by a CRIC on the reduction of the paid-up capital with respect to a class of shares of its capital stock that exceeds the amount by which the paid-up capital of that class is thereby reduced.[9]

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Lastly, Canadian foreign affiliate dumping rules frequently will deem an "investment" (broadly defined) by a CRIC in a foreign affiliate of the CRIC (or of another corporation with which the CRIC does not deal at arm's length) when the CRIC in turn is or becomes controlled by a nonresident corporation to be a dividend paid to the nonresident parent.[10] Canadian foreign affiliate dumping rules are expansive and complex, and frequently apply with adverse results to transactions that would not normally be regarded as offensive or abusive. While a discussion of these rules is beyond the scope of this article, professional advice should be obtained when there is any concern that they might apply.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Canadian income tax law makes no provision for such a reduction with respect to a dividend paid by a CRIC to a nonresident.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Canadian income tax law makes no provision for any such coordination with respect to a dividend paid by a CRIC to a nonresident.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Canadian income tax law makes no provision for any such reduction or exemption with respect to a dividend paid by a CRIC to a nonresident.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

The Canadian income tax rules applicable to a dividend paid or deemed to be paid by a CRIC to a foreign holding corporation are as described above. In particular, Canadian income tax rules do not permit a Canadian foreign tax credit to be set off against Canadian withholding tax on an outbound dividend, regardless of whether the CRIC is otherwise unable to use the foreign tax credit because of an exemption from Canadian tax on inbound dividends.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of interest or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Canada generally does not levy withholding tax on interest paid or credited by a Canadian resident debtor to a nonresident unless either:

- The interest is not "fully exempt interest" and is paid or payable to a person with whom the payer does not deal at arm's length; or
- The interest is "participating debt interest."[11]

"Fully exempt interest" generally includes interest on a debt issued by a Canadian federal, provincial or municipal government, interest on a mortgage secured by real property situated outside Canada provided the interest is not deductible by the payer under Part I of the Canadian Tax Act, and interest on a debt issued by a "prescribed international organization or agency."[12]

"Participating debt interest" generally includes interest any portion of which is contingent or dependent on the use of, or production from, property in Canada, or is computed by reference to revenue, profit, cash flow, commodity price, or any other similar criterion, or by reference to dividends paid or payable on the shares of a corporation.[13]

If either exception applies, 25% Canadian withholding tax will apply to the gross amount of the interest payment, unless a lower treaty rate applies.

Currently, only the Canada-United States tax treaty provides a full exemption from Canadian withholding tax on a payment of interest to a nonresident with which the Canadian payer does not deal at arm's length[14] and then only if the interest is not participating interest described in Article XI(6)(b) of the treaty. Most other Canadian bilateral income tax treaties provide for a reduced rate of Canadian withholding tax on outbound interest payments, generally 10 or 15%.

The Canadian Tax Act contains "back-to-back" rules that can reduce or eliminate treaty benefits in a variety of outbound back-to-back loan structures undertaken to access reduced withholding rates.[15]

Interest paid by a CRIC to a non-arm's length nonresident that exceeds Canadian thin-capitalization limits (roughly 60:40 debt-to-equity) is deemed to be a dividend, and subject to Canadian dividend withholding tax rules.[16] (Similar rules apply to interest paid by a Canadian resident trust to a nonresident that, alone or together with persons with which the nonresident does not deal at arm's length, holds a 25% or greater beneficial interest in the trust. In this case, the trust may designate the denied interest to be an income distribution to a nonresident beneficiary,[17] which will result in 25% (or lower treaty rate, if applicable) Canadian withholding tax on the denied interest.)

2. How is 'interest' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

The Canadian Tax Act does not define "interest." Interest is generally understood at common law to satisfy three criteria:

- It must be calculated on an accrual, usually day-to-day, basis;
- It must be calculated on a principal amount or a right to a principal amount; and
- It must be compensation for the use of the principal amount or the right to use the principal amount.[18]

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount of interest by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Canadian income tax law makes no provision for such a reduction with respect to interest paid by a Canadian resident to a nonresident.

4. Nonresidents with losses: does your tax system provide any coordination of the gross (withholding) tax on interest paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Canadian income tax law makes no provision for any such coordination with respect to interest paid by a Canadian resident to a nonresident.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Canadian income tax law makes no provision for any such reduction or exemption with respect to interest paid by a Canadian resident to a nonresident.

6. How does your domestic law deal with interest payments to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound interest payments when such foreign tax credits cannot be otherwise used because of the exemption of inbound interest?

The Canadian income tax rules applicable to interest paid by a Canadian resident to a nonresident are as described above. In particular, Canadian income tax rules do not permit a Canadian foreign tax credit to be set off against Canadian withholding tax on an outbound interest payment. There is no exemption from Canadian tax on inbound interest payments.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

A royalty paid or credited by a Canadian resident to a nonresident:

- for the use of or right to use in Canada any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process, or other thing whatever;
- for information concerning industrial, commercial, or scientific experience if the payment is wholly or partly dependent on the use to be made of or the benefit to be derived from the information, production or sales of goods or services, or profits;
- for the nonresident's agreement not to use any of the above;
- for services of an industrial, commercial, or scientific character if the payment is wholly or partly dependent on the use to be made of or the benefit to be derived from those services, production or sales of goods or services, or profits; or
- that was dependent on the use of or production from property in Canada, even if it is an installment of the sale price for the property,

will generally be subject to 25% Canadian withholding tax on the gross amount of the royalty payment,[19] unless a lower treaty rate applies.

The Canadian Tax Act provides for a number of exceptions to withholding tax on royalties, including in particular:

- a royalty or similar payment on or with respect to the copyright relating to the production or reproduction of a literary, dramatic, musical or artistic work;
- a payment under a *bona fide* cost-sharing arrangement with respect to research and development (R&D) expenses in exchange for an interest in the results of the R&D; and
- a payment to an arm's-length nonresident if the amount is deductible in computing the payer's income from a business carried on by the payer outside Canada.

Canada's bilateral income tax treaties generally provide lower rates of withholding tax on royalties where the payee is a resident of the other treaty country and entitled to full benefits under the relevant treaty. While those rates vary by treaty, in general they are 10 or 15%.

Many of Canada's bilateral income tax treaties exempt certain royalties altogether from Canadian withholding tax. For example, the Canada-United States tax treaty exempts:

- copyright royalties with respect to the production or reproduction of literary, dramatic, musical or artistic work (other than movies and film, video or other means of reproduction for use on television);
- payments for the use of or right to use computer software;

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- payments for the use of or right to use a patent or information concerning industrial, commercial or scientific experience; and
- broadcast payments if covered in an exchange of diplomatic notes.[20]

Canadian "back-to-back" rules can also apply to outbound royalty structures intended to access reduced Canadian withholding tax rates that, if applicable, can reduce or eliminate treaty benefits in a variety of back-to-back royalty structures.[21]

As with dividends and interest, Canadian income tax rules do not permit a nonresident to reduce the taxable amount of a royalty by any expense, or to "coordinate" gross withholding tax on royalties to reflect any losses of the nonresident payee. There are no special rules applicable to royalties paid to a nonresident holding company that differ from the rules described above.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

Canadian income tax rules do not have any such category of royalty.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Canada uses several different unilateral mechanisms to protect residents from double taxation resulting from source-country tax with respect to inbound dividends. Which mechanism is used will depend on the relationship between the nonresident corporation and the resident, and the character of the nonresident's income.

In all cases, Canada will require the Canadian resident to include any dividend received from a nonresident corporation in income in the year of receipt.[22] Mitigation of double taxation then occurs fundamentally via one of two mechanisms:

- In the case of a dividend from a "foreign affiliate" or "controlled foreign affiliate" of a Canadian resident (roughly, a nonresident corporation in which the resident has a 10% or more, or a more than 50%, interest, respectively), a system of direct or indirect deductions from income intended to serve as an approximate proxy for the Canadian tax that would have been paid had the resident earned the foreign income directly rather than through the foreign affiliate or controlled foreign affiliate; and
- In all other cases, a foreign tax credit by which a credit against Canadian tax is provided for foreign tax paid by the Canadian resident.

a. Foreign accrual property income of a controlled foreign affiliate

A Canadian resident must include in income for a year the resident's share of the "foreign accrual property income" (FAPI) for the year of a controlled foreign affiliate of the resident[23] regardless of whether the resident is paid or receives any part of its share of the FAPI in the year, and may deduct a calculated amount with respect to any "foreign accrual tax" paid by the controlled foreign affiliate on its FAPI.[24]

If the controlled foreign affiliate subsequently pays a dividend of its FAPI to the Canadian resident, the resident will be required to include the amount of the dividend in income but will generally be entitled to claim an equivalent deduction so that it pays no further Canadian income tax[25].

If the resident is a corporation, it will also generally be entitled to deduct any foreign withholding tax that it pays on the dividend.[26] In any other case, the resident will generally be entitled to a foreign tax credit with respect to such tax (see II.A.1.c., below), subject to certain limitations discussed below.

b. Foreign active business income of a foreign affiliate

A different set of rules applies to the Canadian taxation of the active business income (i.e., non-FAPI) of a foreign affiliate of a Canadian resident.

Under these rules, Canada does not tax the resident's share of the foreign affiliate's foreign active business income on an accrual basis, but instead defers Canadian taxation until the foreign affiliate pays a dividend to the resident. At that time the resident is required to include the dividend in the resident's income on receipt.

If the resident is a corporation, double taxation is then mitigated in Canada by a deduction with respect to the dividend. The deduction rules vary depending on the source of the foreign affiliate's active business income. Very generally:

- If the income was earned in a country with which Canada has a bilateral income tax treaty or a tax information exchange agreement ("exempt surplus"), the resident corporation will be entitled to deduct the full amount of the dividend[27] and thus will pay no Canadian corporate tax on it, but will not be entitled to any further deduction with respect to any foreign withholding tax that it pays on the dividend;
- If the income was earned in any other country ("taxable surplus"), the resident may be allowed a deduction with respect to "underlying foreign tax," if any, up to the lesser of the amount of the dividend and a calculated proxy amount intended to approximate the Canadian corporate tax that the resident would have paid had it earned the income directly,[28] and will generally also be entitled to deduct any foreign withholding tax that it pays on the dividend;[29] and
- In either case, the resident corporation may elect to deem the dividend to be paid out of "pre-acquisition surplus," in which case it will be entitled to a full deduction[30] from income, but will also be required to reduce its "adjusted cost base" (ACB) in its shares of the foreign affiliate by the same amount, which may result in a capital gain to the extent the ACB thereby becomes a negative amount.

c. Foreign tax credits

In any case not described in II.A.1. a. or b., above, the Canadian resident will generally be entitled to a foreign tax credit with respect to any foreign withholding tax that it pays on an inbound dividend.[31] If the resident is an individual (including most trusts), his or her foreign tax credit will be limited to 15% of the dividend, but he/she should be entitled to claim any foreign withholding tax in excess of that amount as a deduction against income.[32] If the resident is a corporation, it may elect to deduct some or all of the foreign withholding tax against its income rather than claim the amount as a foreign tax credit.[33]

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

In general, see II.A.1., above.

Regardless of the applicable tax credit or deduction mechanism, as a general proposition, Canadian income tax rules are designed to limit Canadian relief with respect to foreign tax to the amount of Canadian tax (or an approximate proxy for it) that would have been paid if the amount had been earned directly.

Canadian income tax rules governing the computation of FAPI and foreign active business income, and the allocation of foreign accrual tax or underlying foreign tax to those amounts, are extremely complex and well beyond the scope of this article.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in II.A.2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Corporate deductions with respect to dividends from a foreign affiliate or a controlled foreign affiliate cannot exceed the amount of the dividends, and so should not generate a loss that can be applied to other taxation years.

Canadian foreign tax credits with respect to foreign withholding tax on dividends cannot be carried forward or back to be applied in other years.

A Canadian resident that is required or chooses to deduct a portion of foreign withholding tax against income as discussed above rather than claiming a foreign tax credit may thereby generate a non-capital loss. In general, a non-capital loss may be deducted against income from any source in any of the three preceding, or 20 following, taxation years.[34]

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

See II.A.1-3., above.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The elaborate system described above with respect to dividends does not apply to a payment of interest from a nonresident to a Canadian resident.

Canadian relief from double taxation with respect to an inbound interest payment is provided through Canada's foreign tax credit system. A Canadian resident that receives an interest payment from a nonresident payer will generally be required to include the amount of interest in income in the year in which it is received, and be entitled to claim a foreign tax credit with respect to it.

If the interest payment is not considered to be part of the resident's income from a business that it carries on in a foreign country, the foreign tax credit rules will be as described in II.A.1.c., above with respect to dividends.

If the interest payment is considered to be part of the resident's income from a business that it carries on in a foreign country, the resident will be entitled to claim a foreign tax credit equal to the lesser of:

- The tax that the resident paid to the foreign country on the resident's income for the year from its businesses carried on in that country plus its "unused foreign tax credit" with respect to that country for any of its three preceding or 10 following taxation years; and
- That portion of its Canadian tax otherwise payable that its income from businesses in the foreign country (subject to certain adjustments) is of its income from all sources for the year.[35]

The resident's unused foreign tax credit with respect to a foreign country for a year is the amount by which the business income tax that the resident paid to the foreign country for the year exceeds the Canadian foreign tax credit claimed by the resident with respect to the foreign country for the year.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Inbound royalty payments into Canada would generally be treated in the same way as inbound interest payments as described in II.B., above.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

In general, the terms of a Canadian bilateral income tax treaty will prevail over a conflicting Canadian domestic provision. This typically arises under the particular Act of the Canadian Parliament by which a particular treaty is enacted and given the force of law in Canada. For example, subsection 2(2) of the Canada-United States Tax Convention Act (Canada) by which the Canada-United States tax treaty was enacted states that "[i]n the event of any inconsistency between the provisions of this Act, or the Convention, and the provisions of any other law, the provisions of this Act and the Convention prevail to the extent of the inconsistency."

Section 3 of the Income Tax Conventions Interpretation Act (Canada) stipulates that a term in a treaty that is not defined in the treaty, or only partly defined in it, or that is to be defined by reference to Canadian law, has the meaning of that term under the Canadian Tax Act from time to time. The same Act contains a miscellany of relatively minor rules that, where applicable, dictates the meaning of certain terms in Canadian bilateral income tax treaties.

Virtually all of Canada's bilateral income tax treaties permit a taxpayer to seek competent authority review if the taxpayer considers that the action of either (or both) treaty partner(s) will result in taxation of the taxpayer that is not in accordance with the applicable treaty. Generally, the taxpayer is required to submit a written application for review to the competent authority of the taxpayer's country of residence, which, if it is unable to resolve the issue unilaterally, must submit the matter to the competent authority of the other treaty partner for resolution by mutual agreement.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

While one would never want to say that this could never arise, in principle it should be extremely rare, as historically the fundamental principle underlying all Canadian bilateral income tax treaties is the avoidance of double taxation.

NOTES

[1] Subsection 212(2). All statutory references are to the Income Tax Act (Canada) (the "Canadian Tax Act") as currently in force unless otherwise indicated.

[2] Subsection 215(1).

[3] *Marshall*, 2011 TCC 497 at 16.

[4] Subsection 248(1).

[5] Subsection 214(16).

[6] Subsection 84(1). Certain other exceptions to this rule may apply in specific circumstances. The "paid-up capital" with respect to the share of capital stock of a CRIC is generally the capital of the share under applicable corporate law, subject to reduction if shares of that class have been issued in the course of certain tax-deferred transactions: section 89.

[7] Subsection 84(2).

[8] Subsection 84(3).

[9] Subsection 84(4).

[10] Section 212.3.

[11] Paragraph 212(1)(b).

[12] Subsection 212(3).

[13] Subsection 212(3).

[14] Canada-United States tax treaty, Art. XI(1).

[15] Subsections 212(3.1)-(3.8).

[16] Subsection 214(16).

[17] Subsection 18(5.4).

[18] *Miller*, 85 DTC 5354 (TCC) at 8-9. The CRA accepts this definition of interest: Income Tax Folio S3-F6-C1, "Interest Deductibility" at 1.1.

[19] Paragraph 212(1)(d).

[20] Canada-United States tax treaty, Art. XII(3).

[21] Subsections 212(3.9)-(3.94).

[22] Subsection 90(1).

[23] Subsection 91(1). FAPI generally includes income from property, income from investment businesses and most capital gains.

[24] Subsection 91(4).

[25] Subsection 91(5) and paragraph 113(1)(b).

[26] Paragraph 113(1)(c).

[27] Paragraph 113(1)(a).

[28] Paragraph 113(1)(b)

[29] Paragraphs 113(1)(c).

[30] Subsection 92(2) and paragraph 113(1)(d).

[31] Subsection 126(1).

[32] Subsection 20(11).

[33] Subsection 20(12).

[34] Paragraph 111(1)(a).

[35] Subsections 126(2) and (2.1).

DENMARK: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Dividends are generally taxed at source, with the dividend-paying entity being obliged to withhold dividend tax at the rate of 27%. Denmark's tax treaties are generally based on the OECD Model Convention, which ensures the source country's right to tax a dividend but also in many cases reduces the tax rate applicable to dividends paid to nonresident corporate shareholders, typically to 15% (but in some cases to a lower rate). Where the taxation of Danish-source dividends is reduced under the terms of an applicable tax treaty, tax is withheld at the domestic law rate and the nonresident recipient of the dividends must apply for a refund.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Under the Danish law definition, any distribution, whether in kind or in cash, from a company to its shareholders is deemed to be a dividend and taxed accordingly.

Dividend taxation applies to any and all income items characterized as a dividend for tax purposes. As Denmark does not tax capital gains from the sale of shares in Danish companies, a number of anti-avoidance rules are in place to ensure that dividend taxation is not avoided by using instruments that would otherwise result in the realization of capital gains on shares. For this reason, certain income items may be reclassified as dividends, including: liquidation proceeds, proceeds from the buy-back of shares, interest on hybrid loans, and certain sale proceeds where the shareholder retains some ownership of the entity whose shares it has sold. In these cases, characterization as a "dividend" is based primarily on objective factors such as: the type of entity (corporate or transparent/hybrid), the country of residence of the taxpayer (tax treaty or non-tax treaty country), and the ownership percentage.

Further, abuse doctrines developed by the courts (the rightful recipient and substance-over-form doctrines) may entail a payment being reclassified as a deemed (disguised) dividend distribution. However, the withholding obligation does not apply to such disguised dividend distributions.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

The withholding tax on dividends is in principle computed based on the gross amount declared, which precludes any deduction of expenses from the taxable basis. A number of decisions of the Court of Justice of the European Union (CJEU) suggest that this position may not be sustainable within the European Union, as denying nonresident taxpayers deductions similar to those awarded to resident taxpayers may violate the

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freedoms granted by the EU Treaty (specifically the freedom of establishment and the free movement of capital).

However, the denial of deductions to a nonresident taxpayer would not be in violation of the EU Treaty if similar deductions would not have been allowed to a Danish resident taxpayer. Danish tax law as developed through case law to a significant extent justifies the non-deductibility of expenses relating to dividend income, since, in the case of a resident taxpayer, such expenses are regarded as non-deductible expenses relating to the establishment or expansion of a business, or as expenses attributable to the acquisition price of the shares on which the relevant dividends are paid.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Danish tax law does not provide for any right to deduct other losses against Danish-source dividend income.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

There is no provision under Danish tax law to account for the non-utilization of foreign tax credits in the residence country.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Outbound dividends distributed by a Danish company to its foreign parent company are exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for the elimination or reduction of Danish withholding tax under the Danish law implementation of the EU Parent-Subsidiary Directive, or the terms of a tax treaty between Denmark and the parent company's country of residence. The exemption for dividends paid to parent companies also applies with respect to dividends paid on "group shares," i.e., where the parent holds directly less than 10% of the nominal share capital of the Danish company, but holds indirectly more than 50% of such capital.

Foreign tax credits may not be set off against the withholding tax on outbound dividends.

B. Interest and Similar Payments Related to Interest

1. If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends?

While Danish domestic law generally imposes withholding tax on dividends paid to a nonresident, Denmark does not generally impose withholding tax on interest paid to a nonresident. However, a 22% withholding tax does apply to interest payments made by a Danish company to a foreign related entity. For these purposes, a lender is a related entity if it owns or controls, directly or indirectly, more than 50% of the shares or voting rights in the Danish borrowing company.

The withholding tax does not apply if: (1) taxation is required to be reduced or waived under the terms of an applicable tax treaty or the EU Interest and Royalties Directive, (2) the creditor is controlled by a company situated in Denmark or a tax treaty country and the creditor is within the scope of Danish controlled foreign company (CFC) taxation, or (3) the interest is subject to tax in the creditor's country of residence at a rate of at least three quarters of the ordinary Danish flat corporate tax rate (i.e., at a rate of at least 16.5%) and no back-to-back loan arrangement is in place that results in taxation at a rate of less than three quarters of the ordinary Danish tax rate.

In essence, withholding tax on interest is levied only on group-related interest payments where the recipient is resident in a low-tax jurisdiction that is not an EU Member State and that has not signed a tax treaty with Denmark. The scope of Danish interest withholding tax is thus quite limited.

Withholding tax on interest may not be reduced by foreign expenses, losses, tax credits or the like.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Payments of Danish-source royalties to a nonresident recipient are liable to Danish withholding tax. However, Danish withholding tax on royalties does not apply to payments for the use of rights to literary, artistic or scientific work, for example, author's royalties, music royalties and motion picture royalties. The withholding tax rate on royalty payments is 22%.

Royalty taxation may be waived or reduced if the recipient qualifies under the EU Interest and Royalties Directive, or the terms of a tax treaty between Denmark and the recipient's country of residence.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

Withholding tax on royalties may not be reduced by foreign expenses, losses, tax credits or the like.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

As regards juridical double taxation (i.e., taxation of the same person on the same income in two different countries), Denmark grants unilateral relief for foreign tax paid in the form of an ordinary credit against the Danish tax due. Foreign tax paid on income may thus be credited against Danish tax on the same income, but the credit is limited to the lower of: (1) the foreign tax paid; or (2) the Danish tax payable on the foreign net income. Relief may be restricted to the tax that the foreign country is entitled to levy under an applicable tax treaty. Where a treaty is in effect, alternative relief may be granted pursuant to the methods allowed under that treaty.

No credit is available for foreign tax paid on a dividend that is exempt from Danish taxation.

Inbound dividends distributed by a foreign subsidiary (on a shareholding of at 10% or more) are generally exempt from Danish corporate income tax provided that: (1) the foreign subsidiary qualifies as a "company" under Danish law, (2) the foreign subsidiary is covered by the EU Parent-Subsidiary Directive or is resident in a country that has concluded a tax treaty with Denmark (under which the withholding taxation of dividends is reduced or waived), or (3) the Danish company and the foreign subsidiary qualify for international joint taxation (i.e., where the Danish company controls more than 50% of the votes in the foreign subsidiary) and the foreign subsidiary cannot deduct the dividend payments.

Dividends paid on portfolio shares (i.e., shareholdings of less than 10%) are taxable, but only to the extent of 70% of the dividend received.

As regards economic double taxation, Danish law does not generally provide for relief. However, an exception is made with regard to a dividend received from a subsidiary (where the shareholding is at least 10%) not covered by the tax exemption described above (i.e., a dividend received from a subsidiary resident in a non-tax treaty country outside the European Union). In such a case, Danish tax law provides for credit relief for any underlying taxes paid on the income out of which the distribution was made. The credit is equal to the Danish tax on the dividend but may not exceed the tax paid by the subsidiary.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

As indicated in II.A.1., above, relief is granted under Danish domestic law using the ordinary credit method. The credit is limited to the lower of the following two amounts: (1) the Danish tax levied on the foreign income concerned, or (2) the actual tax paid on that income in the foreign country concerned. Simply put, the aggregate taxes levied by Denmark and the foreign country on the foreign income can never be lower than the Danish taxes due on that income and, if the foreign tax exceeds the Danish tax on the income, the aggregate taxes due will exceed the Danish tax.

The foreign-source income relevant to the calculation of relief is determined according to Danish law (unless otherwise provided for in the applicable tax treaty, if any). In calculating the relief, the net income principle generally applies, which entails the foreign-source income being reduced by deductible expenses allocable to it. For these purposes, expenses directly related to the foreign income are deducted in full, whereas general expenses incurred by the entity in receipt of the income are allocated proportionally to the foreign income.

There will seldom be deductible expenses related to dividend income.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in II.A.2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Where there is an excess amount of foreign tax that is not available for credit because of the limitation on the amount of the tax credit (as described in II.A.2., above), the excess cannot be carried forward for use in subsequent years nor can it be deducted. The excess amount thus represents an additional tax.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

If the entity is in a loss position (or has losses carried forward resulting in zero income for taxation) for a particular year, the ordinary credit will also be zero. In such a case, the entity is allowed to defer losses (or part thereof) for utilization in later years, the total taxable income for that particular year being equal to the foreign income, thus allowing full set off of the credit. In such a case, the Danish income is taxable at the ordinary Danish tax rate and relief can thus be granted for foreign taxes subject to the ordinary tax credit computational rules, i.e., both the limitation and the net income principle described in II.A.2., above apply.

There is no alternative method for preserving a tax credit, i.e., no refund, carryover of credit, nor deduction as an expense.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in II.A. be different from those given in relation to dividends?

The position described in II.A., above also applies to interest income. However, an additional rule regarding timing differences applies only to interest. The rule ensures that interest expenses related to foreign interest income are allocated to the same income year as the interest income, thus preventing arbitrage with respect to interest based on timing differences.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in II.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The position described in II.A., above also applies to royalties.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

When an income item is expressly defined in a tax treaty, the treaty definition must be applied with respect to the treaty allocation of taxing rights. This does not, however, prevent Denmark from applying the Danish domestic law definition in determining the income tax position for purely domestic purposes (typically when Denmark is the country of residence). For example, Danish domestic law provides a narrow definition of interest, while most of Denmark's treaties (which are based on the OECD Model Convention) provide a wider definition. As a result, certain types of income from debt will be defined as capital gains under Danish law but as interest under a treaty. In such cases, Denmark must respect the source country's right to tax such "interest" (defined as capital gains under Danish law); however in computing the Danish tax due (where Denmark is the country of residence of the recipient), such income items will continue to be classified as capital gains. In practice, Denmark will thus respect the source country's right to tax the income and will grant relief for the foreign tax concerned, but for domestic tax purposes will still treat the income in accordance with the Danish classification.

If an applicable tax treaty expressly refers to the definition in the domestic law of one of the contracting states, this definition must also be respected under the domestic law of the other state. If an income item is defined by reference to the domestic law definition of the source country, that definition must also be applied in the residence country even if the definition is in conflict with residence country's domestic law. The treaty will typically include a provision establishing the limits of the definition to prevent the source country from expanding the definition beyond what is reasonable.

If the applicable tax treaty does not contain any definition of a particular term (in the form of either an autonomous treaty definition or a definition by reference one of the contracting states' domestic law), each contracting state will typically be free to interpret the treaty with respect to that term in accordance with its own domestic law.

There is limited precedent addressing such conflicts of income classification. It appears that the Danish tax authorities and Danish courts will to a certain extent rely on internationally acknowledged definitions such as those in the OECD Model Convention and the Commentary thereon; however, the fact that recourse is had to such guidance does not allow specific definitions under Danish law to be disregarded.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

The application of a tax treaty will, in general, not result in a higher tax burden than would result from the direct application of domestic law.

As regards passive income such as dividends, interest and royalties, Denmark contends that the tax treaty concept of "beneficial ownership" may allow Danish withholding taxes to be levied even in the absence of a similar concept under Danish domestic law and thus in situations where Danish domestic law would not allow withholding taxes to be levied. This debate is, however, not relevant to income derived subsequent to the introduction of a general anti-abuse provisions in Danish law in 2015.

Denmark generally applies a global income principle; however, in the case of corporate bodies, this global income principle is modified to exclude income and expenses related to foreign permanent establishments (PEs) and foreign real property. However, if a tax treaty (or other international agreement) causes the source country to waive its right to tax such income, Denmark will tax the income. In this respect a treaty can have the consequence of income being taxable in Denmark that would not be so taxable if the treaty had been not entered into.

IV. Conclusion

As regards outbound payments, Denmark's tax system has traditionally been quite investor-friendly, with withholding taxes being levied only on dividends and certain royalties—and, as a result of Denmark's fairly extensive tax treaty network and its domestic law implementation of EU Directives, withholding taxes are often mitigated or even eliminated (especially for non-portfolio investors). In recent years, however, the introduction of a number of anti-abuse provisions, including general anti-abuse provisions, has made the regime complex and significantly less investor-friendly.

As regards inbound payments, the case law is very limited. This might suggest that the unilateral relief from juridical double taxation granted under Danish domestic law (as well as under Denmark's tax treaties) adequately protects taxpayers. In recent years, however, it seems that the net income principle applied in computing such relief has resulted in more litigation before the courts and may in the future prove to be a factor that needs to be taken into account in assessing the actual relief position under Danish law.

FRANCE: Source-Residence Country Coordination

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Introduction

Although the mitigation or elimination of international double taxation of income is a core principle of most countries' international tax policy, many factors—some practical and some policy—result in a lack of coordination between a source country's taxation of income items and a residence country's provision of unilateral and tax treaty relief. The result is that double taxation of cross-border income flows remains stubbornly resistant to elimination.

This issue examines countries' outbound and inbound treatment of some common kinds of passive income (in particular dividends), and inconsistencies between their treatment of these items that result in double taxation.

The study focuses on the elimination of double taxation, by domestic law or by treaties under a country's normal tax treaty policy (i.e., it does not address special rules relating, for example, to the existence of specific matching credits). Specifically, it addresses regular, plain vanilla situations involving cross-border income flows between corporations (partnerships will not be discussed). These "regular" situations also exclude cases involving rules that depart from the normal as a result of BEPS considerations (for example, it does not discuss special rules dealing with payments to tax havens or the definition of "effective beneficiary").

I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Under French domestic law, dividends are in principle subject to withholding tax at the rate of 30%. The rate of withholding tax is, however, reduced to 12.8% with effect from January 1, 2018, for dividends paid to individuals (a rate of 21% used to apply to EU residents before 2018), and to 15% for dividends paid to certain charities located in the European Union.

The normal 30% rate remains applicable to other beneficiaries (including foreign corporations, though specific rules apply to holding companies: see I.A.6., below), but is reduced to 15% under most of France's tax treaties (with a lower rate of 0 to 10% generally granted by treaties for dividends paid to a holding company).

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

The withholding tax applies to dividends as defined by French domestic law, except where the express terms of a tax treaty provide a different definition. Where it is unclear whether a particular item of income comes within the meaning of dividends for purposes of a particular treaty, France would normally classify the income by reference to its internal law and would not rely on the classification of the income used in the country of residence of the recipient. See discussion in III.A., below.

French domestic law allows disguised distributions of income to be treated as dividends (for example, where an expense paid to a foreign beneficiary is found to be non-deductible leading to reassessment and recharacterization of the payment). Despite the fact that domestic law allows such treatment, the French High Court has held that the definition of dividends contained in the France-Netherlands tax treaty, which lists a number of income items that are to be regarded as dividends, should be construed narrowly. The decision thus excludes disguised distributions from the scope of withholding tax when the dividend definition in the treaty concerned does not expressly provide for a larger scope that would encompass such distributions by referring to the tax definition of dividends.[1]

That being said, most of France's more recent tax treaties refer to both the legal and tax definitions of dividends and, thus, bring indirect and disguised distributions within the scope of the withholding tax.

In the case of disguised distributions, when the definition of dividends in the treaty concerned allows such payments to be treated as dividends, the French Tax Administration considers that, where a reassessment is made, the amount deemed distributed abroad is to be treated as representing a net amount and a gross-up computation is to be made (i.e., a withholding tax of 30/70 of the payment is imposed, resulting in an effective rate of 42.85% or, when an applicable treaty provides for a 15% rate on dividends, 15/85 of the payment, resulting in an effective rate of 17.64%). This gross up computation can be avoided (under the "cascade" provision in Article L 77 of the Tax Procedure Code) in certain situations at the request of the distributing entity, when the shareholders commit to refund the amount of the tax due to the company.

After some equivocation, share buy-backs are now always treated as generating a capital gain and not a dividend distribution.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

This question of whether withholding tax can be computed on a net basis can be important in the context of certain transactions involving stock. The withholding tax on dividends is in principle computed based on the gross amount paid,[2] which would appear to preclude any deduction of expenses from the taxable basis. A number of factors seem to indicate that this position could be evolving, although the definition of what constitute "deductible expenses" for these purposes is open to debate:

- The Court of Justice of the European Union (CJEU) recently handed down two decisions on this issue (*Miljoen* and *Société Générale*[3]) holding that the existence of a different taxable basis for the taxation of residents on the one hand and for withholding tax imposed on nonresidents on the other can be discriminatory. The CJEU held that a deduction need only be granted for expenses that are directly linked to the actual payment of the dividends. The Court did not seem to regard the purchase coupon and the funding costs as being related to the payment of dividends but rather as being related to the acquisition of the shares on which the dividends are paid. This narrow definition of deductible expenses reduces the practical effect of the deduction, but the question should be reviewed with respect to each domestic law and how the costs are attributed between dividends and gains. In another precedential case (*Bouanich*[4]), the CJEU held that the inability of a nonresident to deduct the acquisition cost of shares in the case of a share buy-back can be discriminatory.

These decisions confirming that taxation on a gross basis can be discriminatory when the discrimination is not eliminated by the effective use of a tax credit, are consistent with a number of other interesting decisions of the CJEU concerning the deduction of expenses related to dividends received by pension funds,[5] interest received by a bank[6] and royalties.[7]

- The French High Court[8] recently transmitted a request to the CJEU for a determination on whether the taxation at source of dividends paid to nonresidents at a withholding tax rate that is lower than the corporate income tax rate applicable to dividends paid to resident companies adequately compensates for the fact that the withholding tax is computed based on gross income.

The High Court had already upheld the possibility of claiming a deduction for expenses directly related to the income concerned from the taxable basis subject to withholding tax in the case of royalties received by an individual,[9] but had denied it in the case of interest.[10]

- In the reverse situation (i.e., in the case of a dividend received from a nonresident company by a French resident), the French High Court [11] held that the method of computing the maximum amount of a foreign tax credit ("*le butoir*"—this is referred to in the rest of this paper as the "ceiling") should take into account borrowing costs. There does not seem to be any good reason why the definition of expenses directly related to the payment of dividends should be wider when the expenses have the effect of limiting the amount of a tax credit than when they have the effect of reducing the basis for withholding tax purposes.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

This question, which concerns a shareholder that cannot benefit from a total exemption from withholding tax as a holding company (see further at I.A.6, below and also see Article 119 *ter* of the CGI) has been the subject of debate in France for some five years and is now giving rise to discussions at the European level. The question arose in relation to the fact that the withholding of tax at the time of payment of a dividend has negative cash flow consequences for a nonresident shareholder in a loss position compared to the position of a resident shareholder, which is able to set off its losses against its dividend income.

The temporary disadvantage resulting from a nonresident shareholder's inability to set off its losses can even become a permanent disadvantage if the shareholder's loss position is of a structural nature, or the shareholder is about to terminate its activities.

The French High Court held in the past that, despite the negative timing consequences, the withholding tax on dividends was not discriminatory, even if the recipient nonresident corporation was in a loss position, because a French shareholder in a loss position became taxable at some point, i.e., when it became profitable and when the amount of the dividends reduced the amount of the loss carryover.[12]

In 2014, the European Commission issued a first request to France[13] asking France to change its withholding tax rule so as to allow the foreign loss position of a foreign shareholder to be taken into account.

The CGI was then amended (new Article 119 *quinquies*) so as to allow an exemption from withholding tax on dividends, including where the dividends are paid to a shareholder that is not resident in the European Union (because the free movement of capital, which is the relevant freedom provided for under the Treaty on the Functioning of the European Union (TFEU), also covers non-EU situations). The principal features of, and conditions for the availability of, the exemption are as follows:

- The exemption applies to dividends and payments treated as dividends;
- The beneficiary must be an entity (or a branch) located in an EU Member State, a non-EU European Economic Area (EEA) country[14] or a country with which France has signed a treaty allowing for the exchange of tax information;
- The beneficiary must be subject to a corporate income tax;
- The loss position can be computed using local tax rules (had this not been allowed, it would have created substantial practical problems); and
- The beneficiary must be in the process of being liquidated (whether this condition is fulfilled is considered at the entity level rather than the branch level).

Despite this amendment, the European Commission returned, on May 17, 2017, with a further request for France to change its law to comply with EU rules. The reason for this second request was that the exemption under new Article 119 *quinquies* of the CGI did not address the situation of a beneficiary whose loss position is of a structural nature. The European Commission gave notice that, if no further amendment was made, the matter would be referred to the CJEU (although this does not necessarily mean that the CJEU would agree with the Commission's position).

This question was also raised before the CJEU following the French High Court decisions in *Sté Sofina*, *Sté Rebelco* and *Sté Sidro*.[15]

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

There is no general provision guaranteeing any modification of French withholding tax where incomplete double tax protection is afforded in the country of residence of the recipient of French-source dividends. The withholding tax normally applies even if the classification given to the income in the residence country does not allow the recipient to obtain a tax credit (although France's tax treaties generally contain a nonbinding clause providing for the possibility of the two Contracting States reaching an agreement to resolve the double taxation arising in such circumstances).

However, in accordance with CJEU case law, such situations may be taken into account when the imposition of withholding tax potentially results in discrimination. In a landmark case concerning the imposition of French withholding tax on dividends paid to an EU parent company, the CJEU[16] held that, for purposes of determining whether potential discrimination exists, the effect of a tax treaty on the treatment of the income in the country of residence of the recipient may be taken into account by the source country if the granting of a tax credit in the residence country allows the discrimination to be eliminated. However, in the case of a Dutch holding company that was fully exempt in the Netherlands with respect to dividends received from a French subsidiary and could not utilize the tax credit corresponding to the French withholding tax on such dividends, the discrimination resulting from the imposition of withholding tax (which arose from the fact that no withholding tax was imposed on dividends paid to a French resident holding company) was not eliminated by a tax credit. The CJEU therefore held that there was discrimination in these circumstances.

Pursuant to the *Denkavit*[17] decision, dividends paid to an EU holding company owning more than 5% of a French subsidiary (i.e., the French domestic law threshold for a French holding company to be exempt on dividends paid to it) but less than the percentage required to be held to benefit from the withholding tax exemption under the EU Parent-Subsidiary Directive (i.e., 10% since 2009), can be exempted from withholding tax, if the beneficiary cannot effectively use the corresponding tax credit in its country of residence.[18] A similar reasoning was followed by the ECJ in *Société Générale*,[19] in which the Court held that the discriminatory treatment resulting from the taxation of a gross dividend with no deduction for directly related expenses can be compensated by the granting of a tax credit in the residence country under the applicable tax treaty, but only to the extent the credit can be effectively used, which may not necessarily be possible because of the application of ceiling rules (see II.2., below) or because the beneficiary is in a loss position preventing the set-off of any tax credit if no deferred imputation is allowed in the residence country (see II.3 below).

Another situation in which the tax treatment in the residence country might be taken into account is where a company is in a loss position and may never return to a profitable position because it is being terminated. Article 119 *quinquies* of the CGI allows dividends paid to such a company to be exempted from withholding tax (see I.A.4., above).

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Under French domestic law, distributions made to foreign holding companies are subject to the normal 30% withholding tax rate (no withholding tax applies to domestic payments, except for payments made to individuals). France's tax treaties generally reduce the rate of withholding tax on distributions made to foreign parent corporations resident in treaty partner countries to between 0% and 10%.

Tax credits corresponding to foreign withholding tax on in-bound dividends received by a French holding company that cannot be utilized for corporate income tax (CIT) purposes, because such dividends are exempt from CIT, can be set off against the withholding tax due on the outbound flow, when the French holding company re-distributes its foreign dividend income to a nonresident parent company (this possibility is only available for tax credits attached to dividends received during the preceding five years).

Under the EU Parent-Subsidiary Directive, distributions made to holding companies located in the European Union (or a non-EU EEA country), holding more than 10% of the capital of the distributing French company and committing to hold the shares for at least two years are exempt from withholding tax.

Even before the implementation of the Parent-Subsidiary Directive, the CJEU had held in *Denkavit* (discussed in I.A.5., above) that France's imposition of withholding tax on dividend payments made by a French resident company to a holding company located in another EU Member State, while dividends received by a French parent company holding 5% or more of the paying company were exempt from CIT, created discrimination prohibited by the principle of freedom of establishment principle enshrined in the TFEU (at that time the EC treaty). It should be noted here that the freedom of establishment principle applies only in an EU context.

Further to the *Denkavit* decision, Article 119 *ter* 2.c of the CGI provides that a holding company resident in an EEA country benefits from a total exemption from French withholding tax on dividends when it holds at least 5% of the capital of the distributing French company, if the holding company cannot effectively utilize the tax credit corresponding to the dividends in its country of residence.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The principles discussed in I.A., above in relation to dividends would also normally apply in relation to interest and similar payments, but no withholding tax has been imposed on interest payments under French domestic law since 2009. In addition, France's tax treaties generally provide for an exemption from source-country taxation of interest.

It is worth noting that, before the withholding tax on interest payments was eliminated, the French High court had refused to allow a deduction for interest expenses in computing the basis for withholding tax on interest payments.[20] Given the position of the CJEU,[21] which seems to indicate that, in the case of interest paid on a bank loan, a deduction can be given not only for directly related expenses, but also for funding costs and a portion of general expenses, the position of the French High Court seems questionable.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Under Article 182 B of the CGI, payments made by a French resident professional or corporation to a nonresident service provider are subject to withholding tax at the rate of 33.33%.[22] The withholding tax is imposed on gross payments made in consideration of business services furnished or used in France, which gives the tax a wide scope that is not limited to payments for the use of industrial or intellectual property (IP). Article 182 B also applies to certain income derived from non-business activities, such as income from patents and other IP, and income deriving from sporting activities.[23]

According to EU Directive 2003/49 of June 3, 2003, payments made to a related entity (i.e., where there is at least a 25% stake in the capital) located in the European Union, should be exempt. A large number of France's tax treaties also prevent the imposition of this withholding tax under their articles dealing with business profits (which require an enterprise of the treaty partner country to have a permanent establishment (PE) in France if the enterprise's business profits are to be subject to French source-country taxation) and royalties.

This is not always the case, however, and a number of treaties allow withholding tax to be imposed, albeit at a reduced rate of between 5 and 15%, on income from IP and patents. Even where this is the case, the treaty concerned will always provide that business services are outside the scope of the Royalties Article and are dealt with by applying the treaty rules under the Business Profits Article. While France respects this principle, a number of other countries do not take the same approach in the reverse situation, which can give rise to difficulties with respect to the use of tax credits.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

When applicable, the withholding tax on royalties is normally computed based on the gross income. The CJEU held in *Arnoud Gerritse*[24] that the computation of withholding tax based on gross income where residents are taxed on net income is discriminatory if it results in a higher taxation burden on nonresidents than on residents. The decision in that case relied on the freedom to provide services principle,[25] which forbids the creation of discrimination between French service providers and service providers located in other EU Member States. It should be noted that, unlike the free movement of capital principle[26] (which is the only one of the four EU "freedoms" that applies in a non-EU context), the freedom to provide services principle is limited in its scope to services provided by EU resident suppliers.

The French High Court recently confirmed[27] that in the case of royalties paid to a nonresident individual, it is possible to require the withholding tax to be computed on a net basis after the deduction of related expenses. There is no clear guidance on what expenses can be deducted in this context, but they should be determined by reference to the expenses normally deductible by a French resident with respect to this kind of income. It remains to be confirmed whether the same position would apply with respect to royalties paid to a corporate beneficiary in a non-EU context, except when the non-discrimination provision of an applicable tax treaty would allow a case to be mounted based on non-discrimination arguments.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

The economic double taxation of dividend income derived from an investment (i.e., the taxation of the business income in the hands of the company invested in followed by the taxation of the dividend income in the hands of the shareholder) is partially avoided in two cases:

- Corporate shareholders are 95% tax-exempt on dividends they receive if they hold at least 5% of the capital of the distributing company (the same threshold as applies for withholding tax purposes to dividends paid to corporations resident in other EU Member States, see I.A.5., above).

Corporate shareholders holding less than 5% of the distributing company's capital do not benefit from any elimination/reduction of economic double taxation. Such a reduction used to be available when a 50% tax credit (the "*avoir fiscal*") was granted with respect to French-source dividends (whatever the shareholder's percentage shareholding in the distributing company) but this system was repealed when the CJEU held that it was discriminatory not to grant such a tax credit with respect to foreign-source dividends.[28]

- Individual shareholders benefit from a 40% basis rebate with respect to dividends received from a corporation resident in France or another EU Member States (this basis rebate replaces the repealed *avoir fiscal*).

French domestic law does not contain a specific rule protecting French residents from other forms of double taxation. As regards juridical double taxation (i.e., the taxation of the same person on the same income in two different countries), unlike the laws of many countries (for example, that of the United States), French domestic law does not contain any rule providing for the avoidance of double taxation by the granting of a tax credit. Such tax credits are only provided as a result of the application of the provisions of one of France's tax treaties.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

a. Domestic law and tax treaties

Limitations on the use of foreign tax credits mainly derive from the terms of France's tax treaties, which in most cases provide that the amount of the tax credit granted under the treaty is limited to an amount equal to the amount of the French tax on the corresponding income (the "ceiling," or in French le "butoir"). Unlike the tax treaties of many countries, none of France's treaties make any reference to a domestic law limitation in this respect, simply because French domestic law contains no such general limitation.

The only relevant provision in French domestic law in this context is contained in Article 220.1 paragraphs a and b of the CGI, the scope of which is limited to income from securities (there is no equivalent rule in domestic law regarding royalty income but where a tax treaty provides for a tax credit limitation, such limitation would anyway apply to credits for tax imposed on royalties). Since it refers to limitations provided for in France's treaties, Article 220.1.b has no additional practical impact. Article 220.1.a provides for a limitation with respect to the old domestic withholding tax that no longer exists.

A specific anti-abuse rule has been inserted into Article 220.1.a of the CGI (although it would have made more sense for it to have been inserted into Article 220.1.b, which concerns foreign income and tax credits deriving from the terms of a tax treaty) with respect to lending transactions between related parties. This rule allows the amount of a tax credit to be limited to the tax on the net income from the borrowed securities, after deduction of the capital loss on the transfer back of the securities and other amounts paid to the related lender. The rule does not apply if the taxpayer establishes that the transaction concerned was not entered into for purposes of avoiding tax.

The ceiling limitation thus mainly derives from the provisions in France's tax treaties that impose such a limitation. The French High Court has recently handed down a number of decisions on the limitation rules deriving from treaty provisions and, to a limited extent, from France's domestic law, that have provided some clarification, although some of the conclusions of the court have been challenged.

b. Case law on the computation of the ceiling limit

A particularly delicate question that arises in the context of computing the theoretical tax on the foreign-source income to which the appropriate rate of tax should be applied is whether expenses related to that income should reduce the income and, if so, how the deductible expenses should be determined.

In its *Sté Crédit Industriel et Commercial* decision of December 7, 2015, the French High Court confirmed that the tax credit should be computed based on the theoretical tax payable on a particular item of income. The Court also modified its precedential case law on such computation and decided that some expenses had to be deducted from the income for purposes of computing the available tax credit. The decision concerned a stock lending transaction involving a French borrower and a foreign lender. The Court held that all expenses relating to the acquisition, custody and sale of the shares generating the dividends should be deducted from the basis used to compute the theoretical French tax on the dividend income, irrespective of whether any anti-abuse considerations apply. This is in contrast to Article 220.1.a of the CGI (discussed in II.A.2.a., above), which provides that such a computation is to be made only in abusive situations). This decision significantly reduces the amount of tax credit available in the context of stock lending transactions.

The *Sté Crédit Industriel et Commercial(CIC)* decision has been the subject of a great deal of criticism for a number of reasons:

- First, it endorses the use of a method in non-abusive situations that statutory domestic law has, since 2009, expressly limited to abusive situations involving related parties.
- Second, it creates a clear distortion between the treatment of in-bound flows (where the amount of the tax credit is limited to the amount of tax on net income) and out-bound flows (where the withholding tax is computed based on gross income, without any deduction for expenses). Like France (so far), the majority of countries compute their withholding tax based on gross income. It would seem to be antithetical to the objective of tax treaties to accept that the residence country may limit the tax credit if the source country has not limited the basis for the computation of the corresponding tax. Besides, the scope of deductible expenses is determined by the French High Court by reference to French domestic law, while the imperative of eliminating double taxation would require that the definition in the source-country law should prevail.
- Third, the scope of deductible expenses as defined by the High Court is much wider than that of the expenses regarded as direct expense by the CJEU for withholding tax purposes,[29] which is limited to costs relating to the payment of dividends, thus excluding the costs of acquisition and custody, funding costs and sale costs (which the French High Court takes into account).

c. Absence of 'basket rules'

There are two "baskets" of income for purposes of computing French CIT: (1) ordinary income, which is subject to the normal CIT rate; and (2) certain income that is subject to a reduced CIT rate, for example, patent royalties. The ceiling computation (see II.A.2. a. and b., above) must be performed with respect to the amount of French tax "theoretically" payable on the foreign-source income concerned, determined by applying the relevant rate of tax to such income. Thus, if the income concerned is, in principle, subject to a reduced rate of tax, the maximum tax credit (the ceiling) should be computed by reference to such reduced rate. Where no tax is effectively due on the income concerned (because losses have been set off against that income), this has no relevance for the computation of the ceiling limit.

The French High Court has confirmed[30] that, once the ceiling limit computation has been performed, the resulting credit can be set off against any part of the tax due: there is only one CIT, not a number of different taxes. Thus, where a tax credit is generated with respect to income subject to tax at normal rate, but no tax is effectively due on that income because the taxpayer is in a loss position with respect to ordinary income, the tax credit can still be set off against the tax due at a reduced rate. There are no tax credit "baskets" into which tax credits are separated depending on what CIT rate applies to the related income. France's tax treaties do not make any distinction between different corporate taxes with different rates. Hence, the tax treaty rule regarding the computation of the tax credit ceiling (applying the appropriate rate of tax to the income) is independent of the rule regarding the imputation of the credit (against any part of the CIT liability).

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Where there is an excess amount of foreign tax that is not available for credit because of the limitation of the amount of the tax credit to an amount equal to the "theoretical" tax on the net income (the ceiling computation described in II.A.2., above), the excess cannot be carried forward for use in subsequent years. It used to be possible to deduct such an excess as an expense, but the law has recently been amended to disallow the deduction of foreign taxes where a tax treaty applies (see II.A.4., below).

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

A recent decision of the French High Court[31] clearly rejects the possibility of a refund being granted for a foreign tax credit that could not be utilized. The decision did not come as a surprise, since it could hardly be expected that the French State would be willing to refund a tax paid in another country (i.e., the source country), but it leaves open the question of whether the source country was right to levy withholding tax despite the existence of the loss position that prevented utilization of the credit.

As regards the possibility of carrying forward unused tax credits, the French Tax Administration currently does not allow such a carryforward. A question was raised before the Constitutional Council with a view to establishing whether the failure of French domestic law to afford such a possibility created discrimination contrary to the principles of equality, but the Council,[32] again unsurprisingly, answered to the effect that French constitutional principles do not concern taxes paid outside France: this is a matter that concerns not French law, but the interpretation of tax treaties.

This is where the debate currently stands over whether France's tax treaties implicitly require that it should be possible to carry forward unused tax credits. Such a carryforward possibility is the only way to guarantee the elimination of double taxation for taxpayers in a loss position, which, one would assume, should not be treated less favorably than taxpayers that are profitable.

The predicament of corporations in a loss position has been further exacerbated by new provisions introduced by the latest (2018) Finance Bill, under which, when a tax treaty applies that provides for the granting of a tax credit to eliminate double taxation, withholding tax with respect to which no tax credit can be taken, can no longer be deducted from the taxable basis.

This amendment was introduced after the French High Court raised doubts as to the deductibility of withholding tax in these circumstances (which had previously always been available under Article 39-1-4° of the CGI) with its *Sté Céline* decision,[33] in which it held that the wording of the Elimination of Double Taxation Article in certain of France's tax treaties expressly indicates that no such deduction in basis is allowable. While this 2014 case law made a distinction between the few treaties that contain such a provision and the vast majority of treaties that do not, the new law effectively aligns all the treaties with those that are the least taxpayer-favorable in this respect and prohibits a deduction in every case in which a treaty applies.

According to this new provision in the law, the ability to deduct withholding tax is preserved where no French tax treaty applies, with the somewhat surprising result that, according to the French High Court and now to French domestic law, the existence of a treaty can worsen the position of taxpayers and increase double taxation by allowing a tax credit amount, which does not correspond to a real asset, to be taxed.

The new provision probably (administrative guidance is expected) also preserves the right to take a deduction where the treaty partner country does not correctly apply the tax treaty concerned in computing the withholding tax or where there are differences between France's interpretation of the treaty and that of the treaty partner country. Where it is agreed that the treaty partner country has applied a treaty incorrectly or where there are differences of interpretation, the French Tax Administration would, in principle, endeavor to negotiate with the treaty partner country to ensure the fair application of the treaty (this is generally a lengthy process). The French High Court has confirmed[34] that, in the meantime, where the straightforward application of the treaty does not allow the taxpayer to take a tax credit for withholding tax, the withholding tax can be deducted from the taxpayer's basis.

The impact of the new rule in Article 39-1-4° of the CGI is mitigated by the fact that, so far, it is possible to record foreign income on a net basis (i.e., without recording the tax credit as an income item), which has a similar effect to granting a deduction.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The rules applicable to interest are in principle the same as those applicable to dividends, as described in II.A., above.

Although French domestic law does not contain any express rule that would limit relief for foreign taxes imposed on interest (as already noted, Article 220.1.a and b of the CGI, discussed in II.A.2., above, in principle only concern interest on loans taking the form of securities), the French Tax Administration applies the same principles to double taxation relief with respect to interest as it does with respect to dividends. Such principles, in most cases, are consistent with the terms of France's tax treaties, which generally include a ceiling provision limiting the tax credit to the tax due in France on the income concerned (although it should be noted that some of France's treaties do not provide for any limitation on relief).

One consideration that relates specifically to interest (and royalties, see II.C., below) is that because of the recording of income on an accruals basis, timing differences may arise between when a payment is made (and withholding tax levied) and when the tax system applicable to the recipient of the corresponding income records that income as being received. In such circumstances, the French administrative guidance allows the beneficiary to accrue in advance a tax credit proportional to the accrued income and set it off against the tax on the accrued income of that year.[35]

In principle, the "theoretical" tax for purposes of the ceiling (see II.A.2., above) must be computed for each separate item of income, which requires the attribution of expenses specific to each income item. However, in the case of a bank, the French Tax Administration acknowledges the difficulty of computing the net income from each particular transaction (because banks do not normally allocate a specific funding resource to each interest-generating asset). The guidance consequently allows a bank to compute the theoretical French tax that represents the maximum amount of the tax credit by reference to the net balance of interest on loans (excluding domestic loans) in each sector of its activity.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

In principle, the same answers apply with respect to royalties as apply with respect to interest (see II.B., above). One specific consideration in the case of royalties is that a reduced rate may apply to royalty income (for example, to patent royalties and income treated as patent royalties). The limitation on the amount of the tax credit by reference to the theoretical French tax payable (the ceiling) must take into account this reduced CIT rate of 15%, when applicable.

The principles deriving from the recent *Sté Crédit Industriel et Commercial* decision concerning dividends (see II.A.2.b., above) seem to indicate that expenses relating to the foreign income concerned may have to be taken into account in computing the limitation on the tax credit with respect to that income and that the expenses that are deducted for these purposes must be determined in accordance with French principles. When a tax treaty authorizes the imposition of a withholding tax by the source country, it is, therefore, important to seek to reduce the amount of withholding tax imposed by claiming a deduction for the expenses incurred in earning the income subject to withholding tax in the source country (when that country allows such a claim), which, in turn, may raise difficulties in connection with determining what expenses are deductible.

The current approach of the French Tax Administration and the French courts to the limitation of tax credits with respect to royalties is open to the same criticism as it is with respect to dividends, i.e.:

Because it is not consistent with the position of the French High Court in the reverse situation (i.e., the High Court allows withholding tax to be computed on a net basis only in limited circumstances: see I.A.3., above); and

Because the fact that the computation of the tax credit ignores the method of computing the withholding tax in the source country generates structural double taxation, which seems contrary to the purpose of tax treaties.

It is worth noting that, as a consequence of mismatches in classification and tax credit limitations, the risk of double taxation with respect to royalty flows is, in practice, significantly higher than it is with respect to dividends. Because it is not possible to carry forward unused tax credits, loss positions are another significant source of double taxation.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Since these are extremely complex issues that are difficult to explain succinctly and really require a separate study, the discussion here confines itself to setting out a few of the major principles:

As a matter of principle, Article 55 of the French Constitution provides that the provisions of treaties signed by France prevail over French domestic law, subject to the reciprocal application of the treaty concerned by the other Contracting State. Thus, in the case of a conflict between a treaty and domestic law, the treaty rule should prevail, even if the relevant law took effect subsequent to the treaty.

In *Schneider Electric*,[36] the French High Court formulated a theory under which France's treaties would be "subsidiary" to French domestic law, requiring that the correct application of the domestic law treatment be verified first to ensure that the taxation treatment applied by the French Tax Administration was applied on the correct basis and in accordance with the correct classification, before applying the rules and definitions provided for by the treaty concerned. In the case of a conflict, the treaty should still prevail and may prevent taxation of income that is normally taxable under domestic rules (in *Schneider Electric*, the Court concluded that the application of the French controlled foreign company (CFC) rules was not consistent with the terms of the France-Switzerland tax treaty, which do not allow France to tax the business income of a corporation established in Switzerland unless the Swiss corporation has a French PE).

In classifying an item of income, the income definition in the applicable tax treaty, in principle, overrides the definition in internal law (by way of example, see I.A.2., above). However, when the applicable treaty does not provide a clear definition, the treaty will generally allow each Contracting State to refer to its domestic law.[37] As in the case of the equivalent provision in the OECD Model Convention, this provision in

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France's treaties generally allows such reference to domestic law to be bypassed "when the context requires otherwise," which allows some degree of flexibility.

French case law has a strong tendency to endorse reference to French domestic law in this context (even though the *Banque de l'Orient* decision referred to in I.A.2., above demonstrates that there are exceptions to this tendency). Article 31 of the Vienna Convention on the Law of Treaties (which France has not signed but the principles of which France generally adheres to) provides that "*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*." Nonetheless, the French High Court generally gives priority to the specific rule in (the equivalent of) Article 3(2) of the OECD Model Convention, which permits reference to domestic law, over the contextual approach suggested by France's tax treaties.

In principle, the definition used by the other Contracting State is not taken into account. The High Court generally classifies a transaction whose classification is not clearly determined by the terms of the applicable tax treaty by reference to the classification of that transaction under France's domestic rules. The Commentary on the OECD Model Convention[38] suggests that, in the case of a conflict of classification, the residence country should follow the source-country classification, but in the absence of a clear statement in France's treaties expressly confirming this proposition, the application of Article 3(2) leads in most cases to recourse to the domestic law classification.

That being said, the High Court has sometimes agreed to take into account the foreign tax treatment. For example, in its landmark *Diebold Courtage* decision,[39] the Court was prepared to take into account the fact that a Dutch CV was transparent for Dutch tax purposes when it held that the Dutch partners of the CV were subject to CIT and could therefore be regarded as residents of the Netherlands and benefit from the treaty exemption from withholding tax on royalties under the France–Netherlands tax treaty.

In the case of a conflict between the tax treatment of a transaction in each of a tax treaty's Contracting States, France's treaties generally provide that the two States should endeavor to reach an agreement, which hardly represents a concrete guarantee for taxpayers and, where no agreement is reached, often leaves them with the sole possibility of taking a deduction from basis, resulting in only the very incomplete elimination of double taxation of the taxes borne in the source country (see II.A.4., above for the ability to deduct foreign taxes from taxable income).

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

The principle that the application of a tax treaty cannot result in a higher tax burden than would result from the direct application of the relevant domestic law would seem to follow from the objective of such treaties, which is to avoid double taxation in circumstances where both Contracting States would, in the absence of a treaty, seek to tax the same income.

In relation to corporations, Article 209 I of the CGI, which provides that corporate tax is normally assessed on a territorial basis, also encompasses "income the taxation of which is attributed to France by tax treaties." Hence, when a tax treaty applies, French domestic law sometimes specifically allows income to be taxed that would normally not be taxable in France.

The recent case law goes further than this rule (which is limited in its application to corporate tax) and seems to reject the application of such a "non-aggravation" principle. A first *BNP Paribas* decision[40] upheld the non-deductibility of a loss on a substantial stake in a corporation the taxation of which was granted to Canada only by the terms of the France-Canada tax treaty, although the deduction would have been allowed under France's domestic rules. A second *BNP Paribas* decision,[41] which concerned the taxation of foreign exchange gains on a debt taken out to finance the acquisition of real estate in the United Kingdom, allowed the stand-alone taxation of the foreign exchange gains (which the High court treated as business income under the treaty, although the High Court decided in a later *sté DGFP ZETA* decision[42] that FX on the sale of the real estate itself should be treated as part of the gain on that real estate) but denied the deduction of all other losses relating to the real estate, including interest on the same debt (which the High court treated as part of real estate income under the treaty, although it is a business expense under domestic law), while the overall loss would normally have been deductible under French domestic rules in the absence of a PE of the French enterprise in the United Kingdom.

Even more explicitly, in *Sté Céline*, [43] (see II.A.4, above), the French High Court held that, when a tax treaty provides for the possibility of using a tax credit and expressly prevents the deduction of the corresponding tax from the taxable basis, no deduction can be taken even if the tax credit cannot be effectively used because the taxpayer is in a loss position. This approach is now enshrined in statutory law (see II.A.4., above).

IV. Conclusion

The French rules applicable to withholding tax, foreign tax credits and the elimination of double taxation are heavily influenced by the EU rules—not so much by EU Directives as by CJEU case law. This CJEU case law has concentrated on situations involving discrimination between residents and nonresidents, based on the various freedoms guaranteed by the TFEU, i.e., the freedom of establishment, the freedom to provide services and the free movement of persons and of capital (the last being the only freedom that applies in a non-EU context), rather than on the avoidance of double taxation. This is consistent with the fact that the elimination of double taxation is the purpose of tax treaties and not the prime objective of the European Union, even though the CJEU has pointed out that it should not be ignored and that it is important to the economic efficiency of the Union. The CJEU case law has, for this reason, sometimes had the indirect effect of increasing double taxation (see, for example, the Court's finding that the *avoir fiscal* was discriminatory unless it was also granted with respect to dividends on shares in foreign companies, resulting in the cancellation of this tax credit, as noted in II.A.1., above).

Notwithstanding the impact of CJEU case law, the elimination of double taxation is still very imperfect, even in an EU environment, and the French rules still create tax leakage with respect to cross-border flows. The main source of distortion come from the limitations imposed by French law on the use of foreign tax credits for the following reasons: (1) the rules regarding the use of tax credits are not always consistent with the withholding tax rules applicable in the source country, which rarely provide for the computation of withholding tax on a net basis and, when they do so provide, never make use of the definition of deductible expenses used in the country of residence of the recipient of the income; (2) the fact that recourse is had to the French domestic law definition or classification of income rather than the source country classification/treatment increases the risk of double taxation; and (3) the French approach to the treatment of in-bound flows is still not consistent with its approach to out-bound flows (see, respectively II.A.2., above and I.A.3., above).

Apart from these questions of consistency, corporations in a loss position are also the subject of systematic discrimination because they are unable to carry forward tax credits and use them in later, profitable years, a situation that does not seem consistent with the tax treaty obligation to eliminate double taxation (while the treaties themselves are silent on this question, they never indicate that double taxation relief should be afforded only in the same year as that in which the income concerned is included in the tax basis). These corporations cannot use the tax credit and when a treaty applies cannot deduct the foreign tax from the taxable basis. The fact that the existence of a tax treaty can result in taxation higher than that which would be imposed in the absence of a treaty is also a French peculiarity.

After it has expended so much effort on its BEPS initiatives, it is perhaps time for the OECD and the European Union to direct their attention to the elimination of double taxation, which, like BEPS, is a matter of economic fairness and efficiency. The recent Directive on tax dispute resolution mechanisms in the European Union[44] may be of some assistance in an EU context, though it is important to note that the final wording of the Directive refers to situations in which the EU Member States "differently interpret or apply the provisions of bilateral tax agreements," which may not cover all the instances of double taxation discussed above.

NOTES

[1] See CE, Oct. 13, 1999, n° 190083, *SA Banquefrançaise de l'Orient*.

[2] French Tax Code (*Code Général des Impôts* or CGI), Art. 48 of Appendix II.

[3] CJEU Joined Cases dated Sept. 17, 2015: *B. G. T. Miljoen* C10/14, and *Société Générale* C17/14.

[4] ECJ, 3e ch., Jan. 19, 2006, aff. C-265/04, *Bouanich*.

[5] CJEU June 2, 2016, aff. 252/14 *Pensioenfonds Metaal en Techniek*.

[6] CJEU July 13, 2016, aff. 18/15 *Brisal - Auto Estradas do Litoral SA*.

[7] ECJ June 12, 2003, aff. C-234/01, *Arnoud Gerritse*.

[8] CE 9e-10e ch. Sept. 20, 2017 n°398662 and 398663: *Sté Sofina*, n°398666 and 398672: *Sté Rebelco*, and n° 398674 and 398675: *Sté Sidro*.

[9] CE Feb. 17, 2015 n° 373230, 3e et 8e s.-s., *M. Fisichella*.

[10] CE June 4, 2012 no 330075 *Société Agrekko France* and CE June 4, 2012 n°330088 *Société Aqualon France BV*.

[11] CE Dec. 7, 2015 n° 357189 *plén., Sté Crédit Industriel et Commercial*.

[12] CE May 9, 2012 n° 342221, *Sté GBL Energy* and CE Oct. 29, 2012 n° 352209, *min. c/ SA Kermadec*.

[13] 2013/4244 of March 28, 2014.

[14] The EEA comprises the EU Member States and Iceland, Liechtenstein and Norway.

[15] CE 9e-10e ch. Sept. 20, 2017 *Sté Sofina*, *Sté Rebelco* and *Sté Sidro*: n°398663, 398666, 398672, 398674 and 398675.

[16] ECJ Dec. 14, 2006 aff. 170/05 *Denkavit International BV*.

[17] See note 15, above.

[18] This rule, which was initially given effect by way of administrative guidance, is now provided for in CGI, Art. 119.1 *ter*.c.

[19] CJEU *Société Générale* C17/14 ; see I.A.3.

[20] CE June 4, 2012 no 330075 *SociétéAgrekko France* and CE 4-6-2012 n°330088 *SociétéAqualon France BV*.

[21] In particular in CJEU July 13, 2016, aff. 18/15 *Brisal - Auto Estradas do Litoral SA*.

[22] The rate is 15% in the case of payments to athletes, but such payments are beyond the scope of this paper.

[23] Income derived from artistic activities is dealt with in a separate article, CGI, Art. 182 A *Bis*.

[24] See note 7, above.

[25] TFEU, Art. 56.

[26] TFEU, Art. 63.

[27] CE Feb. 17, 2015 n° 373230, 3e et 8e s.-s., *M. Fisichella*.

[28] ECJ Sept. 7, 2004 aff. 319/02, *Petri Manninen*, which concerned the equivalent mechanism applicable in Finland.

[29] *Société Générale* and *Miljoen*: see note 3, above.

[30] CE June 26, 2017 n° 386269, *Sté Crédit Agricole SA* and CE June 26, 2017, *Sté BPCE*.

[31] CE June 27, 2016 n° 388984, *SA Faurecia*.

[32] Cons. const. Sept. 28, 2017 no 2017-654 QPC, BPCE.

[33] CE March 12, 2014 n° 362528 Sté Céline.

[34] CE Nov. 20, 2002 n° 230530, *SA Etablissement Soules et Cie*.

[35] BOI-IS-RICI-30-10-20-10, para. 200.

[36] CE, ass., June 28, 2002 n°232276, *Schneider Electric*.

[37] Cf. OECD Model Convention, Art 3(2).

[38] Commentary on Articles 23 A and 23 B Concerning the Methods for Elimination of Double Taxation, para. 32.3.

[39] CE Oct. 13, 1999 n° 191191, *Diebold Courtage*.

[40] CE June 12, 2013 n° 351702, *Sté BNP Paribas*.

[41] CE Oct. 1st, 2013 n° 351982, Sté BNP Paribas.

[42] CE March 12, 2014, n° 352212, *sté DGFP ZETA*.

[43] See note 32, above.

[44] Directive 2017/1852, Oct. 10, 2017.

GERMANY: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Dividends paid to nonresident corporations qualify as domestic income.[1] The same holds true for certain other kinds of income derived by nonresidents, in particular income from the liquidation of domestic corporations,[2] income from silent partnerships in domestic business firms, and income from profit-sharing loans made to domestic business firms.[3] Such income is, therefore, subject to corporation tax.[4] The tax is levied by way of withholding.[5] The general withholding tax rate is 25%.[6] In addition, a solidarity surcharge of 5.5% of the withholding tax invariably applies.[7] The withholding tax rate is reduced to 15% if the recipient of the dividends is a nonresident corporation,[8] the reduction being attributable to the fact that the German corporation tax rate is 15%. If the recipient is an EU corporation, the dividends are tax-exempt, provided the EU corporation holds at least 10% of the shares in the German subsidiary distributing the dividends.[9] Under Germany's tax treaties, the withholding tax on the dividend income of a nonresident corporation is generally reduced to a relatively low rate. If the nonresident corporation holds a portfolio share in the dividend-paying German corporation, the withholding tax rate is normally reduced under an applicable treaty to 15%,[10] a reduction that, as noted above is also provided for by § 44a(9) of the EStG. If the nonresident corporation holds a substantial share and certain other conditions are fulfilled, the rate is normally reduced to less than 15%. There is a wide variety in the conditions for this further reduction. For example, under the Germany-Russia tax treaty, the withholding tax rate is reduced to 5% if the recipient holds at least 10% of the equity capital of the dividend paying corporation and that share has a value of at least 80,000 euros or its equivalent in roubles.[11] There has been a controversy as to whether the 80,000 euro value refers to the market value of the holding[12] or its book value.[13] Under the Switzerland-Germany tax treaty the withholding tax rate is reduced to zero if the recipient is a corporation that has held at least 10% of the share capital of the dividend-paying corporation for at least 12 months.[14] Under the Germany-United States tax treaty, the withholding tax rate is reduced to 5% if the recipient corporation holds at least 10% of the voting shares of the dividend-paying corporation;[15] the rate is reduced to zero if the recipient corporation has held at least 80% of the voting shares for the 12 months preceding the distribution of the dividends and the conditions of the limitation on benefits (LOB) clause[16] are fulfilled.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Under German domestic tax law, dividends encompass income from shares and *jouissance* rights in corporations, i.e., profit distributions, which may be either "open" (declared) or "hidden."[17] Germany's tax treaties generally contain definitions of what is meant by the term "dividends."[18]

The withholding tax described in I.A.1., above is imposed on both open and hidden distributions.[19] There is no statutory definition of a "hidden profit distribution;" rather it is a concept developed by the courts.[20] The elements of a hidden profit distribution are as follows:[21]

The business property of the corporation concerned must be decreased, or an increase in the business property must be prevented:

- As a result of the corporation-shareholder relationship; and
- Without an ordinary distribution decision having been made.

The decrease or prevented increase must have an impact on the corporation's income under § 4(1) of the EStG.

If the beneficiary of the hidden distribution is a related person of a shareholder, the decrease/increase is deemed to be the result of the corporation-shareholder relationship.

For example, the business property of a corporation is decreased if a shareholder grants the corporation a loan at an unusually high rate of interest. An increase in the business property of a corporation is prevented if the corporation grants a shareholder a loan at an unusually low rate of interest. In both cases the income of the corporation must be adjusted and withholding tax paid on the hidden distribution.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

The tax base for the withholding tax is the gross dividend income.[22]

The withholding tax on dividends paid to a nonresident corporations is a final tax.[23] Thus if, in addition to its dividend income, a nonresident corporation derives other (German) domestic income that is subject to tax by way of assessment, the dividend income is not taken into account in the assessment.

The rate of withholding tax on dividends paid to *resident* shareholders is 25% (i.e., it is not reduced to 15%) and this tax is not a final tax. Instead, it is treated as an advance payment of the assessed corporation tax. This legal situation raises the issue of whether the fact that the withholding tax on dividends paid to nonresident EU-corporations is a final tax constitutes discrimination under the EU free movement of capital principle.[24] It should be noted that the issue is relevant only with respect to cases in which the recipient nonresident EU-corporation holds less than 10% of the German dividend-paying corporation, i.e., in cases, where the withholding tax rate is not reduced to zero under the Parent-Subsidiary Directive. However, since a resident corporation that is in a comparable situation owes corporation tax at the rate of 15% (i.e., at the same rate as the nonresident corporation) one may assume here that there is no discrimination.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

The German tax system provides no such coordination (see also I.A.3., above).

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

The task of providing double taxation protection is left entirely to the residence country.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Nonresident holding companies are treated in the same way as any other corporation holding shares in a German subsidiary.[25]

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Interest (i.e., income from loans) paid by a German corporation to its nonresident parent corporation is normally not taxable, because it does not qualify as domestic income under the catalogue of such income in § 49(1) of the EStG. By way of exception, interest does qualify as domestic taxable income, if the loan, on which the interest is paid, is secured by domestic real estate.[26] Germany's tax treaties confirm the tax exemption provided for under domestic German law and normally extend the tax exemption to cases in which the loan on which the interest is paid is secured by domestic real estate.[27]

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Royalties paid to a nonresident corporation qualify as domestic income.[28] They are taxable income and subject to a 15% withholding tax.[29] If the nonresident creditor with respect to the royalties is an EU corporation that is closely related to the domestic debtor, it may be able to claim an exemption from withholding tax under the Interest and Royalties Directive.[30] Many of Germany's tax treaties also exempt royalties from withholding tax and leave their taxation to the residence country.[31] Other German treaties provide for a reduction of the withholding tax rate. Despite such treaty exemptions or rate reductions, Germany applies withholding tax at the unreduced rate. The right to do so may be provided for by the applicable treaty[32] or by § 50d(1) of the EStG. To the extent the withholding tax so paid exceeds the tax payable at the treaty rate, it is subsequently reimbursed. Alternatively, the licensee may pay the royalties without withholding tax or may withhold at the reduced rate, as the case may be, if the recipient of the royalties has obtained an exemption certificate by filing a request with the Federal Central Tax Office.[33]

It is worth noting that royalties paid to a nonresident creditor are treated as nondeductible expenses, if the conditions for the application of the royalties barrier rule[34] are fulfilled.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

The tax base for the withholding tax is the gross amount of the royalties. The relevant provision[35] does not permit the deduction of expenses. The administration, however, does permit the deduction of expenses that are directly attributable to the royalties if the nonresident recipient of the royalties is an EU corporation.[36] This represents the administration's reaction to a decision of the BFH[37] that held that allowing the deduction of such expenses was compulsory under EU law. The expenses must be supported by evidence that allows them to be verified by the administration.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Dividends received by a German corporation are generally tax-exempt.[38] At the same time, the law deems an amount equal to 5% of dividends to qualify as nondeductible expenses.[39]. This is the source of the frequent insistence of practitioners that dividends are only 95% tax-exempt. In legal terms, however, the tax exemption is a 100% exemption but deemed 5% nondeductible expenses must be added to the income of a shareholder in receipt of dividends, regardless of whether or not expenses have actually been incurred.

The general tax exemption for dividends received by a German corporation is not granted if the recipient corporation holds less than 10% of the capital of the foreign corporation distributing the dividends.[40] This exception from the general tax exemption was introduced in 2013 as the consequence of a decision of the Court of Justice of the European Union (CJEU), which held that the final nature of the withholding tax on dividends paid on portfolio holdings of EU corporations was discriminatory and incompatible with European law.[41] While domestic German corporations were able to obtain a refund of the tax withheld on dividends paid to them, because such dividends were exempt from corporation tax, the withholding tax on dividends paid to nonresident corporations was final.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

If double taxation is not avoided under § 8b of the KStG, as will be the case where a German corporation in receipt of dividends from a foreign corporation holds less than 10% of the share capital of the foreign corporation, the method used to avoid double taxation is the foreign tax credit method. This method is provided for under domestic law[42] where it is not provided for under tax treaty law.[43] Where the foreign tax credit is provided for by a tax treaty, the relevant treaty provision normally makes reference to the German domestic law.[44]

The foreign tax credit is limited to the amount of German tax on the foreign income concerned ascertained according to German rules.[45] This limitation is imposed on a per-country basis. Since the foreign tax on dividends is normally reduced to 15% under Germany's tax treaties, it would be fully creditable against the 15% German corporation tax, if the domestic tax base is not reduced by expenses or losses. In this – probably rare - case the foreign tax credit method would be more favorable for a German corporation than the tax exemption under the substantial holding privilege, because it does not involve any presumption that nondeductible expenses equal to 5% of the amount of the dividends received have been incurred. If because of expenses or losses the German tax burden on the foreign dividends is less than 15% or if the foreign tax rate is not reduced under a treaty and is higher than 15%, there will be an excess of foreign tax that cannot be utilized in Germany.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

To the extent foreign tax paid exceeds the creditable amount, double taxation is not avoided. The excess may not be carried forward or back. In these circumstances, instead of taking a foreign tax credit, a taxpayer may choose to have the foreign tax deducted from its taxable income.[46]

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

In a loss situation, the foreign tax credit cannot be utilized, because there is no German tax against which the foreign tax concerned may be credited. In these circumstances, a German corporation may request that the foreign tax paid be treated as a deductible expense.[47] The effect of the tax deduction is to increase the loss that may be carried either forward or back. No other relief is available in a loss situation.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Unlike dividends, interest received by a resident corporation is not tax-exempt. Germany's ability to tax interest in the hands of its residents is confirmed by Germany's tax treaties, which provide for the taxability of interest by the residence country.[48] Since, on the other hand, the source country does not have the right to tax interest, no double taxation arises.[49]

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Royalties received by a German resident corporation are taxable income in its hands. Under many of Germany's tax treaties, the residence country has the exclusive right to tax royalties.[50] Where Germany is the residence country and the source country also has the right to tax royalties,[51] Germany grants a foreign tax credit[52].

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

a. Conflicts between treaties and domestic law

Normally Germany's tax treaties prevail over German domestic tax law. This principle is expressly stated in § 2 of the AO.[53] However, the German legislator has enacted a considerable number of provisions that override the tax treaties.[54] Unlike under French law, for example, in the case of Germany, the ascendancy of tax treaties over domestic tax law is provided for not by a constitutional provision, but by a simple legal provision, which can be overruled by a later simple legal provision, i.e., a treaty override provision. At the same time, it is true that the German constitution provides for the ascendancy of the general principles of public international law over domestic law. For this reason, the Federal Finance Court held that treaty override provisions were unconstitutional and presented the question of their constitutionality to the Federal Constitutional Tribunal.[55] This tribunal in turn held that tax treaties do not represent general principles of public international law and that the legislator has the sovereign power to modify its previous acts by which tax treaties are transformed into applicable domestic law.[56] Thus while a treaty override is evidently an offense against public international law, it is not an offense against domestic law.

b. Conflicts in the classification of income under, and differences in the application of, a treaty

The application of a tax treaty by its two contracting states inevitably gives rise to conflicts, generally due to differences in the interpretation of treaty provisions in accordance with the domestic law principles of the two states.[57] In other words, such conflicts are "preprogrammed" and, indeed, treaties themselves anticipate such conflicts. All of Germany's treaties contain a provision for the resolution of conflicts in their application based on Article 25 of the OECD Model Convention, which requires the competent authorities of the two contracting states to endeavor to reach an agreement on how to eliminate a conflict that arises. This mutual agreement procedure (MAP) represents

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an approach that effectively moves the resolution of such a conflict from the domestic level to the level of public international law. The MAP applies both in cases in which the conflict concerned gives rise to juridical double taxation and in cases in which it gives rise to a double economic tax burden.

It is possible, that Germany, as the source country, may characterize a payment made to a corporation resident in a treaty partner country as a dividend, while that county (i.e., the residence country) treats the payment as an interest payment. In such circumstances, Germany will levy a withholding tax on the payment, to the extent permitted under the equivalent of Article 10(2) of the OECD Model Convention, while the residence country will claim an exclusive right to tax the payment under the equivalent of Article11(1) of the OECD Model Convention. The resulting double taxation will have to be eliminated via a MAP.

It is also possible that Germany may characterize a payment made by a German corporation to its nonresident parent as a hidden dividend, for example because it considers that the price paid by the German corporation for goods exceeds the price that would have been agreed on between unrelated parties. As a result, Germany will add the excess to the German subsidiary's taxable income and levy a withholding tax on the deemed dividend income of the nonresident parent. If the country of residence of the parent does not recognize the existence of a hidden profit distribution under its transfer pricing rules, it will characterize the entire payment as business income of the parent. The result is not only juridical double taxation of the nonresident parent but also the imposition of an economic double tax burden on the German subsidiary and the nonresident parent. Both the juridical double taxation and the double economic tax burden will have to be eliminated via a MAP. Although tax treaties are designed to avoid double taxation, the manner in which Article 9 of the OECD Model Convention brings transfer pricing into the scope of application of tax treaties is somewhat unsystematic. The MAP must therefore also accommodate transfer pricing conflicts. Within the European Union, however, transfer pricing conflicts are also a subject of the EU Arbitration Convention,[58] which unlike the treaty MAP offers the advantage of binding arbitration should the MAP fail.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

The exemption method provided for by Germany's tax treaties may result in a higher tax burden than would result from the direct application of domestic law because, in accordance with the "symmetry theory," this method leaves out of account both foreign profits and foreign losses.

For example, under German domestic law, a German corporation that has a foreign permanent establishment (PE) may deduct losses incurred by that PE from its taxable income for German corporation tax purposes. However, if the PE is located in a country with which Germany has a tax treaty, the income derived by the PE (whether positive or negative) will normally be exempt from German corporation tax, i.e. where the PE incurs a loss, it will not be taken into account for corporation tax purposes.[59]

Both profits and losses that are exempted under the terms of a tax treaty are normally taken into account for purposes of the determining applicable progressive tax rates, though this is, of course, irrelevant in the case of corporations, which are taxed at a flat rate.[60]

IV. Conclusion

Thanks to Germany's extensive network of tax treaties, which are normally based on the OECD Model Convention and the German negotiation model, it can be assumed that double taxation with respect to dividends, interests and royalties is a relatively rare phenomenon. Where it does occur despite the existence of an applicable treaty, mutual agreement between the treaty's contracting states ought to eliminate it. The MAP also applies in transfer pricing cases where an economic double tax burden is borne by related taxpayers. If the parties to a MAP fail to reach an agreement, the German administration may consider granting "equitable relief" under § 163 of the AO.

NOTES

1 § 8(1) KStG (*Körperschaftsteuergesetz* – Corporation Tax Act) and § 49(1) No. 5 with § 20 (1) No.1 EstG (*Einkommensteuergesetz* – Income Tax Act).

2 § 49(1) No. 5 with § 20 (1) No.2 EStG.

3 § 49(1) No. 5 with § 20(1) No.4 EStG.

4 § 2 KStG.

5 § 43(1) EStG.

6 § 43a(1) EStG.

7 §§ 1 ff. SolZG (*Solidaritätszuschlagsgesetz* – Solidarity Surcharge Act). The solidarity surcharge is always added to the corporation tax or the income tax, as the case may be.

8 § 44a(9) EStG.

9 § 43b EStG, which is the transformation of the parent-subsidiary-directive of the EU into German tax law

10 Cf. OECD Model Convention, Art. 10(2)(b) and DE-VG (*Deutsche Verhandlungsgrundlage* - German negotiation model), Art. 10(2)(b).

11 Germany-Russia tax treaty, Art. 10(1)(a).

12 *Kramer*, IStR (*Internationales Steuerrecht*) 2003, 159.

13 BFH (*Bundesfinanzhof* – Federal Finance Court), decision of May 16, 2004, I R 54/03, BStBl.II 2004, 767.

14 Germany-Switzerland tax treaty Art. 10(3).

15 Germany-United States tax treaty, Art. 10(2)(a).

16 Germany-United States tax treaty, Art. 10(3) with Art.28.

17 § 20(1) No.1 EStG.

18 OECD Model Convention, Art. 10(3) and DE-VG, Art. 10(3).

19 § 43 (1) No.1 and § 20(1) No.1 EStG.

20 Cf. BFH, decision of Feb.22, 1989, I R 44/85, BStBl.II 1989, 475.

21 R 36 KStR (*Körperschaftsteuer-Richtlinien* – Corporation Tax Regulations).

22 § 43a(2) EstG.

23 § 32 (1) No.2 KStG.

24 Treaty on the Functioning of the European Union (TFEU), Art. 63 and 65; cf. CJEU, decisions of Sept. 17, 2015, C-10/14, C-14/14, C-17/14, *J.B.G.T. Miljoen, X and Société Générale SA/Staatssecretaries van Financien*, IStR 2015, 921.

[25] See note 1, above.
[26] § 49(1) No.5 c) EStG.
[27] DE-VG, Art.11.
[28] § 49(1) No.2 f) EStG.
[29] § 50a(1) No.3, (2) EStG.
[30] § 50g EStG, which is the implementation into German law of the EU Interest and Royalties Directive, Directive 2003/49/EG, ABl. No. L157/2003,49).
[31] OECD Model Convention, Art. 12(1) and DE-VG, Art. 12(1).
[32] E.g., Germany-United States tax treaty, Art. 29.
[33] § 50d(2) EStG.
[34] § 4j EStG, cf. *Kramer*, TNI, Nov. 27, 2017, p.879.
[35] § 50a(3) EstG.
[36] BMF (*Bundesministerium der Finanzen* – Federal Finance Ministry), letter of June 17, 2014, BStBl.I 2014, 887.
[37] BFH, decision of July 27, 2011, I R 32/10, BStBl.II 2014, 513.
[38] § 8b(1) KStG.
[39] § 8b(5) KStG.
[40] § 8b(4) KStG.
[41] CJEU, decision of Oct. 20, 2011, C-284/09, European Commission / Federal Republic, IStR 2011, 840.
[42] 42§ 26(1) KStG with § 34c(1) EStG.
[43] OECD Model Convention, Art. 23(2) and DE-VG, Art.22(1) No.3)a).
[44] I.e., to § 34c EStG.
[45] § 34 c (1) EStG, § 68a EStDV (*Einkommensteuer-Durchführungsverordnung* – Income Tax Ordinance).
[46] § 34c(2) EStG.
[47] § 26(1) KStG with § 34c(2) EStG.
[48] OECD Model Convention, Art. 11(1) and DE-VG, Art. 11(1).
[49] Particular problems arise where a resident corporation that is a partner of a foreign partnership receives interest from that partnership. Under a special German doctrine, the interest is characterized not as interest, but as business income, which would not be taxable in Germany, but in the country where the partnership's business is conducted. In these circumstances, Germany will wish to apply the Business Income Article of the applicable tax treaty (i.e., OECD Model Convention, Art. 7), rather than the Interest Article (i.e., OECD Model Convention, Art. 11). The particular problems that arise as a result of the application of this doctrine will not be discussed here, but see *Kramer*, German Tax Treatment of a Foreign Partner of a Domestic Limited Partnership, TNI 2014 (Vol.72), 241.
[50] OECD Model Convention, Art.12 and DE-VG Art.12.
[51] E.g., Germany-Poland tax treaty, Art. 12(2).
[52] Cf. e.g., Germany-Poland tax treaty, Art. 24(1)(b).
[53] *Abgabenordnung* – Fiscal Code.
[54] Particularly § 50d EStG.
[55] BFH, decisions of Jan. 10, 2012, I R 66/09, IStR 2012, 426 and Aug. 20, 2014, I R 36/13, IStR 2014m 812.
[56] BverfG (*Bundesverfassungsgericht* – Federal Constitutional Tribunal), decision of Dec.15, 2015, 2 BvL 1/12, IStR 2016, 191.
[57] Cf. OECD Model Convention, Art. 3(2).
[58] Convention of July 23, 1990, ABl. L /225 of Aug. 20, 1990.
[59] OECD Model Convention, Art. 23A(1).
[60] It is worth noting that the Austrian Administrative Court does not apply the symmetry-theory. The Court held, that the purpose of a tax treaty is to avoid double taxation, not to create a higher tax burden, cf. VwGH, decision of Sept. 25, 2001, 99/14/0217 E, IStR 2001, 754 and *Kramer*, Austrian Court Rules on Exemption Method for Foreign Losses, TNI 2001(Vol.24), 1254.

INDIA: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Under the domestic tax law of India, a domestic company is liable to pay, in addition to corporate tax, a dividend distribution tax (DDT) at the rate of 15%[1] on amounts declared, distributed, or paid as dividends (including items that, although not so treated under general law, are treated as dividends for tax purposes. The effective DDT rate is 20.56% (as a result of the grossing up of the amount of dividends, as discussed in I.A. 2., below).

Such dividend income is not taxable in the hands of the recipient shareholder (whether resident or nonresident, and whether or not having a permanent establishment (PE) in India).[2] As dividend income is entirely non-taxable, India's tax treaties apparently have no effect in this respect.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

a. Definition of term 'dividend'

India's domestic law contains an inclusive definition of "dividend" that encompasses five specific instances of disguised distributions of profits. Thus, in addition to its ordinary meaning as understood under corporate law, the term "dividend" for purposes of domestic tax law includes these specific instances.

Since Indian-source dividend income is not taxable in the hands of shareholders, the definition of a "dividend" under India's tax treaties has no significance for Indian tax purposes.

b. Computation of amount of dividend chargeable to tax

For purposes of computing the amount that is liable to DDT, the amount of a dividend declared, distributed or paid by a domestic company is subject to the following two adjustments:

- Grossing up of the dividend amount: the amount of a dividend liable to DDT must be increased by the amount of the DDT liability itself. For example, if a company proposes to declare a dividend of INR 100 to its shareholders, the amount of INR 100 must be increased so that, after the payment of DDT at the rate of 15% on the increased amount, the amount of the dividend must be equal to INR 100 in the shareholders' hands. This can be illustrated by following equation (where INR X is the DDT liability):

$$X / (100 + X) = 15\%$$

If the above equation is solved, X will be 17.6471. Applying the surcharge (12%) and the cess (4%) will give the DDT rate of 20.56%. Thus, when it pays INR 100 as a dividend, the company will have to pay DDT of INR 20.56, so that the effective rate of tax on the dividend is 20.56%.

- Removal of cascading effect: a domestic company that receives dividend income that has already been subject to tax, may claim the amount of the dividend as a credit against the amount of a dividend declared by the domestic company in computing its DDT liability. Specifically, the amount of the dividend declared by the domestic company that is liable to DDT may be reduced by: (1) the amount of any dividend received from a domestic subsidiary during the financial year if the subsidiary has paid the relevant DDT at the time the dividend was declared, distributed or paid; and (2) the amount of any dividend received from a nonresident subsidiary provided tax is payable on such dividend income by the Indian company at the rate of 15%.[3] However, the same dividend amount may not be taken into account for purposes of such reduction more than once.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Under the domestic tax law of India, any expense incurred in earning exempt income is not deductible in computing taxable income. Since, as noted in I.A.1., above, dividend income is exempt in the hands of shareholders, there is no question of reducing the income by any expense or allowance.

The amount liable to DDT is to be computed as discussed in I.A.2., above.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

As dividend income is exempt in the hands of shareholders, there is no withholding tax on dividend payments. Thus, there is no question of offsetting dividend income with any loss whatsoever.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

The answers to these questions are essentially the same as those given in I.A.3. and 4., above.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

There are no provisions in India's domestic tax law that specifically deal with the taxation of dividend payments made by a domestic company to its nonresident holding company. The comments in I.A.1. to 5., above, apply equally to such dividend payments.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Unlike dividend income, interest income is taxable in the hands of the recipient. The payer is required to withhold tax at the applicable rate at the time of payment or credit, whichever is earlier.

Interest income received by a nonresident (lacking a PE in India) from the Indian government or an Indian concern on monies borrowed or debt incurred in foreign currency is taxable at the rate of 20%.[4] A lower rate of 5% has been prescribed for specified categories of interest income such as interest on monies borrowed outside India by way of the issue of rupee-denominated bonds.

The above tax rate is subject to any lower/beneficial rate prescribed in an applicable tax treaty. Thus, if the relevant treaty provides for a lower tax rate, then such lower rate will apply.

The term "interest" is defined in domestic tax law to mean interest payable with respect to any moneys borrowed or debt incurred, including any service fee or other charge in that respect or with respect to any credit facility that has not been utilized. This definition is subject to the restrictive definition, if any, contained in an applicable tax treaty.

No deduction is allowable with respect to any expenditure or allowance in computing the amount of interest chargeable to tax. However, if a nonresident taxpayer in receipt of Indian-source interest income has incurred any tax loss from any other source in India, then such loss[5] can be set off against the interest income and only the net amount will be chargeable to tax in India. Any loss incurred outside India is not taken into account in determining the tax liability in India.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The taxation of royalty income earned by a nonresident taxpayer (lacking a PE in India) is similar to that of interest income.

The applicable tax rate is 10% on a gross basis[6] (i.e., without the basis being reduced by any deduction with respect to any expenditure or allowance). India's tax treaties provide for source-based taxation of royalty income and typically prescribe a tax rate of 10% or 15%.

The term "royalty" is defined in India's domestic tax law in a wide and exhaustive manner. However, if the relevant tax treaty contains any restrictive definition, that restrictive definition will apply.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

As noted in I.C.1., above, royalty income earned by a nonresident taxpayer (lacking a PE in India) is taxable on a gross basis. Any expense/loss wherever incurred is not taken into consideration in determining the tax liability in India.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

India's domestic tax law does not provide for any relief from economic double taxation with respect to dividends received from outside India. Dividend income received by an Indian company from a foreign subsidiary (in which the former holds 26% or more in the nominal value of equity share capital) is taxable at the rate of 15% on a gross basis (i.e., without reducing the basis by any deduction with respect to any expenditure or allowance). Thus, if an Indian company receives the dividend income from a foreign company in which it holds less than 26% of equity shareholding, such dividend income is taxable in India at the ordinary base rate of 30%/ 25%.[7]

This is subject to foreign tax credit (FTC) relief (discussed in II.A.2., below).

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

The FTC rules lay down broad principles and conditions for the computation and claiming of foreign taxes paid in foreign countries by resident taxpayers. (There are no separate rules for claiming FTCs in relation to dividend income derived from outside India.)

The total available FTC is the aggregate of the amounts of FTC computed separately for each source of income arising from a particular country. The amount of FTC is the lower of: (1) the tax payable under the domestic law on such income; or (2) the foreign tax paid on such income. Where the foreign tax paid exceeds the amount of tax payable under the provisions of a tax treaty, the excess amount is not taken into account.

The FTC is not available with respect to the payment of any interest, fee or penalty under domestic law or any amount of foreign tax disputed by the taxpayer.

A credit for disputed foreign tax is available for the year in which the corresponding income is subject to tax or assessed to tax in India, if the taxpayer furnishes the following evidence within six months from the end of the month in which the disputed foreign tax is finally settled:

- evidence of settlement of the dispute;
- evidence to the effect that the liability for THE payment of such foreign tax has been discharged by the taxpayer; and
- an undertaking that no refund with respect to such amount has been directly or indirectly claimed or will be claimed by the taxpayer.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

An FTC is available to a taxpayer in the year in which the income corresponding to the foreign tax concerned has been subject/assessed to tax in India. Where the income corresponding to the foreign tax is offered to tax in more than one year, the FTC will be available across those years, in proportion to the income subject/assessed to tax in India.

As noted in II.A.2., above, where the foreign tax paid exceeds the amount of tax payable under the provisions of a tax treaty, the excess amount is not taken into account and is also not allowed to be carried forward to subsequent years. Nor is such excess deductible as an expense in computing taxable income.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

As dividend income is exempt in the hands of shareholders (see I.A.1., above), there is no question of offsetting dividend income with any loss whatsoever.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Interest income derived by an Indian resident from outside India is chargeable to tax in India on a net basis (i.e., after the deduction of expenses and allowances) at the normal corporate tax rate.

The rules for claiming an FTC with respect to interest income are the same as those discussed in II.A., above in relation to dividends.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The domestic tax law of India provides for a lower tax rate of 10% on a gross basis (i.e., without the deduction of any expense) on income derived by way of royalty by an eligible taxpayer (i.e., a person resident in India that is the genuine first inventor of the invention concerned and whose name is entered on the patent register as the patentee in accordance with the Patents Act).

If this beneficial provision is not applicable (for example, because the royalty is not derived by an eligible taxpayer), the royalty income is chargeable to tax in India on a net basis (i.e., after the deduction of expenses and allowances) at the normal corporate tax rate.

The rules for claiming an FTC with respect to royalty income are the same as those discussed in II.A., above in relation to dividends.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Section 90(2) of the Income-tax Act, 1961 provides that where the Central Government has entered into an agreement with the government of any country outside India for granting relief from tax or the avoidance of double taxation, the provisions of the Act are to apply, in relation to a taxpayer to which such agreement applies, to the extent they are more beneficial to the taxpayer than the provisions of the agreement.

Thus, if a particular item of income is classified differently in an applicable treaty from the way in which it is classified under Indian domestic law, in accordance with section 90(2) of the Income-tax Act, 1961, the classification that minimizes the tax liability of the person deriving the income is the classification that should be adopted.

For example, assume that a certain payment is classified as "salary" under Indian domestic law and as a "pension" under the terms of an applicable tax treaty. Absent the treaty or the relevant clause in the treaty, the item would be taxed as salary because, under domestic law, even a pension falls within the definition of "salary." The effect of the treaty will be that, despite the treatment provided for in domestic law, the payment will be treated as a pension. (The taxation of pensions is restricted under India's treaties. For example, under the India-Japan tax treaty, pensions are taxed in the contracting state of which the recipient is a resident even if the employment giving rise to the pension was exercised in the other contracting state).

There is little Indian case law that addresses conflicts in classification, or even in tax treatment, between a source country and India as the residence country. As long as the item concerned has been taxed both in the source country and in India as the residence country, India's tax treaties generally provide for the granting of a tax credit. The tax credit will be restricted to the lower of tax actually paid in the source country and the Indian tax on the item of income concerned. This rule places no emphasis on how the income item is taxed in the source country and the residence country (for example, on the specific head of income[8] under which it is taxed in source country and the head under which it is taxed in India).

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

As a general principle, whichever of the provisions of domestic law or of a tax treaty are the more beneficial to a taxpayer will apply. Accordingly, the application of a tax treaty cannot result in a higher tax burden than would result from the direct application of the domestic law.

IV. Conclusion

Double taxation problems can arise when India (as the source country) characterizes a particular payment as a royalty or fees for technical services and the country of residence of the recipient treats the same payment as business profits. It is then not easy to obtain a credit for the tax withheld in India in the country of residence. For instance, certain Indian courts characterize payments for software as royalties. If the country of residence of the recipient of such payments regards them as business income, it may deny a credit for taxes paid on the payments in India.

Another instance where lack of coordination between countries makes the alleviation of double taxation difficult is when, due to differences in the timing rules of two countries as regards the incidence, assessment and collection of tax, income is charged to tax in the two countries in two different years and the domestic law of the residence country provides for a tax credit only in the year in which the income is subject to tax.

That apart, certain unilateral measures taken by countries to prevent base erosion (for example, the equalization levy recently introduced in India to tax revenue from online advertising services) may lead to double taxation. For example, the equalization levy it has been designated as a tax that is not a tax on income, with the result that tax treaties by definition cannot alleviate any double taxation arising from its imposition.

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NOTES

[1] Plus applicable surcharge (12%) and cess (4%) for tax year 2018-9.

[2] In the case of certain categories of resident taxpayers, such as individuals and partnerships, dividends are chargeable to tax at the rate of 10%, if the aggregate amount of dividends received from a domestic company during the year exceeds INR 1 million. However, there is no such taxation in the hands of nonresident shareholders.

[3] Dividends received by an Indian company from a foreign subsidiary (in which the former holds 26% or more of the nominal value of the equity share capital) are taxable at the rate of 15% on a gross basis (i.e., without any deduction with respect to any expenditure or allowance).

[4] Plus applicable surcharge and cess.

[5] There are restrictive rules with regard to the set-off of certain categories of losses.

[6] Plus applicable surcharge and cess.

[7] Plus applicable surcharge and cess.

[8] The "head of income" is the category into which an item of income falls under Income-tax Act, 1961. Broadly, the tax treatment of an income item depends on the head of income under which the item falls.

IRELAND: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

A nonresident person that does not have an Irish permanent establishment (PE) or an Irish branch or agency comes within the charge to Irish income tax with respect to Irish-source income. An exemption from liability to Irish income tax may apply under Irish domestic law or under a relevant Irish tax treaty.

As a dividend paid by an Irish resident company is Irish-source income, a nonresident will be liable to Irish tax on the receipt of such a dividend unless the nonresident qualifies for a specific exemption under Irish tax law or under the terms of one of Ireland's tax treaties. The Irish domestic exemptions broadly track the exemptions from Irish dividend withholding tax (DWT) (see below). In other words, a nonresident person that is eligible for exemption from DWT has no further liability to account to the Irish Revenue Commissioners for tax on receipt of a dividend. Where a nonresident person is eligible for one of the DWT exemptions, but the dividend-paying company has nonetheless operated DWT, for example, where the requisite documentation has not been provided to the dividend-paying company, the nonresident should have an entitlement to recover from the Irish Revenue Commissioners the DWT withheld by the company and paid over to the Revenue Commissioners.

Where a nonresident person is not exempt from Irish tax on the receipt of the dividend paid by an Irish resident company, the nonresident will be liable to Irish tax. However, in those circumstances, where DWT has been withheld by the company from the dividend, the withholding should satisfy in full the liability to Irish tax of the nonresident on the receipt of the dividend.

While many of Ireland's tax treaties limit the liability to Irish tax of a resident of the other Contracting State to an amount less than the standard rate of income tax in Ireland, in most cases, the resident of the other treaty country will have a complete exemption from DWT under the Irish domestic law provisions. The instances in which a resident of a Contracting State for the purposes of one of Ireland's tax treaties would be entitled to exemption from withholding tax under the treaty and not under domestic law exemptions are likely to be very few.

Irish tax on dividends is collected primarily through the operation of DWT. This is done by the imposition on the dividend-paying company of an obligation to withhold income tax at the standard rate (currently 20%) from the amount of dividends paid, subject to certain exemptions.

There are various exemptions from DWT. For certain exemptions to apply, the shareholder must have provided to the Irish dividend-paying company a signed and completed Irish Revenue prescribed declaration supporting the conditions of the relevant exemption. Exemption from DWT applies where the shareholder:

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- Is resident in an EU Member State or a country with which Ireland has signed a tax treaty and, in the case of a company, is not under the control of persons resident in Ireland; or
- Is a company under the control, directly or indirectly, of persons that by virtue of the law of an EU Member State or a country with which Ireland has signed a tax treaty are resident in that country and that person or persons is not itself/are not themselves under the control, whether directly or indirectly, of a person that is not resident in such a country; or
- Is a company, and the principal class of shares of the shareholder or another company of which the shareholder is a 75% subsidiary is substantially and regularly traded on one or more recognized stock exchanges in an EU Member State or a country with which Ireland has signed a tax treaty or a stock exchange approved by the Irish Minister for Finance. This also applies where the shareholder is wholly owned by two or more companies each of whose principal class of shares is substantially and regularly traded on a recognized stock exchange in an EU Member State or a country with which Ireland has signed a tax treaty or a stock exchange approved by the Minister for Finance.[1]

For the purpose of the control test above, control is deemed, *inter alia*, to be possession of the greater part of the shareholding in the company concerned.

Exemption may also be available under the Irish domestic provision implementing the EU Parent/Subsidiary Directive;[2] such exemption does not require prescribed declarations to be made. The provision requires 5% ownership of the share capital of the Irish dividend-paying company in order for the company in receipt of the dividend to be considered a parent company.

In each case, the exemption looks to the beneficial owner of the dividends.

> "The term 'dividend' is not defined in the relevant Irish tax legislation."

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

The term "dividend" itself is not defined in the relevant Irish tax legislation. A dividend is one instance of a distribution that can be made by an Irish company. The term "distribution" is defined in Irish tax legislation[3] and, while it includes dividends, it has a much wider meaning and includes a number of other types of company payments with respect to shares and/or securities of a company. A distribution is not necessarily a payment of money and may consist of the transfer of an asset to a shareholder with respect to shares or at any undervalue.

There are rules in Ireland that recharacterize certain interest payments as a distribution.[4] These include:

- Interest on a security that is issued other than for new consideration;[5]
- Interest on a security that is convertible, directly or indirectly, into shares of a company, where the security is neither quoted on a recognized stock exchange nor issued on terms comparable to those on which similar quoted securities are issued;[6]
- Interest on a security that is profit-dependent interest, being interest that is dependent on the results of a company's business or part of a company's business;[7]
- Interest that represents more than a reasonable commercial rate of return for the use of money;[8] and
- Interest on a security connected with shares of a company, where, in consequence of rights attaching to either the security or the shares, it is necessary or advantageous for a person that has or disposes of or acquires the securities also to have, dispose of or acquire a proportionate holding of the shares.[9]

Another instance in which interest on a security might be recharacterized as a distribution for Irish tax purposes is where the interest is paid to a 75% parent of the borrower, or where the borrower and lender are both 75% subsidiaries of a third company.[10] Such recharacterization does not apply where the lender is tax-resident in the European Union, or where the lender is tax-resident in the European Union or in a country with which Ireland has a tax treaty in circumstances where the borrower is making the payment on the security in the ordinary course of its trade and makes the necessary election that the recharacterization is not to apply. In addition, the recharacterization does not apply, regardless of the tax residence of the lender, in the case of "yearly" interest (generally being interest on a loan where the term is, or is capable of being, for one year or more) where the borrower is making the payment on the security in the ordinary course of its trade and makes the necessary election that the recharacterization is not to apply. In addition, under the terms of a relevant Irish tax treaty, the non-discrimination clause might also override the Irish domestic recharacterization.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Irish DWT is operated on the gross amount of the dividend paid. The Court of Justice of the European Union (CJEU) has found that Dutch legislation that imposes withholding tax on nonresidents, without an appropriate mechanism for its deduction or refund, is in breach of EU law principles.[11] Potentially, it could be contended that the difference in treatment between Irish resident and nonresident shareholders is discriminatory in nature[12] and is contrary to EU law. However, given the wide exemptions from both Irish DWT and the underlying Irish income tax charge for nonresident shareholders, both corporate and noncorporate, the circumstances in which a nonresident shareholder (in particular, a shareholder that is tax resident in an EU Member State other than Ireland) is subject to Irish tax on Irish-source dividend income are somewhat limited.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Irish tax law does not provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

There are no Irish tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Irish domestic law deals with distributions to foreign holding companies in the manner described at I.A.1., above. The dividend-paying company is required to operate Irish DWT on the making of the distribution, absent an applicable exemption. Many of Ireland's tax treaties reduce the liability to Irish tax of a resident of the other Contracting State to an amount less than the standard rate of income tax in Ireland. However, in most cases, the resident of the other treaty country will have a complete exemption from DWT under the domestic law provisions. The instances in which a resident of a Contracting State for the purposes of one of Ireland's tax treaties would be entitled to exemption from withholding tax under the treaty and not under domestic law exemptions are likely to be very few.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

If the Irish-source payment is denominated as interest or some equivalent, the answers to the questions in I.A., above, would be similar to those given in relation to dividends. The nonresident person will come within the charge to Irish income tax with respect to Irish-source interest income. An exemption from liability to Irish income tax may apply under Irish domestic law or under a relevant Irish tax treaty.

As in the case of dividends, Irish-source interest paid to non-Irish tax residents must be considered from the perspective of: (1) withholding tax; and (2) the underlying Irish tax charge that the nonresident might have under the Irish self-assessment rules. With regard to withholding tax, where the interest paid is treated as interest for Irish tax purposes, if the interest is "yearly" interest, the payor of the interest is obliged to operate interest withholding tax on making the payment, currently at the rate of 20%, absent an exemption.[13] Yearly interest generally is interest paid with respect to a loan that is intended to continue, or is capable of extending, for one year or more. Where no term for the loan is specified, interest on the loan is considered to be yearly interest.

There are several Irish domestic law exemptions from the interest withholding tax obligation.[14] One such exemption applies if the nonresident is a company that is beneficially entitled to the interest and is tax resident in an EU Member State (other than Ireland) or a country with which Ireland has signed a tax treaty, and that jurisdiction imposes a tax that generally applies to interest receivable by companies from foreign sources. An Irish domestic exemption also applies if the nonresident is a company that is beneficially entitled to the interest and the interest is exempted from Irish tax under a relevant Irish tax treaty that has the force of law, or would be exempted from Irish tax under a relevant Irish tax treaty that has been signed but does not yet have the force of law. The exemptions outlined do not apply where the interest is paid in connection with a trade or business carried on by the nonresident recipient company in Ireland through a branch or agency.

While exemption may also be available under the terms of a relevant Irish tax treaty, it should generally not be necessary to rely on such exemption, as the Irish domestic exemption, which unlike the tax treaty exemption does not require Irish Revenue authorization, will apply where the nonresident company is tax resident in a country with which Ireland has signed a tax treaty.

As a separate matter from the matter of whether or not the interest has been subject to withholding tax, a nonresident may have an exposure to account for income tax under the Irish self-assessment rules on any Irish-source interest it receives. Exemptions exist under Irish domestic law from this direct tax liability but these exemptions do not align perfectly with the withholding tax exemptions. For example, interest may be paid free of Irish withholding tax where it is paid on a quoted Eurobond (broadly an interest bearing security issued by a company quoted on a recognized stock exchange and fulfilling certain other conditions) but if the recipient of the interest is not tax resident in an EU Member State or a tax treaty country (or is not under certain control) it may not be exempt from the underlying tax charge.

Exemptions under Irish domestic law from the charge to income tax for interest include the following. A nonresident that is a company will not be liable to Irish income tax with respect to interest income if it is tax resident in an EU Member State (other than Ireland) or in a country with which Ireland has signed a tax treaty, and that jurisdiction imposes a tax that generally applies to interest receivable by companies from foreign sources.[15] An Irish domestic exemption also applies if the nonresident is a company and the interest is exempted from Irish tax under a relevant Irish tax treaty that has the force of law, or would be exempted from Irish tax under a relevant Irish tax treaty that has been signed but does not yet have the force of law.

Irish domestic law does not expressly provide for the reduction of the taxable amount by any expenses (or allowances in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country. However, the CJEU decision in *Brisal*[16] may support a contention that Irish withholding tax that taxes a nonresident financial institution on a gross basis is contrary to EU law.

Brisal concerned interest payments made by a Portuguese company on a commercial loan advanced by an Irish bank. The Portuguese borrower was required to withhold Portuguese tax at a rate of 15% on the gross amount of its interest payments (in accordance with the Ireland-Portugal tax treaty). By contrast, a Portuguese lender would have been required to pay Portuguese corporate income tax at the rate of 25% on its net (rather than gross) profit. The Irish lender argued that the Portuguese withholding tax rules unjustifiably infringed the freedom to provide services and that it should be allowed to deduct from the withholding tax base its business expenses, including the financing cost relating to the loan, in the same way as Portuguese financial institutions.

While it found that imposing withholding tax did not in itself infringe the freedom to provide services, the CJEU held that prohibiting nonresidents from obtaining a deduction for financing costs and other expenses was an infringement. This was the case notwithstanding the fact that nonresidents were taxed at a lower rate. The CJEU held that interest withholding taxes that tax nonresident financial institutions on a gross basis are contrary to EU law.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

If the Irish-source payment is denominated as a royalty or some equivalent, the answers to the questions in I.A., above would be similar to those given in relation to dividends. The nonresident person will come within the charge to Irish income tax with respect to Irish-source royalty income. An exemption from liability to Irish income tax may apply under Irish domestic law or under a relevant Irish tax treaty.

Patent royalties are subject to Irish withholding tax, currently at the rate of 20%, absent an exemption.[17] Withholding obligations are not generally imposed on non-patent royalties. However, a royalty that is an “annual payment” is subject to Irish withholding tax, currently at the rate of 20%, absent an exemption. To be an “annual payment,” a royalty must be “pure income profit” in the hands of the recipient, which broadly denotes income of the kind that does not require the incurring of some expense by the recipient.

A nonresident is exempt from Irish income tax on patent royalties where the payments are made by a company in the ordinary course of a trade or business to a company resident in an EU Member State (other than Ireland) or in a tax treaty country.[18] The payments must be made for *bona fide* commercial reasons to a company in a territory that generally imposes a tax on royalty payments receivable from outside that territory. The exemption does not apply where the royalties are paid in connection with a trade carried on in Ireland through a branch or agency by the receiving company. Such patent royalties are also exempt from Irish withholding tax.

In addition to the statutory exemption from withholding on patent royalties, a further category of exemption is provided for under an administrative statement of practice issued by the Irish Revenue Commissioners.[19] Gross patent royalties gross can be paid free of withholding tax where the recipient is not resident in the European Union or a tax treaty country, provided a number of conditions are fulfilled, including that the Irish Revenue Commissioners are notified by the payor of the royalties that it is availing itself of the administrative practice. The royalties must be paid with respect to a non-Irish patent by a company in the course of its trade, and under a licence agreement executed outside Ireland and governed by a law other than Irish law. The recipient company must be the beneficial owner of the payment and must be neither resident in Ireland nor carrying on a trade in Ireland through a branch or agency (even if that branch or agency is unconnected with the royalty payment). Where the conditions of the administrative practice are fulfilled, patent royalties paid to a nonresident recipient will not give rise to an Irish income tax charge on the recipient.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

The Irish domestic royalty withholding tax provisions do not provide for any reduction or other recognition of costs involved in earning royalties. It may also be that *Brisal* (see I.C.1., above) has application in the case of payments other than interest. A nonresident in receipt of an Irish-source royalty payment may be subject to Irish withholding tax on that royalty. Any Irish withholding tax will be operated on the gross royalty payment. However an Irish resident company in receipt of a royalty payment would likely be taxed on a net basis in Ireland. This is similar to the situation that arose in *Brisal* concerning interest.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Ireland generally taxes residents on their worldwide income and gains. Depending on the type of income, credit may be available for foreign taxes suffered on the income. In the case of dividends, dividends received by an Irish resident company are exempt if received from another Irish resident company. Dividends received on a shareholding in a foreign company of less than 5%, where those dividends form part of the trading income of an Irish company, are also exempt from Irish tax.[20] Otherwise, foreign dividends are taxable—the gross dividend is fully subject to tax with credit for any foreign tax suffered, as set out below.

To the extent dividends are received from companies resident in the European Union, a tax treaty country or a territory that has ratified the Convention on Mutual Administrative Assistance in Tax Matters, and are payable out of the trading profits of such subsidiaries, those dividends may, subject to election, be taxed in the hands of the Irish holding company at the lower 12.5% rate. The lower rate may also apply to dividends paid out of the trading profits of a company resident in a non-treaty country, where the company is owned by a publicly quoted company. In any other scenario, the 25% rate should apply.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

A credit is available against Irish tax for: (1) foreign corporate income tax that is directly charged on dividends (for example, withholding tax); and (2) foreign corporate income tax that is paid with respect to the underlying profits out of which the foreign company paid the dividends. For credit relief to be available, there is a threshold requirement that must be met. The Irish resident company receiving the dividends must either directly or indirectly own, or be a subsidiary of a company that directly or indirectly owns, not less than 5% of the ordinary share capital of the dividend-paying company.

Related company provisions may apply to allow an Irish company to drill down below the foreign dividend-paying company to various lower-tier companies so as to pick up credits for taxes paid by those companies on their profits. Essentially, where the dividend paying company has itself received a dividend from a third company that is "related" to the dividend paying company and "connected" with the claimant company, then any underlying tax payable by the third company and any tax charged on the dividend that neither the dividend-paying company nor the third company would have borne had the dividend not been paid can be taken into account in computing the credit, subject to the general rules outlined above.

For a company to be a "related" company of another company, one company must control, directly or indirectly, or be a subsidiary of a company that controls, directly or indirectly, at least 5% of the voting power of the other company. For a company to be a "connected" company of another company, one company must control, directly or indirectly, or be a subsidiary of a company that controls, directly or indirectly, at least 5% of the voting power of the other company.

Credit for underlying tax is calculated based on the effective rate (rather than the nominal rate) of tax paid in the source country.

Recent changes to the Irish tax code introduced an additional foreign tax credit available in certain circumstances with respect to dividends received by Irish companies from subsidiaries that are resident for tax purposes in EU Member States or European Economic Area (EEA) countries. Where the conditions for relief are fulfilled, an additional "deemed" foreign tax credit is granted to top up any existing credit to the lower of: (1) the rate of Irish corporation tax applying to the foreign dividend; or (2) the nominal rate of tax applied to the profits in the source country. For an entitlement to an additional foreign tax credit to arise, the dividend must be paid to the Irish company by a company resident in an EU Member State or EEA country. Additionally, where the profits out of which the dividend is paid were not "subject to tax" in the EU/EEA source country and the dividend is paid out of profits received directly/indirectly by way of dividends from lower-tier subsidiaries resident in non-EU/EEA countries (and that are "connected" with the Irish company), relief will only be available if those profits were "subject to tax" at the level of one of these lower-tier subsidiaries (the nominal rate applying in these circumstances being determined by the rate of tax applied in the jurisdiction in which the profits were "subject to tax").

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3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Where foreign tax on dividends exceeds the Irish tax attributable to the dividends, excess foreign tax credits will arise. Such excess foreign tax credits (excluding the additional "deemed" foreign tax credits referred to at II.A.2., above) may be available for set-off against Irish tax on other dividends, subject to certain "ring fencing" rules in the case of dividends taxable at the different Irish rates (12.5% and 25%). Excess credits arising on dividends taxed at the 12.5% rate will be available for offset only against tax on other dividends taxed at that rate. Excess credits at the higher rate can be used against dividend income at either rate. Any unrelieved excess (excluding the additional "deemed" foreign tax credits referred to at II.A.2., above) can be carried forward to subsequent accounting periods for use against tax on dividends in those periods, subject to "ring fencing" rules similar to those described above.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

Where an Irish resident has a loss on an overall basis, a foreign tax credit that would otherwise be available is not allowed. In order to allow it to preserve certain foreign tax credits, a company may allocate certain tax deductions that are capable of being set against different types of profit to such profits as it sees fit.[21] This measure allows a company to allocate certain deductions first against any income that is subject to Irish tax without credit relief, with any remaining deductions allocated as far as possible against foreign income carrying effective foreign tax rates that are lower than the Irish rate applying to that income, rather than have those certain deductions set against income that carries higher rates of foreign tax credit.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Where an Irish resident company receives interest income in the course of carrying on an Irish trade, relief for foreign withholding taxes suffered by the Irish company is generally given by way of a credit against the Irish corporation tax payable on the interest. Where relief by way of a credit cannot be taken with respect to foreign taxes suffered, a measure of relief may be available by way of a deduction from the company's income. Credit for foreign withholding tax suffered may be available under: (1) the terms of the relevant Irish tax treaty; or (2) unilateral credit provisions in Irish domestic law. The Irish unilateral credit rules also grant a credit with respect to income withholding taxes suffered, and not refunded, on interest in a country with which Ireland has no tax treaty.

The calculation of the amount of foreign taxes available for crediting in Ireland is an involved matter. However, the rules broadly require that the Irish company establish the portion of net trading income referable to each stream of interest income and then gross that amount up by the lower of the foreign effective tax rate or the Irish effective tax rate. Generally, the amount of the credit for foreign tax is the amount by which the income has been grossed up. Subject to the comments below, the excess of the foreign tax suffered on the interest over the credit that is allowed may not be set off against Irish tax payable on other income or be carried forward to future accounting periods.

An enhanced credit is also available under the Irish domestic rules where an Irish company receives "relevant interest." Relevant interest for this purpose is trading interest received by an Irish resident company from a source within a country with which Ireland has signed a tax treaty and from an affiliate company (whether a company is an affiliate being decided by what is essentially a 25% test that looks to ordinary share capital ownership, entitlement to profits available for distribution and assets available for distribution on a winding up). If relevant interest received by an Irish company has suffered foreign withholding tax and that foreign tax exceeds the creditable tax on that interest, an enhanced credit is available with respect to some or all of the excess for setting off against Irish tax attributable to other relevant interest received by the Irish company.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Irish tax legislation provides for a foreign tax credit for companies receiving royalties as part of the income of a trade. Foreign tax in this context means tax that, under the laws of a foreign jurisdiction, has been deducted from the amount of the royalties and that tax must correspond to Irish income tax or corporation tax. Therefore, only foreign withholding type taxes should qualify and not foreign taxes levied by direct assessment or underlying taxes.

The relief is 87.5% of the relevant foreign tax or, if less, the Irish corporation tax attributable to the amount of the relevant royalties. The attributable Irish corporation tax is 12.5% of the amount of the company's income referable to the amount of the relevant royalties, less the amount of the relevant foreign tax.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

The Irish tax authorities have published their practice with respect to the tax treatment of interest paid by an Irish company to a 75% parent that is tax resident in a country with which Ireland has a tax treaty.[22] Where the relevant tax treaty was signed on or before 1976, interest that is recharacterized as a distribution due to the relevant 75% relationship between the parties[23] will continue to be regarded as interest for tax deductibility purposes. The recharacterized payment will be treated as interest for the purpose of the Interest Article in the relevant tax treaty, unless the payment is treated under that treaty as a dividend. Therefore, where DWT is applicable with respect to the recharacterized payment, the rate of DWT will normally be limited to the source country taxation rate applicable to interest under the relevant treaty.

Where the relevant tax treaty was signed after 1976 and the treaty includes a Non-discrimination Article based on Article 24(4) of the OECD Model Convention, interest that is recharacterized as a distribution due to the relevant 75% relationship between the parties[24] will continue to be regarded as interest for tax deductibility purposes unless there are specific references in the relevant tax treaty that permit the application of the Irish domestic recharacterization provision.[25] The DWT treatment will depend on how "dividends" are defined in the relevant treaty. Where the definition includes interest treated as a distribution, then DWT, where applicable, will be applied at the rate of the source country taxation applicable to dividends in the relevant treaty. Where the treaty definition of dividends does not include recharacterized interest, the DWT, where applicable, will be limited to the source taxation rate applicable to interest under the relevant treaty.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

The application of an Irish tax treaty cannot result in a higher tax burden than would result from the direct application of Irish domestic law.

IV. Conclusion

A nonresident is within the charge to Irish income tax with respect to Irish-source dividends, interest and royalties. In addition to possible tax treaty relief, there are various Irish domestic exemptions from both Irish withholding tax and the underlying Irish income tax charge. In certain instances, those exemptions are broad, in particular in the case of dividends. Irish withholding tax provisions have not been amended in light of recent CJEU decisions concerning withholding taxes being contrary to EU law. Ireland generally operates a credit system rather than an exemption system for Irish residents taxable on foreign-source income. The retention of the benefit of foreign tax credits is facilitated in certain ways, including the pooling of certain excess credits and the ability to allocate certain deductions against particular types of income. Enhanced foreign tax credits are provided for in certain instances.

NOTES

[1] Taxes Consolidation Act (TCA) 1997, s. 172D.

[2] TCA 1997, s. 831.

[3] TCA 1997, s. 130(2).

[4] TCA 1997, s. 130.

[5] TCA 1997, s. 130(2)(d)(i).

[6] TCA 1997, s. 130(2)(d)(ii).

[7] TCA 1997, s. 130(2)(d)(iii)(I).

[8] TCA 1997, s. 130(2)(d)(iii)(II).

[9] TCA 1997, s.130(2)(d)(v).

[10] TCA 1997, s. 130(2)(d)(iv).

[11] *JBGT Miljoen*, (C-10/14), X (C-14/14), and *Société Générale SA v Staatssecretaris van Financiën* (C-17/14) (Sept. 17, 2015).

[12] See also the comments below concerning *Brisal - Auto Estradas do Litoral SA* (C-18/15).

[13] TCA 1997, s. 246.

[14] TCA 1997, s. 246(3).

[15] TCA 1997, s. 198.

[16] *Brisal - Auto Estradas do Litoral SA* (C-18/15).

[17] TCA 1997, s. 238.

[18] TCA 1997, s. 242A.

[19] Statement of Practice SP – CT 01/10.

[20] TCA 1997, s. 21B.

[21] TCA 1997, Para. 4(5) of Schedule 24.

[22] Tax Briefing 45, published in Oct. 2001.

[23] TCA 1997, s. 130(2)(d)(iv).

[24] TCA 1997, s. 130(2)(d)(iv).

[25] Such as the Ireland-Israel, -Poland, -Sweden and -Switzerland tax treaties.

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ITALY: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Under Italian domestic law, dividends distributed by resident companies in favor of nonresidents are considered, under Article 23, Paragraph 1, letter b) of the Italian Income Tax Code (ITC), to be Italian-source investment income and, as such, are subject to Italian taxation. The sourcing rule in Article 23, Paragraph 1, letter b) relates to individual income taxation, but it also applies to corporate income taxation based on the reference made to the general source of income rules set forth in Article 23, Paragraph 1 letter b) by Article 151 of the ITC.

Under Article 27, Paragraph 3 of Presidential Decree 600/73, dividends paid to nonresident shareholders (that lack a permanent establishment (PE) in Italy) are generally subject to a 26% final withholding tax. This withholding tax is also applicable to the portion of liquidation proceeds that corresponds to the retained earnings of a liquidated company.

Under Article 27, Paragraph 3-*ter* of Presidential Decree 600/73, the rate of withholding tax is reduced to 1.20% on dividends distributed to companies and entities subject to corporate income tax in another Member State of the European Union, or in another European Economic Area (EEA) country that allows an adequate exchange of information with the Italian tax authorities. Under Article 27, Paragraph 3 of Presidential Decree 600/73, in the case of a dividend distribution made in favor of a pension fund established in the European Union or the EEA, the rate is reduced to 11%. Under Article 27-*bis*, Paragraph 1 of Presidential Decree 600/73, the rate is further reduced to zero where the conditions of the EU Parent-Subsidiary Directive[1] are met. The rate of withholding tax on dividends is otherwise generally reduced to 5% or 15% under the terms of Italy's tax treaties.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

The Italian definition of "dividend" is contained in Article 44 Paragraph 1, letter e) of the ITC and includes "profits deriving from participation in the capital or in the assets of companies and entities subject to corporate income tax" within income from capital. Thus, the definition is based on the tax classification of the distributing entity rather than its corporate law classification. Furthermore, under Article 44, Paragraph 2, letter a) of the ITC, financial instruments are assimilated to shares to the extent the remuneration on such instruments is linked to the economic results of the issuer, of another company in the same group as the issuer or of specific business initiatives.[2]

Interest exceeding an arm's length value (or any other outbound payment exceeding the respective arm's length value) is not construed as being a dividend and is not subject to withholding tax as such.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Under domestic provisions, withholding tax on dividends is computed on the gross amount of the dividends. This is in accordance with the general rule in Article 45, Paragraph 1 of the ITC to the effect that investment income is to be taxed on a gross basis. No costs associated with investment income can, therefore, be deducted from the tax base for withholding tax purposes. This applies also to dividends paid to resident recipients where a withholding tax is imposed.

As of the time of writing, no amendment to Italian law is envisaged as a consequence of the decision of the Court of Justice of the European Union (CJEU) in *Brisal*.[3] In *Brisal*, the CJEU held that withholding tax on interest paid to a financial institution resident in an EU Member State should be levied on the net income after deduction of business expenses incurred in providing financial services. Following that decision, a domestic rule, such as the Portuguese legislation at issue, which denies nonresident taxpayers the right to deduct business expenses when taxing their gross income, while resident taxpayers are taxed on their net income, constitutes a restriction of the freedom to provide services.[4]

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Under Article 152, Paragraph 2 of the ITC, income of a nonresident company without a PE in Italy, or income of a company with a PE in Italy that is not attributable to that PE, is to be classified in accordance with Chapter I of the ITC, i.e., based on the rules that apply for individual income tax purposes. As a result, income earned by nonresident companies is not automatically classified as business income, but is classified based on its intrinsic nature ("*trattamento isolato*" or "isolated treatment"), in the same way as income derived by a taxpayer who is an individual.

There is no specific coordination between the gross withholding tax on dividends paid to nonresidents and losses attributable to such nonresidents.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Under Article 27, Paragraph 3 of Presidential Decree 600/1973, a partial refund of the Italian withholding tax (up to 11/26ths of the relevant amount) may be claimed by a nonresident recipient subject to the general, unreduced 26% Italian final withholding tax that demonstrates that a final tax has been paid on the same dividend in its country of residence.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

There are no special rules for distributions made to foreign holding companies – for the general rules that would apply, see 1.A., above.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The principles discussed in I.A., above in relation to dividends, would also generally apply in relation to interest and similar payments. In particular, Article 44, Paragraph 1, letters a) and b) of the ITC provides that interest and similar payments on loans, deposits and accounts, and on bonds and similar securities qualify as investment income.

Under Article 23, Paragraph 1, letter b) of the ITC, items of investment income are considered to be sourced in Italy for individual income tax purposes when paid by a resident of Italy, with the exception of interest paid to nonresidents on deposit accounts and current accounts with banks and post offices. The same rule applies for corporate income tax purposes under Article 151, Paragraph 2 of the ITC.

Where interest is taxable in Italy and is paid to a nonresident by a person that qualifies as a withholding agent, a final withholding tax is levied in accordance with Article 26, Paragraph 5 of Presidential Decree 600/1973. The withholding rate is generally 26%.

In specific circumstances, mainly dependent on the nature of the instrument on which the interest is paid and the nature of the nonresident recipient, interest may be subject to lower withholding tax rates or even be exempt from withholding tax. There is a wide range of applicable regimes.

In particular, Legislative Decree 239/1996 provides for a substitutive tax at the rate of 12.5% that applies – as defined in Article 1, Paragraph 1 of the Decree – to interest and similar payments accrued on government bonds, securities and commercial paper issued by Italian banks or by publicly traded companies. Under Article 6, Paragraph 1 of the Decree, such remuneration may be exempt where paid to recipients resident in white-list jurisdiction and other specifically designated recipients.

Article 26, Paragraph 2 of Presidential Decree 600/1973 provides a general exemption for interest paid by an Italian bank (or an Italian PE of a foreign bank) to a foreign bank (or a foreign PE of an Italian bank), with the aim of facilitating foreign interbank loans by making the interest on such loans not subject to withholding tax.[5]

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Under Article 26-*quater* of Presidential Decree 600/73, the rate is further reduced to zero if the conditions of the EU Interest and Royalties Directive (Directive 49/2003/CE) are met. Article 26-*quater*, Paragraph 5 provides for the application of a 5% rate to interest paid by an Italian company to an EU resident affiliate in the event that the beneficial ownership condition in the EU Interest and Royalties Directive is not fulfilled, subject to other specific requirements being met.

Otherwise, the rate of withholding tax is reduced (generally to 10%) under most of Italy's tax treaties. Some treaties provide for a 15% rate on interest, while a few eliminate the source taxation of interest entirely (i.e., provide for a zero rate of withholding tax).

Like withholding tax on all categories of investment income (as described above in relation to dividends), withholding tax on interest is levied on the gross amount and without taking into account any losses of the recipient.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Under Article 23, Paragraph 2, letter c) of the ITC, "royalties" are defined as "remuneration for the use of intellectual property rights, patents, processes or formulae, or information concerning industrial, commercial or scientific experience" and are deemed to have their source in Italy when paid by an Italian resident. Under Article 25, Paragraph 4 of Presidential Decree 600/1973, a 30% final withholding tax is generally to be withheld from royalties paid by a resident withholding agent to a nonresident recipient (without a PE in Italy).

The withholding tax is imposed on the taxable amount of a royalty, which is generally the gross amount of the royalty, without taking into consideration any losses of the recipient. However, when the recipient is the author or inventor of the intellectual property giving rise to the royalty, the taxable portion of the royalty is 75% of the gross amount (a standard 25% cost deduction is thus provided), resulting in an effective withholding rate of 22.5%. The rate is further reduced to zero if the conditions of the EU Interest and Royalties Directive are fulfilled. Otherwise, the rate of withholding tax is reduced under Italy's tax treaties to rates ranging from 0 to 25%.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

As noted in II.C.1, above, the withholding tax is generally imposed on the gross amount of a royalty. However, when the recipient is the author or the inventor of the intellectual property giving rise to the royalty, the taxable portion of the royalty is 75% of the gross amount (a standard 25% cost deduction is thus provided), resulting in an effective withholding rate of 22.5%.

No other deduction or allowance is provided.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

The juridical double taxation of dividends is partially avoided by means of a participation exemption regime (provided for in Article 89, Paragraph 2 of the ITC), which applies both to domestic-source dividends received by Italian resident entities from other Italian resident entities and to foreign-source dividends received by Italian resident entities from non-Italian resident entities that are resident in countries other than countries with privileged tax regimes. Under the regime, dividends are 95% tax-exempt, so that the taxable portion is 5% and the resulting effective income tax rate is 1.2%.

Under Article 89, Paragraph 3-*bis* of the ITC, the same exemption is explicitly granted with respect to the remuneration on hybrid financial instruments assimilated to shares to the extent of the portion of such remuneration that is not deductible in the hands of the nonresident issuer under Article 109 of the ITC: this applies whether or not there is a deductible portion.

The above rule derives from a recent statute[6] that implemented in Italian law the provisions of Directives 2014/86/EU and (EU) 2015/121, both of which amend the EU Parent-Subsidiary Directive (Directive 2011/96/EU). In adapting the Italian rules to the requirement set forth in Article 1 of Directive 2014/86/EU (i.e., that only profits that are "not deductible by the subsidiary [distributing the dividends]" should be exempted), the new legislation, also introduced a new subparagraph into Article 89, ITC, with respect to domestic situations. As a result, an exemption is now granted with respect to the portion of the remuneration on domestic financial instruments that is not deductible for the issuer under Article 109 of the ITC: this applies whether or not there is a deductible portion.

The classification rule in Article 44, Paragraph 2, letter a) of the ITC (see above) also applies to financial instruments issued by a nonresident company, subject to the further condition that the issuer be resident in a country other than a country with a privileged tax regime.

Under Article 89, Paragraph 3-*bis* of the ITC (as amended on the implementation of Directives 2014/86/EU and (EU) 2015/121 referred to above), an exemption is thus explicitly granted with respect to the portion of the remuneration on hybrid financial instruments assimilated to shares that is not deductible in the hands of the nonresident issuer. This is determined based on a declaration of the nonresident issuer or by certain other specified means.[7]

The exemption rule, however, applies only to remuneration on financial instruments issued by companies that meet all the conditions laid down in the EU Parent-Subsidiary Directive, and would thus not apply in cross-border situations where, for example, the issuer of the instrument concerned is not an EU resident or the investor does not hold a participation in the issuer of more than 10%. Such situations are subject to the general rules in Article 89, Paragraph 3 of the ITC, under which an exemption is granted only if the remuneration concerned is entirely nondeductible for the issuer (with double taxation being imposed on the remuneration on instruments with respect to which even only a partial deduction is granted in the issuer's country of residence).[8]

Items of income that are not exempt under the participation exemption regime are generally subject to tax in the hands of their Italian recipients. In any case, a foreign tax credit is granted with respect to the portion of foreign income that is taxable in Italy (under Article 165, Paragraph 10 of the ITC). In practice, this means that where foreign income is fully taxable in Italy, the full amount of any foreign withholding tax imposed on the income is creditable; on the other hand, where the foreign income is partially exempt, the creditable foreign tax is reduced proportionally (thus, in the case of dividends eligible for the participation exemption regime, only 5% of the foreign withholding tax would be creditable).

Other quantitative limitations and procedural conditions apply with respect to the granting of the foreign tax credit.

With respect to individual taxation, dividends are subject to a 26% final substitute tax, under Article 27 of Presidential Decree 600/1973. This regime was introduced by the Italian Budget Law 2018[9] and renders irrelevant for these purposes the level of share ownership.[10] Withholding taxes levied in the foreign source country are not deductible from the substitute tax, but are deductible from the taxable base.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

Under Article 165 of the ITC, the foreign tax credit method applies to foreign-source income, what income is "foreign-source" being determined by applying the rules in Article 23 of the ITC (which define the nexus criteria for Italian-source income earned by nonresidents) on a mirror basis.

The tax credit method applies when foreign-source income contributes to the generation of the overall income subject to tax in Italy based on the worldwide taxation principle; it does not apply when the income produced abroad is exempt from Italian tax or is subject in Italy to a final substitute tax.[11]

Italian domestic law provides for other limitations on the foreign tax credit. In particular, under Article 165, Paragraph 1 of the ITC, the credit for taxes paid abroad (on a permanent basis) is restricted to the portion of domestic tax corresponding to the ratio between the Italian resident taxpayer's foreign-source income and its total income, net of losses brought forward from previous tax periods and eligible for deduction. This limitation is applied on a per-country basis.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

It may be that the amount of foreign tax paid by an Italian resident taxpayer is higher than the amount of the tax credit granted under Italian domestic law provisions. In such a case, the difference is characterized as "excess foreign tax" and can be carried back or forward and credited against the Italian tax liability of, respectively, earlier or later years. Under the rules provided for in Article 165, Paragraph 6 of the ITC, any excess foreign tax over the limitation based on the amount of the Italian tax payable in the same tax period, can be carried back or carried forward over a time period of 16 years (eight years carryforward and eight years carryback).

Some questions have been raised as to the deductibility as an expense of taxes paid abroad, particularly in view of the fact that under Article 99, Paragraph 1 of the ITC, generally neither Italian nor foreign income taxes are deductible expense for Italian income tax purposes. A recent Circular Letter by the Italian Revenue Agency addressed this issue, stating that foreign taxes that fail to meet the application requirement in Article 165 of the ITC (see II.A.2, above) can be considered deductible negative components for purpose of determining a resident taxpayer's total income.[12]

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

As described in II.A.2., above, Italian domestic law provides for certain limitations on the use of the foreign tax credit. A taxpayer that exceeds one of these limits for the year concerned is not allowed to claim a foreign tax credit to the extent of the excess, and the amount of foreign tax paid that exceeds the limit is characterized as "excess foreign tax" that can be carried back and forward in accordance with the rules described in II.A.3., above.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The rules applicable to interest are similar to those described in II.A., above, in relation to dividends, subject to the exception that the participation exemption regime does not apply to interest payments.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The rules applicable to royalties are similar to those described in II.A., above in relation to dividends.

When the recipient of royalties is the author or the inventor of the intellectual property giving rise to the royalties, the taxable portion of the royalty is 75% of the gross amount (a standard 25% cost deduction is thus provided). Correspondingly, under Article 165, ITC, 75% of the amount of any foreign withholding tax is in such event deductible from the Italian income tax liability.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Problems of an interpretative nature may arise when the authorities of a tax treaty's two Contracting States construe a particular notion or concept differently (even when the applicable treaty provides an express definition of the concept or notion concerned).

Italian doctrine has identified a number of separate criteria for providing solutions to cases of conflicts of classification arising from differences in the respective laws of a treaty's two Contracting States:[13]

- *Lex fori* criterion: the classification is made according to the domestic law of the Contracting State that is applying the provision in question;
- *Lex causae* criterion: the classification is made according to the domestic law of the source State;
- Automatic classification criterion: both Contracting States undertake to seek a unanimous classification based on the overall meaning of the treaty; and
- Unanimous classification criterion: a unanimous classification is agreed based on the domestic law of one of the Contracting States.

Considerations of practicality and legal certainty mean that preference will be given to the *lex fori* criterion, i.e., classification based on the domestic law of the Contracting State that is applying the provision at issue. However, the application of this classification criterion may lead to the different application of the tax treaty by its two Contracting States, in turn leading to international double taxation or double non-taxation. In such a case, it has been argued that: "[. . .] the different possibilities of an autonomous classification that takes into account the concrete praxis in the drafting of the conventions by the states, the evolution of their terminology, the OECD model and its commentary must be considered."[14]

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Under Article 169 of the ITC, the provisions of the ITC are to prevail over the provisions of Italy's tax treaties when the domestic law provisions are more favorable to the taxpayer. Many commentators have characterized this position as a more general effect of tax treaties, which are not apt to create a charge that does not exist under domestic law [15]

However, in a few instances,[16] the Italian courts have reached the opposite conclusion. In particular, in specific circumstances, the Italian Supreme Court decided that an item of income was taxable under tax treaty provisions even though an exemption was provided for that item under Italian domestic law. It may be argued that the decision concerned was prompted by the desire to prevent the double non-taxation of the cross-border income flow concerned, and that the conclusions reached by the court would likely not apply in a different scenario.

IV. Conclusion

The Italian tax system is quite consistent in its classification of outbound and inbound income flows. Conflicts may, however, arise in relation to the classification of items of income under treaty law (for example, interest on a profit participating loan may continue to be treated as interest under a tax treaty, while, in some circumstances, it is treated as a dividend under Italian domestic law.) Also, while the imposition under Italian domestic law of substitute taxes at a flat rate on certain items of income would appear to result in the symmetrical treatment of outbound and inbound income, the non-application of the tax credit system (which is replaced by a mere deduction system that only applies with respect to dividends), in practice results in the residual double taxation of inbound income that has been subject to withholding tax at source.

NOTES

[1] Council Directive 2011/96/EU of Nov. 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[2] According to the Italian Revenue Agency, financial instruments qualify under ITC, Art. 44, Para. 2, letter a) only if represented by securities or certificates.

[3] Case C-18/15, *Brisal – Auto Estradas do Litoral SA and KBC Finance Ireland v. Fazenda Pùblica* (CJEU, July 13, 2016),

[4] The reasoning in *Brisal* makes reference to a similar case concerning withholding taxes on the remuneration of artists: Case C 234/01, *Arnoud Gerritse* (CJEU June 12, 2003).

[5] G. Ferranti, I. Scafati, *Redditi di natura finanziaria*, IPSOA, 2012, p. 402.

[6] Law No. 122 of July 7, 2016, with effect from July 23, 2016.

[7] Further procedural details are provided in Circular Letter No. 4/E dated Jan., 18, 2006, which specifies that the issuer declaration does not need to be ratified by the tax authorities of the country of residence, but may be replaced by a statement of those authorities or a recognized institution (e.g.,: stock exchange authorities, qualified information providers, etc.).

[8] See, on this point, R. Michelutti, C. Silvani, *Modifiche alla direttiva madre – figlia e BEPS: un'occasione per ripensare il regime degli strumenti ibridi*, in *Corriere Tributario*, 11 / 2016, p. 857 f.

[9] Italian Budget Law 2018, Art. 1, Para. 1003.

[10] Before amendments made by Budget Law 2018, the previous version of Article 27 of Presidential Decree 600/1973, provided for the application of the 26% substitutive tax rate only to dividends deriving from non- qualified participations, while those deriving from qualified participations were partially (49.72%, realization by December 2017; 58.14%, realization by December 2018) subject to personal income tax with progressive rates.

[11] Italian Revenue Agency, Circular Letter n. 9/E, 2015, Para. 2.2.

[12] Italian Revenue Agency, Circular Letter n. 9/E, 2015, Para. 2.1.

[13] A. Pozzo, *L'interpretazione delle convenzioni internazionali contro la doppia imposizione*, in V. Uckmar, *Diritto Tributario Internazionale*, Padova, 2005, p. 164.

[14] A. Fantozzi, K. Vogel, *Doppia imposizione internazionale*, in Digesto IV, sez. comm., V, 1990, Torino, p. 196.

[15] See, *inter alia*, M. Vitale , *Doppia imposizione, a) Diritto internazionale*, in *Enciclopedia del diritto*, XIII, Milano, 1964, p. 1012; P. Adonnino, *Doppia imposizione*, in *Enciclopedia giuridica Treccani*, XII, 1989, Roma: A. Fantozzi, K. Vogel, *Doppia imposizione internazionale*, in *Digesto IV*, *sez. comm.*, V, 1990, Torino, p. 191.

[16] Italian Supreme Court, Nov. 30, 2012, n. 21424; Italian Supreme Court, Feb. 20, 2013, n. 4164; Italian Supreme Court, Sept. 4, 2013, n. 20138.

JAPAN: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Under Japanese domestic law, dividends paid to a nonresident (whether a nonresident individual or a foreign corporation) that lacks a permanent establishment (PE) or other local establishment are subject to withholding tax at the rate of 20.42%[1] in general, or at the rate of 15.315%[2] in the case of qualified dividends, which are dividends paid by a listed company to shareholders owning less than 3% of the total issued shares of the payor company.

The rate of withholding tax is reduced to: (1) 10% under Japan's recently modified tax treaties (including the Japan-Australia, -France, -Netherlands, -Sweden, -Switzerland, -United Kingdom and -United States tax treaties) with a lower rate of 0% to 5% for dividends paid to a parent or other certain major shareholders; or (2) 15% under Japan's other treaties, with a lower rate of 5 to 10% for dividends paid to a parent or other certain major shareholders.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Withholding tax applies to dividends within the meaning of the Companies Act of Japan (Law No. 86 of 2005, as amended—CA), but the Japanese domestic tax law assigns different meanings to "dividends" for its purposes, depending on context.

First, under the provisions of the CA, a Japanese corporation can distribute cash out of its paid-in capital (capital reserves)—it does not necessarily have to make such distributions out of earnings. However, Japanese tax law treats amounts distributed out of paid-in capital partly as taxable dividends, instead of as a return of capital (which is not taxable). Specifically, where a distribution is made out of paid-in capital, Japanese domestic tax law treats as dividends such part of the distribution as corresponds to the ratio of retained earnings to the whole of the equity (which is composed of the paid-in capital and retained earnings) of the distributing corporation.[3]

Second, when payments from a Japanese corporation are in violation of the CA and, thus, are not "dividends" for purposes of the CA, Japanese domestic tax law treats such payments as dividends if the payments are made to shareholders based on their status as shareholder,s and the payments are ostensibly distribution of earnings, by virtue, for example, of their having been the subject of a corporate resolution.[4]

Many of Japan's tax treaties define dividends as "income from shares or other rights, not being debt-claims, participating in profits, as well as income which is subjected to the same taxation treatment as income from shares by the tax laws of the Contracting State of which the payor is a resident" in line with Article 10(3) of the Model Tax Convention on Income and on Capital published by OECD (the "OECD Model Convention"). In accordance with this definition, when Japanese tax law treats certain payments (not necessarily out of earnings) as dividends, those payments would be treated as dividends for tax treaty purposes and qualify for reduced tax rates or exemption pursuant to the conditions prescribed under the respective treaty (as stated in I.A.1., above).

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Withholding tax on dividends is computed based on the gross amount paid,[5] which precludes any deduction of expenses from the taxable basis for withholding tax purposes. Therefore, a nonresident (whether a nonresident individual or a foreign corporation) that lacks a PE or local establishment cannot reduce a taxable amount by deducting any expense or allowance from the gross dividend amount.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

The Japanese tax system provides no coordination of the gross (withholding) tax on dividends paid to a nonresident with the fact that the nonresident may have other losses or an overall loss.[6] As a result, when the withholding of tax at the time of payment of a dividend has negative cash flow consequences for a nonresident shareholder in a loss position, the nonresident shareholder is in a disadvantageous position compared to a resident shareholder, which is able to set off its losses against its dividend income. The temporary disadvantage resulting from a nonresident shareholder's inability to set off its losses can even become a permanent disadvantage where the tax law of the nonresident shareholder's resident country offers no effective relief and the shareholder's loss position is of a structural nature, or the shareholder is about to terminate its activities.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

There is no general provision guaranteeing any modification of Japanese withholding tax where incomplete double tax protection is afforded in the country of residence of the foreign recipient of Japanese-source dividends. Withholding tax normally applies even if the classification given to the income in the residence country does not allow the foreign recipient to obtain a tax credit, although many of Japan's tax treaties have provisions providing for methods for the elimination of double taxation in line with Article 23A or 23B of the OECD Model Convention and, in addition, contain non-binding clauses providing for the possibility of the two Contracting States reaching an agreement to resolve issues of double taxation that is not in accordance with the provisions of the relevant treaty in line with Article 25 of the OECD Model Convention.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Under Japanese domestic law, distributions made to foreign holding companies are subject to withholding tax at the rate of 20.42% in general, and Japan's tax treaties generally reduce the rate of withholding tax on distributions made to non-Japanese parent corporations resident in treaty partner countries to between 0% and 10% subject to certain conditions set forth in the treaties. Dividends paid by a Japanese operating subsidiary and received by a Japanese holding company are subject to Japanese withholding tax at the rate of 20.42%,[7] which may be refundable when the Japanese holding company earns dividends from Japanese domestic subsidiaries only (such dividends being exempt from corporate income tax[8]) and no other revenues.

Dividends paid by a non-Japanese operating subsidiary and received by a Japanese holding company are generally subject to foreign withholding tax in the source country. While a foreign tax credit is given against tax withheld in the source country[9] under Japanese domestic law, tax credits corresponding to such withholding tax cannot be used against the withholding tax due on the outbound flow when the Japanese holding company re-distributes its dividend income to a non-Japanese parent company,[10] as the withholding tax under Japanese domestic law is imposed on a gross basis, no expenses being deducted.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

1. Overview

The principles discussed in I.A., above in relation to dividends would also normally apply in relation to interest and similar payments, subject to certain differences.

Specifically, under Japanese domestic law: (1) interest on government bonds, corporate bonds issued by Japanese corporations or bank deposits is subject to withholding tax at the rate of 15.315%;[11] and (2) interest on business loans is subject to withholding tax at the rate of 20.42%.[12] The rate of withholding tax is reduced to 10% under most of Japan's tax treaties or to 0% for certain interest under Japan's recently modified tax treaties. See I.B.5., below.

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2. Interest on government and corporate bonds

a. Interest

Interest on Japanese national or local government bonds, or corporate bonds issued by a Japanese corporation that is paid to a nonresident bondholder (whether a nonresident corporation or a nonresident individual) is generally subject to Japanese withholding tax at the rate of 15.315%.[13] There are important exceptions to this rule for interest on: (1) corporate bonds issued outside Japan by Japanese corporations;[14] and (2) book-entry government bonds and corporate bonds.[15]

b. Original issue discount

The 2013 Tax Reform, which came into force on January 1, 2016, introduced a new rule for withholding tax on discounted corporate bonds. Under this new rule, the withholding tax that had been imposed at the time of the issuance of discounted corporate bonds was eliminated, and the imposition of withholding tax at the time of redemption was introduced. Specifically, a company issuing discounted corporate bonds is generally required to withhold, at the time of the redemption of such bonds, 15.315% of an amount equivalent to, as the case may be: (1) 0.2% of the amount of the redemption (if the term of the bond in question is one year or less); and (2) 25% of the amount of the redemption (if the term of the bond in question is more than one year).[16] There are important exceptions to this rule for: (1) corporate bonds issued outside Japan by Japanese corporations;[17] and (2) book-entry government and corporate bonds.[18]

3. Interest on bank deposits

Interest on bank deposits and other similar deposits made by a nonresident depositor (whether a nonresident corporation or a nonresident individual) with any office of a bank or other institution in Japan is generally subject to Japanese withholding tax, under Japanese domestic tax law, at the rate of 15.315%.[19]

4. Interest on loans

Interest on loans extended by a nonresident lender (whether a nonresident corporation or a nonresident individual) to a Japanese company in relation to such company's business carried on in Japan is generally subject to Japanese withholding tax, under Japanese domestic tax law, at the rate of 20.42%,[20] subject to certain exemptions.

5. Treaties

Most of Japan's currently in-force tax treaties provide that the withholding tax rate on interest (regardless of whether it is interest on bonds, deposits or loans) is reduced generally to 10%. It is worth noting that under Japan's modern tax treaties (including the Japan-Austria, -Germany, -Sweden, -United Kingdom and -United States tax treaties), interest income may be exempt from source country taxation, subject to certain requirements being met.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

a. Overview

The principles discussed in I.A., above in relation to dividends would also normally apply in relation to royalties, subject to some differences.

Specifically, under Japanese domestic tax law, royalties relating to patents, trademarks, designs, know-how with respect to technology and copyrights used for any Japanese company's business carried on in Japan and paid by a Japanese taxpayer to a nonresident licensor (whether a nonresident company or a nonresident individual) are subject to Japanese withholding tax at the rate of 20.42%, subject to certain exemptions.[21]

b. Treaties

Most of Japan's currently in-force tax treaties provide that the withholding tax rate on royalties is generally reduced to 10%. Furthermore, under a certain limited number of modern treaties recently signed by Japan (including the Japan-France, -Netherlands, -Sweden, -Switzerland, -United Kingdom and -United States tax treaties), an exemption from source country taxation may be available.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

a. General

When applicable, withholding tax on royalties is computed based on gross income. There is no general rule applicable to royalties paid to nonresidents (whether nonresident individuals or foreign corporations) that requires withholding tax to be computed on a net basis after the deduction of related expenses.

b. Distinction between licensing of intellectual property and rendering of personal services

In relation to research and development (R&D) activities, if a payment is considered to be for personal services, it would be taxed on a net income basis (albeit subject to withholding tax), while if the payment is a royalty for a license, it would be subject to withholding tax on a gross basis.

When R&D activities take place in providing intellectual property (IP) or certain valuable information, for purposes of Japanese domestic tax law, it will be necessary to review whether the provision of the IP or valuable information falls within the use of "industrial property rights" and their equivalents enumerated in Japanese domestic tax law. The determination is factoriented and the distinction between the licensing of IP and the provision of personal services is extremely subtle and requires in-depth factual analysis. As a rule of thumb, in practice, if the provider uses its customary skills in rendering advice or consulting for clients, this will likely be treated as personal services (subject to withholding tax and net income tax). In contrast, if the provider provides IP under a confidentiality agreement to a client that receives it and uses it at the client's own responsibility without significant assistance from the provider, it will likely be licensing (subject to withholding tax).

c. Taxation of consideration for personal services

Under Japanese domestic tax law, consideration received by nonresidents (whether nonresident individuals or foreign corporations) for providing "personal services" (as defined below) within Japan is subject to withholding tax at the rate of 20.42% on a gross basis.[22]

In addition, a nonresident individual or foreign corporation that receives consideration for providing personal services in Japan is also subject to individual or corporate income tax on a net income basis,[23] and therefore must file an individual or corporate income tax return (through which the taxes withheld will be credited against the individual or corporate income tax[24]) with the Japanese tax authority, even if the individual/foreign corporation has no PE in Japan.

"Personal services" for purpose of the Japanese domestic tax law include services provided by persons who have expert knowledge or specialized skills in science and technology, business management or other fields by utilizing such knowledge or skills, which is sometimes difficult to distinguish from the "licensing" of IP, especially know-how, or other valuable technical information.

A payment that is considered to be for personal services as opposed to a license would be taxed on a net income basis, expenses being deductible.

The above withholding tax and net income tax on consideration for providing "personal services" may be eliminated under Japan's tax treaties. Generally speaking, Japan's currently in-force tax treaties provide that, "Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein" in line with Article 7 of the OECD Model Convention. On the other hand, some of Japan's treaties (including the Japan-China and Japan-New-Zealand tax treaties) effectively provide that a PE encompasses "the furnishing of services, including consultancy services, . . ., but only if activities of that nature continue . . . within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period" in line with Article 3(b) of the United Nations Model Double Taxation Convention Between Developed and Developing Countries. Accordingly, if a nonresident does not have any PE in Japan, which may be constituted by the furnishing of services under an applicable treaty, consideration received by the nonresident for providing "personal services" will be exempt from withholding tax as well as net income tax.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

a. General rule

As a general rule, an individual who is permanently resident in Japan and a Japanese corporation is taxed on all income regardless of its source, in or outside Japan.[25] Under the general, unilateral method of protecting Japanese taxpayers from economic and juridical double taxation, an individual resident or a Japanese domestic corporation is eligible for a credit, subject to certain limitations, against individual income tax or corporation income tax, respectively, for foreign taxes (including withholding tax) that correspond to Japanese income tax.[26]

With respect to timing, foreign taxes qualifying for credits are taxes that are due or incurred (such obligations being fixed) during a Japanese individual's relevant calendar year or a Japanese corporation's relevant taxable year, respectively. A Japanese taxpayer may choose to take a deduction for foreign taxes for which no credit is given.

b. Dividends from foreign subsidiaries

An important exception to the taxation of worldwide income is that 95% of dividends paid to a Japanese domestic corporation by its foreign "subsidiary" (defined below) are exempt (i.e., excluded from taxable income) if the Japanese corporation owns at least 25% of the foreign subsidiary's issued and outstanding shares or voting shares for at least six months.[27] The 25% threshold requirement may be altered if an applicable tax treaty explicitly so provides or if a particular taxpayer is eligible for treaty benefits under an applicable tax treaty in which a lower threshold is required for treaty-based indirect foreign tax credit eligibility (for example, a 10% shareholding threshold is provided for under the Japan-United States tax treaty). By way of exception to the exemption described above, when all or part of the dividends paid by a foreign subsidiary (defined above) is deductible in the country in which the foreign subsidiary is located, that portion is fully taxable in the hands of the recipient Japanese corporation, in order to avoid "double nontaxation."[28] This rule was introduced based on "Action 2—Neutralising the Effects of Hybrid Mismatch Arrangements" under the OECD's BEPS project.

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2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

a. Foreign tax credit limitation

(1) General—overall limitation

Under Japanese domestic law, foreign tax credits are limited so that foreign taxes in excess of the corresponding Japanese tax amount may not be used to reduce Japanese individual/corporation income tax on domestic income. Japanese domestic law adopts an overall limitation, as opposed to a per-country limitation or a separate basket limitation. Specifically, the amount of the foreign tax credit limitation is calculated as follows:

> Foreign tax credit limitation for a Japanese taxpayer = Japanese individual or corporation income tax X "Foreign source income" (as adjusted)/total (worldwide) income[29]

(2) Itemized limitations

For purpose of the foreign tax credit limitation calculation set out in II.A.2.a.(1), above, the following rules apply:[30]

- Untaxed foreign income is not included in the "foreign source income" (as numerator) of a Japanese corporation, but remains included in total (worldwide) income (as denominator) for purposes of the formula (in order to prevent inflation of the limitation);
- The ratio of the "foreign source income" of a Japanese corporation to its total (worldwide) income is limited to a maximum of 90% (to ensure that Japanese corporation income tax is paid on at least 10% of a corporation's Japanese domestic-source income);
- Common expenses in relation to total (worldwide) income are allocated between Japanese domestic-source income and "foreign-source income" on a reasonable basis; and
- If the amount of foreign taxes paid is in excess of the foreign tax credit limitation for individual/corporation income tax purposes, the excess is creditable against local tax (specifically, local corporation tax and prefectural and municipal inhabitant tax) to the extent of the credit limitation for local tax purposes, which is calculated in a similar manner to the national individual/corporation income tax limitation.

b. Scope of creditable "foreign tax"

(1) General

A foreign tax credit is granted for foreign taxes on income regardless of the name given to such taxes, including excess profits tax. A credit is taken for taxes on income that are collected based on receipts for the convenience of tax collection (such as withholding taxes on interest, dividends and royalties).[31]

(2) Uncreditable foreign 'taxes' that are not forced payments

The following foreign taxes are not treated as creditable "foreign taxes" for purposes of the Japanese foreign tax credit:[32]

- Foreign tax that is fully or partially refundable at the taxpayer's request;
- Foreign tax that is deferred at the taxpayer's wish; and
- Such part of foreign tax as is paid under an agreement between the taxpayer and the relevant tax authority and that is in excess of the minimum rate.

(3) Increditable foreign taxes

No foreign tax credit is granted for foreign tax imposed on the following income:[33]

- Corporate income that is taxed at a rate higher than 35% (such tax may be deductible);
- In the case of a Japanese corporations with substantial interest revenues: the amount of tax in excess of 10% or 15% of the gross amount of interest, depending on the category of the principal business and the ratio of its net income to gross revenue (such tax may be deductible), as explained in II.B., below;
- Income from certain extraordinary transactions that are structured to inflate foreign tax credits;
- Income deemed to be dividends under the Income Tax Act (ITA) or the Corporation Tax Act (CTA) that arises from a merger, reorganization or decrease of capital in excess of taxable basis;
- Dividends from foreign subsidiaries that are exempt under the CTA (see II.A.1.a., above); and
- Dividends from foreign subsidiaries that are exempt from domestic taxation under the Japanese controlled foreign company (CFC) regime.

Nor is any foreign tax credit granted for foreign taxes paid at a rate in excess of a reduced rate or in spite of an exemption afforded under an applicable treaty. (This is to prevent exploitation of the Japanese foreign tax credit, with foreign tax potentially being paid at the expense of Japanese taxes.)

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

a. Excess foreign tax amount (carryover of unused excess limitation amount)

Where an amount of foreign tax is not creditable because it is in excess of the foreign tax credit limitation (for national and local taxes combined) as described in II.A.2.a., above in the current taxable year, the excess foreign tax amount can be credited against the carried-over foreign tax credit limitation amounts (national and local tax combined) that were not used in the past three taxable years.[34]

While the Japanese taxpayer may choose to deduct, as opposed to credit, the amount of foreign taxes as expenses in general, once the taxpayer chooses to take a credit for foreign taxes in a particular taxable year, no deduction is allowed for any part of the foreign tax amounts incurred in that taxable year even if the foreign tax amount is in excess of the credit limitation.

Conversely, if a Japanese taxpayer chooses to take a deduction, instead of a credit, for foreign taxes, all excess credit limitation amounts and excess foreign tax amounts originating in that or any prior year are lost, and may not be used in the current or any future year. However, such carryovers are not lost as a result of the deduction of foreign taxes on highly-taxed income (which are not creditable as explained in II.A.2.b.(3), above).

b. Excess limitation amount (carryover of excess foreign tax amount)

Where an amount of foreign tax credit limitation is not used because the amount of the limitation is greater than the creditable foreign taxes (for national and local taxes combined) in the current taxable year, the excess foreign tax amount that was not credited in the previous three taxable years can be carried over and credited against the excess limitation amount (national and local tax combined) in the current taxable year.[35]

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

There is no provision in Japanese tax law that grants a refund for a foreign tax credit that could not be utilized because a resident taxpayer has a loss on an overall basis. This is natural, given that the Japanese State could hardly be expected to be willing to refund tax paid in another country (i.e., the source country).

Whether the source country was right to levy withholding tax despite the existence of the loss position that prevented utilization of the credit is generally considered to be a matter for the tax law of the source country and there are no provisions in Japanese tax treaties that restrict the source country's right to levy such tax.

Uncredited foreign tax and unused foreign tax limitation are carried forward for three taxable years as explained in II.A.3., above, which may give full or partial relief to a Japanese taxpayer in an overall loss position on which foreign withholding tax was nevertheless imposed. Alternatively, a Japanese corporation (though not an individual resident[36]) may wish to take a deduction for foreign withholding tax, which is then included in the net loss that can be carried over for a maximum of ten years (subject to certain limitations).[37]

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The rules applicable to interest are in principle the same as those applicable to dividends, as described in II.A., above.

A special foreign tax credit limitation applies with respect to foreign tax on interest received by a Japanese corporation:[38]

<table>
<tr><td colspan="2">Category of principal business</td><td>Income ratio: ratio of net income to gross revenue</td><td>Foreign tax credit limitation</td></tr>
<tr><td colspan="2" rowspan="3">Finance, securities and insurance</td><td>10% and less</td><td>10% of gross interest amount</td></tr>
<tr><td>More than 10% and not more than 20%</td><td>15% of gross interest amount</td></tr>
<tr><td>More than 20%</td><td>Full tax amount</td></tr>
<tr><td rowspan="4">Any other businesses</td><td rowspan="3">Ratio of interest revenue to sum of interest revenue and gross revenue: 20% or more</td><td>10% and less</td><td>10% of gross interest amount</td></tr>
<tr><td>More than 10% and not more than 20%</td><td>15% of gross interest amount</td></tr>
<tr><td>More than 20%</td><td>Full tax amount</td></tr>
<tr><td>Ratio of interest revenue to sum of interest revenue and gross revenue: less than 20%</td><td colspan="2">No special limitation applies</td></tr>
</table>

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

The rules applicable to royalties are in principle the same as those applicable to dividends, as described in II.A., above.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

1. General

It is a well-established constitutional principle in Japan that no treaty is overridden by any rule of domestic law (whether existing at the time the treaty takes effect or enacted subsequently). Therefore, in the case of a conflict between a treaty and domestic law, the treaty rule should prevail, even if the relevant law took effect subsequent to the treaty.

2. Conflicts involving the classification of income

Despite the general principle described in III.A.1., above, there is neither any explicit provision in Japanese domestic law nor any judicial precedent declaring that a treaty rule will prevail in classifying an item of income. On the contrary, there is a view that a treaty should not prevail in this context given that the definitions and classifications of income under treaties are neither comprehensive nor complete.[39] For example, under Japanese domestic tax law, interest is classified into three categories: (1) interest on business loans; (2) interest on bonds; and (3) interest on non-business loans, for each of which a different tax treatment is prescribed. However, the Japan-United States tax treaty has only a definition of "interest" that covers all three categories. Thus, if the treaty definition prevailed, it would not be possible to identify how each item of "interest" would be taxed since the treaty only provides for the source and the limitation on applicable tax rates, not the specific treatment of "interest" (including withholding tax, net income tax, tax rate and so on). For this reason, it is argued that Japanese domestic tax law prevails in the context of classification issues. Under this view, in the case of a conflict involving the classification of income, Japanese domestic tax law prevails, and if a certain item defined under a treaty is still applicable with respect to source and/or tax rate (whether an exemption or a reduced rate), the treaty will modify the domestic tax law to that extent. In taking this approach, reference is made to Article 31 of the Vienna Convention on the Law of Treaties (to which Japan is a signatory). Article 31 provides that, "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

3. Determination of income source

If there is an inconsistency in the determination of the source of income between Japanese domestic tax law and a tax treaty, the sourcing rule set forth in the tax treaty will prevail.[40] Accordingly, when income is deemed to be sourced outside Japan in accordance with the provisions of a tax treaty, the income will be treated as foreign-source income for purposes of the foreign tax credit limitation.

4. Difference in tax treatment in treaty partner countries

In the case of a conflict between the tax treatment of a transaction in each of a tax treaty's Contracting States, Japan's treaties generally provide that, "The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention" in line with Article 25(3) of the OECD Model Convention. For example, assume a certain non-Japanese tax authority imposes withholding tax on consideration received by a Japanese resident for technical services rendered in its country that, under the applicable tax treaty, should be classified as business income and thus should not be taxable in that source country in the absence of a PE of the Japanese resident in that country. Seemingly, the enforcement of such withholding tax is contrary to the applicable treaty; however, since such foreign tax is paid in spite of an exemption afforded under the treaty, the Japanese foreign tax credit will not be granted (see II.A.2.b.(3), above). The Japanese tax authority has taken the position that such overpaid foreign taxes are outside the scope not only of credits but also of deductions,[41] which means the Japanese payer would suffer full double taxation on the income concerned. While the competent authority relief could be obtained, it may not be practical to seek such relief given the time and expense involved in such a course and, even if relief is sought, it may be the case that no agreement will be reached.

Fortunately for Japanese taxpayers, effective for fiscal year beginning on or after April 1, 2016, the Japanese tax authority has changed its position and now allows deductions for over-paid foreign taxes (as previously, no credit is granted) with a view to the partial recovery of the foreign taxes in the hands of the Japanese taxpayer. In such a case, the taxpayer will still be left with the incomplete elimination of double taxation of the taxes borne in the source country.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Generally speaking, the application of a tax treaty cannot result in a higher tax burden than would result from the direct application of the relevant Japanese domestic tax law, given that the purpose of a tax treaty is to avoid double taxation in circumstances in which both Contracting States would, in the absence of the treaty, seek to tax the same income. Some Japanese tax treaties explicitly provide that the purpose of the treaty is to preserve any tax benefits to taxpayers. For example, Article 1(2) of the Japan-United States tax treaty provides that, "The provisions of this Convention shall not be construed to restrict in any manner any exclusion, exemption, deduction credit, or other allowance now or hereafter accorded: (a) by the laws of a Contracting State in the determination of the tax imposed by that Contracting State."

To the extent of the author's knowledge, there is no case law in Japan that is in conflict with this principle.

IV. Conclusion

While Japanese tax law imposes withholding tax on dividends, interest and royalties, most of Japan's currently in-force tax treaties generally provide that source country is to apply a reduced treaty rate or exemption. Most of Japan's in-force tax treaties generally follow the OECD Model Convention, which means that relief from double taxation would be expected to be provided under the tax law of the country of residence of the recipient of the income concerned, provided that country follows classification rules that do not significantly deviate from those in the OECD Model. In particular, the Japanese government has been eager to amend existing treaties, especially after Japan agreed with the United States to amend the old Japan-United States tax treaty in 2003, and such treaties as have been amended or have been newly entered into after 2003 adopt a reduced rate of 10% to 0% for the source taxation of dividends, interest and royalties, which mitigates the risk and degree of double taxation on inbound and outbound investments.

Of course, this does not mean that double taxation has been completely eliminated. The risk of double taxation can be especially significant for a Japanese taxpayer when the source country taxes certain income so extensively that such foreign tax is beyond the scope of the foreign tax credit in Japan. In such circumstances, the taxpayer may have to resign itself to obtaining partial relief by deducting the foreign tax concerned as an expense.

NOTES

[1] Income Tax Act (Law No. 33 of 1965, as amended — ITA), Arts. 161(1)(ix), 212(1) and 213(1)(i). The standard withholding tax rate on cross-border payments for inbound portfolio investments is 20%, with an exceptional 15% applying to interest and certain other exceptions. On top of the withholding tax rate of 20% and 15%, 0.42% and 0.315%, respectively, of the taxable amount (i.e., 2.1% of 20% and 15%, respectively) is added on as surtaxes for reconstruction funding until 2037. No additional surtaxes are added to the reduced rate provided for under Japan's tax treaties in general.

[2] Special Taxation Measures Law (Law No. 26 of 1957, as amended—STML), Art. 9-3(1)(i). The STML provides, *inter alia*, special rules by way of exception to the rules provided in the ITA and the Corporation Tax Act (Law No. 34 of 1965, as amended—CTA).

[3] ITA, Art. 25(1)(iv) and CTA, Art. 24(1)(iv).

[4] Supreme Court Judgement dated Nov. 13, 1968, Bulletin of Civil Judgments of the Supreme Court of Japan, vol. 22-12, page 2449.

[5] ITA, Art. 213(1)(i).

[6] ITA, Arts. 169(2) and 170, for nonresident individuals, and ITA, Art. 178 and 179(i), for foreign corporations.

[7] ITA, Arts 174(ii), 212(3), and 213(2)(iii).

[8] CTA, Art. 23(1)(6). 100% exemption is available when a Japanese holding company owns more than one third (1/3) of the issued shares of its subsidiary.

[9] CTA, Art. 69(1).

[10] ITA, Arts. 161(1)(ix), 212(1), and 213(1)(i).

[11] ITA, Arts. 161(1)(viii), 212(1), and 213(1)(iii).

[12] ITA, Arts. 161(1)(x), 212(1), and 213(1)(i).

[13] ITA, Arts. 161(1)(viii), 212(1), and 213(1)(iii).

[14] STML, Art. 6.

[15] STML, Arts. 5-2(1), 5-3(1), and 67-17(1)(2).

[16] STML, Art. 41-12-2.

[17] STML, Arts. 41-13(3) and 67-17(3).

[18] STML, Arts. 41-13(1)(2) and 67-17(1)(2).

[19] ITA, Arts. 161(1)(viii), 212(1), and 213(1)(iii).

[20] ITA, Arts. 161(1)(x), 212(1), and 213(1)(i).

[21] ITA, Arts. 161(1)(xi), 212(1), and 213(1)(i).

[22] ITA, Arts. 161(1)(vi), 212(1), and 213(1)(i).

[23] ITA, Arts. 164(1)(ii) and 165, for nonresident individuals, and CTA, Arts. 138(1)(iv), 141(ii), 142-10, and 143(1)(iii)(2), for foreign corporations.

[24] ITA, Arts. 120(1)(v) and 165, and CTA, Arts. 68 and 144.

[25] ITA, Art. 7(1)(i) and CTA, Art. 5.

[26] ITA, Art. 95, for resident individuals, and CTA, Art. 69, for Japanese domestic corporations.

[27] CTA, Art. 23-2.

[28] CTA, Art. 23-2(2)(i).

[29] Income Tax Act Enforcement Order (Cabinet Order No. 96 of 1965, as amended—ITAEO), Art. 222, and Corporation Tax Act Enforcement Order (Cabinet Order No. 97 of 1965, as amended—CTAEO), Art. 142.

[30] ITAEO, Art. 222, and CTAEO, Art. 142.

[31] ITAEO, Art. 221(1)(2), and CTAEO, Art. 141(1)(2).

[32] ITAEO, Art. 221(3), and CTAEO, Article 141(3).

[33] ITAEO, Art. 222-2, and CTAEO, Art. 142-2.

[34] ITA, Art. 95(2), and CTA, Art. 69(2).

[35] ITA, Art. 95(2), and CTA, Art. 69(2).

[36] Loss carryover for purposes of income tax is granted for three years to a Japanese individual resident taxpayer, and generally speaking, there is no advantage in taking a deduction rather than taking a credit, which can be carried over for three years. ITA, Art. 70(1).

[37] CTA, Art. 57.

[38] CTAEO, Art. 142.

[39] Koichi Inoue and Eiichiro Nakatani, *Interaction of Tax Treaties and Domestic Tax Law, 2nd Ed.*, 2011.

[40] ITA, Art. 162(1), and CTA, Art. 139(1).

[41] Corporation Tax Act Basic Circular issued by the National Tax Administration (CTA Circular), 16-3-8, which was withdrawn in 2014.

MEXICO: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Under the Mexican Income Tax Law (MITL), dividends paid to a nonresident shareholder are subject to a 10% withholding tax. The dividend withholding tax was introduced with effect from January 1, 2014 and applies to dividends paid out of earnings generated on or after January 1, 2014. Dividends paid to a nonresident shareholder out of earnings generated prior to January 1, 2014 are not subject to tax at the shareholder level.

In this regard, domestic law requires a Mexican company to maintain an after-tax earnings account (CUFIN). The determination of earnings is based on the CUFIN account, with separate accounts having to be maintained for earnings generated up to December 31, 2013, and for those generated on or after January 1, 2014. It should be noted that a Mexican distributing company is also taxed on a distribution of earnings if the distribution is in excess of the total CUFIN balance. A distribution in excess of CUFIN is taxed at the distributing company level at a rate of 30% on a grossed-up basis, the gross-up factor being 1.4286.

In the case of nonresident recipients, the 10% tax rate on dividends may be reduced or eliminated under the terms of one of Mexico's tax treaties.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

While Mexican domestic law does not provide a specific definition of the term "dividend" in the context of distributions made to nonresidents, Article 164 of the MITL provides that, where dividend income, profit or gains generally are distributed by a legal entity, the distribution will give rise to Mexican-source income if the legal entity making the distribution is resident in Mexico. In this regard, there are Mexican court decisions stating that dividends are the returns received by the shareholders of a company for the rights conferred by their participation in the capital of the company; dividends derive from the profits generated by the company, which, either previously or at the time of the distribution, has paid income tax. Based on these rules, dividends, in general terms, are distributions of profits to the shareholders of a company.

In addition, the MITL includes certain provisions that identify transactions that will be treated as giving rise to dividends. Specifically, Article 164 of the MITL provides that, for purposes of determining Mexican-source income subject to withholding tax, dividends will also be deemed to include certain items listed in Article 140 of the MITL, including the following:

- Profits, including interest on equity, allowed under corporate law to be paid to shareholders;
- Loans made to shareholders or partners, except: loans made in the normal course of business; loans with a term of less than one year; and loans on which the interest is at a rate higher than the rate on tax liabilities, where all terms of such loans are complied with;
- Nondeductible expenses that benefit shareholders;

- Amounts of unreported income and purchases not actually completed; and
- Income imputed by the tax authority as a result of transactions with related parties.

Furthermore, the payment of interest on certain loans from related parties, including back-to-back loans, will be treated as dividends for purposes of the MITL.

There are thus certain tax adjustments that must be considered dividends for purposes of withholding tax on payments to nonresidents.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

For Mexican tax purposes there is no reduction of the taxable income earned by a nonresident for any expense nor any other such allowance. The withholding tax is imposed on the gross amount of a dividend.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

For Mexican tax purposes, there is no reduction of the gross tax on dividends paid to a nonresident to provide any coordination with the tax position of the nonresident.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

In essence, exemptions from, or reductions of, the withholding tax on dividends paid to a nonresident are generally only provided for under the terms of Mexico's tax treaties.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

The Mexican tax rules do not provide for any special treatment of dividends paid to foreign holding companies. There is no ability to use foreign tax credits against the withholding tax on dividends paid to a foreign shareholder. To the extent dividends are received from a foreign investment, there are rules that allow the use of foreign tax credits against the tax liability related to the income at the Mexican company level. However, further distributions of such income are not subject to any rules that allow for the use of foreign tax credits. Nor do Mexico's tax treaties provide any relief from withholding in this respect.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Under the provisions of the MITL, interest is deemed to be Mexican-source income and subject to withholding tax if it arises from capital invested in Mexico or is paid by a Mexican resident. Withholding tax on interest is due at the earlier of the time at which the interest is paid or the time at which the interest becomes payable under the terms of the relevant loan agreement.

The definition of interest in the MITL for withholding tax purposes is a broad one and includes: returns, regardless of the name given to them, on credits of any kind, whether with or without mortgage security, and whether or not carrying a right to profit sharing; returns on public debt, bonds, or obligations, including premiums for returns on such securities, premiums paid on securities lending, discounts for placement of security titles, bonds, or debentures from the commissions or payments made by virtue of the opening or guaranteeing of loans, even when they are of a contingent nature, from the payments made to a third party due to the opening or guaranteeing of loans, even when they are of a contingent nature, or from payments made to a third party for credit acceptance by a guarantor.

Different withholding tax rates are applied to different kinds of interest, as follows:

- 4.9%: interest paid to qualifying foreign banks resident in tax treaty countries, and interest paid to nonresident financial institutions in which the federal government owns a percentage of the paid-up capital, provided certain conditions are fulfilled and such institutions are the beneficial owners of the interest. The 4.9% rate also applies to interest paid with respect to securities that are publicly traded in Mexico and securities that are publicly traded abroad through banks and brokerages in a country that has concluded a tax treaty with Mexico.
- 15%: interest paid to reinsurance companies and interest on finance leases.
- 21%: interest paid by a Mexican financial institution that is not subject to the 4.9% or 10% rate and interest paid to nonresident suppliers financing the acquisition of machinery and equipment that is included in the fixed assets of the acquirer.
- 40%: interest paid to certain residents of tax havens.
- 35%: all other interest.

The MITL grants exemptions from tax on interest: (1) accrued on credit granted to the federal government or the central bank or on bonds issued by those bodies, acquired and paid abroad, or placed in Mexico among the investing public at large (in the latter case provided the beneficial owners are nonresidents); (2) accrued on credit with a term of three or more years granted or guaranteed by a nonresident financial institution devoted to promoting exports by granting loans or guarantees on preferential terms; or (3) accrued on credit granted or guaranteed on preferential terms by a nonresident financial institution to, or on behalf of, an institution authorized to receive tax-deductible donations.

Most of Mexico's tax treaties provide for a maximum general withholding rate of 10% or 15%. Again, currently, all banks resident in treaty jurisdictions are entitled to a 4.9% rate under domestic rules, which have been extended annually.

In most of Mexico's tax treaties, reference is made to the domestic law definition of interest, so that a broad definition of interest applies for withholding tax purposes.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Royalties are considered to be Mexican-source income and subject to withholding tax if the intangible with respect to which the royalties are paid is exploited in Mexico or if payment of the royalties is made by a Mexican resident or a nonresident with a permanent establishment (PE) in Mexico. Withholding tax is generally due on royalty payments made to nonresidents on the earlier of the date on which they are paid or the date on which they become due and payable.

The MITL defines royalties as:

> [P]ayments of any kind for the temporary use or enjoyment of: patents; invention or improvement certificates; trademarks; trade names; rights with respect to literary, artistic or scientific works including: movies, television or radio recordings; computer software programs; drawings or models; plans and formulas; commercial, scientific or industrial equipment; the transfer of technology and information related to industrial, scientific or commercial experience, as well as other similar rights and properties; and the right to receive for retransmission visual images and/or audio sounds or both, or the right to allow the general public to access such images or sounds, when in both cases the transmission is made by way of satellite, cable, fiber optics or other similar means.

Mexican domestic law specifically excludes technical assistance from the definition of royalties. For this purpose, technical assistance is defined as the rendering of independent personal services whereby the provider of the personal services is obliged to provide non-patentable knowledge that does not involve the transfer of confidential information related to industrial, commercial or scientific experience, and that requires the recipient of the services to intervene in the application of such knowledge. Under this definition, most service arrangements, including management and other corporate service arrangements, may be treated as technical assistance. Under Mexican domestic law, fees for technical assistance are generally subject to a 25% withholding tax rate. However, under many of Mexico's tax treaties, fees for the services concerned may qualify as business profits not subject to withholding tax.

The withholding tax rates for royalties vary as follows:

- 35%: royalties for the temporary use or enjoyment of patents, certificates of invention, trademarks and commercial names;
- 5%: royalties for the temporary use of rail cars;
- 25%: all other royalties, except those referred to in the next bullet; and
- 40%: royalties paid to certain residents of tax haven countries.

Most of Mexico's tax treaties reduce the withholding tax rate on royalties to 10%.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

Mexico's tax rules do not include provisions that allow the reduction of royalty income subject to withholding tax for expenses or other similar costs.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Mexico has a credit system that allows foreign tax credits to be set against a resident taxpayer's Mexican tax liability with respect to the taxpayer's foreign-source income. With respect to dividend income, a direct credit is allowed for foreign withholding taxes and an indirect credit is allowed, in certain instances, for taxes paid by the foreign company distributing the dividends on the earnings out of which the dividends are paid.

The foreign tax credits are limited to the income tax payable in Mexico on the net foreign-source income, which generally must be calculated on a country-by-country basis. A 10-year carryforward of unused foreign tax credits is allowed.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

Article 5 of the MITL lays down certain general rules related to the crediting of foreign taxes:

- The income on which the taxpayer paid income tax abroad must also be taxable in Mexico under the terms of the MITL;
- The foreign-source income considered taxable in Mexico must include the income tax paid abroad (i.e., the foreign-source income must be grossed up by the amount of the foreign tax);

- The foreign tax paid must be an income tax, in accordance with the general rules established by the Tax Administration Service, or a tax that is specifically covered in a tax treaty to which Mexico is a signatory; and
- The payment of the tax in the foreign country may not be conditioned on the right to credit the tax in Mexico.

In addition to the above, the amount of the foreign tax credit allowed is limited to the Mexican tax liability on the foreign-source income. The net foreign source income for this purpose must be calculated on a country-by-country basis, as follows:

1. The total amount of the taxpayer's foreign source income is reduced by:
2. Deductions:
   - The full amount of deductions that are exclusively attributable to the foreign-source income concerned; and
   - A proportionate share of the deductions that are attributable to both foreign- and domestic-source income. The share is calculated based on the proportion that the taxpayer's gross foreign-source income bears to its total income.
3. The net foreign-source income so calculated is multiplied by the tax rate of 30% to determine the overall foreign tax credit limitation.

Foreign taxes not credited in a given year may be carried forward for a period of up to 10 years.

In addition to the direct credit for withholding taxes, an indirect credit is allowed with respect to dividend income for a proportionate share of the corporate income tax paid by the distributing company on the earnings that are distributed. This credit is allowed provided the Mexican taxpayer in receipt of the dividends owned at least 10% of the capital of the distributing company for at least six months prior to the distribution.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

The excess foreign tax can be carried forward for a period of up to 10 years but cannot be deducted as an expense.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

The general rules for foreign tax credits in Mexico do not include exceptions or special provisions for a year in which the taxpayer is in a loss position. In such circumstances, the amount of the foreign tax credit would have to be calculated and any amount of usable (but unused) tax credit would be carried forward for a period of up to 10 years.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Any foreign withholding tax on interest would be subject to the direct foreign tax credit calculation described above with respect to dividends. There are no additional rules for taxes on interest.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Any foreign withholding tax on royalties would be subject to the direct foreign tax credit calculation described above with respect to dividends. There are no additional rules for taxes on royalties.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

As a general rule, the definition of any item of income provided in a tax treaty signed by Mexico will apply over the Mexican domestic law definition. If such a tax treaty provides a specific definition of dividends, interest or royalties, the treaty definition will apply, unless the treaty definition is broader than the domestic law definition. One income item with respect to which there has historically been a difference between the scope of the treaty definition and that of the domestic law definition has been interest, the Mexican tax law definition of which is very broad. That being said, most of Mexico's treaties refer to the domestic definition of interest, with the result that there are not many differences between the way in which Mexico, as the residence country, applies a treaty with respect to interest income and the way in which the source country applies the treaty.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Broadly speaking, the application of one of Mexico's tax treaties should not result in a higher tax burden than would result from the direct application of Mexi-

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can domestic law. The Mexican Supreme Court has held that a taxpayer may opt to benefit from a tax treaty if the treaty provides for a withholding rate lower than the rate provided for by domestic law. Conversely, if a treaty happens to provide for a higher withholding rate than the domestic law provisions, the taxpayer may choose to apply the domestic law provisions. One example of this is afforded by the fact that many of Mexico's treaties do not provide a reduced withholding tax rate for interest paid to nonresident financial institutions, but Mexico's domestic tax rules allow (on an annual basis) for a reduced withholding tax rate of 4.9% on interest paid to financial institutions resident in any treaty jurisdiction.

In Mexico, whether to apply the provisions of a tax treaty is at the discretion of the taxpayer, provided the taxpayer complies with the formalities prescribed by the MITL. Thus, the tax burden under a treaty cannot be higher than that which would result from the direct application of the relevant domestic law.

IV. Conclusion

Mexico has fairly straightforward rules regarding income paid to nonresidents that require the withholding of tax on payments of most types of income. In most cases, withholding tax is imposed on a gross basis and there are no special rules for reducing the withholding tax or allowing reductions of the amount of income subject to tax. The general withholding tax rate is 35%, but this is reduced in the case of payments to certain types of taxpayers and where a tax treaty applies. Most nonresidents invest in Mexico through treaty jurisdictions with a view to minimizing their Mexican withholding tax burden.

THE NETHERLANDS: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Profit distributions made by a Dutch resident corporation to a nonresident corporate shareholder generally are subject to Dutch dividend withholding tax (DWT), which is levied on the paying entity, and, in specific circumstances, to Dutch corporate income tax (CIT), which levied on the shareholder.

a. Dividend withholding tax

Under the Dutch Dividend Withholding Tax Act 1965 (DWTA), profit distributions made by Dutch resident corporations are generally subject to 15% Dutch DWT.[1] DWT is calculated on the gross amount of a distribution. If the DWT is not withheld from the distribution or the shareholder/recipient is otherwise compensated by the paying entity, a gross-up computation must be made.

Under a fiction, a corporation incorporated under Dutch company law will be deemed to be Dutch resident—and, thus, subject to DWT—even if it is resident outside the Netherlands, based, for example, on its place of effective management.[2]

b. Corporate income tax

Profit distributions made by a Dutch corporation to a nonresident corporate shareholder are subject to Dutch CIT only if the nonresident shareholder owns a shareholding in the Dutch corporation of 5% or more (a "substantial interest") and the shareholder is part of an artificial structure that was set up with one of the principal purposes of mitigating a liability to Dutch personal income tax.[3] If these rules apply, such profit distributions (net of allocable expenses) will be subject to CIT at the standard rate of 25%, with a step-up rate of 20% applying to the first 200,000 euros of taxable profit.

Where a profit distribution is subject to CIT, the CIT is levied on the nonresident shareholder. If the profit distribution is also subject to DWT (withheld by the Dutch corporation), the shareholder can credit the DWT against its CIT liability. Any excess DWT will be refunded under Article 25 of the Corporate Income Tax Act (CITA).

The above also applies to legal entities incorporated under Dutch company law that have their place of effective management outside the Netherlands.[4]

c. Impact of tax treaties

The Netherlands' tax treaties generally provide for a reduced rate of, and sometimes even an exemption

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from, source country taxation on profit distributions, subject to specific ownership thresholds.

As noted in I.A.1.a., above, under a fiction, a corporation incorporated under Dutch company law but tax-resident outside the Netherlands is still subject to Dutch DWT. If the Dutch corporation is tax-resident in a tax treaty country for treaty purposes, the applicable treaty would generally prohibit the Netherlands from levying DWT.[5]

A tax treaty may also limit the Netherlands' taxation rights where the treaty definition of an item of income differs from the domestic definition of that item, for example, in relation to interest payments that are treated as dividends under the Netherlands' domestic rules because the debt on which they are made is classified as equity for Dutch tax purposes. See further at I.A.2., below.

As of 2018, the DWTA provides a specific exemption for dividends paid to corporate shareholders residing in tax treaty jurisdictions where specific criteria are satisfied. This is described in more detail in I.A.6., below.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

a. Dividend withholding tax

The DWTA does not use the term "dividend" but instead refers to a "return" on shares, profit certificates, and debt qualifying as equity for Dutch CIT purposes. Article 3 of the DWTA includes a summary of what is understood by the term "return." A return on shares comprises—among other things—the following:

- Profit distributions under whatever name and in whatever form;
- Consideration received in the event of a buy-back of shares in excess of the average paid-up capital on the shares concerned;
- Liquidation distributions in excess of the average paid-up capital on the shares of the company being liquidated;
- A repayment of share premium to the extent the paying entity has retained profits;
- The nominal value of shares issued to shareholders to the extent those shareholders did not contribute capital on those shares; and
- Interest on debt that qualifies as equity for Dutch CIT purposes.

The Dutch domestic debt classification rules have been developed in case law. The general rule is that a funding instrument qualifying as a loan under Dutch civil law in principle should also be considered a loan for Dutch income tax purposes.[6] There are three exceptions to this rule, i.e., where the loan is:

- A "sham loan": The borrower and the lender represent the transaction concerned as a loan, but the actual intention of both parties is to make a capital contribution;[7]
- A "bottomless pit loan": The lender has provided a loan to a company based on the lender's status as a shareholder in that company under such conditions that, when the loan was provided, it should have been obvious to the lender that the loan could not be repaid (in full);[8]
- A "participating loan": The loan is granted under conditions that, to a certain extent, give the lender, by way of the money lent, a participation in the borrower's business. A loan is considered a participating loan if it fulfills the following cumulative conditions:[9]
  - The loan has no maturity date (i.e., repayment of the loan can only be demanded by the lender on the liquidation, bankruptcy or insolvency of the borrower) or the repayment date is more than 50 years after the date of granting of the loan;
  - The loan is subordinated to all ordinary debts and obligations of the borrower; and
  - The remuneration due on the loan is completely dependent (or almost completely dependent) on the profits of the borrower.

Given the broad scope of the definition in the DWTA, profit distributions in kind and hidden distributions will also be subject to DWT. For instance, a hidden distribution would be recognized where a Dutch corporation afforded a benefit to a shareholder via the incorrect pricing of an intercompany transaction, based on the "arm's length principle" enshrined in Dutch tax law.

b. Corporate income tax

The CIT rules described at I.A.1., above cover taxable "income," which is defined as regular profits from a "substantial interest" reduced by allowable expenses, and capital gains on a disposal (whether actual or deemed) of such a substantial interest. The broad definition of "income" essentially covers any kind of profit distribution.

c. Tax treaties

Based on the Dutch legal system, tax treaty definitions will generally prevail over domestic law definitions. See also III.A., below.

A tax treaty may affect the Dutch tax treatment of interest payments on debt that is treated as equity under Dutch tax rules. Generally the Netherlands' treaties provide lower source taxation rates for interest payments (in some cases even a 0% rate) than for dividend payments.

Interest payments on loans that qualify as equity for Dutch income tax purposes will generally be treated as dividends for tax treaty purposes only if, considering all the relevant circumstances, the lender effectively shares the risks run by the borrower, i.e., when the repayment of the loan depends largely on the success or otherwise of the borrower's business.[10] In other cases, such interest payments are generally treated as interest for treaty purposes.

Some of the Netherland's tax treaties explicitly include interest on a profit participating loan within the scope of their Dividend Articles.[11]

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

a. Dividend withholding tax

Following a 2016 court decision, the Netherlands has introduced measures that, in certain circumstances, allow the recognition of expenses incurred by shareholders for purposes of determining the DWT liability on profit distributions made to such shareholders.[12]

Broadly, under Article 10a of the DWTA, in certain circumstances, a corporate shareholder resident in the European Union or the European Economic Area (EEA), or in a country that has concluded an agreement with the Netherlands for the exchange of information on tax matters, may claim a refund of DWT to the extent the DWT withheld exceeds the Dutch CIT that would have been due had the shareholder been tax-resident in the Netherlands.[13] In calculating the deemed Dutch CIT liability, only expenses directly connected with obtaining the dividend income may be deducted.[14]

The refund facility in Article 10a of the DWTA only applies to nonresident corporate shareholders that are not liable to Dutch CIT, since shareholders that are so liable can deduct allowable expense from their Dutch taxable income. Any DWT in excess of an actual Dutch CIT liability is refunded under Article 25 of the CITA.

The refund facility in Article 10a of the DWTA is not available to a nonresident shareholder that is entitled to a full credit for Dutch DWT in its country of residence under a tax treaty concluded between that country and the Netherlands.

b. Corporate income tax

As noted in I.A.3.a, above, a nonresident corporate shareholder that is liable to Dutch CIT on dividend income derived from a "substantial interest" is generally allowed to deduct expenses that are allocable to that interest. In principle, this will include financing costs in connection with the acquisition of the substantial interest.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

There is no general rule in Dutch tax law recognizing an overall loss position of a nonresident shareholder.

a. Dividend withholding tax

In certain circumstances, Article 10a of the DWTA allows a limited deduction for expenses of a nonresident shareholder in determining the Dutch DWT liability. See I.A.3., above.

b. Corporate income tax

Nonresident corporate shareholders that are subject to Dutch CIT on Dutch-source dividend income are allowed to deduct expenses allocable to that dividend income, and may also deduct expenses and losses connected to other Dutch taxable sources of income (for example, expenses or losses connected to a substantial interest in another Dutch corporation) and expenses or losses connected to Dutch real estate.[15]

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Dutch tax law does not provide for a general tax reduction or exemption in situations where a nonresident shareholder cannot claim full relief in its country of residence.

Subject to certain conditions, Article 10 of the DWTA allows a nonresident corporate shareholder that is tax-exempt in its country of residence (and thus typically not able to apply a credit for foreign withholding taxes) a refund of DWT. A condition for the refund is that the nonresident shareholder would have been exempt from Dutch CIT had it been tax-resident in the Netherlands (for example, a qualifying pension fund). Article 10 applies only if the nonresident shareholder is resident within the European Union/EEA or in a country that has concluded an agreement with the Netherlands for the exchange of information on tax matters. A nonresident shareholder that is resident in a treaty country can only enjoy the refund facility if the DWT relates to income from "portfolio investments," i.e., investments governed by the free movement of capital principle in Article 63 of the Treaty on the Functioning of the European Union (TFEU).

As discussed in I.A.3., above, in certain circumstances, Article 10a of the DWTA allows a refund of DWT on dividends distributed to nonresident shareholders. This refund facility takes into account the shareholder's ability to claim relief in its country of residence: i.e., the refund facility is only available if the nonresident shareholder is *not* entitled to a full credit for the Dutch DWT in its country of residence, based on a tax treaty concluded between that country and the Netherlands.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

a. Domestic DWT exemption—anti-abuse rule

The DWTA provides for an exemption from DWT in the case of cross-border intra-group dividends. Broadly, the conditions for the exemption are that the corporate shareholder concerned:[16]

- Is tax-resident within the European Union/EEA or in a country that has concluded a tax treaty with the Netherlands that includes a Dividend Article;
- Would have been able to apply the Dutch participation exemption on its shareholding in the Dutch corporation if it were tax-resident in the Netherlands, which generally requires the holding of a shareholding of 5% or more (see II.A.1., below);[17]
- Is not comparable to a Dutch fiscal investment institution (*fiscale beleggingsinstelling* or FBI)—the Dutch equivalent of a REIT—or a Dutch tax-exempt investment institution (*vrijgestelde beleggingsinstelling* or VBI); and
- Is not part of an artificial structure that was set up with one of the principal purposes of mitigating a liability to Dutch DWT (the "anti-abuse rule").

The anti-abuse rule referred to above was introduced with effect from January 1, 2018, and is intended to be in line with the "general anti-abuse rule" in the EU Parent Subsidiary Directive[18] and the "principal purpose test" included in the BEPS Action 6 Final Report "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances."

The domestic anti-abuse rule may currently be applied only in the context of existing Dutch tax treaties that include an anti-treaty shopping clause, for example, in the form of a principal purpose test. In June 2017, the Netherlands and many other OECD member countries signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument" or MLI). The MLI implements the treaty-related anti-tax avoidance measures of the BEPS project in bilateral tax treaties, including the possible introduction of a principal purpose test as part of BEPS Action 6. At the time of signing the MLI, the Netherlands submitted a list of 82 tax treaties concluded with other jurisdictions to be amended through the MLI. It is expected that once the MLI enters into effect, the domestic anti-abuse rule will have an impact under many more treaties.[19]

b. Remittance reduction

Article 11 of the DWTA provides for a DWT remittance reduction in situations where a Dutch corporation receives dividend income from foreign participations that is subject to foreign DWT and on-distributes dividends to foreign shareholders subject to Dutch DWT. The facility is available if the foreign dividends are exempt from Dutch CIT under the Dutch participation exemption rules (see II.A.1., below), in which case the Dutch corporation cannot credit or deduct the foreign DWT. The facility is available only if and to the extent that the Dutch corporation receives dividend income from participations of 25% or more in foreign entities that are resident in tax treaty countries.

Under Article 11 of the DWTA, the Dutch corporation can claim a reduction of the Dutch DWT on the dividend it distributes of up to 3% of the amount of the distribution, but no more than 3% of the gross dividend income it received from its qualifying foreign participations in the year of the distribution up until the time of the distribution and the preceding two calendar years to the extent such dividends have not yet been taken into account for purposes of the 3% reduction rule.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

a. Withholding tax

Currently, the Netherlands does not levy withholding tax on arm's-length interest payments on genuine debt, i.e., debt that does not qualify as equity for Dutch tax purposes (however, see IV., below). In the case of excessive interest payments on genuine debt, i.e. interest payments in excess of an arm's-length remuneration, the excess will be treated as a dividend under Dutch domestic law if the payments are made to a direct or indirect shareholder or sister company and, as such, will be subject to Dutch DWT. DWT also applies to interest on debt that is treated as equity for Dutch tax purposes.

b. Corporate income tax

A nonresident corporate lender will be liable to Dutch CIT on interest income on a loan provided to a Dutch corporation in which it owns a substantial interest in accordance with Article 17, paragraph 3 of the CITA. For this to apply, the nonresident lender must hold a shareholding in the Dutch corporation of 5% or more and there must be an abusive situation, i.e., the nonresident shareholder/lender must form part of an artificial structure that was set up with one of the principal purposes of mitigating a liability to Dutch personal income tax. Where the rules apply, the interest income on the loan to the Dutch corporation—net of allowable expenses—will be subject to CIT at the standard rate of 25%, with a step-up rate of 20% applying to the first 200,000 euros of taxable profit.

c. Impact of tax treaties

The Netherlands right to levy CIT on interest income may be limited under the terms of one of its tax treaties. Most of these treaties include an Interest Article providing for a reduced rate of taxation on interest or even an exemption.

For the treatment under the Netherlands' tax treaties of interest payments on loans that are classified as equity for Dutch tax purposes, see I.A.2., above. As a general rule, such interest payments will fall within the scope of the treaty Interest Article despite their "dividend classification" under Dutch domestic tax law.

The Netherlands' tax treaties generally include a provision stating that excessive interest payments will be governed by the Dividend Article, i.e., dividend classification under domestic tax law will generally be followed under the Netherlands' tax treaties.[20]

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Currently, the Netherlands does not levy withholding tax on arm's-length royalty payments (however, see IV., below). In the case of excessive royalty payments, i.e., royalty payments in excess of an arm's-length remuneration, the excess will be treated as a dividend if the payments are made to a direct or indirect shareholder or sister company and, as such, may be subject to Dutch DWT.

The Netherlands' tax treaties generally include a provision stating that excessive royalty payments will be governed by the Dividend Article, i.e., dividend classification under domestic tax law will generally be followed under the Netherlands' tax treaties.[21]

The CITA does not provide for the taxation of royalty payments made by a Dutch corporation to a nonresident corporation that does not have a permanent establishment (PE) in the Netherlands.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

This question is not relevant—see I.C.1., above.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

a. Domestic relief rules – general

The Netherlands taxes its tax-residents on their worldwide income. The Netherlands has concluded many tax treaties with other countries that divide taxation rights and include methods for the avoidance of the double taxation of profits and payments. Moreover, Dutch tax law includes a number of unilateral rules and regulations designed to mitigate the (juridical or economic) double taxation of foreign profits and payments. The most relevant of these are:

- The Unilateral Decree for the Avoidance of Double Taxation 2001 (the "Unilateral Decree"), which contains measures designed to avoid the double taxation of foreign business profits derived by Dutch personal income taxpayers, and of payments of dividends, interest and royalties from designated development countries received by both Dutch corporate and Dutch personal income taxpayers.[22] The rules for the computation of relief contained in the Unilateral Decree can also be applied under the Netherlands' tax treaties, either through references in a tax treaty to domestic law or based on the Decree of July 18, 2008 (see below).
- The Decree dated July 18, 2008, which contains the policies of the Dutch Ministry of Finance on relief from double taxation under tax treaties.[23]
- Articles 13 through 13aa of the CITA, containing the main principles of the participation exemption.
- Articles 15e through 15j of the CITA, containing the rules for the avoidance of double taxation on foreign business profits derived by Dutch corporate taxpayers (the "source exemption").

b. Dividends

A Dutch corporation receiving dividends from a foreign company may be tax-exempt under the participation exemption rules if—broadly—the following criteria are satisfied:[24]

- The Dutch corporation owns a shareholding in the foreign company of 5% or more (by reference to the paid-up share capital of the foreign company); and
- One of the following tests is passed:
  - The shareholding in the foreign company is held as an active investment, i.e., is not held merely to realize a return expected from a passive portfolio investment (intention test); or
  - The foreign company is subject to a profit tax that results in a reasonable level of taxation according to Dutch standards (subject to tax test); or
  - Less than 50% of the aggregate assets of the foreign company usually consist of low-taxed passive investments (asset test).

Where the participation exemption applies to dividend income, any foreign dividend withholding tax withheld on that income cannot be credited or deducted from taxable profits. The Dutch corporation may be able to claim relief for part of the foreign withholding tax through the application of the remittance reduction facility in Article 11 of the DWTA (see I.A.6., above).

Article 13aa of the CITA, in conjunction with Articles 23c and 23d of the CITA, includes detailed relief rules dealing with foreign taxes on dividend income derived from participations of 5% or more that do not qualify for the participation exemption (low-taxed passive investment participations).

If the dividend income received by a Dutch corporation is not covered by the participation exemption rules—typically where the Dutch corporation holds a shareholding of less than 5% in the distributing corporation—the Dutch corporation can claim a credit for foreign withholding tax on the dividend income only if the dividend is paid by a company resident in a tax treaty country (based on the applicable treaty) or a designated development country (based on the Unilateral Decree). Alternatively, the Dutch corporation may opt for a tax deduction for the foreign withholding tax.

If the dividend is paid by a company that is not resident in a tax treaty country or a designated development country, the domestic tax rules do not allow the Dutch corporation to credit foreign dividend withholding tax. The Dutch corporation will then only be entitled to a tax deduction for such withholding tax.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

Under Article 36 of the Unilateral Decree, relief for foreign withholding tax on foreign dividends, interest and royalty payments is limited to the *lower* of the following:

- The amount of foreign withholding tax actually levied but, in the case of dividends, no more than 15% of the gross amount of the foreign dividend income (first limit);[25] or
- The amount of Dutch CIT actually due on the foreign income, reduced by allocable expenses (second limit). The allocable expenses also comprise expenses incurred by related companies or individuals that are allocable to the foreign income and deducted from Dutch taxable income.[26]

Where a tax treaty applies, the first limit will generally be determined by that treaty. For instance, if a treaty provides for a "tax sparing credit," i.e., a deemed percentage of foreign withholding tax, the first limit is equal to the amount of the tax sparing credit.

Relief is calculated on the total of foreign dividend, interest and royalty payments that are subject to foreign withholding tax.[27]

The Unilateral Decree provides for the computation of relief based on an overall approach that includes foreign payments from *all* designated development countries that are subject to foreign withholding tax. As a general rule, relief under tax treaties is calculated on a per-country basis. However, subject to certain conditions and at the taxpayer's request, relief under a treaty may also be calculated on an overall basis.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

If the foreign withholding tax available for credit based on the first limit exceeds the second limit (see II.A.2., above), the excess may be carried forward for an indefinite period of time. The excess amount cannot be deducted as an expense either in the year in which the foreign withholding tax is incurred or in future years.

A carried forward unused credit for foreign withholding tax may be forfeited where there is a substantial change in the ultimate ownership of a Dutch corporation.[28]

As an alternative to a credit, a Dutch corporation may opt to claim a tax-deduction for the full amount of foreign withholding tax.

The above principles follow from the Unilateral Decree but also apply under the Netherlands' tax treaties, as confirmed by the Ministry of Finance in the Decree dated July 18, 2008. Under the Netherlands' treaties, a tax deduction for foreign withholding taxes will not be available if the Dutch taxpayer opted to calculate relief on an overall basis (see II.A.2., above).

The Ministry of Finance has made a concession applying to situations in which relief cannot be availed of due to the limits described at II.A.2., above, as a result of timing differences, for example, where foreign interest income is subject to Dutch CIT on accrual in year one, and foreign withholding tax is levied on the actual payment of the foreign interest, for example, in year two. If the Dutch taxpayer does not have qualifying foreign taxable income in year two, no relief will be available in that year because of the application of the second limit. Under the concession, in such circumstances, the Dutch taxpayer may include the foreign interest income as taxed in year one in the relief computation for year two.[29]

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

If a Dutch corporation incurs a tax loss in a year, no credit will be available in that year for qualifying foreign withholding tax incurred on dividend income received in that year. This is a consequence of the second limit described in II.A.2., above (under which the credit is limited to the CIT actually due on the dividend income concerned).

The foreign withholding tax can be carried forward and credited in future years against Dutch CIT on foreign income derived in those years. Alternatively, the Dutch corporation may claim a tax-deduction for the amount of foreign withholding tax, thereby increasing the tax loss for the year. A tax loss can be carried forward for nine years.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Foreign-source interest payments received by a Dutch resident corporate taxpayer will be subject to regular CIT. Unlike in the case of dividends, which may – subject to certain conditions – be exempt from CIT under the participation exemption, Dutch tax law does not provide for an exemption for interest income.[30]

The relief rules set out in II.A., above in relation to dividends also apply to interest payments.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Foreign-source royalty payments received by a Dutch resident corporate taxpayer will be subject to regular CIT. Unlike in the case of dividends, which may – subject to certain conditions – be exempt from CIT under the participation exemption, Dutch tax law does not provide for an exemption for royalty income.

The relief rules as set out in II.A., above in relation to dividends generally also apply to royalty payments. Article 36a of the Unilateral Decree includes specific credit rules for foreign withholding tax on royalty payments that are taxed under the innovation box regime in Article 12a of the CITA. Article 12a provides for the taxation of 28% of income from qualifying intangible assets (IP).

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Based on the Dutch Constitution, treaties prevail over domestic law.[31] As a consequence of this principle, the classification of income under a tax treaty will generally prevail over the classification of such income under Dutch domestic tax rules. (See also I.A.2., above in relation to interest payments on debt qualifying as equity under Dutch domestic tax rules, which are generally covered by the Interest Article in the Netherlands' tax treaties.)

It follows from Dutch case law that various sources of information are relevant for the interpretation of terms used in a tax treaty. In the first instance, the wording of the treaty concerned and any protocol(s) to that treaty form an important source of information. As most of the Netherland's tax treaties are based on the OECD Model Tax Convention, the OECD Commentary on the Model Convention is also relevant for the interpretation of those tax treaties. Generally, the OECD Commentary available at the time of the conclusion of the tax treaty concerned will take precedence. Subsequent changes to the OECD Commentary are only relevant for the interpretation of a tax treaty where those changes are meant to clarify, not to alter, the OECD position.

Other relevant sources are the Vienna Convention,[32] the UN Model Convention and explanatory notes issued in the course of the tax treaty ratification process.

Once a Dutch governmental authority (the tax authorities or a court) has taken a position on the classification of an element of income under a tax treaty based on the sources of information referred to above, if this position conflicts with the interpretation by a governmental authority of the other Contracting State, the prescribed way to mitigate double taxation of the income concerned is to initiate a mutual agreement procedure (MAP). The Netherlands' tax treaties generally include a MAP in line with Article 25 of the OECD Model Tax Convention.

In the case of a clear treaty override (for example, when the other Contracting State disregards a tax treaty provision, taking the view that a subsequent change in its domestic tax law prevails over the treaty), a MAP is unlikely to result in a reasonable outcome. As an ultimate remedy against such a treaty override, the Netherlands may threaten the other State with the suspension, or even termination, of the treaty concerned.[33]

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Based on the Dutch Constitution a tax treaty may limit the Dutch tax authorities' right to levy tax on certain elements of income. However, a tax treaty cannot create a taxation right.[34]

Based on the above principle, the application of a tax treaty generally should not result in a higher tax burden than would result from the direct application of Dutch domestic law. In highly exceptional cases (involving dual tax-residents/ Dutch domestic tax residence fictions), a tax treaty may result in the non-recognition of an expense or a loss where the expense or loss would be recognized for Dutch tax purposes if the tax treaty were not to apply.[35]

IV. Conclusion

The previous sections of this paper provide a broad overview of the Dutch domestic tax treatment of inbound and outbound dividend, interest and royalty payments between corporations, under the currently applicable rules. There are a number of domestic and international developments that will have a material impact, in particular on the Dutch tax treatment of outbound payments, in the next few years. Two of those developments are discussed below.

As noted in I.A.6., above, the MLI will impact designated existing Netherlands' tax treaties that currently do not include an anti-treaty shopping provision, such as a principal purpose test. The MLI may impact the Dutch DWT position under these tax treaties, at the earliest from 2019.

In February of this year, the Dutch State Secretary of Finance issued two letters containing his tax plans for the near future. In these "tax policy letters," the State Secretary announced, among other things (and further to previous communications), his intention to abolish the dividend withholding tax with effect from 2020. On the other hand, the State Secretary announced his intention to introduce conditional withholding taxes on intra-group dividend, interest and royalty payments. These withholding taxes would apply to payments to companies located in low-tax jurisdictions and countries that are on the EU list of non-cooperative jurisdictions (the "EU blacklist"). The conditional withholding tax on dividends will be introduced with effect from 2020. The conditional withholding taxes on interest and royalty payments will be introduced with effect from 2021.

NOTES

[1] There are exceptions to the general rule, e.g., a cooperative association is liable to DWT only if it functions as a holding entity (a "holding cooperative" under DWTA, Art. 1, para. 8) and an "exempt investment institution" (*vrijgestelde beleggingsinstelling* or VBI) is exempt from DWT (DWTA, Art. 1, para. 4.

[2] DWTA, Art. 1, para. 3.

[3] CITA, Art. 17, para. 3.

A Dutch personal income tax liability, and thus the mitigation thereof, could generally only arise where a private individual (ultimately) owned a shareholding in the Dutch corporation of 5% or more. See Personal Income Tax Act 2001 (PITA), Art. 7.3 in conjunction with PITA, Section 4.3.

[4] CITA, Art. 2, para. 4.

[5] OECD Model Tax Convention on Income and Capital (the "OECD Model Tax Convention"), Art. 10(5) (prohibition of extra-territorial taxation)

[6] E.g., Dutch Supreme Court, Jan. 27, 1988, BNB 1988/217 (ECLI:NL:HR:1988:ZC3744).

[7] E.g., Dutch Supreme Court, Jan. 27, 1988, BNB 1988/217 (ECLI:NL:HR:1988:ZC3744).

The "sham loan" is in fact not a real exception, since such a loan generally will also not qualify as a loan under civil law (under civil law the intentions of parties take precedence, not the form of the transaction).

[8] E.g., Dutch Supreme Court, Jan. 27, 1988, BNB 1988/217 (ECLI:NL:HR:1988:ZC3744), and Dutch Supreme Court, May 24, 2002, BNB 2002/231 (ECLI:NL:HR:2002:AE3171).

[9] E.g., Dutch Supreme Court, March 11, 1998, BNB 1998/208 (ECLI:NL:HR:1998:AA2453).

[10] See section 25 of the Commentary on OECD Model Tax Convention, Art. 10(3).

[11] E.g., the Netherlands-Luxembourg tax treaty.

[12] Verdict of the Dutch Supreme Court of March 4, 2016 (ECLI:NL:HR:2016:361 - 363) in follow-up to the verdicts of the Court of Justice of the European Union (CJEU) of Sept. 17, 2015, in joint cases *J.B.G.T. Miljoen* (C-10/14), X (C-14/14) and *Société Générale S.A.* (C-17/14) (ECLI:EU:C:2015:608).

[13] In the case of nonresident shareholders that are resident in a treaty country, the refund facility is only available if the DWT relates to income from "portfolio investments," i.e., investments that are governed by the free movement of capital principle in TFEU, Art. 63.

[14] It could be argued that allowing a recognition of only expenses incurred in collecting the dividend income is in violation of EU law. Dutch resident corporate shareholders that cannot apply the participation exemption may deduct more expenses, e.g., interest expense on loans financing the equity participation in the company paying the dividend. There is no clear justification for this difference in treatment.

[15] CITA, Art. 17 in conjunction with CITA, Arts. 17a and 18.

[16] DWTA, Art. 4, paras. 2 and 3.

[17] In case of a "shareholding" (in fact, a membership right) in a Dutch cooperative association, this minimum ownership criterion does not apply.

[18] Council Directive 2011/96/EU of Nov. 30, 2011 as amended by Council Directives 2014/86/EU of July 8, 2014 and 2015/121/EU of Jan. 27, 2015

[19] On Dec. 20, 2017, the Dutch government submitted the bill for ratification of the MLI to parliament. The Dutch government intends to complete the ratification procedure in the first half of 2018, so that the MLI may have effect for tax treaties concluded by the Netherlands as of Jan. 1, 2019 (this will depend on ratification by the Netherlands' treaty partners).

[20] OECD Model Tax Convention, Art. 11(6).

[21] OECD Model Tax Convention, Art. 12(4).

[22] Unilateral Decree, Art. 6 includes the criteria for classification as a "development country." This classification is primarily based on the most recent "List of Recipients of Official Development Assistance" from the Development Assistance Committee of the OESO.

[23] Nr. CPP2007/664M, State Journal nr. 151

[24] CITA, Art. 13.

[25] The 15% equals the Dutch DWT rate

[26] An entity (or individual) will generally be considered related to the taxpayer if it holds a direct or indirect share interest in the taxpayer of 1/3 or more, if the taxpayer holds such a direct or indirect share interest in the entity or if there is a party that holds such direct or indirect share interests in both the entity and the taxpayer.

[27] Foreign payments may also be included in the relief computation if they are not subject to foreign withholding tax based on foreign domestic tax rules, provided the levy of foreign withholding tax is allowed under an applicable tax treaty and is not prohibited under another international arrangement, e.g. the EU Interest and Royalties Directive (EU Directive 2003/49).

[28] Unilateral Decree, Art. 46.

[29] Decree dated July 18, 2008, Para. 3.3.

[30] In specific circumstances, interest income on loans that qualify as debt for Dutch tax purposes may fall within the scope of the participation exemption, provided the interest is not deductible for the debtor. See CITA, Art. 13, paras. 4 and 5, in conjunction with CITA, Art. 13, para. 17.

[31] Dutch Constitution, Arts. 93 and 94.

[32] Vienna Convention on the law of treaties, concluded on May 23, 1969.

[33] See 2011 Tax Treaty Policy Note of the Dutch Ministry of Finance, page 69.

[34] Dutch Constitution, Art. 94 in conjunction with Dutch Constitution, Art. 104.

[35] E.g., Verdict of Dutch Supreme Court, March 12, 1980 (ECLI:NL:HR:1980:AX0028).

SPAIN: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

As a general rule, non-Spanish tax residents are subject to nonresident income tax (NRIT) on their Spanish-source income derived either directly or through a Spanish permanent establishment (PE). Dividends and profit distributions are considered to be Spanish-source income if they are derived from participation in the equity of any kind of Spanish resident entity.

Under Spanish domestic law, Spanish-source dividends are subject to NRIT at the rate of 19%, unless a lower rate applies under an applicable tax treaty or the dividends qualify for the Spanish domestic exemption under the EU Parent-Subsidiary Directive.

In order for the Spanish domestic exemption referred to above to apply, the following requirements must be met:

- The Spanish subsidiary distributing the dividends must be a corporation (SA), a limited liability company (SL), a partnership limited by shares or a public law body operating under private law.
- The non-Spanish resident parent company must have one of the corporate forms in its country of residence that are listed in the Annex to the EU Parent-Subsidiary Directive and must be subject to CIT in its country of residence.
- The non-Spanish resident parent company must hold a direct participation of at least 5% or with an acquisition value of at least 20 million euros in the share capital of the distributing Spanish subsidiary.
- The shareholding must be held continuously for at least one year. If dividends are declared before the participation has been held for one year, there is no exemption from withholding tax, but the non-Spanish parent company may apply for a refund if it subsequently fulfills the holding period condition; and
- The amount distributed may not derive from the liquidation of the Spanish subsidiary.

The Spanish domestic exemption for dividend distributions to EU residents contains the following anti-abuse provisions:

- The beneficiary of the dividends may not be tax resident in a tax haven jurisdiction; and
- The majority of the voting rights of the parent company (i.e., the beneficiary of the dividends) must be held, directly or indirectly, by individuals or entities that are resident in the European Union or a European Economic Area (EEA) country with which Spain has an effective exchange of tax information, unless the incorporation and operation of the parent company are based on valid and substantial business purposes.

Likewise, within the framework of BEPS and the Multilateral Instrument (MLI), in order to prevent treaty abuse, Spain has confirmed that it will include the Principal Purpose Test (PPT) clause in its existing tax treaties (if they do not already have an analogous clause). Under the PPT clause, the benefits of an applicable tax treaty will not be granted where the principal purpose, or one of the principal purposes, of any arrangement or transaction, or of any person concerned with an arrangement or transaction, is to obtain benefits under the treaty.

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2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Article 10 of most of Spain's tax treaties includes a broad definition of the term "dividends,"[1] which, in addition to specifying certain kinds of income, makes reference to the laws of the Contracting State of which the company making the distribution is a resident. This is essentially in line with Article 3 of most of these tax treaties,[2] which provides that the interpretation of a term by the source State prevails over the interpretation of the other State.

Thus, Spanish domestic law will apply to determine the scope of the term "dividends" for purposes of the taxation of Spanish-source dividends in the hands of a nonresident, except where the express terms of a tax treaty provide a clear and explicit definition, and Spain will not rely on the classification of the income in the country of residence of the recipient.

The NRIT Law provides that the characterization of income derived by nonresidents is to be made in accordance with the Spanish Personal Income Tax (PIT) Law. Under the PIT Law, the concept of a dividend is broad enough to encompass any kind of revenue, whether in cash or in kind, derived from equity participations. It includes: dividends, profit distributions, and income arising from assets entitling the holder to participate in profits, sales, income or similar items, not being consideration for personal services; premiums for attending general shareholders' meetings; income arising from the creation or assignment of a right to use or enjoy shares or participations in the equity of a company; any other emolument received from a company as a consequence of the recipient being a partner or shareholder; and the distribution of the paid-in surplus on shares or participations, among other items.[3]

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

As a general rule, non-Spanish tax residents are subject to NRIT on their Spanish-source "gross" income. In the case of dividends, the taxable base is the gross income, with no deduction of expenses. There is an exception in the case of residents of EU Member States or EEA countries that have an effective exchange of tax information with Spain. Such residents can deduct the expenses provided for in the PIT Law or in the Corporate Income Tax (CIT) Law, depending on whether they are, respectively, individuals or legal entities and provided the expenses concerned have a direct economic link with the activity carried on in Spain.

In the case of individuals, the PIT Law provides that only fees paid for the custody and administration of negotiable securities are deductible.

It should be noted that Spanish resident entities are allowed to deduct all expenses related to the income derived by them, whereas non-Spanish resident taxpayers are only allowed to deduct expenses subject to the conditions set out above and only if they are residents of an EU Member State or an EEA country. This has been challenged as a potential infringement of the freedom of establishment. On September 11, 2017, and November 2, 2017, the Spanish Central Administrative Economic Court (TEAC) reviewed the possible existence of an infringement of the freedom of establishment contrary to the Treaty on the Functioning of the European Union (TFEU). The TEAC held that this difference in treatment corresponds to a positive distinction, insofar as it was established based on the different tax rates applied to Spanish residents and non-Spanish residents. Thus, according to the TEAC's decision, the difference in treatment is in line with the fundamental freedoms provided for in the TFEU.

4. Nonresidents with losses: does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

Under Spanish domestic law, taxation is imposed on non-Spanish tax residents on a transaction-by-transaction basis. Thus, Spanish law does not take into account the fact that a nonresident may have other losses or an overall loss.

In fact, such a situation is not even taken into account when withholding tax is imposed on dividends distributed to Spanish residents, whether individuals or legal entities (where applicable). That being said, a Spanish-resident taxpayer that has no PIT or CIT liability after aggregating all income and expenses on his/her/its tax return is entitled to obtain a refund of any excess tax paid.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

Spanish NRIT normally applies even if the classification given to the income concerned in the residence country does not allow the recipient to obtain a tax credit. In order to minimize the double taxation potentially arising, Spain's tax treaties generally contain a clause providing for a mechanism to avoid such double taxation. However, there is no general provision allowing a reduction of, or exemption from, Spanish NRIT where incomplete double tax protection is afforded in the country of residence of the recipient of Spanish-source income.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Spanish domestic law does not contain any provisions that specifically address dividends distributed to foreign holding companies. As indicated in I.A.1., above, non-Spanish tax residents are subject to NRIT on their Spanish-source dividends at a 19% rate, unless a lower rate applies under a tax treaty or the dividends qualify for the Spanish domestic exemption under the EU Parent-Subsidiary Directive.

The NRIT law does not allow foreign tax credits to be set off by a nonresident shareholder against the applicable withholding tax on dividends distributed to it, even where such foreign tax credits cannot be otherwise used because inbound dividends are tax-exempt under domestic law.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends?

As a general rule, non-Spanish tax residents are subject to NRIT on the gross amount received in the form of interest or any other income derived from the granting to third parties of the right to use the taxpayer's capital, when such income is paid by a Spanish resident individual or company (including a Spanish PE of a nonresident individual or company) or when the taxpayer's assets or capital are used in Spain. Spanish-source interest is taxed at the rate of 19%, unless a lower rate applies under a tax treaty or the interest falls into one of the following categories, which qualify for an exemption under Spanish domestic law:

- Interest derived by a resident of another EU Member State or an EU-situs PE of an EU resident, unless the beneficiary of the interest is resident in a tax haven jurisdiction;
- Interest from a nonresident account held with a Spanish financial entity;
- Interest on public bonds, even if the beneficiary is resident in a tax haven jurisdiction; and
- Interest on securities issued in Spain by a nonresident entity without a PE in Spain.
-

As in the case of dividends, most of Spain's tax treaties include a definition of interest that covers all other income assimilated to income from money lent by the taxation laws of the country in which the income arises. Also, the characterization of income obtained by a nonresident as interest is to be made in accordance with the PIT rules. In this respect, interest is defined as income in cash or in kind derived from the granting to third parties of the right to use the taxpayer's capital, including: income derived from the transfer or endorsement of commercial instruments, unless the assignment is made in payment of accounts payable to suppliers; interest or any other consideration received from lending money; income arising from the assignment of credits belonging to financial entities; and income derived from the transfer, endorsement, payment on maturity, exchange or conversion of any financial asset representing the obtaining and use of third party capital.

Non-Spanish tax residents are generally subject to NRIT on their Spanish-source "gross" income. The rules described in I.A.3., above in relation to dividend income apply to interest income insofar as they concern the tax-deductibility of expenses.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in I.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Non-Spanish tax residents are generally subject to NRIT on Spanish-source royalties that they derive when they are paid by a Spanish resident individual or company (including a Spanish PE of a nonresident individual or company) or are used in Spain.

Under Spanish domestic law, royalties are subject to withholding tax at the rate of 24% (19% if the beneficiary is a resident in an EU Member State or an EEA country), unless a lower rate applies under an applicable tax treaty or the royalties qualify for the Spanish domestic exemption under the EU Interest and Royalties Directive.

For the EU royalties exemption to apply, the following requirements must be met:

- Both companies (i.e., both the payer and the beneficiary of the royalties) must be subject to, and not exempt from, an income tax (i.e., one of the taxes listed in Article 3 a) iii) of the Directive).
- Both companies must have one of the legal forms listed in the Annex to the Directive.
- Each company must be tax resident in an EU Member State and not treated as resident in a third non-EU country under a tax treaty with that country.
- In the case of royalties paid by a PE, the royalties must qualify as tax-deductible expenses for that PE.
- The company receiving the royalty payments must be the beneficial owner of the payments. This excludes, among others, cases in which the recipient is acting as an intermediary, such as an agent, a trustee or an authorized signatory. Where the recipient is a PE, this requirement means that the royalties must be related to the PE's business and included in its taxable income.
- Both companies must be "associated companies." Under the NRIT Law, two companies are deemed to be "associated companies" for this purpose if:
  - One of the companies holds directly at least 25% of the capital of the other company; or
  - A third EU company holds directly at least 25% of the capital of both companies.
- The minimum 25% holding referred to in the previous bullet must be held for at least one year prior to the payment of the royalties or must continue to be held after the payment for the time necessary to complete the one year period.

The EU royalties exemption described above does not apply if the beneficiary of the royalties is directly or indirectly controlled by a company or an individual that is not resident in an EU Member State, unless the incorporation and business of the parent company in the EU Member State are based on valid and substantial business purposes.

Under Spanish domestic law, a royalty is defined as any kind of payment made for the use or the grant of the right to use:

- literary, artistic or scientific rights, including films;
- patents, trademarks, drawings, maps, and know-how;
- software;
- information relating to industrial, commercial, or scientific experience;
- transferable personal rights, such as image rights; and
- any other right similar to the above.

It should be noted that if the taxpayer is the author/inventor of the intellectual/industrial property with respect to which the royalties are paid, the royalties received are treated as business income, but if the right to exploit the property is assigned to a third party, the remuneration received is normally deemed to be employment income. Special rules also apply to software to the effect that, in certain circumstances, payments for software do not qualify as royalties, but as business income.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

As indicated above, non-Spanish tax residents are subject to NRIT on their Spanish-source "gross" royalty income, and the rules discussed in I.A.3., above in relation to dividend income will apply regarding deductible expenses. This means that non-Spanish tax residents deriving Spanish-source royalties are subject to NRIT on their Spanish-source "gross" income and only EU and qualifying EEA residents are entitled to deduct expenses directly linked to the activity carried on in Spain. Apart from royalties covered by this rule, there is no special category of royalties that can be reduced in amount, granted an allowance or otherwise taxed after recognizing potential costs.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Spanish tax residents (both individuals and corporations) are taxed on their worldwide income and must therefore include income from foreign sources in their tax returns, irrespective of whether the income has been taxed abroad.

Where foreign-source income has been taxed abroad, Spain uses the ordinary credit method as a unilateral measure for the avoidance of juridical double juridical taxation. Under Spanish CIT Law, Spanish resident entities and Spanish PEs of nonresident companies deriving income from a foreign source that has been taxed abroad can credit the lower of the following two amounts against the Spanish tax due with regard to such income: (1) foreign income tax of a nature identical or analogous to Spanish CIT effectively paid abroad; and (2) the amount of the Spanish tax payable on that income.

The foreign tax credit is generally determined on a per-country basis. However, the foreign tax credit granted to the foreign PE of a Spanish resident company is computed individually for each PE and determined independently of the credit available with respect to other kinds of income derived from the same country in which the company is acting through the PE.

To determine the tax credit basis, foreign withholding taxes must be added to the foreign income concerned. In the case of a PE, the foreign corporate income tax paid by the PE must also be added to the PE's net income.

Any excess of foreign taxes that cannot be deducted from a Spanish resident taxpayer's tax liability can be carried forward without limitation. It is not possible to carryback excess foreign tax credits. The above tax relief method applies, even if the foreign taxes concerned are paid in a tax haven jurisdiction.

The existence of double international taxation is a requirement for the application of the tax relief method described above. Thus, if there is no double taxation in Spain (for example, in the case of dividends that are tax exempt in Spain), there is no possibility of deducting the taxes paid abroad.

The right of the Spanish tax authorities to review pending tax credits becomes statute-barred after a period of 10 years from the date of filing of the tax form on which the credit was generated.

As an alternative to availing themselves of the tax credit provided for under Spanish domestic law, Spanish resident taxpayers may instead apply the method provided for in an applicable tax treaty to avoid double taxation, if this is more favorable. However, under its network of comprehensive tax treaties, the method generally used by Spain for the avoidance of double taxation is the ordinary credit method described above.

Regarding relief from economic double taxation (i.e., in this case, the taxation of the income of the dividend-paying company in the hands of that company followed by the taxation of the dividend income in the hands of the shareholder), Spanish law provides for two alternatives: (1) the participation exemption regime for dividends and capital gains; and (2) the indirect tax credit with respect to the underlying CIT paid on the profits out of which dividends are paid.

The participation exemption regime, which is governed by the CIT Law, provides that foreign-source dividends derived by a Spanish tax resident company are exempt if the conditions summarized below are fulfilled:

- The Spanish tax resident company has, directly or indirectly, a participation of at least 5% or with a value of more than 20 million euros in the nonresident company, and that participation has been maintained uninterrupted over a one-year period (which includes any period during which the participation was owned by another entity in the same group of companies). The exemption may be also granted if the distribution is made before the conclusion of the one-year period, provided the resident parent continues to hold the participation for the remainder of that period after the distribution is made; and

- The nonresident subsidiary is subject to a tax comparable to Spanish CIT. This requirement is assumed to be met if: (1) Spain has signed a tax treaty containing a tax information exchange clause with the jurisdiction of which the subsidiary is a resident; or (2) the nonresident subsidiary is taxed at a nominal tax rate of at least 10%.

To be able to apply the indirect tax credit system with respect to the underlying CIT paid on the profits out of which dividends are paid, the Spanish parent company must meet the holding percentage, acquisition cost and holding period requirements set out above that apply for purposes of the Spanish participation exemption regime. The tax credit may not exceed the total CIT payable in Spain but any excess credit may be carried forward.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

As indicated in II.A.1., above, under the credit system, the limit on the double tax relief granted to a Spanish resident is to the amount of Spanish tax payable on the income concerned. Thus, if the income received is a dividend that qualifies for the application of the Spanish participation exemption, no double tax relief will be granted under the credit system.

Additionally, in the case of a company with a turnover exceeding 20 million euros, tax credits for the avoidance of double taxation, if any, have, since 2016, been limited to 50% of the overall Spanish tax due for the tax period concerned.

Regarding the creditability of foreign income tax, the authors understand that any kind of foreign direct income tax imposed and effectively paid on the relevant income qualifies for the tax credit, irrespective of how it is determined or levied. If the foreign company qualifies for a tax incentive, it is not possible to credit the tax that would have been paid if such incentive had not applied (unless the relevant tax treaty provides otherwise, i.e., in a tax-sparing clause).

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in II.A.2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Any excess foreign taxes that cannot be credited against the tax liability of a Spanish tax resident can be carried forward without limitation.

At the same time, foreign taxes that exceed the limit on the amount that can be credited in Spain may instead be deducted from the taxable base, provided they correspond to economic activities carried on abroad by the Spanish entity concerned. In the author's view, this requirement likely refers to the delivery of goods or the provision of services abroad by the Spanish entity and therefore would not be met in the case of dividends received from foreign sources.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

A Spanish resident entity that has an overall loss and receives income from foreign sources that has been subject to tax abroad, would still be allowed a tax credit, subject to the conditions set out in II.A.1., above, i.e.: (1) the income must be taxable in Spain (i.e., the participation exemption either does not apply or is not applied); and (2) the maximum amount of the credit is limited to the tax payable in Spain, unless an applicable tax treaty provides otherwise.

The foreign taxes that cannot be credited by a Spanish resident entity because the entity is in a loss position can be carried forward without limitation, but may not be carried back.

Foreign taxes that exceed the limit on the amount that can be credited in Spain may be deducted from the taxable base as indicated in II.A.3., above.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in II.A. be different from those given in relation to dividends?

Double taxation of interest income may be avoided via the application of the Spanish tax relief for the avoidance of juridical double taxation (i.e., the ordinary credit method), i.e., a Spanish company in receipt of foreign-source interest income can deduct the tax payable abroad up to the amount of the tax payable in Spain. However, the Spanish participation exemption and the indirect tax credit mechanism do not apply with respect to interest income.

It should be noted that for purposes of determining the tax payable in Spain with respect to foreign-source income, expenses related to such income must be taken into account. Thus, the Spanish income tax rate is applied not to gross income but to net income after the deduction of the expenses incurred in order to derive that income.

The rules discussed in II.A.3., above in relation to dividends regarding: (1) the carryforward of foreign taxes that cannot be deducted; and (2) the possibility of deducting from the taxable base foreign taxes that exceed the limit on the amount that can be credited in Spain, also apply with respect to foreign-source interest income.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in II.A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

As in the case of interest (see II.B. above), double taxation of royalties may be avoided via the application of the Spanish tax relief for the avoidance of juridical double taxation (i.e., the ordinary credit method), the Spanish participation exemption and the indirect tax credit not being applicable to royalty income.

Again, the rules discussed in II.A.3., above in relation to dividends regarding: (1) the carryforward of foreign taxes that cannot be deducted; and (2) the possibility of deducting from the taxable base foreign taxes that exceed the limit on the amount that can be credited in Spain, also apply with respect to foreign-source royalty income.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Since a tax treaty signed by Spain prevails over Spanish domestic law, where there is conflict between the two, the terms of the tax treaty will apply. Thus, in classifying income, the parties should first apply the definition provided in the tax treaty, if any.

When the applicable Spanish tax treaty does not provide a clear definition of a term, the treaty will generally allow the Contracting State in which the item of income concerned is sourced to refer to its domestic law definition, in line with the Commentary on the OECD Model Convention. In these circumstances, the income characterization adopted by the source country should bind the residence country for purpose of applying the respective treaty. However, this does not limit the entitlement of residence countries to classify income in accordance with the provisions of their domestic laws.

The Brazilian "interest on net equity" (*Juros sobre o capital propio* or JCP) affords an example of a conflict between the classification of an income item under the provisions of a tax treaty and its classification under domestic law. On March 16, 2016, the Spanish Supreme Court upheld the characterization of JCP as a "dividend" under Spanish domestic law. However, the participation exemption does not apply to JCP distributions, since such distributions represent a deductible expense for tax purposes at the level of the paying entity. On the other hand, the Spanish General Directorate of Taxes (GDT) has issued two binding rulings[4] that classify Brazilian JCP as "interest" under the Spain-Brazil tax treaty, thus entitling taxpayers to the tax-sparing credit method provided for in that tax treaty.

Specifically, the GDT confirmed that JCP falls within the definition of "interest" in the Spain-Brazil tax treaty, which encompasses "other income assimilated to income from money lent by the taxation law of the Contracting State in which the interest arises." Thus, income derived from JCP should be characterized in accordance with the domestic law of the source country (i.e., Brazil in the case at hand). Nonetheless, the DGT has accepted the characterization of JCP as "dividends" under Spanish domestic law, as confirmed by the Spanish Supreme Court.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Like most countries, Spain endorses the general principle that the application of a tax treaty cannot result in a higher tax burden than the tax that would result from the direct application of the relevant domestic law. The contrary position would not be in line with the inherent purpose of tax treaties, which is to avoid double taxation in circumstances in which both Contracting States would, in the absence of a treaty, seek to tax the same income. In fact, a taxpayer may choose to apply Spanish domestic law if it is more favorable than the application of the relevant tax treaty.

Notwithstanding the above, there may be situations in which, although a tax treaty assigns taxing rights with respect to a particular item of income to one of the Contracting States (generally up to a percentage limit where the taxing rights are assigned to the source State), such income may be tax-exempt under the domestic law of that State or situations in which the tax paid abroad in the source State cannot be totally recovered in the residence State (generally because the taxing rights in the source country apply to gross income, while the residence country tax credit applies to net income). From a technical perspective, even in these scenarios, the application of a tax treaty should not result in a higher tax burden than would result from the application of the domestic law, since tax treaties do not impose taxation but only assign taxing rights between Contracting States.

IV. Conclusion

The Spanish domestic rules applicable to withholding taxes, foreign tax credits and the elimination of double taxation are heavily influenced by the EU rules (for instance, EU Directive requirements and the EU freedoms). The Spanish domestic rules are also in line with the BEPS initiatives, and in some cases are even ahead of them — in several instances Spanish domestic laws are already compliant with the different Actions that are proposed to be implemented within the BEPS framework. However, Spain's methods for eliminating double taxation as the country of residence are still in need of improvement: since these methods generally do not take into account the rules in the source country, there is the potential for double taxation to arise in practice.

While residents of EU Member States or EEA countries that derive income from Spanish sources are entitled to better tax treatment than non-EU/EEA, residents since they are allowed to deduct expenses that are wholly linked to that income, they are still in a worse position than Spanish residents.

As regards the imperfect elimination of double taxation suffered by Spanish residents, the main source of distortion derives from the limitations imposed by the Spanish law on the use of foreign tax credits, which computes the tax payable in Spain by reference to net income, while the withholding tax imposed by the source country generally applies to the gross income derived in that country.

Although double taxation is not, at the moment, the main focus of the EU institutions, which are currently preoccupied with BEPS and MLI initiatives, the authors would argue that there are a number of measures that European countries need to take to ensure that their taxpayers do not suffer double taxation.

NOTES

[1] Income from shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

[2] Regarding the application of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

[3] Note that special rules apply to determine the taxation of premium distributions, capital reductions, and refunds of the amount contributed, particularly in the case of non-quoted companies, as all or part of the amount distributed/refunded to a shareholder/partner may be treated as equity income and/or will be reduced by acquisition cost. Specifically, such distributions are treated as dividend payments up to the amount of the positive difference between the net equity of the distributing entity (proportional to the shareholding held) and the tax base cost of the relevant shareholding. The excess over this amount, if any, will reduce the tax base cost of the shares.

[4] Numbers V2960-16 and V2962-16.

SWITZERLAND: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

Dividends and similar payments made to a nonresident recipient that are neither attributable to a Swiss permanent establishment (PE), nor to a Swiss sole proprietorship nor to a Swiss partnership are outside the scope of Swiss income taxation.[1] Dividends and similar payments distributed by a Swiss tax resident company are, however, subject to a 35% federal withholding tax.[2] The 35% federal withholding tax generally applies regardless of whether the recipient is tax resident in Switzerland. Under Swiss domestic tax law, Swiss tax residents, as well as PEs of nonresidents, are generally entitled to request a full refund of the federal withholding tax, provided the dividend or similar payment is duly recorded as an income item.[3] In certain circumstances (for example, where the dividends concerned are intragroup dividends), federal dividend withholding tax can also be settled by mere notification of the taxable payment.[4] However, Swiss domestic tax law does not provide withholding tax relief for any nonresident.

A nonresident can, however, claim relief from Swiss federal dividend withholding tax to the extent a Swiss tax treaty provides for such relief. All Switzerland's tax treaties generally provide full or partial dividend withholding tax relief for residents of the other treaty country (Switzerland tries to (re-)negotiate tax treaties providing full relief from withholding taxes). Many of the treaties provide full withholding tax relief for dividends paid to shareholders with a minimum shareholding (the threshold shareholding percentage is usually 10%, but in a few treaties is as high as 50%). Under some of the treaties (including the Switzerland-United States tax treaty), there is still a residual dividend withholding tax on dividends paid on qualifying participations (usually at the rate of 5%). As regards dividends paid to other shareholders, most of Switzerland's treaties provide for a residual withholding tax of 10% or 15%.

The Swiss tax authorities and Swiss courts unilaterally deny tax treaty benefits if they consider that the request for relief is abusive or that the recipient of the dividend payment is not the actual beneficial owner of the dividend concerned. This is the practice regardless of whether the relevant treaty includes any explicit anti-abuse language and/or a beneficial ownership concept.[5]

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

Every payment on an equity instrument, such as a share, participation right or participation certificate issued by a Swiss share corporation, a Swiss limited liability company or a Swiss cooperative, or by a similar non-Swiss legal entity having its place of effective management and a business activity in Switzerland, (including a bonus share or liquidation gain) is generally subject to Swiss dividend withholding tax, unless the payment constitutes a repayment of nominal capital or of duly recorded and reported share premium or other capital contribution made by any holder of equity instruments after December 31, 1996.[6] In this context, the Swiss Federal Withholding Tax Ordinance and practice use the term "monetary benefit" (German: *geldwerte Leistung*; French: *prestation appréciable en argent*; and Italian: *prestazione valutabile in denaro*) rather than the term "dividend" to describe this kind of income subject to Swiss federal withholding tax.[7] A monetary benefit basically includes any payment or benefit in kind: (1) that is made neither to repay paid-in nominal capital or capital contribution reserves nor against receipt of an equivalent consideration in return; (2) that is made to the holder of the equity instrument concerned or to a related person and is therefore made because of a shareholder/participation relationship; and (3) that the competent corporate bodies could have recognized as not being compensated by any adequate consideration in return.[8] If a company makes a payment (in cash or in kind) and receives either no consideration at all or only consideration that is evidently lower in value than the payment, the Swiss tax authorities and courts will assume that the payment is made to a related person and that the mismatch between the payment and the consideration received in return should have been discovered by the competent corporate body. That is, if a company makes a payment that is clearly not at arm's length, it is usually up to the company, if it is to avoid Swiss federal dividend withholding tax, to produce evidence to the effect that the payment was made to an independent third party or that the competent corporate body could not have recognized the mismatch.[9]

The classification of monetary benefits under Swiss domestic withholding tax law as "dividends" within the meaning of Article 10 (3) of the OECD Model Convention is generally considered to be in compliance with treaty law.[10] That being said, a consideration that may result in a higher residual withholding tax being imposed is the fact that the Swiss federal tax administration generally only considers the immediate recipient of a monetary benefit to be entitled to request relief from Swiss dividend withholding tax. That is, if the monetary benefit is paid to a related person rather than the immediate shareholder, the Swiss federal tax administration only grants relief from Swiss dividend withholding tax based on the portfolio treaty rate applying under the tax treaty between Switzerland and the country of residence of the immediate recipient of the monetary benefit. This usually results in a higher residual withholding tax burden than that which would apply to a distribution made by a Swiss subsidiary to its non-Swiss parent company. Given that a monetary benefit subject to Swiss dividend withholding tax always has its origin in the relevant shareholding, Swiss doctrine takes the position that the treaty rate for that shareholding should apply.[11] To date, there has been no Federal Supreme Court decision taking a position on this question.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

Swiss withholding taxes in general, and federal dividend withholding tax in particular, are levied on the gross amount of the relevant payment. While a Swiss resident that does not claim a credit for foreign tax can generally claim a deduction for foreign withholding tax, a nonresident receiving Swiss-source dividends cannot claim any relief unless such relief is granted by an applicable tax treaty. The payer of a dividend must deduct any federal withholding tax owed from the payment made to the recipient.[12] Should a dividend be paid without deduction of the federal withholding tax owed, the Swiss Federal Tax Administration considers the dividend paid to be a net dividend and claims a grossed-up withholding tax (i.e., if the statutory rate of 35% applies, a withholding tax of 53.8% is claimed on the net payment (100/(1-35%) x 35%).

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

The primary liability for Swiss federal dividend withholding tax lies with the payer of the dividend. The income or loss situation of the payee is not taken into account.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

For Swiss resident recipients, the purpose of Swiss withholding tax is merely to ensure the payment of income taxes, because a resident duly reporting the income taxable in Switzerland is eligible for a full withholding tax refund. In an international context, however, the withholding tax has a fiscal purpose: the purpose of Swiss withholding tax for persons that are not subject to Swiss income taxation is the creation of a final tax burden, except where an applicable tax treaty provides for relief. That is, to the extent there is no tax treaty relief, it is the intent and purpose of Swiss withholding tax to create a final tax burden for the nonresident recipient of the payment concerned.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Swiss domestic tax law generally does not treat distributions to holding companies any differently from distributions to other companies. Holding company structures are, however, usually scrutinized with regard to treaty abuse and beneficial ownership considerations. Where a holding company has no substance, holds only a single Swiss company and is controlled by shareholders that would not benefit from treaty relief were the holding company not interposed, tax treaty benefits are generally denied. Based on recent practice, the Swiss federal tax administration usually grants treaty benefits to holding companies provided they hold a number of shareholdings and have a debt-to-equity percentage of at least 30%. Depending on the specific case, the holding of only one (Swiss) subsidiary and/or a lower debt-to-equity percentage may not preclude the allowing of treaty benefits provided the holding company or an affiliate in the same treaty country has significant substance (offices, personnel, business operations).

Foreign tax credits are not taken into account for Swiss dividend withholding tax purposes.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Only specific types of interest are subject to Swiss withholding taxes:

- Interest paid on debt secured by real estate situated in Switzerland is subject to federal, cantonal and municipal income taxes. If the recipient of the interest is not tax resident in Switzerland and does not receive the interest via a Swiss PE, such income tax is levied by way of withholding tax at the level of the Swiss debtor paying the interest.[13] The tax rate depends on the canton in which the real estate is situated. Such taxes are levied by the cantonal tax administration. To the extent a tax treaty provides for relief from Swiss interest withholding tax, such relief is generally granted at source. Full relief applies under many of Switzerland's treaties and always applies if the debtor is tax resident in a country other than Switzerland with which Switzerland has signed a tax treaty.
- Interest paid on bonds, cash bonds and bank deposits paid by a Swiss resident debtor is subject to a 35% federal withholding tax.[14] For federal withholding tax purposes, in addition to regular bonds, cash bonds and bank deposits, etc., debt qualifies:
  - As a bond, where a Swiss debtor has borrowed debentured funds of at least CHF 500,000 in total at agreed fixed sums under the same conditions from more than ten lenders that are not qualifying banks (the "10 Non-Bank Rule");[15]
  - As a cash bond, where a Swiss debtor has borrowed debentured funds of at least CHF 500,000 in total at agreed fixed sums under different conditions from more than 20 lenders that are not qualifying banks, including bonds under the 10 Non-Bank Rule (the "20 Non-Bank Rule");[16] and
  - As a bank deposit, where a Swiss debtor has borrowed at least CHF 5 million in total from more than 100 lenders that are not qualifying banks (the "100 Non-Bank Rule").[17]

If a Swiss company provides security for a debentured loan issued by a foreign affiliate, the Swiss company may be classified as the issuer of a bond and consequently become subject to Swiss federal interest withholding tax if proceeds exceeding the issuer's net equity per any balance sheet date are on-lent to Switzerland.[18]

For federal interest withholding tax purposes, there is no tax relief at source. That is, the Swiss debtor must always deduct Swiss federal interest withholding tax at the statutory rate of 35% and it is then up to the payee to request a refund of the withholding tax. A full refund of interest withholding tax is granted under many of Switzerland's tax treaties.

If the interest income of a nonresident not having any PE in Switzerland does not fall under either of the above categories, there are no Swiss tax consequences.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Royalties are not subject to any Swiss withholding taxes. That is, there are no Swiss tax consequences for a nonresident without any PE in Switzerland receiving royalties from Switzerland.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

This question is not relevant because Switzerland does not levy any withholding tax on royalties.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Swiss tax resident corporations, limited liability companies and cooperatives can claim the participation reduction with respect to dividend income and capital gains derived from qualifying shareholdings. The participation reduction with respect to dividend income can be claimed if the dividend relates to a shareholding of at least 10% of the capital or of 10% of the earnings and reserves of the dividend-paying company or a shareholding with a fair market value of at least CHF 1 million.[19] The participation reduction allows total taxable income to be reduced in proportion to the net dividend income (i.e., the gross dividend income less the proportionate financing and administrative costs, deprecation caused by the payment of dividends, and non-refundable foreign withholding taxes) derived from qualifying shareholdings. The participation reduction usually results in a virtual income tax exemption for dividends derived from qualifying shareholdings.

In outbound situations, the parameters of the term "dividend" that determine what is subject to Swiss dividend withholding tax are quite clear.[20] In inbound situations, however, what is meant by the term "dividend" for purposes of benefitting from the participation reduction is often somewhat less clear. In the absence of any controlled foreign company (CFC) legislation, the participation reduction does not require any minimum taxation of the subsidiary distributing the dividend to Switzerland. However, if the subsidiary can deduct the distribution as an expense in the source country for income tax purposes, the participation reduction is denied (i.e., in an inbound situation, it is not possible to structure a tax-effective hybrid loan).[21] For income to be classified as dividend income qualifying for the participation reduction, the distributing company must qualify as a company that is more similar to a Swiss share corporation, limited liability company, cooperative, or collective investment company with fixed capital than to any other Swiss legal entity or partnership. Particularly in situations where the distribution is made by a foreign legal entity similar to a qualifying Swiss legal entity but the foreign entity is treated as a partnership or disregarded entity for foreign income tax purposes, the determination of whether the foreign entity qualifies for the participation reduction is not always made consistently and the courts generally analyze the question based on the specific fact pattern of the individual case. Besides the legal form of the distributing vehicle, the tax treatment of the entity in the source country is an important criterion in such an analysis.[22]

A Swiss credit for foreign withholding tax is granted to Swiss residents taxed on an ordinary basis, provided the dividend income concerned is taxable in Switzerland and there is an applicable tax treaty providing for withholding tax relief.[23]

Swiss residents that are not entitled to treaty relief or that opt not to claim treaty relief can claim a deduction for foreign withholding taxes paid from their income taxable in Switzerland.[24]

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

While it generally uses the exemption method to avoid double taxation, Switzerland uses the credit method with respect to dividend, interest, and royalty income subject to residual foreign withholding tax. Except where the income concerned is not subject to taxation in Switzerland (for example, where the participation reduction applies to dividend income, where the Swiss recipient enjoys holding company status or where *forfait* taxation applies in the case of certain individuals), double taxation of a Swiss resident is avoided by the granting of a lump sum tax credit. The lump sum tax credit that a Swiss resident can claim basically corresponds to the lower of either: (1) the foreign residual treaty withholding tax; or (2) the Swiss tax burden that would have applied to the relevant net income.[25] In computing the Swiss tax burden applying to dividend income, expenses such as financing and administrative costs pertaining to the dividend income are deducted.[26] Unless the actual administrative costs are significantly higher or lower, a lump sum deduction of 5% of the relevant gross dividend income applies to compensate for administrative costs.[27] Financing costs are generally allocated proportionally based on the book value of the shareholding in relation to the book value of all assets.

Currently, the Swiss PE of a nonresident is not entitled to a lump sum tax credit in Switzerland. There may therefore be double taxation if the PE derives income subject to foreign withholding tax in a situation where the country in which the non-Swiss head office is situated also does not grant a tax credit for third country withholding tax. Switzerland is planning to extend the lump sum tax credit to Swiss PEs of nonresidents in the course of the ongoing corporate tax reform (Tax Proposal 17).[28]

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

If a lump sum tax credit is limited because the Swiss income tax liability is lower than the residual foreign withholding tax, no tax deduction or carryforward to a subsequent year is allowed. If there is a tax loss carryforward from previous years resulting in a lower income tax liability in the year with respect to which the lump sum tax credit is claimed, that lower tax liability is taken into account for purposes of the computation of the lump sum tax credit amount.[29]

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

A Swiss resident individual receiving dividends from privately held assets cannot claim a tax credit if the individual does not have any income. Neither a Swiss resident individual receiving dividends from business assets nor a legal entity can credit foreign residual withholding taxes in a loss situation. The loss (which is increased because no tax credit can be taken) can generally be carried forward for seven years.[30]

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Apart from the fact that an interest payment cannot benefit from the participation reduction, the treatment of foreign-source interest income subject to residual foreign withholding tax is generally the same as that of dividend income; that is, the Swiss tax resident recipient of an interest payment can claim a lump sum tax credit equal to the lower of either: (1) the foreign residual interest withholding tax; or (2) the Swiss tax liability that would have applied to the relevant net interest income. Unlike in the case of dividend income, there are generally no attributable costs to be deducted from gross interest income in computing the Swiss income tax liability.[31]

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Apart from the fact that a royalty cannot benefit from the participation reduction, the treatment of a foreign-source royalty subject to residual foreign withholding tax is generally the same as that of a dividend; that is, the Swiss tax resident recipient of the royalty can claim a lump sum tax credit equal to the lower of either: (1) the foreign residual withholding tax on the royalty; or (2) the Swiss tax liability that would have applied to the relevant net royalty income. Unlike in the case of dividend income, the attributable costs to be deducted from the gross royalty income in computing the Swiss income tax liability are equal to 50% (rather than 5%) of the gross royalty income, unless there is evidence that the actual attributable costs are significantly higher or lower.[32]

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

From a Swiss point of view, international law generally prevails over domestic law at least if it was not the intention of the federal parliament to violate international law.[33] That is, if a provision of Swiss domestic tax law is in violation of a tax treaty, the relevant treaty provision generally prevails over Swiss domestic tax law. To the extent treaty law implicitly or explicitly refers to domestic law, the relevant treaty provision is to be interpreted based on the Vienna Convention on the law of treaties dated May 23, 1969 in line with the purpose of the relevant treaty.[34] Only to the extent that the interpretation of the relevant tax treaty does not provide a clear result will the relevant treaty provision be interpreted in line with the meaning of the term concerned under Swiss domestic tax law.[35] In such circumstances, there may be a mismatch between the interpretation of a treaty provision by Switzerland and its interpretation by the other treaty country and a mutual agreement procedure (MAP) will not necessarily result in a solution. In this context, the authors welcome newer Swiss treaty policy under which Switzerland tries to include an arbitration clause in newly (re-)negotiated tax treaties and has opted into the arbitration clause of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.[36]

Treaty override situations are rare in Switzerland. An anti-avoidance resolution under which Switzerland unilaterally denies treaty benefits in inbound situations where a Swiss resident tax resident is deemed to claim treaty benefits in an unjustified way might be regarded as a treaty override.[37] Given that this anti-abuse resolution was introduced as a result of pressure from other treaty countries to prevent treaty shopping through Switzerland, it has not and generally does not result in any actual conflicts with other treaty countries.

As a matter of fact, legislators, the courts and the tax authorities tend to interpret Swiss domestic tax law based on the relevant international tax law and aim at aligning Swiss domestic tax law with treaty law to avoid mismatches between domestic tax law and treaty law.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

According to established Swiss practice and doctrine, Switzerland's tax treaties only restrict the rights of the federation and the cantons to levy taxes and may not give rise to a higher burden than that provided for under domestic law. The main reasoning advanced for this position is that treaty law lacks democratic legitimacy. It has been disputed whether tax treaties include "important legislative provisions" and must therefore be subject to a facultative referendum (in the same way as federal acts).[38] Recently, Switzerland has started to provide for facultative referenda on new tax treaties because of the introduction of exchange of information clauses in accordance with the OECD standard, which are regarded as important legislative provisions. As a result of the option for a referendum, there are new voices in Swiss doctrine suggesting that tax treaties may also include provisions that increase the tax burden.[39] While existing Swiss tax treaties may actually create additional obligations for Swiss tax residents because of exchange of information and binding arbitration provisions, they contain no provisions that would result in the imposition of taxes that could not be levied under domestic law.

IV. Conclusion

As regards outbound situations, Switzerland levies withholding taxes on dividends and certain kinds of interest payments. Switzerland's tax treaties provide full or partial relief from Swiss withholding taxes and a tax credit for any residual Swiss withholding tax is granted in the country in which the recipient is resident, thus generally avoiding double taxation in outbound situations. While Switzerland does not require there to be effective taxation in the country where the recipient is resident in order to grant treaty relief, it denies treaty withholding relief in abusive cases and in cases in which the recipient is not regarded as the actual beneficial owner of the income concerned. In a situation in which there is no treaty, Swiss withholding taxes on dividends and certain kinds of interest may give rise to actual double taxation, which is then in line with the purpose of Swiss withholding tax.

As regards inbound situations, the double taxation of dividend income derived by corporates from qualified shareholdings is generally unilaterally avoided by means of the participation reduction (in the absence of CFC legislation, double non-taxation is possible, though the participation reduction is denied where a dividend qualifies as a tax deductible expense in the source country). As regards other dividends, interest and royalties, double taxation is generally avoided by means of a lump sum tax credit system. There are only a few specific situations in which double taxation may arise because no tax credit is granted in Switzerland (i.e., in abusive treaty-shopping cases and, for the time being, where a nonresident has a Swiss PE) or because a loss situation (with no ability to carry tax credits back or forward to other years) prevents the utilization of an available tax credit.

NOTES

[1] Swiss Federal Act on the Swiss Income Tax dated Dec. 14, 1990 (DBG), arts. 4 *et seq.*; Swiss Act on the Harmonization of Direct Taxes of the Cantons and Municipalities dated Dec. 14, 1990 (StHG), art. 4.

[2] Swiss Federal Withholding Tax Act dated Oct. 13, 1965 (VStG), arts. 4(1) lit. b, 13(1) lit. a.

[3] VStG, arts. 21 *et seqq.*

[4] VStG, art. 29; Swiss Federal Withholding Tax Ordinance dated Dec. 19, 1966 (VStV), arts. 24 *et seqq.*

[5] Decisions of the Swiss Federal Supreme Court 141 II 447 dated May 5, 2015, 2A.239/2005 dated Nov. 28, 2005.

[6] VStG, arts. 4(1) lit. b, 5 (1*bis*), 9 (1).

[7] VStV, art. 20 (1).

[8] Marco Duss/Andreas Helbing/Fabian Duss, in: Martin Zweifel/Michael Beusch/Maja Bauer-Balmelli (ed.), *Bundesgesetz über die Verrechnungssteuer*, 2nd ed., Basel 2012, art. 4 nos. 132a *et seqq.*

[9] Cf. decisions of the Swiss Federal Supreme Court 119 Ib 431, consideration 3b, 2A.590/2002 dated May 22, 2003, consideration 3.3.

[10] Stefan Oesterhelt/Reto Heuberger, in: Martin Zweifel/Michael Beusch/René Matteotti (ed.), Commentary on International Tax Law, Basel 2014, art. 10, nos. 232 *et seqq.*

[11] Oesterhelt/Heuberger, *loc. cit.*, art. 10, nos. 234 *et seqq.*

[12] VStG, art. 14(1).

[13] DBG, arts. 5(1), lit. c, 51(1) lit. d, 94, 100; Swiss Federal Ordinance on Source Taxes dated Oct. 19, 1993 (QStV), 9, 14; StHG, art. 4(2) lit. c; 21 (2) lit. a.

[14] VStG, arts. 4(1) lit. a and d., 9, 13(1) lit. a.

[15] Guideline S-02-122.1 of the Swiss Federal Tax Administration, dated April 1999, concerning bonds; guideline S-02-130.1 of the Swiss Federal Tax Administration, dated April 1999, concerning money market instruments and book claims of domestic debtors.

[16] According to practice, cash bonds are divided into the following three baskets: (1) debt with a term of at least 12 months; (2) debt with a term of less than 12 months; and (3) guarantee and security deposits. Swiss interest withholding tax applies only to "cash bonds" where there are more than 20 non-bank lenders in a basket (Stefan Oesterhelt, *Verrechnungssteuer und Emissionsabgabe bei Konzernfinanzierung*, in: Der Schweizer Treuhänder 9/2011, p. 757.

[17] Circular no. 34 of the Swiss Federal Tax Administration, dated July 26, 2011, concerning customer credit balances.

[18] See VStV, art. 14a.

[19] DBG, arts. 69 *et seq.*; StHG, art. 28(1).

[20] See I.A.2.

[21] DBG, art. 70(2) lit. b.

[22] See Decision of the Swiss Federal Supreme Court 2C_894/2013 dated Sept. 18, 2015.

[23] See ciph. 2 below.

[24] DBG, art. 32(1).

[25] Swiss Federal Ordinance on Lump Sum Taxation dated Aug. 22, 1967 (VpStA), art. 8(2).

[26] VpStA. art. 11.

[27] Swiss Federal Ordinance on Lump Sum Taxation of the Federal Finance Department no. 1 dated Dec. 6, 1967, art. 4(2).

[28] Federal Act regarding the implementation of bilateral federal treaties to avoid double taxation dated June 22, 1951, draft art. 2(1) lit. g, published under https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-70181.html (visited on April 6, 2018).

[29] VpStA, art. 11 (3); for sample computation see André Binggeli, in: Martin Zweifel/Michael Beusch/René Matteotti (ed.), Commentary on International Tax Law, Basel 2014, art. 23, no. 171.

[30] DGB, arts. 31(1), 67(1); StHG, arts. 10(2), 25(2).

[31] VpStA, art. 11(2) *e contrario*.

[32] Swiss Federal Ordinance on Lump Sum Taxation of the Federal Finance Department no. 1 dated Dec. 6, 1967, art. 4(3).

[33] Swiss Federal Constitution dated April 18, 1999 (BV), art. 190; decision of the Swiss Federal Supreme Court 139 I 16 dated Oct. 12, 2012, consideration 5.1; René Matteotti/Nicole Elischa Krenger, in: Martin Zweifel/

Michael Beusch/René Matteotti (ed.), Commentary on International Tax Law, Basel 2014, Introduction, nos. 178 *et seqq*.

[34] René Matteotti/Christine Horn, in: Martin Zweifel/Michael Beusch/René Matteotti (ed.), Commentary on International Tax Law, Basel 2014, Introduction, no. 36.

[35] Matteotti/Krenger, *loc. cit*., nos. 169 *et seqq*.

[36] https://www.sif.admin.ch/sif/en/home/dokumentation/medienmitteilungen/medienmitteilungen.msg-id-66981.html (visited on April 5, 2018).

[37] Ordinance of the Swiss Federal Council concerning measures against the unjustified application of federal double tax treaties dated Dec. 14, 1962.

[38] See BV, art. 141(1) lit. d ciph. 3.

[39] Matteotti/Krenger, *loc. cit.*, nos. 186 *et seqq*.

UNITED KINGDOM: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

The United Kingdom takes a relatively generous approach to imposing tax on non-U.K. residents with respect to their U.K.-source income and gains. Tax is only imposed or sought to be recovered in specific cases, where it is perceived that the opportunity for avoidance arises. A famous example is the United Kingdom's long-standing practice of declining to tax the capital gains of non-U.K. residents realized from disposals of U.K. real estate, although this was changed in 2015 with regard to residential real estate, and will change with effect from April 2019 with regard to all other types of real estate—no longer will it be more tax-efficient for U.K. properties to be held through offshore, as opposed to U.K., holding companies.

The United Kingdom does not impose withholding tax on the payment of dividends or similar payments, the only exception to this being certain types of dividends paid by U.K. real estate investment trusts (REITs). As a result, the United Kingdom does not regard the payment of dividends to nonresidents as giving rise to avoidance opportunities and does not seek to impose tax on nonresidents by reference to their U.K.-source dividend income. Technically, nonresidents are liable to U.K. income tax on their U.K. dividends in the same way as U.K. residents but a specific statutory provision treats them as having paid the income tax due on those dividends.[1]

Distributions paid by U.K. REITs fall into two categories: normal dividends and property income distributions. Property income distributions are required to be paid to non-U.K. residents subject to withholding of U.K. income tax at the rate of 20%, subject to relief under any applicable tax treaty. Normal dividends are taxed in the same way as distributions paid by other U.K. companies and are not subject to any withholding tax. Other than the withholding tax, however, no other U.K. tax consequences apply for non-U.K. recipients of U.K. distributions.

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

A dividend is one example of a category of payments for U.K. tax purposes called distributions, all of which benefit from the treatment described in I.A.1., above. A distribution includes any of the following:[2]

A dividend paid by a company;

Any distribution out of the assets of a company with respect to shares in the company (other than however much of the distribution:

- Represents repayment of capital on the shares; or
- Is equal in amount or value to any new value received by the company for the distribution);

Redeemable share capital issued with respect to shares in or securities of a company other than in exchange for value received by the company;

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Any security issued by a company with respect to shares in or securities of the company other than in exchange for value received by the company;

Interest or any other distribution out of assets of a company with respect to securities of the company where the value given by the company for the use of the principal secured exceeds a reasonable commercial return for the use of that principal, to the extent the amount paid does not represent the principal amount of the securities and exceeds the reasonable commercial return that would otherwise apply;

Certain interest or other distribution of assets of a company paid to persons that are not subject to U.K. corporation tax on the receipt with respect to certain specified types of securities, including:

- Certain types of convertible securities;
- Securities issued on terms under which the return on the securities depends to any extent on the results of the company's business or any part of it (except where the rate of return reduces if the results improve (or vice-versa); and
- Securities where it is necessary or advantageous for a person that has, disposes of or acquires the securities also to hold, dispose of or acquire shares in the company as a result of the rights attaching to the shares or securities.

It can be seen that the definition of what constitutes a distribution is potentially very wide. This is driven by need to impose a limit on the concept of what could be treated as interest on debt, which would generally be treated as potentially deductible for the purposes of U.K. tax, and with respect to which greater restrictions apply as regards payments to nonresidents (see I.B., below).

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

This question is not relevant for non-U.K. recipients of U.K. dividends.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

This question is not relevant for non-U.K. recipients of U.K. dividends.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

This question is not relevant for non-U.K. recipients of U.K. dividends.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

This question is not relevant for non-U.K. recipients of U.K. dividends.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Interest receivable by a non-U.K. resident from a U.K. source is subject to U.K. income tax, generally at the rate of 20%. This covers a range of types of payments, including true interest payable on debt securities, interest payable on certain bank accounts, interest payable on U.K. government securities (although non-U.K. residents are specifically not subject to tax on this interest), certain payments made by offshore funds and unit trusts, discounts and premiums on debt securities, and payments under Sharia-compliant financing structures.

Tax due on these payments is generally collected by way of withholding tax, which generally applies to any payment of interest (but not discount or premium) made by a U.K. person to a non-U.K. person with respect to any debt that has a term of longer than one year, subject to certain exceptions.

The principal exception is where relief under a tax treaty is claimed by the recipient of the interest. Many of the United Kingdom's extensive range of tax treaties provide for full exemption for non-U.K. residents from U.K. tax on U.K.-source interest, so that where relief has been claimed, tax should not be withheld from interest payments.

The other key exception is that for "quoted Eurobonds," where interest is paid by a U.K. company on debt that is listed on certain stock exchanges that are recognized for the purpose by HM Revenue & Customs (HMRC). In any such case, the interest may be paid without withholding of U.K. income tax. The recipients of the interest are still subject to U.K. income tax with respect to the interest, subject to any relief under an applicable tax treaty. Where a person is liable to income tax that has not been collected through withholding tax, the person is required to file a U.K. tax return and account for the tax to HMRC.

Where the interest is paid to an affiliated company in another EU jurisdiction, relief may be obtained under the EU Interest and Royalties Directive.[3] However, the great majority of the United Kingdom's tax treaties with other EU jurisdictions provide for full exemption from withholding tax on interest, so that the relief under the Directive effectively largely duplicates relief that would anyway be available under tax treaties.

Generally no allowance is made for non-U.K. residents with respect to losses or expenses available to them outside the United Kingdom, and no distinction is drawn between corporate and individual taxpayers.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Royalties and other receipts from intellectual property are subject to U.K. tax if they derive from a U.K. source. This includes receipts from any patent, trademark, registered design, copyright, design right, performer's right or plant breeder right, as well as similar rights in other jurisdictions. Tax is also charged on income from disposals of knowhow and patent rights.

Tax required to be paid by nonresidents is generally collected by withholding tax at a rate of 20%, subject to tax treaty relief. Where tax is payable that is not collected by withholding tax, a tax return must be filed and the tax paid to HMRC following the end of each tax year.

As with payments of interest, where the royalties are paid to an affiliated company in another EU jurisdiction, relief may be obtained under the EU Interest and Royalties Directive. However, the great majority of the United Kingdom's tax treaties with other EU jurisdictions provide for full exemption from withholding tax on royalties, so that the relief under the Directive effectively largely duplicates relief that would anyway be available under tax treaties.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

The U.K. tax payable on most types of royalty income can be calculated taking into account expenses wholly and exclusively incurred for the purpose of generating the income. In addition, tax on patent income can take into account any expenses of an inventor who alone or jointly devised an invention that are attributable to the devising of the invention, and expenses incurred in connection with the grant or maintenance of a patent, the extension of a term of a patent or a rejected or abandoned application for a patent.

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

Most U.K. companies are able to treat dividends received from foreign companies as exempt from U.K. tax. A small company can generally treat a dividend it receives as exempt, provided the company paying the dividend is a resident of a country with which the United Kingdom has a tax treaty that includes a nondiscrimination article and that company is not entitled to a tax deduction with respect to the payment of the dividend.

Other U.K. companies are entitled to treat dividends received from foreign companies as exempt provided both the above conditions are fulfilled and in addition the payments fall into one of a number of categories, including:

- distributions paid by companies controlled by the recipient of the dividend;
- distributions with respect to ordinary, nonredeemable shares;
- distributions with respect to portfolio holdings (i.e., where the shareholder holds less than 10% of the shares in the company paying the dividend); and
- distributions of profits that derive from transactions that are not designed to reduce U.K. tax.

Other taxpayers are subject to income tax on distributions from foreign companies in much the same way as they are subject to tax on distributions from U.K. companies. Income tax is payable on dividend income at lower rates than apply to most other types of income. In addition, each individual is exempt from tax on £2,000 of dividends each tax year.

Under many of the United Kingdom's tax treaties, relief is available to a U.K. resident recipient of foreign-source dividends with respect to tax imposed in the jurisdiction of the non-U.K. company paying the dividends. Where the United Kingdom does not have a tax treaty with the relevant overseas jurisdiction or where the relevant treaty does not provide for full relief, unilateral credit can be claimed for any tax that:

- is payable in an overseas territory;
- is calculated by reference to income arising or any chargeable gain accruing in the territory; and
- corresponds to U.K. tax.

For example, taxes paid to individual states of the United States are generally not covered by the United Kingdom-United States tax treaty, so unilateral relief is available with respect to such taxes.

It is also possible to claim a deduction for taxes paid in the place where the income arose.

In addition, U.K. companies receiving dividends from subsidiaries in other EU jurisdictions should be able to claim relief from tax imposed on dividends in the overseas jurisdiction under the EU Parent-Subsidiary Directive.[4] It remains to be seen how, if at all, relief may be available with respect to arrangements with EU subsidiaries following the United Kingdom's exit from the European Union. However, many of the United Kingdom's tax treaties with EU jurisdictions provide for equivalent relief.

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2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

In general, the amount of double tax relief is calculated by comparing the amount of tax actually paid in the overseas jurisdiction and the amount of tax that would be paid in the U.K. on the same income, but this is subject to specific rules.

Most of the United Kingdom's tax treaties provide that credit is to be given only for taxes that are deducted from dividends paid by an overseas company and not for underlying tax or company tax deducted, and this is the position that generally applies unless the U.K. shareholder is a company that holds at least 10% of the voting power in the overseas company. In this situation, the U.K. company may claim credit for underlying tax paid by the overseas investor on the profits that give rise to the dividend. However, the amount of credit is limited to the excess of the foreign underlying tax as compared with the U.K. tax that would be payable on the same income (for example, if the foreign tax were 30, and the U.K. tax were 19, the credit would be limited to 11).

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in 2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

Where the foreign tax exceeds the amount of credit allowed under U.K. rules, no benefit is generally available with respect to the excess. However, see II.A.4., below, for the ability to claim a deduction with respect to foreign taxes paid instead of a credit for such taxes.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

As noted above, it is open to a taxpayer with foreign income either to make a claim for credit for the foreign tax paid, or to claim the tax paid in the source jurisdiction as a deduction in calculating tax on its profits. Only one of these options may be chosen for any individual item of income (so that it is not possible to claim a credit for part of an item of income and a deduction for the remainder). Claiming a deduction allows a taxpayer that pays no tax in the United Kingdom because it has other losses to obtain a benefit from an overseas tax payment, as it will effectively increase the taxpayer's losses, which may therefore be available to it for use in future years.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

The same principles apply for obtaining credit for foreign tax on interest income as apply for foreign tax on dividends. However, in determining the credit available to a U.K. company by reference to a loan relationship entered into otherwise than as part of a trade, credit is limited to the excess of the credits that accrue on the loan relationship over the debits that relate to the same relationship.

Where the interest income is paid by a connected company in another EU jurisdiction, relief may be obtained under the EU Interest and Royalties Directive.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Similar rules apply for double tax relief with respect to royalties. Of course, royalties may be paid with respect to an asset in more than one jurisdiction, in which case royalty income arising in multiple foreign jurisdictions can be treated as a single item of income, and credits available for foreign tax are to be aggregated accordingly.

Where the royalty income is paid by a connected company in another EU jurisdiction, relief may be obtained under the EU Interest and Royalties Directive.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

Tax treaties are incorporated directly into U.K. law by means of statutory instruments so that they can be relied upon directly by U.K. taxpayers. U.K. taxpayers are entitled to relief under a tax treaty in accordance with the interpretation of the treaty, with relief under domestic legislation serving as a safety net if relief under treaty is not available. In practice, if a treaty definition is in doubt, unilateral relief would generally be available, meaning that questions of definitions under tax treaties rarely generate substantive disputes with U.K. tax authorities. Also, in general, the way in which the relevant treaty is interpreted by the other party will not affect the U.K. taxpayer's rights as a matter of U.K. taxation.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Because of the way in which double tax relief applies in the United Kingdom, with U.K. taxpayers entitled to relief either under a tax treaty or under domestic legislation at their choice, and with relief under domestic legislation often following the same principles as relief under double tax treaties, it would be exceedingly rare (if not impossible) for the introduction of a tax treaty to give rise to an increase in taxation for a U.K. taxpayer.

IV. Conclusion

The United Kingdom's wide network of tax treaties and extensive unilateral relief for overseas taxes for U.K. residents with respect to foreign income ensure that U.K. taxpayers can be certain of achieving an attractive tax position with respect to the overall taxation treatment of their foreign-source income. This is an important part of the United Kingdom's position as an attractive jurisdiction for holding companies and as a destination for inbound investment.

NOTES

[1] Income Tax (Trading and Other Income) Act 2005, s. 399.

[2] Corporation Tax Act 2010, s. 1000.

[3] 003/49/EC.

[4] 90/435/EEC.

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UNITED STATES: Source-Residence Country Coordination

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I. Source Country Taxation

A. Dividends and Similar Payments

1. Under domestic law, how does your country tax a nonresident (lacking a PE or other local establishment) on payments of dividends or similar amounts? How is this domestic treatment generally affected by your country's tax treaties?

There are two ways for a nonresident alien to become subject to U.S. federal income tax under the Internal Revenue Code of 1986, as amended (the "Code"): first, a nonresident alien is subject to tax on a net basis on income effectively connected with a trade or business that the alien carries on in the United States (including the holding of real estate located in the United States), and, second, a person that makes a payment of certain U.S.-source "fixed, determinable, annual and periodic income" (FDAP) is required to withhold 30% of the gross amount of such payment and pay it over to the Internal Revenue Service (IRS). FDAP generally includes a dividend from a corporation organized in the United States.

The United States generally agrees to a reduced rate of withholding with respect to a recipient of a dividend that is eligible for the benefit of one of the United States' tax treaties. Under most of the United States' treaties, the rate of withholding on dividends from a subsidiary corporation to a parent corporation that holds at least 10% of the subsidiary corporation's stock is reduced to 5%, and the rate of withholding on other dividends is reduced to 15%.[1]

2. How is a 'dividend' defined for these purposes? For example, does the tax apply to any declared distribution, or some other amount (and how is that determined)?

For purposes of the Code, a distribution from a corporation can generally be divided into three parts.[2] First, a "dividend" is technically defined as the amount of the distribution made out of the corporation's current-year and accumulated "earnings and profits." Second, any distribution in excess of the corporation's earnings and profits is treated as a tax-free return of capital to the extent of the shareholder's basis in the corporation's stock. Finally, any additional amount distributed is treated as gain from the sale or exchange of property.

A corporation keeps track of its earnings and profits in its own books and records in accordance with Treasury regulations and other guidance. When a corporation makes a distribution, the corporation must notify the shareholders of the portion of the dividend that reflects the corporation's earnings and profits. The shareholder, however, is expected to keep track of his or her own basis in the corporation's shares for the purposes of determining how much of any distribution in excess of earnings and profits is characterized as return of capital as opposed to gain.

The characterization of a corporation's distribution as a dividend, return of capital and gain is generally effective for all purposes of the Code. Accordingly, the withholding tax on a dividend paid to a nonresident alien only applies to the portion of a corporate distribution that is technically characterized as a dividend under the rules described above.

Gross-basis withholding under the Code is also required with respect to "dividend equivalents" under § 871(m). Generally, a dividend equivalent is either a payment made in connection with a securities lending or sale-repurchase transaction or a payment made under certain notional principal contracts that are contingent on, or determined by reference to, a U.S.-source dividend. For instance, an amount paid to a counterparty reflecting a dividend under a total return swap would be a dividend equivalent and withholding would be required with respect to that dividend equivalent even if neither counterparty is a U.S. taxpayer. The dividend equivalent rules are complex and the IRS is still developing guidance on how to apply them.

3. Can nonresidents (that lack a PE or local establishment) reduce a taxable amount by any expense (or allowance in place of deductions) to reflect the fact that only a net amount might be taxable in a residence country?

There are no provisions under U.S. tax law that reduce the amount of withholding required with respect to a dividend paid to a nonresident alien to reflect the fact that only a net amount is taxable in the country of residence.

4. Nonresidents with losses: Does your tax system provide any coordination of the gross (withholding) tax on dividends paid to nonresidents (that lack a PE or other local establishment) with the fact that a nonresident may have other losses or an overall loss? If so, please describe how this coordination is put into effect.

The United States does not permit a nonresident alien to reduce U.S. tax on U.S.-source dividends unless the dividends are considered to be effectively connected with a U.S. trade or business, and even then losses can only be used as an offset if they are also effectively connected with a U.S. trade or business. (The 2017 tax reform act, formerly known as the Tax Cuts and Jobs Act or TCJA,[3] limits the amount of net operating loss (NOL) carryforwards from 2018 and beyond available to reduce a taxpayer's taxable income to 80% of the taxpayer's taxable income, computed without taking NOL carryforwards into account.)

The United States' tax treaties include a provision on nondiscrimination, which generally provides that the United States is not to subject nationals of a treaty partner to more burdensome taxation than it imposes on nationals of the United States in the same circumstances.[4] It could be argued that, in a case where a national of a treaty partner has an overall loss, but bears the burden of U.S. withholding tax on a payment of FDAP, the nondiscrimination provision of the applicable tax treaty should apply to reduce the U.S. withholding tax because a U.S. national can use its losses to offset tax on such a payment, whereas the treaty partner's national cannot benefit from its losses in a similar way. Therefore, in such a case, the treaty partner's national is subject to more burdensome taxation than the U.S. national.

U.S. courts, however, have hesitated to find that U.S. and non-U.S. taxpayers are generally "in the same circumstance" for purposes of the antidiscrimination provision. For instance, in *Square D*, the U.S. Tax Court and the U.S. Court of Appeals for the Seventh Circuit considered whether regulations under § 267(a), which essentially forces deductions for interest payments to a related non-U.S. lender to be taken on the cash method, violate a tax treaty's antidiscrimination provision.[5] In *Square D*, a French parent corporation made a loan to its U.S. subsidiary and, accordingly, regulations under § 267(a) prevented the U.S. subsidiary from taking tax deductions on an accrual basis with respect to interest on the loan. The U.S. subsidiary claimed that this situation was a violation of the nondiscrimination clause of the United States–France tax treaty, on the grounds that this tax treatment was more burdensome to the French parent than it would have been to a U.S. parent that made a similar loan to a subsidiary corporation. The Tax Court held that the nondiscrimination provision of the United States–France tax treaty did not apply because there was no connection between the residence of the French parent corporation and the different tax treatment that results under U.S. law.

The Seventh Circuit agreed with the Tax Court, finding as follows:

> The regulation requires that all interest payments to a foreign related party must use the cash method of accounting without regard to the nationality of the owner. The regulation does not impose the cash method simply because of foreign ownership, which would be prohibited, but rather for payments to a foreign related party. Even if a corporation were owned by a United States parent, it still appears all interest payments to one of these foreign related parties would lead to the use of the cash method. The requirement, therefore, hinges on the nationality of the related party to whom the payment goes and does not fluctuate based on nationality of the ultimate owner. It is merely fortuitous that, in this case, the foreign related party to which the payment was made also happened to be the owner. The regulation does not discriminate based on foreign ownership, and thus, does not violate the nondiscrimination clause.

The reasoning behind this holding is difficult to understand. The court seems to be saying that, since the regulation does not specifically single out foreign-owned corporations for burdensome tax treatment, the regulation does not discriminate in a way that could be addressed under the applicable nondiscrimination provision. Section 267(a) and its regulations, however, are directed at foreign related parties with respect to a U.S. subsidiary corporation generally, which certainly includes the U.S. subsidiary corporation's owner. It is not clear that other related parties of the interest-paying corporation would not also have a claim that they are discriminated against in comparison to a U.S. entity that stood in the same relationship to the interest-paying corporation.

Although the courts did not say so explicitly in *Square D*, the implication of their reasoning was that the French parent corporation and a hypothetical U.S. parent corporation were not "in the same circumstance," as required by the tax treaty. In fact, the courts and the IRS have repeatedly ruled that challenges under the nondiscrimination provision fail because the litigants were not in the same circumstance as the hypothetical U.S. taxpayers to which they compared themselves.

5. Are any tax reductions or exemptions allowed to account for the possibility of incomplete double tax protection in the residence country? What are those, and when are they permitted?

U.S. tax law does not provide for any reductions of gross-basis withholding on dividends paid to a nonresident alien to reflect inadequate double-tax protection in the country of residence.

6. How does your domestic law deal with distributions to foreign holding companies? Do these measures apply in the treaty context as well as the domestic law context? Does the domestic law allow foreign tax credits to be set off against withholding tax on outbound dividends when such foreign tax credits cannot be otherwise used because of the exemption of inbound dividends?

Distributions to foreign holding companies under the Code are treated in the same way as any other corporate distributions to nonresident aliens. As mentioned above, the United States' tax treaties generally provide a lower rate of withholding for dividends to a foreign corporation that holds at least 10% of the payor corporation's stock.

B. Interest and Similar Payments Related to Interest

If the payment from your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Generally, as in the case of dividends, a payment of interest from a U.S. borrower to a nonresident alien lender is treated as FDAP under the Code and is subject to a 30% withholding tax on a gross basis. The treatment of interest under the Code and the United States' tax treaties, however, is more favorable than the treatment of dividends in several respects.

One significant exception from gross-basis withholding for outbound payments of interest is the "portfolio interest" exception.[6] Generally, under the portfolio interest exception, withholding is not required on interest if: (1) the underlying debt is in registered form; (2) the recipient of the interest payment does not own 10% or more of the borrower's voting stock or, in the case of a borrower that is classified as a partnership for U.S. federal income tax purposes, 10% or more of the borrower's capital or profits interests; (3) the interest is not "contingent interest" (i.e., the interest is not contingent on the borrower's gross receipts or net income, etc.); (4) in the case of a corporate lender, the lender is not a bank or controlled foreign corporation (CFC); and (5) the lender provides a statement certifying that the recipient of the interest is a foreign person.

The portfolio interest exception is provided by the Code and, accordingly, is available to all non-U.S. recipients of U.S.-source interest, regardless of whether a tax treaty is available. This exception is widely relied on by non-U.S. creditors to avoid U.S. federal withholding tax on U.S.-source interest.

Even if a nonresident alien is not eligible for the portfolio interest exception, an applicable tax treaty may also offer advantages to interest payments over dividends. The treaty rate for interest is generally lower than the treaty rate for dividends and in fact many of the United States' tax treaties provide a zero rate of withholding with respect to payments of interest (other than contingent interest).

The TCJA, enacted at the end of 2017, included several provisions that impose U.S. federal income tax with respect to transactions that are intended to avoid tax altogether, but as noted below, application of these provisions does not require either proof of intention to reduce U.S. tax or actual avoidance of taxation (or reduction in overall taxation) of the affected payments. These new rules apply to the payor, rather than the payee, and so appear to adopt the approach favored by the OECD under its Base-Erosion and Profit Shifting initiative.

First, the TCJA replaced the former earnings stripping rules under § 163(j), which limited the deductibility of interest paid to related foreign parties, with a broader limitation on deductions for interest paid to any person. Under the new version of § 163(j), business interest deductions are generally limited to 30% of the borrower's EBITDA (and to 30% of EBIT after 2025), with exceptions for borrowers in certain industries, such as the energy industry, agriculture, and real estate.

Second, the TCJA added a new § 267A, intended to discourage the use of hybrid entities and instruments to produce payments that are deductible in both the United States and another jurisdiction or that are otherwise not subject to tax in either such jurisdiction. Section 267A operates by denying tax deductions for related-party interest (and royalties) paid in connection with such transactions.

Section 267A applies to "hybrid transactions" or transactions that involve "hybrid entities." For this purpose, a "hybrid transaction" is "any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for purposes of this chapter and which are not so treated for purposes [of] the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax." A "hybrid entity" is an entity that is either "(1) treated as fiscally transparent for purposes of this chapter but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of such tax law but not so treated for purposes of this chapter."

After the application of Section 267A, the payments involved in such transactions should be subject to tax in the United States.

Third, the TCJA added an expansive new corporate alternative minimum tax called the "base-erosion and anti-abuse tax" (BEAT). New Section 59A requires large corporations to pay a minimum tax on their income, computed without regard to the tax benefit of certain "base erosion payments" made to foreign related persons.[7] A base erosion payment is any payment to a foreign related party that is deductible or is used to acquire depreciable or amortizable property.[8]

While the BEAT might have been limited to arrangements where the base erosion payments would otherwise be free of tax, the BEAT often will apply without regard to whether the payments are subject to tax in any other jurisdiction (or even in the United States, in the case of base erosion payments made to a CFC).

In order to be subject to the BEAT, a corporate group's average annual gross receipts for the previous three years must be at least $500 million and the ratio of the corporation's base erosion payments to its total deductions for the taxable year (the "base erosion percentage") must be at least 3%.[9] The BEAT is generally imposed at a rate of 10%, though the rate for 2018 is 5%, and a 1% higher rate applies to a corporate group that includes a bank or securities dealer.[10]

Once the BEAT is determined to apply, the amount of the BEAT is generally equal to the excess of the BEAT tax rate applied to the excess of the corporation's "modified taxable income" over its federal income tax liability (computed without regard to the BEAT, but reduced by certain tax credits). Modified taxable income for this purpose is the corporation's taxable income with the base erosion payments and NOLs added back. The BEAT cannot be reduced by certain tax credits, including the foreign tax credit.

C. Royalties

1. If the payment from your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Like interest and dividends, a payment of U.S.-source royalties to a nonresident alien is considered to be FDAP and is accordingly subject to 30% withholding on a gross basis.[11] The withholding applies to the entire amount of the royalty (i.e., there is no apportionment of royalty payments into different types of income as there is with corporate distributions). For purposes of FDAP withholding, the Code does not provide differing treatment for different categories of royalty.

The rate of withholding for royalties may be reduced under an applicable tax treaty. Unlike the Code, the United States' tax treaties do in some instances provide different rates of withholding depending on the type of royalty. The withholding rate for royalties under the United States' tax treaties is generally 15% to 5%, although many of the United States' tax treaties provide for zero withholding for certain types of royalty.

Generally, for purposes of the United States' tax treaties, royalties may be classified as "cultural royalties," such as payments for the use of copyrights and for the reproduction of literary, dramatic, musical, or artistic work, or "industrial royalties," such as payments for the use of patents, trademarks, or know-how. In addition, the royalty provision of some tax treaties provides a separate withholding rate for payments for the use of tangible personal property.

For instance, Article XII(2) of the U.S.-Canada tax treaty provides a general rule whereby withholding on royalty payments is reduced to 10%. Article XII(3) of the tax treaty, however, provides several exceptions to the general rule for certain types of royalty, which are subject to zero withholding. Under these rules, cultural royalties (other than payments for film and TV rights), payments for the use of, or the right to use, computer software, payments for the use of patents and other industrial information, and certain payments with respect to broadcasting all qualify for zero withholding, whereas royalties for the use of tangible property and for the production or reproduction of film and TV shows remain subject to the general withholding rate of 10%. The United States' tax treaties vary widely with respect to the withholding rates applicable to different types of royalty, but in general cultural royalties are subject to lower withholding rates than industrial royalties.

The considerations described in I.B., above with respect to § 267A and the BEAT also apply to payments of royalties.

2. Royalties are particularly likely to have expenses associated with earning them, whether R&D costs, acquisition costs, or marketing costs. Is any category of royalty reduced in amount, granted an allowance or otherwise taxed after recognition of possible costs?

As in the case of interest and dividends, neither the Code nor the United States' tax treaties provide any mechanism for deducting costs before determining the amount to be withheld on U.S.-source royalty payments.[12]

II. Residence Country Taxation

A. Dividends and Similar Payments

1. What is your country's domestic law's general, or unilateral, method of protecting a resident from economic and juridical double taxation resulting from the imposition of source country tax?

The Code provides double tax relief to U.S. taxpayers on a unilateral basis in the form of a foreign tax credit. Subject to certain limitations, a U.S. taxpayer is entitled to a credit against his or her U.S. federal income tax in the amount of taxes paid to a foreign government. A withholding tax imposed by a foreign jurisdiction on the recipient of a dividend from a foreign corporation is considered to be a tax paid by the recipient of the dividend for purposes of the foreign tax credit.

With the enactment of the TCJA, the United States has changed its international tax system into a "partial territorial system" in which the active business income of a foreign subsidiary is, at least partially, no longer subject to U.S. federal income tax when distributed to a domestic parent corporation.

Before the enactment of the TCJA, the domestic parent would be eligible for a "deemed paid" or "indirect" foreign tax credit for foreign taxes paid by the subsidiary. The TCJA eliminated the indirect foreign tax credit, since the post-TCJA system, at least in theory, no longer taxes the active business income of a foreign subsidiary of a domestic parent corporation, making a credit for foreign taxes paid with respect to such income no longer necessary.

2. How does your country limit double tax relief, or coordinate the amount of it with its own taxation of a resident? (For example, if there is a limit equal to the domestic tax on foreign income, how is the amount of foreign income determined? Furthermore, is the amount of foreign tax for which relief is granted reduced if the domestic tax on the foreign income is at less than the full corporate tax rate?)

Section 904 provides the principal limitation on the availability of the U.S. foreign tax credit. Under Section 904, the percentage of a taxpayer's U.S. taxes that can be offset with a foreign tax credit cannot exceed the percentage of a taxpayer's worldwide taxable income that is foreign-source income. This effectively means that a U.S. taxpayer cannot claim a foreign tax credit to the extent that the foreign tax rate exceeds the U.S. tax rate.

The Section 904 limitation must be applied separately to different categories of income, known as "baskets." Over the history of the foreign tax credit, the number of baskets has been as high as nine and as low as two. Before the TCJA was enacted, there were only two baskets — one for passive category income and one for general category income. The TCJA added baskets for global intangible low-taxed income (GILTI) and foreign branch income.

3. If foreign taxes for which relief is theoretically available exceed the allowed relief because of a limitation described in II.A.2., what does the tax system provide for the excess amount? Is the excess amount subject to being carried to another year, and under what conditions? Can the excess amount be deducted as an expense?

If an amount of foreign tax credit is denied under Section 904, that amount can be carried back one year and carried forward for 10 years, to a year in which the taxpayer did not exceed the Section 904 limitation.

4. If a resident has a loss on an overall basis, but received income from a foreign country subject to a withholding or other income tax in that country, is a credit or other relief that would otherwise be available still allowed? What measures, if any, exist to preserve that right to relief (for example, a direct refund of the amount of tax in the loss year, a carryover of credit, an alternative deduction of the foreign tax as an expense, etc.)?

If a taxpayer has domestic losses that reduce his or her foreign-source income, the § 904 limitation could limit the availability of the foreign tax credit more dramatically than Congress intends. Section 904(g), therefore, allows a taxpayer to recharacterize U.S.-source income into foreign-source income, which has the effect of raising the § 904 limitation and may make it easier for the taxpayer to utilize foreign tax credits. The amount of U.S.-source income for each year following an overall domestic loss that is recharacterized as foreign-source income is equal to the lesser of: (1) the amount of the unrecharacterized overall domestic losses for years prior to the succeeding year; or (2) 50% of the taxpayer's U.S.-source income for such succeeding year. (A similar mechanism applies under the foreign tax credit to overall foreign losses of a U.S. taxpayer.)

In determining the "basket" (or type of foreign source income and taxes) into which a withholding tax payment will fall, U.S. corporate shareholders may be entitled to look through the payor to its underlying income if the payor is a CFC. Similar look-through rules apply to indirect credits, which are generally also only available to 10% or greater corporate shareholders of a CFC.

B. Interest and Similar Payments Related to Interest

If the payment to a resident of your country is denominated as interest or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends?

Interest income is generally treated in the same way as dividend income for purposes of the U.S. foreign tax credit.

C. Royalties

If the payment to a resident of your country is denominated as a royalty or some equivalent, how would the answers to the questions in A. be different from those given in relation to dividends? Are there certain categories of royalty that are treated differently from others?

Royalties are also generally treated in the same way as dividend income for purposes of the U.S. foreign tax credit.

III. Inconsistencies Between Treaty and Domestic Law Treatment

1. How are conflicts of income classification between treaties and domestic law treated? What happens in the case of a conflict involving the classification of income or differences between the way in which your country, as the residence country, applies a treaty and the way in which the source country applies the treaty? Summarize the principles.

There is no general consistency requirement or standard that applies under U.S. law with respect to the Code and tax treaties. The IRS has issued regulations that deny access to tax treaties in certain cases where an entity is viewed as a taxpayer in one jurisdiction but a flow-through vehicle in another.[13] A handful of the United States' tax treaties also provide specific rules for such "hybrid entities."[14] As noted in I.B., above, new § 267A extends the consistency rules by denying deductions with respect to certain hybrid payments, or to certain hybrid entities, and broad regulatory authority has been granted to extend the application of such rules. Courts in the United States also have applied a "substance over form" analysis to transactions and that approach has leached slowly into certain areas of the Code, including § 7701(o) (codifying application of the "economic substance" doctrine under the case law).

Under the U.S. Constitution, treaties and legislation are both supreme laws of the land. Recent Congressional tinkering and case law have resulted in a "later in time" rule, although Congress may provide specifically for a treaty override if it intends a statute to take precedence over tax treaty provisions.

While the United States has not adopted the Vienna Convention generally, it tends to follow the same guidelines. So a term not defined in the treaty generally has the meaning provided under internal law. And in the event of a potential conflict between a tax treaty and a statute, say due to the context of the tax treaty clearly requiring another interpretation, U.S. courts "endeavor to construe them [i.e. the tax treaty and the statute] so as to give effect to both, if that can be done without violating the language of either."[15] If a consistent reading is not possible, however, the most recent authority generally controls.[16]

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)[17] provides an example of a treaty override. Before Congress enacted FIRPTA, gain on the sale of real property located in the United States was exempt from U.S. federal income tax under most of the United States' tax treaties. Since the purpose of FIRPTA was to subject such sales to taxation in the United States, the legislative history of FIRPTA expressly provides that FIRPTA was meant to override any inconsistent tax treaty provisions in effect at the time.

The anti-conduit regulations under § 7701(l) provide another example of a treaty override.[18] Under these regulations, the IRS has broad authority to disregard a "conduit entity," which is generally an intermediate entity that participates in a financing arrangement pursuant to a tax avoidance plan. An entity that is disregarded as a conduit entity cannot claim the benefit of any applicable tax treaty (although the participants in the financing arrangement as recharacterized by the IRS can claim the benefits of a tax treaty).

It is not entirely clear whether certain provisions of the TCJA will override tax treaties, because there is no evidence of whether Congress considered there to be a conflict and intended to override tax treaties. The authors expect there will be challenges under tax treaties to various provisions of the new legislation, including under the BEAT and, possibly, under the anti-hybrid rules of Section 267A.

When a conflict is between the United States and its treaty partner, taxpayers must look to the mutual agreement procedures provided in almost all of the United States' tax treaties for relief. This mutual agreement provision generally has the following functions:

- To provide a mechanism for a taxpayer to present a case to the competent authority of the jurisdiction of residence, if the taxpayer considers that the actions of one or both of the treaty partners results in taxation not in accordance with the tax treaty.
- To obligate the treaty partners to endeavor to resolve any difficulties or doubts arising as to the application of the tax treaty by mutual agreement.
- To provide that the treaty partners will consult together to eliminate double taxation in cases not provided for in the treaty.
- To allow the treaty partners to communicate with each other directly to resolve the issues described above.

The United States has provided extensive detail on how a taxpayer can access the mutual agreement procedures in Revenue Procedure 2015-40.

2. Can the application of a tax treaty result in a higher tax burden than would result from the direct application of the domestic law? Summarize the principles.

Generally, the United States' tax treaties are not intended to cause any taxpayer to owe more tax than it would in the absence of the tax treaty. This principle informs Article 1(2) of the U.S. model income tax treaty, which provides as follows[19]:

1. This Convention shall not restrict in any manner any benefit now or hereafter accorded:
   a) by the laws of either Contracting State; or
   b) by any other agreement to which both Contracting States are parties.

The technical explanation of the U.S. model tax treaty states the general principle explicitly:

> In no event are the rules of the Treaty to increase overall U.S. tax liability from what it would be if there were no Treaty. It follows that a right to tax under the Treaty cannot be exercised unless that right also exists under the Code.

The technical explanation states the principle strongly and clearly. The words "in no event" leave no room for any exceptions to the general principle that the tax treaty should not increase the U.S. tax liability of any person.

The IRS implicitly acknowledges this principle by allowing a taxpayer to waive the application of a tax treaty from year to year.[20] Accordingly, if a taxpayer is worse off under the tax treaty, he or she can just choose to ignore it. The IRS's position, however, is that a taxpayer cannot pick and choose the application of tax treaty provisions to particular items of income within the same tax year.[21]

IV. Conclusion

In a global society, double taxation is a pervasive threat. Luckily, the United States has recognized that preventing double taxation is a necessary precondition to a vibrant and open international economy.

NOTES

[1] *See, e.g.,* U.S.–Canada tax treaty, Art. X(2).

[2] § § 301 and 316(a). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[3] The Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97.

[4] *See, e.g.,* U.S.–Canada tax treaty, Art. 25.

[5] *Square D Co. & Subsidiaries v. Comm'r*, 118 T.C. 299 (2002), *aff'd*, 438 F.3d 739 (7th Cir. 2006).

[6] § § 871(h) and 881(c).

[7] The threshold for a party to be related for purposes of the BEAT is generally 25%.

[8] Certain other payments relating to reinsurance or made to a "surrogate foreign corporation" are also considered base erosion payments when made to a related foreign person.

[9] For banks and registered securities dealers, this threshold is reduced to 2%.

[10] The BEAT is scheduled to increase to 12.5% in 2026.

[11] Although the provisions of the Code defining FDAP do not specifically include royalties, the courts and the IRS universally treat royalties as FDAP. *See, e.g.,* Rev. Rul. 74-555; *Comm'r v. Wodehouse*, 337 U.S. 369 (1949).

[12] Royalties (and most other payments) that are effectively connected to a trade or business in the United States are taxed on a net basis, but payments of FDAP are always subject to U.S. federal income tax withholding on a gross basis.

[13] Treas. Reg. § 1.894-1; see also § 894(c).

[14] *See, e.g.,* U.S.–Canada tax treaty, Art. IV(6) and (7).

[15] *Whitney v. Robertson*, 124 U.S. 190 (1888).

[16] *Chae Chan Ping v. U.S.*, 130 U.S. 581 (1889).

[17] Pub. L. No. 96-499.

[18] Treas. Reg. § 1.881-3.

[19] The Treasury Department did not change this provision in the most recent revision of the U.S. model income tax treaty, even though it made many other changes.

[20] Rev. Rul. 80-147.

[21] Rev. Rul. 84-17.

APPENDIX: Elimination or Mitigation of Juridical Double Taxation—An EU Perspective

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This EU Perspective Note focuses on the question of whether EU law, as it currently stands, encompasses an obligation for EU Member States to eliminate or mitigate juridical double taxation[1] with respect to their respective taxpayers' dealings in an EU cross-border context. This question is addressed from two perspectives, i.e.: (1) the "principle of sincere cooperation" laid down in Article 4(3) of the Treaty on European Union (TEU) (see I., below); and (2) the "fundamental freedoms" enshrined in the Treaty on the Functioning of the European Union (TFEU) (see II., below). The analysis of these two perspectives will demonstrate that neither of them imposes, at least not in the opinion of the Court of Justice of the European Union (CJEU), an effectively enforceable obligation on the part of Member States to (take appropriate measures to) eliminate or mitigate juridical double taxation. Against this backdrop, it was felt that a legislative instrument was required to tackle the issue of double taxation in an EU context. This culminated in the recently-adopted Tax Dispute Resolution Mechanisms Directive,[2] though this Directive has its intrinsic limitations and flaws (see III., below).

I. Juridical Double Taxation and the Principle of Sincere Cooperation

Under Article 293, second indent of the EC Treaty (the predecessor of the TFEU) Member States were urged "so far as is necessary, [to] enter into negotiations with each other with a view to securing for the benefit of their nationals (. . .) the abolition of double taxation within the Community." While this provision could be held to constitute a genuine impetus to do away with double taxation, at least in an EU context, the CJEU held in *Gilly*[3] that Article 293 "is not intended to lay down a legal rule directly applicable as such, but merely defines a number of matters on which the Member States are to enter into negotiations with each other 'so far as is necessary'. Its second indent merely indicates the abolition of double taxation within the Community as an objective of any such negotiations. Although the abolition of double taxation within the Community is thus included among the objectives of [the EC] Treaty, it is clear from the wording of that provision that it cannot itself confer on individuals any rights on which they might be able to rely before their national courts." In other words, lacking direct effect, Article 293 could not be relied upon by individual taxpayers to challenge any double taxation that they were facing.

Upon the repeal of Article 293 of the EC Treaty by the Lisbon Treaty,[4] the question arose as to whether the general provisions of Article 4(3) of the TEU (former Article 10 of the EC Treaty) could be of any assistance in the context of the elimination or mitigation of juridical double taxation. Article 4(3) provides as follows:

- Pursuant to the principle of sincere cooperation, the Union and the Member States shall, in full mutual respect, assist each other in carrying out tasks which flow from the Treaties [i.e., the TEU and the TFEU].
- The Member States shall take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties or resulting from the acts of the institutions of the Union.
- The Member States shall facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardize the attainment of the Union's objectives.

In the author's opinion, it is doubtful whether Article 4(3) may indeed be, in and by itself, a sufficient basis for imposing an obligation on the EU Member States to eliminate or mitigate double taxation in an EU cross-border context. The reason for this skepticism is, first and foremost, that in the CJEU's view the obligations contained in Article 4(3) are insufficiently precise and thus cannot produce a direct effect in relations between the Member States and their subjects, i.e., Article 4(3) is not a self-sufficient legal provision from which subjective legal rights may be derived.[5] Rather, Article 4(3) is intended to come into play, not independently, but only on an entirely residual basis as, normally, a measure that is incompatible with Article 4(3) will fall within the scope of some other, more specific prescriptive provision of the TFEU (for example, the fundamental freedoms—see II., below). In such cases, it will be the specific provision that must be applied and not the prohibition laid down by the second paragraph of Article 4(3).[6] The "residual" character of Article 4(3) is further illustrated in the recent decision of the CJEU in *Caterpillar Financial Services*[7] in the value added tax (VAT) area. Against this backdrop, it is reasonable to contend that the principle of sincere cooperation, as interpreted by the CJEU to date, does not offer, *per se*, a basis for imposing an obligation on Member States to eliminate or mitigate double taxation in an EU cross-border context.[8] In the author's opinion, implicit confirmation of this proposition may be found in *Levy and Sebbag*,[9] in which the CJEU considered the free movement of capital in conjunction with Article 4(3) of the TEU and concluded that Article 4(3) cannot be interpreted in such a way as to impose obligations on Member States that go beyond the obligations arising from the free movement of capital laid down in Article 63 of the TFEU.

II. Juridical Double Taxation and the Fundamental Freedoms

To the extent that, in the author's opinion, Article 4(3) of the TEU offers an insufficient basis for imposing a genuine obligation on EU Member States to eliminate or mitigate double taxation in an EU cross-border context, the question arises as to whether unrelieved double taxation, like any other tax impediment, may constitute a violation of the fundamental freedoms enshrined in the TFEU.[10] This question is nearly as old as the TFEU (as it developed from its predecessors) itself.[11]

It is true that the CJEU has developed an extensive (and ever-increasing) body of case law following which the powers retained by the EU Member States must nonetheless be exercised consistently with EU law (although, as EU law currently stands, direct taxation does not as such fall within the purview of the Union). In other words, national direct tax provisions, including international tax conventions, of the Member States must not compromise the freedoms enshrined in the TFEU. In the CJEU's case law, a national tax rule is found to be in breach of the fundamental freedoms—unless it can be justified—if it differentiates based on nationality (direct or overt discrimination) or if it applies other differentiating criteria (for example, residence) but in fact leads to the same result as a directly discriminatory rule (indirect or covert discrimination); at the same time, equally applicable restrictive measures also may be found to violate the Treaty freedoms where they hinder intra-EU trade and render the exercise of the freedoms less attractive.[12]

> "The CJEU has so far proven unwilling to hold that juridical double taxation violates EU law and, in particular, the fundamental freedoms."

That being said, double taxation is different from discriminatory taxation, at least in the following two ways. First, double taxation is created by the concurrent application of the laws of two taxing jurisdictions, rather than just one. Second, double taxation is not a problem that can be fully cured by the harmonization of domestic tax laws—unlike discriminatory taxation arising from tax disparities in EU Member States' tax legislation, double taxation would persist even if all Member States had exactly the same tax laws because double taxation arises from the simultaneous assertion of source taxing rights by the source country and residence taxing rights by the residence country; even if every country had the same source and residence rules, those rules would still overlap, resulting in double taxation.[13] On the other hand, abstracting from these differences, double taxation imposes a burden on cross-border transactions that wholly domestic transactions do not face, putting taxpayers that exercise their fundamental freedoms under the TFEU at a disadvantage. Taking that approach, it could well be argued that the fundamental freedoms encompass an obligation for the Member States to abolish or mitigate double taxation.

While fully acknowledging that the risk of unrelieved double taxation of cross-border economic activities in the Community poses a hindrance to competition and hampers the effectiveness of the Internal Market and that the abolition of double taxation is definitely a Union goal, the CJEU has so far proven unwilling to hold that juridical double taxation violates EU law and, in particular, the fundamental freedoms. Quite the contrary. In a series of cases, the CJEU has held that, under EU law as it currently stands, EU Member States are not obliged to adapt their own tax systems to the different systems of taxation of other Member States. Member States are therefore not obliged to eliminate double taxation if such taxation exclusively arises from the exercise in parallel by those States of their remaining fiscal sovereignty.

The CJEU first expressed this position in *Kerckhaert-Morres*.[14] In that case, the CJEU found that Belgian income tax legislation that, in the context of tax on income, made dividends on shares in companies established in Belgium and dividends on shares in companies established in another EU Member State subject to the same uniform rate of taxation, without providing for the possibility of setting off tax levied by deduction at source in that other Member State, did not restrict the free movement of capital. The Court's reasoning was that the adverse consequences that might arise from the application of an income tax system, such as the Belgian system at issue, resulted from the exercise in parallel by two Member States of their fiscal sovereignty and that EU law, as it currently stands, in a situation such as that at issue, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Union.

The CJEU reiterated its position in *Damseaux*.[15] At issue in that case was a Belgian resident who received dividends from a French listed company. Those dividends were subject initially to a 25% withholding tax in France. Under Article 15(2) of the France-Belgium tax treaty, Mr. Damseaux was able to request the reimbursement of part of that withholding tax, so that the dividends were subject, in France, to only a 15% withholding tax. The amount remaining after that taxation was subject to a 15% income tax levied by way of withholding in Belgium. Mr. Damseaux took the position that his French dividends were taxed at a higher rate than Belgian dividends and that, as Belgium had accepted that France would impose a withholding tax, as the EU Member State of residence, Belgium should have either allowed the French withholding tax to be credited against the Belgian withholding tax or waived the withholding tax so as to avoid the imposition of double taxation. The Belgian tax authorities disagreed. The CJEU first noted that it did not have jurisdiction either to rule on a possible infringement by a contracting Member State of provisions in bilateral conventions entered into by the Member States and designed to eliminate or to mitigate the negative effects of the coexistence of national tax regimes, or to examine the relationship between a national measure and the provisions of a double taxation agreement, since such a question does not fall within the scope of the interpretation of Community law. The Court concluded that, in such circumstances, the free movement of capital does not preclude a bilateral tax convention under which dividends distributed by a company established in one Member State to a shareholder residing in another Member State are liable to be taxed in both Member States and that does not provide that the Member State in which the shareholder resides is unconditionally obliged to prevent the resulting juridical double taxation.

In *Levy and Sebbag*,[16] the CJEU held that, insofar as Union law, as it currently stands, does not lay down any general criteria for the attribution of areas of competence between the EU Member States in relation to the elimination of double taxation within the Union, the free movement of capital is to be interpreted as meaning that it does not preclude a situation in which a Member State that has undertaken, in a bilateral double taxation agreement, to establish a mechanism to eliminate such double taxation of dividends, then abolishes that mechanism by way of a legislative amendment that has the effect of reintroducing double taxation.

In *Baudinet and Others*,[17] the CJEU held that Articles 49, 63 and 65 of the TFEU do not preclude legislation of an EU Member State that does not remedy the double taxation resulting from the simultaneous exercise of taxing jurisdiction by two Member States. Under the legislation of that Member State, when a resident of that Member State that is a shareholder in a company established in another Member State receives from that company dividends taxed in both States, that double taxation is not remedied by the grant in the shareholder's State of residence of a tax credit at least equal to the amount of tax paid in the State of the source of those dividends. Indeed, the residence Member State is not required, under EU law as it currently stands, to compensate a tax disadvantage resulting from the simultaneous exercise of taxing jurisdiction by both Member States.

The CJEU's position is undoubtedly prompted by the fact that EU law, as it currently stands, does not lay down any general criteria for the attribution of areas of competence between the EU Member States in relation to the elimination of double taxation, implying that the Member States (continue to) enjoy a certain degree of autonomy in the area of direct taxation as long as they exercise their powers in compliance with EU law. Perhaps even more significant is the fact that if the CJEU were to hold that double taxation violates the fundamental freedoms enshrined in the TFEU, it would presumably also have to decide which State—source or residence—is responsible for reliev-

> Resolving the discrimination issue under the fundamental freedoms may in certain instances be conducive to … double taxation.

ing the double taxation,[18] which potentially raises compatibility issues with the fiscal sovereignty of Member States and thus also with the principle of subsidiarity, especially in a non-harmonized area such as that of direct taxation.

In short, under CJEU case law as it currently stands, a national tax provision creating juridical double taxation may only be open to challenge under the fundamental freedoms if it has a discrimination feature (whether overt or covert) attached to it. By contrast, in the Court's opinion, juridical double taxation *per se* is not contrary to the fundamental freedoms, i.e., where it exclusively arises from the exercise in parallel by EU Member States of their remaining fiscal sovereignty.[19]

By way of a side comment on the discussion, it is worth noting that, paradoxically, resolving the discrimination issue under the fundamental freedoms may in certain instances be conducive to (juridical or economic) double taxation. A notable example is the CJEU's finding that the *avoir fiscal* that used to be available under French tax law was discriminatory unless it was also granted with respect to dividends on shares in foreign companies;[20] this decision eventually resulted in the cancellation of the tax credit altogether, thus indirectly increasing double taxation.[21]

III. The Dispute Resolution Mechanisms Directive

On October 10, 2017, the Council adopted the Dispute Resolution Mechanisms Directive (the "DRM Directive").[22]

The DRM Directive applies to all cross-border situations subject to double income taxation, and thus (unlike the Arbitration Convention) not just to transfer pricing and permanent establishment (PE) issues. Specifically, the DRM Directive is intended to cover situations in which different EU Member States differently interpret or apply the provisions of bilateral tax agreements and conventions or the Arbitration Convention providing for the elimination of double taxation of income and, where applicable, capital, as such situations can create serious tax obstacles for businesses operating across borders (i.e., they create an excessive tax burden for businesses and are likely to cause economic distortions and inefficiencies and to have a negative impact on cross-border investment and growth).[23] Thus, the resolution of disputes under the Directive should extend to the different interpretation and application of bilateral tax treaties and of the Arbitration Convention – in particular to different interpretation and application leading to double taxation.[24]

Situations that represent double non-taxation or cases of fraud, willful default or gross negligence are expressly excluded.

In other words, not only is the scope of application of the DRM Directive limited to bilateral tax treaties or conventions concluded by and between Member States, but also to (the resolution of) double taxation arising from the different interpretation or application by Member States of the provisions of such bilateral tax agreements or conventions. It does not extend, therefore, to the resolution of (the existence or occurrence of) double taxation in other circumstances.

NOTES

[1] For purposes of this EU Perspective Note, "juridical double taxation" refers to cases in which the same income is taxed twice in the hands of the same taxpayer. For example, a dividend is taxed in the country of source by way of withholding tax and then again in the country of residence of the shareholder by way of tax assessment.

[2] Obviously, other instruments such as the Parent-Subsidiary Directive (Council Directive 2011/96/EU of Nov. 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States) (dividends), the Interest and Royalties Directive (Council Directive 2003/49/EC of June 3, 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States) (interest and royalties) and the Arbitration Convention (Convention of July 23, 1990, on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC)) (transfer pricing) have as their objective the elimination of juridical and/or economic double taxation, albeit only in the context of affiliated or associated companies. These instruments are not further discussed in this EU Perspective Note.

[3] Case C-336/96, *Gilly* (referring to Case 137/84, *Mutsch*).

[4] Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, Lisbon, Dec. 13, 2007 (2007/C 306/01) (Official Journal of Dec. 17, 2007, C 306).

[5] *See* Case 9/73, *Schlütter*; Joined Cases C-79/90 to C-83/90, *Compagnie Commerciale de l'Ouest and Others*.

[6] Opinion of Advocate General TESAURO in Joined Cases C-79/90 to C-83/90, *Compagnie Commerciale de l'Ouest and Others*; compare with the CJEU's reasoning in Joined Cases C-79/90 to C-83/90, *Compagnie Commerciale de l'Ouest*, following which "[t]he wording of [Article 4(3)] is so general that there can be no question of applying [it] independently when the situation concerned is governed by a specific provision of the [TFEU]."

[7] Case C-500/16, *Caterpillar Financial Services*. The CJEU held that, in the absence of harmonized rules governing the reimbursement of charges imposed in breach of EU law, the principles of effectiveness and equivalence, read in the light of TEU, Art. 4(3), must be interpreted as not precluding national legislation that allows a request for a refund of an overpayment of VAT to be refused where that request was submitted by the taxable person after the expiry of the five-year limitation period, although it fol-

lows from a judgment of the Court, delivered after the expiry of that period, that the payment of the VAT that was the subject of that request for a refund was not payable. As regards the principle of sincere cooperation, the CJEU specifically noted that, where a limitation rule provided for in a national tax code is consistent with the principles of equivalence and effectiveness, it cannot be considered to infringe the principle of sincere cooperation – in those circumstances, it cannot be claimed that the EU Member State concerned, by applying that limitation rule, undermines the achievement of the Union's aims.

[8] N. Wittock, The Influence of the Principle of Union Loyalty in Tax Matters, *EC Tax Review*, 2014-3, at p. 171 *et seq.*.

[9] Case C-540/11, *Levy and Sebbag* (Order of the Court); see also II.

[10] The "fundamental freedoms" that the TFEU confers on EU nationals encompass the free movement of goods, the free movement of persons (consisting of the freedom of movement of workers and the right of establishment), the freedom to provide services and the free movement of capital.

[11] A. J. Rädler, Entspricht unser Auszensteuerrecht der Neuordnung unserer Auszenwirtschaft im Gemeinsamen Markt?, *Steuer & Wirtschaft*, 1960, at p. 731.

[12] A detailed overview of the CJEU case law that emerged under the TFEU fundamental freedoms may be found in Faes, 7450-2nd T.M. *Business Operations in the European Union – Taxation*, at III.A.4.

[13] G.W. Kofler and R. Mason, Double Taxation: A European "Switch in Time?", *Columbia Journal of European Law* [Vol. 14, 2007] at p. 67-68; see also the opinion of Advocate General Geelhoed in Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, where it is emphasized that the fact that direct tax systems are national has as a restrictive consequence that it is necessary to divide taxing jurisdiction over the income of cross-border economic operators (dislocation of tax base). As with disparities, these restrictions should be distinguished from discrimination, as they result not from the rules of one tax jurisdiction alone, but from the co-existence of two separate tax jurisdictions (i.e., no one tax jurisdiction is to blame for the tax disadvantage). However, unlike disparities, they would continue to exist even if national tax systems were exactly the same in design and content.

[14] Case C-513/04, *Kerckhaert-Morres*.

[15] Case C-128/08, *Damseaux*.

[16] Case C-540/11, *Levy and Sebbag* (Order of the Court).

[17] Case C-194/15, *Baudinet and Others* (Order of the Court).

[18] G.W. Kofler and R. Mason, Double Taxation: A European "Switch in Time?" *Columbia Journal of European Law* [Vol. 14, 2007] at p. 67.

[19] Needless to say, this case law attracted (and continues to attract) severe criticism. The main point of criticism relates to the fact the CJEU's holdings in *Kerckhaert-Morres*, *Damseaux* and *Baudinet and Others* are, arguably, a departure from the "double (or dual) burden" approach that the CJEU seems to have adopted in areas other than direct taxation. Under that approach, it is recognized that the dual burden (and thus the disadvantage) placed on cross-border activities by the concurrent (and uncoordinated) application of two or more Member States' national legal systems may violate the fundamental freedoms, particularly if such dual burden hampers EU nationals' access to markets in other EU Member States. The CJEU first applied this approach in Case 120/78, *Rewe-Zentral* ("*Cassis de Dijon*") in the context of regulatory restrictions on the free movement of goods, and subsequently in the VAT (e.g., Case 15/81, *Schul I*) and social security (e.g., Joined Cases 62/81 and 63/81, *Seco*) areas.

[20] Case 270/83, *Avoir Fiscal*. Under the *avoir fiscal* rules, a dividend distributed by a French company to its French resident shareholders carried a tax credit (the *avoir fiscal*) equal to 50% of the net dividend (or 33.33% of gross) as part of the French imputation system. The *avoir fiscal* was designed to give some relief from the double taxation resulting from the income tax being imposed both on the company distributing the dividends and on the recipient of the dividends. At issue in *Avoir Fiscal* was France's refusal to extend the *avoir fiscal* benefit to PEs of foreign companies, *in casu*, branches and agencies in France of insurance companies whose registered offices were in another EU Member State, with respect to dividends paid to them by French companies on the same terms as applied to insurance companies whose registered offices were in France. See the discussion in P. Faes, 7450-2nd T.M. *Business Operations in the European Union – Taxation*, at III.A.4.d.(1).

[21] See T. Pons, Lack of Source Country-Residence Country Tax Coordination and Double Taxation, *this Issue*, at II.A.1.

[22] Council Directive (EU) 2017/1852 of Oct. 10, 2017 on tax dispute resolution mechanisms in the European Union. The three key procedural stages of the DRM Directive are the complaint, the mutual agreement procedure (MAP) and the dispute resolution procedure – for more detail, see P. Faes, 7450-2nd T.M. *Business Operations in the European Union – Taxation*, at VIII.F.8. The DRM Directive is to apply to any complaint submitted from July 1, 2019 onwards relating to questions of dispute concerning income or capital earned in a tax year commencing on or after Jan. 1, 2018. The competent authorities of the EU Member States concerned may, however, agree to apply the DRM Directive with regard to any complaint that was submitted prior to that day or that relates to earlier tax years.

[23] DRM Directive, Recital (1).

[24] DRM Directive, Recital (6).

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Bodil Tolstrup specializes in tax controversies in all areas of tax. Besides major corporations, her clients range from individuals and small independent businesses to venture funds and labor unions. During her career, she has continuously publishes articles in both Danish and international tax journals. She received an LLM from the University of Copenhagen in 2002, and upon graduating worked as a legal officer with the Danish Tax Tribunal (the administrative tax appeals agency in Denmark) from 2003 to 2005. Since then she has contrinuously worked as a lawyer with some of the major Danish/Scandinavian law firms: Bech-Bruun (2005 – 2010); Hannes Snellman (2011 – 2013); and Plesner (2014 – 2016). Bodil Tolstrup is a member of the International Fiscal Association, the Danish Bar Association, and the Danish Tax Lawyer Association.

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GERMANY

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Dr. Jörg-Dietrich Kramer studied law in Freiburg (Breisgau), Aix-en-Provence, Göttingen, and Cambridge (Massachusetts). He passed his two legal state examinations in 1963 and 1969 in Lower Saxony and took his LLM Degree (Harvard) in 1965 and his Dr.Jur. Degree (Göttingen) in 1967. He was an attorney in Stuttgart in 1970-71 and during 1972-77 he was with the Berlin tax administration. From 1977 until his retirement in 2003 he was on the staff of the Federal Academy of Finance, where he became vice-president in 1986. He has continued to lecture at the academy since his retirement. He was also a lecturer in tax law at the University of Giessen from 1984 to 1991. He is the commentator of the Foreign Relations Tax Act (Auszensteuergesetz) in Lippross, BasiskommentarSteuerrecht, and of the German tax treaties with France, Morocco and Tunisia in Debatin/Wassermeyer, DBA.

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Pia Dorfmueller is a partner at P+P Pöllath + Partners in Frankfurt. Her practice focuses on corporate taxation, international tax structuring, M&A, finance structures, European holding companies, German inbound, in particular, from the United States, and German outbound structures. For her PhD thesis "Tax Planning for U.S. MNCs with EU Holding Companies: Goals—Tools—Barriers," Pia received the Award "International Tax Law" from the German Tax Advisor Bar in 2003. Moreover, Pia is a frequent speaker on corporate/ international tax law and has written more than 80 publications on tax law. She is a current co-chair of the International Tax Committee of the International Law Section of ABA.

INDIA

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IRELAND

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Peter Maher is a partner with A&L Goodbody and is head of the firm's tax department. He qualified as an Irish solicitor in 1990 and became a partner with the firm in 1998. He represents clients in every aspect of tax work, with particular emphasis on inbound investment, cross-border financings and structuring, capital market transactions and U.S. multinational tax planning and business restructurings. He is regularly listed as a leading adviser in *Euromoney's Guide to the World's Leading Tax Lawyers*, *The Legal 500*, *Who's Who of International Tax Lawyers*, *Chambers Global* and *PLC Which Lawyer*. He is a former co-chair of the Taxes Committee of the International Bar Association and of the Irish Chapter of IFA. He is currently a member of the Tax Committee of the American Chamber of Commerce in Ireland.

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Louise Kelly is a corporate and international tax director with Deloitte in Dublin. She joined Deloitte in 2001. She is an honours graduate of University College Cork, where she obtained an accounting degree. She is a Chartered Accountant and IATI Chartered Tax Adviser, having been placed in the final exams for both qualifications. Louise advises Irish and multinational companies over a wide variety of tax matters, with a particular focus on tax-aligned structures for both inbound and outbound transactions. She has extensive experience on advising on tax efficient financing and intellectual property planning structures. She has advised on many M&A transactions and structured finance transactions. She led Deloitte's Irish desk in New York during 2011 and 2012, where she advised multinationals on investing into Ireland. Louise is a regular author and speaker on international tax matters.

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Philip McQueston is a senior associate in the tax department of A&L Goodbody, Solicitors. He is a qualified solicitor in Ireland and an associate of the Irish Income Taxation Institute. He practices all areas of Irish tax law and tutors and lectures in taxation and business law at the Law School of the Law Society of Ireland. He has published articles in the *Irish Tax Review* and is a contributing author to *Capital Taxation for Solicitors*, an Oxford University Press/Law Society of Ireland publication. He is a frequent speaker on Irish tax issues and is a former vice president of the Tax Law Commission of Association Internationale des Jeunes Avocats (AIJA).

ITALY

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THE NETHERLANDS

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SWITZERLAND

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Jonas Sigrist qualified both as an attorney-at-law and a Swiss certified tax expert. He graduated with summa cum laude from the University of Zurich, where he specialized in international taxation and social security contributions. Jonas has developed broad experience in acquisitions, mergers, spin-offs, reorganizations, relocations, and tax reliefs. His tax practice also covers international employment and employee stock and option plans. His client portfolio varies from multinationals to small and medium-sized companies in life sciences, commodities, financial services, and other sectors. He joined Pestalozzi's tax department as an associate in 2009, after he gained several years of experience in corporate taxation with a Big Four accounting firm and as a consultant in financial services. He has regular speaking engagements and frequently publishes in tax journals.

UNITED KINGDOM

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UNITED STATES

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Peter Glicklich is managing partner and senior tax partner with Davies Ward Phillips & Vineberg LLP, New York. For over 25 years, Peter has counseled North American and foreign-based multinationals on their domestic and international operations and activities. Peter advises corporations in connection with mergers and acquisitions, cross-border financings, restructurings, reorganizations, spin-offs and intercompany pricing, in diverse fields, including chemicals, consumer products, real estate, biotechnology, software, telecommunications, pharmaceuticals and finance. He has worked with venture funds, investment banks, hedge funds, commodities and securities dealers and insurance companies. Peter is a contributing editor of the *Canadian Tax Journal*, and a contributor to the *Tax Management International Journal*. He was a national reporter for the International Fiscal Association's project on Treaty Non-discrimination, and is the author of *BNA Tax Management Portfolio: Taxation of Shipping and Aircraft*. Peter is a frequent speaker and author of numerous articles. Presently, Peter is the finance vice-president and an Executive Committee member of IFA's USA Branch as well as the IFA Worldwide Executive Committee. He is also a member of the U.S. Activities of Foreign Taxpayers and Foreign Activities of U.S. Taxpayers Committees of the Tax Sections of the American Bar Association; the International Committee of the Tax Section of the New York State Bar Association; and the Tax Management Advisory Board-International. Peter is included in *The International Who's Who of Corporate Tax Lawyers 2004*, *The Best Lawyers in America*, and *Super Lawyers*. Peter graduated with high honors from the University of Wisconsin-Madison and received his J.D. (cum laude) from the Harvard Law School. Peter joined the firm as a partner in 2003.

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Heath Martin is an associate in the New York office of Davies Ward Phillips & Vineberg. With more than a decade of experience, he advises on extensive tax matters, and clients rely on him for his expertise in domestic and cross-border transactions. He focuses on the formation and operation of private equity funds, hedge funds, REITs and other investment funds. He is a graduate of Boston University and Stanford Law School and holds a Ph.D in Greek and Latin Literature from Brown University as well as a master's of science degree from the London Business School.