



Foreign Tax Credit

1. Foreword

2. FTC Requirements

- 2.1 Foreign Sourced Income
- 2.2 Foreign Income Taxes
- 2.3 Final Taxes
- 2.4 Relevance in determining the overall Italian taxable income

3. FTC calculation

- 3.1 Foreign Tax Credit Amount
- 3.2 Differences Between Foreign and Italian Taxes
- 3.3 FTC and Tax Return

4. Request for data

5. Glossary

1. Foreword

Under Italian tax law, international double taxation is reduced by granting Italian tax residents a credit for taxes paid abroad. The Italian mechanism to avoid double taxation has the features of an ordinary credit method.

Pursuant to Art. 165 of the **TUIR** where an Italian tax resident derives income that is sourced abroad and subject to tax therein, to the extent that the same item of income is also subject to tax in Italy in the hands of the same person, then such person is entitled to off-set the taxes levied abroad against his Italian tax exposure.

Furthermore, the Italian tax system also provides for a specific **branch exemption regime** which can only be applied upon election of the relevant Italian taxpayers.

2. FTC Re- quirements

In order for a foreign tax credit to be granted, some substantive requirements need to be met.

2.1 Foreign Sourced Income

Taxes paid abroad must refer to an income which is sourced from another jurisdiction.

To understand whether such requirement is met, one needs to distinguish between:

- foreign Countries having entered into a double **tax treaty** with Italy: in such case, if the treaty allows for source taxation, then the income should be considered to be sourced in the relevant foreign Country;
- foreign Countries that have not signed a double tax treaty with Italy: in such cases, to assess if an item of income might actually be considered as sourced in a given foreign Country, one must approach the case by reversing the principles enshrined in the Italian sourcing rule. In other words, one has to check if whether by applying the Italian domestic **sourcing rule** enshrined in Art. 23 of the TUIR a given income would have been considered sourced in Italy if derived by a non-resident. If so, then the same income derived by an Italian resident abroad must be considered as sourced abroad.

2.2 Foreign Income Taxes

Taxes paid abroad are creditable under Art. 165 of the TUIR if characterised as income taxes or taxes of a similar nature.

A distinction also needs to be made in this regard between:

- foreign Countries having entered into a double tax treaty with Italy: in such case, if the tax levied abroad is a tax covered by the treaty, then this requirement is met;
- foreign Countries that have not signed a double tax treaty with Italy: in such cases, a case-by-case analysis needs to be carried out to assess if the tax levied abroad might be considered as similar to the Italian income tax – and hence creditable – or not.

2.3 Final Taxes

For taxes paid abroad to be recognized as a credit in Italy, they need to qualify as a final levy. In other words, only taxes that are not paid on a provisional basis and that cannot be refunded in the relevant foreign jurisdiction might be recognized as a credit.

As taxes paid abroad might become final after the correspondent income has been brought to taxation in Italy, Art. 165 of the TUIR provides for a set of rules aimed at ascertaining when taxes paid abroad might actually be credited in Italy.

2.4 Relevance in determining the overall Italian taxable income

In order for foreign taxes to be recognized as a credit against Italian taxes, Art. 165 of the TUIR requires that the relevant foreign income is taken into account while calculating the **overall Italian taxable income** of the relevant Italian resident.

From this, it follows that taxes paid abroad on income which is subject to tax in Italy with a

substitute tax (as it is the case for foreign sourced dividends and interest) might not be credited in Italy. Nonetheless, a recent Supreme Court decision (decision no. 25698/2022) has stated that taxes paid on foreign sourced dividends might be credited despite the wording of Art. 165 of the TUIR where the language of the relevant double tax treaty allows it.

In addition, where the relevant foreign income is only partially taken into account when determining the overall Italian taxable income, then even the taxes paid abroad are only partially recognized as a credit.

| REQUIREMENT | CONTENT |
|--|---|
| Foreign sourced income | Taxes to be credited need to be related to income sourced abroad. Income is deemed to be sourced abroad either by applying the rules set forth in Art. 23 of the TUIR or by referring to the relevant tax treaty. |
| Foreign taxes on income | Taxes paid abroad must be income taxes or taxes of a similar nature. Where a tax treaty is in place with the source State, then taxes listed therein a covered taxes can be credited. |
| Final taxes | Taxes paid abroad need to be final, meaning that they do not qualify as provisional taxes, nor they can be asked for a refund. |
| Relevance in determining the overall Italian taxable income | Taxes paid abroad must be taken into account when determining the overall Italian taxable income. |

3. FTC calculation

Where the substantive requirements described above are met, then taxes paid abroad might be recognized as a credit in Italy based on the calculation and adjustments described below.

3.1 Foreign Tax Credit Amount

Taxes paid abroad might be recognized as a credit in Italy up to the amount resulting from the following formula:

$$\frac{\text{Foreign income}}{\text{Overall income} - \text{losses}} \times \text{Italian taxes}$$

The foreign income in the numerator must be determined pursuant to Italian tax rules.

If, as a result of prior losses, the foreign income is higher than the overall income and overall income exceeds 100%, then the proportion is deemed to be equal to 1.

As already highlighted under para. § 2.4 above, where the foreign income is partly subject to tax in Italy (e.g. white-listed dividends which are usually subject to **IRES** for 5% of their entire amount) then also the credit will be granted in the same proportion (i.e. only 5% of the taxes levied abroad).

In addition, a per-country limitation is applied while calculating the foreign tax credit. That means that the Italian taxpayer shall separately account for income and taxes paid in a specific jurisdiction. If such Italian taxpayer derives income from different Countries, then separate calculation must be carried out and all the foreign income and corresponding taxes are not blended together.

3.2 Differences Between Foreign and Italian Taxes

The Italian foreign tax credit system allows for differences to arise between the amounts of foreign taxes paid and domestic taxes paid.

In particular, it might occur that foreign taxes paid are higher than the taxes paid in Italy on the same income. This difference could arise as a consequence of, among other things:

- the foreign tax rate applied to that income is higher than the Italian tax rate;
- losses have entirely offset the overall income of the Italian taxpayer.

Another kind of difference may arise where:

- the foreign tax rate applied to the foreign income abroad is lower than the Italian tax rate;
- the taxable base is calculated differently in the foreign Country compared to how it is calculated in Italy.

In such cases, an excess of Italian taxes over foreign taxes occurs.

The **excess foreign tax credit** may be carried back (up to the eighth previous fiscal year) and carried forward (up to the eighth following fiscal year) to be offset against any possible excess Italian taxes arisen. However, pursuant to the per-country limitation rule, the carry back and carry forward can only occur in relation to income derived and taxes paid in the same Country.

3.3 FTC and Tax Return

Foreign tax credits are usually reported in a specific section of the **tax return** (CE Form).

From a temporal standpoint, the credit shall be calculated and reported in the tax return related to the fiscal year when the relevant income was earned, to the extent that foreign taxes have become final before the filing of the tax return.

As an exception to such rule, foreign taxes can be reported as a credit even if, at the date of the filing of the relevant tax return, they are not yet final but they will become final within the deadline for the tax return related to the following fiscal year. If so, the taxpayer shall clarify how much of the foreign tax credit reported in the tax return refers to foreign taxes which are not yet final.

No foreign tax credit is allowed where a taxpayer has omitted to file the relevant tax return.

| DOCUMENTATION NEEDED | |
|--|--|
| Proof that taxes have been paid abroad | Usually, where foreign taxes are levied and collected by a foreign withholding agent, such agent issues a certification. Where taxes paid abroad are self-assessed, copy of the relevant form and proof of its submission together with the receipt issued after the payment. |
| Proof that taxes paid are final | Where the documentation provided for by the withholding agent (if any) does not clearly state that taxes paid are final, a declaration from a local tax authority or tax consultant might be used. |
| Chart with all the relevant calculation | A chart containing all the data and calculation made to determine the foreign tax credit, the excess foreign tax credit to be carried forward or back. |
| Translation of the relevant documentation | It might be necessary to translate documentation drafted in a foreign language. |

The following draft letter might be used to request all the relevant data for the calculation of the foreign tax credit:

- real estate properties and ties in foreign Country (in order to assess the tax residence), see B.1;
- income from foreign sources (see B.2);
- properties held in the foreign Country (see B.3);
- taxes paid or withheld in the foreign Country (see C).

4. Request for data

CLIENT FORM - FISCAL YEAR

A. CLIENT

Name:

Company:

Permanent address in ESTONIA

.....

New client

Existing client

B. INCOME AND PROPERTIES FROM SOURCES IN ESTONIA

| B.1 - Real estate properties and relationships held in ESTONIA during the fiscal year | | Notes |
|--|--------------------------|--------------|
| The Client has a permanent home available to him/her in ESTONIA (property, lease etc.) | <input type="checkbox"/> | |
| The Client has his/her permanent abode in ESTONIA | <input type="checkbox"/> | |
| The Client is married or in a civil partnership | <input type="checkbox"/> | |
| The Client's family (spouse or husband / children etc.) lives in ESTONIA | <input type="checkbox"/> | |
| The Client has relevant and recognized political, cultural, social relationships in ESTONIA | <input type="checkbox"/> | |
| B.2 - Income from ESTONIAN sources | | |
| Income from employment (please specify if from private or public sources) | <input type="checkbox"/> | |
| Income from independent personal service | <input type="checkbox"/> | |
| Pensions | <input type="checkbox"/> | |
| Income from immovable property (rentals etc.) | <input type="checkbox"/> | |
| Dividends, capital gains etc. | <input type="checkbox"/> | |
| Royalties | <input type="checkbox"/> | |
| Other (please specify) | <input type="checkbox"/> | |
| B.3 - Properties in ESTONIA | | |
| Bank accounts (checking, savings etc.) | <input type="checkbox"/> | |
| Stocks, bonds etc. | <input type="checkbox"/> | |
| Immovable properties (real estate, farms etc.) | <input type="checkbox"/> | |
| Movable properties (ships, aircraft etc.) | <input type="checkbox"/> | |

C. TAXES PAID OR WITHHELD

Income and Tax are reported in:

- Employer Tax Forms
- Tax Returns

Income Tax is:

- withheld by the employer
- reported in a Tax Return
- other (please specify)

Tax Returns are filed:

- Separately
- Jointly (with spouse or husband etc.)

Date

Signature

5. Glossary

Branch exemption regime

Regime provided for by Italian law. As an exception to the credit method, it allows Italian taxpayers to exempt foreign income derived by their permanent establishments.

Excess foreign tax credit

Taxes paid abroad that, in principle, might be credited against Italian taxes but that actually, pursuant to the Italian tax credit mechanism, are not immediately off-set as they exceed Italian taxes paid on the same income. A carry-back and a carry-forward mechanism is provided to mitigate the issue.

IRES

Italian Corporate Tax, levied with a 24% flat rate.

Overall income

Taxable income subject to IRPEF (Italian Income tax) or IRES (Italian Corporate Tax) and, thus, not subject to substitute taxes or withholding taxes.

Sourcing rule

Rule aimed at establishing that a given kind of income, under certain conditions, is considered to be sourced in Italy, i.e. it is considered to be taxable therein even if the person deriving such

income qualify as non-resident in Italy for tax purposes. The most important Italian sourcing rules are provided for by Art. 23 of TUIR.

Substitute Tax

Tax applied either by the taxpayer or by a withholding agent. Income subject to such kind of taxes do not form part of the general overall income of a taxpayer (subject to a progressive tax rate system).

Tax return

Form issued by the Italian Tax Authorities on a yearly basis through which taxpayers have to declare their annual income.

Tax treaty

Tax treaty International Convention concluded between two States for the avoidance of double taxation and double non-taxation in economic transactions involving them.

Taxable income

Income that is subject to tax in Italy.

TUIR (“Testo Unico delle imposte sui redditi”)

Italian Income Tax Code, enacted through Presidential Decree no. 917/86.