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Relief From Double Taxation Under The New Italy-U.S. Tax Treaty

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Relief From Double Taxation Under the New Italy-U.S. Tax Treaty

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The United States and Italy signed a new income tax treaty and protocol (the treaty) on 25 August 1999. This will replace the current treaty and protocol that entered into force on 20 December 1985. The treaty must be ratified by both countries and will enter into force when the instruments of ratification are exchanged.

The primary purpose of the treaty is to eliminate or reduce taxation of the same income by more than one jurisdiction, that is, to eliminate or reduce juridical double taxation.

In addition to the treaty, both Italy and the U.S. eliminate double taxation on their residents, and, in the case of the U.S., citizens, by employing — in their domestic laws — a highly developed foreign tax credit (FTC) mechanism.

Thus, article 23 functions mainly to adapt U.S. and Italian domestic law principles to the relationship between the two countries,[1] and in accordance with these principles the article provides relief from double taxation using the "ordinary credit" method.[2]

Article 23 refers to article 2 (Taxes Covered) to identify the taxes of the treaty partner which are creditable, precluding the need for any additional administrative guidance.[3]

Also, article 23 is not subject to the saving clause, so that the U.S. will waive its overriding taxing jurisdiction to the extent that the article applies.

U.S. Domestic Law

The United States unilaterally attempts to mitigate double taxation by allowing taxpayers to credit the foreign income taxes that they either pay or accrue against U.S. tax imposed on their foreign-source income.[4]

However, because the FTC mechanism seeks to deny an offset of U.S. tax on either U.S. income or foreign-source income that is not subject to foreign taxes, the FTC is limited to U.S. tax liability on foreign income based on the following formula:

Foreign-source taxable income (divided by) Worldwide taxable income x U.S. tax on worldwide taxable income before FTC

However, for a foreign tax to qualify as a creditable income tax for U.S. federal income tax purposes, it must be shown that the foreign levy is a tax and that its predominant characteristic is that of an income tax within the meaning given to this term under U.S. law.

In addition, the foreign levy must be "compulsory" and levied under the authority of a foreign country. An amount paid is not a "compulsory" payment to the extent that it exceeds the amount of tax liability under foreign law, including applicable tax treaties.[5]

Unlike Italy, the United States restricts the cross-crediting of foreign taxes through the application of separate limitations to "baskets" of different types of foreign income. All income and expenses relating to the income of a particular basket are subject to a separate limitation fraction, partially eliminating the ability to cross-credit taxes.[6]

Another peculiarity of the U.S. FTC, compared to its Italian counterpart, is that when the tax paid

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[1] *See* American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation II* (1992), at 232.

[2] The "ordinary credit" method limits a taxpayer's credit to that portion of the taxpayer's tax liability in the country of residence that is attributable to income taxed in the source country. In contrast, the "full credit" method allows a taxpayer to credit, against tax imposed by the residence country, the entire amount of taxes paid to the source country, even if the foreign taxes paid by the taxpayer exceed the amount of tax imposed by the residence country that is attributable to the foreign-source income. *See OECD Model Commentary* on arts. 23A and 23B, paragraphs 15-17.

[3] By way of comparison, the 1955 treaty applied the domestic laws of the two countries in determining whether a particular tax was creditable. *See* for example Rev. Rul. 79-291, 1979-2 CB 273 (social security tax paid or accrued on an individual's self-employment income or wages to Italy is not a creditable tax under the 1955 treaty).

[4] *See* Internal Revenue Code (IRC) sections 901-908.

[5] *See* Treas. reg. section 1.901-2(a)(2)(i).

[6] Cross-crediting taxes, or averaging of foreign income, "means using taxes imposed at a high rate to offset the U.S. tax on income subject to a lower rate of foreign tax. The history of the U.S. foreign tax credit illustrates the struggles U.S. legislators have had with this continuing problem, as they shifted from the overall limitation to the per country limitation because each limitation presented different problems. Finally, the separate basket approach was enacted in 1986 to limit cross-crediting to each separate limitation." *See* C. P. Tello, "Basic Tax Considerations for Conducting Ongoing Business Activities Abroad," in *Tax Management International Journal*, 1998.

or accrued to a foreign country is more than the amount allowable as a credit under the above limitation, the excess may be carried back two tax years and then forward five tax years.[7]

Under the U.S. "classical" corporate income tax system,[8] the FTC has two components. The first component, the *direct* credit, is a credit for foreign taxes paid or accrued on income when it is received by a U.S. taxpayer. Foreign taxes that are eligible for the direct credit include withholding taxes on remittances to the U.S. taxpayer, including dividends, interest, and royalties, and also income taxes on foreign branch operations.

The second component, the *indirect* — or *deemed-paid* — credit,[9] is a credit for foreign income taxes paid on the income, for example, of a U.S.-controlled Italian corporation, out of which a distribution is made to the U.S. taxpayer. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its earnings.

The availability of the deemed-paid credit is confirmed by article 23 of the treaty.

For the purpose of eliminating or reducing multiple taxation on dividend distributions among U.S. domestic corporations, the deemed-paid credit is replaced by a provision granting the recipient a "dividend received" deduction. Individual taxpayers are not entitled to the deduction.

Italian Domestic Law

Corporations and individuals may claim a tax credit for foreign income tax that has been paid on income earned and subject to tax in another country.[10] Unlike the United States,[11] Italian taxpayers generally cannot carry back and forward unused credits,[12] nor may they claim — if advantageous — a deduction instead of a credit, because under Italian tax law neither income, nor foreign and real property taxes are deductible.[13]

In addition, while the United States allows a credit for taxes accrued, the Italian statute provides that taxes cannot be credited unless actually paid.

Similar to the situation in the United States, under Italian law there is a ceiling limitation formula that may result in some form of double taxation. An Italian taxpayer receives full tax credits for its foreign taxes paid only when it is in a "deficit credit" position — that is, when its foreign tax rate is less than its rate on Italian operations.

Italy does not require that the foreign tax be 'compulsory.'

The FTC allowed is the lesser of the foreign taxes paid or the limitation determined under the following formula:

Foreign-source taxable income (divided by) Worldwide taxable income x Italian tax on worldwide taxable income before FTC

Unlike the United States, the limitation on the FTC is not computed for each basket of income but is instead computed for each foreign country. While the "per-country limitation" limits an Italian taxpayer's ability to cross-credit taxes to a greater degree than under a U.S. basket approach, it is potentially advantageous for the taxpayer because any losses from a foreign country will not reduce income from other foreign sources, and therefore, will not reduce the amount of foreign taxes that may be used as a credit against Italian tax.

Italy does not require that the foreign tax be "compulsory." Therefore, an Italian resident might take the position that even if the amount paid to a foreign country, for example, the United

[7] IRC section 904(c).

[8] For purposes of dividend remittances, countries are usually classified into three different categories depending on their corporate income tax systems: classical systems, split-rate systems, and imputation systems. Under a classical corporate income tax system, the foreign taxes creditable against domestic tax liability are deemed-paid and withholding taxes. Under the split-rate system, distributed profits are taxed at a different, usually lower, rate than undistributed profits. Finally, under an imputation system of taxation, double or triple taxation of dividend distributions is eliminated by providing the shareholders with a tax credit equal to a portion, or the entire amount, of the dividends received. *See* R. Altshuler and T. S. Newlon, *Studies in International Taxation*, National Bureau of Economic Research, The University of Chicago Press (1993), at 84-87.

[9] *See* IRC section 902. Because the purpose of the deemed-paid credit is to provide equivalent treatment for branches and subsidiaries of U.S. corporations, similar relief is not provided for U.S. individuals who own foreign subsidiaries.

[10] *See* D.P.R. 917/86, commonly referred to as *Testo Unico delle Imposte sui Redditi* (TUIR) art. 15.

[11] *See* IRC section 164.

[12] However, there is an exception under TUIR art. 11(3). *See* below.

[13] *See* TUIR art. 64. Because of this provision, taxpayers who paid taxes to a foreign country, but are in a loss position for Italian tax purposes, might lose not only the benefit of the foreign tax credit, which cannot be carried back or forward, but also the partial relief — which, conversely, is available to U.S. taxpayers under their domestic rules — of a deduction, which would at least increase the net operating losses for carrying forward to future years.

States, exceeds the amount of tax liability under the relevant tax treaty,[14] it is still an amount of tax paid and thus creditable in its entirety against Italian tax. Such a position, however, might not satisfy the Italian requirement, discussed below, that the foreign tax be "definitive."[15]

Also, an Italian company does not have to apportion its domestic business expenses against its foreign-source income. This is an advantage compared to a U.S. company which — under U.S. laws — has to apportion many of its domestic expenses against its foreign-source income, thus reducing the amount of foreign income that may be taken into account in meeting the FTC limitation and creating unused foreign tax credits.

Finally, Italian domestic law does not provide for an indirect, or deemed-paid, tax credit. Rather than allowing — like the United States — a credit for both corporate and withholding taxes paid abroad on repatriated income, Italy adopts a hybrid system, or a partial "participation exemption" regime, by exempting a fraction, generally 95 percent,[16] of foreign dividends from domestic corporate income tax.[17] Regarding the remaining 5 percent of income, Italian income tax (the IRPEG) is due on the income received prior to withholding taxes being paid abroad. The tax withheld by the foreign country on the distribution of dividends can then be claimed as a credit against IRPEG.[18]

Conversely, under the Italian imputation system of taxation, to eliminate double taxation in the case of domestic dividend distributions, the partial participation exemption system is replaced by a dividend imputation scheme. Italian shareholders of an Italian corporation are provided with a tax credit equal to 56.25 percent[19] of the dividends received. The tax credit on dividend distributions is limited to the tax actually paid by the distributing company.[20]

However, the tax credit dividend imputation scheme does not extend to foreign investors.[21] Therefore, a U.S. shareholder receiving a dividend distribution from an Italian corporation will not be entitled to the Italian dividend tax credit; rather, the U.S. shareholder is subject to a 5 percent or 15 percent, depending on the percentage of ownership, Italian withholding tax on the dividend distribution.

Accordingly, a U.S. shareholder of an Italian corporation might be subject to a greater Italian tax burden than an Italian shareholder of an Italian corporation. Although it might be argued that this disparate tax treatment violates article 24, the non-discrimination article of the treaty,[22] and notwithstanding the fact that other treaties concluded by the U.S. contain provisions enabling U.S. shareholders to claim the benefit of a treaty partner's dividend tax credit,[23] the authorities of the two countries did not address the issue in drafting the new version of article 23.

Creditability in the U.S. of the IRAP Tax

Paragraph 2(c) of article 23 provides that only a portion of the Italian regional tax on productive activities, the IRAP tax — *Imposta Regionale sulle Attivita Produttive*, is considered an income tax that is available for credit against U.S. tax liability.

Because the IRAP tax base is calculated without expensing labor costs and, for certain taxpayers, including manufacturing companies, without expensing interest costs, when the tax was

[14]For example, an Italian resident with dividend income from U.S. sources may find it more advantageous to have U.S. tax withheld at the U.S. 30 percent statutory rate rather than at the reduced treaty rate for dividends of 5 percent or 15 percent (*see* article 10 of the Treaty).

[15]*See* F. Roccatagliata, *Aspetti fiscali delle operazioni internazionali*, EGEA (1995), at 444-445. The Italian Ministry of Finance considers "definitive" those foreign taxes for which there is no possibility of obtaining even a partial refund. The fact that the statute of limitations to audit the return is not expired, does not prevent a tax from being considered "definitive." *See Circolare Dir. Gen. II.DD.* No. 3 of 8 February 1980. Taxes paid to the United States by an Italian resident should be considered "definitive" only after expiration of the two year-period allowed under IRC section 172(b) to carry back net operating losses.

[16] *See* TUIR art. 96-bis.

[17]*See* R. Gordon and J. Jun, *Studies in International Taxation*, National Bureau of Economic Research, The University of Chicago Press (1993), at 19-20.

[18]While the statute is silent on the amount of the credit available, for the Italian tax authorities the foreign tax must be reduced in the same proportion that the foreign dividend is taxable. *See Circolare Min. Fin.* No. 33 of 4 October 1984 and *Circolare* No. 24656 of 28 May 1996. Conversely, the courts have held that the entire amount of tax withheld by the foreign country can be credited against Italian tax. *See Commissione Tributaria I grado* Firenze, Decision No. 423, of 19 September 1995.

[19]*I.e.*: 36/(100-36), 36 is the regular IRPEG tax rate.

[20]*See* TUIR art. 14(1). To avoid situations perceived to be potentially abusive, where shareholders could benefit from a dividend tax credit higher than the amount of taxes actually paid by the distributing corporation, Italian law provides for two separate baskets of taxes: basket "A", which contains any income tax paid at the corporate level, and basket "B", which contains tax that was not paid as a result of exemptions or other provisions. The shareholders will enjoy full dividend tax credits only for the tax in basket A. Any excess credit resulting from basket A can be either carried forward to the succeeding tax year or claimed as a refund. *See* TUIR art. 11(3).

[21]*See* TUIR art. 105(1).

[22]Article 24 states that "nationals of a Contracting State shall not be subject in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected."

[23]For example, under article 10(4) of the U.S.-France tax treaty, qualifying U.S. shareholders are entitled to the French dividend tax credit (the *avoir fiscal*) regarding dividends received from French companies, and the U.S. shareholder entitled to the *avoir fiscal* may claim a refund from the French Treasury.

first introduced the IRS argued that it was not a tax imposed on "net" income nor was it a tax imposed on gross income less expenses incurred in generating that income. In the IRS's view, the IRAP is not a tax "in lieu of an income tax" under the relevant U.S. statutory and regulatory language,[24] and therefore should not be creditable.

The treaty provision, without expanding the definition of creditable taxes beyond that prescribed by U.S. law, represents a compromise between the positions of the IRS and Italian tax authorities.[25]

Under the compromise,[26] the amount of IRAP creditable against U.S. tax is calculated by multiplying the "applicable ratio" by the total amount of IRAP tax paid or accrued to Italy. The applicable ratio is a fraction, the numerator of which is the total IRAP tax base decreased (but not below zero) by labor expense and interest expense not otherwise taken into account in connection with the IRAP tax base. The denominator of the fraction is the actual tax base on which Italy imposes the IRAP tax. The result of this calculation is an amount of the IRAP tax that approximates what the tax would have been had it been imposed on net income.[27] By agreeing to credit the tax only to the extent it is imposed on net income, the United States has maintained consistency with U.S. principles, which only permit credits for foreign taxes on net income.

The IRAP provisions are intended to reward companies that are adequately capitalized. Businesses that are over-leveraged or under capitalized, that incur high interest or borrowing costs, are subject to a higher IRAP tax. Thus, for U.S. companies with no Italian loans on the books and low labor costs, the difference between the IRAP tax paid and the amount of IRAP creditable in the United States will be minimal. For example, capital-intensive businesses, where rent and depreciation represent a large portion of expenses, usually incur an amount of IRAP tax in Italy that may result in a large FTC for U.S. tax purposes, depending on their labor costs.[28]

In any case, the portion of the IRAP which does not qualify for credit may be deductible in the United States as a tax or expense.[29]

Creditability in Italy of State and Local Taxes Paid in the U.S.

Because the treaty does not cover state and local taxes,[30] a credit is not available under the treaty to Italian taxpayers for taxes paid to U.S. local jurisdictions. However, under internationally accepted principles, a treaty may limit, but never increase, the tax jurisdiction of a contracting state.

An Italian taxpayer may therefore choose to be taxed under Italian domestic law.

An Italian taxpayer may therefore choose to be taxed under Italian domestic law,[31] which generally allows the creditability of any taxes paid on foreign income as long as they are definitive.[32]

The Foreign Tax Credit and the U.S. Alternative Minimum Tax

The U.S. tax laws provide that, in addition to the regular U.S. federal tax, a U.S. taxpayer may have to pay the alternative minimum tax (AMT).[33] As in the case of the regular federal tax, taxpayers can reduce their AMT liability by means of a foreign tax credit.[34] The AMT credit is subject to the same basic limitation as the regular credit, that is, the AMT credit is limited to the percentage of AMT attributable to foreign source income which is taxable for AMT purposes.

However, the AMT credit is subject to a second limitation: it cannot exceed 90 percent of AMT liability.

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[24] *See* IRC sections 901 and 903 and the regulations thereunder.

[25] The Italian tax authorities consider the IRAP tax as being equivalent to the former ILOR tax repealed effective 1 January 1998. For an analysis of the character of the old ILOR tax for U.S. tax purposes, *see IBM v. United States*, 38 Fed. Cl. 661, 678 (1997) (ILOR tax held to be an income tax under the U.S. meaning of that term).

[26] *See* article 23(2)(c).

[27] The U.S. Treasury Technical Explanation contains two examples — the first example involving a manufacturing business and the second a banking operation — that illustrate how the creditable portion of the IRAP is calculated. Both examples involve a U.S. company with a branch in Italy.

[28] *See* W. Green, *Effective Tax Rate in Italy Reduced*, in International Tax News, Council for International Tax Education, Sept. 1998, page 1.

[29] IRC section 164.

[30] *See* paragraph 2(a) of article 2 (Taxes Covered).

[31] *See* TUIR art. 128, which allows a taxpayer to choose the code or the treaty.

[32] *See* Ris. Min. No. 9/2540 of 21 April 1983, concerning the creditability against Italian tax of the Algerian *taxe forfetaire*.

[33] *See* IRC section 55. While in theory the AMT is an "additional" tax, in reality it is integrated with the regular federal income tax. The basic concept of the AMT is that taxable income is larger but subject to a smaller rate (for corporations, 20 percent). For a discussion of the AMT, *see* B.I. Bittker and J.S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sixth Edition, Warren Gorham & Lamont (1998).

[34] *See* IRC section 59.

Example 1: Alpha is a U.S. corporation doing business in Italy through a permanent establishment. On its U.S. tax return, Alpha reports $200,000 of taxable Italian-source income and $61,250 in tax.[35] Alpha paid Italy income tax of $72,000.[36] Because Alpha paid foreign tax in an amount exceeding its reported U.S. income tax liability, for U.S. regular income tax purposes, it can claim a foreign tax credit that reduces its U.S. tax liability to zero.

Alpha is also subject to the AMT. Assuming that its taxable income for AMT purposes is also $200,000,[37] it results in an AMT of $40,000. Because of the basic limitation, Alpha's AMT foreign tax credit is limited to $40,000.[38]

However, the AMT credit is further limited to 90 percent of the AMT liability. As a result, the AMT credit is reduced to $36,000 and Alpha owes $4,000 of AMT.

While this result accords with the underlying U.S. policy objects of the AMT,[39] it subverts the purpose of the foreign tax credit which is to mitigate double taxation of worldwide income.

Article 23 of the treaty recognizes, and does not prohibit, the AMT credit limit as double taxation. Specifically, paragraph 2(a) provides that the United States will allow as a credit against U.S. tax, taxes paid or accrued to Italy by U.S. citizens or residents, subject to the limitations of U.S. law. Because the AMT provisions had been enacted by the United States before the treaty was signed, they are recognized as existing laws which limit the treaty.[40]

Italian Credit for U.S. Tax on Italian-Source Income

In paragraph 3 of the FTC article, Italy agrees to allow its residents a credit against Italian tax for U.S. income taxes. Regarding items of income that the United States may tax under the treaty other than by reason of the saving clause applied to U.S. citizens, for example, withholding tax on dividends, interest, and royalties, Italy will include the items of income in the tax base of its residents, unless otherwise provided by the treaty.

In this case, the taxes paid in the United States will be allowed as a credit against the Italian tax liability, in an amount not exceeding the proportion of Italian tax that the items of income, that are taxable by the United States, bear to the total income of the taxpayer.

Article 23 of the treaty recognizes, and does not prohibit, the AMT credit limit as double taxation.

However, Italy will not give an FTC in cases where the taxpayer has elected under Italian law to pay a final withholding tax on an item of income, for example dividends, thereby excluding the income from the tax base subject to the ordinary rates of tax.

Example 2: Mr. X is a U.S. citizen and an Italian resident. Mr. X receives $100,000 of interest income from Italian sources. Under Italian statutory provisions, the income — assuming it represents interest from a loan — is subject to a withholding tax at source at a reduced rate of 12.5 percent,[41] or $12,500. Because the withholding is final, Mr. X does not have to report the income on his Italian return. However, because of his U.S. citizenship, Mr. X must report the Italian-source interest income to the United States. Assuming a U.S. regular income tax rate of 22 percent, Mr. X would have to pay $9,500 to the United States, that is, the excess of the U.S. tax ($22,000) over the FTC for the $12,500 of taxes paid to Italy.[42]

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[35]Using the U.S. corporation income tax rates for 2001.

[36]IRPEG tax at 36 percent on $200,000. For the purpose of this example, the IRAP tax is ignored.

[37]For the purpose of this example, it is assumed that Alpha must not make adjustments under IRC section 56(c).

[38]The AMT foreign tax credit is limited to the pre-credit tentative AMT of $40,000 multiplied by the ratio of foreign-source taxable income for AMT purposes ($200,000) to the worldwide taxable income for AMT purposes (also $200,000).

[39]The U.S. Congress enacted the AMT primarily for political reasons to ensure that every taxpayer with significant income pays a "fair share" of the U.S. tax burden. Under the regular tax system, taxpayers with substantial income can occasionally take advantage of tax deductions or credits to reduce, or even eliminate, their tax liabilities.

[40]The interaction of IRC section 59 and the treaty is specifically recognized in the U.S. Technical Explanation to the treaty. Paragraph 321 states that "When the alternative minimum tax is due, the alternative minimum tax foreign tax credit generally is limited in accordance with U.S. law to 90 percent of alternative minimum tax liability." The harmony between the AMT limitation of the foreign tax credit in IRC section 59 and article 23 has also been found by U.S. courts. *See Pekar v. Comm'r*, 113 T.C. No. 12 (1999).

[41]*See* D.P.R. 600/1973 art. 26(5).

[42]For the purpose of this example, the U.S. Alternative Minimum Tax is ignored.

On his Italian return, Mr. X cannot credit the $9,500 of U.S. tax against Italian tax on income, if any, derived by Mr. X from U.S. sources.

In the preceding example, one might argue that, regardless of the treaty, the FTC would not be available anyway under Italian law because the income is from Italian sources.

Italian Credit for U.S. Taxes Imposed Solely by Reason of the Saving Clause

Paragraph 4 addresses cases where a U.S. citizen, who is an Italian resident, earns income from U.S. sources. Because of the saving clause, even though under the treaty the income is exempt from, or is subject to a reduced rate of U.S. tax, the United States instead taxes the income at its domestic rates. To avoid double taxation, at least to some extent, Italy provides a relief which is limited to the U.S. tax that would have been paid if the Italian resident had not been a U.S. citizen.

Example 3: Taxpayer X is a U.S. citizen who for tax purposes resides in Italy. X receives $100,000 of interest income from U.S. sources. Absent the treaty's saving clause, the maximum amount of tax that could be imposed by the United States would be 10 percent, or $10,000.[43] However, because X is a U.S. citizen, the saving clause applies and X is taxed at the U.S. rates.

Assuming that X pays U.S. tax at an actual rate of 22 percent, X's U.S. tax liability would be $22,000. Under article 23(4)(a), the FTC granted by Italy is limited to $10,000, or 10 percent, that is, the rate of tax that X would have paid had he not been a U.S. citizen.

When the U.S. tax is less than the treaty rate, only the lesser tax would be credited against Italian tax.[44]

Because Italy does not provide complete relief for the U.S. tax imposed on U.S. citizens resident in Italy, article 23(4)(b) further reduces double taxation by providing that the United States will credit the income tax paid, or accrued, to Italy net of the credit that Italy is required to grant under article 23(4)(a).[45]

However, in allowing the credit, the United States will not reduce its tax below the amount that Italy credited against U.S. tax under subparagraph 4(a). The provision guarantees that the United States, at a minimum, will be entitled to collect the tax due under the treaty (in Example 3, $10,000) as if there were no saving clause, and the United States were taxing solely on source.[46]

When the U.S. tax is less than the treaty rate, only the lesser tax would be credited against Italian tax.

Example 4: In Example 3, if X's Italian tax rate is 46 percent, X's Italian tax on the $100,000 of interest income is $46,000. Against this amount, X can credit the $10,000 of U.S. tax. Thus, the Italian tax after the credit is $36,000.

In computing X's tax liability on the interest income, subparagraph 4(b) requires the United States to provide X with a credit for the $36,000 of Italian tax paid, provided that the credit does not reduce the U.S. tax below the $10,000 amount that Italy credited against its taxes.

Because X pays U.S. tax at an actual rate of 22 percent, X's U.S. tax liability before the credit is $22,000 ($100,000 x 22 percent). Given that the treaty limits the cumulative amount of credit so as not to reduce U.S. tax liability below $10,000, the amount of the credit is $12,000 ($22,000 - $10,000).[47] As a result, the total amount of tax paid by X is $46,000, of which $36,000 is paid to Italy and $10,000 to the United States.

Special Sourcing Rule for U.S. Citizens

Because the income described in paragraph 4 of article 23 is U.S.-source income, special rules are required to re-source some of the income to Italy in order for the United States to be able to credit Italy's tax. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income to be from Italian sources to the extent necessary to avoid double taxation under paragraph 4(b).

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[43] *See* article 11 of the treaty.

[44] *See* R. L. Doernberg and K. van Raad, *The 1996 United States Model Income Tax Convention*, Kluwer Law International, 1997, at 195.

[45] The provisions of article 23 apply to U.S. citizens because, although under article 1(2)(b) the U.S. may tax its citizens as if the Treaty were not in effect, art. 1(3)(a) provides that the FTC provisions are not affected by the saving clause.

[46] *See* R.L. Doernberg and K. van Raad, *The 1996 United States Model Income Tax Convention*, Kluwer Law International, 1997, at 196.

[47] *See* P.H. Blessing, *Income Tax Treaties of the United States*, Warren, Gorham & Lamont, (1996, 1999), at 19-50.

The source rule facilitates double taxation relief and allows the United States to retain secondary taxing jurisdiction.[48]

Under the exception in article 1 of the treaty relating to personal scope,[49] article 23 is not subject to the saving clause. Thus, the United States will allow a credit to its citizens under article 23, even if the article provides the re-sourcing benefit discussed above which is otherwise not available under U.S. domestic law.

Italy's Requirement That Foreign Tax Be 'Definitive'

Unlike Italy's domestic law, article 23 does not require that — for purposes of claiming the FTC in Italy — the U.S. tax be "definitive." It might be argued that the absence of such a requirement constitutes a benefit granted by the treaty to Italian residents who may therefore choose to apply the treaty rather than the domestic provisions.[50] However, it is generally agreed that, while treaty law provides general principles, statutory domestic provisions apply to determine the application of the tax credit.[51] Thus, it is likely that for Italian residents article 23 of the treaty will be applied by reference to Italian domestic procedures.[52] The only remedy available to Italian residents seeking to avoid double taxation is to present their case before the competent authority under mutual agreement procedure (article 25).

Treaty Override by the U.S.

It is interesting to note that article 23 is subject to an outright override by the United States. By virtue of U.S. domestic provisions, which address a situation perceived to be potentially abusive, the FTC for withholding tax on dividends distributed by an Italian corporation, would not be allowed in the United States unless the shares are held for at least 16 days during the 30-day period beginning 15 days before the date on which the shares become ex-dividend.[53]

Re-sourcing Rule for Certain Government Services

Finally, paragraph 5 of article 23 provides a re-sourcing rule for purposes of the U.S. foreign tax credit in the case of a person who is a dual national of the United States and Italy with income for services rendered to the Italian government in the United States.

This person is taxable by both Italy, under the Government Service article[54] and by the United States, under the saving clause.[55]

To relieve potential double taxation, paragraph 5 provides that the income is treated as Italian-source income for purposes of the U.S. foreign tax credit. Thus, the United States may tax the income but must allow a credit for the Italian income tax, if any, in accordance with the other provisions of article 23. ✦

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[48]*Id.* at 18-37.

[49]*See* article 1(3)(a).

[50]*See* M. Piazza, *Guida alla fiscalità internazionale*, Il Sole 24 Ore (2001), at 750. If, in connection with the FTC for taxes paid in the United States, an Italian resident were to choose the treaty provision, the resident would also be likely to choose the Italian statutory provisions for state and local taxes paid in the United States and not covered by the treaty. This would give rise to a so-called "cherry-picking" situation, *that is* choosing the domestic statute for one result and the treaty for another result. However, the author is not aware of any pronouncement by the Italian tax authorities or courts denying the use of this practice. By way of comparison, in the United States "cherry-picking" is prohibited. *See* Rev. Rul. 80-147, involving a Canadian corporation with a branch in the United States.

[51]*See* for example K. Vogel, *Klaus Vogel on Double Taxation Conventions*, Kluwer Law International, Third Edition (1997), at 1131.

[52]The Italian authorities have already taken this position in a ruling involving the Italy-France tax treaty. *See Risoluzione Min. Fin.* No. 59 of 31 March 1999.

[53]*See* IRC section 901(k). Special rules apply for preference shares. *See* P.H. Blessing, *Selected Aspects of Contemporary U.S. Income Tax Treaty Practice*, New York University, Advanced Topics in International Taxation Conference, (16-17 March 2000), at 43-44.

[54]*See* article 19(1)(a).

[55]*See* article 1(2) (Personal Scope).