International Juridical Double Taxation in Cross-Border Economic Activity: Reliefs under the Agreement between Turkey and Italy for Avoidance of Double Taxation

by Fatma Bilim

Under international law, the right of every State to tax all income arising within its geographical borders is recognized as of fundamental character. Tax jurisdiction is one of the most evident manifestations of a State's sovereignty and one of the matters which sovereign nations are most jealous about. With the explosion of globalization, the development of e-commerce, and the widening of worldwide trade cooperation, however, it has become clear that national fiscal systems cannot operate separately any more, as cross-border economic activity may trigger tax liability in more than one jurisdiction. Double taxation results from an overlap of jurisdiction to tax between residence States, where the recipient of income lives, and a source State, where the income was generated. Many mechanisms have been put in place by States unilaterally and multilaterally in order to eliminate (or, at least, mitigate) this distortion and encourage mutual investments and trade. In this article we will discuss and provide an insight on the reliefs provided for by the Agreement concluded between Turkey and Italy for the Avoidance of Double Taxation.

World-wide Income Taxation Principle (or Residence Principle) versus Territorial Source Principle of Taxation (or Source Principle)

In most countries, the returns from work, trade and investments are generally subject to income taxation[1]. The majority of tax systems are based on a dual approach, as they adopt simultaneously two different taxation principles: the world-wide income taxation principle, on the one hand, and the principle of the source, on the other. The concurrent adoption of these two principles leads to conflicts between jurisdictions when flows of capital and goods move across the states' boundaries, as they may involve, in one way or another, double taxation of the same income. According to the definition provided by the OECD, international double taxation arises from "the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods".

The world-wide income taxation principle holds the place of residence of the taxpayer as the basis for the assessment of tax liabilities. According to this criterion, persons (both natural and legal persons) resident in one country are subject to unlimited taxation therein, and have to submit their total annual income, from both domestic and foreign sources, to tax. The use of residence principle is mostly found in the practice of industrialized countries.

By contrast, the source principle considers the geographical source of income as the basis for assessment of tax liabilities. Under this principle, all income generated within the boundaries of the country are subject to tax therein, regardless of the residence or citizenship of the income recipient. By adopting a mixture of the two principles, both residents and non-residents are subject to taxation: the formers on their world-wide income (therefore they have full tax liability in their country of residence), the latters on

1 Despite scholars do not always agree on the definitions of capital and income, in a nutshell, income is defined as a flow of wealth in a definite period of time, as opposed to capital, which is a stock of wealth at a certain moment. While capital is a fund, income is a flow. For example, a dwelling house now existing is a capital; the shelter it affords or the money-rent which it brings, if rented, is its income.

the income originated within the country (they have thus limited tax liability in that country).

For example, an individual works as an employee in State A and is resident thereof. He/she also rents an apartment of his own situated in State B. In such a situation, the individual may (and generally will) be required from State A to pay taxes on both his salary and his rental income (according to the worldwide taxation principle). In addition, also State B will generally levy taxes on the income obtained by him/her from lease of his/her property located on the territory of State B. Or, for example, a joint stock company located in State A pays dividends to a shareholder, resident of State B. Both States A and B will generally require the shareholder to pay a tax on such income. As a result of this dualistic approach, not only is it possible, but in fact it is very common that taxpayers that engage in cross-border transactions are taxed more than once on the same amount of income.

The Agreement between Turkey and Italy for the Avoidance of Double Taxation

A double taxation convention is an agreement concluded between two States in order to allocate the taxation rights in a way that prevents taxpayers from being taxed on the same income in both countries. As most tax treaties worldwide, the agreement signed between Italy and Turkey (hereinafter referred to as "treaty") on July 27, 1990 and in force as of December 1, 1993, is modeled after the OECD Model Convention for Avoidance of Double Taxation.

Since the 1960s, the OECD has developed a model of convention (which is regularly being updated) for the purpose of facilitating the conclusion of international double taxation agreements. The importance of this model is indisputable, as it provides clear consensual rules for taxing income and capital, as well as rules helping to tackle international fiscal evasion.

The treaty concluded between Turkey and Italy is applicable to persons (may it be individual, companies or any other body of persons) who are resident of one or both the contracting States, and covers all income taxes, including taxes on gains from the alienation of movable or immovable property, taxes on salaries or wages paid by enterprises, and taxes on capital appreciation. As well as laying down rules for the allocation of the taxation rights between the two jurisdictions, the treaty addresses relevant issues such as transfer pricing, non-discrimination, mutual agreement procedure, exchange of information, etc., aiming at enhancing inter-state cooperation against international tax evasion. The next paragraph will focus on the main provisions allocating the taxation rights between Italy and Turkey.

Most Relevant Provisions of the Agreement Concluded Between the Turkish and the Italian Governments

Immovable Property Income and Capital Gains (Articles 6 and 13)

Under the terms of the treaty, income derived from immovable property (including income from agriculture and forestry) is taxable in the country in which the property is located. For this category of income, taxation at the place of situs has priority over all other distributive rules. This provision is applicable also to income originated from lease or from any other use of the property. It must be noted that also the usufruct of immovable property, as well as the rights to variable or fixed payments related to the working of mineral deposits and mineral and natural sources fall within the scope of this provision. This article is applicable also to income from immovable property belonging to an enterprise or used for the performance of independent personal services.

Likewise, capital gains derived form the alienation of such immovable property shall be taxed in the State where the immovable property is located.

Business Profits (Article 7)

The treaty stipulates that the profit that is derived to an enterprise of one State through a permanent establishment[2] situated in the other State shall be taxed in that other State (i.e. the source State), but only on condition the profit is attributable to that permanent establishment. In all other cases the residence State has the right to tax business profits. Remarkable anti-abuse rules are laid in paragraphs II and IV for prevention of double non-taxation of profits.

Dividends (Article 10)

As per the treaty, the residence State of the recipi-

2 The treaty defines permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes, among others, a place of management, a branch, an office, a factory, a workshop and a mine, an oil or gas well (or any other place of extraction of natural resources), and, subject to some time limits, a building site, a construction or assembly project or supervisory activities in connection therewith, the furnishing of services (including consultancy services).

ent of the dividends has the right to tax. However, the same dividends may also be taxed in the source State, but the taxing right is limited to 15% if the recipient is the beneficial owner[3] of the dividends. It must be noted that the taxes withheld in the source State can be credited against the residence State's taxes payable (Article 23).

The concept of dividends for the purpose of the treaty is defined by a list of "corporate rights", such as shares, jouissance shares or rights, founders' shares or other rights participating in profits (but not debt claims), as well as income from other corporate rights which is subjected to the same fiscal treatment as income from shares under the laws of the concerned State.

It must be noted that the dividend rules are not applicable if the recipient, resident in one contracting State, carries on business through a permanent establishment or performs independent personal services from a fixed base located in the other contracting State (of which the company paying the dividends is resident). In such cases, the dividends are taxable in that other contracting State (i.e. the source State), provided that the holding is effectively connected with such permanent establishment or fixed base.

Interest (Article 11) and Royalties (Article 12)

As dividends, also interest and royalties arising in a contracting State and paid to a resident of the other contracting State are taxed in that other State. However, the treaty prescribes that interest and royalties may also be taxed in the source State, but if the recipient is the beneficial owner thereof the tax so charged shall not exceed, respectively, 15% and 10% of the gross amounts of such payments.

Capital Gains (Article 13)

This article grants to the residence State of the alienator the exclusive right to tax gains from the alienation of movable property such as shares, debt instruments and various financial instruments.

However, also the source State may levy a tax on gains derived to a resident of the other contracting State from the alienation of shares or bonds pertaining to a company which is resident in the former if two conditions are fulfilled: i) the securities are sold to a resident of the source State itself and ii) the period between the acquisition and alienation of such movable property does not exceed one year.

The treaty sets forth a special provision with reference to the case of alienation of movable property pertaining to permanent establishments or fixed bases that an enterprise or an independent professional, residing in one contracting State, owns in the other contracting State. In such cases, the gains are taxable in that other State (that is, where the permanent establishment or the fixed base are located).

Independent Personal Services (Article 14)

The term professional services includes, among others, independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

As per the general rule provided for by the treaty, income derived from the performance of professional services or activities in an independent capacity shall be taxed only in the residence State. However, the income may be taxed also in the other contracting State if i) such activities or services are performed there, ii) the income is attributable to a fixed base available to the subject in that other State; iii) the individual is present in that other State for an aggregate period of over 183 days in a 12-month period.

If the professional services are performed by an enterprise through a permanent establishment in the other contracting State the same rules apply. However, the enterprise may elect to be taxed under Article 7 (business profits).

Dependent Personal Services (Article 15)

The treaty postulates that the remuneration in respect of an employment derived by an individual is taxable only in the individual's State of residence unless the employment is exercised in the other State. In that event, such income may be taxed also in the source State. However, the employment income shall be taxed only in the State of residence if three conditions are satisfied: i) the employee is present in the other State for a period not exceeding in the aggre-

3 The beneficial owner doctrine aims at preventing abuse of the treaty benefits. In other words, if the recipient of the dividends is not the beneficial owner of such income, being instead an agent or nominee of a person that is not resident of the other contracting State, the dividends are not entitled to the benefits provided in this article.

gate 183 days in the calendar year; ii) the remuneration is paid by or on behalf of an employer who is not resident in the other State; iii) and the remuneration is not borne by a permanent establishment or a fixed base of business that the employer has in the other State.

Directors' Fees (Article 16)

Payments made to directors in their capacity as members of boards of directors are taxed in the country of residence of the company paying such remunerations. This Article overrides the general rule provided for by Article 15.

Pensions (Article 18)

This provision attributes exclusive tax jurisdiction over pensions to the State of residence of the recipient. Therefore, the taxation of pensions will take place and will have to comply with the domestic laws of the State of residence, being exempted in the State of the source. It must be noted, though, that this rule does not apply fully to pensions paid by the governments for services rendered in their name, which is regulated under Article 19.

Elimination of Double Taxation: Reliefs under Article 23

As seen in the foregoing, the general allocation rule adopted by the treaty attributes the jurisdiction to tax to the residence State of taxpayers, regardless of the territorial source of income. However, some categories of income may be taxed also in the source State, in some cases with full taxing rights (for example, immovable property income, business profits derived to foreign companies through a permanent establishment in the country, etc.), in others with reduced taxing rights (as is the case of dividends, royalties, and interests). As a result, some categories of income are subject to taxation in both States. Under Article 23, the treaty provides for mechanisms, to be implemented by the State of residence, aiming at eliminating such double taxation.

There are two methods that are commonly used to eliminate double taxation: the tax credit method and the tax exemption method. The Turkey-Italy tax treaty prescribes the credit method as the general relief method. While under the exemption method the foreign income is tout court excluded from the taxable base, under the credit method the residence State at first determines the tax due under domestic law in the absence of a double taxation treaty (that is on a world-wide basis). Subsequently, this tax is reduced by the foreign tax paid, thereby eliminating double taxation. More in detail, income derived by residents of Italy from sources within Turkey will be included in their taxable income in Italy, but the tax to be paid therein will be reduced by the amount of tax paid in Turkey. This credit, however, is limited to the amount of tax that is attributable under Italian tax law to non-resident income[4].

As far as Turkey is concerned, Article 23, paragraph 2 stipulates that Turkey shall, subject to the provisions of Turkish taxation laws regarding credit for foreign taxes, allow a deduction from the income tax due by its residents an amount equal to the income tax paid in Italy. Such deduction, however, shall not exceed the amount of Turkish tax, as computed before the deduction is made, attributable to such income.
Through these mechanisms, which over the years have proved efficient in eliminating double taxation, taxpayers of both countries can rely on a higher degree of predictability and fairness in the tax treatment of cross-border investments.

Conclusion

The Double Taxation Agreement in force between Turkey and Italy codifies a set of rules which allocate the taxation rights of the two jurisdictions with respect to direct taxation, covering both the taxation of companies and individuals. The avoidance of double taxation is achieved through either the attribution of exclusive taxing rights, or, where both countries are entitled to levy taxes on the same income, by requiring the residence country to grant credit against its tax for the taxes paid in the source country.

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4 The foreign tax will be credited to the domestic tax in its entirety only if such amount is less than or equal to the amount of tax which would have been paid in the residence country in accordance with domestic tax laws. This occurs because allowing the deduction of the total amount of the tax paid abroad could prove burdensome for the residence State in case of a higher foreign tax rate. This variation of the credit method is called ordinary credit method, as compared to the full credit method.