assets by means of German CFC taxation infringes Art. 43 respectively 56 of the EC Treaty.

7. Conclusion

Until 2003 most incidences of German CFC rules could be prevented by treaty protection of CFC low taxed ordinary passive income and passive investment income from intra-group financing.¹¹⁹ Since treaty protection has been abolished, the significance of CFC legislation has increased substantially.¹²⁰ Simultaneously, attention shifts from the legal consequences to the legal prerequisites and its interpretation.¹²¹

Therefore, critical issues in German CFC legislation come to the fore.

The increased significance of German CFC legislation also has an impact on permanent establishments situated in double tax treaty states. Prior to the latest amendments, only passive investment income was subject to a possible switch-over. Now, s. 20(2) of the FTA covers any passive income.

All in all it is arguable whether the latest amendments to German CFC taxation have triggered a shift of paradigm in German tax law by departing from the principle of capital import neutrality and turning closer to the principle of capital export neutrality.

Notes

¹¹⁹ Eckl, ET 2003, p. 289.

¹²⁰ Sieker, IStR 2003, p. 80; Köhler, DStR 2002, p. 2158.

¹²¹ Sieker, IStR 2003, p. 81.

Taxation of Capital Gains in Spanish Tax Treaties: The Belgium-Spain Double Taxation Convention on Income and Capital

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1. Article 13 of the model tax conventions

The global trend of expanding tax treaty networks continued in 2003. Notwithstanding the goal of including more detailed and specific provisions in addition to the standard treaty clauses, most of the income tax treaties are still based upon the Model Convention of the Organization for Economic Cooperation and Development (OECD Model Convention) or the 2001 Model Convention of the United Nations (UN Model convention). The year 2004 can also expect to see further developments in this field and, particularly, on the taxation of capital gains, as a consequence of the new paragraph recently introduced in Art. 13 of the OECD Model Convention – the current version of this Model after the adoption of the fifth update by the

OECD Committee on Fiscal Affairs is of 28 January 2003 – regarding the taxation of capital gains on the alienation of shares.

To begin with, it must be said that Art. 13 deals only with taxation in the state of source. To what extent the state of residence should take account of taxation allowed under the treaty and imposed by the state of source, is governed by Art. 23. Besides, the expression ‘capital gains’ is not defined neither in the aforementioned Models nor in the United States Model Convention of 1996 (US Model Convention). According to the internationally unanimous understanding, Art. 13 covers¹ gains derived from the sale or exchange of property, from a partial alienation, expropriation, a transfer to a company in exchange for stock, or a sale of a right. The question of what else should be

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¹ Paragraph 5 of the OECD Model Convention Commentary on Art. 13 furthermore refers to gains from gifts and from the passing of the property on death. However, as it is established in para. 19 of the OECD Model Convention Commentary, this provision is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.

classified as a capital gain depends on domestic law.

Article 13 of the Model Conventions largely leaves taxation of capital gains to that state which, prior to the alienation of the property disposed of, was entitled to tax both such property and the income derived therefrom. This distributive rule does not prejudice whether and, if so, how the state should levy tax on capital gains. There is nothing in this Article to prevent each Contracting State from imposing either a capital gains tax of its own or to include such gains in taxable income and, therefore, to submit them to general income taxation.²

In particular, Art. 13(1) of the Model Conventions assigns the primary taxing jurisdiction over gains from the alienation of immovable property to the state in which such property is situated.³ The contents of this provision in the OECD, UN and US Model Conventions are identical, except from the additional arrangements envisaged in the latter for 'real property companies'.⁴ Thus, the *situs* principle applies to capital gains derived from the alienation of immovable or 'real property'.

For the definition of 'immovable property', Art. 13(1) of the OECD Model Convention refers to Art. 6. Apart from that, the term also includes immovable property forming part of the current assets of an enterprise and, consequently it is applicable to gains from the alienation of owner-occupied flats, condominiums, holiday houses and the like, built abroad by an enterprise for sale.⁵ In this sense, it should be noted that para. 2 of Art. 13 of the US Model Convention defines 'real property' by referring not only to Art. 6 (for example, an interest in the real property itself), but also to a 'United States real property interest' (when the United States is the other Contracting State under para. 1), and an equivalent interest in real property situated in the other Contracting State.⁶ As the OECD Model Convention does not refer to real property interests other than the real property itself, the United

States has entered a reservation⁷ on this point with respect to the former Model Convention, reserving the right to apply its tax under Foreign Investment in Real Property Tax Act (FIRPTA) to all real estate gains encompassed by that provision.

Moreover, the principle laid down in Art. 13(1) of the Model Conventions also applies to gains from the alienation of all or part of the shares in a company holding immovable property. In accordance with Art. 13(4) of the OECD Model Convention and UN Model Convention, and Art. 13(2) of the US Model Convention, gains from the alienation of shares in a company may be taxed in the state where the property held by the company is situated, provided that such property consists principally of immovable (or real) property.

On the other hand, Art. 13(2) of the OECD Model Convention states that:

'gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.'⁸

The rule in question covers only such items of property as directly pertain to the activities of a permanent establishment and it discards the force of attraction principle in connection with permanent establishments.⁹

Apart from the reference to the 'fixed base' contained in the 1996 US Model Convention and in the 2001 UN Model Convention, both are in complete conformity with the OECD Model Convention. This provision deals with the taxation of movable business property,¹⁰ that is to say, it must be attributable to a

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² In the United Kingdom, for instance, double tax treaties apply to capital gains taxed by the capital gains tax; in France it is considered as capital gains those which are taxed by the *Impôt sur le revenu* and in Switzerland, those submitted to the cantonal taxes on capital gains.

³ Included in the 1963 OECD Draft Convention and amended by the 1977 OECD Model Convention, Art. 13(1) of the OECD Model Convention 2003 sets out that: 'Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State'.

⁴ The US Model Convention uses the term 'real property' rather than 'immovable property', but there is no substantive difference. Paragraph 1 of Art. 13 of the US Model Convention preserves the non-exclusive right of the state of source to tax gains attributable to the alienation of real property situated in that state and, it permits therefore the US to apply s. 897 of the Code to tax gains derived by a resident of the other Contracting State that are attributable to the alienation of real property situated in the US.

⁵ K. Vogel, *Klaus Vogel on double taxation conventions* (Kluwer International Law, The Netherlands, 1997), p. 821.

⁶ Under s. 897(c) of the Code the term 'United States real property interest' includes shares in a US corporation that owns sufficient US property interests to satisfy an asset-ratio test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as US corporations for this purpose. Section 897(i) states that in applying para. 1, the US will look through distributions made by a REIT. Accordingly, distributions made by a REIT are taxable under para. 1 of Art. 13 (not under Art. 10, Dividends) when they are attributable to gains derived from the alienation of real property. See para. 192 of the US Model Technical Explanation.

⁷ This reservation on the Article reads as follows: 'The United States wants to reserve its right to apply its tax on certain real estate gains under the Foreign Investment in Real Property Tax Act'. See para. 46 of the OECD Model Convention Commentary to Art. 13.

⁸ Included in the 1963 OECD Draft Convention and amended by the 1977 OECD Model Convention (notably by deleting the last sentence, the principle of which has been taken up in para. 3), the wording of this paragraph was recently updated in 2000, by deleting the references to the 'fixed base'.

⁹ As it is said in para. 27 of the OECD Model Convention Commentary, certain states consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. On the contrary, Art. 13(2) of the OECD Model Convention is not based on such a conception, which is sometimes referred to as 'the force of attraction of the permanent establishment'.

¹⁰ The term 'business property' encompasses both necessary property and that established by intent as long as it is attributable to the permanent establishment. Participations in corporations or partnerships may also come under the field of this term in some cases.

permanent establishment. If movable private property is alienated, it is Art. 13(5) of the OECD Model Convention that will be applicable. Although the term 'movable property' is not defined in the Model Conventions, the context reveals that it covers property of any kind other than immovable property within the meaning of Art. 6(2). Incorporeal property, such as goodwill, licences, etc., is also included in the scope of this rule.¹¹

Article 13(2) of the OECD and UN Model Conventions corresponds to Art. 13(3) of the US Model Convention, which differs from the other two in that, rather than referring to gains from the alienation of movable property 'forming part of the business property of a permanent establishment', it uses the sentence 'which are attributable to a permanent establishment'.¹² Obviously, this change in form does not bring about any change in substance.

An exception from the previous rule is provided, however, for ships and aircraft operated in international traffic and for boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, aircraft and boats. In accordance with Art. 13(3) of the OECD and UN Model Conventions, gains from the alienation of such assets are usually taxable only in the state in which the place of effective management of the enterprise operating such ships, aircraft and boats is located.¹³ This rule corresponds to the provisions of Art. 8 and of para. 3 of Art. 22.

It is important not to lose sight of the fact that this paragraph does not apply where the enterprise owning the boats, ships or aircraft does not operate them (for instance, where the enterprise leaves the property to another person, other than in the case of an occasional bare boat lease as referred to in para. 5 of the Commentary on Art. 8). In this hypothesis, the gains accruing to the true owner of the property, or connected movable property, will be covered by Art. 13(2) or (5).

Further, we would like to highlight the alternative version of Art. 13(3) which, according to para. 28.2 of the OECD Model Convention Commentary, might adopt member countries in their bilateral conventions in order to clarify the application of this provision:

'Gains from the alienation of property forming part of the business property of an enterprise and consisting of ships or aircraft operated by that

enterprise in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.'

In contrast to this *criterium*, the US Model Convention attaches primary taxation of this kind of gains to the enterprise's residence. Article 13(4) of the US Model Convention limits the taxing jurisdiction of the state of source concerning gains from the alienation of ships, aircraft, or containers operated in international traffic or movable property pertaining to the operation of such ships, aircraft, or containers. Under para. 4, when such income is derived by an enterprise of a Contracting State it is taxable only in that state. As it is said in the Technical Explanation, this result is consistent with the general rule under Art. 8 (Shipping and air transport) of the US Model Convention, that confers exclusive taxing rights over international shipping and air transport income on the state of residence of the enterprise deriving such income.

Article 13(4) of the US Model Convention does not approach the primary taxation of any other movable property pertaining to the operation of ships or aircraft. Being gains not expressly referred to, they come under the catch-all clause in Art. 13(6) of the US Model Convention and are, therefore, generally taxed at the alienator's residence.

The fifth edition of the OECD Model Convention includes a new paragraph in Art. 13. Paragraph 4 allows the state of source to tax gains from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in that state. In this respect, the entire gain attributable to such shares (even where part of the value of the share is derived from property other than immovable property located in the source state) may be taxed in the source state. As explained in the Commentary, the determination as to whether shares of a company derive more than 50 per cent of their value from immovable property situated in the state of source should be made by comparing the value of such immovable property to the value of all property owned by the company without taking into account debts or other liabilities of the company.¹⁴

It can also be quoted that, in their bilateral tax treaties the Contracting States can agree on a different scope of the paragraph and/or on a different percentage. As far as the scope is concerned, it can

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¹¹ Paragraph 24 of the OECD Model Convention Commentary on Art. 13.

¹² As Vogel indicates, the phrase is on the same lines as the wording of Internal Revenue Code, s. 864(c)(4) and is, thus, more easily understood by US tax experts (see n. 5 above, p. 828).

¹³ In view of this particular situation in relation to shipping, Greece will retain its freedom of action with regard to the provisions in the Convention relating to capital gains from the alienation of ships in international traffic and movable property pertaining to the operation of such ships. This reservation on the Art. 13(3) of the OECD Model Convention is contained in para. 47 of the OECD Model Convention Commentary.

¹⁴ Paragraph 28.4 of the OECD Model Convention Commentary on Art. 13.

be broadened,¹⁵ for example, to gains from the alienation of interests in other entities, or narrowed, for instance, by excluding gains on shares of companies listed on an approved stock exchange. Moreover, it is also possible for Member States to increase or reduce the percentage of the value of the shares. This would simply be done by replacing '50 per cent' by the percentage that these states would agree to. Finally, another possible change would be to restrict the application of the provision to cases where the alienator holds a certain level of participation in the entity,¹⁶ as it will be commented on below in more detail.

In practice, some treaties already contain a similar provision on the taxation of gains from shares deriving their value from immovable property located in the state of source.¹⁷

Nevertheless, it is important to borne in mind that previously to the introduction of this new paragraph by the 2003 OECD Model Convention version, both the 2001 UN Model Convention and the 1996 US Model Convention already included this rule with regard to the alienation of that type of shares. While Art. 13(2) of the US Model Convention refers to this matter, the wording of Art. 13(4) and (5) of the UN Model Convention states the following:

'4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular: 1) Nothing contained in this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of . . . per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.'

All three Model Conventions ultimately have catch-

all clauses basically alike for capital gains not covered by the preceding paragraphs. In line with it, Art. 13(5) of the OECD Model Convention provides that gains from the alienation of any property other than that referred to in Art. 13(1), (2) or (3), are taxable exclusively by the alienator's state of residence.¹⁸ That state taxes such gains in accordance with its own domestic law without being restricted by the treaty in so doing. As a consequence of that, the state of source is deprived of its right to tax and it is obliged to exempt such gains. This corresponds to the rules laid down in Art. 22.

It should be emphasized that, rather than being restricted to the alienation of property situated in a Contracting State, Art. 13(5) extends to cover the alienation of property situated in third states as well. If a person entitled to treaty protection derives gains from the alienation of immovable property situated in the alienator's state of residence or in a third state, this paragraph authorises such gains – subject to the existence of a tax treaty between the state of residence and the third state – to be taxed exclusively in the alienator's state of residence. This is so even in cases where land situated in a third state formed part of a permanent establishment in the other Contracting State, since Art. 13(2) applies only to movable business property.¹⁹

In addition to that, Art. 13(5) of the OECD Model Convention also applies to entitlements to receive current payments in respect of dividends, debt claims, patents or the like. Gains from the alienation of such entitlements remain subject to tax in the alienator's state of residence. However, receipts from the redemption of such alienated entitlements continue to be yields of the right or property giving rise to the dividends, etc., which means that the provisions on dividends, interest or royalties should be applied to them.²⁰

Similarly, para. 196 of the US Model Convention's Technical Explanation details that this rule grants to the state of residence of the alienator the exclusive right to tax gains from the alienation of property other than that referred to in the previous paragraphs. For instance, gains derived from shares, other than shares described in Art. 13(2) or (3), debt instruments and various financial instruments, may be taxed only in the state of residence, to the extent such income is

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¹⁵ According to para. 28.5 of the OECD Model Convention Commentary, some states consider, for instance, that 'the provision should not only cover gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, that do not issue shares, as long as the value of these interests is similarly derived principally from immovable property. States wishing to extend the scope of the paragraph to cover such interests are free to amend the paragraph as follows: "4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State".'

¹⁶ Paragraph 28.6 of the OECD Model Convention Commentary on Art.13.

¹⁷ Reservations on this Art. 13(4) of the OECD Model Convention have been made by Mexico, which reserves its position to retain the possibility of applying the provisions in its laws relative to the taxation of gains from the alienation of shares or similar rights in a company that is a resident of Mexico; and Luxembourg, which reserves the right not to include para. 4 in its conventions. See paras. 49 and 51 of the OECD Model Convention Commentary on Art. 13.

¹⁸ In line with it, the answer of the Spanish *Dirección General de Tributos* of 19 September 2002 with regard to the application of the Morocco-Spain Double Tax Treaty.

¹⁹ See Vogel, n. 5 above, p. 842.

²⁰ Paragraph 31 of the OECD Model Convention Commentary on Art. 13.

characterized as income taxable under another Article.²¹

To sum up, it is also remarkable the numerous OECD Member States that have reserved the right through declaration in the OECD Model Convention Commentary, in order to include in their tax treaties similar provisions for shares of a company.²² In this point, taxation in the state of the company's seat is occasionally limited in such treaties to instances when there is a 'substantial participation'.²³

2. Tax treatment of capital gains in Spanish tax treaties. New provision on the taxation of capital gains on the alienation of shares in the Belgium-Spain Double Tax Treaty

Generally, Spanish tax treaties follow closely the OECD Model Convention concerning the taxation of capital gains. Taking this idea as a starting point we would like to underline, however, some dissimilarities embodied in several treaties concluded by Spain relevant to understand the Spanish tax treaty practice.

This lack of conformity points first at the taxation of gains from the alienation of shares, participations or other rights in a company or any other body corporate²⁴ the assets of which principally consist of immovable property, that may be taxed in that state. Among others, the double tax treaties signed by Spain with Belgium, Canada, China, France, Greece, Iceland, India, Ireland, Israel, Korea, Luxembourg, Mexico, Norway, Philippines, Poland, Portugal, Russia, USSR, US and Venezuela,²⁵ contain a clause of this nature.²⁶ Likewise, in the double tax treaty between Spain and Sweden this rule applies provided certain conditions are met. In particular, Art. 13(5) states that:

'the provisions of the first sub-paragraph of paragraph 4 shall not affect the right of a Contracting State to tax, according to its own legislation, any gain from the alienation of shares in a company the main assets of which consist of

immovable property, provided the alienator is an individual resident of the other Contracting State, who (a) is a national of the first-mentioned Contracting State without being a national of the other Contracting State; (b) has been a resident in the first-mentioned Contracting State during any part of a five year period immediately preceding the alienation; and (c) at the time of the alienation alone or together with a closely related person had a decisive influence on the company.'

By virtue of Art. 13(4) of the double tax treaty between Spain and the UK,²⁷ capital gains from the alienation of time-share rights which may be used for periods not exceeding four weeks in any calendar year shall be taxable only in the Contracting State of which the alienator is a resident. Under this provision, in the computation of the period or periods there shall be taken into consideration all time-share rights owned by a resident of a Contracting State in respect of immovable property situated in the other Contracting State.

Although most double tax treaties concluded by Spain settle an explicit reference to the special treatment of ships and aircraft, the general rule of the alienator's state of residence will apply in the absence of that clause. This is the case, indeed, of the Spanish conventions signed with Austria, Canada, Denmark, Finland, France, Morocco, Norway, Poland, Rumania and Switzerland, for example, where no reference to this kind of property exists at all.

As previously noted, para. 28.6 of the OECD Model Convention Commentary on Art. 13 allows member countries to restrict the application of Art. 13(4) of the OECD Model Convention to cases where the alienator holds a certain level of participation in the entity. As far as Spain is concerned, the underlying aim of this rule is also reflected in para. 45 of the OECD Model Convention Commentary, where Spain reserves the right to tax gains from the alienation of shares or other rights forming part of a 'substantial participation' in a company which is a resident.

Notes

²¹ Gain derived from the alienation of any property, such as patent or copyright, that produces income taxable under Art. 12 (Royalties) is taxable under Art. 12 and not under this rule, provided that such gain is of the type mentioned in Art. 12(2)b (for example, it is contingent on the productivity, use or disposition of the property).

²² Among others, Finland reserves the right to tax gains from the alienation of shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and held by the company; New Zealand reserves its position on paras. 3 and 5; Sweden wants to reserve the right to tax gains from the alienation of shares or other corporate rights in Swedish companies. See paras. 35, 38 and 39 of the OECD Model Convention Commentary on Art. 13.

²³ For instance, France accepts the provisions of para. 5, but wishes to retain the possibility of applying the provisions in its laws relative to the taxation of gains from the alienation of shares or rights which are part of a substantial participation in a company which is a resident of France; Japan wishes to retain the right to tax gains from the alienation of shares or other corporate rights which are part of a substantial participation in a Japanese company; Korea and Spain reserve the right to tax gains from the alienation of shares or other rights forming part of a substantial participation in a company which is a resident. See paras. 36, 42 and 45 of the OECD Model Convention Commentary on Art. 13.

²⁴ Namely, the bilateral Spanish conventions with Canada, Ireland, Philippines and Portugal explicitly refer to 'partnerships' or 'trusts' whose assets principally consist on immovable property. A similar provision is included in Art. 10 of the Protocol to the Double Tax Treaty between Spain and the US.

²⁵ Double taxation convention on income and on capital recently signed between Spain and Venezuela. Date of conclusion: 8 April 2003, not yet in force.

²⁶ Other significant particularities exist on this matter in the Spanish tax conventions with Argentina, Eslovenia, India and The Netherlands.

²⁷ This provision was modified by an Exchange of notes of 13 December 1993 and 17 June 1994, so its wording is effective since 26 May 1995 (Spanish Official Bulletin of 25 May 1995).

In this sense, it would be desirable from our point of view to have an explicit reference in the OECD Model Convention to this issue, as it is worded in Art. 13(5) of the UN Model Convention:

'Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ... per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.'

The main reason for introducing such a rule resides in the fact that many treaties framed on the basis of the OECD Model Convention depart from its wording on this point, by providing more often than not the taxation in the state of the company's seat where it concurs a 'significant participation'.

In practice, this clause has been included in several Spanish tax treaties, such as the new double taxation convention between Spain and Belgium²⁸ signed in 2003, whose Art. 13(5) establishes that:

'Notwithstanding the provisions of paragraph 2, gains from the alienation of shares, participations or other rights forming part of a substantial holding in a company which is a resident of a Contracting State, may be taxed in that State. A substantial holding shall be deemed to exist if the alienator owns, directly or indirectly, alone or together with associated or related persons, at any time during the five years prior to the alienation, shares, participations or other rights which, together, entitled to at least 25% of the profits of the company or represent at least 25% of the capital of that company.'

Similarly, the double tax treaties concluded by Spain with Portugal, US, Mexico, Ireland, Korea²⁹ and Argentina,³⁰ among others, contain also this provision with an identical percentage of participation in the capital of the company.³¹ The India-Spain Income and Capital Tax Treaty provides the same rule except from

this latter percentage of participation, which must be of at least 10 per cent in a company which is a resident of a Contracting State. In line with it, it should be kept in mind the answer of the *Dirección General de Tributos* of 16-July-1992 in application of the provision regarding this 'substantial participation' in the US-Spain Double Taxation Convention³² (Art. 13.40.5.b. of the Protocol).

Needless to say, the recent tax treaties signed by Belgium and, specially the Belgium-Spain Double Tax Treaty, are coherent with the Belgian domestic law with regard to the taxation on capital gains. Moreover, the new treaty clause introduced in the latest tax treaties was absolutely necessary in order to adequate the content of the Belgian tax treaties currently in force to the Belgian tax system on this matter.

In broad terms, the Belgian corporate income tax is levied on the worldwide profits of resident companies,³³ whereas the worldwide income of resident individuals is subject to the individual income tax.³⁴ Concerning the Belgian corporate income tax, it must be clarified that only entities with legal personality are subject to it.³⁵ The taxable base for this purpose is the worldwide income, less allowable deductions. In contrast to income derived by individuals, which is divided into four categories, it is assumed that all income derived by the company is business income, more specifically profit.

The Income Tax Code describes six successive steps to determine the taxable base of the company, starting from the financial statements:³⁶

- (1) profit determination (increases in reserves, non-deductible expenses and distributed dividends);
- (2) classification of the profit according to its source (Belgian-source profit, profit from non-treaty countries, profit from treaty countries);
- (3) deduction of profit from treaty countries and other exempt profits;
- (4) deduction of intercompany dividends (participation exemption);
- (5) use of previous losses; and
- (6) investment deduction.

Notes

²⁸ Effective date 1 January 2004. (See Art. 29, amended by a Protocol signed on 22 June-2000).

²⁹ According to Art. 13(3) of the Double Tax Treaty between Korea and Spain, the tax so charged shall not exceed 10 per cent of the mentioned gains.

³⁰ Article 13(4) of the Double Tax Treaty between Argentina and Spain also envisages some limitations in this field, as the tax charged shall not exceed: 10 per cent of the gain in the case of a direct participation in the capital of at least 25 per cent; and, 15 per cent of the gain in all other cases.

³¹ A further aspect we would like to raise is the wording of Art. 22(5) of the Belgium-Spain Double Tax Treaty, which reads as follows: 'Capital represented by shares, participations or other rights forming part of a substantial holding in a company which is a resident of a Contracting State, may be taxed in that State. A substantial holding is deemed to exist if a person, alone or together with associated or related persons, directly or indirectly, owns shares, participations or other rights which, together, entitle to at least 25% of the profits of the company or represent at least 25% of the capital of the company.'

This additional depart from the literal text of the OECD Model Convention with regard to the taxation of capital – coherent with the rule concerning 'capital gains' – should be also emphasized, as other treaties concluded by Spain have already included a similar provision too, such as those signed with Iceland, Norway, Israel, India, Mexico and France.

³² By virtue of this administrative doctrine, capital gains obtained by an American trust and derived from the alienation of shares in Spanish entities, are not subject to taxation in Spain, as long as this shares do not represent a substantial holding of at least 25 per cent in the Spanish companies referred to.

³³ Belgian-source profits of non resident companies are subject to the Income tax on non-residents.

³⁴ In addition, individuals must pay social security contribution and inheritance and gift taxes. There is no net wealth tax.

³⁵ By the terms of the Income Tax Code, which governs corporate income taxation, taxable persons include resident companies, associations, cooperatives, establishments and organizations engaged in a business or other profit-making activities.

³⁶ J. Kesti (ed.), *European Tax Handbook 2003* (International Bureau of Fiscal Documentation, Amsterdam, 2003), p. 61.

Capital gains realized on the disposal of business assets are regarded as business income and, therefore, normally subject to taxation at the ordinary rates. Capital gains on shares or participations are exempt if the dividends relating to such shares or participations qualify for the participation exemption at the moment the gains are realized. Nevertheless, the minimum participation requirement for the dividend exemption does not apply to the capital gains exemption, inasmuch as the exemption applies only provided that the gains are higher than previously deducted capital losses on these shares or participations.

The basic corporate income tax rate³⁷ is 33 per cent, increased to 33.99 per cent by the 3 per cent austerity surcharge.³⁸

As it was commented above, resident individuals³⁹ are subject to individual Income tax on worldwide income, by being taxable income the total of the net result for each of the following four categories of income:

- (1) income from immovable property;
- (2) income from movable property, including dividends, interest and royalties;
- (3) earned income, including business income, professional income, employment income and pension income; and
- (4) miscellaneous income.

The net result of each category is gross income less expenses incurred in acquiring or preserving the income and is computed according to each category's own rules. Certain deductions may be allowable from this total net income before applying the progressive tax rates.

In spite of that, capital gains realized by individuals not engaged in business activities are not taxable, except if realized on: speculative transactions; the sale of undeveloped immovable property within five years of the acquisition; the sale of developed immovable property within five years of acquisition; the sale of a substantial participation (more than 25 per cent) in a resident corporation to a non-resident legal entity; and the sale of rights in intangible property (patents and copyrights, for instance).

The individual income tax rates for assessment year 2004 (tax year 2003) are as follows:

Taxable income (EUR)	Rate (%)
Up to 6,480	25
6,480–9,740	30
9,740–14,530	40
14,530–29,740	45
over 29,740	50

The income tax calculated according to the above rate table is increased by a municipal surcharge.⁴⁰ The austerity surcharge was abolished with effect from tax year 2003. Some items of income are taxed separately at a different rate, unless aggregation with other income would be more beneficial. The most important separate tax rates (increased by the municipal surcharges) are the following.

- A rate of 33 per cent applies to: capital gains on speculative transactions; capital gains on undeveloped immovable property if sold within five years of the acquisition; and capital gains on rights in intangible property (patents and copyrights, for example).
- A rate of 25 per cent applies to: dividends, except those subject to a rate of 15 per cent; interest and royalties derived from contracts concluded or from securities issued before 1 March 1990; income derived from the subletting of immovable property or the cession of a tenancy agreement where the immovable property is used for the purpose of advertisement (billboards, etc.); and income from granting hunting, fishing or shooting rights.
- A rate of 16.5 per cent applies to: capital gains on undeveloped immovable property if sold after five years but within eight years of the acquisition; capital gains on developed immovable property if sold within five years of the acquisition; capital gains on a substantial participation (more than 25 per cent) on a resident corporation sold to a non-resident legal entity; lump-sum payments on certain life insurance contracts, state pensions, or from pension funds or group insurance contracts (under certain conditions); capital gains resulting from the complete or partial cessation of a business (within certain limitations); and special awards granted to scientists, etc.

Notes

³⁷ Apart from that, the following progressive rates apply to companies with taxable income up to €322,500:

Taxable income (€)	Rate (%)
Up to 25,000	24.25
25,000–90,000	31
90,000–322,500	34.5

These rates are increased to 24.98 per cent, 31.93 per cent and 35.54 per cent, respectively, by the 3 per cent austerity surcharge. The progressive rates are not applicable, among others, to: companies owning participations exceeding certain limits (financial companies); companies whose shares are at least 50 per cent owned by one or more companies and companies whose dividend distribution exceeds 13 per cent of the paid-up capital at the beginning of the financial year.

³⁸ An austerity surcharge is levied on income taxes due from both resident and non-resident taxpayers. The surcharge is calculated at a rate of 3 per cent on the income tax actually due as computed before the deduction of withholding taxes, advance payments and foreign tax credits and before the application of the increases for insufficient advance payments. The surcharge is subject to the same rules as the tax upon which it is levied.

³⁹ An individual is considered a resident of Belgium if his main home or his centre of economic interests is in Belgium. An individual is presumed to be a resident of Belgium when he is registered in the civil register (rebuttable presumption). Married persons are deemed to be residents of Belgium if their household is established in Belgium (irrebuttable presumption).

⁴⁰ The municipalities may levy surcharges on the national income tax. The rates vary from 0 per cent to 8.5 per cent, according to the municipality (average rate 7 per cent to 7.5 per cent). Regional governments are also entitled to levy surcharges on income tax.

- A rate of 15 per cent applies to other specific cases of dividends and royalties.⁴¹

Going back to the double tax treaties concluded by Belgium – once briefly exposed the main features of the Belgian domestic taxation⁴² on capital gains – it should be noted, on balance, that this provision related to gains from the alienation of shares forming part of a substantial holding in a company which is a resident of a Contracting State, has also been incorporated to other recent tax conventions such as those signed with Mexico, Norway, India and Vietnam, respectively.⁴³

This international treaty practice reflects, in our

opinion, the convenience of an explicit reference to that aspect concerning the taxation of capital gains in the text of the OECD Model Convention (in contrast to the short sentence provided now in the Commentary), as it has already been claimed by some member countries through reservations made on Art. 13 of the OECD Model Convention.⁴⁴ The improvement of this provision by adding the indicated clause would not only approach the wording of this Article to the UN and the US Model Conventions – whose texts expressly reflect this issue – but it would also mean a better adequation of its content to the current tax treaty practice.

Notes

⁴¹ See Kesti, n. 36 above, pp. 75 and 76.

⁴² In this sense, it is significant to take in mind that the Belgian Government has recently announced reforms of labour and capital income taxation. See David Carey, 'Tax reform in Belgium', Economics Department Working Papers no. 354, ECO/WKP (2003) 8, 15 May 2003 (available through OECD's Internet Web site at <http://www.oecd.org/eco>). This paper was originally produced for the OECD Economic Survey of Belgium, which was published in February 2003 under the authority of the Economic Development Review Committee.

⁴³ Whereas the India-Belgium Income Tax Treaty only exiges a participation of at least 10 per cent of the capital stock of a company (similarly to the India-Spain Double Tax Treaty commented above), the double taxation conventions concluded with Mexico and Vietnam, respectively, refer to a participation percentage of 25 per cent. The Norway-Belgium Tax Treaty exiges, finally, a substantial participation of at least 30 per cent in this respect.

⁴⁴ As previously mentioned, France, Japan, Korea and Spain have reserved the right to tax gains from the alienation of shares or other rights which are part of a substantial participation in a company which is a resident in each respective state. See paras. 36, 42 and 45 of the OECD Model Convention Commentary on Art. 13.

Italian Thin Capitalization Rules, Tax Treaties and EC Law: Much Ado About Something

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1. Introduction

The first building within the framework of the major tax reform project,¹ the new Corporate Income Tax² imports into the Italian system many previously unknown provisions, such as participation exemption, consolidated base taxation and thin capitalization: this last set of rules is the subject matter of the present article.

First of all, current provisions – already in force for

tax periods commencing on or after 1 January 2004 – are discussed in section 2; their relationship with the Italian tax treaty network is then dealt with in section 3, along with their potential application to permanent establishments. Section 4 addresses the issue of compatibility with EC primary law (a topic that does not end with *Lankhorst*³) and the influence on the application of the Parent-Subsidiary and the Interest and Royalties Directives; last but not least, section 5 gives an outline of the 'big picture' regarding restrictions on interest expenses.

Notes

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¹ Following a proposal dating back as far as 2001, Parliament eventually delegated Government to enact the tax reform with the Act of 7 April 2003, no. 80, published in the *Official Gazette*, no. 91 of 18 April 2003.

² The legislative decree, 12 December 2003, no. 344, published in supplement 190 to the *Official Gazette*, no. 291 of 16 December 2003, amends so heavily the existing Income Tax Code, that many practitioners now call it 'the NEW code'.

³ Case C-324/00 *Lankhorst-Hoborst GmbH v Finanzamt Steinfurt*, ECJ, 12 December 2002.