

Juridical double taxation as barrier to the internationalization of companies: the role of international conventions and national tax measures*

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1. Legal sources that correct international double taxation in spanish law

In Spanish domestic law the correction of the international juridical double taxation is included in the laws of personal income tax and corporate income tax, considering that the income taxes of the State of residence, according to the international tax conventions, should correct it.

Law 35/2006 of 28 November, of Spanish Personal Income Tax (PIT) contains the definition of residence as subject-to-tax requirement (art. 9). The correction of the double international taxation is included in article 80 of the same Law.

Law 27/2014, of 27 November, of Spanish Corporate Income Tax (CIT) also defines its scope according to the residence of the entities subject-to-tax (art. 8), and provides two methods for the correction of double taxation: 1) exemption method for dividends and income from the transfer of shares as well as for the income obtained from a permanent establishment located

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outside Spain (arts. 21 and 22); and (2) tax credit of the amount paid in the source State (art. 31).

International double taxation is an obstacle to transnational economic integration and therefore European law also helps to eliminate it. Although at the moment there is no a principle for the distribution of tax power between States, European law affects indirectly the correction of double taxation when it tries to avoid its restrictive effects on the freedoms of establishment and movement of capital and workers. Effectiveness and proportionality principles, underlined by prof. Di Pietro², have served to modulate the influence of these freedoms in the correction of double taxation.

Anyway, contributions in this field are scarce because, in general, ECJ has settled that there is no discrimination by the fact that an income is subject to a higher assessment due to the concurrence of taxes from two different States. Thus, in case *Gilly* (C-336/96) the direct effect of article 293 (formerly 220) of the EC Treaty was denied, admitting that the right to deduct the tax paid abroad in the French tax could be less than the tax effectively paid in Germany since this country had a more progressive tax system.

It was the case of French frontier workers taxed simultaneously in Germany for the income obtained in this country and in France by its global income, after a tax credit of the taxes paid abroad as we mention before. The tax burden of these workers may be heavier than the one of people who have an identical income but with exclusively French origin. Such differences derive from the competence of the contracting states to distribute the tax power in order to eliminate double taxation. In this line also the rulings *Kerckhaert Morres* (C-513/04), *Damseaux* (C-128/08), *Haribo* (C-437/08) and *Levy-Sebbag* (C-540/11)³. It has also been stated in relation to the Inheritance and donations tax that the concurrence of two EU countries

² In *Los principios europeos del Derecho Tributario*, Atelier, Barcelona, 2015.

³ HERRERA MOLINA, "STJCE 4.11.2006, Kerckhaert-Morres, As. C-513/04: ¿es discriminatoria la doble imposición jurídica internacional?", *Crónica tributaria*, n. 148, 2013, pp. 248-250.

taxes is not an obstacle to the free movement of capital prohibited by European Law- *Block* (C-67/08)⁴.

⁴ ECJ 12/2/2009, case C-67/08, *Margarete Block vs. Finanzamt Kaufbeuren*:

"27. In that regard, it should admittedly be noted that, as Ms Block submits, the fact that inherited assets such as capital claims are excluded in Germany from 'foreign assets' which, under national rules, establish an entitlement to have inheritance tax paid abroad credited against inheritance tax payable in Germany results – where the claims are against a financial institution in another Member State which has levied inheritance tax on those claims, in the present case, the Kingdom of Spain – in a higher tax burden than if those claims had been against a financial institution established in Germany.

(...)

29 In this respect, double taxation conventions such as those envisaged in Article 293 EC are designed to eliminate or mitigate the negative effects on the functioning of the internal market resulting from the coexistence of national tax systems referred to in the preceding paragraph (*Kerckhaert and Morres*, paragraph 21, and *Columbus Container Services*, paragraph 43).

30 Community law, in the current stage of its development and in a situation such as that in the main proceedings, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the European Community. Consequently, apart from Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (OJ 1990 L 225, p. 6), the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (OJ 1990 L 225, p. 10) and Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (OJ 2003 L 157, p. 38), no uniform or harmonisation measure designed to eliminate double taxation has as yet been adopted at Community law level (see *Kerckhaert and Morres*, paragraph 22, and *Columbus Container Services*, paragraph 45).

31 It follows from this that, in the current stage of the development of Community law, the Member States enjoy a certain autonomy in this area provided they comply with Community law, and are not obliged therefore to adapt their own tax systems to the different systems of tax of the other Member States in order, inter alia, to eliminate the double taxation arising from the exercise in parallel by those Member States of their fiscal sovereignty and, in consequence thereof, to allow the inheritance tax paid in a Member State other than that in which the heir is resident to be deducted in a case such as that of the main proceedings (see, to that effect, *Columbus Container Services*, paragraph 51).

32 These considerations are not liable to be affected by the fact that, as Ms Block claimed in her written observations, Paragraph 21 of the *ErbStG* lays down more favourable offsetting rules where the person whose estate is being administered was, at the time of death, residing in a Member State other than the Federal Republic of Germany, inasmuch as Paragraph 21(2)(2) of the *ErbStG* defines 'foreign assets' in such cases more broadly than in a situation such as that of the applicant in the main proceedings.

33 Admittedly, as the German Government and the Commission confirmed at the hearing, where the person whose estate is being administered was, at the time of death, residing in a

There are, however, European standards in other fields such as movable capital income (dividends, interest and royalties) and transfer pricing which avoid causing double international taxation or collaborate to correct it: is the case of Directives 2011/96/EU (parent-subsidiary)⁵, 2003/49 (on interest and royalties)⁶, 2014/48 (saving directive)⁷ and the Convention 90/436 on transfer pricing⁸.

Member State other than the Federal Republic of Germany, national rules provide – as regards the assessment of inheritance tax payable in Germany by a resident heir in respect of the capital claims of the deceased against a financial institution in that other Member State – for inheritance tax paid in that other Member State to be credited against those claims, since those claims are, in such cases, covered by the concept of ‘foreign assets’ under Paragraph 21(2)(2) of the ErbStG.

34 However, that difference in treatment, as regards the inheritance of a person who was not resident at the time of death, arises equally from the choice by the Member State concerned – made, according to the case-law cited in paragraphs 28 to 31 of this judgment, pursuant to the exercise of its fiscal sovereignty – of the place of residence of the creditor as a connecting criterion for the purposes of establishing the ‘foreign’ nature of the estate and, therefore, for the ability to offset in Germany inheritance tax paid in another Member State.

35 Furthermore, according to the settled case-law of the Court, the Treaty offers no guarantee to a citizen of the Union that transferring his residence to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen’s advantage or not, according to circumstances (see, to that effect, Case C-365/02 Lindfors [2004] ECR I-7183, paragraph 34, and Case C-403/03 Schempp [2005] ECR I-6421, paragraph 45).

36 Accordingly, the answer to the questions referred is that Articles 56 EC and 58 EC must be interpreted as not precluding legislation of a Member State, such as that at issue in the main proceedings, which – as regards the assessment of inheritance tax payable by an heir who is resident in that Member State in respect of capital claims against a financial institution in another Member State – does not provide for inheritance tax paid in that other Member State to be credited against inheritance tax payable in the first Member State where the person whose estate is being administered was, at the time of death, resident in the first Member State.”

⁵ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

⁶ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

⁷ Council Directive 2014/48/EU. of 24 March 2014, amending Directive 2003/48/EC on taxation of savings income in the form of interest payments.

⁸: 90/436/EEC: Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

In this regard, international tax treaties are very important for the avoidance of double taxation.

2. Purpose of the study

According to Comments 1 and 2 of article 23 of the MCOECD juridical double taxation requires that the double tax is supported by the same person; economic double taxation however occurs when two different people can be taxed by the same income or the same wealth.

There may be international juridical double taxation in three cases: a) there are two States of residence. b) there is a source State and a State of residence. (c) there are two source States source and a State of residence.

We will refer mainly to the international juridical double taxation which involves the intervention of two States on the same subject and a the same taxable base, although this is not the only (also economic double taxation has a role) which may affect cross-border relations, and therefore economic integration and the configuration or elaboration of a European tax law.

In addition, we will limite the scope to income direct taxation since in indirect taxation:

1) Usually there are involved other specific integration mechanisms (harmonization), although cases of double taxation have occurred in the Transfer Tax⁹; and (2) double taxation tends to be economic, not juridical,

⁹ ECJ 1/12/2011, European Commission v Republic of Hungary, Case C-253/09:

Hungary allows to detract from the tax base of Transfer tax in the purchase of housing the price of the former dwelling if it is located in Hungary. The Court that this is a justified restriction by the general interest and does not go beyond what is necessary, although there are objectively comparable situations. It stated that this restriction may be justified in order to preserve the coherence of the tax (avoiding the double internal taxation of the same subject with the same tax) and is appropriate to achieve such an objective because Hungary has no power to tax the housing located in another Member State: "While the property transactions carried out in other Member States might also have been subject to similar or even identical taxes to that at issue, it must be noted, however, that in the current stage of the development of EU law, the Member States enjoy a certain autonomy in the area of taxation provided they comply with EU law, and are not obliged therefore to adapt their own tax systems to the different systems of tax of the other Member States in order, inter alia, to eliminate the double taxation (see, by analogy, Case C-298/05 Columbus Container Services [2007] ECR I-10451, paragraph 51, and Case C-67/08 Block [2009] ECR I-883, paragraph 31)". In the same line, ECJ 1/12/2011, European Commission v. Kingdom of Belgium, C-250/08.

since it occurs due to the concurrence of tax required to different taxpayers (due to the exemptions caused by the structure of the imposition and the pyramiding of the output tax) and occurs more in the domestic market than in the intra-UE¹⁰. We also exclude the wealth tax because it has disappeared in almost all countries.

3. Juridical double taxation

When taxes are not levied on the same taxpayer we usually do not consider the existence of juridical double taxation, but economic double taxation. This follows the comment to arts. 23 A and 23 B of the MCOECD¹¹. However, the concept should be eased because, as we will see, there are cases of plurality of taxpayers that should be considered as juridical double taxation.

3.1 Brief reference to economic double taxation

1) Model Convention of the OECD

Paragraphs 50 and 51 of the comments to the Art. 23.A of the MCOECD (p. 337) covered the economic double taxation of dividends, saying that many States are favourable to correct it because it is a major obstacle to cross-border investments. However, the inclusion of such a provision in the Model Convention raises many difficulties due to the diversity of approaches of the States and the multiplicity of possible solutions. Thus, the Committee of Fiscal Affairs of the OECD has preferred to leave to the States the choice of the possible solutions, and suggests three ways to correct this double taxation:

- a) exemption with progression
- b) credit for underlying taxes

¹⁰ Edoardo TRAVERSA, "La prohibición de doble imposición", in DI PIETRO, *Los principios europeos del Derecho tributario*, Barcelona, 2015, p. 251 and on.

¹¹ "1. These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State.

2. This case has to be distinguished especially from the so-called economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

c) assimilating permanent establishments to their own enterprises

2) Parent-subsidiary Directive 2011/96, (abolish Directive 90/435/EEC)

The directive deals with the elimination of international double taxation both juridical and economic. On the one hand prohibits withholding tax at source on those dividends both in the source State and the State of residence (juridical double taxation). On the other hand, obliges the State of residence of the parent or the permanent establishment holding the shares not to tax the dividends earned from subsidiaries - even indirectly owned - based in other Member States, well declaring them exempt well allowing a tax credit (economic double taxation).

3) Spain

Spain has acted with generosity when dealing with this problem at CIT and combines both methods, giving the same treatment to the dividend distributed by residents and non-residents subsidiaries

First, it applies the exemption method to dividends and profits of companies - whether or not residents - when the resident company has a significant shareholding, being the concept of significant shareholding broader than the contemplated by the MCOECD, because it is sufficient to own a share of 5% or that the acquisition value is higher than 20 million € (article 21.1 LIS)¹².

In the case of non-resident subsidiaries, can also be optionally applied the tax credit method of the amount paid abroad (art. 32 LIS). This option can be attractive for the Spanish parent and promotes the investment abroad in two cases:

- (1) When the period for compensating previous years losses is next to overcome (which now is irrelevant because there is unlimited *carry forward* of tax losses.
- (2) If there is a tax benefit associated with the incorporation of such income to the tax base.

¹² SIMON YARZA, *La exención de dividendos y plusvalías para corregir la doble imposición en el Impuesto sobre Sociedades*, Editorial Aranzadi, Cizur Menor, 2015.

On the other hand, there is not any corrective measure of economic double taxation on PIT. Until 2006 there was a tax credit method consisting on a fix 40% deduction of the dividend. It only applied to dividends of companies resident in Spain and its compatibility with the non-discrimination principle was in question. This is why it was transformed into a lump sum deduction of 1,500 euros (year 2006) and ended up disappearing in the year 2015. Therefore, economic double taxation is not currently corrected.

In this evolution has a crucial role the ECJ jurisprudence that considers that the income of an investment (dividends, interests, royalties etc.) cannot be subject to a superior levy when it comes from non-resident payers (ECJ Gerhard Dijkman and Maria Dijkman - Lavaleije against Belgische Staat, 7/1/2010, case C-233/09)¹³. This ruling was not properly referring to international double taxation but to national income that was subject to a liberatory withholding tax and did not have to be integrated into the income tax, where it was applied a municipal surcharge affecting only foreign income.

3.2 Juridical double taxation with plurality of taxpayers

There are situations in which international double taxation may occur because the same income causes the birth of tax liabilities which do not have the same taxable person in two different States. These are cases of real juridical double taxation, because the diversity of subjects on which the tax liability is imposed is caused by mere tax technical reasons. This occurs when the source State uses the figure of the substitute of the taxpayer (withholding tax), when certain groups without legal personality are configured as taxable persons (family taxation and partnerships), or when the controlled foreign company regime is applied.

1) Withholding tax

¹³ As ruled in the final paragraph: "Article 56 EC precludes legislation of a Member State according to which taxpayers resident in that Member State who receive interest or dividends from investments made in another Member State are subject to a supplementary municipal tax when they have not elected for that income from moveable assets to be paid to them by an intermediary established in their Member State of residence, whereas income of the same type from investments made in their Member State of residence, because it is subject to withholding tax at source, need not be declared and, in that case, is not subject to the supplementary municipal tax".

There is a diversity of taxable persons when the source State requires the payer of income a liberatory withholding tax as a definitive assessment, while the State of residence levies income tax on the beneficiary. The logic of the institution requires that the beneficiary of the income is the one considered to support the tax but it raises the problem of determining when this will be applied, since it cannot be accepted that the State of residence must correct in any case the international double taxation caused by the economic impact of the tax.

The dividing line should be established with two criteria that have to be fulfilled simultaneously: 1) On the one hand, the tax in the source State must have as its final object the income. (2) on the other hand, there is only double taxation if the law of the source State recognizes to the payer of the income the right of retention or refund against the beneficiary (translation ex lege and not only contractual or economic)¹⁴.

In General, the payer of the income in Spain has the duty of retention and deposit on the income obtained by a non-resident without a permanent establishment when the payer perform economic activities and when it is a legal person (art. 31 TRLIRNR). This is a liberatory retention, a relationship of tax substitution, and as article 36.3 LGT stands "the substitute may demand the taxpayer the amount of the tax paid".

In addition, when there is no obligation to withhold, Spain declares the payer of the income jointly and severally responsible of non resident income tax of IRNR as well as the depositaries or managers of assets that generate the income obtained by non-residents without permanent establishment (art. 8 TRLIRNR). Also in this case the final object of the tax is the income and article 41.6 of Spanish LGT recognizes the responsible the right of reimbursement against the principal debtor.

Therefore, based on the concept that we have accepted, there should not be obstacle for the correction by the State of residence of the double

¹⁴ FUSTER GÓMEZ, "La eliminación de la retención en origen o "withholding tax" practicada sobre los dividendos por parte del estado de la fuente de la renta: una visión diferente de la denominada "doble imposición jurídica internacional", in SIMON ACOSTA (Ed.), *Fiscalidad y globalización*, Aranzadi, Cizur Menor, 2012, pp. 743 and on.

international taxation suffered by the beneficiary due to the tax that Spain requires to a different person.

However, the MCOECD is not sufficiently clear in this respect. Art. 23 imposes an obligation to correct international double taxation when "a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention" It does not cover specifically the case of taxes demanded to substitutes or responsible, but it is a common opinion in the doctrine that those third persons are simple withholding agents or intermediaries in the collection of the tax levied to the beneficiary¹⁵. The jurisprudence of United States recognized it in the Crawford Music Corp case¹⁶.

Spanish domestic legislation allows to deduct the tax abroad "when among the income of the taxpayer there are income or capital gains obtained and taxed abroad" (art. 80 LIRPF and 31 LIS). There is no reference to the identity of persons, so there should be no obstacle to allow the tax credit of the tax paid by retainers or responsables in the source State.

2) Differences in qualification

Juridical double taxation may occur also when due to differences in qualification of the domestical legislation the same income (born of the same transaction) is fiscally attributed to different people in each State.

¹⁵ CALDERON CARRERO, "La doble imposición internacional y los métodos para su eliminación", in SERRANO ANTÓN (ed.), *Fiscalidad Internacional*, vol 1, Centro de Estudios Financieros, Madrid, 2015, pp.. 372 and on.

¹⁶ In *Crawford Music Corporation*, 40 B.T.A. 284 (1939) it was discussed the possibility of a tax credit of the British tax on copyrights of non residents in United Kingdom. The Court considered that the tax was levied on the beneficiary although it was paid by the payer, admitting the deduction. In *Biddle v. Commissioner*, 302 U.S. 573 (1938) the solution was just the opposite. In this case, British tax was levied on the profits and gains of a British company. The company paid a dividend to taxpayers in the United States and retained the portion of the tax which it had paid. American taxpayers sought to declare the gross return (dividend plus tax withheld) and apply a tax credit of the amount paid. The Administration understood that the British tax was levied on the company of the United Kingdom and not on the U.S. partners, which had to declare in the federal income tax the amount that they had actually received without deducting the withheld tax, ruling which was confirmed by the Supreme Court.

The comments to the MCOECD are specifically referred to partnerships, illustrating the possible juridical double taxation with the example of the sale of a stake in a permanent establishment. It is possible that both the State of residence of the seller and the one where the establishment is situated apply a levy on the capital gains because of the different qualification of the transaction. There will be juridical double taxation if the State of the permanent establishment considers that the entity does not have legal personality and that the partner has sold its share in the assets of the permanent establishment, being the transaction subject in its territory according to article 13.1 and 2 of the MCOECD referred to capital gains. On the contrary, the State of residence will tax the capital gains if the transaction is qualified as a purchase of shares that can only be taxed in the State of residence (art. 13.5 MCOECD).

If there is a DTC this problem must be solved with the interpretation of the comments to the MCOECD where it is said that the State of residence should be considered that the State of the permanent establishment has taxed the income in accordance with the provisions of the Convention and is forced to correct the international double taxation, well with the exemption method, well with a tax credit (par. 32.4).

In the absence of DTC, Spanish legislation does not apply the exemption method to the income doubly taxed due to discrepancies in qualification between source State and the residence one. The solution would be in the tax credit of the foreign tax, which could be deducted from Spanish tax if the other legal requirements are fulfilled. However, both art. 31 of the LIS and article 80 of the LIRPF admit the tax credit of foreign tax" when among the income of the taxpayer there are income or capital gains obtained and taxed abroad", and it is not set when the income is understood to have been obtained abroad. Regarding this issue the criteria established in the IRNR to determine what rents are understood to be obtained in Spain may be applied by analogy.

Neither European Union Law solves this issue because it understands that European Law does not provide rules for the distribution of tax power among States and does not oblige to correct the excess assessment due to

the concurrence of various income taxes or even above inheritance taxes as in the *Block* case (see note 2).

An interesting case of correction of double taxation under different qualifications of the income is the one of Brazilian "juros". Spanish Central Administrative Court (TEAC) considered them interest (denying the exemption) while the ruling of Spanish National High (AN) of 27 february 2014 (JT 2014\672) qualified them as dividends¹⁷.

3) Other similar cases

Juridical double taxation arises also in other cases when the source State assessment is falls on a person who is jointly taxed with others in the State of residence or vice versa. International double taxation also occurs in these cases and should be corrected. The specific regimes are:

1) family taxation joint (cited in par. 55 of the commentary to article 23 MCOECD).

¹⁷ Spanish National High (AN) of 27 february 2014 (JT 2014\672): (traducción propia)

"The approach of the parties on the subject of the present appeal is purely interpretative, are trying to determine the legal nature of the "juros sobre o capital propio (JSCP), for the purposes of its tax treatment in Spain, from the perspective of our internal system, taking into consideration the Brazilian regulation governing them. The rule governing them is the Ley Federal No. 9.249, of 26 December 1995. In its article 9, provides that: "for purposes of the determination of the real benefit, the legal person may deduct the interest paid or credited individually to the proprietor, partners or shareholders, as the remuneration of the capital, calculated upon the counts of equity, and limited to the variation pro time day (sic), of the long term interest rate:

(...)

From this rule, it can be said that the JSCP are called or identified as "interest", and that their distribution or payment requires the prior existence of an "income", being subjected to the " tax rate of income at the source". On the other hand, the source of these "interests" is the same as the one of "dividends", i.e., the existence of a "profit", because "the amount of interest paid" "can be attributed to the amount of dividends", in the manner provided in article 202, of Ley. 6.404 . Therefore, the JSCP have the same "leitmotif" that "dividends", i.e., the existence of profits and their distribution by agreement of the shareholders meeting, being able to understand that the JSCP fulfilled a purpose similar to the cast of "dividends", without equip them fiscally, given the limitation that the fiscal standard sets and call them as "interest".

Therefore, the JSCP have the same "leit motif" that "dividends", i.e., the existence of profits and their distribution according to an agreement of the shareholders meeting, being able to understand that the JSCP fulfilled a purpose similar to the distribution of "dividends", without putting them on a pair given the limitation that the Ley sets and call them as "interest".

2) Income allocation of entities without legal personality (partnerships). In these cases Spain taxes the participant, but there should be no impediment to the deduction of the taxes paid by the entity in the event that the source country consider the entity a taxable person.

3) Control Foreign Corporations regime. Spain allows the companies that are taxed according to the CFC regime to apply a tax credit of the withholding taxes in the source and the identical or analogous taxes to CIT effectively satisfied by the subsidiary or by their investees, in the part that corresponds to the positive income allocated in the tax base (art. 100 LIS). It also admits that Temporal Union Companies (UTE), which are taxed on a special regime of transparency, that operate abroad may apply the exemption of article 21 LIS or the tax credit for international double taxation of arts. 31 and 32 LIS.

(4) Groups of companies. A company of the Group perceives incomes abroad and it is subjected to taxation there, a duality of subjects appears as the taxable person at Spanish tax is the Group of companies, but these taxes can be credited (art. 71 LIS). That said, if a company resident in Spain is integrated in a foreign group, Spain would not permit the deduction of the tax paid abroad from the income obtained in Spain because the deduction is consent only "when income obtained and taxed abroad in integrated in the tax base of the taxpayer "(art. 31 LIS). The reverse case cannot happen because in Spain non-resident companies are not part of the group (art. 58 LIS).

3.3 Triple taxation or triangular taxation

The triple legal imposition may occur when there are two source States and the State of residence. This case happens if a permanent establishment perceives income from a different State than where it is located.

There is a certain international consensus that the State of the permanent establishment must correct the international double taxation caused by the source State, given that it taxes the permanent establishment on its worldwide income. This approach is implicit in article 24.3 of the MCOCDE: "The taxation on a permanent establishment which an Enterprise of a Contracting State has in the other Contracting State shall no be less

favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities".

Spanish law did not allow this tax credit in the past, but does it after the adoption of the LIRNR. Specifically, article 18 of the TRLIRNR states that "the tax base of the permanent establishment shall be determined in accordance with the provisions of the general Corporate Income Tax regime". This means that dividends and profit participation of non-resident entities will be exempt if the requirements of article 21 LIS are fulfilled as well as the benefits from other permanent establishments situated outside Spain (art. 22 LIS). At the same time, article 19 of the TRIRNR admit the application of credits and deductions included in articles 30 to 44 of the TRLIS, including the allocation of foreign tax regime.

4. Elimination of double taxation: the exemption method

The comments to the MCOECD include two principles or methods for eliminating double international taxation: the principle of exemption, involving the distribution of the taxable matter between two States, and the credit method where the tax is shared between both States¹⁸. The first can be an integral exemption, when the foreign income is not taken into account for the calculation of the national tax or exemption with progression, the most consistent method with the principle of economic capacity, progressivity and the personal nature of income taxation.

4.1 Exemption with progression

The exemption with progression is useful when the State of residence tax is progressive¹⁹.

¹⁸ Cfr. UCKMAR, ASOREY et al, *Manual de Derecho Tributario Internacional*, E. La Ley, Buenos Aires, 2011, p. 145.

¹⁹ "This is a method that is capturing a growing interest in States with an evolved tax system such as Switzerland, Belgium, France and Germany and is included among the measures to avoid double international taxation in article 23 A of the aforementioned OECD model conventions" – traducción propia del original. UCKMAR, ASOREY et al, *Manual de Derecho Tributario Internacional*, op. cit., p. 147).

In Spain, CIT is not a progressive tax in relation to the tax base so it is indifferent whether the exemption is integral or with progression.

Only PIT is progressive, and the exemption with progression will be applied to the income of foreign source that the DTC attributes exclusively to the source State. The exemption with progression is planned in the DA 20th of the LIRPF²⁰ (added by law 26/2014, 27-XI, to counter the RTEAC 8/6/2001 and 4/15/2003 SAN who denied the integration of the income in the tax base in the DTC that provided for the exemption with progression, for not being established in the domestic legislation).

With this regulation some of the problems detected by the Committee of Fiscal Affairs of the OECD and reflected in the comments to the MCOECD might be solved

- a) the use of the tax base of PIT as a reference for other purposes (e.g., scholarships).
- b) the fair implementation of the minimum exempt, meeting the demands of ECJ jurisprudence.
- c) the computation of foreign losses to avoid the violation of the principle of non-discrimination, as settled by the ECJ in its ruling *Hans-Jürgen*²¹. At this point Spanish regulation is not sufficiently clear, but the General Tax

²⁰ "Disposición Adicional vigésima. Rentas exentas con progresividad

Tienen la consideración de rentas exentas con progresividad aquellas rentas que, sin someterse a tributación, deben tenerse en cuenta a efectos de calcular el tipo de gravamen aplicable a las restantes rentas del período impositivo.

Las rentas exentas con progresividad se añadirán a la base liquidable general o del ahorro, según corresponda a la naturaleza de las rentas, al objeto de calcular el tipo medio de gravamen que corresponda para la determinación de la cuota íntegra estatal y autonómica.

El tipo medio de gravamen así calculado se aplicará sobre la base liquidable general o del ahorro, sin incluir las rentas exentas con progresividad."

²¹ Case C-152/03 *Hans-Jürgen Ritter-Coulais and Monique Ritter-Coulais v Finanzamt GERMERSHEIM*, judgment of 21.2.2006 (*Freedom of establishment – Tax legislation*). It is about a marriage of teachers resident in Germany seeking to allocate losses generated by their home located in France as if it were a home located in Germany. The Court held that a measure that discriminates against those who develop an economic activity in the territory of another Member State and, therefore, this marriage of German teachers who works in Germany and resides in France for strictly personal reasons is contrary to the Treaty, so they are entitled to compute such losses.

Direction (DGT) interpreted it correctly and allows the computation of losses when determining the tax rate²².

d) does not deprive the taxpayer that applies the exemption from the right to apply the personal and family deductions that personalise the tax. This is what emerges from the case *De Groot* (C-385/00) in a case in which Holland applied exemption with progression of foreign income integrating it in the tax base and crediting from the tax the result of applying the average tax rate to the foreign income reduced in the proportional part of the personal deductions²³.

²² DGT V2138/2008

“El Convenio Hispano-Alemania para evitar la doble imposición y prevenir la evasión fiscal en materia de impuestos sobre la Renta y sobre el Patrimonio de 5 de diciembre de 1966 (B.O.E. de 8 de abril de 1968), dispone en su artículo 13.1: «Las ganancias derivadas de la enajenación de bienes inmuebles, conforme se definen en el párrafo 2 de artículo 6, pueden someterse a imposición en el Estado contratante en el que están sitos».

En consecuencia, la ganancia procedente de la venta del inmueble sito en Alemania puede someterse a imposición en Alemania, pero deberá tenerse en cuenta que, de acuerdo con lo dispuesto en el artículo 23.2.a) para determinar el impuesto a pagar en España por un contribuyente residente en España, se trata de una renta exenta con progresividad.

(...)

En el Impuesto sobre la Renta de las Personas Físicas, la transmisión de la vivienda puede generar una ganancia o una pérdida patrimonial... El importe de esta ganancia o pérdida patrimonial se determinará por la diferencia entre los valores de transmisión y de adquisición, definidos en los artículos 35 y 36 de la citada Ley, y su integración, al derivar de una transmisión de un elemento patrimonial, se efectúa en la base imponible del ahorro, en la forma prevista en el artículo 49 de la Ley del Impuesto.

No obstante, de acuerdo con lo dispuesto en el artículo 23.2.a) del Convenio Hispano-Alemania anteriormente transcrito, la ganancia patrimonial derivada de esta transmisión estará exenta del impuesto español, pero esta renta se tendrá en cuenta para calcular el impuesto correspondiente a las restantes rentas a integrar, en este caso, en la base imponible del ahorro del consultante.”

²³ “Article 48 of the EC Treaty (now, after amendment, Article 39 EC) precludes rules such as those at issue in the main proceedings - irrespective of whether or not they are laid down in a convention for the avoidance of double taxation - whereby a taxpayer forfeits, in the calculation of the income tax payable by him in his State of residence, part of the tax-free amount of that income and of his personal tax advantages because, during the year in question, he also received income in another Member State which was taxed in that State without his personal and family circumstances being taken into account.

4.2 The requirement of being subject to tax at the source State

In order to apply the exemption it is required, as a general rule, that the income is effectively subject to a similar tax in the source State, which poses two major problems: 1) The determination of what tax in the source State is comparable to the one of the State of residence. 2) The determination of the minimum amount or intensity of taxation which is considered necessary, given that some countries that apply the foreign income exemption also apply certain restrictions that may deny the exemption if the foreign tax is not appropriate²⁴.

In Spain the regulation of this limit at CIT has always been very lax. Article 21 LIS simply requires that the foreign tax had intended the imposition of the income obtained by the investee entity, regardless of what constitutes the object of the tax (the income, the turnover or any other indicative element of that one). From a quantitative point of view, it is required that the income has been subject and not exempt to a foreign tax with a nominal rate of, at least, 10 per cent.

Anyway, the comparability has been considerably eased by the introduction, in law 62/2003, of a *iuris et de iure* presumption or legal fiction according to which the requirement "will be considered fulfilled" when the investee entity is resident in a country with whom Spain has signed a DTC that may apply and which contains an exchange of information clause (before it was just a *iuris tantum* presumption). This fiction only requires, in practice, that the Convention might be of application and that the tax is covered by the DTC, without need of an effective exchange of information.

Community law contains no specific requirement with regard to the way in which the State of residence must take into account the personal and family circumstances of a worker who, during a particular tax year, received income in that State and in another Member State, except that the conditions governing the way in which the State of residence takes those circumstances into account must not constitute discrimination, either direct or indirect, on grounds of nationality, or an obstacle to the exercise of a fundamental freedom guaranteed by the EC Treaty."

²⁴ UCKMAR, ASOREY et al, *Manual de Derecho Tributario Internacional*, op. cit., p.146.

This way of interpreting the subjection to a similar tax (including the legal fiction) has been extended by the Spanish jurisprudence to other precepts such as article 31 LIS and article 80 LIRPF.

4.3 The requirement that the income is from a foreign source

The enjoyment of the exemption usually requires that the perceived income is from a foreign source according to the domestic law of the State of residence. The problem is that domestic law does not state, as a general rule, what is meant to be foreign source income. This is the case of Spanish law, as the Non-resident Income Tax only defines the income that is considered to be obtained in Spain.

This is not problematic in PIT, where domestic legislation only incorporates the credit method. When the exemption is derived from a DTC, is the DTC the one that determines what income is from a foreign source. On the other hand, the exemption for a DTC with regard to natural persons only occurs in the case of income paid by public entities of the source State which have a clear origin.

In Spanish CIT rules the exemption of arts. 21 and 22, which should not raise interpretation problems since the first applies to dividends and participation in profits from an entity subject and not exempt in a foreign tax; and the second declares exempt the positive income obtained abroad through a permanent establishment situated outside Spanish territory (the concept of permanent establishment is defined in paragraph 3 of article 22)²⁵.

²⁵ "3. Se considerará que una entidad opera mediante un establecimiento permanente en el extranjero cuando, por cualquier título, disponga fuera del territorio español, de forma continuada o habitual, de instalaciones o lugares de trabajo en los que realice toda o parte de su actividad, o actúe en él por medio de un agente autorizado para contratar, en nombre y por cuenta del contribuyente, que ejerza con habitualidad dichos poderes. En particular, se entenderá que constituyen establecimiento permanente las sedes de dirección, las sucursales, las oficinas, las fábricas, los talleres, los almacenes, tiendas u otros establecimientos, las minas, los pozos de petróleo o de gas, las canteras, las explotaciones agrícolas, forestales o pecuarias o cualquier otro lugar de exploración o de extracción de recursos naturales, y las obras de construcción, instalación o montaje cuya duración exceda de 6 meses. Si el establecimiento permanente se encuentra situado en un país con el que España tenga suscrito un convenio para evitar la doble imposición internacional, que le sea de aplicación, se estará a lo que de él resulte."

5. Elimination of double taxation: tax credit method

This method does not prevent double taxation, but corrects its effects. It has two variants that are called "imputation or full credit" in the MCOECD "imputation or ordinary credit". In the ordinary, the tax deduction is limited, well applying the marginal rate of the State of residence (top slice method) or the average tax rate which preserves the progression effect of the tariff of the State of residence. This second limite is usually used.

The application of the method of credit method generally required double taxation to be effective.

Spanish legislation seems to demand it in article 80 LIRPF and article 31 LIS which refer to effective tax paid, but before 2014, Spanish Supreme Court (TS) had understood otherwise, as we will see later, admitting the tax sparing. Also, the cited article 31 LIS says: " Taxes not paid due to an exemption, bonus or any other tax benefit shall not be deducted" (traducción propia).

Spain does not provide for the possibility of a chargeable event in a later date in the source State so, in principle, the tax credit is not applied because there is no tax effectively satisfied. However our legal system admits the modification of the self tax assesment and the administrative assesment not yet verificated and not prescribed even when the modification is based on unexpectedly circumstances.

The rule of the effective subjection is not applied in DTC which include the tax sparing, more frequent when the State of residence wants to respect the investment incentives of a developing country. Nonetheless, comments to article 23.B of the MCOECD are not favorable to tax sparing because it may lead to abuse of taxpayers and may be counterproductive insofar as they encourage dividends and descapitalization of companies situated in the source State.

In a first stage, jurisprudence of Spanish Supreme Court (TS) just interpretate domestic legislation which, as we have said, speaks of "effective tax paid" in the sense of accepting tax sparing or deduction with exemption given that in the previous General Tax Law of 1963 (LGT) there was a rule that established, in general, the respect to exemptions in the

legislation of deductible taxes. It did not make sense that the internal standard for elimination of international double taxation (when there was no DTC) was applied according to the criterion established by the cited LGT and that when existing a DTC the exemption of the source State was offset because only the effective tax paid could be credited.

In this way, based on article 57 of the LGT from 1963 (exemption with progression) the ruling of Spanish Supreme Court from 27/1/1988 said:

"when a tax credit of other previous taxes may be applied, the credit shall be their full amount even if there had been exemptions or bonifications. Given that the precept refers to the profits that have already been taxed abroad, according to the principles and purpose of the law of avoiding double taxation, the tax credit must be applied well in the case of the tax effectively paid, well in the case of an exemption because if the tax not paid abroad is not credited the beneficial effect of the exemption for the taxpayer would be lost" (traducción propia).

However, we should recognize that the mentioned precept the LGT from was designed for the old tax where analytical taxes and personal income ones coexisted. In the latter, the analytical taxes were respecting the possible exemptions that Spanish legislator had established in them.

Today this doctrine has been overcome Spanish Supreme Court openly rejects tax sparing. The ruling of 21/1/2010 clearly expresses:

"The text applicable to the case mentions «the effective tax paid», and it does not leave any room for another interpretation than the one that arises from its literalism which, in addition, is adapted to the goal pursued. This is ratified, as said in the ruling under appeal, by article 29 LIS... which... clarifies this question establishing explicitly that taxes not paid due to an exemption, bonus or any other benefit shall not be fiscally deducted.

The text of the legislation applicable to this case is crystal clear, with no legal reasons for prevailing a finalist interpretation over the literal, when the legal text is clear and there is no doubt of its scope. But in addition, it should be noted that the finalist interpretation leads to the same result, far from the one alleged by the appellant; it is intended to avoid international double taxation in no case not allowing a deduction on income that has not

been taxed. Article 23 LGT, moreover, calls for a strict interpretation of rules that contain exemptions or other tax benefits. Accepting the thesis of the appellant will cause an outcome against that principle when it is clear that the legislator has not created this exemption. Foreign exemptions established by other States cannot be imposed, sometimes with the deceptive intent to attract foreign capital through unilateral tax benefits" (traducción propia).

As we have said before, current LIS has removed the uncertainty by establishing in article 31 that " taxes not paid due to an exemption, bonus or any other tax benefit shall not be deducted ".

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