Supreme Court Case on the Denial of Access to the Arbitration Convention

The author considers a landmark decision rendered by the United Sections of the Italian Supreme Court which grants a taxpayer access to domestic legal remedies where the taxpayer’s request for opening a mutual agreement procedure under the Arbitration Convention is denied by the competent tax authority.

1. Introduction

Although the Arbitration Convention has quite a long history, thus far its implementation by the Member States has followed a tortuous path, frequently suffering serious setbacks and false starts. However, in recent years the number of cases initiated under the Arbitration Convention has appreciably increased. Statistics show that in the last few years, multinational enterprises do extensively rely on the Arbitration Convention with a view to eliminating double taxation following uncorrelated upward transfer pricing adjustments in two or more Member States. This favourable international trend leads to an augmented need to coordinate the mutual agreement procedure enshrined under the Arbitration Convention (Arbitration Convention MAP) with other domestic procedures, especially with regard to domestic settlement (both administrative and judicial) as well as litigation proceedings.

This issue does not come completely unexpectedly. Indeed, the absence of coordination between the provisions enshrined in the Arbitration Convention and domestic procedures is a well-known Achilles’ heel of the Convention, which can be directly traced back to the legal instrument originally chosen by the European Member States, i.e. an international multilateral convention in lieu of a directive. Needless to say, whilst a directive is directly binding for all EU Member States, a convention, as an ordinary international treaty, does not per se prevail over domestic legislation. Therefore, the legal force of the Convention is significantly different in each contracting State. Furthermore, the Convention faces another serious drawback, as the Court of Justice of the European Union (ECJ) does not have jurisdiction to interpret the provisions contained therein. Consequently, different interpretations, as well as inconsistent applications of the wording of the Arbitration Convention, are common among the domestic practices of the contracting States. Neither of these inefficiencies has been completely addressed by the adoption of the Code of Conduct in the version revised in 2009, despite its aim to respond to the need of both Member States and taxpayers to have more detailed rules to efficiently implement the Convention.

Given this, the Italian Supreme Court decision that is the subject of this article is notable insofar as the judges have removed a specific hurdle in the functioning of the Arbitration Convention MAP, by ensuring the availability of legal remedies for taxpayers where a denial of access to the MAP is asserted by the competent tax authority. In this regard, neither the Arbitration Convention nor the Code of Conduct provide any remedy or – at least – guidance for determining whether such a denial is justified.

The significance of this decision is further increased by the circumstance that a recommendation on this specific subject was recently released by the European Joint Transfer Pricing Forum (EU JTPF) in its work for the revision of the 2009 Code of Conduct.

Reference:
3. From an Italian perspective, recourse to the Arbitration Convention as a consequence of transfer pricing adjustments made by the Italian tax authorities has notably increased in the last five years. According to the more recently available statistics, in 2013 Italy had 173 pending cases, 62 of which were initiated in that year, while only 5 were concluded in the same span of time. See EU JTPF, Statistics on Pending Mutual Agreement Procedures (MAPs) under the Arbitration Convention at the end of 2013 (Brussels 24 Oct. 2014).
5. In 2001, the Commission proposed to submit the provisions of the Arbitration Convention to interpretation by the ECJ, preferably by turning the Directive into an instrument of European law. See European Commission, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Towards an Internal Market without Corporate Tax Obstacles, COM(2001) 582 of 23 Oct. 2011, point 4. However, no proposal of a new directive or protocol extending the ECJ’s jurisdiction to the Arbitration Convention has been undertaken since then.
6. See Hinnekens, supra n. 2, at 83-84; P. Adonnino, Some Thoughts on the EC Arbitration Convention, 43 Eur. Taxn. 11 (2003), at 403-404, Journals IBFD.
8. See, in this regard, X. van Vlem, B. Markey, A. Leclercq & I. Verlinden, The EU Arbitration Convention: Reinforcing the Procedure To Cope with an Expected Flood of Double Taxation Disputes, 21 Intl. Transfer Pricing J 1 (2014), at 233, Journals IBFD (noting that “although only a limited number of cases have been denied access to the Arbitration Convention (90/436/EEC) procedure thus far according to the statistics, it is expected that denied access under the Arbitration Convention (90/436/EEC) may become a bigger issue as the number of disputes increases”).
2. Relevant Legislative and Administrative Background

2.1. Article 6 of the Arbitration Convention

The Arbitration Convention provides very few meaningful definitions of the expressions contained therein. Thus, many terms that are keystones in determining the Convention’s scope of application, principles and procedures, remain undefined. Specifically, as regards the subject matter of the Supreme Court’s decision, article 6(1) of the Arbitration Convention states that, in case of double taxation arising from uncoordinated tax assessment, an enterprise may present a complaint to the competent authority of the contracting State of which it is resident or in which it has a permanent establishment to resolve the case by mutual agreement procedure. However, article 6(2) points out that the competent authority is obliged to initiate the MAP only “if the complaint appears to it to be well-founded”. Despite the lack of clarity surrounding the expression “well-founded”, no further explanation is included in the text of the Arbitration Convention in this regard.

2.2. The Code of Conduct

The Arbitration Convention merely lays down a procedural framework. Consequently, it is the task of Member States to determine substantive rules to safeguard the effective implementation of the provisions included therein. An important step forward in that direction was taken by the Commission in October 2002 when it set up the European Joint Transfer Pricing Forum (EU JTPF), an expert group with a mandate to sketch out pragmatic solutions to issues arising from the application of the Convention. To this end, on 28 July 2006 the European Council decided to formally adopt a Code of Conduct developed by the EU JTPF. On 22 December 2009, a revised version of the Code was subsequently adopted by the European Council.

The Code of Conduct provides many clarifications and definitions, most notably related to issues such as the admissibility of a case and the interpretation of the two-year/three-year periods under the Arbitration Convention, the notion of serious penalties, as well as the members’ selection and the procedural functioning of the advisory commission. However, no specific guidance is set forth in the Code as regards the refusal by the competent authority to set in motion the Arbitration Convention MAP nor is the problem of legal remedies available to taxpayers in case of a denial, tackled.

2.3. The Italian Circular Letter

On 5 June 2012, the Italian Tax Agency published Circular Letter 21/E (the Circular), which contains extensive guidance on the functioning of a MAP under tax treaties concluded by Italy, as well as on the procedures set forth by the Arbitration Convention. As regards the latter, the Circular emphasizes the intent of the tax authorities to comply with the provisions contained in the Code of Conduct, as revised in 2009, although, in principle, the Code constitutes only a political commitment for the contracting States – therefore not affecting the rights and obligations of the Member States or the respective spheres of competence between the Member States and the European Union as settled in the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU). Despite including some provisions on various aspects of the functioning of the Arbitration Convention MAP (such as links with domestic law and, more specifically, with the so-called ‘deflationary instruments of litigation’, which are considered an alternative to the procedures set forth by the Convention), the Circular fails to establish any legal remedy for taxpayers if their requests for opening an Arbitration Convention MAP are rejected or revoked by the competent authority.

2.4. Proposal by the EU Joint Transfer Pricing Forum to improve the MAP under the Arbitration Convention

The specific question related to the legal remedies offered by each Member State in case of a denial of access to the Arbitration Convention MAP was recently addressed in the works of the EU JTPF. Particularly, in the recommendations delivered on the occasion of the revision of the existing Code of Conduct in March 2015, the Forum emphasized the necessity to ensure effective legal remedies in the case of a refusal of access to the Arbitration Convention, as had already been realized by some Member States in their own domestic legislation. In brief, this recommendation, which would constitute point 5 of the new revised Code of Conduct, suggests that all contracting States should ensure that appropriate legal remedies are available for taxpayers at the domestic level.

Against that recommendation, the Italian administrative authorities advanced a reservation, stating that “Italy expresses its disagreement with this recommendation, given that this possibility of challenging the position of the Competent Authority is not provided for in the Italian

10. For instance, notions such as ‘enterprise’ and ‘permanent establishment’ are not defined in the text of the Arbitration Convention.
14. See EU JTPF, supra n. 9, at 5 (“Member States should consider providing domestic legal remedies for determining whether the denial of access to the Arbitration Convention by their administrative bodies is justified”).
2.5. The current proposal to improve the MAP under the OECD Model Tax Convention

Similar issues equally affect the implementation of the MAP set in accordance with the OECD Model Tax Convention (OECD Model). In fact, article 25(2) of the OECD Model apparently accords a discretionary power to the competent authorities of the contracting states in evaluating whether the complaint submitted by the taxpayer is justified, thus leaving the taxpayer without any legal remedy in case of a refusal by the competent authority to activate the MAP. In this regard, the Commentary on the OECD Model laments the lack of clarity resulting from the discretion enjoyed by tax authorities, highlighting that "the circumstances in which a State would deny access to the mutual agreement procedure should be made clear in the Convention." This specific point was recently addressed in a Discussion Draft released under the framework of Action 14 of the BEPS project. Specifically, this Discussion Draft points out that:

[a]s interpretations of treaty provisions may vary between treaty partners, circumstances may arise in which one competent authority does not find the objection presented by the taxpayer under paragraph 1 of Article 25 to be justified, whilst the other competent authority would find the objection to be justified. [...] Given this dynamic, a process in which a competent authority can unilaterally determine, under paragraph 2 of article 25, that the taxpayer’s objection is not justified — and thereby prevent the case from being addressed bilaterally through the second stage of the MAP — raises legitimate issues as to the bilateral nature of treaty application and implementation.

Therefore, also with regard to the MAP included under article 25 of the OECD Model, the precise terms under which the competent authority might deny access to the MAP procedure are relatively vague and unsettled.

3. The Italian Case

3.1. Facts of the case

In November 2009, the tax office (Direzione Regionale del Piemonte dell'Agenzia delle Entrate) re-assessed an Italian tax resident company for transfer pricing on intercompany transactions with an associated enterprise based in Germany. In January 2010, the Italian company initiated a settlement procedure with the Italian tax authority. Although the parties reached an agreement on that issue, the amicable proceeding failed to come to a positive conclusion, as the payment associated with the settlement was not executed.

Meanwhile, the Italian company filed a request to the International Relations Directorate of the Finance Department of the Italian Ministry of Economy and Finance to open a MAP under article 6 of the Arbitration Convention. Although the successful beginning of the MAP was initially notified to the taxpayer by the Ministry of Economy and Finance, the procedure was nevertheless subsequently struck down by the Ministry itself on the grounds that domestic settlements (both administrative and judicial) are incompatible with the procedures set forth in the Arbitration Convention. In this regard, the Ministry concluded that the settlement promoted by the company was positively concluded even if, as stated, no payment was effectively made.

Against that refusal, the Italian company brought an action before the Tax Court of First Instance of Rome, this being the main seat of the Ministry of Economy and Finance. In the legal proceedings before the Tax Court, the Ministry argued that the denial of access to the MAP pertains to a subject matter that could not be brought before a court, as it would involve only public interests of Member States and, thus, the principle of immunity granted to public authorities would prevent any court from rendering a ruling on that. Considering that question unsettled and controversial, the case was therefore remitted by the Tax Court of First Instance to the Supreme Court for its decision on the issue. Against that refusal, the Italian company brought an action before the Tax Court of First Instance of Rome, this being the main seat of the Ministry of Economy and Finance. In the legal proceedings before the Tax Court, the Ministry argued that the denial of access to the MAP pertains to a subject matter that could not be brought before a court, as it would involve only public interests of Member States and, thus, the principle of immunity granted to public authorities would prevent any court from rendering a ruling on that. Considering that question unsettled and controversial, the case was therefore remitted by the Tax Court of First Instance to the Supreme Court for its decision on the issue.

3.2. Decision of the Supreme Court

In its ruling, the Supreme Court considered the allegations of the Ministry of Economy and Finance to be ill-founded. Particularly, the Supreme Court judges strove to draw a line between the first part of the MAP – concerning the filing of the request before the competent authority, which represents a purely internal procedure – and the second part in which, instead, only the competent authorities of the contracting States are involved. Making that distinction clear, the judges held that the principle of immunity could be invoked only in relation to the latter phase of the procedure and, thus, no legal remedy may be denied to taxpayers where access to the Arbitration Convention MAP is impeded by the competent authorities, as otherwise the functioning of the Convention would be undermined.

15. See EU JTPF, supra n. 9, at 5 note 5. For a comment on the issue about the denial of access to the Arbitration Convention, see I. Verlinden & M. Haupt, The EU JTPF Shifts Gears on Dispute Resolution, 22 Intl. Transfer Pricing 3 (2015), Journals IBFD. For a general discussion of the proposals to improve the Arbitration Convention, see H.M. Pit, Improving the Arbitration Procedure under the EU Arbitration Convention (1), 24 EC Tax Rev. 1 (2015), at 15; H.M. Pit, Improving the Arbitration Procedure under the EU Arbitration Convention (2), 24 EC Tax Rev. 2 (2015), at 78.

16. According to article 25(2) of the OECD Model, ‘the competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.’

17. OECD Model Tax Convention on Income and on Capital: Commentary on Article 25 (22 July 2010), at point 26. Models IBFD.


19. Art. 7(3) Arbitration Convention.
4. Analysis of the Case

The present case opportunely sheds light on an unclear point that hampers the effective implementation of the Arbitration Convention MAP in domestic laws and administrative practices of the Member States. In its ruling, the Supreme Court held that the defect of coordination between the procedure included in the Arbitration Convention and the internal administrative settlement proceedings cannot be a valid justification for failing to provide legal remedies to a taxpayer in the case of a refusal by the competent tax authority in response to the request of that taxpayer to accede to the Arbitration Convention MAP. As stated, the lack of any legal remedy might really undermine the effectiveness of the Convention in avoiding double taxation as taxpayers could be induced to prefer a domestic administrative settlement to filing a request under article 6 of the Arbitration Convention.

The decision in this case is also noteworthy to the extent that it adheres to the opinion that has already been articulated by the majority of scholars and practitioners in this regard. For instance, Terra and Wattel notably highlight that although “article 6(2) would seem to confer a discretionary power on the competent authority”, this provision “may be used only to dismiss manifestly ill-founded applications.”20 In the same vein, Hinnekens significantly adds that “the effectiveness of the Convention as a whole, the performance in good faith of the arbitration clause, and in particular of the guarantee which it contains, would be frustrated” if the term “well-founded” were intended as a conditio potestativa in the hands of the authority concerned.21

The literature appears to have extensively warned against granting too much leeway to the competent authorities in evaluating whether a complaint is “well-founded”, as this could easily become an escape hatch for refusing to resolve a dispute by international settlement under the Arbitration Convention MAP.22 Obviously, this event is highly undesirable, as it defeats the ultimate purpose of the Convention to avoid the double taxation resulting from uncoordinated transfer pricing assessments.

Furthermore, it has already been noted that the decision of the Supreme Court is also consistent with the recommendations for the new Code of Conduct issued by the EU JTPF in March 2015, which aim at improving the transposition of the norms enshrined in the Arbitration Convention by the Member States into their domestic laws. This aspect is crucial because, as seen, no harmonization in the interpretation of the Convention can be ensured by the ECJ. Therefore, an application consistent with the aim to eliminate double taxation becomes particularly desirable in the areas in which the Convention lacks unanimous meaning, which is where practices of the contracting States might differ significantly.

The lack of detailed rules on the implementation of the Convention is reflected also in article 6 of the Arbitration Convention, which fails to provide information regarding the grounds on which a refusal may be legitimately made by the competent tax authority in response to a taxpayer’s request to access the MAP. Even the Code of Conduct is silent on this specific aspect. The intervention of the Supreme Court opportunely fills this gap, reducing the risk of possible steps by Member States to circumvent the application of the Convention.

The principle crystallized in the decision of the Supreme Court might be extended to analogous issues arising with regard to the MAP enshrined in the OECD Model. As seen also in the event of an objection proposed under article 25(2) of the OECD Model, the competent authorities of the contracting states might dismiss the complaint if it does not appear justified. In that case, the taxpayer is manifestly left short of any legal remedy. In such case, serious concerns might arise, given that the denial asserted by the competent authorities could prevent the matter from even reaching the stage where it is considered by both States, thus leaving the double taxation issue unresolved. To prevent this from happening, it would be desirable to extend the principles found with regard to the Arbitration Convention MAP also to the MAP under article 25 of the OECD Model.

5. Conclusion

The Supreme Court decision represents a milestone in the long path towards the effective implementation of the Arbitration Convention by allowing taxpayers to file a complaint before a domestic court in the case of a refusal by the competent tax authority in order to set in motion an Arbitration Convention MAP.

Indeed, this continues to constitute a practical area of concern in which the surrounding uncertainty hinders the efficient application of the Arbitration Convention. To remove this unfortunate result, the EU JTPF delivered a specific recommendation in its meeting of March 2015, urging Member States to provide domestic legal remedies for determining whether the denial of access to the Arbitration Convention as determined by their administrative bodies is justified. In this regard, it is likely that a new provision on that issue will be included in the expected update of the Revised Code of Conduct.

From an Italian perspective, the Supreme Court decision is even more welcomed insofar as it directly contradicts the reservation made to the cited JTPF recommendation by the Italian authorities excluding any legal remedy for taxpayers in the case of a refusal to open an Arbitration Convention MAP. In light of these last findings, it would be convenient if Italy were to lift its reservation, as a step in that direction may contribute to reinforce the effectiveness of the Arbitration Convention.