New Guidelines from Tax Authorities on Management of Tax Disputes under Mutual Agreement Procedures

The Italian tax authorities issued guidance in June 2012 on the management of tax disputes under mutual agreement procedures. The authors consider this guidance along with its interaction with the EU Arbitration Convention and the OECD Model Convention.

1. Introduction

According to data collected by the OECD in collaboration with member and non-member countries, in the five-year period from 2006 through 2010 the number of mutual agreement procedures (MAPs) opened to settle international disputes on the subject of double taxation increased by more than 40%. This international trend is also reflected in statistics published in Italy: in the two-year period from 2009 through 2010, there were 53 procedures initiated involving the Italian tax authorities (31 in 2009 and 22 in 2010), with an increase of over 50% compared to such procedures initiated during the previous two-year period, 2007-2008 (totalling 24).

As a result of the proliferation of international disputes to resolve cases of double taxation, as well as recent developments in legislation and interpretation concerning this subject the need has emerged for the Italian tax authorities to issue some guidance on the management of tax disputes under MAPs, for taxpayers to use, as well as by the peripheral offices (regional and provincial) of the same tax authorities which are required to support the Department of Finance (Ministry of Economy and Finance) from preliminary preparatory activities to the conducting of the procedure and right up until the final decision stage. These guidelines have been collected in Circular 21/E of 5 June 2012 (Circular 21), which deals, in particular, with the resolution of disputes in the more general scope of bilateral income tax treaties, the Arbitration Convention (90/436) refers only to cases of double taxation of profits in transactions between associated enterprises resident in the European Union.

Circular 21 clarifies that the situations subject to the Arbitration Convention (90/436) include only those adjustments made in application of article 110, paragraph 7 of Presidential Decree 917 of 22 December 1986 and not those increases based on the absence of relevance of double taxation in cross-border transactions between enterprises belonging to the same group. These increases were also dealt with in Chapter IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (2010) (OECD Guidelines), International Organizations’ Documentation (IBFD) which mentions, among the recommended paths for non-adversarial settlement, the MAP referred to in article 25 of the OECD Model (2010). Circular 21, however, makes no reference to the further bilateral process codified in article 9(2) of the OECD Model (2010), namely the corresponding adjustment under which, with regard to transfer pricing, a contracting state may grant a downward adjustment of the taxable income of an associated enterprise in order to balance, at the group level, the effect generated by a corresponding increase implemented in another state.

3. The Italian tax authorities note that practices for the avoidance or removal of double taxation in cross-border transactions between enterprises must comply with international best practices, namely, the model referred to in article 25 of the Arbitration Convention (90/436) of 23 July 1990, agreed between the EU Member States with the purpose of ami-

cably settling disputes on transfer pricing between associated enterprises.

In addition to a broad overview of the subjective and objective requirements for a taxable person resident in Italy to access procedures, as well as the procedural steps related to the two different procedures in order to outline which ones comply with international best practices, the tax authorities have focused on some important aspects which previously had not been clarified, concerning the links with domestic law, and, more specifically, with domestic disputes, collection of any additional taxes or sanctions, and with the so-called “deflationary instruments of litigation”.

These latter aspects will be dealt with in this article, bearing in mind that while the MAP provided for under article 25 of the OECD Model (2010) may cover all cases generating legal and economic double taxation in contrast with bilateral income tax treaties, the Arbitration Convention (90/436) refers only to cases of double taxation of profits in transactions between associated enterprises resident in the European Union.
costs incurred between the enterprises of the same group (article 109, paragraph 5 of Presidential Decree 917 of 22 December 1986).\footnote{Under article 109, paragraph 5, 'costs and other negative elements other than interest payable, [...] are deductible if and to the extent that they refer to assets or property from which derive revenue or other income that would form income or would not as they are excluded'.}

\section{Relationship with Domestic Disputes and Identification of “Serious Penalties” under the EU Arbitration Convention}

In Circular 21, the tax authorities examine the relationship between domestic judicial proceedings and the amicable settlement between states separately for each of the two procedures, due to their differing natures. They take into account, however, a commonly applied principle under which it is understood that, whatever the outcome of a MAP, where domestic judicial proceedings have run their course, the Italian tax authorities may not object to, derogate from or act in a manner contrary to the decision of the judicial body.

\subsection{Bilateral income tax treaties: article 25 of the OECD Model}

Paragraph 1 of article 25 of the OECD Model provides that any taxpayer that believes that double taxation has or may occur contrary to the provisions of the treaty, may request the activation of a MAP to remedy this situation, regardless of the procedures prescribed by the national legislation of the contracting states. Until 2008, a taxpayer that requested the activation of a MAP had to rely on the goodwill and diligence of the competent authorities to reach a satisfactory result, as there was no obligation for the tax authorities of the two contracting states to produce a result that would effectively remedy the situation.

With the insertion of the new paragraph 5 in article 25 in July 2008, the possibility opened for a taxpayer to request, in cases where the competent authorities of the states involved in a MAP do not reach an agreement within two years, that the matter be resolved through recourse to independent arbitration.

The introduction of paragraph 5, according to the Commentary on Article 25 of the OECD Model,\footnote{The meaning of ‘deflationary instruments’ is here ‘administrative instruments aimed for the limiting or lowering of penalties’.} has the primary purpose of increasing the actual success of the resolution of disputes with a MAP (with paragraph 5 representing the final stage) through independent decisions that are binding on the contracting states. However, its application and effectiveness depend on the compatibility of arbitration with the domestic rules of each state and on the binding nature of an arbitration decision. For this reason, each state may decide to introduce in its bilateral income tax treaties paragraph 5 in its standard treaty formulation or to include paragraph 5 but limiting its application to certain specific cases.

No recently concluded (after July 2008) Italian bilateral income tax treaty contains or has been modified to contain an arbitration clause in accordance with paragraph 5, as the Italian tax authorities note in Circular 21. Only some Italian treaties, referred to in the Circular, including that with the United States, provide for the possibility, under particular conditions, of submitting a case for binding arbitration with the consent of both contracting states and the taxpayer concerned. Therefore, in all other cases of bilateral income tax treaties that do not include an arbitration clause, a taxpayer resident in Italy which complains of double taxation and which has carried out a MAP to no avail in accordance with paragraph 1 of article 25, is currently unable to resort to arbitration.

In this context, where (1) the activation of the MAP does not interrupt the time period specified under domestic law to access national courts or ‘deflationary instruments’\footnote{agreement procedures provided for under bilateral income tax treaties.’} in the event of objections from the tax authorities and (2) above all, the use of a MAP, save for a few exceptions, does not guarantee that a result will be reached and does not bind the national authorities to observe the decisions of independent arbitration, if in Italy notices have already been served or measures have been taken that cause an increased tax liability for the taxpayer, to start, alongside the MAP, a domestic proceeding too is a particularly appropriate, although unnecessary action (Circular 21, paragraph 4.2.5). It is appropriate (or, more correctly, necessary) to refer the matter to the national court because, where an increased tax liability is determined and such determination becomes definitive owing to the expiration of the statute of limitations for filing an appeal with the tax court and no decision has been agreed by the competent authorities as a result of the MAP, the taxpayer would have no other forum to argue the case and would remain affected by the double taxation.

The concurrence of domestic judicial proceedings with a MAP may lead to the following consequences, depending on whether the agreement between the contracting states, if reached, occurs before or after the judge’s decision:

- in the former case, the execution of the MAP will take place following the waiver of the domestic action by the taxpayer; or
- in the latter case, should the mutually agreed solution be in conflict with the judgement, the Italian tax authorities may not lawfully adopt any agreement concluded with the other contracting state in favour of the taxpayer as part of a MAP. In this situation, the removal of the double taxation may take place only if the foreign tax authorities so desire.

It remains possible for a taxpayer to request that the tax court suspend any decision pending the conduct of the MAP in order to know the outcome before the conclusion of the proceedings.

Similarly, a taxpayer may resort to ordinary domestic procedures to obtain, either administratively or judicially, the
benefit of the suspension of collection of the additional taxes and the related penalties temporarily imposed.

2.2. EU Arbitration Convention

2.2.1. Generally

The scenario is different when a case of double taxation can be remedied by resorting to the Arbitration Convention (90/436). In these cases, the states involved are required to reach an agreement by means of a MAP, or, should the MAP be ineffective, by resorting to arbitration (article 7, paragraph 1). A taxpayer, therefore, having activated the MAP in accordance with the Arbitration Convention (90/436), has the assurance that the tax authorities of the states involved, either independently or with the help of an ad hoc commission, will seek a joint solution.

However, the choice of the path of international dispute resolution for an Italian taxpaying enterprise is limited by the principle mentioned above, whereby an arbitration decision may not in any case derogate from a judgment issued by a domestic court. For Italy, paragraph 3 of article 7 of the OECD Model is applicable, which provides that:

where the domestic law of a Contracting State does not permit the competent authorities of that State to derogate from the decisions of their judicial bodies, paragraph 1 shall not apply unless the associated enterprise of that State has allowed the time provided for appeal to expire, or has withdrawn any such appeal before a decision has been delivered.

The resident taxpaying enterprise generally may both activate the treaty-based MAP and rely on the national tax court. However, in the case where no amicable solution is found, recourse to the arbitration commission is precluded if the same enterprise does not waive its right to appeal against the Italian tax authorities before the tax court.

In any case, the Arbitration Convention-based path may no longer be taken when the national tax court has delivered its first judgment.

If, once a national proceeding has been initiated, a decision has been given by the court, and if no elimination of double taxation has resulted therefrom, the court’s decision will remain in place until the foreign competent authority remedies it by adapting its work to comply with the decision of the Italian court.

With regard to the collection of additional taxes and related sanctions assessed on a provisional basis, pending an arbitration proceeding, the domestic law ratifying the Arbitration Convention (90/436) contains a special provision that states that the Italian tax authorities may order the suspension in accordance with the purpose of the arbitration in process. Circular 21 naturally specifies that the specific remedy referred to in the ratifying law may be activated only if the taxpayer has already waived its right to domestic litigation, as an alternative to the request for suspension provided by the tax process.

2.2.2. Serious penalties

A further limitation on accessing EU conciliation procedures is contained in the Arbitration Convention (90/436), which provides that a MAP (article 6) or arbitration procedure (article 7) may be suspended when the enterprise concerned must pay “serious penalties” in accordance with a concurrent judicial procedure or domestic administrative procedure. With regard to the identification of serious penalties, accepting suggestions in this regard that have emerged from the Joint Transfer Pricing Forum, as well as integrating the Code of Conduct for the application of the Arbitration Convention (90/436), the EU Council of Ministers has stated: “Member States are recommended to clarify or revise their unilateral declarations in the Annex to the Arbitration Convention (90/436) in order to better reflect that a serious penalty should only be applied in exceptional cases like fraud.”

Italy had already expressed its position, which complies with the following recommendation, in the Italian enactment of the Arbitration Convention (90/436), stating: “The term ‘serious penalties’ means penalties laid down for illicit acts, within the meaning of the domestic law, constituting a tax offence.”

Circular 21 aims to clarify and limit the cases of tax offenses that may constitute an obstacle for the continuation of a MAP or arbitration. Italy has chosen to limit the field of relief referred to in article 8 of the Arbitration Convention (90/436) to tax offenses of a criminal nature, without extending it to the field of administrative penalties.

Cases involving the following crimes are precluded from seeking relief under the Arbitration Convention (90/436):

– a fraudulent tax return deriving from the use of invoices or other documents relating to non-existent transactions (article 2 of Legislative Decree 74 of 10 March 2000); and

– a fraudulent tax return deriving from the use of other means (article 3 of Legislative Decree 74 of 10 March 2000).

The tax authorities emphasize that in the case of such offenses, the breach is not generated by a problem in the evaluation of the transactions between associated enterprises under the principle of the free market, but rather originates from actions or false or forged documents in order to conceal material facts that actually or otherwise occurred. In other words, the criminal offense is pre-existing and prevalent with regard to any defect of evaluation of transfer prices within the group.

The case of criminal risk connected with the offense of lodging an untrue tax return is different (article 4 of Legislative Decree 74 of 10 March 2000). Under this provision, a violation involving the lodging of an untrue tax


11. Arbitration Convention (90/436) – Unilateral Declaration on Article 7 – Italy – “The term ‘serious penalties’ means penalties laid down for illicit acts, within the meaning of the domestic law, constituting a tax offence.”
return, which is a considerable violation for criminal purposes, occurs if the increases in declared income discovered by the tax authorities exceed the value limits provided under this provision. However, the criminal characterization may no longer be applied if the taxpayer’s conduct indicates no deliberate intent to defraud the tax authorities. Therefore, a variation (increase) in the taxable amount deriving from the revision of the method of evaluating transfer prices between associate enterprises may occur, which would entail, given the amount, the offense of lodging an untrue tax return. Circular 21 clarifies, however, that such violation would be punishable under criminal law and consequently would result in the suspension of a MAP or arbitration only if, during the process of evaluating the transfer prices, the taxpayer is found to have been deliberately evasive.

3. Relationship with “Deflationary Instruments of Litigation”

The Italian legal system provides certain legal processes – so-called “deflationary instruments of litigation” (settlement of tax assessment, tax mediation and settlement in court) – which the taxpayer and the tax authorities may (or should) use to attempt to reach an out-of-court resolution to a dispute arising from a proposed increase to tax liability, prior to the involvement of a judicial authority or pending the tax proceeding. At the national level, if a dispute is resolved through the application of one of these legal processes, the defining decision is binding on both of the subjects involved (the taxpayer and the tax authorities) and, except in specific cases, may not be revised. If, however, a resolution is not agreed under one of these legal processes, there would continue to be a possibility of referring the case to the tax court (or such a possibility would arise).

3.1. Bilateral income tax treaties: article 25 of the OECD Model

With regard to the activation of a MAP pursuant to article 25(1) of the OECD Model, the access to a deflationary legal process and the resulting resolution by means of an agreement between the taxpayer and the tax authorities, renders any resolution regarding the same case agreed between the tax authorities of the two states involved ineffective. In other words, should the tax authorities and the taxpayer reach an agreement with regard to the case of alleged double taxation, this understanding may not be modified and is consolidated while the MAP is still in progress and independently of the result of the MAP. This is also the case if the domestic agreement reached under a deflationary process does not have the effect of eliminating the original double taxation entirely; in which case the only possible remedy is the substantially unilateral discretion of the foreign authorities to conform their position in order to eliminate the double taxation.

3.2. EU Arbitration Convention

Albeit for different reasons arising from the substantially different nature of the two procedures, both the principle of unmodifiability of agreements reached under the deflationary acts of defining the domestic dispute and the effects of such agreements on the result of the non-adversarial procedure governed by article 25 of the OECD Model are, according to the opinion expressed by Circular 21, equally valid with respect to the procedure for resolving disputes as provided under the Arbitration Convention (90/436).

The use of a deflationary process is an explicit expression of the desire to define the relationship between taxpayers and the tax authorities without resorting to national or international (EU) litigation. Therefore, an agreement reached at the conclusion of the deflationary process precludes any effect of an intervening arbitration decision in application of the Arbitration Convention (90/436).

If the double taxation has not been fully removed by means of the deflationary process, in this case too it remains possible to achieve the elimination of the double taxation through the unilateral intervention of the foreign tax authority during a MAP.