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Decision of the Supreme Court of Cassation n. 21047/2023, published on 18/07/2023

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Laws and treaty relevant in this case:

IRAP – Tax on Productive Activities [Legislative Decree No. 446 of 15 December 1997]

Italy-France Double Taxation Convention [ratified by Italian Law No. 20 of 7 January 1992]

Summary

Tax treaties take precedence over domestic rules, which must comply with the constraints imposed by international obligations.

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This case concerns a credit for income taxes paid abroad.
According to the judgment of the Supreme Court in the present case, the credit can be deducted from both the Corporate Income Tax (IRES) and the Regional Tax on Productive Activities (IRAP):
"if, these taxes are explicitly mentioned by the tax treaty".

This means, in summary, that, in the light of their special nature, double taxation treaties have the value of a primary source and, more importantly, take precedence over domestic rules.
Domestic rules **must** respect the international obligations, as laid down in tax treaties.

This judgment is based on a newly formulated principle by the Court that a foreign tax has also to be credited against the local income tax, if required by the treaty.
This principle is not explicitly included in the Italian income tax law.

In order to better understand the case, given the vast international audience in this room, income tax is levied from individuals and companies: individual income tax and corporate income tax.
On top of the corporate income tax, a regional surcharge is levied on the production and distribution activities of companies: the *Imposta Regionale sulle Attività Produttive*.
In everyday terms known by the acronym: IRAP.

The standard rate of the IRAP is 3.9%, but each of the 20 regions in Italy can choose to slightly increase this rate up to one percent.
The tax is determined by the factors: capital and labor.

Article 12, paragraph 1, of the IRAP provides that Italian companies that are also active in other countries may reduce the taxable amount with the production and distribution activities carried out abroad.
In other words, the value of the net production and distribution activities carried out outside Italy is exempted.

The IRAP was introduced in 1997 and replaced – with some modifications - the local income tax: in everyday terms known by the acronym ILOR.

Therefore, the tax treaties concluded by Italy since 1997 refer in article 2(3), dealing with the taxes covered, to IRAP while the treaties concluded before 1997 refer to ILOR.

Relevant in this case is further that the Italian tax treaties follow article 2(4) of the OECD Model in respect of the applicability of the treaty to future taxes of the same or substantially similar nature which are imposed after the date of signature of the treaty in addition to, or in place of, the existing taxes.

Furthermore, the treaties contain also the second sentence of this provision, dealing with the notification of the treaty partner.
This means that the competent authorities notify each other of any substantial changes to their domestic tax laws.

And, also relevant in the case at hand is article 44 of IRAP providing that, for the purposes of the application of tax treaties, IRAP is to be treated in the same way as the taxes it replaces, which refers to the ILOR, the local income tax.

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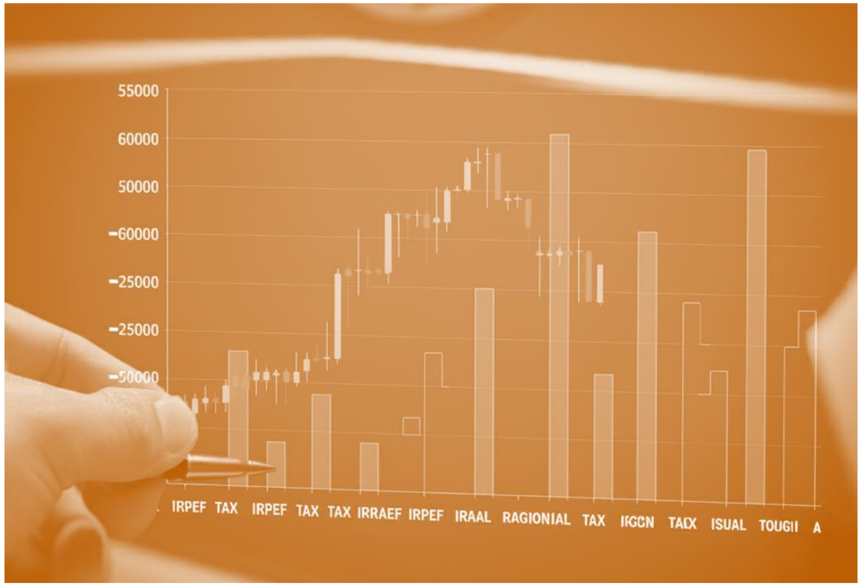

Now the recent decision of 2023 on the matter.

Let's see why the Court of Cassation ruled in favor of the taxpayer.

The case concerns an Italian real estate company that in 2011 sold a property in France where it had paid French taxes on the capital gain realized.

However, since the tax paid in France was higher than the tax paid in Italy, the company submitted a request to the Italian tax authorities for a foreign tax credit, not only for the corporate income tax but also for the IRAP to the extent that the French tax exceeded the corporate income tax.

This request was based on the tax treaty that was concluded with France in 1989 that in article 2 referred to the ILOR and not to the IRAP.

The tax authorities didn't react. They remained silent which is considered as a refusal under Italian procedural law.

The taxpayer appealed but the first and second instance courts ruled in favor of the tax authorities.

However, in the end, the Supreme Court joined the views of the taxpayer.

The Supreme Court reasoned, that international conventions once transposed into domestic law by means of a law of ratification, acquire the value of primary source on the basis of the Italian Constitution, i.e. priority over domestic law.
This is laid down:
- in article 10 of the Constitution, which sets the adaptation of the Italian legal system to the norms of international law; and,
- in article 117 of the Constitution, which provides for the obligation of the State and its Regions to comply with the obligations imposed by EU law and treaties.

These rules are reaffirmed in tax matters:
- in the application of the provisions concerning income taxes, international agreements enforceable in Italy are without prejudice according to the law on collections *[art. 75 D.P.R. n. 600 of 1973]*.
Furthermore, there is a domestic rule that if the domestic law is more favourable to the taxpayer than the tax treaty, the domestic law prevails in derogation from the treaty *[which is laid down the Consolidated Law on Direct Taxes (Article 169 of Presidential Decree No. 917 of 1986) for which the provisions of the same Consolidated Law apply]*.

On the basis of these rules, therefore, the Supreme Court affirmed the general principle that tax treaties like other international conventions take precedence over domestic law.

This means in the field of income tax that tax treaty rules to avoid double taxation prevail over domestic rules. This is explicitly decided by the Supreme Court in its rather recent decision of 24 November 2016 *[number 23984]*.

This means also that, even in a situation that a tax treaty rule is not supported by a corresponding rule in the income tax, the treaty rule must be applied *[Article 165 of the Consolidated Law on Income]*.

In the present case, it was just this issue that was at stake with regard to the creditability of the IRAP with the local income tax. The domestic Italian law didn't provide for such credit.

The Italian tax treaty with France of 1989 enumerates in article 2(3) the taxes to which the treaty applies, for Italy and France. However, the list of Italian taxes does not mention the IRAP, since the IRAP was only introduced in 1997.

As a result, the Court proceeded to verify whether the IRAP had, in any case, a relevance under the tax treaty.

The Court found that article 2 *[paragraph 3, letter a) point III)]* of the treaty made an obvious reference to the ILOR, which was repealed in 1997.

This was relevant according to the Court because the law establishing the IRAP expressly provided that, for the purposes of the application of international treaties on tax matters, IRAP was equivalent to the state taxes abolished by article 36 which included the ILOR according to Article 44 of Legislative Decree number 446 of 1997.

However, in the opinion of the Supreme Court, this was in itself not sufficient reason to consider the IRAP as a tax covered by the treaty with France.

Indeed, the domestic law was clear. No doubt about that: the IRAP replaced the ILOR, but this did not apply automatically also under the treaty.
Or, in other terms, the domestic rule could not determine the classification of the IRAP under the treaty with France.

The Supreme Court then recalled that the limits of the applicability of the tax treaties is determined by the treaties themselves.
Article 2(1) of the treaty with France refers, in accordance with the Organization for Economic Co-operation and Development (OECD) model, only to taxes on income and capital and contains in article 2(3), as said, a list of the Italian taxes covered by the treaty.
Following the standard of the OECD model, the French treaty contains in article 2(4) a specific provision for future taxes.
This means two things:
- first, the treaty with France is also applicable to any identical or substantially similar taxes which are introduced after the date of the signature of the treaty and which are in addition to or in place of, the existing taxes.
- second: the competent authorities have to notify each other of important changes in their domestic laws.

Decisive factor in this case was a circular of the Italian tax authorities of 18 April 2002, number 33/2002.

In this circular, it was announced that Italy had notified all its treaty partners, including France, that the ILOR was replaced by the IRAP.
Moreover, it was noted in the circular that France had explicitly recognized the IRAP as a tax to which the treaty applied.
So, there was a solid basis to hold that the IRAP was covered by the treaty with France:
- it was a new tax, substantially similar to the ILOR,
- the treaty partner was notified, and last but not least:
- France had even accepted the new tax as a tax covered by the treaty.

The Supreme Court then noted that it had already ruled in a previous decision, for other purposes, that the IRAP could be assimilated with the ILOR because of the common characteristics:
- the ILOR was repealed at the introduction of the IRAP;
- the IRAP was a Decree, like the ILOR it replaced;
- it was a proportional tax; and
- the non-deductibility regime for income tax purposes applied to it.
[cf. Cass. U. Section 29/05/2017, no. 13452, Cass. U. Section 20/06/2012, no. 10145].

In addition, these common characteristics were emphasized by the IRAP itself, in article 17, dealing with productive activities abroad.
According to this provision, taxpayers who, on the date of the entry into force of the IRAP, retained the right to benefit from the ten-year exemption regime for local income tax on productive activities abroad under the ILOR regime for the remaining period under the IRAP.

Furthermore, the Supreme Court pointed out that it had already decided in previous decisions under the tax treaty with the United Kingdom that the ILOR was indeed a local income tax but, in any case a ‘state tax’ on income, like the IRAP, which is not a ‘local tax’ on local income’.
And yet, in this treaty with the UK, the ILOR was not explicitly mentioned in the list of tax laws covered by the treaty!!
[Cass. 05/06/2015, No. 11622 and Cass. 9942 of 28/07/2000]

Finally, the Supreme Court made clear that no argument could be derived from article 24 of the treaty with France dealing with the elimination of double taxation.
According to this article, Italy 'may' include in the taxable amount the items of income taxable in France.
However, it '**must** deduct from the taxes thus calculated the income tax paid in France'.
In this respect the Supreme Court disagreed with the Court of Appeal that had decided that this treaty provision contained not more than an indication of general criterion, not relevant in the present case.
According to the Supreme Court it is just the contrary: where an element of income – in the present case the capital gain realized by the sale of the land in France – is included in the taxable amount in Italy, the deduction of tax paid abroad must be permitted on the basis of the treaty.
In conclusion, the Supreme Court decided in respect of the application of the tax treaty with France in short as follows:
- the relevance of IRAP must be assessed on the basis of the provisions of the individual tax treaty;

- the tax treaty with France applicable to the ILOR also applies to the law by which it is replaced, i.e. the IRAP;
- the wording of the IRAP itself does not leave any doubt about this;
- the ILOR and IRAP are substantially similar taxes;
- the notification by Italy and the subsequent recognition by France does not leave any room for doubt that the treaty partners are of the opinion that the IRAP is covered by the treaty.

Thank you for your attention!