Italian Supreme Court: foreign tax credit is due under treaty even if the foreign-sourced income was not reported in an Italian tax return

In orders no. 24160 and no. 24205 of 9 September 2024 (together, "**Orders**"), the Italian Supreme Court ruled on the interaction between domestic and tax treaty provisions on foreign tax credit. In both cases, the Supreme Court recognized that, if there is a double tax treaty in force between Italy and the State where the income is sourced, Italian residents can offset the foreign taxes paid in the other contracting State against Italian income tax even if the income was not reported in a tax return filed in Italy.

Both Orders concern situations in which Italian resident individuals filed an application for the first Italian "voluntary disclosure" procedure, enacted in 2015 with the aim of allowing Italian taxpayers to disclose undeclared foreign-sourced income and pay the Italian taxes due, thereby benefitting from reduced penalties.

Order no. 24160/2024 deals with an Italian resident individual who initiated the voluntary disclosure procedure for FYs 2009 to 2013 but did not complete it. The Italian Revenue Agency then issued separate notices of tax deficiency against her, claiming that certain items of income sourced and taxed in Brazil disclosed in the request for admission to the procedure should have also been taxed in Italy. The taxpayer challenged the notices, seeking a credit for the taxes paid in Brazil pursuant to Article 23(2) of the tax treaty between Italy and Brazil.

Similarly, Order no. 24205/2024 addresses the case of an Italian resident airline pilot who earned employment income in FYs 2010 and 2011 from a company tax resident in Portugal, where the income was subject to withholding tax. In the context of the voluntary disclosure procedure, the Italian Revenue Agency argued that the employment income should have also been taxed in Italy under Article 15 of the tax treaty between Italy and Portugal and denied the foreign tax credit because the income had not been reported in Italy. After completing the procedure, the taxpayer filed a request for a refund of the taxes paid in Portugal under Article 22(2) of the treaty, which the Revenue Agency rejected.

In both cases, the Italian Revenue Agency refused to grant a credit for the taxes paid abroad by relying on Article 165(8) of the Italian Income Tax Code ("**ITC**"), which establishes that unilateral foreign tax relief is not available if the taxpayer has either failed to file the income tax return in Italy or has not reported the foreign-sourced income in the income tax return filed.

With the two Orders, the Supreme Court ruled that the Italian Revenue Agency may legitimately apply Article 165(8) ITC and, consequently, deny the foreign tax credit in the case of failure to file the tax return in Italy (or to report the foreign-sourced income in the return filed) only when there is no double tax treaty with the source State. Conversely, if a double tax treaty exists and has a foreign tax credit provision substantially in line with Article 23B of the OECD Model Convention, the credit must be granted without any special restriction,

save for the limit of the amount of taxes due in Italy on the same income (ordinary credit limitation). According to the Supreme Court, by concluding a double tax treaty, Italy assumes an unconditional obligation towards the other contracting State to relieve double taxation; therefore, the Revenue Agency cannot deny the treaty credit only based on a domestic rule, which, in the Supreme Court's view, sets forth a mere formal requirement and, in any case, is not agreed bilaterally, because such refusal would leave Italy's treaty obligations unfulfilled and would thus trigger a violation of international treaty law.

The Supreme Court's decisions are to be welcomed. It must be noted that a specific exception to the rule of Article 165(8) ITC was later included in the legislation governing the second Italian voluntary disclosure procedure (enacted in 2017), but only with respect to foreign-sourced employment and self-employment income. Apart from this exception, the Italian Revenue Agency has always adopted a very strict interpretation of Article 165(8) ITC (see Circular Letter no. 9/2015) and denied the foreign tax credit when the conditions under that provision were not met even if a double tax treaty was in force with the source State. Italian case law has so far been inconsistent on this matter. Although the Supreme Court has sometimes recognized the entitlement to the treaty credit even in cases of foreign-sourced income not reported in a tax return in Italy, its reasoning has often been less accurate than in these Orders (see, for instance, Decision no. 23984/2016, Order no. 20291/2018 and Order no. 9725/2021). These two recent Orders thus represent two important precedents that might be used to support the entitlement to the foreign tax credit under a double tax treaty also in situations beyond the voluntary disclosure procedures. For instance, the foreign tax credit could be recognized in those cases where the Italian tax authorities disregard the foreign residence of a company (or an individual) and claim that the company (or individual) should have filed a tax return in Italy as a resident. In these cases, Italian tax authorities generally invoke Article 165(8) ITC to deny credit for the foreign taxes that the company (or individual) may have anyway paid abroad. These two new decisions might affect this outcome if a double tax treaty can be invoked.

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