



# Insights: Transfer Pricing

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Associates

## Current transfer pricing and international taxation issues in Italy

The ACB Group in Milan, Italy, organized a seminar regarding national (Italian) and international developments in transfer pricing on May 9, 2013.

Part of the seminar was dedicated to a discussion with participants, all Italian tax professionals affiliated with the ACB Group, and the sharing of practical experience of practitioners dealing with transfer pricing (TP) issues in Italy.

This article summarizes the main lessons learned there and our experience with the following key topics:<sup>1</sup>

- Transfer pricing documentation
- Growing competence of tax authorities
- Growing efficiency of tax audit activities
- Focus on permanent establishment
- Criminal law implications

### Transfer pricing documentation

Italy has a peculiar set of regulations<sup>2</sup>, under which transfer pricing documentation is optional but highly recommended. When properly drafted<sup>3</sup>, it protects from significant administrative penalties that are applied in case of a tax adjustment and its existence (or not) will be considered as an element of the risk assessment analyses performed by the tax administration. When the documentation rules were introduced in 2010, many practitioners feared that a formalistic approach

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<sup>1</sup> The authors also presented regarding international taxation in Italy at an International Chamber of Commerce (ICC) seminar in June 2012 in Paris. Material presented at the seminar "Italy and International Taxation (What a Foreign Investor Should know)" is available on the ICC website at: <http://www.iccwbo.org/News/Articles/2012/ICC-seminar-tackles-Italian-taxation-for-foreign-investors/>.

<sup>2</sup> On September 29, 2010, the Italian Revenue Agency (IRA) issued regulations on transfer pricing documentation requirements. This was initially released as Article 26 of Legislative Decree No. 78 of May 31, 2010, and became law on July 30, 2010. These regulations outline the documentation content requirements based on an entity's operating status in Italy. Proper transfer pricing documentation grants taxpayers relief from administrative penalties provided by Article 1.2 of Legislative Decree No. 471 of December 18, 1997.

<sup>3</sup> According to the September 2010 regulation and administrative instructions issued in December 2010 penalty protection is granted only if the documentation strictly adheres to the detailed requirements in terms of document structure, format, content, language, formal communication to tax authorities, and delivery deadlines.

could prevail and that tax inspectors could disallow the penalty protection with challenges to the completeness of documentation.

Three years after the introduction of the documentation regulation, the consensus expressed at the seminar is that there is no widespread feeling that documentation is disallowed. The seminar participants, coming from all regions of northern Italy, have not reported negative experiences of unreasonable rejections of transfer pricing documentation. On the other hand, some participants reported that a certain number of taxpayers and advisors chose to prepare some documentation, but do not notify its existence to tax authorities, thus giving up the entitlement to penalty protection. The explanation for such behavior is the fear that detailed documentation will provide the tax administration more elements for justifying a tax assessment that auditors are perceived as aggressively pursuing. While the fear may be justified in some cases, we also have experience of positive outcomes resulting from proactive and exhaustive provision of documentation and explanations to tax authorities. The pros and cons of different audit strategies are discussed in more detail in the conclusion.

### **Growing competence of tax authorities**

The Italian tax administration is devoting significant efforts to increase the competence of its teams. The central teams dealing with policy matters, rulings, and APAs have rapidly grown their skills and experience in the last few years. They are also increasingly active at the international level, in particular within the context of the current Organisation for Economic Co-operation and Development (OECD) project on Base Erosion and Profit Shifting (BEPS).

The regional offices in Rome and Milan centralize the competencies for dealing with transfer pricing audits and settlement discussions. These offices support the local offices in dealing with complex cases. However, the capability level of local offices varies and this leads certain tax inspectors to formalistic or oversimplified approaches. For example, during the seminar a case was reported of a local tax inspector in a small town adjusting the profit of the Italian head-office entity from the lower quartile to the median of comparables' results, disregarding the fact that the foreign subsidiaries, operating as low risk distributors, are making losses.

### **Growing efficiency of tax audit activities**

The Italian tax authorities increasingly focus on the efficiency of their audit activities. Formal operational instructions about "preventing and fighting tax evasion" are issued (the most recent one dated July 31, 2013). Quantitative and qualitative targets are set and results are monitored. Risk assessment is a focus area and internal IT tools have been developed to support the risk assessment activities.

Large taxpayers are constantly monitored and a special process, called "tutorship" has been implemented to deal with all entities with revenue higher than 100 million euros. The operational instruction for monitoring the large taxpayers recommends a particular focus on specific risk areas including aggressive tax planning schemes, corporate losses utilization, hybrid mismatch arrangements, and transfer pricing. Enhanced relationships with taxpayers are encouraged, but not formally regulated. Cooperating with the tax administration is considered an element for rating the risk, but taxpayers are not formally entitled to any specific simplification for being proactive.

## Focus on permanent establishment

In the last couple of years, the Italian tax authorities have focused on the investigation of undisclosed permanent establishments (PE) of non-resident multinationals. While in many respects the attribution of income to the challenged PE resembles a TP reassessment, it should be noticed that the challenge based on the omission to file the tax return of the PE brings with it longer statutes of limitations. This can be from five to 10 years, depending on whether the claim exceeds the thresholds provided under criminal law, which are pretty low, and therefore easy to be passed. The ordinary statute of limitations in case of TP adjustment would be either four or eight years, always depending on the criminal relevance of the alleged violations. It also brings a different addressee of the claim, the non-resident entity rather than the local entity, and consequently also different addressees of the criminal charges, the non-resident entity's legal representatives instead of those of the local entity. Controversies have arisen, in particular, in those cases where the multinational group had chosen to manifest its operations in the country through the constitution of a local entity providing services, usually sales and marketing support, to the mother (or other related) company, and the tax authorities consider that the functions actually performed by the local entity go beyond the scope of the contractual agreement it has with the mother (or related) company. In these cases, provided the "additional" functions really exist and they are not of an auxiliary or preparatory nature, the OECD guidelines leave it to the single States to determine whether to base the reassessment on a PE challenge, or on transfer pricing. The Italian authorities' approach so far has been to challenge the existence of an undisclosed PE, and this has caused litigation, even in those cases where the amounts were not material. This is because groups whose business structure applies similarly throughout a wider region tend to reject the option of a settlement that could be viewed as a recognition of the existence of an undisclosed PE.

Also, the set of comparables used by the tax agency in order to determine the reassessment is not always undisputable, and this has also caused litigation.

## Criminal law implications

Another issue to report relates to the concurrent applicability of administrative and criminal proceedings for the same tax violation. Administrative sanctions are applied as a proportion of the taxes claimed. Criminal sanctions, on the other hand, now also include the confiscation of an amount equal to the unpaid taxes. Provisional seizures may be applied in the course of the proceedings. While the settlement of the case on the administrative side might eliminate the risk of confiscation, this is not granted, as the criminal court has independent powers of evaluation and qualification of the case.

It is thus important to bear in mind that the most important tax cases should be managed, as early as possible (e.g., in order to avoid the risk of disproportionate seizures) both on the administrative side and in criminal proceedings.

## Conclusion

The overriding lesson learned is that it is very important to engage in discussion with the tax auditors at the very beginning of a transfer pricing or PE enquiry in order to ensure that the taxpayer's arguments will be heard and well considered before the final decision of issuing a tax adjustment.

In practice, many audit cases are still managed by taxpayers in the opposite way, i.e. producing as little as possible information and documentation. Three types of reasons typically lead to this type of behavior:

- the fear of helping auditors to better structure and justify a tax adjustment,
- the hope of winning the case in court on the basis of formalistic issues, and
- the lack of experience in dealing with complex transfer pricing discussions.

Unfortunately this type of attitude more and more frequently drives a taxpayer into a “lose-lose” situation:

- lose credibility with the tax administration, and
- lose most of the chances of a positive outcome of the audit.

In fact, a reticent approach is likely to push tax auditors to issue a large assessment. After this, the taxpayer still has the opportunity to open settlement discussions and try to convince the higher ranks of the tax administration to reduce or withdraw the assessment. However, in practice, the tax administration will be reluctant to significantly reduce a large assessment because this could be reviewed and challenged by internal audits within the tax administration or by a diverging attitude of the public prosecutor (although formally separate processes, the tax and criminal investigations obviously somehow influence each other).

However, no general conclusions should be drawn and each case has to be evaluated on the specific facts and circumstances. For example, some taxpayers may rationally choose a “reactive” approach because they don’t have the skill or adequate support to discuss the conceptual background of transfer pricing issues.

Nevertheless it is worth mentioning that the ideal, “win-win” situation implies a proactive approach, under which the taxpayer:

- wins the confidence of the auditors by being proactive and providing reliable information, and
- after fair and exhaustive discussions with tax inspectors and, in some cases, with their hierarchy, obtains either a validation of its policies or limited adjustments, avoiding undesirable side effects like the opening of a criminal investigation.

### **About the authors**

Paolo de’ Capitani di Vimercate is an Italian tax lawyer, partner at Studio Uckmar Associazione Professionale in Genoa and Milan. He holds an ITP degree from Harvard Law School and a PhD from the University of Pisa. He is also admitted to the New York Bar. He is a researcher in tax law at the University of Brescia and sits on the ICC Commission on Taxation in Paris. He assists Italian and foreign clients in structuring their transactions and complying with Italian tax rules; he also defends their cases before the competent tax courts in Italy. Mr. de’ Capitani di Vimercate is fluent in Italian, English, German, and Spanish.

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