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Transfer Pricing and Tax Avoidance: the Italian Perspective

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Framework

1) Italian Case Law on transfer pricing is rather scarce, and this is confirmed by the circumstance that the Transfer pricing area has been attracting the attention of Tax Authorities for audit purposes, only especially in the past few Year.

2) "Tax avoidance" and "Transfer Pricing" are two topics much studied by Italian scholars, but it is not really easy to identify the relationships between these notions.

Framework

3) There are at least four recent and significant judgments of the Supreme Court that analyze the relationship between transfer pricing and tax avoidance;

- The "nature" of art. 110 Tuir (Italian Income Tax Code) is not clear: in particular, it is not clear if art. 110 is or is not an anti Tax avoidance rule.

- In the Italian Taxation Law there is not a GAAR (General Anti Avoidance Rule), but there are only some specific anti avoidance rules;

Framework

- The Italian Supreme Court introduced a general “anti – abuse of tax law” principle, also applied in direct taxation, really similar to Tax Avoidance (if not equal): so, the Supreme Court introduced a General Anti Avoidance Rule by “judicial method” and not by legal rules;
- Italian case law is not consistent with European interpretation of the concept of Abuse of Tax Law;
- Italian Case Law on transfer pricing is not clear and seems to “confuse different profiles”;

Tax Avoidance and Abuse of Tax Law: the Italian Perspective

- The Italian Taxation law doesn't have a General Anti Avoidance Rule (GAAR) but provides specific anti-avoidance rules: in fact the art. 37 – bis, D. P. R. 600/1973 lists only a series of transaction (for example, mergers and acquisitions) considered "potentially elusive";

- These transactions can be considered "tax avoidance transactions" if they do not have **any economic justification**, except for the fiscal one, and they aim exclusively to obtain tax benefits.

Tax Avoidance and Abuse of tax law: the Italian perspective

- Transaction **without valid economic reasons** may be "reclassified" by Tax Authorities in accordance with the "**prevalence of substance over form**" principle (economic substance);

- **December 2008**: a "key date". The Supreme Court (judgment number 30055 e 30056, 23 December 2008, so-called "Judgments Twins Christmas") introduced a general notion of Abuse of Tax Law in the Italian Taxation system;

Tax Avoidance and Abuse of tax law: the Italian perspective

- **What is the source of this principle**?
- The Supreme Court identified the source of the Abuse of Tax Law, applied to all direct and indirect taxes, not only in the European Case Law, but on the basis of "***ability to pay principle***" and of "***progressive taxation***" (rules contained in Article 53 of the Italian Constitution).
- In other words, the Italian Supreme Court identified the abuse of Tax law on the basis of **fundamental constitutional principles**.

Tax Avoidance and Abuse of tax law: the Italian perspective

- The Italian Supreme Court, in the following case law (for example Cass. 19234/2012; 21782/2011; 11236/2001), applied the anti abuse principle in many types of transactions and **created the notion of "*distorted use of legal arrangements*."**
- In other words, the abuse of tax law requires the "**distorted use of legal arrangements**" but not a *contra legem* behavior of tax payer.

Tax Avoidance and Abuse of tax law: the Italian perspective

- This broad notion of Abuse of Tax Law has been criticized by a lot of scholars because it is in contrast with the general principle of **LEGAL CERTAINTY.**
- But, if the "fulcrum" of abuse of tax law is identified in the "*absence of valid economic reason*" and in the "*circumvention*" of legal rules, **abuse of tax law and tax avoidance are really close;**
- A lot of scholars observed that **abuse is actually avoidance**, **a friction between form and substance**.

THE NATURE OF ART. 110 TUIR IN THE ITALIAN CASE LAW

- The nature of Italian Transfer Pricing rule is not completely clear;
- Some scholars feel art. 110 has only the function to determine the tax base ("substantial nature"): so, the rules do not concern tax assessment.
- In other words, according to this interpretation, transfer pricing rules are not anti Tax avoidance rules.

THE NATURE OF ART. 110 TUIR IN THE ITALIAN CASE LAW

- However, four recent judgments of the Supreme Court (sent. n. 7343/2011: 17953/2012 e 11949/2012; 4927/2013) state art. 110 is an **anti-avoidance clause**, in accordance to the **European principle of Anti-abuse of Law.**
- In this framework, the Courte states:

✓ - The avoidance behavior "assumes the form" of "**ARTIFICIAL PRICE ADJUSTMENT**" in order to move income flows produced in Italy abroad;

✓ - «**VALID ECONOMIC REASONS"** are "**IRRELEVANT"** to apply the Transfer Pricing Rules : art. 110 requires the taxpayer to consider the criterion of the "normal value" of the asset (given or received) and service (paid or received), instead of the ordinary contractual fee.

THE NATURE OF ART. 110 TUIR IN THE ITALIAN CASE LAW

- **Why in this case law "*valid economic rules*" "*are irrelevant*", if the Supreme Court states art. 110 is an Anti Avoidance Rules**?
- The Supreme Court identifies the "fulcrum" of the notion of Tax avoidance (or Abuse of Tax Law) into the "*absence of Valid economic reasons*", but in the Transfer Pricing Case Law states ***"valid economic rules"*** "***are irrelevant".***
- I think this is an **evident contradiction**.

THE NATURE OF ART. 110 TUIR IN THE ITALIAN CASE LAW

- So, it is really difficult to understand why the lack of valid economic reasons is "irrelevant", if the Court stated art. 110 TUIR is an **anti-avoidance clause**, in accordance with the **European principle of Anti-abuse of Law.**
- In accordance to this interpretation, the art. 110 seems to have a "hybrid" nature: "substantial" and "anti elusive" at the same time.

The notion of anti-abuse rule in the European Soft Law

- The national tax law must be interpreted in accordance with European Law.
- The question is the following: is the Italian notion of Abuse/Tax Avoidance in accordance to the Commissions "Idea"? And, what is the impact of the European "soft law" in the Transfer Pricing area?
- In this respect, a recent European Commission Recommendation (6.12.2012 n. 2012/772/UE) on "***Aggressive tax planning in the area of direct taxation***" is really important.

The notion of anti-abuse rule in the European Soft Law

- Firstly, it is clear that this recommendation concerns also transfer pricing rules: at the "whereas n. 1" the European Commission states that this recommendation concerns "*the tax planning structures*" that "*develop across various jurisdictions and effectively, shift taxable profits towards states with beneficial tax regimes*". Then for the European Commission "*a key characteristic of the practices in question is that they reduce tax liability through strictly legal arrangements which however contradict the intent of the law*".
- This is the classic "scheme" of Transfer Pricing.

The notion of anti-abuse rule in the European Soft Law

- The European Commission stated: "*To counteract aggressive tax planning practices* ***which fall outside the scope of their specific anti-avoidance rules****, Member States should adopt* ***a general anti-abuse rule****, adapted to domestic and cross-border situations confined to the Union and situations involving third countries*".

The notion of anti-abuse rule in the European Soft Law

- **What is the "Abuse of law" for the European Commission**?

*"An **artificial arrangement** or an **artificial series of arrangements** which has been put into place for the essential purpose of avoiding taxation and leads to a tax benefit shall be ignored. National authorities shall treat these arrangements for tax purposes by reference to their economic substance"*

The notion of anti-abuse rule in the European Soft Law

- I think that according to the definition of the European Commission, **the notion of avoidance and evasion are very close** and the concept of abuse of law must be interpreted strictly.
- The notion of "*artificial arrangement*" is quite similar to the concept of "*fraud*" or of "*false*", "sham", situation (in some European member States is difficult to identify the difference between "evasion" and "avoidance").

Conclusions

- The notion of "abuse of tax law" is not the same as one by Italian Supreme Court.
- The concept of "*artificial arrangement*" is different from that of "***distorted use of legal arrangements***" or "*circumvention of legal rules*".
- In other words, it is possible to have completely genuine transactions (i.e. not "artificial") but, for the Supreme Court, related to the concept of abuse of law.
- I think the approach of the jurisprudence must change in accordance with the European Union soft law.

Conclusions

- **What is the "impact" of this conclusion on the interpretation of transfer pricing rules?**
- I think we have to distinguish between two kinds of transactions: "***genuine transactions***" and "***abusive transaction***".
- This distinction, in particular, is very important with reference to the application of criminal and administrative penalties.

Conclusions

- Prof. Della Valle, in the sub topic 4, will speak about Sanctions and penalties in Transfer Pricing because the Italian Taxation Law provides some specific rules (Article 26 of Decree- Law No. 78/2010).
- In brief, the penalty for the filing of a discrepant income tax return is not applicable in the case where, during access, investigations, audits, or other preliminary activity, the **enterprise submits the necessary documents to justify the determination criteria for transfer prices applied towards other non-resident group companies.**

Conclusions

- If the tax payer doesn't send the transfer pricing documentation, Tax Authorities can (but must not) disapply penalties, in a discretionary manner.
- Against this backdrop, it is clear that the second case is more complex because Tax Authorities have the discretionary power to apply penalties.
- The question is the following: in which cases can be applied tax penalties?

Conclusions

- It Is a common opinion that there are no specific penalties associated with abusive transactions, and the Supreme Court confirmed this principle: the Court states that the violation of a general principle is not relevant for the application of penalties (administrative and *a fortiori* criminal penalties).
- However, in a recent and famous case law (7739/2011) the Supreme Court confirmed this principles but stated that the penalties **must be applied if taxation law provides a specific anti tax avoidance rule.**

Conclusions

- I think the penalties for transfer pricing can be applied only if the transaction is qualified as an "*artificial arrangement*" and not in the case of "*genuine transaction*".
- In a recent judgment the Court of Milan (Tribunale di Milano, 26 ottobre 2012) excluded the application of criminal penalties in a transfer pricing case. The Court, in fact, states that the concept of avoidance is different from that of "evasion": **the avoidance assumes the absence of fraudulent behavior.**

Conclusions

- I think it is possible to debate whether in the case of genuine transaction Tax Authorities can apply, automatically, the criterion of "normal pricing practice of the industry" (normal value).
- If the function of transfer pricing rules is to determinate the tax base, yes, it's possible.
- But if art.110 is an "expression" of the principle of Anti abuse, Tax Authorities must demonstrate the avoidance, **without an automatic application of the "normal pricing practice of the industry"**.