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Italy: An Outlook on the Supreme Court's Transfer Pricing Decisions

Piergiorgio Valente*

Transfer pricing litigation in Italy is becoming increasingly common. Notwithstanding the increasing interest in the above area, Italy has yet to establish a consolidated approach, particularly concerning issues such as the burden of proof, the qualification of transfer pricing rules, documentation requirements and proper transfer pricing methods.

1 Introduction

Over the past decade, Italy has seen a significant rise in transfer pricing disputes and assessments by the Tax Authorities in application of Article 110, paragraph 7 of the Italian Income Tax Code (hereinafter 'TUIR').[1]

Notwithstanding the growing number of transfer pricing proceedings initiated by the Tax Authorities and subsequently brought before the Courts and Supreme Court, to date, a consolidated approach that can serve as a guideline for reporting intercompany transactions has not yet been adopted.

The theory advanced by the Judges on transfer pricing issues is rooted in the belief that the normal value must be determined on the basis of international standards (e.g., OECD Guidelines),[2] bearing, in any case in mind, that the TUIR requires that the normal value benchmark[3] be used to determine pricing at arm's length.

In analysing Court decisions on transfer pricing, decisions on tangible assets must be distinguished from the ones relating to intangible assets and services. In any event, it is important to note that the respective approaches are rather fragmented and, at times, excessively so, and that few decisions have been issued on transfer pricing in the case of intercompany exchanges of tangible assets.

Indeed, the Tax Authorities mainly focused on intercompany transactions that entail the exchange of services and the use of intangible assets, such as transactions regarding royalties, interest and various types of intercompany services.[4]

The complexity of transactions regarding exchanges of tangible assets, given the intrinsic features of the assets themselves, poses significant practical challenges when determining intercompany transfer pricing.

With reference to the exchange of intangible assets,[5] notwithstanding the volume of transfer pricing litigation

Notes

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1 Article 110, para. 7 of the ITC states that '*Elements of income arising from transactions with non-resident companies which control – directly or indirectly – the enterprise, or are controlled by the enterprise or by the same person controlling the enterprise, are evaluated, in accordance with paragraph 2 of this article, on the basis of the normal value of the goods supplied, the services rendered and the goods and services received, if they produce an increase in taxable income; this provision shall also apply if the result is a decrease in taxable income, but only in compliance with agreements concluded by the competent authorities of foreign States in accordance with the mutual agreement procedures provided for by international conventions for the avoidance of double taxation. This provision applies also to goods supplied and services rendered by non-resident companies on behalf of which the enterprise carries out the sale and marketing of raw materials or manufactured goods or the manufacturing or processing of products*.'
For further analysis on transfer pricing issues, see Valente P., *Manuale del Transfer Pricing*, Milan, Ipsoa, 2012.

2 For further analysis on transfer pricing methods, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 2053 et seq; Valente P., "*Il metodo Transactional profit split nella disciplina OCSE del transfer pricing*", in "*Il fisco*", No. 16/2011; Valente P., Mattia S., "*Principi e criticità nella selezione del metodo per determinare il transfer pricing*", in "*Corriere tributario*", No. 3/2011; Valente P., "*Il Transactional net margin method nella disciplina transfer pricing OCSE e nella circ. n. 58/E del 2010*", in "*Il fisco*", No. 12/2011.

3 Article 9 of the TUIR provides that '*Subject to the provision under paragraph 4 as to the goods considered therein, normal value means the price or consideration charged on average to goods and services of equal or similar kind at arm's length and at the same marketing stage, at the time and place the goods and services have been purchased or supplied and, where such information is lacking, at the nearest time and place. For determining the normal value, reference is made, as far as it is possible, to the price lists or tariffs of the person supplying goods or services and, where such information is lacking, to the market lists of the Chamber of Commerce as well as to professional tariffs, taking into account distributor discounts (…)*'.

4 For further analysis on intra-group services, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 2285 et seq; see also Valente P., "*Il transfer pricing nelle prestazioni di servizi infragruppo*", in "*Il fisco*", No. 5/2011.

5 For further analysis on transfer pricing rules applicable to intangible assets, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 2193 et seq.
For further analysis on recent OECD considerations on intangible assets, see *Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions* of 6 Jun. 2012, in http://www.oecd.org/tax/transferpricing/50526258.pdf; Valente P., "*Transfer pricing e beni immateriali: il Discussion Draft OCSE del 6 giugno 2012*", in "*Il fisco*", No. 33/2012.

case, challenges have arisen, from a practical standpoint, not necessarily because of the intrinsic complexity of the assets, but because no comparable independent transactions effectively exist.

A much-debated issue in transfer pricing proceedings relates to the burden of proof[6] and the documentary requirements,[7] if any, multinational enterprises must comply with for transfer prices applied to transactions with associated companies in order to ensure that the arm's length principle has been observed.

The paragraphs below provide a brief analysis of the main transfer pricing decisions issued by the Supreme Court.

2 Supreme court decision no. 11949 of 13 july 2012

Decision No. 11949/2012 has brought back the focus on the issue of the burden of proof in transfer pricing litigation.

With Decision No. 164/4/09, filed on 27 November 2009, the Regional Tax Court of Lombardy rejected the Italian Revenue Office's appeal against the Provincial Tax Court ruling in favour of the claim filed by the company T. S.r.l. against the corporate income tax, VAT and regional tax on productive activities (IRAP) notices of assessment served to the same in relation to the 2003, 2004, 2005 and 2006 tax periods.

The company T. S.r.l. is wholly owned by H. S.A., with offices in Switzerland, and is part of the US-based multinational group T., acting as its sole Italian subsidiary for the exclusive sale of software products (games for personal computers, for play stations, etc.).

These products are imported by T. S.r.l. through T. Ltd. (also belonging to the same multinational group and controlled by the same parent company) based in the UK and sole supplier of the products sold by the Italian branch.

On 31 October 2004 (the last day of the fiscal year), T. S.r.l. recorded an invoice issued to it on the same date as above by the UK company T. Ltd. for GBP 947,456.

The invoice, which was titled *Price adjustment to product sold during FY 2003/2004,* was issued for the charge made to the Italian company for upward adjustments for prices previously applied to certain software products, purchased by the same during the aforementioned financial year.

The Italian Revenue Office challenged the transaction, deeming it an avoidance practice in view of its being aimed at lowering the Italian company's taxable income through the misuse of transfer pricing.

In support of this reasoning, the Italian Revenue Office pointed out that:

– the transaction was carried out on the last day of the tax period;

– the invoice concerned an upward adjustment on prices already applied by the UK supplier company;

– the prices were not in line with the average purchase price of the products produced by T. S.r.l.

The Regional Tax Court of Lombardy rejected the Tax Authorities' reasoning and held that the burden to prove that the taxpayer engaged in avoidance behaviour fell upon the Tax Authorities (in this case, the Tax Authorities did not comply with the above burden-related requirement), and that there was no evidence of the taxpayer's avoidance behaviour or consequent tax benefit.

Having heard the Tax Authorities, the Supreme Court established that:

> the application of transfer pricing rules does not counter the concealment of income, which is a form of evasion, but rather the measures that have an impact on the manifest income, making it possible to covertly transfer profits from one State to another such as to effectively influence the tax regime. On the basis of these key elements, therefore, it must be deemed that such rules constitute – according to the interpretation in the case-law of this court – an anti-avoidance clause.

The violation of an anti-avoidance clause entails that the burden to prove the existence of factual conditions, in principle, is on the Tax Authorities intending to make the consequent adjustments. However, the Supreme Court established that:

> '*(…) with reference to the calculation of corporate income, the issue of intercompany cost distribution also relates to the subject of inherence, in addition to that of existence, of the costs declared following a service charged or an asset transferred by the parent company to the controlled company, or by another company subject to the same control (…). The burden to prove the existence and inherence of such negative income items (…) must, by virtue of the so-called «proximity to evidence» principle, necessarily fall on the taxpayer*'.

Transfer pricing rules fall within the scope of anti-avoidance regulations and aim to avoid cross-border

Notes

6 For further analysis on the burden of proof in transfer pricing, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 1173 et seq; see also Valente P., *The Burden of Proof and Transfer Pricing*, in *International Transfer Pricing Journal*, July–August 2011.

7 For further analysis on transfer pricing documentation, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 561 et seq; Valente P., Betti R., "*Idoneità teorica e sostanziale ai fini della disapplicazione delle sanzioni nel transfer pricing*", in "*Il fisco*", No. 3/2012"; Valente P., "*Strategie di comunicazione sul possesso della documentazione nel transfer pricing*", in "*Corriere tributario*", No. 25/2011; Valente P., Mattia S., "*Documentazione transfer pricing per holding e subholding: come valutare il perimetro soggettivo*", in "*Fiscalità e Commercio internazionale*", No. 3/2011; Valente P., "*Transfer pricing: oneri di documentazione per i gruppi italiani ed esteri*", in "*Fiscalità e Commercio internazionale*", No. 1/2011; Valente P., "*Primi chiarimenti in materia di oneri di documentazione in Italia*", in "*Il fisco*", No. 2/2011.

income transfers made through the *manipulation* of intercompany prices. Consequently, the burden to prove that conditions of avoidance exist rests, in principle, with the Tax Authorities, which are called upon to prove either the validity of their adjustment or, that the price has not been applied at arm's length.

However, given that the allocation of intercompany costs also relates to the existence and relevance of such costs, the burden to prove that the costs relate to the activity of the enterprise, according to the Supreme Court, is on the taxpayer.

3 Supreme court decision no. 7343 of 31 march 2011

With Decision No. 7343 of 31 March 2011, the Supreme Court addressed the issue of transfer pricing by examining, in particular, the discounts applied by N. S.p.A. for the exclusive benefit of its associated companies.

More specifically, N. S.p.A. sold assets to its foreign associated companies at a lower price than that charged to third-party independent companies, even though the products sold were identical, and applied a 2%, 3% or 4% discount on sales made to certain foreign associated companies domiciled in the European Union.

The Tax Authorities issued assessment notices for the tax periods of 1996, 1997 and 1998, which the taxpayer challenged.

The Provincial Tax Court of Milan rejected the taxpayer's claim and supported the Italian Revenue Office's grounds.

The Regional Tax Court of Lombardy later upheld the taxpayer's appeal. Ultimately, the Italian Revenue Office filed an appeal to overturn the ruling issued by the Regional Tax Court.

The Supreme Court mainly focused on identifying the function of the transfer pricing regime and, incidentally, the method for determining the transfer prices.

This decision partially amended the position held in the historical decision on the *Ford*[8] case in which the Supreme Court expressly attributed an anti-avoidance nature to the transfer pricing regime and stated that the Tax Authorities should have verified whether taxation in the State of residence of the foreign associated company, with which Ford Italia had engaged in transactions, was lower than that applied in Italy.

Differently, with Decision No. 7343 of 31 March 2011, the Supreme Court established that the function of transfer pricing rules is to avoid *the artificial price adjustment of transfers of assets and/or services (possible between the companies to which the rules refer since they report to a single center of economic interest; therefore, essentially, a single decisional center) basically aimed (from the perspective of both the Italian and foreign tax legislator) at transferring the flow of domestic income abroad* and that, solely on an ancillary basis, transfer pricing rules have an anti-avoidance character.

By virtue of this position, the Supreme Court ruling was in line with international transfer pricing principles. Indeed, it should be noted that OECD Guidelines state that the strategic function of transfer pricing rules is two-fold:

–to allocate the power to tax between the contracting States; and

–to prevent double taxation, while not attributing any expressly anti-avoidance character to the rules.[9]

The Supreme Court also deemed transfer pricing rules as being *the single legal criterion to be adopted for evaluating the income of a specific economic transaction, irrespective of the price effectively agreed and consequently disregarding altogether the actual underlying economic reasons as to why a lower price was established by the taxpayers*.

As to the methods of determining transfer prices, the Supreme Court reiterated that, for the purposes of determining the calculation method, reference must be made to Article 9 of the TUIR. This provision makes a selection among the criteria laid down by the OECD Guidelines, favouring the traditional price comparison method.[10]

The so-called *remise*, in other words the price discounts applied to transactions between the companies envisaged in Article 110, paragraph 7 of the TUIR, do not constitute the *usual discounts* referred to in Article 9, paragraph 3 of the TUIR since the discounts applied to *pricelists* and/or *fee* discounts that the provision considers as *usual discounts* are only those usually applied by the *party* on its own *pricelists* or *fees* (if any) for transactions concluded *under free market conditions,* that is, for economic transactions concluded with non-group parties.

The Court upheld the appeal of the Italian Revenue Office with reference to *usual discounts* and overturned the challenged ruling in relation to the grounds granted, referring the case, even with regard to the costs of the Supreme Court proceedings, to another division of the Regional Tax Court of Lombardy.

Notes

8 See Supreme Court, Tax Division, Decision No. 22023 of 13 Oct. 2006 and Supreme Court, Tax Division, Decision No. 11226 of 16 May 2007. For further analysis on the '*Ford*' case, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 439 et seq.

9 In the judgment C-311/08, *SGI*, of 21 Jan. 2010, the European Court of Justice ruled that transfer pricing rules have the function to allocate taxing power between States as well as, on an auxiliary basis, to prevent tax avoidance.
For further analysis on the role, evolution and rulings of the Court of Justice, see Valente P., *Manuale di Governance fiscale,* Milan, Ipsoa, 2011, pp. 2075 et seq.

10 For further analysis, see Valente P., *Manuale del Transfer Pricing*, *supra*, pp. 2053 et seq.

4 Supreme court decision no. 11226 of 27 march 2007

By way of Decision No. 11226/2007, the Tax Division of the Supreme Court established that the burden to prove non-compliance with the arm's length principle of transactions with associated companies resident in different States rests with the Tax Authorities.

An official tax audit was performed by the Tax Police on the company F. S.p.A. Italia for the years 1987–1992, subsequent to which the Tax Office of Rome issued a tax assessment notice to *recapture* IRPeG and ILOR for the 1991 tax period. In particular, tax was recaptured for alleged *over-invoicing* on cars purchased by foreign Group companies, on the supply of intercompany services, and entertainment and promotional expenses that were irrelevant.

In addition, the Tax Authorities assumed higher costs relative to the assumption of repair and maintenance burdens on new vehicles by F. S.p.A. and in favour of foreign associated companies, without payment of any remuneration.

The Italian Revenue Office filed an appeal with the Supreme Court after the first- and second-degree courts ruled in favour of the appellant.

The Tax Authorities stated that:

> without prejudice to the contractual autonomy in the case of cross-border transactions, commercial relations must take into account for tax purposes national regulations on evaluations and, in the case in hand, on Article 76 of Presidential Decree no. 917/1986 (currently Article 110), on the normal value of the goods transferred, which could not have been such had F. Italia S.p.A. entirely shouldered the economic burden for the replacement and repair of vehicles with manufacturing defects, refunding dealers and authorized repair shops the materials and manpower used in numerous services.

The matter brought before the Supreme Court refers to the accounting and deduction of costs relating to the purchase of goods by the Italian commercial company belonging to F. Group. Such costs were deemed excessive by the Tax Authorities since they included repair and maintenance costs charged to the Italian company by virtue of an intercompany agreement.

The Supreme Court established that such intra-group agreements were fully relevant even concerning relations with the Tax Authorities of the States of establishment, in whatever form these were drawn up.

The Italian Tax Authorities should have complied with the OECD Guidelines, which set forth that the burden to prove that the conditions for tax evasion exist rests with the Tax Authorities themselves, which, consequently, also have the burden of comparing the transaction prices with those applied to transactions between independent parties, relying on any discrepancies to challenge the transfer of the taxable base to States with a more favourable tax regime.

The taxpayer is not required to prove the fairness of the transfer prices applied until after the Tax Authorities have provided evidence of non-compliance with the *arm's length principle*. According to the Supreme Court and in accordance with the aforementioned principles, the Italian Tax Authorities should have first ascertained whether at the time of the events the applicable Italian tax regime was more burdensome than the tax regime in force in the State of origin of the vehicles sold. As a result, and with the aim to recapture tax, the Tax Authorities should have verified the actual level of prices applied with regard to comparable transactions carried out by third-party competitors.

5 Supreme court decision no. 22023 of 22 june 2006

The decision stems from a notice of assessment served to the company F.I. S.p.A. on the basis of the tax audit performed by the Tax Police relating to a tax assessment for the tax periods going from 1987 to 1992. The Tax Authorities determined that foreign associated companies resident in countries with lower taxation achieved profits that were higher than those of the Italian associated company, assuming a cost higher than the arm's length price for the purposes of Article 76 of the TUIR (currently Article 110).

F.I. S.p.A. manufactures cars and sells them to associated companies that, in turn, are entrusted to sell them worldwide. These intercompany transactions include maintenance costs governed by an intercompany agreement dating back to 1967. The Tax Authorities determined that the amount paid for the cars was excessive since the maintenance costs borne by the Italian company should have lowered the price of the cars. In any case, the Tax Authorities neither proved that the Group benefited from a tax advantage nor that the relevant States levied different tax rates.

The Regional Tax Court, which rejected the adjustments made by the Tax Authorities, identified a violation of the Vienna Convention of 11 April 1980. As it concerned a matter of international law, the appeal should have complied with the directives and principles contained in the Convention, which include the freedom to choose the form of a contract.

In this case, the Supreme Court held that the price applied must include a reserve against the assumption of the burden of warranty and future maintenance. The Tax Authorities failed to prove that such a reserve was not included in the price applied. As a result, the Supreme Court dismissed the grounds on the basis of which the adjustment had been made, as unfounded.

The aforementioned 1967 agreement is not devoid of economic and strategic aspects. For the sake of image and cost-effectiveness, the agreement requires associated companies to provide assistance on the cars sold by them in the States in which they operate.

Refuting the main appeal presented by the Tax Authorities, the Supreme Court supported the opposing company, stating that the contractual clauses for the assumption of the burden of warranty and future maintenance on the sale of cars are legitimate insofar as they are in line with the principles of cost-effectiveness and provided that a price reserve for such future burdens is included in the purchase or sales price.

6 Supreme Court Decision No. 10802 of 24 July 2002

S.E.A.S. S.r.l., an Italian company, received a notice of assessment for the tax periods 1987–1991 whereby the Tax Authorities challenged the taxpayer company's deduction, as negative income items, of costs for the use of boats and vehicles let to the taxpayer company by its parent company, *Finanziaria Commerciale Marittima* (FCM), which purchased them from its subsidiary companies to, in turn, hire them out to the same companies.

The Tax Office of Trieste rejected the deduction on the basis that the cost incurred was inevitable. It therefore follows that it was not the *legitimate choice of the economic entity* to decide on which entity – within the Group – such burden should fall.

S.E.A.S. S.r.l. filed an appeal, which was upheld by the Provincial Tax Court of Trieste. The Tax Authorities then filed an appeal before the Regional Tax Court of Friuli Venezia Giulia, which issued a ruling on July 1997 and partially upheld the claim (as regards the tax recovery of certain non-deductible items), in substance, confirming the first-degree decision. The Tax Authorities lodged an appeal with a deed served on 29 October 1998, stating in their sole claim item that presumptions proving that the transaction was aimed at circumventing taxation existed. According to the Italian Revenue Office, the amounts paid to the parent company FCM by S.E.A.S. S.r.l. to hire the boats and vehicles were unjustified and *beyond any economic rationale*, the avoidance nature of the transaction was evident since the company benefited from the lower tax rate provided for under the *law for Trieste* No. 26 of 29 January 1986.

The Tax Authorities adjusted the taxpayer's income in view of its assertion that Article 37 of Presidential Decree No. 600/1973 had been violated. The Supreme Court held that the foregoing provision did not apply to the case in question since the subject-matter of the provision is fictitious interposition.

Furthermore, the Supreme Court clarified that, in the event that a taxpayer engages in behaviour that does not uphold the principle of cost-effectiveness, an assessment pursuant to Article 39, paragraph 1 of Presidential Decree No. 600/1973 would be legitimate. In this regard, *to nullify an assessment, {the Court deciding on the substance of the case} must specify, with valid arguments, the reasons for which it deems that the taxpayer's anti cost-effective behaviour is not symptomatic of possible tax law violations*.[11]

The entrepreneurial activity must be carried out on a cost-effective basis, while it must not aim at undue tax savings. Second-degree Court should have excluded the fact that amounts paid might have effectively been aligned to a business strategy and not merely intended to achieve undue tax advantages. The second-degree decision only declared that entrepreneurial choices were indisputable, without going further into the merits of the consistency of costs borne.

The Supreme Court upheld the Tax Office's appeal, overturning the decision and referring it to a different Section of the Regional Tax Commission of Friuli Venezia Giulia. Among the motivations proffered, the conclusions reached by the second-degree Court were deemed insufficient as they did not thoroughly examine the consistency of costs incurred. The Court maintained that the company does not have the right to indisputable choices with regard to its own economic initiatives, such to disregard a strategy that is consistent with the principles of cost-effectiveness.

7 Supreme Court Decision No. 13233 of 22 June 2001

The company N. S.r.l. received, for tax period 1989, an assessment notice for purchases of bearings, by the foreign associated companies C. and L. The Tax Authorities judged the above transactions to be a *considerable bargain* as they were not carried on at a normal value (i.e., arm's length), and recaptured the amount of L. 51,855,000.

The Regional Tax Court of Campania upheld the appeal filed by the Company N. N. S.r.l. The Tax Authorities lodged an appeal against the second-degree decision with the Supreme Court.

The Supreme Court determined that the transaction occurred between an Italian company that purchased a given good from its parent company, applying a price that the Tax Authorities considered high with regard to normal value. The Supreme Court seized the opportunity to provide a conclusive interpretation on the concept of *free competition*. Pursuant to paragraph 3 of Article 9 of the TUIR, the normal value of transactions must be gauged *on*

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11 Cf. Supreme Court, 9 Feb. 2001, No. 1821; Supreme Court, 25 Jun. 1998, No. 6300.

the price or consideration applied on the average for goods and services of the same or similar kind, under free market conditions and at the same trading phase, at the time and place in which the goods or services were acquired or loaned and, in the absence thereof, at the time and place that are nearest.

In defining the expression *free competition*, one should not consider the abstract notion provided by manuals of economic policies: taking into account a market with an unlimited number of agents and consumers and with a perfect exchange of information is unthinkable. The definition of free competition must adjust to the transfer pricing regime.

In the case at issue, a *free competition* is excluded a priori as the transaction occurred between a controlling and a controlled entity.

The Supreme Court agreed with the lower Court Judge on the fairness of the price applied to the transfer of goods and rejected the Tax Authorities' appeal.

8 Supreme Court Decision No. 3861 of 31 May 2001

On 18 December 1992, the UK company T. was served at its own permanent establishment in Milan, a tax assessment notice to adjust income declared for IRPeG and ILOR. Pursuant to the Tax Authorities, irrelevant management costs were borne and adjusted thus deductions relating thereto while increasing the taxable income for the relevant period.

First-degree Judges partially upheld the appeal of the Company T., while before the second-degree Court, the Judges of the Regional Tax Court upheld the grounds pleaded by the Tax Authorities. The company T. lodged an appeal with the Supreme Court.

By means of Decision No. 4355 of 16 May, 1997, the Supreme Court asserted that:

> '*controlled entities of an enterprise, even if organized under the legal form of companies, are not deemed as independent legal imputation centers: their being recorded in the Register of Companies, pursuant to Articles 2197 and 2299 of the Italian Civil Code, is therefore not aimed at revealing a legal separation vis-à-vis the main office, but rather to manifest the existence of an organic link between the enterprise and its branches*'.

Such principles cannot be derogated from, not even for subsidiaries of foreign corporations, deemed *operating structures* of the foreign company; even in such case, the presence of an entity (so-called *permanent representative*), institutionally required to act – within that territorial context – in the name and on behalf of the company,[12] is required.

The second-degree ruling acknowledged that *(p)ermanent establishments do not constitute legal entities independent from foreign companies*; however, with regard to the decisional powers of the former, the Regional Tax Court established that management fees were non-deductible maintaining that *(p)ermanent establishments would not have any decisional power on such costs, which consequently could not be deemed relevant for the production of income*.

Pursuant to Supreme Court Judges, *if permanent establishments are an integral part of the business being carried out by the foreign company, this latter, regardless of the positions adopted within the context of its internal management and the structure of its decisional powers, must be considered as a whole*. The motivation of the second-degree ruling with regard to management fees was deemed groundless, given that the permanent establishment is by nature an entity that is not legally independent, and is, therefore, devoid of any own decisional power; thus, attributing the non-deductibility of costs incurred, as established by the parent company, is to be excluded.

As a consequence, the Supreme Court upheld the appeal lodged by the company T. and quashed the second-degree ruling.

9 Supreme Court Decision No. 1133 of 26 January 2001

The Milan Office of Direct Taxation issued an assessment notice for the 1984 tax year for IRPeG and ILOR purposes vis-à-vis the permanent establishment in Italy of the French company B.N.P., as it deemed management fees borne to be irrelevant. Furthermore, deductions on insurance costs for the Group's employees, borne by the subsidiaries were also adjusted.

The first-degree Tax Court upheld the tax recapture of the IRPeG sum amounting to L. 1,831,476,000, for:

– non inherent management fees;

– interests on tax credits;

– non-documented extraordinary losses.

The ruling of 4 March 1997, issued by the Regional Tax Court of Lombardy, partially rejected the adjustments challenged by the Tax Authorities, establishing that the tax recapture of interests on tax credits was unfounded, while it resolved that adjustments on non-deductible costs for management fees were justified. Such ruling re-stated the principle according to which all general expenses must be characterized by certainty, competence and inherence.

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12 Cf. Supreme Court, 12 Jun. 1982, No. 3573; Supreme Court, 26 Oct. 1992, No. 5597.

B.N.P. lodged an appeal against such ruling with the Supreme Court.

The Tax Authorities disagreed with the ruling by submitting a counter-appeal. In particular, the Tax Authorities invoked the principles contained under Article 75 of the TUIR (at present Article 109 of the TUIR) which provides that the deductibility of costs and burdens is allowed when these refer to the same activities from which income and proceeds derive, without the need for these latter to generate any proceeds directly. The violation of the France-Italy Double Tax Treaty was also challenged.

Management fees regarding the two entities (i.e., the French company and the Italian permanent establishment) that do not constitute separate entities, can only be allocated to the French company and proportionally charged back to the Milan office. Deduction of expenses incurred for the permanent establishment's objectives is also provided by the Italy-France Treaty.

The company B.N.P. stated that the possibility to impute to permanent establishments quotas relating to general and administrative expenses incurred by the parent company, without there being any specific link between the said costs and the activity of a permanent establishment, is acknowledged by Resolution No. 60 of 17 July 1995 issued by the Coordination Committee of SECIT (i.e., Italian Tax Inspectors Office, hereinafter 'SECIT').

Pursuant to the Supreme Court,[13] the allocation of management fees is legitimate where such costs comply with certainty, competence and inherence requirements. The coherence of the principle described above is further endorsed by Circular No. 30 of 7 July 1983 which, after having stated that (…) *all costs and burdens are deductible if and to the extent they comply with certainty, competence and inherence requirements*, asserts that the concept of inherence (…) *is no longer linked to the proceeds of the enterprise, but to the activity itself*. The allocation criterion for B.N.P.'s expenses, therefore, appears to have been grounded on sound economic reasons of a systematic nature that are in line with the national legal system.

The position according to which deductibility of taxes – even where there is no direct link with proceeds – applies, is again confirmed by Resolution No. 158/E/1998 of 28 October 1998, which principles were later transposed into the TUIR.

As far as allocating costs incurred by the parent company to the permanent establishment, the Supreme Court established that the Tax Authorities' position on the case at issue is in conflict with Article 7, No. 3 of the OECD Model Convention.

Ultimately, it established that the deduction for insurance expenses was adequate as the relevant costs are aligned to the current employment agreement entered into by and between the Group and its own employees. As health and casualty insurance expenses are an integral part of employment agreements, the said expenses could not possibly be deemed irrelevant.

Therefore, the Supreme Court upheld the appeal by quashing the adjustment of costs for insurance coverage – as the said components were consistent with the collective employment agreement for professionals – and overruled the decision, by concluding that, in any case, the burden to prove that costs are allegedly inadequate rests, in any event, with the Tax Authorities.

10 Supreme Court Decision No. 3547 of 24 March 2000

The District Office for Direct Taxes adjusted, for tax year 1984, the loss declared by the company S., assessing income for an amount of L. 272,123,000 with regard to the payment of royalties to the parent company P.S.A., deemed to be taxable in Italy ex Article 11 of the Italy-France Double Tax Treaty.

Pursuant to the first-degree Judges, the holding of a 99.95% participation stake of an Italian company by a French company allows the controlled company to be qualified as a permanent establishment; the said condition does not, however, allow the application of a withholding tax – *ipso facto* – on the royalties paid.

The Tax Authorities impugned the second-degree ruling before the Supreme Court Judges. The company S. filed, in turn, a counter-appeal.

The petitioning Tax Authorities pressed charges for the violation of Article 11 of the Italy-France Convention as well as of Article 75 of Pres. Dec. No. 600/1973 and 74 of Pres. Dec. No. 597/1973, maintaining that the second-degree Judges' motivations were insufficient and contradictory with regard to the most crucial and decisive points of the controversy.

The company S. challenged the validity of the appeal and retorted that Article 75 of Pres. Dec. No. 600/1973 should have been interpreted in the sense that International Treaties against Double Taxation do not in any way prevent the application of more favourable domestic rules.

The Supreme Court asserted that, pursuant to the Italy-France Convention (communication exchanged among the Ministers of Finance that were in office at the time), the control requirement is not sufficient to requalify a company as a permanent establishment.

In particular, the control requirement is not sufficient to prove that the company is devoid of all legal status and can, therefore, be deemed as a permanent establishment. Furthermore, the said link between parent company and

Notes

[13] Cf. Supreme Court, 17 May 2000, No. 10062; Supreme Court, 5 Sep. 2000, No. 11648; Supreme Court, 6 Sep. 2000, No. 11700.

subsidiary cannot – in and of itself – be regarded as a good enough reason to consider the structure at issue as an artificial arrangement. Consequently, the subsidiary may fully enjoy the use of intangibles received against the cost incurred, and the said cost cannot but be subject to the rules regulating negative income components.

The Supreme Court rejects the main appeal submitted by the Tax Authorities, observing that, as stated by the EU Court of Justice in its ruling of 28 January 1986,[14] Article 52 of the EU Treaty, grants – on the one hand – to economic operators the right to freely choose the legal structure most suitable to their business activity in another Member State while – on the other hand – forbids Member States to restrict the said faculty of choice by means of tax provisions that discriminate against non-residents and favour residents.

Notes

14 Cf. European Court of Justice, C-270/83, *EU Commission v. France*.

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