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Italy: Transfer pricing aspects of restructuring

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Corporate restructuring operations and/or functional redefinition involve multinationals' cross-border reallocation of functions, risks, assets and profit potential between/among associated enterprises.

In general terms, the economic reasons on which restructuring operations are based are the following:

- Maximization of synergies and economies of scale;
- Rationalization of business lines management;
- Enhancement of value chain efficiency;
- Penetration of strategic markets; and
- Optimization of tax burden.

Business restructuring operations can significantly impact the transfer pricing policies of multinational groups, because they influence the functions carried out by the single associated enterprises and, as a consequence, the comparability and functional analyses, namely on key activities for the determination of transfer prices.

In this context, the reallocation of functions, assets and risks within a group should, in fact, result in a different attribution of profits between/among associated enterprises, according to the general rule pursuant to which, within the framework of a normal market rationale, each part of a transaction must be remunerated for functions performed, assets employed and risks assumed.

Italy follows the OECD developments with a view to apply the guidelines comprehensively and consistently regarding its guidance on transfer pricing matters. Consequently, the inflow and outflow of profits upon value chain reshuffling causes the Italian tax authorities to closely monitor international developments in this field, in particular in relation to Chapter IX of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (transfer pricing guidelines) published on July 22 2010.

Challenges and opportunities

Value chain optimization/rationalization represents one of the most important motivations that drive the multinational enterprise to embark on a restructuring operation. The said operations may involve a number of difficulties with regard to transfer pricing matters, such as:

- Reallocation of functions, risks and assets between/among group enterprises (a fundamental aspect is to understand the new functional role of the group companies, post restructuring);

- Redefinition of intercompany flows (functional analysis of entities involved for each single transaction);

- Identification of the transfer pricing method (where the method selected during the pre-restructuring phase should not turn out to be the most suitable one to the specific circumstances of the case at issue) and application thereof;

- Compilation of the relevant documentation (transfer pricing documentation that illustrates changes deriving from the restructuring operation, relevant agreements relating to intercompany transactions).

Therefore, in case of tax audits in Italy, it might be convenient for enterprises to compile the relevant documentation aimed at supporting the group's reorganization process by providing explicit information regarding any changes that might have occurred with regard to the prior tax period as well as to the sound economic purposes underlying the restructuring (by emphasizing that the tax motivation is not the main restructuring purpose).

Studies performed by the OECD revealed how a great number of tax planning structures provide for the allocation of significant functions, risks and high-value intangibles in privileged tax jurisdictions, thus generating taxable base erosion through profit shifting.

Consequently, the Italian Tax Authorities are concerned about verifying that Italian enterprises do not carry out restructuring operations to such end.

Regulatory overview

Italian legislation does not provide a specific set of tax rules with regard to corporate/functional restructurings. Therefore, from a transfer pricing standpoint, it is necessary to follow OECD regulations with reference to the shifting of cross-border functions, risks and assets.

In 2010 the option to submit special transfer pricing documentation (consisting of a master file and a country file, depending upon the kind of entity required to compile the said documentation) was introduced, which – if considered formally and substantially suitable – the tax authorities might, in the course of audits, allow for exemption from the penalties ensuing from any transfer pricing adjustments.

Therefore, transfer pricing documentation is not compulsory but allows:

- taxpayers to benefit from the so-called penalty protection; and

- tax authorities to have a basis for the evaluation and the ascertainment of the group's transfer pricing policy and, where appropriate, to perform an audit procedure.

Structure and contents of Italian transfer pricing documentation are reported in the regulations issued by the tax authorities director on September 29 2010 and by Circular No. 58/E of December 15 2010.

The transfer pricing documentation must make special reference to the business restructuring operation. In particular, it is necessary to:

- describe general strategies pursued by the enterprise and any possible strategic changes involving the prior tax period, especially in case of business restructuring;

- carry out a specific functional analysis, with a detailed description of functions carried out, of instrumental goods employed and of risks assumed, by each of the enterprises involved in the operations and for any changes that might have occurred in relation to functions, goods and risks during the prior tax period, with special reference to the ones deriving from corporate restructuring operations; and

- provide a complete list of the group's intangibles, by paying special attention not only to the property and to the creation of assets, but also to any other possible corporate restructurings which might have involved a reallocation of intangibles.

For penalty protection to be acknowledged, enterprises are required to notify the tax authorities, on occasion of their tax return filing, that they are in possession of the transfer pricing documentation: Notification of ownership is by now a strategic choice of multinational enterprises operating in Italy.

It might be worth noting that Italian tax laws provide a specific regime for the transfer abroad of corporate residence, which is an operation that may also occur within the framework of corporate restructurings.

The Article 166 of the Italian Income Tax Code (TUIR) provides for taxation of latent capital gains on transferred corporate assets, save for the case in which these are being channeled towards a permanent establishment in the state's territory.

The provision is based on the rationale that entities transfer the company's residence abroad in order to eliminate any and all links with the territory, which identification would allow the Italian State to exercise its own taxing authority.

Article 91, paragraph 1, of Legislative Decree No. 1/2012, introduced into Article 166 of the TUIR the paragraphs 2-*quater* e 2-*quinquies*, which provide that taxation of latent capital gains – as at the date of the corporate seat's transfer

abroad – may be suspended and postponed upon realization of such corporate assets.

Court cases

The last few years saw an increase of court decisions on transfer pricing matters in Italy.

Notwithstanding the growing trend of procedures being activated in this area by the Tax Authorities, which subsequently underwent the scrutiny of both the ordinary courts as well as the Supreme Court, there is no well-established position – to date – that may effectively guide the interpreter in the reconstruction of intercompany transactions.

A frequently debated topic in relation to transfer pricing procedures involves the burden of proof: From the analysis of existing case-law on the subject-matter of the burden of proof in transfer pricing controversies, a salient aspect is the considerable attention Judges pay to the presence of avoidance cases, consisting in the transfer of taxable matter towards other states. According to prevalent case-law, the burden of proof in the recurrence of factual evasion assumptions befalls – in principle – the tax authorities, which are left with the responsibility of substantiating the validity of any adjustment applied, in that the variance of the remuneration applied with regard to the arm's length value.

Another topic, which has been subject to court decisions, is the application of so-called internal transfer pricing: in working practice, the tax authorities frequently challenge the inaccuracy of prices applied, focusing in particular on the "unprofitability" of entrepreneurial choices adopted within the group's framework. The theory advanced by the tax authorities was further – if only partially – upheld by the Supreme Court, which expressed itself in favor of the possibility, during audit, to also refer to the arm's length value to assess the accuracy of transfer prices applied between/among resident companies. The Supreme Court has repeatedly reasserted that in intercompany transactions entered into by companies belonging to the same group, and all of which have offices in Italy, the arm's length principle must be considered as an anti-avoidance clause, constituting performance of the general prohibition of law abuse in tax matters, in view of the taxpayer's being precluded the attainment of tax advantages – such as the shifting of the taxable base towards associated enterprises which, in the territory, enjoy exemptions or lower taxation – through the distorted use of juridical tools, even if these are not in conflict with any particular law provision that might be suitable to obtain advantages due to the lack of reasons other than the mere expectation of securing such benefits.

Ruling practice

The international standard ruling, introduced by the Italian Tax system in 2003 and formally implemented in 2004, was actually launched only as late as February 2005, as a consequence of the favorable opinion expressed by the European Commission in that respect. The legal institution, intended for

enterprises that operate on an international level, allows these to define, in advance, with the Italian Tax Authorities, the relevant calculation methods of the arm's length value of operations ex paragraph 7 of Article 110 of the TUIR (transfer pricing regime).

In that respect, it might be useful to point out how on March 19 2013, the Italian Tax Authorities published the second edition of the *Bollettino del Ruling di Standard internazionale*, (International Ruling Standard Bulletin), which illustrates the statistics relating to the above-mentioned legal institution as at 31 December 2012.

To provide clarifications on the submission procedure regarding either the request and/or general topics, the International Rulings Office, before opening the procedure formally, sets some pre-filing meetings with taxpayers, which may evaluate whether it might or might not be convenient to proceed with a debate with the Tax Authorities for the purpose of reaching a settlement agreement.

Since December 31 2012, 89% of agreements concluded involve transfer pricing rules: none of the agreements reached involve any business restructuring operations.

It is however worth mentioning that in the 134 pre-filing requests, 5 referred to corporate restructuring operations.

The International Ruling Standard Bulletin reveals that, towards the closing of 2010, the Italian tax authorities set forth the option for taxpayers to file requests aimed at the conclusion of bilateral or multilateral APAs.

On June 5 2012, the Italian tax authorities published Circular No. 21/E, which treated the subject-matter of amicable settlement procedures (Article 25) and which further illustrated the interaction between the latter procedures and litigation avoidance tools.

In the first place, the existence of a litigation procedure does not affect the course of the MAP until a Tax Court decision is issued. In such a case, the Circular clarifies that the decision of the Tax Court becomes final for the Italian tax authorities having the same effect on MAPs as under the settlement procedures.

Lastly, as far as the tools that are available to taxpayers for the purpose of requesting the Italian Tax Authorities for advance rulings on a given kind of operation/transaction/rule, it should be emphasized that Law No. 23 of March 11 2014 (so-called "Delegated Tax Legislation"), delegating to the Italian Government the realization of a "tax system that is more equitable, more transparent and aimed at development", provides for a review of the regime on rulings, "to ensure greater consistency, to enhance legal protection, and to accelerate the drafting of opinions, even through the elimination of mandatory ruling forms, which do not produce any benefits but only add encumbrances for taxpayers and the Tax Authorities as well".

Moreover, Article 6 of the Delegated Tax Legislation provides for the need to introduce into the Italian Tax system additional rules to foster relations between tax authorities and taxpayers by means of enhanced forms of communication and cooperation.

Tax authorities' focus

The Italian tax authorities are very attentive when assessing business restructuring operations and any consequences deriving therefrom, and this is especially true with regard to transfer pricing issues.

In particular, operating guidelines followed by the tax authorities to counter international tax evasion and avoidance entail a given number of control activities (tutoring activities) for the so-called Large Corporations, focusing especially on presumably high-risk transactions, such as transfer pricing regulations, aggressive tax planning structures and issues involving fictitious corporate residence abroad as well as hidden permanent establishments.

The said risk analysis activity performed by Italian tax authorities is also carried out with the aim to assign each taxpayer with an adequate risk level, so as to define the required audit strategy, by optimizing the ratio between audits performed and tax revenues.

The risk for multinational enterprises to be audited seems to be rather high.

Generally, audits of the said enterprises involve transfer pricing issues: Italian tax authorities challenge transfer prices applied by deeming them as non-compliant with the arm's length value and, by pointing out some inconsistency, for example, between the characterization of some given entities and the relevant remuneration, or by simply highlighting the fact that the intercompany price applied is different from the one applied by third parties.

Analyses performed by auditors include all transfer pricing aspects, for example, methodology applied to determine transfer prices, functional analysis carried out and benchmarking analysis drawn up to support the group's transfer pricing policy.

Further assessments by the Italian tax authorities involve the presence, within the framework of a multinational group, of any possible "hidden permanent establishment" in the State's Territory.

The concept of "hidden permanent establishment" does not originate from the current tax legislation in force, nor from national administrative practice. The concept developed in the course of tax audits at the level of Italian companies belonging to multinational groups, characterized as formally independent legal entities. The primary basis for such concept may be traced back to Supreme Court case-law, in the *Philip Morris* case, with regard to both income tax and VAT. The notion of "hidden permanent establishment" refers to a fixed place of business in which the foreign enterprise – entirely or partially – carries out its

activity, wittingly or unwittingly – by means of an organization of men and means, or rather through an entity acting in the capacity of dependent/independent agent – without however declaring to the Tax Authorities of the Country in which it is located the relevant proceeds generated by the same or directly imputable thereto. The notion of "hidden permanent establishment" (of a material/personal kind) refers to multiple cases that are concealed, hidden, or dissimulated, and in any event not declared, inferable on the basis of a logical-deductive process based on identifiable indicators or elements that might have been detected in the course of a tax audit by the competent authorities.

As previously stated in relation to business restructuring operations, it is necessary to enhance any transfer pricing documentation by highlighting changes deriving from corporate restructurings, and mainly, in terms of functions performed and risks assumed by the parties involved in intercompany transactions, and in terms of methodologies applied to determine transfer prices of inter-company flows.

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