

## **Italian Supreme Court rules TP irregularities must be substantiated with clear avoidance behaviour**

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### **ITR Correspondent**

**In Ruling No. 27296, Italy's Supreme Court rejected the tax authorities' appeal against an Italian company's transfer of goods and services to its German parent. The Supreme Court ruled that if there is no clear economic advantage for a company, simply proving a transaction is not at arm's-length is insufficient grounds for an adjustment.**

### **Undeclared payments**

The company under audit is an Italian company controlled by a company incorporated under German law.

Officials from the Tuscan Tax Authorities raised objections over the taxpayer's failure to declare payments for the transfer of goods carried out in relation to the German company. According to the tax authorities, the payments had been determined at an amount deemed lower than the arm's length and therefore the issue should be treated as a transfer pricing case.

The Italian company had produced and sold heat detectors for trains (*FUES*) to the foreign parent company, the owner and title holder of the related know-how, at a lower price than it charged to another third-party company. The tax authorities; therefore, challenged the criterion applied by the Italian company in fixing the sales price for the German holding which, in their opinion, did not comply with the arm's-length principle.

### **Italian transfer pricing rules and regulations**

Article 110, paragraph 7 of the Italian Income Tax Code (TUIR) establishes that any income from transactions with companies not residing in the Italian State's territory, and which directly or indirectly control the enterprise, are controlled by the same company that controls the enterprise and are assessed on an arm's-length basis in relation to goods transferred, services rendered and goods and services received, to avoid underestimation of sales and/or overestimation of purchase costs.

Under Article 9, paragraph 3 of TUIR the "arm's length value" indicates the price or consideration applied on the average for goods and/or services of the same or similar kinds of goods and/or services, under free competition (that is, arm's-length) conditions and, at the same distribution level, at the place and time in which the goods and services were purchased or loaned/rented and, should such references be lacking, at the closest possible place and time. To determine the arm's-length value, reference is made – where possible – to price lists or tariffs of the party that supplied the goods or services and, should these be lacking, market reports or Chamber of Commerce lists as well as to professional tariffs, taking special discounts into account.

### **Rulings by courts of first and second instance**

The tax authorities challenged the matter at issue before the Provincial Tax Court (of First

Instance) and the competent Regional Tax Court (of Second Instance), given that, to compute the taxable base to determine income taxes, the Italian company omitted to declare payments for transfers of FUES to the parent company.

The tax authorities had reached the conclusion that payments were undervalued by examining two FUES sales agreements: the one entered into by the parent company and the controlled company and the one between the parent company and a third-party enterprise.

The Provincial Tax Court of Florence upheld, with Ruling No. 24/09/07, the company's appeal on the matter. The tax court maintained that the tax office had mistakenly assessed the taxable difference by referring to the application of Article 110, paragraph 7 of the TUIR, thus applying the arm's length value of the goods to the challenged transactions, on the basis of transactions carried out by the same company with a third-party client.

The tax authorities proposed to file an appeal against the Provincial Tax Court's, requesting that the Tax Assessment Notice be upheld by the Court as being lawful to all effects.

Tuscany's Regional Tax Court (CTR) rejected the appeal with Ruling No. 116/31/07.

The judge excluded the applicability of transfer pricing rules on the grounds that:

- 1) *“non-existence of any advantage derived from the shifting of income (as a consequence of the price transfer) given that, at the time in which the challenged transactions were carried out, taxation in Germany was higher than that applied in Italy”*; and
- 2) *“the circumstance for which, even assuming that the «arm's length value» was higher than the one agreed upon by the parties, it should in any case be considered that the Tax Office, in order to assess the adequateness of the remunerations of the single units, had consulted two agreements with entirely different subject-matters, which remunerations could not, therefore, be compared”*.

In particular, the CTR based its decision on a number of aspects involved in the complex contractual relations between the sister companies and the third-party client company because such relations are deemed to have a direct bearing on the determination of the arm's-length value.

The CTR pointed out that there is a remarkable difference between the economic and contractual positions of the German company, know-how owner and title holder of the FUES production, and the Italian manufacturing company, as established on the basis of a license agreement entered into with the parent company, with the obligation to resell products to the same parent company or to the Italian purchaser.

The CTR also considered the different contractual positions which represented the two separate relations entered into between the parent company and the controlled company, and which had an impact on the economic content of both. Firstly, the Italian company represented a mere manufacturer of a product to be supplied to the German company, which owned and held title to intellectual property rights. Secondly, having obtained the right to manufacture equipment on its own and to sell it – the Italian company also assumed the risks related to the transaction.

As a result, there was a significant difference between the related risks of the situations being compared. In the first case, the Italian company operated through a non-resident entity that was becoming a client for the acquisition of products, with the guarantee deriving from the fact of being a group company. In the second case, the Italian company operated with the burden of the risk existing in competitive markets.

### **Supreme Court ruling**

The Supreme Court (SC) rejected the Tax Authorities' appeal (Ruling No. 27296) on December 23 2014 and upheld the CTR's motivations in connection with the qualification of contractual relations and the evidence resulting from the comparison between inter-company transactions and the one between the third-party client company.

The SC confirmed that, as far as the applicability of transfer pricing rules is concerned, what should be ascertained is not merely the fact that the transaction is not at arm's length, but that there is a clear intent to adopt an avoidance behaviour, along with the existence of an evident economic advantage attained as a result of the relevant transaction.

In this case, there was no economic advantage to be gained since the tax appropriate for the German company, during the period challenged against the taxpayer (2003), was higher than the one applied to the Italian company.

The SC denied the tax authorities' motion to challenge the determination of prices of goods produced and sold to the German holding, about two-thirds lower than the ones applied by the controlled Italian company to the third-party Italian company.

The ruling issued by the SC deemed that the higher price as applied by the Italian company to the third-party company as opposed to the price applied to the group, was justified because:

- (i) The German company owned and held title to the FUES production know-how; and
- (ii) The holding company had allowed the controlled Italian company to distribute the same product under a license agreement. These facts and circumstances fully justified the sale of the goods produced by the Italian company, at a price two or three times lower than the one applied by the Italian company to a third-party client.

The ruling at issue is especially significant in view of these fundamental considerations:

1) Application of transfer pricing rules does not strictly depend on the ascertainment of the transaction's irregularity, but also on the substantiated existence of a clear intent to avoid, in addition to the consequent achievement of a concrete economic advantage;

2) In the determination of the arm's length value of transfer prices, all contractual aspects, which may in any way affect prices applied, must be duly considered among group companies.

By Piergiorgio Valente ([p.valente@gebnetwork.it](mailto:p.valente@gebnetwork.it)) and Federico Vincenti ([f.vincenti@gebnetwork.it](mailto:f.vincenti@gebnetwork.it)), Valente Associati GEB Partners

Valente Associati GEB Partners  
Viale Bianca Maria, 45

20122 Milano  
Tel 39 02 7626131  
Fax 39 02 76001091  
[www.gebpartners.it](http://www.gebpartners.it)