Piergiorgio Valente* and Ivo Caraccioli**

Transfer Pricing – Criminal Tax Risks under Italian Law

The authors examine the potential criminal liability of taxpayers in the transfer pricing domain. In particular, they examine the types of criminal offences, the use of estimates regarding values, cases where penalties are not to be imposed, the burden of proof and who may be found criminally liable.

1. Introduction

The determination of transfer prices for goods and services provided in regard to inter-company transactions is regulated by Art. 110(7) of the Italian Income Tax Code (*Testo Unico delle Imposte sui Redditi*, TUIR), which sets forth that items of income derived from transactions with non-resident companies that directly or indirectly control the enterprise, or are controlled by the same company that controls the enterprise, are to be valued on an arm's length basis in terms of the goods transferred, services provided, as well as goods/assets and services received, as determined under Para. 2, if this results in a corresponding upward adjustment. This provision also applies if the result is a downward adjustment, but only to carry out the terms of agreements concluded with the competent authorities of a contracting state under a mutual agreement procedure provided for under a tax treaty. The same rule applies to transferred goods/assets and services provided by non-resident companies on whose behalf the enterprise makes sales and provides raw materials and goods for the manufacturing or the processing of products.

The literal interpretation of the transfer pricing rule at issue and its inclusion in Art. 110 of the TUIR – which establishes "general valuation rules" with regard to corporate income – demonstrate the importance of the rule.

It was thought, for the longest time, based on the literal wording of Art. 110(7) of the TUIR, that the tax authorities had been relieved of the burden of calculating "inter-company" transactions, by means of adjustment procedures; instead, it was thought that the onus to determine transfer prices on an "arm's length" basis was on the taxpayer. This view has been disproven, in particular, in light of a recent Italian Supreme Court decision that held that the onus was on the tax authorities (see 5.).

It should be noted that erroneous transfer pricing calculations are not, generally, criminally relevant. For example, Art. 3 of Legislative Decree No. 74 of 10 March 2000 makes it clear that such errors are generally due to unreliable accounting procedures. In order for criminal liability to be imposed, however, what is necessary is the existence of behaviour that transforms a real fact into a fraudulent deed. An example would be where a service is recorded in the accounting records as having been provided between entities that, in fact, did not provide or receive the service. In fact, in the above event, an accounting method that is absolutely contrary to civil, as well as tax rules, would be adopted.

An issue that frequently appears in case law is how transfer pricing adjustments, pursuant to the arm's length principle, should be made. The issue is whether the adjusted transaction should be disclosed in the financial statements, should be recorded in an invoice or credit note in the accounts, or whether or not it would be sufficient to increase the tax base in the tax return.

The first solution is preferable, as it complies with the principles of transparency and accuracy established by the provisions of the TUIR and prevents difficulties that may arise due to the need to calculate income differently for accounting and tax purposes.

2. Tax Offences

2.1. Introductory remarks

In the criminal tax law context, the question is what the risks are in the event a transfer pricing calculation is determined to be inaccurate by the tax authorities.

Initially, it was thought that no criminal sanctions would be applicable, as Art. 4(f) of Law No. 516/1982 provides that valuation estimates are not criminally punishable. This is due to an amendment implemented by means of Law No. 154/1991, which refers to "material facts". As such, all questions involving valuations, including transfer pricing valuations, were deemed not criminally relevant.

With the entry into force of Legislative Decree No. 74/2000, the regulatory framework has, however, changed. Art. 16 provides for the non-punishability of taxpayers aligned with the position of the Ministry of Economy and Finance only with reference to matters that it applies to.

As a consequence, a concern was expressed in the literature that, in regard to all other subject matters (including transfer pricing) that have not been addressed, there may

* Managing Director of Valente Associati Studio Legale Tributario GEB Partners and Professor at the Advanced Course for the Tax Police of the Revenue Guard Corps (Corso Superiore di Polizia Tributaria della Guardia di Finanza). The author can be contacted at p.valente@gebnetwork.it.

** Professor of Criminal Law, Turin University and President of the Centre for Criminal Tax Law. Partner of Valente Associati Studio Legale Tributario GEB Partners. The author can be contacted at i.caraccioli@gebnetwork.it.

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be a risk of criminal sanctions in regard to one of the violations (for example, the violation under Art. 4) contained in Legislative Decree No. 74/2000 with regard to "elusive behaviours".

Subsequently, the "international ruling", which also pertains to "transfer prices", was introduced (Art. 8 of Decree Law No. 269/2003) but, surprisingly, did not expressly set out particular criminal offences (in contrast to Art. 16 of Legislative Decree No. 74/2000 and Art. 11 of the Taxpayer's Statute), with the result that there is significant uncertainty in this regard that will hopefully be dealt with by way of further legislative clarification.

Due to the above, criminal cases are based on tax fraud offences. There are two specific and discrete types of cases: the filing of a "fraudulent tax return through other subterfuges"(Art. 3) and the filing of a "tax return with discrepancies" (Art. 4).

2.2. Fraudulent tax return violations

The offence under Art. 3 of Legislative Decree No. 74/2000 relates to a violation of the obligation on a taxpayer to truthfully disclose income, or, rather, the tax base, in circumstances where the fictitious accounting is artificially supported by "fraudulent means intended to obstruct the assessment".

Such a case depends on the existence of a transaction (1) that satisfies all of the conditions necessary for it to be considered "fraudulent", such as, for example, the simulation of legal transactions, the fictitious interposition of persons or the utilization of a hidden warehouse; (2) that may hinder the assessment of accounting entries; and (3) in respect of which a "false representation" ("falsification of accounts") was made. It does not appear that it would be easy to satisfy such conditions in regard to transfer pricing (since such circumstances will only occur in situations where the Italian company's management has an intention to behave in such a manner so as to circumvent an assessment or, rather, to cause the criteria adopted during inspection to become unintelligible for the purpose of verifying the arm's length principle in regard to the transactions at issue). In such circumstances criminal punishability is still not applicable unless a certain threshold is reached, as set out in Art. 3 of Legislative Decree No. 74/2000.

2.3. Violations regarding discrepancies in tax returns

Art. 4 of Legislative Decree No. 74/2000 establishes a penalty – subject to a minimum quantitative threshold that is easily met by large corporations – for tax returns that are merely discrepant, devoid of any fraudulent connotations.

The offence is simply based on the taxpayer reporting, in an annual tax return, less income or a lower tax base than what was actually the case, either by underreporting income or by claiming fictitious losses.

With regard to the definition of "gains/losses" under Art. 1(b) of Legislative Decree No. 74/2000, the issue arises as to whether or not the definition is intended to exclusively refer to "direct" income or tax base components in the strictest sense (such as, in regard to income tax, income, extraordinary items, capital losses and surplus and, in regard to VAT, fees, ancillary services, etc.).

If the answer is affirmative, this would, in fact, clearly preclude the possibility of the definition including "indirect" components, i.e. those (such as in regard to transfer pricing) that merely represent an identification and evaluation standard of the components themselves.

Furthermore, since the definition is constructed in causal terms, such a restrictive interpretation would not be in line with the specific object and purpose of the legislation, which is broader.

In this regard, it should be noted that, on the basis of two Circulars (14 April 2000 of the General Headquarters of the Tax Police and 4 August 2000 of the Ministry of Economy and Finance), the concept of "fictitious loss elements" not only refers to costs that do not objectively exist and are thus fictitious, but also to those deemed non-deductible for tax purposes, although actually incurred.

Deeming a cost to be fictitious due to it being higher than an arm's length cost, in regard to transfer pricing, would, indeed, lead to a questionable disparity of treatment – in view of the "bi-directional" scope of Art. 110 of the TUIR, which is aimed at avoiding both underreporting of income, as well as excessive cost deductions – depending on whether it refers to transfer pricing of one kind or another.

In any event, the extension to costs deemed non-deductible, introduced by the above Circulars, seems debatable; even assuming that the extension is acceptable, within the context of transfer pricing, the technical concept of tax deductibility adopted by the same Circulars does not apply.

As there is no case law on this particular issue, the relevant solution is left to the manifold interpretations of scholars.

2.4. The inapplicability of fraudulent invoicing offences in the transfer pricing area

In regard to offences under Arts. 2 and 8 of Legislative Decree No. 74/2000 (the use in a tax return or the issuance of invoices for totally or partially fictitious transactions), the intention is not to penalize estimates or valuations in regard to the transaction that may be different from estimates that are deemed to be correct, but rather the "material fact" that the transactions, either subjectively or objectively, did not in fact occur.

Therefore, in the event a transaction is challenged, a valid defence may be based on the definition of "fictitious transactions" contained in Art. 1(a) of Legislative Decree No. 74/2000, which specifically excludes issues relating to the "fairness" or "lack of fairness" of certain valuations in regard to a transfer of goods or a supply of services actually carried out or paid for. The above definition of "fictitious transactions", should not – according to the acknowledged interpretation of scholars – be deemed

applicable in regard to a violation pertaining to tax return discrepancies.

3. "Transfer Pricing" and Valuation Estimates

It should first be noted that what is meant by "valuation estimates" are estimates concerning the quantum of taxable items, such as, for example, the determination of the sales price of a building or the determination of income based on estimates or on an analytical approach. Therefore, "valuation estimates" relate to the determination of market or arm's length values. Such a definition applies, for the purposes of transfer pricing calculations, to transactions where evaluation and determination criteria regarding the transfer values are structured on essentially technical measures.

As described in 2.2. and 2.3., the new criminal tax regime contained in Legislative Decree No. 74/2000 has, pursuant to Arts. 3 (fraudulent tax return) and 4 (tax return discrepancies) made the incorrect application of valuation criteria criminally relevant.

Indeed, whereas under Law No. 516/1982, which was repealed, the scope of criminal culpability for fraudulent behaviours was restricted to cases where the falsehood was connected to "material pretenses", under the current provision, the intention of the legislator is to target tax evaders by penalizing fraudulent accounting of income debits or credits, without the need for such accounting to relate to "material facts".

Further evidence of this conclusion is found in Art. 7 of the same decree, which is entitled "accounting and financial statement findings", which provides that "findings and valuation estimates" are not criminally relevant.

It should be noted that penalties are imposed not only for false accounting entries that violate general civil provisions that are tax relevant but also in regard to mere tax violations *per se*.

The above interpretation is in line with the intention of the legislator, which has been consistently emphasized, to penalize any valuations that are based only on estimates that relate to the determination of the value of goods or services.

Furthermore, following the above interpretative method, it may be possible to reduce inconsistencies in the treatment of violations for criminal law purposes, for example, differences in treatment that depend on whether or not the accounting adjustment is made through the identification of correct transfer prices in regard to accounting entries of a civil nature or through a mere increase in the tax base.

Following the above reasoning, it is rather obvious that transfer pricing would be included within the arena of a criminal tax regime.

Ultimately, it would also be useful to comment on the issue of the value of the specific fraudulent intention in regard to the matter of transfer pricing.

In fact, contrary to a transfer of a good or supply of a service, transfer pricing calculations not only entail the determination of a price, which is a mere factual issue, but also involve estimates.

Thus, if a taxpayer uses incorrect valuation criteria and, as a result, records inaccurate transfer prices in his financial statements, but was, however, convinced of the accuracy of the interpretation provided, it would be difficult to argue that he should be liable for one of the criminal offences contained in Arts. 3 and 4 of Legislative Decree No. 74/2000.

Indeed, under such circumstances, the subjective element, i.e. knowingly committing the offence, would be absent. The existence of fraudulent intention could not, however, be determined a priori; it would need to be assessed on a case-by-case basis.

Finally, fraudulent intention can only be excluded once – even if the valuation criteria may be disregarded – accurate and fair arm's length transfer prices are calculated that are reliable and legally sound.

4. Relief under Art. 7 of Legislative Decree No. 74/2000

4.1. Introductory remarks

Art. 7 of Legislative Decree No. 74/2000 identifies two cases where sanctions are not to be imposed, both of which represent circumstances where there was no fraudulent intention to evade tax.

The first pertains to a violation of the method used to determine transfer prices for the relevant tax year, which is not punishable if such violation derives from the application of routine accounting methods and procedures. In order to benefit from this relief, the adoption of improper imputation criteria and the inaccurate accounting of profits, expenses and other income debits or credits must be the consequence of a defective accounting structure that has resulted in the repetition of erroneous "entries" for several consecutive tax years, since, in such circumstances, tax is simply deferred.

The second, which is rather interesting, concerns discrepancies and valuation estimates in circumstances where the criteria actually adopted are clearly outlined in the documents annexed to the financial statements. Given that the criteria for the estimates have been disclosed in the financial statements, there can be no argument that the taxpayer has attempted to deceive the tax authorities. In such circumstances, it is clear that the facts will not support a finding that there was intent to commit fraud for the purpose of evading tax.

4.2. Irrelevance of valuation criteria disclosed in financial statements

The above relief identifies the financial statements as the necessary means for indicating the criteria adopted. The explanatory note to the financial statements appears, however, to be the document that is designated to contain such information, in view of the fact that it highlights

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the relevant explanations regarding the criteria applied in valuing financial statement items, in compliance with Art. 2427 of the Italian Civil Code.

What might be useful in this regard is to know the extent of the information required regarding the criteria adopted in order to obtain relief under Art. 7(1).

Indeed, the non-punishability of directors in the criminal tax area appears to be dependent on overly rigorous requirements (for example, the need to indicate, not only the methods adopted, such as the "cost-plus method", but also the percentage of the margin applied). This could lead to the dangerous need to reveal industrial and commercial secrets with the consequence of a potential conflict with minority shareholders.

The role and function of the explanatory note, however, serves a civil purpose that does not lend itself particularly well to complex tax calculations such as, for example, those pertaining to inter-company transfer prices; in other words, the above document is not compatible with the complexity of estimating values for the purpose of determining taxable income.

It is the criminal judge's duty to actually verify the degree of specificity of each item and hence, the higher the degree of specificity, the less the risk of objections by the courts on the basis of the vagueness of the criteria at issue and thus, the non-applicability of the relief.

It is clear that, in order to obtain the relief, it is not necessary to attach supporting documentation to the financial statements, since there is no provision for this. Such documentation should, however, be kept amongst the corporate records, in view of the requirement that the explanatory note mention the criteria followed.

4.3. Applicability of a "Cap" under Art. 7(2) of Legislative Decree No. 74/2000

The legislator has also provided for a residual "safeguard measure" under Art. 7(2), which provides that valuation estimates that, when individually considered, are no more than 10% lower than correct valuations, will not be punishable.

The consequence is that incorrect estimates, even if they are not accompanied by an explanation in the financial statements of the criteria adopted, cannot, in any event, be subject to criminal sanctions if the threshold is not exceeded.

In essence, this provision creates a "cap" for the purpose of removing estimate-related issues where the estimates are within the above-noted threshold.

However, this provision creates a number of interpretative issues especially with regard to the phrases "correct valuations" and "individually considered".

In regard to the first, what must indeed be recognized is that the "arm's length principle" does not lead to the identification of a precise amount that could be considered "correct", but rather to a range of values, each of which is equally fair and accurate. It is particularly difficult to establish "correct" valuations on which the 10% difference must be calculated: in the presence of a range of fair values, the computation of an average of such values does not seem to be particularly reasonable, whereas a computation of the 10% difference based on one of the limit-values of the range constituting the limit of fairness, beyond which the arm's length adjustment is triggered, would make sense.

With reference to the second phrase, it should be noted that in transfer pricing cases "individually considered" should not refer to individual inter-company transactions.

It would be more logical to link the said threshold to each of the categories of transactions in respect of which transfer pricing methods were applied to transfer prices deemed erroneous.

5. Burden of Proof in the Transfer Pricing Area

The traditional interpretation of Art. 110(7) of the TUIR was that the burden of proving the validity of transfer prices, in compliance with the arm's length principle, lies with the taxpayer.

Recently, however, the above approach was significantly undermined by an important decision of the Italian Supreme Court (*Corte di Cassazione*), Tax Section,[1] which created significant controversy amongst tax experts and scholars. The Supreme Court held that the burden of proof was on the tax authorities.

The finding in the decision is as follows: it is the duty of the tax authorities to effectively prove that the taxpayer has carried out a transaction for the purpose of deducting costs in the state in which taxation is higher (thus constituting avoidance).

In the case at issue, the tax authorities reassessed tax in regard to alleged over-invoicing of goods purchased by foreign group companies, as well as costs relating to the supply of inter-company services. In these circumstances, the inter-company agreement between a foreign company and its controlled Italian company, which provided that all group companies that sell products produced by them (i.e. cars) are responsible for repair costs as a guarantee for manufacturing defects attributable to associated companies producing such goods, is not subject to Italian law but, rather, to the Vienna Convention of 11 April 1980 (approved and incorporated into Italian legislation through Law No. 765 of 11 December 1985) (the Convention), which is applicable to international sales.

According to the Court decision, in order to determine the international nature of the sale, it is necessary to refer to the place of business of the parties and, if these are located in two different countries, the sale is deemed to be international and thus, subject to the provisions of the Convention. As a consequence, Art. 11 of the Convention must be applied since it endorses the principle of freedom

1. Italian Supreme Court, Tax Section, 16 May 2007, Decision No. 11226.

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of form, pursuant to which a sales agreement need not be concluded or substantiated in writing and is not subject to any other requirement as to form, since it may be substantiated by every means, even through witnesses; thus, the agreement regarding the guarantee did not need to be formalized; nor was any specific form of agreement required in order for it to be challenged.

On the basis of the above principle, on the one hand, the Court may regard the guidelines issued by the parent company as evidence of such agreement. On the other hand, however, the burden of proof in regard to avoidance falls on the tax authorities.

The decision, therefore, stands for the proposition that the burden of proof in assessing non-compliance with the arm's length principle, under Art. 110 of the TUIR, does not fall on the taxpayer, who, during the assessment, is only required to provide evidence for and justify the prices applied in regard to goods and services relating to the international transactions. The burden then shifts to the tax authorities to prove that the said prices are inaccurate.

Subsequent court decisions have followed this approach. In one such decision of the Provincial Tax Commission of Pisa, Section II, the following principle was stated:

> [In] the matter of transfer pricing, the burden to prove that the taxpayer has engaged in an avoidance transaction falls on the Tax Authorities. In particular, the Tax Authorities must adequately substantiate that there was no sound economic basis for the difference between the price applied to related entities, compared with ordinary market conditions. Therefore, the burden of proof in the case of an avoidance transaction falls on the Tax Authorities intending to make the adjustments. Only upon such affirmative assessment, shall the burden of proof be inverted and it shall then be the taxpayer's duty to substantiate the accuracy of the transfer prices applied.[2]

The facts of the case under examination were as follows: products were sold to controlled French companies at a price that was about 10% lower than the price applied by other Italian buyers.

The decision highlights, first, that the tax authorities should have ascertained that taxation in Italy was indeed higher than in France; this determination, which is a condition precedent to characterizing the sales in question as being elusive was, however, lacking and, consequently, the first prerequisite for raising an assessment was missing.

Second, the tax authorities, in regard to this case, compared transactions that were not quite similar, with negative consequences for the proper application of the price comparison method. The transactions compared were only similar with regard to the characteristics of the goods transferred, the geographic market and the time period. According to the decision, the above is not sufficient, in any event, since it is necessary, in order to be able to discuss comparable transactions, that transactions – very similar in terms of quality, time period, location and exchange methods and, in general, also in regard to the nature and the circumstances surrounding such transactions – be identified. In order to identify comparable transactions, all those elements that, together with the characteristics of the goods, contribute to the fixing of a price for a sale/purchase (i.e. the type of transportation, delivery conditions, packaging, advertising, marketing, guarantees, payment terms and volume discounts) must be taken into consideration.

Based on this line of reasoning, the transactions relied on to make the transfer pricing adjustment could not be considered to be on the same level or be deemed analogous as:
- there was a lack of equivalence at the marketing stage;
- although the controlled company acted as a non-exclusive distributor in the French market, the same had no shops or outlets and sold only to wholesalers and large distribution companies;
- other clients carried out their activity at a different marketing stage, such as in the retail market, transferring the product directly to the end consumer.

Based on the reasoning of the decision, since the independent entities used for comparison purposes to determine arm's length prices operated at different marketing levels, the direct price comparison was not reliable for the purpose of determining an appropriate sales price.

Furthermore, the goods exchanged and the consignments forwarded to independent clients were limited in terms of quantities sold by the controlled company, which made a price reduction with a consequent discount possible. In fact, in regard to independent negotiations by private enterprises, a 10% price discount is typical and represents a legitimate business strategy when dealing with a large volume of sales.

According to the judges in the case, it can be concluded that, if the challenged provision is to be interpreted as being an anti-avoidance measure, it is necessary to identify whether, in the case at hand, evidence of such an intention actually exists. Indeed, there was no such evidence, since the unlawful tax advantage at issue never emerged; in particular, an actual transfer of profits that could be subject to taxation was not substantiated.

A recent decision of the Provincial Tax Commission of Milan applies the same principle, i.e. that, in regard to transfer pricing, the burden of proving that the transaction is an avoidance transaction falls on the tax authorities. In that case, the court held that the purpose of transfer pricing rules is to avoid a situation where profits are transferred within a company group at prices that are lower than the ordinary value of the goods, so as to avoid their taxation under the Italian tax system in favour of a foreign regime that provides for lower taxation or a more beneficial tax regime. Therefore, the evidence provided by the tax authorities to prove an avoidance intent, must be rigorous, meaning that it must be serious, accurate and consistent, so as to establish that the criteria adopted by the company should have been different from criteria applied by other companies not belonging to the group.[3]

2. Provincial Tax Commission of Pisa, Section II, 9 May 2007, Decision No. 52.
3. Provincial Tax Commission of Milan, Section V, 11 June 2007, Decision No. 194.

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In this case, the matter involved royalties paid on the basis of a franchising agreement entered into with a foreign company. The audited company had submitted agreements with companies not belonging to the group that included the same conditions laid down in the above agreement.

The tax authorities maintained that it was impossible to compare independent companies (with respect to the agreements submitted) with the company being audited, since the corporate contexts were completely different with respect to profits. But, in the decision in question, the court held that such an element alone cannot make the presumption applicable.

Hence, it seems that the line of reasoning applied by the courts is that the burden of proof in regard to a transfer of goods that is not in accordance with arm's length values falls entirely on the tax authorities and that such burden is particularly onerous (subject to certain exceptions to this strict rule that apply in particular cases).

The question then arises as to whether or not the position of the courts is applicable in the area of criminal tax law and, in particular, with regard to criminal liability for tax return discrepancies under Art. 4 of Legislative Decree No. 74/2000 when a case is referred by the tax inspectors to the Attorney General's Office, who then initiates criminal proceedings.

The answer must be negative since separate and distinct criteria apply in regard to tax litigation, which is patterned, subject to certain differences, on the structure of a civil law suit.

In criminal proceedings, in fact, there is a general rule that, in any event, it is up to the public prosecutor to provide evidence of the facts and of the defendant's culpability. As such, the burden of proof never shifts to the taxpayer.

In criminal proceedings regarding tax crimes, therefore, the judge must disregard any kind of reasoning regarding presumptions and the shifting of the burden of proof. Instead, he must follow the classic canons that provide that the "burden of proof is on the prosecution" and, at the same time, the determination depends on the "independent belief of the Judge" (which is a principle that is traditionally followed in case law).

The criminal theory that applies in this area is that set forth under Art. 4 of Legislative Decree No. 74/2000. On this basis, the Judge must first ascertain whether or not the threshold for imposing sanctions has been exceeded (with reference to the tax avoided and unreported income). If the thresholds are not exceeded the impugned behaviour will constitute only a tax violation and not a criminal offence.

Given the above, the judge will have to verify whether or not there is evidence of the impugned behaviour, i.e. a tax return that is specifically intended to avoid the taxation of a taxable item – although in the absence of tangible elements of fraud – even when the said behaviour relates to valuation transactions, such as in regard to transfer pricing.

At any rate, this does not necessarily mean that criminal liability will be imposed based on a taxpayer's violation of the criteria adopted by the taxpayer for the determination of transfer prices alone.

The facts in a particular case are to be examined with reference to the specific characteristics of the individual case.

Various scenarios, including the following, may arise in this regard:

- the chosen method may be challenged due to the fact that it is not in line with or adequate in regard to the transactions under examination. In such circumstances, the taxpayer's defence will have to focus on indicating the criteria that, in view of the OECD Transfer Pricing Guidelines and international procedures, justify the adoption of the said method;
- the chosen method is not challenged but its concrete application is (i.e. the adoption of one value rather than another within the chosen range). In such circumstances, the taxpayer's defence must attempt to highlight whatever elements justify the choice;
- the chosen method is not challenged or the values assigned, but the inspectors challenge other factual elements (for example, the type or amount of a cost incurred and different parameters to be considered). Obviously, in such circumstances the taxpayer's defence will have to emphasize any considerations that were not taken into account for the purpose of challenging the particular item.

Once the Judge determines that there are discrepancies in the tax return, he will be required to subsequently examine any possible excess in light of the 10% "cap" with reference to "individually considered valuations". If the discrepancy does not exceed the 10% threshold, no criminal offence will have been committed pursuant to Art. 7(2) of Legislative Decree No. 74/2000.

If the discrepancy does exceed the threshold, the Judge will have to ascertain whether or not the facts indicated in the financial statements with regard to the valuation criteria adopted are supported and whether or not the (more or less broad) description relating to such facts is sufficient to establish whether or not the grounds for non-punishability in Para. 1 subsist.

6. Likely Corporate Violations

Under the previous rule, Art. 2621, No. 1 of the Italian Civil Code of 1942, a punishment could be imposed in regard to transfer pricing transactions in the event there were fraudulent corporate communications, provided there was evidence of a specific fraudulent intention to cause damage to the company, the shareholders, creditors or third parties other than the tax authorities.

Now, even if there is an over-valuation or under-valuation in regard to an inter-company transaction, resulting in a shift of the tax base towards countries with lower tax rates or more preferential tax regimes, thus jeopardizing

tax revenues, in accordance with the prevailing orientation of the Supreme Court, only criminal cases relating to tax violations are punishable.

Due to the corporate criminal law amendments introduced by Legislative Decree No. 61/2002, the risk of straightforward valuation estimates being penalized under Arts. 2621 of the Italian Civil Code (fraudulent corporate communications) and 2622 of the Italian Civil Code (fraudulent corporate communications causing damage to shareholders and creditors) does not exist.

In fact, current criminal law rules require not only that the material facts disclosed not correspond with the truth but also that the estimate be supported by objectively untruthful data, for example, recording a particular transfer of goods or supply of services in the financial statements that never transpired.

Therefore, for the purposes of establishing criminal intent, the attribution of a certain value deemed "unfair" is not sufficient.

7. Entities That May Be Criminally Liable

With regard to entities that are potentially culpable in regard to tax crimes, it should be noted in respect of cases brought before the courts that, although Art. 4 of Legislative Decree No. 74/2000 uses the general expression "anyone", the entity perpetrating the crime is to be identified on the basis of general principles and, in particular, on the basis of the principle of "personal criminal liability" (Art. 27(1) of the Italian Constitution).

Surely the answerable party is the person who signs the tax return at issue. Such party cannot validly defend himself by claiming that he did not physically handle the technical aspects of the return, since the case law imposes personal liability on a person in regard to his own return and thus the obligation to file an accurate return cannot be delegated to third parties.

Furthermore, jointly with the signatory (Chairman of the Board of Directors, or Managing Director) – on the basis of general principles contained in the Italian Criminal Code (Art. 110 et seq. of the Criminal Code) – anyone who may have contributed to the fact in a significant manner is answerable; thus, in theory, the Managing and Financial Director, on the basis of his specific mandate from the corporate boards, or an external consultant (tax or legal) who, being perfectly aware of the situation, may somehow have inspired dubious transfer pricing transactions that produced a discrepant tax return, may be liable.

8. Conclusions

Italian tax law provides (in Art. 26 of Decree Law No. 78/2010) for the non-applicability of the (administrative tax) penalty set forth under Art. 1 of Legislative Decree No. 471/1997 in the event the taxpayer provides the documentation relating to the matter indicated in the Regulation issued by the Director of the tax authorities of 29 September 2010. This article has outlined the conditions that have to be met in order to be exempted from administrative violations.

Notwithstanding the fact that Art. 26 does not provide a possibility for virtuous taxpayers to also avoid the criminal tax penalties set forth (for tax return discrepancies) under Art. 4 of Legislative Decree No. 74/2000, the cooperative behaviour of the taxpayer should be considered, in terms of his provision of documentation deemed suitable to enable the tax authorities to properly carry out their tax inspections.

Annex 1: Focus on Transfer Pricing, an Unsolved Puzzle: How to Balance Administrative Penalties and Criminal Offences

Art. 26 of Decree Law No. 78/2010 states the following:

> In case of adjustment of the arm's length value of transfer prices applied within the scope of transactions under Article 110, Paragraph 7 of Presidential Decree No. 917 of 22 December, 1986, which generates higher tax or a credit difference, the penalty under Paragraph 2 [of Article 1 of Legislative Decree No. 471/1997] shall not apply in the case where, during access, inspection or audit or any other preliminary activity, the taxpayer provides the Tax Authorities with the documentation set forth in the relevant Regulation laid down by the Director of the Tax Authorities [*Direttore dell'Agenzia delle Entrate*], which is suitable for the purposes of identifying due evidence of compliance with the arm's length value of transfer prices applied. The taxpayer who is in possession of the documentation set forth under the above Regulation, is required to deliver specific communication thereof to the Tax Authorities according to the procedures and conditions therein set forth. In case of omitted delivery of said communication, Article 2 shall apply.

By means of the foregoing, the legislator's intention was to introduce special measures aimed at enhancing the efficiency of inspections by the tax authorities of financial inter-company transactions in accordance with Art. 110(7) of the TUIR. In particular, the specific aim was to create a documentation standard that would allow for the verification of compliance with the arm's length principle of transfer prices applied by enterprises to inter-company transactions.

The new provision allows multinational enterprises to benefit from a regime that exempts them from penalties for administrative violations under Art. 1 of Legislative Decree No. 471/1997 (tax return discrepancies) that may result from adjustments to the transfer prices adopted and represents a clear incentive to conform to the new documentary duty in order to prevent possible penalties that might arise during an inspection by the tax authorities. The above measure also appears to be aligned with the foundational principles that regulate the relationship

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between taxpayers and the tax authorities, and also with particular reference to the principles of cooperation and good faith provided by Art. 10 of Law No. 212 of 27 July 2000 ("Taxpayer's Statute").

The non-applicability of the (administrative tax) penalty under Art. 1 of Legislative Decree No. 471/1997 – in the event the taxpayer provides the documentation set out in the Regulation issued by the Director of the tax authorities – represents an emphatic "ground for non-punishability" of administrative violations, and is applicable if the required conditions are met.

With reference to the tax return discrepancies offence, pursuant to Art. 4 of Legislative Decree No. 74 of 10 March 2000, a certain irreconcilability persists between the communication submitted to the tax authorities, according to instructions set forth in the Regulation issued by the Director of the tax authorities of 29 September 2010, and the presence of the specific fraudulent intention involving evasion, which is a precise requirement in order for the criminal-tax case under examination to subsist. In other words, communicating that one is in possession of the transfer pricing documentation is a deed of transparency (and therefore, of good faith) that may, in no case, be confused with fraudulent behaviour specifically aimed at tax evasion.

Although Art. 26 of Legislative Decree No. 78/2010 does not voice any opinion regarding the possibility for virtuous taxpayers to also avoid the criminal tax penalties set forth (with reference to tax return discrepancies) under Art. 4 of Legislative Decree No. 74/2000, the cooperative behaviour of the taxpayer should be taken into account, in terms of his submission of proper documentation that is deemed suitable to enable the tax authorities to carry out their tax inspection activity, and for that very reason, the taxpayer should not be accused of fraudulent behaviour, i.e. for the purpose of avoiding tax.

In essence, where the discrepant tax return does not fall under the punishability requirements set forth by Art. 4 of Legislative Decree No. 74/2000 and the evidence provided by the enterprise is deemed valid, so as to exclude the application of administrative penalties, the specific condition for the identification of the "tax avoidance" offence required by the Regulation does not subsist. No criminal judge would reasonably be expected to find a taxpayer criminally liable in such circumstances.

Ultimately, the question arises as to whether or not the tax authorities are somehow obliged to report to the Attorney General, since it is the latter's duty to assess the possible existence of any criminally relevant justifications. In the case in point, Art. 51 of the Criminal Code (exercise of law) is clearly applicable, since anyone who has complied with any rule laid down by the tax authorities may not be deemed punishable. In view of the fact that it is only the judge's or the Public Prosecutor's competence to declare the non-punishability of the offence in the presence of extinctive or non-punishability grounds, the tax authorities should nevertheless report to the latter any evaluations relating thereto. Any elucidations or clarifications by the legislator on the above issues would be most welcome.

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