Transfer pricing and the Ford Italia case

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The Supreme Court refuted all of the tax authorities' challenges

The last decade saw a significant increase of transfer pricing controversies as well as assessments issued by the tax authorities by virtue of the application of Article 110, Paragraph 7, of the TUIR.[1] Notwithstanding the increasing trend of proceedings instituted by the authorities, and subsequently subjected to close examination by the Courts and the Supreme Court, a consolidated Court view that may effectively provide interpretative guidelines in the reconstruction of intercompany[2] transactions has yet to be identified.

Theories endorsed by Judges on transfer pricing matters were based on the certainty that the arm's length value must be determined through methods indicated in international guidelines (i.e., OECD Guidelines), while taking into account the fact that national tax rules contained in the TUIR impose the utilisation of the arm's length value to identify the price within a free competition framework. By virtue of this, case law has often quashed assessments issued by the authorities since they were not deemed consistent with factual circumstances.

Case law on transfer pricing matters may be broken down into two categories:

i. tangibles, and

ii. intangibles and services.

We note that the authorities' attention mainly focuses on intercompany transactions relating to the exchange of services and the exploitation of intangibles involving royalties, interests and various kinds of intercompany services.

Some particular operative difficulties about the exchange of intercompany intangibles and services have been encountered, not so much for the inherent complexity of the goods/assets, but rather for the substantial difficulties in the gathering of actually comparable independent transactions.

As discussed in this article, one of the most debated topics in transfer pricing relates to the burden of proof and the obligation (or rather, the duty[3]) relating to documentation, which multinational enterprises must fulfil to show that prices applied to transactions with associated enterprises are at arm's length.

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In particular, compilation of documentation presents some difficulties as differences in both legal and economic aspects in the various countries in which group companies are based do not facilitate the tracing and collecting of adequate documentation. The identification of comparable transactions can be complex, particularly in the case of certain kinds of intangibles.

With particular reference to this topic, the Supreme Court appears to have confirmed that the burden of proof of non-compliance with the arm's length principle in transactions between associated companies lies with the authorities.

I. The "Ford Italia" case

In the Ford Italia case,[4] the Supreme Court refuted all of the tax authorities' challenges, acknowledging the taxpayer's right to compute and deduct from its own taxable income the following expenses:

- the purchase price of tangibles (i.e., cars), inclusive of costs relating to repairs and maintenance of new cars which, according to Italian Law, should be charged to the manufacturing company but which, in the case at hand, were shifted to the purchaser (Ford Italia) by virtue of a valid group agreement (determining thus a lawful deduction of the taxable base of the Italian purchasing company, to the advantage of other group companies located abroad);
- the costs charged by an associated company, for services which are, in turn, charged also by another company supplying centralised services by virtue of a cost sharing agreement (in which case, according to the Judges, costs are not duplicated);
- promotional expenses, which although considered by the tax authorities as "entertainment" expenses, actually refer, according to the Judges, to advertising expenses, since their real purpose is to increase the company's business volume by enhancing the activity thereof.

In the case under examination, the Supreme Court established that the cost sharing agreements were especially significant regarding the relational aspect with the tax authorities of the relevant countries, irre-

spective of the form they were drawn up in. Pursuant to the Court, the tax authorities should have complied with OECD Guidelines[5] on the matter of transfer prices, according to which the burden of proving the existence of an assessment basis for higher tax falls on the tax authorities, which are required to compare transaction prices with those identified in transactions between independent parties, possibly using any difference found to challenge the transfer of taxable income to Countries with comparatively lower taxation..

In a number of pronouncements, the Supreme Court has also asserted that in transfer pricing controversies the onus is on the tax authorities to prove, by analytical reconstruction of remunerations applied by independent parties, the existence of any presumed difference between:

- inter-company prices actually applied;
- the arm's length value of transfers or services.

The Supreme Court direction is based on the realisation that there is a prevalence of rules and procedures commonly accepted within the OECD, which put the burden of proof on the tax authorities of member and non-member Countries.

Thus, the Italian legal system has acknowledged the OECD Guidelines procedure regarding transfer pricing, first referred to by Circular No. 32 of September 22, 1980, and No. 42 of December 12, 1981 and subsequently confirmed by the Regime issued by the tax authorities Director on September 29, 2010, after the entry into force of provisions governing transfer pricing documentation set out under Article 26 of Decree-Law No. 78/2010.

With respect to results in proceedings regarding transfer pricing, it should be noted that, in most cases, Judges have disregarded the claims advanced by the Italian tax authorities. Most noteworthy is the fact that the Judges encountered some difficulties when having to decide on questions relating to the exchange of tangibles, and in certain cases also of intangibles, due to the lack of shared benchmarking charts.

With regard to intangibles, it may be observed that, occasionally,[6] Judges have endorsed the behaviour of the tax authorities, even where, during assessment, the determination of inter-company prices was obtained through the mere application of the measure[7] set out for royalties under Circular No. 32/1980, without taking into account the fact that as the Circular "admits", said measure must be interpreted only as a mere indication to further examine the assessment. In such cases, the Judges found that the auditors had limited their examination to a comparison of the price against the royalties established by independent taxpayers in the same sector, without in any way verifying whether the potential yield deriving from the exploitation of certain intangible assets was more or less comparable.

Generally, the response towards the taxpayer seems to be essentially favourable by both the Court and the Supreme Court which have, in most cases, rejected the claims advanced by the authorities, basing their judgments on the inadequacy of the evidence produced by the inspectors; what should be noted is that, while the Court has kept a certain basic consistency in its pronouncements, the Supreme Court has adjusted, over time, its "beliefs" until reaching the point of introducing, in the jurisprudential panorama, the concept of *"economic character"*, borrowed from corporate economics. By force of the foregoing principle, the Judges established in certain decisions[8] issued in 2002, that the entrepreneur does not have the indisputable right of choice in his own economic initiatives, which must be consistent with the principle of economic character and thus upheld, albeit only partially, the tax authorities' requests. As expected, the orientation of the Supreme Court, in some cases, was referred to and subsequently confirmed.[9]

Ultimately, we may surmise that the lack of a reference standard, on the one hand, and the (perceived) vagueness of the subject-matter, on the other, have rendered the creation of a uniform jurisprudential view rather difficult, inducing the Judges quite often to settle controversies by means of confused reasoning, often inconsistent with respect to the principle of free competition suggested by the OECD.[10]

Having concluded the essential foregoing premise, we shall examine Decision No. 11226 of March 23, 2007, issued by the Supreme Court with regard to *Ford Italia S.p.A.*, which offers us a starting point for a closer examination of one of the few, but well-established, jurisprudential decision on transfer pricing, that relating to the burden of proof and to the *"proof of the burden"*.[11]

II. The controversy

At the date of the facts under examination, Ford Italia S.p.A. belonging to the US Ford Group, operating in Italy as a distributor-seller of vehicles bought from its own associated European companies and produced in factories located in Germany, Spain and the UK.

As a consequence of a tax audit carried out by the Tax Police Force of the Italian Revenue Service, with reference to the years 1987-1992, the Rome tax authorities issued a tax assessment notice relating to the 1991 tax period, by means of which it recaptured the tax from alleged over-invoicing on cars purchased by foreign group companies, including expenses for the supply of inter-company services as well as entertainment and promotional expenses that were irrelevant.

In particular, the tax authorities assumed the existence of a cost that was higher than the arm's length value,[12] since the Ford Italia company assumed, without receiving any remuneration whatsoever, the burden – which pursuant to the law falls on the manufacturing company – for the repairs and maintenance of the new cars, achieving thus a reduction of the taxable base in Italy to the advantage of companies residing in countries with a more favourable tax regime.

The tax authorities also noted that the Italian company entered into an agreement with the US parent company, on the basis of which some of the services that were of common utility to the entire Group were entrusted to Ford Europe S.p.A. which re-invoiced European companies, including Ford Italia, for a yearly development project.

Some of the services set forth under the agreement (i.e., advertising, the fitting out of motor showrooms, sports programmes, flyers, etc.), further to being invoiced by Ford Europe S.p.A., are also invoiced by other European companies, on the basis of specific agreements, determining, according to the authori-

ties, an unlawful duplication of costs at the level of Ford Italia (which benefited from such services).

With regard to the facts above described, first the provincial Tax Commission and subsequently also the Regional Tax Commission, expressed their opinions in favour of the taxpayer, therefore the tax authorities appealed to the Supreme Court against the decision of the Regional Tax Commission.

The tax authorities, in upholding their reasoning, maintained that there was no "documentary proof" adequately to support the application of a guarantee provision in the determination of transfer pricing and to justify the application of the regulations on international sales[13] in derogation of the Italian regulations.[14] According to the tax authorities, since the Italian company had not requested any price reduction because of the costs incurred, the purchase costs continued to be recorded at the initial disproportionate super-value as opposed to the effective cost of goods, entailing a consequent reduction of Ford Italia S.p.A.'s profits in favour of foreign companies.[15]

In the assessment notice issued to Ford Italia S.p.A., the tax authorities restated tax relating to alleged over-invoicing of cars purchased from foreign Group companies because they deemed that the cost attributed for repairs and maintenance (on the basis of Ford's group guidelines) were merely a scheme to transfer some of the taxable income to foreign associated companies.[16]

The Supreme Court did not share the above approach and maintained that the authorities had not provided sufficient evidence to properly support their thesis, since they should have been able to demonstrate that the transactions carried out by the Italian company were actually performed with the specific purpose of transferring taxable matter abroad.

According to the Judges, the tax authorities (disregarding provisions under the Vienna Treaty) had based their conclusions exclusively on the absence of a written agreement providing for the recovery of repairs and maintenance expenses incurred by Ford Italia S.p.A.

The tax authorities should have first ascertained whether taxation in Italy was actually higher at the time than that applied in the countries where the associated companies resided. This was never supported by a proper analysis explicitly stating that there was any difference in taxation in the associated companies' countries of residence which would provide the necessary evidence the that a tax saving might have been actually engendered by inter-company transactions.

Having quantified the differences in terms of tax rates, the authorities should have evaluated the exchange values to determine the arm's length value of transactions carried out. The analysis should have provided "a concrete verification of the remunerations paid by the same to its own foreign associated companies to ascertain whether these were actually higher than such value by extending the analysis to ensure that the profit margin sufficiently covered repair expenses provided under the guarantee (. . .)".[17]

Considering the lack of evidence, the Supreme Court rejected the tax authorities' appeal in all aspects, splitting the expenses.

III. The Judges' evaluation

The Supreme Court has, with this decision, re-examined the concrete application of the transfer pricing regime, asserting once more, in line with statements previously expressed,[18] that the burden of proof in transfer pricing controversies lies with the competent authorities which intend to apply the consequent adjustments to the taxpayer's income.

In this particular case, the *thema decidendum* is expressed in the evaluation of the grievances lodged by the tax authorities:

a. over-invoicing of the cars relating to inter-company purchases between Ford Italia S.p.A. and its European sister companies (manufacturers/sellers);
b. duplication of costs relating to certain inter-company services invoiced by both Ford Europe S.p.A. and its associated companies (i.e., Ford UK);
c. requalification of advertising and promotional campaign expenses incurred and deducted by Ford Italia S.p.A. as entertainment expenses.

It should be understood that the rationale, as explained by the Judges, mainly involves point a., since the main challenge by the tax authorities revolves around over-invoicing, while arguments regarding b. and c. were discussed in the final two pages of the Judges' purview, since these are of a lesser significance.

Having stated the above, with reference to b., costs duplication, the Judges maintained, without doubt, that as an inter-company agreement had been in force since 1967, Ford Italia S.p.A. could freely purchase any service from other enterprises (e.g., Ford UK). Consequently, the lawfulness of cost reduction and the refutation of the tax authorities' theory, was further substantiated by faulty motivation, since pursuant to the Court, the tax authorities motivated their claim solely through a mere deferment *per relationem* to the Official Record of Findings of the Tax Police, without expressing any judgments on the challenged findings.

Regarding c. above, the Judges highlighted the uncertain borderline between advertising and entertainment expenses, resolving to share the defence's reasoning that the challenged expenses had the purpose of increasing the business turnover of the company by enhancing the activity thereof. In this instance also, the Judges refuted the authorities' view.

Returning to a. above, the authorities asserted in the assessment notice *de quo* that:

> "the foregoing being without prejudice to the contractual autonomy, since the matter concerns international transactions, commercial relations must take national regulations into account for tax purposes on evaluations, and, in this particular case, of provisions set forth under Article 76 (currently Article 110) of the TUIR, on the arm's length value of goods transferred, which could not possibly be such, had Ford Italia S.p.A. assumed entirely the economic burden for replacement and repair of vehicles vitiated by production defects, reimbursing dealers and authorised repair shops for material and labour used in a large number of repair services".

In this case, therefore, the question submitted to the examination by the Supreme Court,[19] concerns the accounting and deduction (unlawful according to the authorities) of costs relating to the purchase of cars by Ford Italia S.p.A. from foreign associated companies

 TPIJ ISSN 2042-8154

in the Ford group. The authorities deemed the costs excessive since they were inclusive of repair and maintenance charges which, instead of being borne by the (US) seller, as provided by the Civil Code, were (unlawfully) charged to the Italian company by effect of specific inter-company agreements signed in 1967 and considered inapplicable by the authorities.

The Court, on the other hand, established that the agreements were fully relevant even with regard to relations entered into with the tax authorities of each relevant country, "in whatever form these might have been drawn up", by virtue of principles dictated by Article 1 of the Vienna Treaty.[20]

The Judges also asserted that the Italian Tax Authorities, by referring to the transfer pricing regime, should have complied with the Transfer Pricing Guidelines, according to which the burden of proof falls on the authorities, with the consequent duty to compare transaction prices with those that may be identified in comparable transactions among independent parties.

The taxpayer (Ford Italia S.p.A. in this case) was not required to demonstrate the accuracy of transfer prices applied, if the tax authorities have not first provided evidence of non-compliance with the arm's length principle, as further elucidated by the Supreme Court.[21]

In particular, pursuant to the Supreme Court, the Italian authorities should have, above all, ascertained if (at the time the facts occurred) the applicable Italian Tax Regime was more burdensome than regulations in force in the countries of origin of the vehicles. As a consequence, the tax authorities should also have verified the actual level of prices applied in comparable transactions carried out by competitors.

Ultimately, as expressly stated by the Judges, with the Decision under examination, the Tax Section of the Supreme Court intends to ratify the jurisprudential view previously expressed with reference to the assessment for the 1980 tax year,[22] according to which the burden of proof of non-compliance with the arm's length principle falls on the authorities.

IV. Burden of proof

A. Introduction

With reference to the concept of "*onus probandi*" in transfer pricing controversies, what should be noted *in primis* is that, in case of income losses/costs, case law acknowledges the duty at taxpayer level to provide evidence of all factual bases that might reduce the tax burden.[23]

It should nevertheless be highlighted that, in controversies pertaining to assessments of higher income gains, the Judges' line of reasoning is based on the analysis of the ratio contained in provision No. 110, Paragraph 7, of the TUIR, introduced "for the purpose of avoiding that taxable matter might be transferred abroad".[24]

In the first place, we may observe that compliance with the burden of proof in transfer pricing is no different from the dialectics that are established between the taxpayer and the tax authorities with reference to other tax cases: indeed, it is the authorities' duty to demonstrate the existence of higher income gains, while the taxpayer is required to provide all factual bases that may reduce the tax burden (i.e., competence, relevance, certainty, accuracy, etc.).

With regard to the Decision under analysis,[25] and particularly with reference to a., above, we note that the Judges have focused on the case of avoidance, which consists in the transfer of taxable matter to countries where taxation is more advantageous than it is in Italy.[26]

Nevertheless, according to the national Legislature, this aspect should not be especially significant for the valuation of transfer prices, if we consider that inter-company transactions are subject to compliance with the arm's length principle.[27] So then, Article 110, Paragraph 7 of the TUIR should be a rule (on evaluations) aimed at the taxpayer, who must take it into account when filing his tax return. Accordingly, the burden is on the taxpayer to provide proof as to the absence of any variance from the arms' length value.

The arms' length principle is a legal criterion that must be observed by anyone who wishes to rely on it (whether it be the authorities or the taxpayer). Where there is disagreement, the tax authorities must proffer a different price for adjustment purposes when determining the arm's length price, as well as justification thereof.

If the cost has been challenged in its existence or its relevance, there is no reason to search for an arm's length value since, in either case, the adjustment would entail the application of the ordinary provisions under Article 109 of the TUIR.

The burden of proof referred to by the Supreme Court is in effect a burden of argument since we are faced with a proof of values, with characteristics that are different from "general proof". It would not, therefore, be proper to refer to "evidence and counter-evidence" in a theoretical sense but rather to "argument and counter-argument" that may mainly manifest the dialectical nature in an encounter between the authorities and the taxpayer with reference to the application of the transfer pricing regime.

In the past few years, a number of significant decisions have been issued by both the Court and the Supreme Court which contributed to define the proper assignment of the *onus probandi* in transfer pricing controversies.

For a comprehensive analysis of the Judges' evaluations, we shall hereinafter examine the concept of the "burden of proof", as applied in the transfer pricing regime, as construed by the Supreme Court in Decision No. 22023/06, correlated to the Decision under analysis, since referred to the same Official Records of Findings of the Tax Police but relating to the assessment of the previous year (1990).

B. The Supreme Court position

The Supreme Court dealt for the first time with the subject of the burden of proof in transfer pricing in Decision No. 22023 of June 22, 2006,[28] which derives from the same inspection relating to Decision No. 11226/07, is the subject-matter under examination.

The controversy concerns the Ford Italia case (but refers to 1990) and originates from the same circumstances described above; nevertheless, in Decision No.

1226/07, the Supreme Court explicitly refers to it, using it as the basis for refutation of the tax authorities main theory regarding the assessment for the 1981 tax period, therefore it may be useful briefly briefly to refer thereto.

The above being stated, we may note also that in Decision No. 22023/06, the authorities, following the theory advanced by inspectors, assumed a higher cost with respect to the arm's length price to be established according to the joint provisions of Articles 76, Paragraph 5 (presently Article 110, Paragraph 7), and 9 of the TUIR, based on the fact that the associated Italian company of the Ford group, the distributor in the Italian market, assumed without any remuneration the burden of repairs and maintenance of new cars that falls, *ex lege*, pursuant to Article 1490 of the Civil Code, on foreign manufacturing companies of the group, achieving thus a reduction of the taxable base in Italy "to the advantage of higher gains of associated companies operating in countries with lower taxation".

After having qualified the transfer pricing regime as an anti-avoidance clause, the Supreme Court established that:

> "the burden of proof in the recurrence of avoidance bases falls, in any case, on the tax authorities that intend to apply the consequent adjustments (. . .) The above is further substantiated in the matter of transfer pricing, since the OECD Guidelines (. . .) in the 1995 Report specifically highlighted that, where the regulations of each national jurisdiction establishes that the burden of proof fall on the tax authorities to prove their claims, the taxpayer is not required to demonstrate the accuracy of transfer prices applied, unless the tax authorities themselves have provided evidence, prima facie, of the non-compliance with the arm's length principle (. . .). Well then, the tax authorities (. . .) should have, first and foremost, ascertained whether taxation in Italy was indeed higher with respect to taxation in force in the source-countries where the bought/sold vehicles originated from. In the second place, they should have determined the arm's length prices of vehicles purchased by F. Italia by actually verifying, if remunerations paid by the same to its associated foreign companies were indeed higher than such value by extending the analysis to ensure that the profit margin sufficiently covered repair expenses provided under the guarantee as well as an analysis of automotive market conditions through a comparison of prices applied within the F. group with those applied by competitors".

In Decision No. 22023/06 (as in the subsequent Decision No. 11226/07), the Supreme Court established that the taxpayer is not required to demonstrate the accuracy of transfer prices applied, if the tax authorities themselves do not demonstrate *prima facie* the non-observance of the arm's length principle.[29]

To substantiate this view, it may be useful to briefly refer back to another pronouncement by the Supreme Court (Decision No. 1709/07) where the Judges, although with a different logical-juridical procedure, stated the same principles.

C. Decision No. 1709/07

In Decision No. 1709/07, the Supreme Court, drawing inspiration from a controversy relating to the proof of existence and relevance of costs, lingers, *inter alia*, on the application of the transfer pricing regime contained by Article 110, Paragraph 7 of the TUIR.

The litigation with the tax authorities originates from an Official Record of Findings by which means the tax authorities re-calculated losses for the 1992 tax year, based on the non-deductibility of costs recharged to the Italian company by its foreign holding for an employee of the same (a Sales Manager) relating to a period of secondment in Italy.

The Supreme Court, by upholding the appeal of the tax authorities, underlines how the Judges, in evaluating the documentation produced by the company for the purpose of verifying the nature and the value of the services subject to challenge, as well as the advantages realised by the Italian company, must be aligned with the following legal principle:

> "(. . .) the burden of proof and the relevance of a cost fall on the taxpayer; as to costs deriving from services supplied by foreign holding companies to a controlled Italian company, the said burden includes each element that allows the tax authorities to verify the arm's length value of the said services".

The Decision under examination, therefore, restates the general principle according to which, in case of income losses/costs, the burden of proof falls on the taxpayer.

It should nevertheless be further underlined that, the logical-juridical procedure of the Supreme Court does not, in this case, originate – differing from Decision No. 22023/06 – from the actual application of Article 110, Paragraph 7 of the TUIR but rather from the verification of compliance with the principle of relevance under Article 109, Paragraph 5 of the TUIR according to which

> "expenses and other losses different from tax losses, with the exception of legal, social security contributions as well as socially useful contributions, are deductible if and to the extent that they relate to assets or goods that generate proceeds or other proceeds that contribute to the formation of income or that do not contribute thereto, since they have been excluded (. . .)".

With reference to the case in point, it is therefore possible to assert that, in theory, it is the taxpayer's duty, according to general criteria, to provide all of the necessary elements to support the deductibility of costs incurred to obtain services provided by the foreign holding, among which the effective utility of the costs themselves for the controlled company.

D. The position of the Court

As to the Court's position, it is worth noting that, in 2005, the Provincial Tax Commission of Milan had dealt, *inter alia*, with the issue of the burden of proof in transfer pricing.

The controversy to which the Provincial Tax Commission's pronouncement referred originated from the tax authorities findings according to which sufficient evidence of the advantages received by the associated Italian company, with respect to the services provided by a European service centre, and of the consequent fairness of remunerations paid, had not been provided.

With reference to the burden of proof, the Milan Tax Commission stated that:

> "it is the Tax Authorities' duty – within the framework of the general principles governing the burden of

proof – to demonstrate the existence of the constituent facts of the advanced higher tax claim, by providing evidence of the circumstances and of the disclosing elements relating to the existence of a higher taxable base, while it is the taxpayer's duty to demonstrate income losses and consequently, among these, also costs with reference to both, existence and relevance thereof (. . .)".

The principles expressed in the Supreme Court's Decisions Nos. 22023/06, 11226/07 and 1709/07 relating to the existence of the burden of proof at the tax authorities' level were also acknowledged by Decision No. 52 of February 26, 2007,[30] of the Pisa Provincial Tax Commission which established that the "burden of proof, pursuant to the regime's applicability falls on the tax authorities which are required to demonstrate that the difference between the price applied to inter-company entities, when compared to ordinary market conditions, does not find any adequate economic justification".

In the case ruled by the Pisa Judges, the controversy derived from the restating of tax for proceeds that had not been recorded subsequent to the transfer of products by an Italian company to its French subsidiary at a price lower than arm's length. In particular, the Commission emphasised that, if the transfer pricing rule must be construed as an anti-avoidance provision, it is necessary to establish whether the relevant elements of such intent actually exist.[31]

V. Documentation

As a consequence of the above amendments, the tax authorities' Director issued a Regime on September 29, 2010 providing procedural guidelines for the compilation and content of transfer pricing documentation for the purpose of avoiding penalties, and in order for such documentation to be deemed suitable. The *de qua* rule does not set forth a documentary burden, but only an optional duty that is aimed at the above-said non-application of penalties.

One of the most salient aspects of transfer pricing policies concerns the documentation required to justify inter-company prices applied, in case of tax audits.

National regulations have recently adopted specific definitions determining the suitability of documentation pursuant to the enactment of Article 26 of Decree-Law No. 78/2010,[32] which establishes that administrative penalties (and likely also criminal penalties) will not be applied to MNEs which have provided documentary evidence of inter-company exchanges where a tax audit relating to transfer pricing may give rise to an adjustment of taxable income.

Prior to the enactment of Article 26 of Decree-Law 78/2010, a specific legal provision governing the matter under discussion was lacking; said gap was partially filled by the general provision under Article 32 of Presidential Decree No. 600/1973, which allowed tax authorities to request information and documentation, even in the form of questionnaires, to ensure that costs incurred were:

- relevant to business;
- lawful;
- accurate.

Further to amendments introduced by Article 26 to Legislative Decree No. 471/1997 and subsequent clarification provided by the tax authorities' Director, Italy aligned itself with other countries in the OECD which have adopted transfer pricing documentation.

Moreover, in structuring their elucidation on the application of the new rule, the tax authorities expressly referred to the Transfer Pricing Guidelines and to the principles ratified by the European Union on transfer pricing. In particular, the Transfer Pricing Guidelines provide a comprehensive picture of the rules to be followed in the compilation of adequate documentation in support of MNEs' transfer pricing policies.

VI. Burden of proof

As far as Italy is concerned, the Supreme Court's Tax Department[33] established that the burden of proof for non-compliance with the arm's length principle falls on the tax authorities.

On a legal level, it is worth noting that Article 110, Paragraph 7 of the TUIR constrains the tax authorities' actions, while not releasing them from having to prove avoidance; on an operational level, problems are more pressing and, on occasion, are not properly solved by the authorities which, rather than proving variance between transfer prices and arms' length value, merely re-qualify the transaction; this is often censured by Tax Judges.

It is nevertheless the tax authorities' duty to demonstrate where there are higher gains than those initially reported, and to provide evidence for adjustment purposes. In particular, the Supreme Court specifies that:

> "(. . .) the burden of proof in the recurrence of avoidance bases falls, in any case, on the tax authorities that intend to apply the consequent adjustments (ex multis, Supreme Court's Decision No. 4317/2003) . The above is further substantiated on the matter of transfer pricing, since the OECD Guidelines, which have long since been involved in developing determination criteria for transfer pricing entailing international transactions (in effect, the arm's length price should emerge from an external comparison with said remuneration against the price applied in a similar sale carried out by independent enterprises or by an internal comparison between a group enterprise and an independent third party), in the 1995 Report specifically highlighted that, where the regulations of each national jurisdiction establishes that the burden of proof fall on the tax authorities to prove their claims, the taxpayer is not required to demonstrate the accuracy of transfer prices applied, unless the tax authorities themselves have provided evidence, prima facie, of the non-compliance with the arm's length principle".

Furthermore, the tax authorities may not demand more documentation from taxpayers than the minimum deemed necessary to facilitate the inspection. The authorities' need to obtain complete documentation from the organisation under audit must not, however, represent an excessive burden for the enterprise deriving from:

a. difficulty in tracing and compiling documentation from foreign associates in a short time-scale;

b. the burden of researching comparables.

Regarding a., the OECD has clarified that tax authority requests for proper documentation must not involve documents that the enterprise does not hold or cannot obtain.

A list of documents and other information which, according to the OECD (and pursuant to the Director's Regime, MNEs ought to be able to produce includes a description of:

- transactions similar to the taxpayer's intercompany transaction;
- the business activity carried out;
- organisational group structure;
- shareholdings within the group;
- total turnover with regard to economic impact of preceding years;
- intercompany transactions against third party transactions;
- methods adopted for the determination of transfer prices and their motives;
- any special circumstances which may impact on the arm's length principle;
- business and industrial conditions of the group;
- various corporate functions and possible risks assumed by associated enterprises involved in intercompany transactions;
- intercompany financial flows;
- negotiations to determine or adjust the prices of inter-company transactions.

As the taxpayer under audit will have to justify the transfer pricing policy adopted in light of the documentation available at the time of audit, it is important to have documentation which has been contemporaneously produced. Before setting intercompany prices, the taxpayer should verify that there is supporting data on comparable transactions, and that any changes of conditions relating to transfer prices are documented.

The European Union supports the OECD in the view that enterprises must produce supporting documentation in proportion to the complexity of the transactions under audit. This approach encourages a general principle of prudence in the development and structure of transfer pricing policies and supports continuous research of comparable transactions to document:

- characteristics of products/services being exchanged;
- analysis of functions performed by related parties;
- analysis of assets utilised;
- verification of risks incurred;
- contractual conditions established, bearing in mind the methodologies applied to regulate burden, risk and responsibilities;
- economic conditions in jurisdictions where group entities are located;
- strategic aspects, e.g. penetration of a new market or start-up.

Consequently, the optional duty pertaining to documentary support of transfer prices contained in the Italian Regime should lead to the compilation of documentation which is adequate to support the approach adopted, and thus avoid the application of penalties if income is adjusted.

VII. The Judges' decision

The pronouncement *de qua*, although examining various subjects (duplication of inter-company costs, application of the Vienna Treaty, deductibility of promotional and entertainment expenses) lingers on the burden of proof in transfer pricing, referring to the concept of the documentary burden which has been subject to innovative provisions within the internal Regime, by effect of Article 26 of Decree-Law No. 78/2010.

The Judges confirmed that which was previously stated[34] in relation to Ford Italia, that the burden of proving non-compliance with relation to the arm's length value, falls on the tax authorities. It seems quite reasonable, where the taxpayer has gathered appropriate documentation which follows ministerial ordinances,[35] that it is the responsibility of the authorities to challenge the data produced. In Ford Italia, it may be observed that the Judges looked unfavourably on the authorities' behaviour, particularly with regard to the evidence they produced to support their accusations.

In attempting to prove inconsistency with the arm's length price, the authorities should have:

- complied with the OECD Guidelines which require that tax authorities prove their assessment by comparison with similar transactions between independent parties
- demonstrated that transactions were actually carried out by the Italian company with the specific purpose of transferring taxable income abroad;
- ascertained whether taxation in Italy was actually higher at time of the transaction than that in the associated companies jurisdiction of residence, which would have resulted in a tax-saving being made through the intercompany transaction;
- after discovering the overseas tax rates, should have evaluated exchange rates to determine the value of intercompany transactions. The analysis should have verified remuneration paid to the company's foreign associated companies to ascertain that the profit margin covered repair expenses provided under guarantee. The analysis should have been carried out following the methods indicated by Circular No. 32/1980; the Judges noted that an analysis of "(. . .) automotive market conditions through a comparison of prices applied within the Ford group with those applied by competitors" should have be provided.

In conclusion, given that all the steps listed above were omitted, the Supreme Court decided to reject all of the grievances advanced by the tax authorities in the appeal, splitting the expenses relating to the proceedings.

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NOTES

[1] *Testo Unico delle Imposte Sui Redditi*, i.e., Italian Income Tax Code, hereinafter "TUIR"

[2] For a comprehensive analysis of inter-company transactions, please see Valente P., *Manuale del Transfer Pricing*, Milano, 2009, p.1583 ss. (i.e., Transfer Pricing Manual, Milan, 2009, p. 1583 et seq.).

[3] Italy does not provide any documentary requirement but rather, only an optional duty at taxpayer level, that provides for the non-application of penalties in case of adjustment of taxable income. Said duty was introduced by Article 26 of Decree-Law No. 78 of May 31, 2010, (so-called "corrective regulation"), which was published in the Ordinary Supplement No. 114 to the Official Gazette No. 125 of May 31, 2010, and became effective on the same day. The Decree-Law No. 78 was subsequently converted into Law No. 122 of July 30, 2010, pub-

   ISSN 2042-8154

lished in the Ordinary Supplement No. 174 to the Official Gazette No. 176 of July 30, 2010. The ministerial clarifications regarding the compilation, contents and e-transmission of the documents have been provided by the Tax Authorities Director's Regime dated September 29, 2010.

[4] Decision No. 11226 of March 27, 2007

[5] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris, 1995.

[6] Cfr., *ex multis*, Decision No. 387 of 19 November, 1998, by means of which the Provincial Tax Commission of Ravenna refuted the fairness of royalties paid by an Italian manufacturing company to the US holding by reason of a licensing agreement for the use of the trademark as well as the technological and productive know-how, The commercial agreement provided for the payment of a royalty equal to 7% of the Italian company's turnover; a percentage that was however judged disproportionate by the Tax Authorities in relation to the economic contents of the agreement. Indeed, with regard to the tax treatment of inter-company transactions relating to intangibles, Circular No. 32/9/2267 of 1980 sets forth that any royalty exceeding 5% of the turnover is deemed fair for tax purposes only under exceptional circumstances, i.e., for goods/assets with considerable technological contents. On the contrary, in this particular case, the inspectors' view was that the audited company did not submit any factual elements that could aptly justify the amount of royalties actually paid. In fact, the circumstances according to which the contractual relationship with the holding, originally entered into at the end of the 60s, had been repeatedly renewed throughout the years without any substantial changes, allowed to presume that the subject-matter of the right of use was not, in effect, characterised by significant technological contents, Furthermore, having realised that the same company was carrying out its own research and development activity aimed at the achievement of its own know-how, contributed to supporting the inspectors' theory. On the basis of such elements, the Provincial Commission of Ravenna, did thus uphold the petition of the Tax Authorities, recognising the taxpayer's tax deductibility of royalties equal only to 2% of the turnover realised. On the other hand, the observance of the principle of correlation between costs and proceeds on an accrual basis imposes that also royalties (just as are all other cost categories) be tax deductible within the extent that they manifest the capacity of producing future economic benefits, or rather, as long as they turn out to be proportionate with regard to achievable advantages from the economic exploitation of goods/assets and rights under a licence. A proportion which, in the case in point, the Tax Authorities felt could be qualified within a maximum of 2% of the turnover.

[7] The amount of the royalties referred to is identifiable in the percentages indicated under Circular No. 32/1980; the latter, as a matter of fact, provides separate documentary duties to support the deductibility of inter-company royalties upon increase of their percentages:
a) Royalties of up to 2% of the turnover shall be accepted by the Tax Authorities when:
The transaction is based on a written contract and is prior to payment of fee;
The utilisation is amply documented and thus, the relevance of the cost incurred;
b) Royalties ranging from 2 to 5% might be deemed fair, further to the conditions under the previous point above, if:
The "*technical*" data justify the declared rate (carrying out research and experiments, obsolescence less than one year or less, technical life, originality, results achieved, etc.);
The declared rate is justified on the basis of "legal" data deriving from the agreement (exclusivity rights, right to grant sub-licences, right of exploiting discoveries or development of intangibles, etc.);
Actual utility achieved by licensee is substantiated.
c) Royalties higher than 5% of turnover shall be recognised only for exceptional cases that might be justified by a significant technological level of the economic sector in question or by other circumstances;
d)Royalties equal to any other amount paid to companies residing in countries with low taxation rates, may be admitted for deduction purposes and deemed fair only on the more onerous conditions set out under point c).

[8] Cfr. Supreme Court for Civil Cases, Tax Section No. 6337 of May 3, 2002 and Supreme Court for Civil Cases, Tax Section No. 10802 of July 24, 2002.

[9] Cfr. Provincial Tax Commission of Vicenza, Section VII No. 1070 of February 13, 2003.

[10] For further information regarding case-law on the non-deductibility of costs for non-economic aspects of the transaction, please refer, without any claim to exhaustiveness, to the following notes on Decisions:
On the questionability of remunerations paid to Directors, Supreme Court, Tax Section, Decision No. 12813 of September 27, 2000; Supreme Court, Tax Section, Decision No. 13478 of October 30, 2001;
On the questionability of remunerations paid to participating associates, Supreme Court, Decision No. 20748 of September 25, 2006;
On the non-economic aspect of a Director's activity carried out without receiving any remuneration, Supreme Court, Tax Section, Decision No. 1915 of January 29, 2008;
With reference to the case of an altered Bill of Lading, Supreme Court, Tax Section, Decision No. 1821, of February 9, in Tax Review 2001, 211 et seq. (*i.e., Rass. trib., 2001, 211 ss.*;)
On the topic of discrepancies between proceeds and costs of machinery and equipment as well as between costs and proceeds for staff, Supreme Court, Tax Section, Decision No. 11645 of September 17, 2001;
With reference to a case of disproportionate valuation of used machinery, Supreme Court, Tax Section, Decision No. 6337 of May 3, 2001;
For a case of non-economic aspects of the rent of real estate, Supreme Court, Section V, Decision No. 398 of January 24, 2003;
Again on the non-economic aspects of rents, Supreme Court, Tax Section, Decision No. 7680 of May 25, 2002;
For a case of non-economic aspects referred to the rental fees of boats and cars among group companies, Supreme Court, Tax Section, Decision No. 10801 of July 24, 2002;
On the non-economic behaviour of a company which, in the presence of income recorded in the financial statements, did not provide to the charging of interests, Provincial Tax Commission of Padua. Section X, Decision No. 92 of December 4, 2007;
On the issue of deductibility on credit losses, Supreme Court, Tax Section, Decision No. 23863 of November 19, 2007;
On the non-economic aspects referred to advertising expenses, Provincial Tax commission of Reggio Emilia, Section I, Decision No. 23 of March 5, 2008;
With regard to the non-economic aspects identified during the checking of recharging percentages, Supreme Court, Tax Section, Decision No. 20832 of October 26, 2005; Supreme Court, Tax Section, Decision No. 21575 of November 7, 2005; Supreme Court, Tax Section, Decision No. 23183 of November 16, 2005; Supreme Court, Tax Section, Decision No. 1546 of January 24, 2007.

[11] With the expression the "proof of the burden", reference is made to the transfer pricing documentation and to the innovations introduced by virtue of Article 26 of Decree-Law No. 78/2010.

[12] Established on the basis of Article 76 (currently 110) of the TUIR.

[13] Treaty of Vienna: In 1967, the US Ford Company provided guidelines to purchasing associated companies (including Ford Italia) according to which the latter committed themselves to bear repair and maintenance charges, for the new cars purchased, towards clients and dealers; said agreement represents an assumption of liability for the guarantee of vitiated goods at the purchasing broker's level towards the end-client of the good which, on the basis of the 1980 Vienna Treaty on international Sales, does not require any written approval of the limitation and liability clauses, ex Article 1341 of the Civil Code.

[14] Article 1490 of the Italian Civil Code

[15] Please note that said issue, which is based on the Tax Police's Official Record of Findings, relating to various tax periods, has already been disregarded by the Supreme Court in a previous pronouncement (Supreme Court, Decision No. 22023/06) with reference to the year 1990. As we shall observe, *infra*, the Judges do not change their position with regard to the assessment pertaining to the tax-year 1991.

[16] Thus, according to the Tax Authorities, thanks to the imputation of higher costs evaluated with respect to those that may be evaluated at "arm's length" for inter-company sales, proceeds deriving from transactions *de quibus*, are taxed in countries with a lower tax burden with respect to Italian tax rates, with obvious advantages for the entire group.

[17] The evaluation hereof should have been performed on the basis of methods indicated under Circular No. 32/1980; in particular, the Judges affirm that it would have been necessary to proceed to an analysis *of the conditions in the automotive market by means of a comparison between prices applied within the Ford group with those of other competitor enterprises)*.

[18] Decision No. 22023/06, relating to the assessment of the same taxpayer. but referring to the year 1990.

[19] Being already the subject-matter of Decision No. 22023/2006 referring to the assessment for the tax year 1990, in which the Judges completely disregarded the tax authorities' views.

[20] Dated April 11, 1980, governing international business transactions.

[21] Decision 4317/2003.

[22] *Cfr.* Supreme Court's Decision No. 22023/2006.

[23] *Cfr.* Decision No. 1709/2007.

[24] *Cfr.* Decisions Nos. 22023/2006, 11226/2007, 52/2007 and Note No. 9/1989 del 10.3.1982.

[25] Supreme Court's Decision No. 11226 of March27, 2007

[26] To such effect, as stated above, the tax authorities should have first provided evidence of the fact that the level of taxation in Italy, at the time in which the transactions were carried out, were actually lower with respect to taxation level existing during the same period in those countries where the foreign associated companies were resident and subsequently proceed to the computation at arm's length according to Transfer Pricing guidelines.

[27] Article 9, Paragraph 3 of the TUIR.

[28] Filed on October 13.

[29] In particular, the Supreme Court acknowledged that it is the tax authorities' duty to actually demonstrate that the rule of assumption of li-

ability for the guarantee had not been duly complied with, constituting thus an avoidance method for the reduction of proceeds in Italy in favour of an increase thereof in countries with lower tax regimes. More specifically, the Court asserted that (as it would again state in Decision No. 11226/07) that the tax authorities should have first ascertained whether tax rates were indeed lower in Italy at the time the facts occurred, with respect to effective tax rates in the source-countries from which the vehicles sold/purchased by the associated Italian companies originated (Germany, France, UK), and only subsequently proceeding to adjustment of the arm's length price by the associated Italian company, in observance of the principle of free competition established by the OECD.

[30] Filed on May 9, 2007.

[31] In the particular case in point, the illicitly pursued advantage never actually emerged. In particular, the tax authorities have not clearly evidenced the allegedly more favourable tax treatment which the pursued French entity was charged with, through a transfer pricing transaction. But, the effective transfer of proceeds, i.e., of taxable matter, had never been demonstrated, as the tax authorities had erroneously assessed.

[32] Amended Article 1 of Legislative Decree 112.1997, No. 471, by supplementing it with Paragraph 2-*ter*.

[33] Decision No. 22023 of October 13, 2006, from which Decision No. 11226/07 under discussion followed.

[34] Decision No. 22023/06

[35] *Cfr.* the Regime dated September 29, 2010 issued by the Tax Authorities Director.

 TPIJ ISSN 2042-8154