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The Italian Supreme Court, in ruling 22023 of October 13, has held that the tax administration, when adjusting the prices of cross-border transactions between related parties under Italy's transfer pricing rules, must provide satisfactory evidence that by setting prices other than at arm's length, the taxpayer has obtained an unfair tax advantage and reduced its overall tax liability.

The tax administration bears the burden of proof, and if it is unable to demonstrate that there has been a shift of taxable income from Italy to a low-tax jurisdiction, with a reduction of the taxpayer's global effective tax rate, any transfer pricing adjustments are not valid and should be set aside, the Court said.

Facts of the Case

The ruling concerned a case in which an Italian company purchased vehicles from its foreign affiliates and distributed them in the Italian market. In the purchase contracts, the Italian company undertook the obligation to maintain and repair the cars and also accepted the liability for damages from the use of the vehicles that would in principle lie with the foreign manufacturers. The Italian company incurred costs for repairs and maintenance under the warranty provided to customers, but did not receive any fee or compensation for relieving its foreign affiliates of the responsibility for repair and maintenance that would rest with them as a matter of law.

The tax administration argued that the purchase prices of the vehicles were not at arm's length, because they did not take into account reasonable compensation for the maintenance and repair obligations assumed by the Italian company in favor of its foreign affiliates. The tax administration also argued that costs incurred by the Italian company unlawfully reduced its taxable income in Italy to the benefit of its foreign affiliates. Therefore, the tax administration reduced the purchase prices by an amount equal to the amount of that compensation and assessed higher profits on the Italian company under the transfer pricing provisions of Tax Code section 76 (now section 110(7)).

The taxpayer challenged the assessment and won at the trial and appellate levels on the basis that there was no proof that by not charging for the maintenance and repair costs, it had actually pursued or obtained a tax advantage. The case then went to the Supreme Court for a final decision.

Transfer Pricing Rules

Italian transfer pricing rules are contained in articles 110(7) and 9(3) of the Tax Code. Article 110(7) provides that transactions between a resident enterprise and foreign entities that control, are controlled by, or are under common control with the resident enterprise must be carried out at arm's length. The concept of resident enterprise is wider than resident companies and includes resident partnerships and Italian permanent establishments of foreign enterprises. Control includes both factual and legal control.

The arm's-length standard is defined in article 9 with reference to the fair market value price charged for similar goods or services exchanged under the same or similar terms in the same market and under the same conditions.

The tax administration, in Circular 32/9/2286 of September 22, 1980, and Circular 42 of December 12, 1981, referred to the OECD's 1979 transfer pricing guidance as directly applicable to supplement Italian law provisions. That extends to subsequent versions and updates of the OECD transfer pricing reports and guidelines.

Transfer pricing rules regulate cross-border transactions between related companies to prevent tax avoidance through the manipulation of prices in controlled transactions and the shifting of income to low-tax jurisdictions. However, based on the language of the applicable statutory provisions, the application of transfer pricing rules should not depend on the fact that there has been actual tax avoidance in a specific case. Indeed, that would seem to be more within the direct scope of the antiavoidance provisions.

Antiavoidance Provisions

Italian tax law contains general tax avoidance provisions in article 37 *bis* of Presidential Decree 600 of September 29, 1973. The provisions apply to specific types of transactions that lack economic substance and business purpose and that have been entered into solely for the purpose of obtaining undue tax advantages.

Furthermore, the Italian Supreme Court has applied the antiabuse rule embedded in the EU Sixth VAT Directive (77/388/EEC of May 17, 1977) and elaborated by the European Court of Justice in its judgment in *Halifax* (C-255/02) (for the judgment, see *2006 WTD 35-19* or *Doc 2006-3356*) and domestic civil code rules denying legal effects to contracts that lack valid consideration.

In addition, beneficial owner, anticonduit, and look-through rules are used in the cross-border context to counteract treaty shopping and EU directives abuse and to subject to full taxation the profits derived from tax haven countries.

Supreme Court Ruling

In ruling 22023, the Supreme Court was asked to rule on the relationship and interaction of the various sets of rules referred to above. The Court argued that the rules have the same rationale: to counteract tax avoidance. It drew a parallel between the EU tax law antiabuse principle in the VAT area and Italy's transfer pricing rules, and it held that transfer pricing adjustments cannot be enforced unless there has been actual tax avoidance.

It also ruled that the tax administration bears the burden of proving that the taxpayer, by setting inappropriate prices in controlled transactions, has been able to move income to low-tax foreign jurisdictions and benefit from lower tax rates applicable to its foreign affiliates, with an overall reduction of the group's effective tax rate.

The Court also addressed the fact that under the vehicle warranty undertaken by the Italian company, the Italian company incurred costs (for maintenance and repair) that reduced its income to the benefit of its foreign affiliates, which had not paid any compensation to the Italian company for that service. The tax administration had argued that the arrangement was fictitious and was aimed only at generating deductible costs for the Italian company.

In that respect, the Court held that under article 11 of the Vienna Convention, the contractual terms of intragroup transactions can be drawn from the instructions and directives of the foreign parent, as regularly applied by the Italian subsidiary, and need not be embodied in a written agreement. The 1995 OECD transfer pricing guidelines also require consideration of the terms of the transaction based on its substance and the way it was actually performed.

Because no evidence was presented to show that the warranty agreement was not a bona fide arrangement and that it had not been carried out, the agreement had to be respected for tax purposes.

Conclusions

The ruling represents the first case in which the Supreme Court has linked transfer pricing adjustments and tax avoidance. Nonetheless, it may be difficult to provide specific proof of tax avoidance as a prerequisite for a transfer pricing adjustment.

If reference must be made to effective tax rates (as would seem to be the case), that proof would require a reliable determination of an array of foreign tax rules concerning the timing of deductions, deferral of income recognition, computation of income and deductions, and so on, to determine the foreign effective tax rate, as well as a complex analysis of the tax profile of the taxpayer companies involved (as net operating loss carryovers or credits may put them in a zero tax bracket).

Information about foreign law often is difficult to obtain, as is information on foreign companies' tax records, which form the basis for determining the effective tax rates.

It is reasonable to anticipate that, in any future case, the Court may be inclined to accept that proof on the basis of a rough comparison of domestic and foreign nominal tax rates, if the foreign jurisdictions involved are low- or zero-tax countries.

However, well-advised taxpayers engaged in reasonably complex cross-border deals now have an additional argument on which to challenge transfer pricing adjustments. The Court has been clear in placing the burden of proof of tax avoidance on the tax administration. In some cases, that may prove useful in defending the transfer pricing policies of foreign multinationals with business operations in Italy. ◆

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