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Italian Audits and TP: Jump Out of the Frying Pan into the Fire?

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Taxpayers grappling with TP and TP-related issues during an Italian audit should consider the right mix of defensive and proactive actions to address them, say KPMG practitioners.

Multinational enterprises might be forgiven for thinking that a transfer pricing examination is sufficiently challenging on its own. Between the need for detailed factual and economic support and the inherent subjectivity of some TP issues, dealing with tax authorities auditing TP can present more than enough to keep one busy. In Italy, the situation can be even more complex, with TP exams routinely bringing additional complications – and significant risks – in their wake. What might otherwise have been a routine TP audit may result in authorities claiming the existence of a hidden permanent establishment of a foreign entity, or creating a brand new transaction involving embedded royalties for intellectual property – and, of course, the local withholding tax liability that goes along with it.

Identifying the tax authorities' intentions early and developing effective audit management strategies are key. So are understanding the options for dispute prevention and resolution. While Italian audits remain in some respects uniquely challenging, the Italian competent authority has developed a strong track record of successful advance pricing agreement resolutions in recent years.

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Background

Tax audits in Italy are conducted either by the Revenue Agency (*Agenzia delle Entrate*) or by the Italian tax police (*Guardia di Finanza*). While regular tax audits can be conducted by either authority, the Italian tax police is typically involved when a case originates from a criminal investigation – which may cover many issues that, in the United States, would be considered purely civil tax matters.

In general, audits conducted by the Revenue Agency focus on TP and tax compliance violations, whereas audits performed by the Italian Tax Policy often investigate areas such as undeclared PEs, value added tax (non-compliance or fraud. Tax police audits are generally more invasive, frequently involving site visits as well as interviews with employees and customers.

A tax audit usually ends with a tax audit report (*Processo Verbale di Constatazione*) drafted by the field auditors, which does not impose liabilities but may lead to preventive measures like asset seizures. The audit reports are then sent to the Revenue Agency, which is responsible for issuing the final notice of assessment. Additional taxes, penalties and interest must then be assessed by the Revenue Agency before the statute of limitations expires (e.g., FY 2018 expires on December 31, 2024) – although an exception to the statute of limitations applies in the case of undeclared PE issues.

Recent changes have enshrined the 'right to be heard' principle as part of the ongoing Italian tax reform: the tax authorities must now alert the taxpayer of a proposed adjustment and allow the taxpayer a chance to provide its position before proceeding with the adjustment. This reform was meant to eliminate the element of surprise that was historically often associated with Italian adjustments. In practice, however, it has not yet been clear that giving taxpayers the right to be heard has substantively altered the positions taken by the Italian tax authorities.

Matters Commonly Challenged by the Authorities

The Italian tax authorities routinely audit Italian subsidiaries of foreign-based MNEs that perform sales and distribution functions, or provide sales support and marketing services to foreign affiliates. For taxpayers who have prepared TP documentation in accordance with the Italian requirements for penalty protection and disclosed this in their tax return, audits typically begin with a request for the TP documentation, followed by requests for further clarification. Penalties can be avoided if:

- the TP report was prepared within the required time frame;
- it is promptly provided to the tax authorities upon request; and
- it is complete and complies with the content requirements set by Italian regulation (including formalities such as electronic signatures, a stamped date, and the use of the Italian language for the country file).

Penalty protection is extremely valuable, as it supports the taxpayer's position, in an environment where draconian penalties can almost double the tax involved, and it also protects the company's legal representative from potential criminal charges related to the TP adjustment.

Audits are generally more intense when significant cross-border transactions exist but no TP report has been prepared. Authorities often challenge:

- the TP methodology, especially if the method does not align with what the Italian tax authorities perceive to be the functional and risk profile of the subsidiary (e.g., Cost Plus versus Transactional Net Margin Method with Return on Sales as the Profit Level Indicator versus Profit Split);
- the comparables in the benchmark set (e.g., loss-making companies are generally excluded from comparable sets) and the PLI results;
- evidence that the intragroup services have actually been provided, are relevant to the local business, or are beneficial for the local entity; and
- criteria for determining the arm's length value in an intragroup business reorganization.

This scrutiny is common among companies operating under various business models, such as limited risk distributors, commissionaires, or contract service providers. These businesses, particularly those engaged in online advertising, digital platforms, and ancillary services like marketing and customer support, often face challenges. The Italian tax authorities tend to question the alignment of these service models with the TP methods used, particularly when they believe that significant sales are driven by local personnel, yet cost-based methods are applied. For example, while many online advertising companies operate through local affiliates with limited risk and limited functionality, the Italian tax authorities often view revenue generation as entirely dependent on local marketing efforts despite their limited nature.

The TNMM analyses using cost-based PLIs are frequently scrutinized and challenged, for under-remunerating the subsidiary's functions. This is particularly common when the Italian subsidiary provides services related to sales made by foreign entities in Italy, such as marketing or sales support services. The remuneration of local subsidiaries selling online advertising services (and related services) is determined using alternative methodologies other than cost plus, as required by Italian regulations.

Additionally, there are operational challenges around changing from a cost-based PLI to an ROS. For many MNEs, sales are concluded using online platforms operated by a foreign affiliate. While Italian personnel may support a portion of these sales, other sales may occur without any involvement by local personnel whatsoever, driven solely by the strength of the global platform and brand. Italian personnel with regional responsibility further complicate matters: an Italian director with responsibility for southern Europe, for instance, may entice the Italian tax authorities to look beyond Italy when computing a revenue base. Identifying an appropriate revenue base for an Italian affiliate's activities can be a particularly fraught issue, both in terms of factual support and in terms of operational accounting.

For MNEs that have determined a cost-based PLI provides an arm's length return for an Italian affiliate, this presents something of a Catch-22: tracking revenue attributable to the affiliate's activities may be viewed by the Italian tax authorities as tantamount to an admission that ROS is the correct PLI, while failing to track this revenue up front may impede later efforts to substantiate that a lower revenue base is appropriate.

Hidden PEs

In particular, local affiliates, operating under a commissionaire, agent, or a cost-based service-provider model can expect to be closely examined for evidence of a hidden PE. This may involve cross-referencing VAT data to uncover perceived discrepancies. Authorities may initiate inspections to verify the roles of local personnel, particularly in negotiating activities or functions that exceed statutory exemptions for auxiliary tasks. Authorities often take a substance-over-form approach to the authority to finalize contracts. Even minimal involvement in contract negotiations can constitute agency activity in the eyes of the Italian tax authorities, emphasizing the importance of accurately defining local operations under Italy's revised PE laws, which were influenced by the OECD's Base Erosion and Profit Shifting project. Confirmation of the role played by the subsidiary's employees is often gathered through questionnaires sent to local clients or customers.

If the Revenue Agency identifies a PE, the foreign enterprise is liable for tax on the income attributed to Italy under profit allocation rules. This profit is considered separate from the profit already declared by the Italian subsidiary and included in its taxable income. The profit associated with the asserted PE is expected to reflect a portion of the profit generated from the foreign entity's risks and assets that have purportedly been "used" in Italy by the PE. Additional taxes incur 4% interest per annum, and penalties for failing to file a corporate tax return are even more draconian here than they are elsewhere, ranging from 120% to 240% of the taxes imposed.

In theory, if a PE is assessed for income tax purposes, this would also have VAT implications (since, due to the presence of individuals, a "fixed establishment" is also deemed to arise). The PE/fixed establishment would theoretically be subject to VAT obligations, including the duty to invoice, collect and remit VAT to the authorities. In our experience, however, the Revenue Agency applies only fixed penalties, and does not extend the PE theory to claim VAT, if the goods are delivered by the foreign entity directly to local customers without becoming physically available to the purported PE, and VAT is accounted for under the reverse charge mechanism by local customers.

Criminal charges may also be brought against the foreign enterprise that ostensibly failed to disclose the PE. If the MNE fails to file an income tax return, VAT return, and WHT agent return, this may trigger a criminal offense if the unpaid taxes exceed EUR 50,000 per fiscal year and may lead to sanctions under corporate criminal liability rules. Mitigating liability requires adequate systems and controls, supported by documentation demonstrating risk management procedures.

During negotiations with the Revenue Agency, it is not uncommon for purported PE issues or other claims to be reclassified as a TP dispute. Reclassifying a PE issue into a TP dispute often reduces penalties and shields legal representatives from criminal charges. In cases involving sales or service activities, negotiations with the Revenue Agency frequently lead to the application of the TNMM method, using ROS as the PLI, rather than a cost-based approach. Depending on the specific circumstances, the ROS may be applied to the sales made by the group in Italy, even if those sales were not directly made by the Italian subsidiary.

Embedded Royalties Claim

In recent years, we have seen an increase in cases where the Italian tax authorities assert claims of embedded royalties in transactions involving subsidiaries of foreign-based MNEs. These claims are particularly prevalent among LRDs operating in industries such as software, data hosting, and medical devices. The authorities often argue that royalties for IP embedded in products or services provided by LRDs should be subject to local WHT at rates as high as 30%, plus interest and penalties, which can reach 110% of the tax amount. Where the MNE holds the European IP rights in a jurisdiction that does not benefit from a treaty-based reduction or elimination of WHT, these adjustments are particularly problematic.

One key point of contention in these cases is whether the local subsidiary, typically structured as an LRD, is deemed to acting as a *de facto* licensee of the IP. The Italian tax authorities frequently assert that the local entity's activities go beyond mere distribution, implying that the local subsidiary should be considered as engaging in transactions involving IP, thus triggering WHT obligations. Taxpayers need to clearly document the ownership structure and responsibilities tied to IP to mitigate this risk, ensuring that their position aligns with both Italian tax laws and international tax treaties.

For cases where outbound payments from Italy to the US are lacking and an EU principal structure exists, taxpayers may also ask the authorities or the court to benefit from full exemption under the EU Interest-Royalties Directive, provided that the EU recipient is the beneficial owner of the payments. It is important to note that demonstrating beneficial ownership requires LRDs to prove sufficient substance at the level of the foreign income recipient. In instances where embedded royalties are challenged, LRDs can often contest the Italian tax authorities' position using dispute resolution mechanisms, such as the mutual agreement procedure ("MAP") under relevant tax treaties, to address or prevent double taxation. For example, LRDs may argue that withholding tax on embedded royalties contravenes the treaty equivalent of Article 12 of the OECD Model Tax Convention, which generally exempts certain royalties from WHT when a distribution model is applied.

Mitigation Options

Since 2010, a penalty-protection regime has been in place for taxpayers who prepare a TP report (both a Master File and a Local File) and disclose it in their tax return. The local Italian requirements for these reports have been aligned with the post-BEPS documentation requirements outlined in the OECD Transfer Pricing Guidelines. Generally, the penalty protection provided by the TP report remains valid even if the authorities dispute the methodology used to test compliance of controlled transactions with the arm's length standard.

TP adjustments or other international tax matters can be resolved through alternative dispute resolution procedures, which can be initiated alongside local measures. When TP adjustments affect multiple European jurisdictions, taxpayers can initiate a MAP under the European Arbitration Convention or under Council Directive (EU) 2017/1852 (from fiscal year 2018 onwards). For non-European jurisdictions, a similar process can be initiated under the relevant bilateral tax treaty. The MAP process between Italy and the US typically functions very well, with the competent authorities on average resolving double taxation within 29 months of the MAP's initiation (OECD MAP Statistics for the United States (2022)).

While MAP provides a good forum for resolving disputes, the best defense is a good offense. To prevent disputes before they arise, taxpayers can pursue unilateral, bilateral, and multilateral APAs. An Advance Pricing Agreement ("APA") establishes the methods for calculating the arm's length value of transactions subject to TP regulations in advance. The APA process can take three to four years and is binding for the fiscal year in which the agreement is issued and the following four years, assuming no changes in the facts or regulations. Roll-back mechanisms may apply to extend that coverage to earlier years, and APAs can be amended or renewed. APAs are not restricted to TP issues: they can also address profit allocation, and, in theory, they can also determine whether a foreign enterprise has a PE in Italy. However, it is important to be aware that for MNEs already operating in the Italian market, pursuing an APA option could potentially trigger exposure for previous fiscal years, effectively acting as a form of self-disclosure.

In recent years, Italy has been very active and very successful in negotiating bilateral APAs, particularly with the United States where it has growing importance as a partner for proactively resolving TP disputes. In 2023, 8% of bilateral APA requests submitted to the IRS involved Italy, making it the fourth most significant US APA partner after Japan, India, and Canada. Additionally, 11% of bilateral APAs executed in 2023 involved Italy, ranking it third, just behind Japan and India (Announcement and Report Concerning Advance Pricing Agreements (2024)).

APAs are not the only option for proactively reducing the TP risk or seeking confirmation that no PE exists in Italy. For instance, Italy has also introduced special voluntary disclosure and cooperative compliance programs for large MNE groups (i.e., those exceeding EUR 1 billion in annual consolidated turnover). These programs allow taxpayers to seek rulings from the Revenue Agency on whether their business activities constitute a PE before an investigation. Identified PEs with effective tax control frameworks can opt into the Italian Cooperative Compliance Regime, which allows them to benefit from reduced penalties and a shorter statute of limitations for tax assessments: just three years.

Italy also participates in cross-border programs that can enhance tax certainty, such as the OECD's International Compliance Assurance Program and the European Trust and Cooperation Approach at the EU level. These voluntary programs require MNEs to engage actively and transparently with the tax administrations in jurisdictions where they operate, offering a proactive approach to managing TP risks. Taxpayers grappling with TP and TP-related issues in Italy, as well as those that can see potential issues looming on the horizon, should consider the right mix of defensive and proactive actions to address them.