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Global Tax Alert

Italy considers significant amendments to tax criminal penalties

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Executive summary

With a law provision introduced with the 2020 Budget Law, the recently-formed Italian Government has introduced significant amendments to the tax criminal penalties provisions applicable to the adjustment of an Italian income tax or value-added tax (VAT) return. Specifically, the amendments would result in a reduction of the fixed thresholds relevant for the application of the tax criminal penalties, that become applicable for the failure to comply with certain tax filing requirements.

These amendments could cause a material increase of the personal liability risks of directors and corporate officers associated with, for example, transfer pricing adjustments, or a failure to file a corporate income tax, VAT or withholding agent return, such as in the case of assessment by local Authorities of an undisclosed permanent establishment of a nonresident legal entity.

Detailed discussion

For decades, one of the key objectives of all Italian governments has been to fight tax evasion, for which Italy still ranks as one of the most non-compliant countries in the world. Among others, this objective has been pursued by introducing very high rates of administrative penalties – currently up to 240% for the failure to file

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a tax return – and by combining a very strict administrative penalty system with criminal sanctions, which are commonly imposed on the directors and corporate officers who are responsible for the tax reporting.

In a law provision introduced with the 2020 Budget Law (Law Decree No. 124 of 26 October 2019, published in the *Official Gazette* the next day, hereafter Law Decree), the recently formed Italian Government has introduced significant amendments to the criminal penalty regime that are applicable in the case of adjustment of an Italian income tax return resulting in an incremental tax liability and in the case of assessment of a failure to file certain tax returns. The relevant law provision is in the form of a Law Decree and it must therefore be converted by Parliament into final legislation within a maximum term of 60 days, or it will lapse. Consequently, the current amendment could ultimately be modified or even lapse if Parliament fails to convert the Law Decree into final legislation within the due term.

Without considering the changes to the penalties for other specific tax fraudulent behaviors or failures, the main amendments brought forward by the Law Decree in relation to criminal penalties are the following:

a) The reference penalty of one to three years detention for "unfaithful tax filing" has been increased to two to five years.

b) The reference penalty of one and a half to four years detention for failure to file an income tax or withholding agent return has been increased to two to six years.

c) The threshold for the application of criminal penalties in the case of a tax authority adjustment of a tax return filing (i.e., "unfaithful tax filing") resulting in incremental taxable income in excess of 10% or €3 million (lowered to €2 million) and in an incremental tax liability of at least €150,000 (lowered to €100,000).

d) The 10% threshold for excluding from the "unfaithful filing" the valuation adjustments that are individually not in excess of 10% of the originally reported amount has been eliminated. For this purpose, transfer pricing is generally considered to imply a valuation process.

Apart from the obvious dissuasive effect of the increase in criminal sanctions, which could allow the use of additional investigative means for prosecution, such as phone tapping, and would pose additional restraints to the reclassification of detention in alternative measures like social services, the above summarized amendments to criminal penalties would result in a material increase of the possible consequences from an assessment of the Italian tax authorities in areas, such as transfer pricing and permanent establishments, in which either because of the specific fact patterns or because of the relevant legislation, Organisation for Economic Co-operation and Development (OECD) Guidelines or case law, there may be no objective and undisputable criteria to support a challenge or defend against it. Clearly, the guidance issued under the OECD Base Erosion and Profit Shifting action plans, the more recent developments of the OECD Transfer Pricing Guidelines, as well as the introduction of possibly disruptive new approaches, like accurate delineation and a new approach to the characterization and remuneration of intercompany financial transactions could add to the already judgmental nature of some areas of transfer pricing, generating a material risk of challenge by the tax authorities, which in the future could bear an incremental criminal penalty burden.

Implications

The above depicted environment requires constant monitoring of the risk associated with the reporting of intercompany transactions and the disclosure of permanent establishments, periodic health checks, a review of new business structures, as well as active management of any tax risk identified.

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