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Tax Alert
KPMG in Italy

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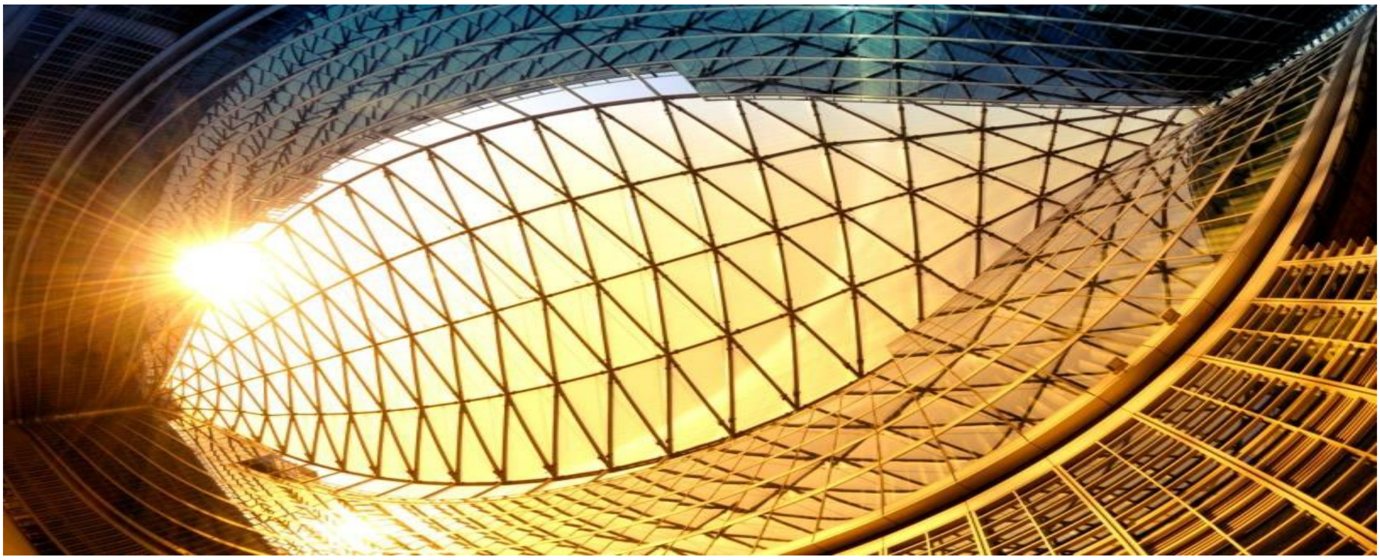
Italy: Supreme Court finds Dolce & Gabbana not guilty of tax evasion



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The Italian Supreme Court has ruled that renowned designers Stefano Gabbana and Domenico Dolce are not guilty of tax evasion(1). This judgment overturns two lower-court judgments that handed down 18-month prison sentences for tax evasion. However, Dolce and Gabbana will still have to pay approximately €343.3 million in fines to the Italian tax administration.

This is a landmark judgment because it sets out important principles for the application of criminal penalties in cases of tax avoidance. These principles are consistent with the new rules(2) on abuse of law(3) and signal a change from the position previously adopted by the Supreme Court(4).

The judgment clarifies that a foreign entity is not deemed to be resident in Italy and therefore does not have to submit an Italian tax return if, outside Italy, it has substance and a structure – even a minimal one – that enables it to pursue the business purpose indicated in its articles of association. By contrast, a business is deemed to be resident in Italy if it is set up abroad with the sole purpose of exploiting a more favourable tax regime.

Facts

Stefano Gabbana and Domenico Dolce ('Dolce and Gabbana') are designers and owners of a multinational group through their holding company (D&G Srl). Each of the designers used to own 50% of the trademarks 'Dolce & Gabbana' and 'D&G Dolce & Gabbana'.

In 2004, Dolce and Gabbana set up two new Luxembourg companies: Dolce & Gabbana Luxembourg Sarl (entirely controlled by D&G Srl) and Gado Sarl (entirely owned by Dolce & Gabbana Luxembourg Sarl).

In March of the same year, Dolce and Gabbana transferred ownership of their trademarks to Gado Sarl ('Gado'), for €360 million. Gado then licensed these trademarks exclusively to Dolce & Gabbana Srl, another group company fully owned by Dolce & Gabbana Luxembourg Sarl.

(1) Supreme Court judgment no. 43809 of 24 October 2014, published on 30 October 2015.
(2) Introduced by Legislative Decree no. 128/2015.
(3) See our Tax Alert of 10 September 2015.
(4) See judgment no. 7739/2012, issued in the same Dolce & Gabbana proceedings.

In this way, royalties were no longer paid to Dolce and Gabbana but to Gado. This company obtained an advance Luxembourg tax ruling that the income tax rate was approximately 4% – significantly lower than the average individual income tax rate in Italy (43% for highest earners).

The proceedings

Following an assessment by the Italian tax authorities, Dolce and Gabbana were prosecuted in Milan in 2007, charged with failing to pay VAT and corporate income tax (IRES). They were also accused of failing to declare income and VAT in Italy. The prosecution maintained that the Luxembourg company Gado was being managed in Italy and was de facto tax resident in Italy pursuant to article 73(3) of the Italian Income Tax Code (IITC)[5]. Moreover, according to article 4 of the OECD Model Tax Convention on Income and on Capital, a company's headquarter is the place where key decisions are taken or the place where the enterprise pursues the main activity for which it has been created. The prosecution identified Gado's Italian sister company – Dolce & Gabbana Srl – as the place where Gado was effectively being managed.

The prosecution relied, in particular, on the following facts.

- Gado did not have its own independent accounting and administrative structure and, until 2005, it did not have any employees.
- Gado's business was entirely managed from Italy, with the exception of certain formalities.
- The conclusion of supply contracts, invoicing and financing were substantially managed from Italy.
- The members of the board of directors were Italian, and Dolce and Gabbana only decided to change the composition of the board in 2007[6].
- Gado, immediately after being set up, licensed its trademarks to a different company; therefore, it apparently had no power to decide how to manage the trademarks.

According to the prosecution, even though the purpose of the restructuring may well have been (among other things) to reinforce the brand and attract investments, the decision to set up a company in Luxembourg and to transfer the trademarks to that company was not fully justified. The prosecution argued that the intention had been to create a 'screen' in a foreign country to avoid Italian taxes on royalties paid from Italy to the Luxembourg entity, as Luxembourg has a more favourable tax regime.

The prosecutors also questioned the price for the transfer of the trademarks to Gado, from the perspective of the arm's length principle[7]. They claimed that the price was lower than the price that would have been set in a transaction between independent parties and that additional income should have been declared.

The Court of Milan eventually decided in favour of the defendants.

Ultimately, the case came before the Supreme Court, which decided to send it back to the lower court. With regard to criminal penalties, the Supreme Court commented in its decision[8] that taxpayers cannot be prosecuted for all forms of tax avoidance, but only for specific avoidance patterns expressly identified by law. Therefore, use of 'strawmen'[9] and infringement of the 'wide-scope' anti-avoidance rule[10] could trigger criminal penalties for failure to declare income and VAT. On the other hand, violation of principles such as abuse of law could not trigger the application of criminal penalties (at the time of this Supreme Court decision, abuse of law had been defined only by the courts and not by law).

After the Court of Milan decided against the defendants[11], the case ended up before the Supreme Court once again.

Supreme Court judgement no. 43809 of 30 October 2015

On 24 October 2014, Dolce and Gabbana were found innocent by the Italian Supreme Court. However, the decision was only published on 30 October 2015, a year later, probably because the Supreme Court wished to publish it after approval of the new Italian measures on penalties for violations of tax rules and on abuse of law.

Essentially, the Supreme Court's decision was based on the following reasoning.

- With respect to Gado's deemed residence in Luxembourg, the lower court had not taken into proper account the sound non-tax reasons on which the group restructuring was based.
- The argument that Gado did not have its own independent financial and administrative structure, and that its management and organisation were decided in Italy, while the Luxembourg entity was in charge only of executing those decisions, in fact confirmed that the Luxembourg entity was 'doing something' and that the structure was therefore real and justified.
- The principle of freedom of establishment had not been considered; the issue of artificial arrangements had also been overlooked.

(5) Under article 73(3) of the IITC, a company is considered to be a resident of Italy if its registered office, place of effective management or main business purpose is in Italy for the greater part of the tax year.

(6) When the Italian tax rules changed and the rule on deemed residency was included in the IITC. Under article 73(5-*bis*) of the IITC, the place of management of a non-resident company is deemed to be in Italy if it controls an Italian company (i.e. has significant influence) and either of the two following conditions is met.
- The non-resident company is directly or indirectly controlled by an Italian resident (company or individual).
- The non-resident company's board of directors (or other managing body) is mainly composed of Italian residents (companies or individuals).

(7) Pursuant to article 9 of the IITC.

(8) Supreme Court judgment no. 7739 of 28 February 2012.

(9) According to article 37(3) of the IITC, income that is attributable, on paper, to a third party (a 'strawman') may be attributed to a taxpayer if it can be demonstrated that the taxpayer is the real owner of the income. In Italian, this arrangement is called '*interposizione fittizia*'.

((10) The former 'wide-scope' anti-avoidance measure contained in article 37-*bis* of Presidential Decree no. 600/1973 was repealed by the new definition of abuse of law (article 10-*bis* of Law no. 212/2000). See our Tax Alert of 10 September 2015.

(11) Judgment no. 7777 of 2013.

- An assessment of the foreign entity's status (to see whether it might be fictitious) and activity (to see whether it matched its stated business purpose) would have been relevant. However, the lower court did not investigate these aspects but cited irrelevant circumstances – such as the fact that Gado employees were constantly in touch with the Italian tax and brand consultants.
- Gado's licencing of trademarks to Dolce & Gabbana Srl was not a key factor because clearly the purpose of the reorganisation was to shift ownership of the trademarks from Dolce and Gabbana (according to financial analysts, this arrangement was weakening the brands) to the group. Therefore, the decision to transfer the trademarks appeared to be consistent with the main business purposes of the reorganisation.
- The Court of Milan had not properly explained and substantiated its ruling that, on the part of Dolce and Gabbana, there was a 'specific intent to evade taxes', which triggered criminal penalties. Instead, it had generically stated that the main purpose of the reorganisation was to avoid filing tax returns and paying taxes in Italy. It did not even analyse the evidence submitted by the defendants.

The last point clarifies a particularly important principle: even if a taxpayer's main purpose is to obtain a tax advantage, this does not automatically mean that the taxpayer specifically intends to evade taxes and is therefore liable to prosecution. In other words, the absence of sound business reasons may result in accusations of tax avoidance/abuse of law, but not accusations of tax evasion; therefore, criminal penalties should not apply automatically.

The Supreme Court's ruling, which differs from the position it took earlier in the case[12], is consistent with the new rule on abuse of law[13], which came into force on 1 October 2015, which expressively excludes the application of criminal penalties in case of tax avoidance/abuse of law.

[12] As expressed in judgement no. 7739/2012.
[13] Article 10-bis of Law no. 212/2000.

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