CH8_ITALIAN TAX MORES: A CASE STUDY Arthur L. Kelly

The Italian federal corporate tax system has an official, legal tax structure and tax rates just as the U.S. system does. However, all similarity between the two systems ends there.

The Italian tax authorities assume that no Italian corporation would ever submit a tax return which shows its true profits but rather would submit a return which understates actual profits by anywhere between 30 percent and 70 percent; their assumption is essentially correct. Therefore, about six months after the annual deadline for filing corporate tax returns, the tax authorities issue to each corporation an "invitation to discuss" its tax return. The purpose of this notice is to arrange a personal meeting between them and representatives of the corporation. At this meeting, the Italian revenue service states the amount of corporate income tax which it believes is due. Its position is developed from both prior years' taxes actually paid and the current year's return; the amount which the tax authorities claim is due is generally several times that shown on the corporation's return for the current year. In short, the corporation's tax return and the revenue service's stated position are the opening offers for the several rounds of bargaining which will follow.

The Italian corporation is typically represented in such negotiations by its *commercialista*, a function which exists in Italian society for the primary purpose of negotiating corporate (and individual) tax payments with the Italian tax authorities; thus, the management of an Italian corporation seldom, if ever, has to meet directly with the Italian revenue service and probably has a minimum awareness of the details of the negotiation other than the final settlement.

This case, which is based on an actual occurrence, was prepared by Arthur L. Kelly. The author is the founder and Managing Partner of KEL Enterprises L.P., a private equity partnership. He has been actively involved in international business for more than 40 years and has served as a member of the Boards of Directors of corporations in the United States and Europe. These include BASF Aktiengesellschaft and Bayerische Motoren Werke (BMW) A.G. in Germany as well as Deere & Company, Northern Trust Corporation, and Snap-on Incorporated in the United States. Copyright 1977. All rights reserved.

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Both the final settlement and the negotiation are extremely important to the corporation, the tax authorities, and the *commercialista*. Since the tax authorities assume that a corporation *always* earned more money this year than last year and *never* has a loss, the amount of the final settlement, i.e., corporate taxes which will actually be paid, becomes, for all practical purposes, the floor for the start of next year's negotiations. The final settlement also represents the amount of revenue the Italian government will collect in taxes to help finance the cost of running the country. However, since large amounts of money are involved and two individuals having vested personal interests are conducting the negotiations, the amount of *bustarella*—typically a substantial cash payment "requested" by the Italian revenue agent from the *commercialista*—usually determines whether the final settlement is closer to the corporation's original tax return or to the fiscal authority's original negotiating position.

Whatever bustarella is paid during the negotiation is usually included by the commercialista in his lump-sum fee "for services rendered" to his corporate client. If the final settlement is favorable to the corporation, and it is the commercialista's job to see that it is, then the corporation is not likely to complain about the amount of its commercialista's fee, nor will it ever know how much of that fee was represented by bustarella and how much remained for the commercialista as payment for his negotiating services. In any case, the tax authorities will recognize the full amount of the fee as a tax deductible expense on the corporation's tax return for the following year.

About ten years ago, a leading American bank opened a banking subsidiary in a major Italian city. At the end of its first year of operation, the bank was advised by its local lawyers and tax accountants, both from branches of U.S. companies, to file its tax return "Italian-style," i.e., to understate its actual profits by a significant amount. The American general manager of the bank, who was on his first overseas assignment, refused to do so both because he considered it dishonest and because it was inconsistent with the practices of his parent company in the United States.

About six months after its "American-style" tax return, the bank received an "invitation to discuss" notice for the Italian tax authorities. The bank's general manager consulted with his lawyers and tax accountants who suggested he hire a *commercialista*. He rejected this advice and instead wrote a letter to the Italian revenue service not only stating that his firm's corporate return was correct as filed but also requesting that they inform him of any specific items about which they had questions. His letter was never answered.

About sixty days after receiving the initial "invitation to discuss" notice, the bank received a formal tax assessment notice calling for a tax of approximately three times that shown on the bank's corporate tax return; the tax authorities simply assumed the bank's original return had been based on generally accepted Italian practices, and they reacted accordingly. The bank's general manager again consulted with his lawyers and tax accountants who again suggested he hire a *commercialista* who knew how to handle these matters. Upon learning that the *commercialista* would probably have to pay *bustarella* to his revenue service counterpart in order to reach a settlement, the general manager again chose to ignore his advisors. Instead, he responded by sending the Italian revenue service a check for the full amount of taxes due according to the bank's American-style tax return even though the due date for the payment was almost six months hence; he made no reference to the amount of corporate taxes shown on the formal tax assessment notice.

Ninety days after paying its taxes, the bank received a third notice from the fiscal authorities. This one contained the statement, "We have reviewed your corporate tax return of 19__ and have determined that [the lira equivalent of] \$6,000,000 of interest paid on deposits is not an allowable expense for federal tax purposes. Accordingly, the total tax due for 19__ is lira ____." Since interest paid on deposits is any bank's largest single expense item, the new tax assessment

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was for an amount many times larger than that shown in the initial tax assessment notice and almost fifteen times larger than the taxes which the bank had actually paid.

The bank's general manager was understandably very upset. He immediately arranged an appointment to meet personally with the manager of the Italian revenue service's local office. Shortly after the start of their meeting, the conversation went something like this:

General Manager: "You can't really be serious about disallowing interest paid on deposits as a tax deductible expense."

Italian Revenue Service: "Perhaps. However, we thought it would get your attention. Now that you're here, shall we begin our negotiations?" ¹

DISCUSSION TOPIC

- 1. Explain the Italian tax system as described in the reading. (Be sure to explain in detail specific Italian terms, such as *bustarella* and *commercialista*, as well as how the whole system works in practice).
- 2. Is this system consistent with Kant's CI₁? (Hint: First write the appropriate maxim of the Italian Corporations, when submitting their tax forms. This maxim should reflect the purpose of the corporation in underdeclaring its taxes.)
- 3. Is this system moral, according to other applicable principles?

¹ For readers interested in what happened subsequently, the bank was forced to pay the taxes shown in the initial tax assessment, and the American manager was recalled to the United States and replaced.