

Italian Supreme Court reinforces arm's-length principle

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ITR CORRESPONDENT - VALENTE ASSOCIATI GEB PARTNERS

Piergiorgio Valente, managing partner of Valente Associati GEB Partners, discusses a Supreme Court ruling (17955/2013) and its impact on the arm's-length principle.

Italian Supreme Court Ruling, No 17955 of July 24 2013, confirmed that, for tax purposes, internal transfer prices must be based on the arm's-length principle.

In particular, the Supreme Court emphasised how international transfer pricing rules “constitute an anti-avoidance clause that is not only rooted in EU principles on the theme of law abuse, but is also immanent in the national tax law sector”.

As a matter of fact, according to the judges, “avoidance principles aimed at preventing that profits be transferred within corporate groups by applying prices of the transferred goods lower than at arm's-length, in order to avoid their being subjected to ordinary taxation in favour of lower territorial taxation, are rooted in both EU mainstays on law abuse, as well as on anti-avoidance clauses of domestic laws generally established (...) or for some peculiar sector cases”.

The Supreme Court, therefore, refers to the concept of “sound economic purpose” to justify ascertainment of compliance with the arm's-length principle in transactions carried out between related entities residing in the state's territory, maintaining that notwithstanding the fact that, although it may not be excluded that enterprises may carry out transactions that are inherently “unprofitable” in favour of other benefits (for example, as might be the case for the development of a business activity in a depressed area), it is necessary that the “various transactions meet economic rationale criteria, which must, in turn, be suitable for market mechanisms within an arm's length principle framework”.

What the authorities say

The Italian transfer pricing regulation (article 110, paragraph 7 of the Italian Income Tax Code, hereinafter TUIR) establishes that transfer prices applied within a multinational group must be determined on an arm's-length basis.

The Italian tax authorities issued some guidelines through Circular No. 32/1980 which, to date, is still the reference point for ministerial instructions on transfer pricing rules, explicitly specifying that transactions must necessarily occur between a foreign and an Italian entity for the regulation to be applicable.

However, the Italian tax authorities set forth, under Circular No. 53/1999, some of the main cases requiring special attention during tax audits, such as evasion and avoidance transactions involving national transfer pricing.

Pursuant to the indications provided by the Circular, transactions that are subject to the tax authorities' audits are the ones entered into by companies incorporated in Southern Italy, which are deriving advantages from the tax benefits provided by the so-called "*Testo Unico delle leggi sugli interventi nel Mezzogiorno*" (Consolidated Code on the Laws for Interventions in Southern Italy, in Presidential Decree No. 218/1978).

A further national transfer pricing issue is represented by the so-called "*tonnage tax*" regulation: Article 160 of the TUIR establishes that, with regard to transfer of goods and the supply of services exchanged between companies subject to the said regulation, and other enterprises – even if resident in the State's territory – the applicable arm's-length provision is the one set forth under article 110, paragraph 7 of the TUIR. In order to avoid that, by exploiting the difference existing between income determination procedures, two companies (i.e., one under a tonnage tax regime and the other under an analytical regime), belonging to the same identical group, may privately reach a mutual agreement to transfer the good at a value higher than at arm's-length for the sole purpose of obtaining a tax advantage.

In practice, the Tax Authorities challenged the inaccuracy of prices applied, by focusing on the "unprofitability" aspects of the entrepreneurial choices made within the context of the corporate group; the said theory was further endorsed by a number of rulings issued by the Supreme Court.

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