tax notes international
Volume 61, Number 9 ■ February 28, 2011

Italian Guidance on Choosing the Appropriate Transfer Pricing Method

by Piergiorgio Valente

Reprinted from *Tax Notes Int'l*, February 28, 2011, p. 681

PRACTITIONERS' CORNER

Italian Guidance on Choosing the Appropriate Transfer Pricing Method

by Piergiorgio Valente

Piergiorgio Valente is managing partner with Valente Associati GEB Partners in Milan.

In Circular No. 58/E of December 15, 2010, the Italian tax authorities clarify how to determine the proper transfer pricing method.

In line with new international guidelines, the tax authorities in some circumstances grant the same status to income-based methods as with traditional methods, overcoming prior rigorous interpretative approaches.

Introduction

In Circular No. 58/E on the documentary burden regarding transfer prices of goods and services under article 110, paragraph 7 of the Italian income tax code (Testo Unico delle Imposte sul Reddito, or TUIR), the tax authorities deal in paragraph 5 with the selection and application of the transfer pricing method and its qualification as the most appropriate method.

The clarifications provide the hierarchical order under which the taxpayer must consider (and eventually apply) the transfer pricing methods identified by the OECD.

Selection of Transfer Pricing Method

According to the tax authorities, in section 5.1.3 of the national documentation the taxpayer must ''disclose the results of the comparability analysis as well as any other available information, and the effects relating thereto regarding the chosen method.'' More precisely, the tax authorities clarified that the taxpayer must illustrate the reasons for qualifying the chosen method as the most appropriate.[1]

This clarification is especially significant regarding the relationship between income-based methods (for example, the transactional net margin method (TNMM) and the profit-split method (PSM)) and traditional methods (for example, the comparable uncontrolled price method, the resale price method, and the cost-plus method).

If one of the income-based methods is equally applicable to the transactions as one of the traditional methods, and the taxpayer were to disregard the latter, he must state why he made that choice.

However, if a traditional method is not as reliable as an income-based method, the taxpayer does not have to justify his choice. Also, no justification is due if an applicable method is chosen other than the CUP.

The clarifications are important because they:

- override the (stringent) position of the tax authorities on the choice of a transfer pricing method for controlled transactions; and
- align the Italian regime to the revised OECD transfer pricing guidelines as updated on July 22, 2010.

Just as noteworthy is the clarification regarding the relationship between any possible judgment during the tax audit on the chosen method or on the motivations

[1]Circular No. 58/E of December 15, 2010, para. 5.

provided by the taxpayer and the exclusion from penalties foreseen by article 26 of Decree Law No. 78 of May 31, 2010.[2] The tax authorities specify that if the judgment is negative, in no case does it constitute an independent basis to the exclusion of the taxpayer from the penalties established by the rule. The above exclusion may only depend on a ''non-suitability'' judgment of the transfer pricing documentation compiled by the taxpayer, which must be based on a judgment of comprehensiveness and compliance of the relevant contents under provisions laid down in the September 29, 2010, regime.[3]

Previous Transfer Pricing Methods

As noted above, the clarifications by the tax authorities provided by Circular No. 58/E/2010 appear to supersede the interpretative position contained in prior relevant procedures.

Circular No. 32/1980

According to Circular No. 32[4] of the Ministry of Finance dated September 22, 1980, for the determination of arm's-length goods or services exchanged, there are two different categories of methods — basic methods and alternative methods.

The basic methods include:

- price comparison method[5];
- resale price method[6]; and
- cost-plus method.[7]

[2]P. Valente, ''La documentazione in materia di transfer pricing'' (Documentation in the Matter of Transfer Pricing), *Il fisco*, No. 34/2010, p. 5481; P. Valente, ''Transfer pricing — I nuovi oneri di documentazione in Italia'' (Transfer Pricing — New Documentary Burdens in Italy), *Il fisco*, No. 39/2010, p. 6330.

[3]Circular No. 58/E/2010 states:

> [in] case of the selection of a transactional income method, in the presence of the potential adoption of a traditional transactional method, it shall be necessary to provide motivations for the exclusion of such latter method. The same holds true in case of the selection of a method that is different from a price comparison method, in the presence of a potential use of such latter method.

[4]P. Valente, *Manuale del Transfer Pricing* (Transfer Pricing Manual), Milan, 2009, p. 236; P. Valente, *Convenzioni internazionali contro le doppie imposizioni* (International Double Tax Treaties), Milan, 2008.

[5]The fairness of the transaction is determined based on a comparison between the price under examination with the price that would have been applied in comparable transactions between or among independent enterprises (external comparison), or between one of the enterprises carrying out the transaction and an independent enterprise (internal comparison).

Article 9 of the TUIR prefers internal comparisons (''price lists or tariffs of the entity that has supplied goods or provided services''), whereas the external comparison is deemed auxiliary (''and, in the absence thereof, to market statements and to Chamber of Commerce price lists''). The circular specifies that an internal comparison is preferable, since substantiation is more likely to occur with similar transactions, whereas, in the case of foreign markets, the comparison engenders difficulties in researching the objectives. *See* Valente, *Convenzioni internazionali contro le doppie imposizioni*, *supra* note 4, at 413.

[6]If due to the characteristics of the transaction under examination such method is not applicable, the resale price method may be adopted.

A price at arm's length is equal to the price at which the goods purchased by one of the group enterprises is resold to an independent operator, decreased by a gross profit margin.

The adoption of the method might be useful when the purchaser or reseller handles only the marketing part of the acquired goods and thus the transactions involve distribution. Its adoption would not be deemed particularly suitable if the goods, before being resold, underwent a further process or are incorporated into a more complex product.

The profit margin to be subtracted must be computed on a percentage basis in relation to the resale price and may be either defined through an internal or external comparison.

In the search for a similar transaction the following factors must be kept in mind:

- kind of product sold;
- reseller's functions relating to the resold good;
- effect of special functions on resale price (such as the incorporation of intangible rights); and
- geographical market in which functions are performed regarding the enterprise's business policies.

In some cases, the purchaser or reseller will assume economic functions that are not significant, restricting his tasks, for example, to receiving or issuing invoices for deliveries directly carried out by the foreign parent company to a third party. In such case, the profit margin will be very slight unless the reseller is able to prove the burden for expenses incurred.

[7]The cost-plus method may be adopted when the controlled enterprise's activity is not limited to the marketing of the product but also to the transformation thereof.

The gross profit margin is computed by multiplying the production cost by a percentage and is determined by:

- comparing the profit margin of the transaction under examination with the margin derived from the same enterprise, for sales to third parties of similar products on the market, and with functions that are identical to those relating to transfers being evaluated (internal comparison);
- in the absence of sales to third parties, the profit margin will be equal to the margin derived from independent third parties involved in similar sales with the same functions; and
- in the absence of similar sales between independent third parties, a comparison of functions performed by the producer against those carried out by third parties may be undertaken.

As in the case of the resale method, the significant factors for determining the similarity of a transaction are:

- functions performed by the producer;
- price impact of special functions; and
- geographic market.

The cost of production may be subject to adjustments when the comparable transaction involves some additional functions.

Because of the complexity and the nature of the evaluations to be effected according to the cost-plus method, its application

(Footnote continued on next page.)

The alternative methods include:

- comparison of profits;
- profit splitting;
- gross margin of the economic sector; and
- yield from invested capital.

Under Circular No. 32/1980, the adoption of alternative methods is supplementary to basic methods: They are used to avoid any uncertainties deriving from the application of basic methods or if the basic methods are not applicable.

Should none of the three basic methods be applicable because of the lack of comparable situations or the impossibility of comparing a controlled transfer with a transfer between independent entities, Circular No. 32/1980 provides for the application of the following alternative methods.

Profit-Split Method

The PSM splits profits deriving from the transactions of two affiliated enterprises in proportion to the costs incurred by both. To properly apply the PSM, an income tax treaty must be in force between the two countries in order to allow coordination between the tax authorities in each country.

Profit Comparison Method

In the profit comparison method, total company profits, computed as profit percentages in relation to sales or operating costs (gross profit rates), are compared against those realized by another entity operating in the same economic sector.

The following items should be compared:

- profits exclusively realized through the sale of goods, without extending the same to total company profits;
- enterprises of the specific sector in which the audited enterprise operates;
- profits realized by enterprises located in other countries;
- more financial years in order to assess the incidence of cyclical fluctuations;
- enterprises with dimensional and structural features similar to the enterprise subject to inspection; and
- functions performed by the audited enterprise with analogous functions carried out by similar enterprises.

is not recommended for transactions carried out between a foreign holding company and its Italian subsidiary. It would not, in effect, be possible to obtain adequate knowledge of cost systems, functions performed, and profit margins applied in the foreign country.

Gross Margins of the Economic Sector

The enterprise's gross margin is compared to that of the relevant economic sector. When alternative methods are applied, a regular profit will be determined rather than the proper transfer price.

Yield From Invested Capital Method

This method is based on the rate of capital invested by the audited enterprise. The tax authorities acknowledge the arbitrariness of the determination, since profit rates vary according to risks and economic factors.

Circular No. 32/1980 establishes that the alternative method is applied:

- accessorily — subsequent to the adoption of one of the three basic methods, uncertainties might arise or it might be necessary to identify the differential element between two transactions for applying one of the three main methods; or
- alternatively — if none of the three basic methods can be applied.

Circular No. 42/1981

The same hierarchical criterion was stated in Circular No. 42 of December 12, 1981 (Paragraph III), which emphasizes the fact that applying an arm's-length price entails the preferential adoption of the price comparison method but:

> in case of an alternative choice between the other two basic methods (resale and cost plus), neither the tax authorities nor the taxpayer need to feel bound to the compliance with a strict mandatory chronological procedure, since the appropriateness and the adequacy of one method over another may only be assessed on a case-by-case basis.[8]

The OECD transfer pricing guidelines of 1979 suggest that the taxpayer should apply the method that guarantees evidence that is most complete, conclusive, and easiest to be obtained.

Finally, Circular No. 42/1981 states that other alternative methods may also be used if the taxpayer complies with the arm's-length principle and the use of the alternative methods will verify a ''regular profit'' rather than the fairness of the transfer price.

Revised Transfer Pricing Guidelines

Introduction

On July 22, 2010, the OECD issued a new version of the transfer pricing guidelines.[9] The main changes are summarized below:

[8]P. Valente, *Manuale del Transfer Pricing*, *supra* note 4, at 246.

[9]OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,* Paris (Aug. 2010), *available at* http://www.oecd.org/document/4/0,3343,en_2649_33753_45690500_1_1_1_1,00.html. *See also* P. Valente, *Le novità del Transfer Pricing* (New Aspects of Transfer Pricing), Milan, 2010, p. 101.

- *Hierarchical application of methods provided for the determination of transfer pricing.* Chapter II, paragraphs 2.1 to 2.49 of the 1995 guidelines, describes the traditional transaction methods for determining transfer prices. The guidelines provide a detailed analysis of the methods, starting from the connection with article 9 of the OECD model convention (from paragraphs 2.2 to 2.5) and continuing with a review of the suggested methods. Chapter III, paragraphs 3.1 to 3.57, analyzes income-based methods, the PSM, and the TNMM.[10] The OECD proposed to abolish the exceptionality of the application of income-based methods in favor of the new standard based on the selection and the application of the ''most appropriate method to the circumstances of the case.''

- *Guidelines for the application of traditional methods*. In Chapter II of the new Section III, the new guidelines provide detailed information on the application of the PSM and the TNMM.

The Methods

According to the OECD, determining the arm's-length price for transactions involving tangibles may be achieved by one of the following methods:

- CUP is based on the comparison between the price applied to tangibles relating to a transaction between associated enterprises and the price applied to tangibles transferred in the course of a comparable transaction in a free market and carried out under similar circumstances.

- The resale price method refers to the price at which a product, purchased by an associated enterprise, is resold to an independent enterprise. This resale price is subsequently reduced by an adequate gross margin, which allows the reseller to cover sales costs and other management expenses in order to derive an adequate profit. The amount obtained by subtracting the gross margin may be considered as a price at arm's length for the original transfer of the good between or among associated enterprises. This method is useful for enterprises that are mainly involved in distribution.

- The cost-plus method considers direct and indirect costs borne by the supplier of tangibles in the course of a controlled transaction between or among associated enterprises. An appropriate additional margin is charged to the production cost (cost-plus markup) calculated on the basis of functions performed and on market conditions in order to determine the arm's-length price. According to the OECD, this method appears to be reliable in transactions relating to the long-term supply of semifinished products to companies belonging to the same group.

If the application of traditional methods based on the transaction does not provide reliable results, the OECD provides for the adoption of alternative methods based on profits deriving from transactions carried out between associated enterprises.

In particular, income-based methods (transactional profit methods) are considered in the 1995 OECD guidelines as ''last resort methods''[11]; their application is restricted to exceptional situations when information on independent transactions is insufficient, when such information is not regarded as being reliable, or when business conditions do not allow the application of traditional methods. ''In such cases of last resort, practical considerations may suggest application of a transactional profit method either in conjunction with traditional transaction methods or on its own.''[12]

Regarding the status of ''last resorts methods'' of transactional profit methods, the OECD stated:

- the selection of a method aims at the correct establishment of an appropriate methodology for transfer pricing determination purposes for each particular case; and

- the selection must be made by taking into account the characteristics of each method foreseen by the OECD, the adequacy of the method regarding the comparability analysis (and the functional analysis) of controlled transactions, the availability of information relating to comparable independent transactions for the purpose of applying the selected method, and the degree of comparability existing between the controlled independent transactions as well as the reliability of adjustments, which may (ultimately) be applied to remove any difference among transactions under inspection.[13]

Regarding the adequacy of the chosen method, there might be situations when the application of income-based methods might be more appropriate than traditional methods. Such situations may include:

---

[10]The 1995 guidelines provide that:

> in those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods and provided all the safeguards set out in this Chapter are observed, application of the transactional profit methods (profit split and transactional net margin method) may provide an approximation of transfer pricing in a manner consistent with the arm's length principle.

OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris, 1995, para. 3.2.

[11]*Id.* at para. 3.50.

[12]*Id. See also* Valente, *supra* note 9, at 110.

[13]OECD, *Transactional Profit Methods — Discussion Draft for Public Comment*, Jan. 25, 2008, para. 5.

- cases in which, following a comparability analysis and an evaluation of independent transactions, an analysis of the net profit margin might be considered more reliable than one performed on a gross margin; and
- cases in which the presence of ''non-benchmarkable intangibles''[14] used by the companies involved in the transactions entails the application of a PSM.

While traditional methods are based on the identification of a fair price, alternative criteria presume the sharing of the transaction's profits.

The OECD clarifies that, in any case, methods based on the transaction are always preferable to others; should their adoption not be feasible, however, those based on profits may be used.

Given that alternative methods must be considered only in exceptional cases, the OECD deems only the PSM and the TNMM to be compatible with the arm's-length principle.

Such was the structure of the 1995 guidelines; as expected, the new guidelines issued on July 22, 2010, are aimed at the selection of the most appropriate method on the basis of the particular case and the transactions under examination.

The OECD states that in practice, some situations might arise when income-based methods might be more appropriate than transaction-based methods. For example, this may occur when entities involved in the transactions effect ''valuable and unique contributions,'' when the parties are involved in so-called highly integrated transactions, or when no information is available on gross margins of third comparable parties.

Income-based methods may not be applied just because all of the information regarding independent transactions is not available or may not be obtained. Methods based on the transaction's profit may be selected and applied, since they are compatible with article 9 of the OECD model tax treaty.

The choice of the ''most appropriate method for each particular case'' does not entail the burden for the taxpayer to make a detailed analysis of each method provided by the guidelines. The OECD clarified that the selection of the method must be documented in the selection process of the comparables.

The new guidelines recognize the possibility for the taxpayer to apply methods not expressly provided by the OECD but that allow it to verify the arm's-length nature of the transactions. The OECD states that:

> Such other methods should however not be used in substitution for OECD-recognised methods where the latter are more appropriate to the facts and circumstances of the case. In cases where other methods are used, their selection should be supported by an explanation of why OECD-recognised methods were regarded as less appropriate or non-workable in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution. A taxpayer should maintain and be prepared to provide documentation regarding how its transfer prices were established.[15] ◆

[14]To date, there is still no definition in the OECD guidelines for the term ''non-benchmarkable.'' The Working Party proposed to include the following definition in the glossary: ''benchmarkable functions, assets and risks are functions, assets and risks for which reasonably reliable comparables exist.'' *Id.* at note 3.

[15]OECD, *Revision of Chapters I-III of the Transfer Pricing Guidelines*, Paris, 2010, para. 2.9. *See also* Valente, *supra* note 9, at 116.