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by Piergiorgio Valente and Federico Vincenti

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PRACTITIONERS' CORNER

Recent Italian Transfer Pricing Decisions

by Piergiorgio Valente and Federico Vincenti

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The authors summarize several of Italy's recent court decisions addressing transfer pricing questions.

In the past few years, the complexity and importance of risks linked to transfer pricing have significantly increased as a natural consequence of the expansion of globalization and cross-border transactions. Revenue offices worldwide are focusing their audits more and more on transactions by enterprises moving in an international context, resulting in a considerable increase of tax controversies involving transfer pricing.

Recent transfer pricing rulings by Italian courts often involved the tax authorities challenging the selection and application of the transfer pricing method, the comparability analysis created by the taxpayer to support intercompany policies of the group, and the analysis of any special transactions such as loans and intercompany services and transactions involving intangibles.

Comparability Factors and Their Importance

In Ruling 9709 of May 13, 2015, the Italian Supreme Court said transfer pricing adjustments by the tax administration may be deemed legitimate only when those adjustments occurred after a comparison was carried out between the audited transaction and the transactions entered into by and among independent third parties that were actually comparable.

In the case, the Italian tax authorities recaptured for tax non-declared proceeds from sales made by the plaintiff company to its foreign associated companies because the sales were deemed made at a price lower than the one applied to independent clients.

The Court confirmed that both national laws and international regulations require the transactions being compared to be effectively comparable — that is, there must be no differences that might affect the transaction price or, if there are differences, they can be removed through specific and objective adjustments.

The plaintiff drew attention to what it called the tax authorities' improper behavior, saying they compared sales made by the same company to its own associated companies with sales made to Italian independent third parties operating at a different distribution phase. The plaintiff said it would have been more appropriate to compare sales made to foreign independent third parties, because they are also distributors, just as the associated companies were. The Supreme Court said the arm's-length value of intercompany transactions must be identified following ''a comparison strongly contextualized for qualitative, commercial, time-related and local purposes.''

In Ruling 27296 of December 23, 2014, the Supreme Court pointed out that it is essential to analyze the contractual positions of the parties to both intercompany transactions and the transactions used for comparison purposes.

In the case, the tax authorities examined two sales contracts — one between the German company and the controlled Italian company (the audited company) and one between the audited company and a third Italian company that did not belong to the group. According to the tax authorities, the prices of the products sold by the audited company to the associated German company were two to three times lower than those in the transaction between the audited company and the third Italian company, even though the goods and the reference market were identical.

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The Italian Supreme Court found the audited company's behavior appropriate, reiterating that the price difference was justified on the basis of the different contractual positions adopted by the companies involved in the transactions being compared.

Selection of the Transfer Pricing Method

On April 21 in Ruling 1670/2015, the Regional Tax Court of Lombardy confirmed that in determining transfer prices among associated enterprises, the comparable uncontrolled price method may be used if it is the most suitable process to quantify the market's value.

It might be worth recalling that even though the so-called hierarchy of methods was discarded in 2010 in favor of the best method application, both the OECD guidelines and Italian practice state that when it is possible to apply the CUP method, that method is deemed the most direct and reliable to ascertain whether the arm's-length principle was complied with.

The Italian tax authorities challenged the company's use of the CUP method, maintaining that the method failed to indicate factual data in the transfer pricing documentation in connection with the average purchase prices of raw materials and instead merely indicated the minimum and maximum prices. Subsequently, the authorities said the transactional net margin method (TNMM) applied and then created a specific benchmarking analysis that led to the adjustment of the transfer prices.

The regional tax court, confirming the lower court (Corte di Prima Istanza), issued a taxpayer-favorable ruling, saying the taxpayer complied with transfer pricing regulations because the commercial transaction prices were determined using procedures analogous to the ones that would have been agreed on in a free — that is, arm's-length — market among independent parties.

Further, the court disagreed with the tax authorities' general practice, saying it cannot challenge the determination of transfer prices by merely switching to a method other than the one applied by the audited company and should instead try to abide by the method identified by the company and challenge it if necessary.

According to the regional tax court, it does not matter whether the company indicated the actual average price; what matters is that the company indicated the minimum and maximum prices it could work with. The appellate court (Corte di Seconda Istanza) referred to the OECD guidelines, noting that all values in a range are suitable to represent the values of a free or arm's-length market, and thus an average value falling between a minimum and maximum price should be adequate.

The appellate court also reiterated an important principle under which companies closing their fiscal year with operating losses may not simply be excluded, because operating losses — like operating profits — are true and proper operating results and therefore should be considered because they provide an accurate picture of the data used for comparison purposes. In fact, under the benchmark analysis, excluding companies with operating losses from the set of comparables would equate to ''not examining with due attention the case subject to trial,'' the court said.

In Ruling 62/04/15, issued February 11, 2015, the Provincial Tax Court of Varese determined that a company provided evidence to support its use of the CUP method, which was further substantiated by the fact that the prices in the relevant intercompany transaction were similar to those in transactions with independent suppliers.

After challenging the plaintiff's choice of the CUP method, the tax authorities applied TNMM, which they deemed most appropriate under the circumstances, and adjusted the plaintiff's taxable base. The court found the tax authorities' benchmarking analysis was inaccurate because:

- the companies selected as comparables operated in different sectors or in different contexts; and
- only companies closing with operating profits were selected, whereas the physiology of both markets and companies envisage alternate phases (so-called ups and downs) in which profitability shifts from higher to lower levels, which should be kept in mind when comparing transfer prices.

Intercompany Loans

In Ruling 27087 of December 19, 2014, and Ruling 15005 of July 17, 2015, the Italian Supreme Court said non-interest-bearing loans issued by an Italian company to its own foreign associated companies were not subject to national transfer pricing regulations.

According to the Italian tax authorities, the non-interest-bearing loan in question evidenced a situation that clearly benefited the foreign controlled companies, which the transfer pricing regulations are intended to prevent. The tax authorities said an advantage like that would not have occurred had the companies obtained their supplies on a free market.

However, the Supreme Court said the application of transfer pricing rules (article 110, paragraph 7 of the Italian Income Tax Code (Testo Unico Delle Imposte sui Redditi, or TUIR) is subject to a twofold condition:

- contractual intercompany transactions generate positive or negative income components for the taxpayer company; and
- application of the arm's-length value increases taxable income.

The Supreme Court said that for the non-interest-bearing loan at issue, ''the service itself — to which the payment of any interests due refers, and which represents the necessary basis for comparison vis-à-vis the arm's-length value — is missing.'' Further, the Court restated that a non-interest-bearing loan is an option

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that does have valid economic reasons — that is, sound business purpose. For example, as pointed out by the Supreme Court in Ruling 15055, the Italian company granted a loan to its own French subsidiary in order to give it the necessary capital to acquire a second-level controlled company, which was also French.

National Transfer Pricing

In Ruling 12844 of June 22, 2014, the Supreme Court confirmed its position in Ruling 17955 of 2013 and Ruling 8849 of 2014 regarding the application of the arm's-length value criterion in article 9 TUIR to intercompany transactions entered into among subjects residing in Italy.

In particular, the Supreme Court said the arm's-length criterion in article 9 is also valid for transactions entered into by subjects belonging to the same group that reside in Italy:

> In observance of the prohibition to abuse the Law, which precludes taxpayer from realizing tax advantages obtained through the distorted use, even if not conflicting with any specific provision, of legal tools that are suitable for the purpose of securing tax advantages or savings, in the absence of any reasons other than the mere expectation of the said benefits. Such principle is rooted, on the one hand, in EU tenets to safeguard resources that are proper to the EU as well as in the constitutional principles of the ability-to-pay principle and of progressive taxation; on the other hand, it does not clash with the ''subject to the law'' principle, ultimately leading to the disavowal of abusive effects of transactions entered into with the purposes of avoiding the application of tax norms. Such transactions include internal transfer pricing schemes, motivated by convenience, within a national context to transfer taxable matter, by impacting on prices negotiated for the transfer of intercompany goods and the rendering of intercompany services. ◆

COMING ATTRACTIONS

A look ahead at upcoming commentary and analysis.

Belgium's new CFC rule: The 'Cayman tax' (*Tax Notes International*)

Giovanni Smet and Virginie Derouck discuss Belgium's new Cayman tax, a controlled foreign corporation provision that allows Belgian authorities to look through low-taxed offshore structures to tax Belgian resident founders and beneficiaries of the structure's income.

Do China's revisions to Circular 2 localize BEPS actions? (*Tax Notes International*)

Yansheng Zhu discusses China's revisions to Circular 2, asking whether the changes reflect China's localization of the OECD's base erosion and profit-shifting actions or simply summarize the country's own antiavoidance practice.

Eyes on e-commerce: What Europe's excessive tax burdens on e-commerce can teach us (*State Tax Notes*)

George Isaacson and Matthew Schaefer provide insight on tax and legal developments in the area of electronic commerce.

Finding a cure: Apportionment illness in the biotech and pharmaceutical industries (*State Tax Notes*)

Kenny Gast explores the state tax problems caused by upfront, milestone, and royalty payments, and attempts to provide a general overview of the sales factor apportionment issues taxpayers face in the biotech and pharmaceutical industries.

Goodwill hunting . . . without a license: Proposed section 367 regulations openly defy legislative intent (*Tax Notes*)

Ken Brewer questions the validity of proposed regulations that would eliminate the favorable tax treatment of goodwill and going concern value in outbound transfers.

Friends don't let corporations pay tax (*Tax Notes*)

Jasper L. Cummings, Jr., examines the many ways that corporations with related entities can avoid gain recognition, highlighting how the related party section 1031 can be used in cross-border transactions.

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