Italy: year-end transfer pricing adjustments under new accounting standard

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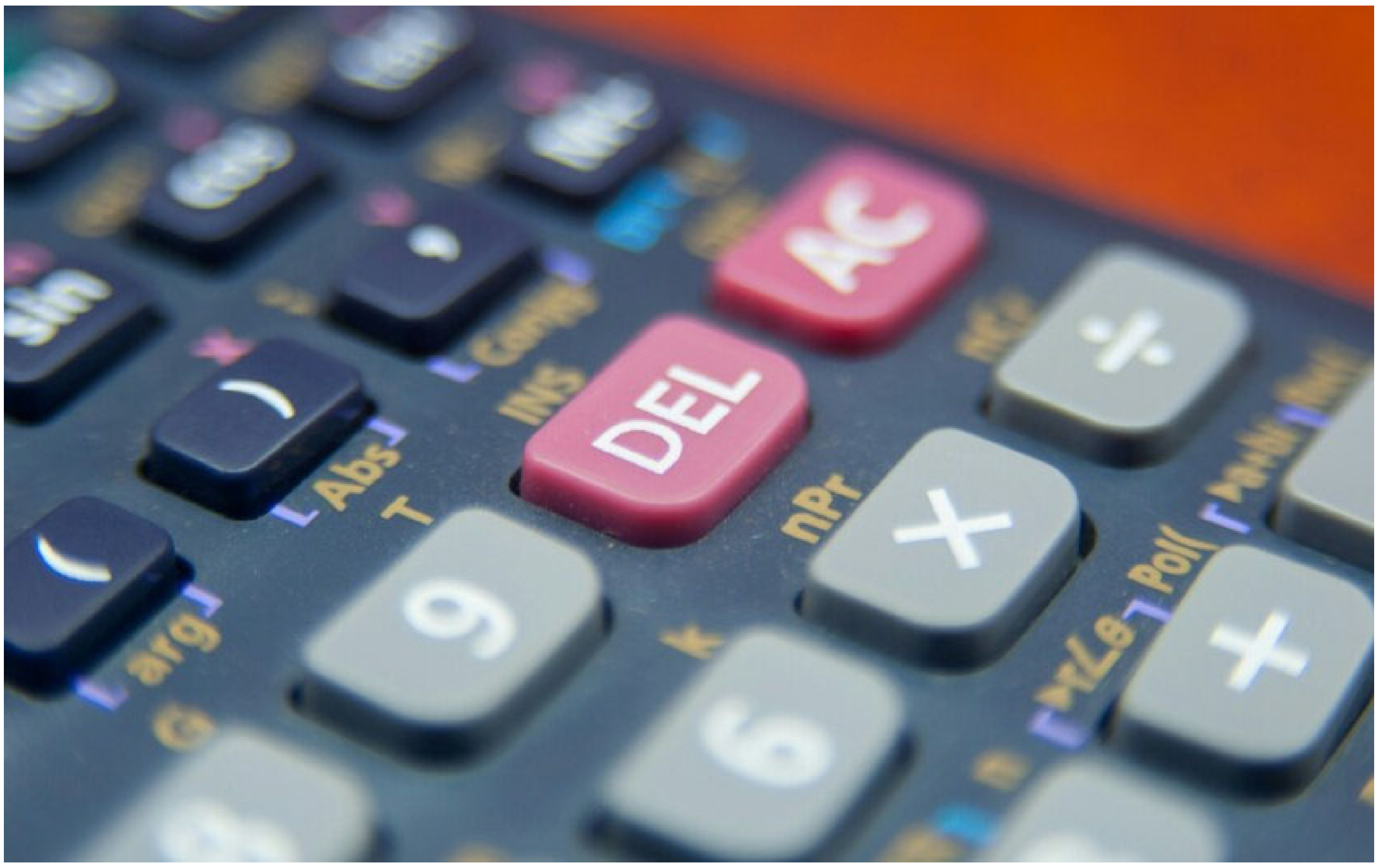

Federico Vincenti and Carola Valente of Valente Associati GEB Partners/ Crowe Valente examine year-end transfer pricing adjustments in light of EU developments and implementation of the OIC 34 accounting standard in Italy

One of the methodologies adopted by multinational enterprises to align the outcomes of their transfer pricing policies with the arm's-length principle involves the application of specific year-end adjustments –particularly in the context of the transactional net margin method. This method aims to attribute to the tested party an operating margin consistent with that which would be earned by independent entities operating under comparable market conditions.

Developments in the European framework on transfer pricing-related adjustments

As indicated by the EU Joint Transfer Pricing Forum in 2014, the adjustment, at a later point, of transfer prices set at the time of a transaction touches upon an important theoretical issue in transfer pricing; namely, whether:

- Taxpayers should be required to establish transfer pricing documentation that demonstrates that they have

made reasonable efforts to comply with the arm's-length principle at the time their intragroup transactions were undertaken based on information that was reasonably available to them at that moment (ex ante or arm's-length price-setting approach); or
- Taxpayers can, or should, test the actual outcome of their controlled transactions to demonstrate that the conditions of the transactions were consistent with the arm's-length principle (ex post or arm's-length outcome-testing approach).

Making such adjustments requires a preliminary analysis of the country-specific rules to verify whether these adjustments are allowed and/or whether specific requirements must be followed.

Transfer pricing should be assessed carefully and ideally more frequently than once a year (e.g., quarterly or monthly), possibly using an updated arm's-length range from benchmarking.

Before performing transfer pricing adjustments, local market conditions and exceptional circumstances must be properly considered, and it is also necessary to evaluate functional profiles, realistic alternatives, and third-party behaviour in comparable situations.

Transfer pricing adjustments also affect customs duties and import VAT, and these implications should be factored into any analysis.

Further guidance has been provided in the proposed EU directive on transfer pricing.

On September 12 2023, the European Commission proposed new rules to harmonise transfer pricing practices and establish a common approach to addressing transfer pricing issues across the EU. The proposal aims to:

- Incorporate the arm's-length principle and core transfer pricing rules into EU law;
- Clarify the role and legal status of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*; and
- Enable the adoption of common, binding rules on specific aspects of transfer pricing within the EU.

With reference to year-end adjustments, Article 7 of the EU directive provided the following.

Member states shall ensure that a compensating adjustment, in the form of a year-end adjustment initiated by the taxpayer, is accepted if the following conditions are met:

- Prior to recording the relevant transaction or series of transactions, the taxpayer made reasonable efforts to achieve an arm's-length outcome;
- The adjustment is made symmetrically in the accounts of all member states involved;
- The taxpayer applies the same approach consistently over time; and
- The adjustment is made before the filing of the tax return.

The Italian position on adjustments

From an accounting perspective, adjustments resulting from transfer pricing are not explicitly addressed by Italian national accounting standards (OICs).

In 2024 (specifically, for financial statements for fiscal years beginning on or after January 1 2024), the new OIC 34 entered into force. This standard governs all transactions that result in the recognition of revenues from the sale of goods or the provision of services, regardless of their classification in the income statement.

In addition, OIC 34 addresses so-called variable consideration, meaning the amounts a company estimates it will need to consider to correctly determine the total contract price. These include incentives, performance bonuses, discounts, allowances, penalties, and returns.

To determine the appropriate accounting treatment of transfer pricing adjustments, it is essential to distinguish between:

- Adjustments involving a revision of sales revenues or incurred costs; and
- Adjustments involving profit margins.

In the first case, the transfer pricing adjustment explicitly involves a revision of sales revenues or incurred costs, for which a debit or credit note is issued.

In such cases, these adjustments fall under the definition of variable consideration and must be recorded as an increase or decrease of the related revenues or costs.

In the case of adjustments involving a profit margin (performed to guarantee an arm's-length margin to the tested party), such adjustments should not be considered as corrections to revenues or costs and they should be classified under the items “A.5 – Other revenues and income” and “B.14 – Other operating costs”.

More specifically, these adjustments do not fall under variable consideration because they are not directly attributable to a specific performance obligation (e.g., the sale of goods), and therefore cannot be recorded as a reduction in revenues.

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