Implementing BEPS Actions 8 to 10

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AUTHORS

Franco Pozzi

Lisa Vascellari

Valentina Bertolini

Introduction

Transfer pricing rules were first introduced in Italy in 1973 and further developed by Circular 32 of 22 September 1980. In 2010 the Organisation for Economic Cooperation and Development (OECD) issued an updated version of its guidelines. As a further step toward alignment with the OECD provisions, a penalty protection regime was also introduced.

As a result, in principle, penalties for transfer pricing adjustments are not applied if the transfer pricing documentation is considered been properly drafted by tax authorities. The Italian Revenue Agency's 29 September 2010 provision and Circular 58/E of 15 December 2010 set out the documentation requirements for taxpayers and report references to the OECD guidelines.

The new principles introduced by Actions 8 to 10 of the Base Erosion and Profit Shifting (BEPS) project and the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Administrations were reflected in Italy through Decree-Law 50/2017's amendments to Article 110 (7) of the Income Tax Code.

The new Article 110(7) includes a specific reference to the arm's-length principle and provides for the implementation of provisions to be issued by the Ministry of Finance in order to align with "international best practices".

Following a public consultation process, the Ministry of Finance issued a ministerial decree on 14 May 2018 concerning transfer pricing guidelines as part of Article 110(7)'s implementation.

The decree is a condensed document of nine articles that contain a number of relevant principles set out in the BEPS project, including explicit references to BEPS and the 2017 OECD guidelines in its introduction and Article 9 (the latter only refers to the OECD transfer pricing guidelines as being "periodically updated").

An Italian translation of the 2017 OECD guidelines' relevant sections has also been issued.

The main points of the ministerial decree concerning transfer pricing guidelines are summarised below.

Definitions

The subjective requirements for the application of transfer pricing provisions are set out in the

definition of 'associated enterprises', which – recovering some concepts from OECD guidelines and the Model Tax Convention – consists of one enterprise participating in the management, control or capital of the other enterprise. This condition is met in the following situations in which 'control' means both juridical and *de facto* control:

- a majority participation (ie, greater than 50%) in capital, voting rights or profits; or
- a controlling influence based on contractual obligations or shareholding interests.

'Controlled transactions' are commercial and financial transactions outlined via written contracts (where they exist) and the conduct of the parties (in the absence of written contracts or in cases where the transaction is inconsistent with formal conditions). In practice, this principle entails that when a transaction is outlined, the conduct of the parties must be investigated and this prevails over written agreements.

Comparability

An independent transaction is considered comparable to a controlled transaction when:

- there are no material differences that significantly affect the profit level indicator that can be used in application of the most appropriate transfer pricing method; and
- in case of differences, they can be eliminated or materially reduced through comparability adjustments.

In this regard, comparability adjustments (eg, working capital adjustments aimed at reducing or eliminating different levels of account receivables and payables and the inventory between the tested party and comparable companies) appear to be legitimate.

The notion of comparability reflects the economically relevant characteristics or comparability factors set out in the new Chapter 1 of the 2017 OECD guidelines, in which emphasis has been placed on risk analysis. The principle is that risks arising from a transaction should be allocated to the party that actually controls them and has the financial capacity to assume them, rather than merely attributing risks according to a written agreement.

Further, when a functional analysis is performed, it is important to understand how value is generated by the group as a whole (ie, global value chain analysis).

As a result, when a functional analysis is performed, specific attention must be paid to any outdated agreements or agreements that do not reflect the actual conduct of the parties. Actual conduct can be investigated through functional interviews with relevant company employees.

According to information provided during the public consultation, additional clarification from the Ministry of Finance will concern benchmark analysis, in particular:

- the use of databases;
- the choice of geographic market of reference;
- the period to be used for the analysis;
- the possible inclusion of loss making companies; and
- the dimension of comparables and comparability adjustments.

Methods

The ministerial decree of 14 May 2018 includes the five transfer pricing methods set out in the OECD guidelines (ie, traditional methods – comparable uncontrolled price, resale price and cost plus methods – and transactional – the transactional net margin and profit split methods) and recommends the following hierarchy:

- where the comparable uncontrolled price method is deemed to be applied in an equally reliable a manner as another method, the former should be preferred; and
- when both a traditional and a transactional method are deemed to be applied in an equal and reliable manner, the former should be considered.

The taxpayer has also the possibility to apply a further method (the "sixth method"), demonstrating that that none of the five methods can be reliably applied and that it is consistent with results that would have been established among independent enterprises.

Tax authorities are bound to the method selected by the taxpayer under the requirements set out in Article 4 of the ministerial decree. This provision entails strong argument for tax authorities to disregard the taxpayer method.

Portfolio approach

The portfolio approach is recognised as an alternative to assess compliance with the arm's-length principle where two or more transactions are strictly connected or form a unitary complex, such that the single transaction, considered as standalone, would not be representative.

Arm's-length range

One of the ministerial decree's most important provisions is the recognition of the entire range obtained from the profit level indicator selected as compliant to the principle of arm's length, as set out in the OECD guidelines. Thus, the entire range of the arm's-length principle applies only in case of perfect comparability between controlled and uncontrolled transactions. This approach will require further clarification.

Taxpayers can prove and report specific elements to support cases where profitability falls outside of the arm's-length range (eg, where sales of a company engaged in distribution activities fall due to a lack of final customers' demand, causing a significant reduction in profitability and the profit level indicator to fall below the minimum value of the arm's-length range).

Low-value adding services

In line with the OECD guidelines, the ministerial decree introduces a simplified approach to define arm's-length remuneration for low-value adding services, which is a 5% flat mark-up applied to direct and indirect costs associated with such services if they:

- are of a supportive nature;
- are not part of the core business of the multinational enterprise (MNE) group;
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

This simplified approach cannot be applied to services that the MNE group performs for third parties.

Specific supporting documentation is required to apply the simplified approach; further clarification in this respect will be issued regarding the computation of (direct and indirect) costs.

Transfer pricing package

The Italian Revenue Agency is set to update provisions concerning transfer pricing documentation to remain in line with international best practices.

The new provision is expected to update the requirements for documentation to be considered properly drafted, replacing the 2010 circular and provision and introducing a more substantial assessment of local and master files. This new approach is expected to reduce the burden for MNE groups, which will be able to use some parts of their documentation and the same master file in different jurisdictions, including Italy.

The decree specifies that such documentation will be deemed "properly drafted" by tax authorities if it contains:

- all data and elements that allow to examine the transfer prices applied, even if the method or selection of operations or comparable companies are different from those selected by tax authorities; and
- an omission or partial inaccuracies that do not prejudice the analysis by tax officers.

Further provisions

Further provisions will be issued by the Revenue Agency to reflect the 2017 OECD guidelines as periodically updated.

The ministerial decree represents an effort to align Italian rules with OECD best practices. Other aspects, such as the relation of outdated rules contained in the circular of 1980 and new dispositions, remain uncertain with particular reference to the following issues:

- financial transactions – since the OECD guidelines do not address this issue, the only reference for Italian taxpayers is the circular of 1980, in which the lender's market is used as a reference for the interest rate to be applied. A draft document that sets out uniform rules that apply to financial transactions has recently been issued by the OECD and is under public consultation; and
- intangibles – the ministerial decree makes no reference to intangibles and the circular of 1980 allows the use of a safe harbour for royalties from technology intangibles (no reference is made to marketing intangibles).

Further practical clarifications, as discussed during the roundtable with representatives from the tax authorities and tax professionals, are expected in the near future.

For further information on this topic please contact Franco Pozzi, Lisa Vascellari or Valentina Bertolini at Studio Legale Tributario Biscozzi Nobili by telephone (+39 02 763 6931) or email (franco.pozzi@slta.it, lisa.vascellari@slta.it or valentina.bertolini@slta.it). The Studio Legale Tributario Biscozzi Nobili website can be accessed at www.slta.it.
