THE TRANSFER PRICING LAW REVIEW

FOURTH EDITION

Editors
Steve Edge and Dominic Robertson

THE LAWREVIEWS

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PREFACE

It has been a great pleasure to edit this fourth edition of *The Transfer Pricing Law Review*. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the *Review*. Each chapter summarises the country's substantive transfer pricing rules, explains how a transfer pricing dispute is handled, from initial scrutiny through to litigation or settlement, and discusses the interaction between transfer pricing and other parts of the tax code (such as withholding taxes, customs duties, and attempts to prevent double taxation).

Other than Brazil, all the countries covered in this *Review* apply an arm's-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines); and Brazil itself has recently launched a project to align its transfer pricing rules with the OECD norm. However, as the chapters make clear, there remains significant divergence, both in countries' interpretation of the arm's-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the administration of the rules (e.g., the documentation requirements imposed, and the availability of APAs). Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers but must in fact engage with their detailed application within each country.

As we have said in earlier editions of the *Review*, transfer pricing rules will be high on the corporate tax agenda for many years to come, and they are continuing to evolve at a rapid pace. Over the next year or so, we expect the following to be among the main areas of focus.

First, as in so many other areas of endeavour, the covid-19 pandemic raises new challenges for transfer pricing, and may in some cases invert the 'normal' argument between taxpayers and tax authorities. For example, will tax authorities which have previously argued that a company is not a routine service provider, and should be rewarded through a profit split, now accept that the company therefore needs to bear a share of the group's covid-19 losses? Looking further forward, the experience from the 2008 financial crisis suggests that, in the medium term, the need for tax revenues is likely to push tax authorities towards a more assertive approach in transfer pricing cases.

Second, a number of countries may see disputes over the extent to which transfer pricing can be used to recharacterise transactions, rather than merely to adjust the pricing of transactions. For example, the German courts held last year that transfer pricing rules are not limited to pricing adjustments alone; and Ireland introduced rules that enable the Irish Revenue to impose a 'substance over form' principle.

Third, the long-awaited OECD Transfer Pricing Guidance on Financial Transactions was published in February 2020. Although its immediate impact has been rather overshadowed by the covid-19 situation, many taxpayers, and tax authorities, will need to get to grips with the potential impact of this guidance on them.

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to work towards its target of presenting an agreed solution by the end of 2020. The current Pillar One and Pillar Two proposals would, if enacted, be the most far-reaching change to transfer pricing principles in close to 100 years, and would mark a significant shift away from the arm's-length principle. The desire to shore up tax revenues in light of covid-19 may well encourage the countries that expect to be 'winners' from the proposals to push for an agreed outcome. It is worth noting, however, that the reforms will not be a silver bullet for public finances. The OECD expects the reform to increase corporate tax revenues by 4 per cent; in the UK, for example, that would raise enough money to fund the National Health Service for only one week.

We would like to thank the authors of all of the country chapters for their comprehensive and illuminating analysis of each country's transfer pricing rules; and the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this *Review*.

Steve Edge and Dominic Robertson
Slaughter and May
London
June 2020

Chapter 12

ITALY

Franco Pozzi, Lisa Vascellari Dal Fiol and Stefano Grossi[1]

I OVERVIEW

Rules on transfer pricing are set out in Article 110 of the Italian Corporate Tax Act (CTA). Transfer pricing rules apply to corporation tax (IRES) and to regional tax on productive activities (IRAP), pursuant to Article 1, Paragraphs 281 to 284 of Law No. 147/2013.[2] There are no separate rules for capital transactions.

Article 110, Paragraph 7 was amended by Law Decree No. 50/2017 and it presently states that an enterprise's income-statement items that derive from operations with non-resident corporations that directly or indirectly control the enterprise (or are controlled by the enterprise or are controlled by the same entity[3] that itself controls the enterprise) are valued on the basis of the conditions and prices that would have been agreed among third parties, at arm's length and in similar circumstances, if an increase in taxable income would arise[4]. Reductions in taxable income are allowed only in the following specific cases expressly indicated by Article 31 *quater*[5] of Presidential Decree No. 600/1973:

a on the basis of mutual agreement procedures (MAPs) or the EU Arbitration Convention;[6]
b after tax inspections carried out in relation to international cooperation activities whose outcomes are shared by the participating countries; or
c upon the filing of a specific request by the taxpayer, if the transfer pricing adjustments involve a state with which Italy has in force a tax treaty to avoid double taxation that provides for an adequate exchange of information.[7]

Previous guidelines from the Ministry of Finance were issued in 1980 in Circular No. 32/9/2267, which provided principles and methods, based on the Organisation for Economic

1 Franco Pozzi is a partner, and Lisa Vascellari Dal Fiol and Stefano Grossi are associates at Studio Legale e Tributario Biscozzi Nobili Piazza.
2 Transfer pricing rules apply to resident companies and permanent establishments of foreign companies resident in Italy.
3 Note that entities controlled by the same individuals are within the scope of the provision.
4 Circular Letter No. 53/1999 and Legislative Decree No. 147/2015 state that – in principle – transfer pricing rules do not apply when both the parties involved in an intercompany transaction, even if they belong to the same group, are resident in Italy for tax purposes.
5 Introduced by Law Decree No. 50/2017.
6 EU Convention No. 90/436/EEC, implemented in Italy by Law No. 99 of 22 March 1993.
7 On 30 May 2018, the Director of the Italian Revenue Agency released a decision containing guidance on the requirements and procedure for implementing this correlative adjustment. See Section IX.ii. for further details of this new regime.

Co-operation and Development (OECD) Transfer Pricing Guidelines applicable at that time ('Transfer Pricing and Multinational Enterprises', OECD 1979), to be used in determining arm's-length prices.

After a process of public consultation, the Ministry of Finance issued on 14 May 2018 a document on Italian guidelines for transfer pricing (the Italian Guidelines). The document aims at making Italian tax practice consistent with the 2017 OECD Transfer Pricing Guidelines and, among the issues covered, provides a specific definition of associated enterprises, a brief description and priority of the methods to be used, and a definition of low value-adding services, and introduces a definition of the arm's-length range.

With regard to the applicable version of the OECD Transfer Pricing Guidelines, as a general rule, the Italian Tax Administration (ITA)[8] and courts refer to the version in force in the tax period under review; the use of a new version of the Guidelines with reference to previous tax periods is not explicitly considered under Italian tax practice. Thus, it is common practice that, in case of topics not considered in a previous version of the OECD Transfer Pricing Guidelines, suggestions reported in a new version can also be extended to issues related to the past, subject, however, to specific analysis to be performed case by case.

The provisions on transfer pricing documentation included in Law Decree No. 78 of 31 May 2010 remain relevant, as subsequently implemented by the Decision of the Commissioner of the Italian tax authorities of 29 September 2010 and by Circular Letter No. 58/E of 15 December 2010. The latter expressly refers to the 2010 version of the OECD Guidelines ('Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations').

In Italy, where a transaction is found not to be compliant with the arm's-length principle, there are no specific corporate law implications; however, this could trigger legal or judicial actions to protect the stakeholders' rights (e.g., on account of overpayment for goods or services, or accounting fraud).

As a general rule, ITA requires the use of data from the public balance sheet and profit-and-loss (P&L) accounts for transfer pricing analysis. However, taxpayers carrying on several activities can use management data (taken from enterprise resource planning systems) to obtain a breakdown of the P&L accounts for areas of business. This approach can be challenged by ITA if the taxpayers are not able to produce a reconciliation with the statutory data.

In addition, Italian accounting principles, as amended by Legislative Decree No. 139/2015 to align them with IFRS standards, had an impact mainly on financial transactions as a direct consequence of the application of the amortised cost method. Additional work is also required for the proper identification of the relevant profit level indicator (PLI) in respect of transfer pricing analysis because of the new representation of the extraordinary (positive and negative) items of income now included in the operating income.

II FILING REQUIREMENTS

In Italy, there are no specific transfer pricing returns and there are no mandatory reports to be prepared, but transfer pricing documentation is recommended as evidence of compliance with the arm's-length principle in inter-company transactions. Further, if the documentation complies with specific regulations, it allows the taxpayer to access the penalty

8 Namely the Italian Revenue Agency and the Italian Finance Police.

protection regime provided for by Article 1, Paragraph 2 *ter* of Legislative Decree No. 471 of 18 December 1997. In this regard, documentation is composed of a master file and country-specific documentation (the local file). However, the documentation requirements change depending on the taxpayer (i.e., subsidiaries are only required to prepare the local file, while sub-holdings and holdings are required to prepare both the local file and the master file).

If taxpayers wish to take advantage of the penalty protection regime, they must communicate the availability of the transfer pricing documentation in their annual income tax return. To obtain penalty protection, the documentation must be compliant from a substantial point of view and it must follow the structure required.[9]

As a general rule, documentation for penalty protection must be updated annually, including the economic analysis, before filing the tax return for each financial year (e.g., by 30 November for companies with financial year ending 31 December).

Small and medium-sized enterprises, defined as enterprises with an annual turnover of less than €50 million, are entitled to update the economic analysis included in their documentation every three years, provided that no significant modifications in the comparability factors have occurred.

The filing of the documentation with ITA must be executed within 10 days of being requested to do so. Tax auditors may also request additional information or documentation, in which case the supplementary information must be provided within seven days of the request (or within a longer period depending on the complexity of the transactions under analysis) to the extent that the above period is consistent with the time frame of the audit. Once these terms have elapsed, ITA is not bound to apply the penalty protection.

On 23 February 2017, the Italian government issued a ministerial decree that sets out the terms and conditions for filing the country-by-country report (CbCR); implementing provisions were published in the decision of the Commissioner of the Revenue Agency, dated 28 November 2017. In particular, the CbCR must be filed by the end of the 12th month following the end of the taxpayer's financial year (the consolidated accounts). The information required is aligned to the OECD standard (except in respect of some minor issues, which mainly concern mismatches in Italian translation).

III PRESENTING THE CASE

i Pricing methods

Acceptable pricing methods are those recommended by the OECD. The selection of a transfer pricing method requires an explanation of the reason for choosing that method, and a statement justifying the results as consistent with the arm's-length principle. According to the Italian Guidelines, transaction-based methods are preferred over profit-based methods, and the comparable uncontrolled price (CUP) method, if applicable, is preferred over the resale price and cost-plus methods. However, ITA is aware of the difficulties that application of the CUP or resale price method present to operators, and so profit-based methods (especially the transactional net margin method (TNMM)) are accepted.

9 The structure indicated by the decision of the Commissioner of the Revenue Agency dated 29 September 2010.

When a TNMM is selected, ITA's approach is often to perform a new benchmark analysis to check the results obtained by the taxpayer, and tax challenges are, in practice, based on the median value of the set of comparables resulting from the benchmark analysis. However, in accordance with the 2017 OECD Guidelines, the Italian Guidelines state that each point in the interquartile range should be compliant with the arm's-length principle, provided all the items included in the benchmark have a sufficient degree of comparability.[10]

Since ITA uses the databases provided by Bureau van Dijk, taxpayers also tend to use them, except for financial transactions or operations involving intangibles (royalties, etc.), for which different databases are used in addition to or instead of the databases provided by Bureau van Dijk.

In addition to the above, ITA has expressly stated in Circular No. 25/E 2014 that activities scrutinising transfer pricing matters must always be carried out with the primary aim of establishing a deeper understanding of the facts and circumstances of the case, and also considering the actual economic conditions that characterise intra-group transactions. This approach is also required in managing possible relationships with foreign tax administrations within MAPs.

In delineating a transaction, and in accordance with the 2017 OECD Guidelines, the Italian Guidelines stress the importance of the investigation of the actual conduct of the parties where this differs from written agreements (i.e., the principle of substance over form).

ii Authority scrutiny and evidence gathering

ITA consists of two entities, the Italian Revenue Agency and the Italian Finance Police, and they are both entitled to carry out inspections aimed at detecting the infringement of tax law.

In recent years, ITA has increasingly been carrying out inspections of companies that belong to multinational groups, with the aim of checking the consistency of the transfer prices applied in inter-company transactions.

The approach of ITA during tax audits is mainly oriented towards understanding the role of the Italian companies under scrutiny in the group's value chain, but also through requests for clarification about the activities performed by their foreign related counterparts. This is to check the consistency of the transfer pricing methods applied and the results of the benchmark analysis. The procedure for acquiring the information usually starts from the analysis of transfer pricing documentation, agreements in force and a breakdown of their figures. Face-to-face interviews can be held with the heads of the relevant departments, also for the purposes of tax rulings or advance pricing agreements (APAs).

If necessary, additional information may be requested from the employees of the Italian company. However, in complex cases, and when the audit is carried out by the Finance Police, the tax auditors can look for evidence for the information provided by the company by asking for confirmation from third parties, such as customers or suppliers, and by seeking access to and inspections of the taxpayer's premises.

Under Italian tax rules, the use of expert witnesses is not explicitly provided for. However, in the pre-litigation phase the taxpayer can provide the tax auditors with any useful documents or information that lead to a better understanding of the specific case.

For confidentiality reasons, audit results are not published.

10 Recent regional tax court and provincial tax court judgments (Regional Tax Court of Lombardy, No. 5005 of 19 November 2018, and Provincial Tax Court of Milan, No. 5445 of 26 November 2018 respectively) recognised this principle as stated in the Italian Guidelines.

The option to ask questions or request documents from taxpayers outside the Italian tax jurisdiction is, however, limited to cases of joint tax audits conducted with foreign tax authorities.

Nevertheless, attention paid to the group is expected to increase following the implementation of CbCRs.

IV INTANGIBLE ASSETS

As a general rule, intangible assets held by each single company involved in inter-company transactions must be considered when setting the correct pricing. To this aim, when taxpayers prepare the transfer pricing documentation (master file), they are required to provide a complete list of such assets with a separate indication of any royalty received and paid or any other type of compensation for intellectual property assets, and to specify the licensor's and the licensee's names. Further, the list of the assets used in a specific transaction must also be reported in the local file, together with the contractual terms.

Given the importance of intangible assets, for completeness, taxpayers are also required to describe any intangibles not reported in the financial statements (e.g., the know-how, the positive impact from synergies and the positive effects of networks). Any business restructuring that involves a reallocation of intangibles must also be included, in addition to the analysis related to the legal ownership and the time of creation of the assets.

Recently in Italy, growing attention has been paid to matters concerning intangible assets from both sides (taxpayers and ITA), with particular focus on the DEMPE[11] functions. These functions are key issues in determining prices for controlled transactions and in determining which entity or entities ultimately will be entitled to returns derived by the multinational enterprise group from the exploitation of intangibles.

These functions are also subject to an in-depth analysis by ITA when taxpayers apply for rulings, or where MAPs are concerned.

In an addition to transfer pricing regulations, as of 2015, Italian taxpayers may elect for a 'patent-box' regime; to establish the tax benefit, taxpayers that apply for the patent-box tax relief are required to explain to ITA the contribution made by the intangibles owned to the creation of value. To this aim, taxpayers must show both the costs incurred in creating, developing and protecting the intangibles, and the extra profits deriving from the intangibles. The methods deemed to be acceptable by ITA for the calculation of the tax relief derive from transfer pricing criteria (CUP or profit split). Even if ITA has not issued specific internal guidelines regarding intangible assets for transfer pricing purposes, further to the introduction of the patent-box relief, it is reasonable to expect a more analytical approach even during ordinary tax audits on transfer pricing matters. Note that, for new applications filed since 1 January 2017, in accordance with the implementation of the OECD recommendations, trademarks are no longer subject to tax relief.

Note also that, regarding arm's-length remuneration for the use of intangible assets, Circular No. 32/1980 (see Section I) provides for safe-harbour ranges with respect to royalties paid by Italian companies for intangibles (royalties higher than 5 per cent must be justified by the legal and economic conditions of the relevant agreement).[12]

11 Developing, enhancing, maintaining, protecting and exploiting intangibles.

12 Actually, safe harbours are not consistent with the BEPS project, and their application during a tax audit by ITA is often disregarded notwithstanding no formal instructions have so far been issued by the competent tax authorities.

V SETTLEMENTS

General rules regarding settlements among taxpayers and tax authorities are applicable to transfer pricing assessments too. The typical settlement process, according to Legislative Decree No. 218 of 19 June 1997, takes place following a tax audit: after the notification of an assessment notice,[13] taxpayers have 60 days to challenge the assessment before the tax court or to submit a request to ITA to reach an agreement. During the 90 days subsequent to the settlement request,[14] taxpayers and ITA can meet several times to discuss their positions and to exchange proposals. In the event that an agreement is reached (before the deadline for filing the appeal against the assessment with the competent tax court), the settlement agreement is signed by both the taxpayer and ITA; the taxpayer is then obliged to pay the related liability immediately.[15] The settlement covers the years under assessment and related matters. If there are multiple years under assessment, they can be dealt with either together or separately. Normally, in the case of unvaried conditions, it is in the interest of both the taxpayer and ITA to settle all the years under assessment in the same manner.

Where an agreement is not reached, litigation continues before the tax court (see Section VII). However, a settlement can be reached even after the judicial procedure has begun and until the hearings take place before the second instance tax court.

Applicable penalties[16] are reduced in the event of settlement; the reduction varies depending on the timing of the agreement (reduction to a third of the original amount before the beginning of the judicial procedure; to 40 per cent before the first instance tax court hearing; and to 50 per cent before the second instance tax court hearing).

After the signature, the settlement cannot be disregarded either by ITA or by the taxpayer. On the other hand, settlements are not binding for future years or different matters and are not automatically incorporated into an APA; they can only represent a starting point for future discussions. Settlements are generally confidential, as well as their contents; in some cases general information about the settlements reached by large multinational groups are made available.

In the above-mentioned framework, the use of APAs is recommended to reduce the risk of future assessments.[17] ITA is currently encouraging the use of APAs to prevent litigation and avoid recourse to MAPs (for further details see Section IX.ii).

13 After investigative activities are concluded, and before the notification of an assessment notice, tax authorities usually issue a preliminary report (PVC) addressing the proposed adjustments to the taxpayer's position and taxable income. After the PVC notification, the taxpayer has 60 days to reply with comments, observations and requests. Otherwise, the taxpayer has the option to settle the audit by correcting its tax return and paying (in part or in full) the amount liable in the PVC, in which case the applicable penalties are reduced to one-fifth of the original amount.

14 During the 90-day discussion period, the deadline for challenging the assessment is suspended. Note that the opportunity to request a settlement cannot be used in an opportunistic way to increase the time frame or to delay the opposition period; in cases of abuse, tax authorities can decide to stop discussions even before the 90-day period has elapsed.

15 An instalment payment plan can also be granted.

16 In principle, penalties should not be applicable for transfer pricing assessment, provided the taxpayer is compliant with the penalty protection regime (see Section II).

17 Rulings for multinational enterprises have been modified by Article 31 *ter* of Presidential Decree No. 600 of 29 September 1973; the new procedure is regulated by the Decision of the Commissioner of the Revenue Agency issued on 21 March 2016.

VI INVESTIGATIONS

Tax auditors involved in transfer pricing investigations have ordinary and broad audit powers provided by law (see Section III.ii).[18]

Law No. 212 of 27 July 2000 provides taxpayers subject to tax audits with several rights and protections (see Article 12).

A tax audit could take several months to be completed; there is a time limit, but this is often surpassed by tax inspectors.[19]

A common issue that is deeply investigated during multinational-enterprise tax inspections relates to management fees and intra-group services; in particular, in cases where costs are borne by the Italian entity in respect of these types of services, ITA often questions their deductibility, on the basis of the general 'principle of inherence'[20] rather than on the basis of transfer pricing provisions (consequently with a higher risk of non-recognition of the full costs borne by the Italian entity, rather than restatement of the pricing of the transaction).

The option for tax authorities to challenge costs related to intra-group services or management fees based on the general principle of inherence (instead of transfer pricing) gives rise to three main negative consequences for taxpayers; in particular, there is no penalty protection regime available; access to MAPs and arbitration is excluded and, under certain conditions, criminal penalties could be applicable.[21]

Therefore, it is very important to keep adequate documentation regarding the detailed activities performed by foreign group entities for the benefit of the Italian entity (e.g., emails, meeting reports, flight tickets, hotel bills, contracts).

The Finance Police issued operative internal instructions in relation to tax inspections applicable as of 2018 (Circular No. 1/2018). Among other things, the Circular provides specific guidelines on transfer pricing assessments, such as the acquisition of information regarding the method followed by the taxpayers for drafting the transfer pricing documentation; for example, by inspecting emails regarding the previous versions of the documentation, to identify any possible omission or fraud.

As a general rule,[22] a tax assessment must be issued by the end of the fifth year following the year when the tax return was filed;[23] as a practical example, the assessment for a tax year ended on 31 December 2018 has to be completed by 31 December 2024 (since the tax return must be filed by 30 November 2019).[24]

18 Reference is made to Presidential Decree No. 600 of 29 September 1973.

19 In principle, investigations based on physical access to the taxpayer's premises cannot last more than 30 days – even when the 30 days are not consecutive. This can be extended for an additional 30 days only, in cases of particular need.

20 As a general rule, the CTA allows deductions of costs only to the extent they are connected to the taxpayer's activity and to the extent they refer to services that have actually been rendered.

21 However, different tax offices may assume different positions on this matter.

22 Reference is made to Article 43 of Presidential Decree No. 600 of 29 September 1973.

23 In the event that the tax return has not been filed, the deadline for the tax assessment is the end of the seventh year following the year in which the tax return should have been filed.

24 For fiscal years prior to fiscal year 2016 different terms apply.

VII LITIGATION

i Procedure

Tax assessments may be settled by reaching an agreement with ITA (see Section V) or directly challenged before the tax court.

According to Italian tax law, witness evidence is not allowed in tax litigations as well as during the public hearings. Thus, declarations made during the tax audit or before the judicial hearing (or both) can be taken into account by the competent tax court.

In brief, the typical litigation process involves the following steps:[25]

a challenge before the tax court of first instance (usually represented by the provincial tax court of reference for the taxpayer's domicile) within 60 days of the notification[26] of the tax assessment;

b first instance tax court hearing: it usually takes place several months (at least six months but up to two years, depending on the workload of the specific court) after the presentation of the petition to the court;

c first instance decision: it is usually issued between three months and one year after the hearing;

d the losing party can then appeal the first instance decision with the tax court of second instance (usually represented by the regional tax court of reference for the taxpayer's domicile); the deadline for filing the appeal is six months after the decision has been issued;[27]

e second instance tax court hearing and decision: the procedure and timing are similar to the first instance hearing and decision; and

f the losing party can then apply to the Supreme Court for the final decision on the litigation; the deadline for filing an appeal is six months after the second instance decision has been issued.[28]

Tax litigation usually takes at least five years. Decisions of the courts of first and second instance are based on facts, while the Supreme Court's decisions refer only to matters of law. Before assuming their positions, the tax courts are allowed to engage independent experts to analyse the case, although this is not a very common practice.

After the decision of the Supreme Court, there are, in principle, no further opportunities to discuss the litigation.[29] Partial payments are imposed by law during the judicial procedure;[30] in the event that the taxpayer is the winning party, these payments are reimbursed by ITA.

25 The relevant provisions regarding the tax litigation procedure are contained in Legislative Decree No. 546 of 31 December 1992.

26 Summer holiday suspension (from 1 to 31 August) should also be considered.

27 The term is reduced to 60 days in the case of formal notification of the decision by the winning party.

28 ibid.

29 In exceptional and specific cases identified by law, even the decision of the Supreme Court could be subject to review.

30 Under certain conditions, a petition to suspend the collection of the partial payments can be submitted either to the competent court or to ITA.

ii Recent cases

Generally speaking, transfer pricing litigation by the Supreme Court in Italy has been limited; the reason is that the tax courts do not have specific and in-depth knowledge of transfer pricing matters and consequently taxpayers often prefer to settle the assessment (before or during the judicial procedure) with ITA, rather than bear the risk of an adverse decision.

The following are the main issues related to transfer pricing dealt with by the Supreme Court in recent years:

a The transfer pricing regime as an anti-avoidance provision, and the burden of proof in transfer pricing assessments:[31] the main position of the Supreme Court is to consider the transfer pricing regime a safeguard of the principle of fair competition between countries, rather than as an anti-avoidance provision (regardless of the tax rate of the foreign countries involved). As far as the burden of proof is concerned, the Supreme Court, in the most recent cases, stated that this should be borne by the tax authority to the extent that an inter-company transaction occurred for a consideration that was not consistent with the arm's-length principle. The burden of proof that the transaction occurred at arm's length is then transferred to the taxpayer, on the basis of the assumption that the latter has a closer and deeper knowledge of the facts.[32]

b The scope of domestic transfer pricing provisions:[33] formerly, the main position of the Supreme Court was to view transfer pricing provisions as general rules, applicable even to transactions between resident entities. The issue has finally been clarified by Legislative Decree No. 147 of 14 September 2015,[34] which expressly excludes the application of transfer pricing provisions to domestic transactions.

c Intra-group services and shareholders' loans:[35] the Supreme Court position confirms that costs deriving from intra-group services (i.e., in application of a cost-sharing agreement) are deductible provided that the benefit for the receiver is proved by the taxpayer. With regard to interest on inter-company loans, the Supreme Court and the provincial and regional courts have taken different positions on the applicability of transfer pricing provisions to non-interest-bearing loans.

The positions of the provincial and regional tax courts are very fragmented and do not represent reliable precedents since Italy is a civil law country. Recent tax court decisions have made reference to the new Italian Guidelines and provide more detailed interpretations on

31 See, for example, the following decisions: Supreme Court No. 2805, 5 February 2011; Supreme Court No. 11949, 13 July 2012; Supreme Court No. 10739 and No. 10742, 8 May 2013; Supreme Court No. 22010, 25 September 2013; Supreme Court No. 15282 and No. 15298, 21 July 2015; Supreme Court No. 16398, 5 August 2015; Supreme Court No. 6311, 1 April 2016; Supreme Court No. 6656, 6 April 2016; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 26545, 21 December 2016; Supreme Court No. 28335, 7 November 2018.

32 See, for example, the decision of the Supreme Court No. 2387, 29 January 2019.

33 See, for example, the following decisions: Supreme Court No. 17955, 24 July 2013; Supreme Court No. 8849, 16 April 2014; Supreme Court No. 13475, 13 June 2014.

34 See, in particular, Article 5, Paragraph 2.

35 See, for example, the following decisions: Supreme Court No. 16480, 18 July 2014; Supreme Court No. 27087, 10 December 2014; Supreme Court No. 15005, 17 July 2015; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 9466, 12 April 2017; Supreme Court No. 11094, 5 May 2017; Supreme Court No. 25566, 29 October 2017.

territoriality of comparables, period of reference for the calculation of the PLI, inclusion of loss-making companies, and compliance with the arm's-length principle where the PLI of the tested party falls within the whole interquartile range.[36]

VIII SECONDARY ADJUSTMENT AND PENALTIES

In Italy, there are no specific provisions for secondary adjustments and, in practice, they are not usually applied.

With specific reference to financial transactions or transactions involving intangibles (or both),[37] primary adjustments may have a consequent effect on withholding taxes. In particular, in the case of outbound interest or royalties on which no withholding rate (based on the EU Interest and Royalties Directive) or a reduced withholding rate (based on double taxation treaties) has been applied, the amount paid in excess to the arm's-length value is challenged as subject to the ordinary withholding rate provided by national legislation (i.e., 30 per cent).

As far as penalties are concerned, if, in the event of a tax assessment, the documentation provided (master file or local file) is considered not to be compliant with Law Decree 78/2010 by ITA, ordinary administrative penalties are applied, ranging from 90 per cent up to 180 per cent of the assessed higher income. No specific reduction or increase is provided for transfer pricing adjustments. On the other hand, where transfer pricing documentation is considered to be compliant, the 'penalty protection' grants the non-application of the above-mentioned penalties. The penalty protection applies also for withholding taxes purposes, in the case of assessment based on the arm's-length value.

Taxpayers can submit preliminary comments on the results of the tax audit before their formalisation in a tax assessment. After the notification to the taxpayer of the tax assessment, penalties can be challenged during subsequent litigation (see Section VII).

Regarding criminal law, penalties are applicable to any director signing the relevant tax returns if certain conditions, set out in Article 4 of Law 74/2000, are jointly met. In principle, provided that transfer pricing documentation complies with the Italian regulations, criminal consequences should be excluded. Thus, the wording of Article 4 is somewhat unclear and some tax offices are still giving notice of criminal offence to the competent public prosecutor. However, in the event of an agreement with ITA before starting formal litigation in the competent tax courts, it is becoming common practice for public prosecutors to stop any criminal law proceedings.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

Profits that are deemed to be realised in Italy (even by non-resident entities)[38] are subject to IRES and – to the extent they are related to activities performed in Italy – to IRAP.

36 See, for example, the following decisions: Regional Tax Court of Lombardy No. 5005 of 19 November 2018, and Provincial Tax Court of Milan No. 5445 of 26 November 2018 and No. 188 of 22 January 2020.

37 Increasingly under scrutiny by ITA.

38 With the exception of individuals.

There are also specific additional anti-avoidance provisions aimed at addressing possible profits shifted to foreign countries, such as: controlled foreign corporation rules; presumptions regarding the residence of foreign incorporated entities; and permanent establishment provisions.[39] These provisions have a broader scope than transfer pricing regulations, since they are enforceable even in the absence of controlled transactions.

Under Italian tax regulations, no other specific rules such as diverted profits tax or BEAT/GILTI provisions are in force.

ii Double taxation

Double taxation represents a very critical issue for multinational enterprises in Italy, since international dispute resolution instruments are not always effective. In principle, at the moment there are two different applicable procedures: (1) the EU Arbitration Convention, in the case of disputes concerning cross-border issues involving other EU countries; and (2) MAPs provided by bilateral treaties (mainly based on Article 25 of the OECD Model Tax Convention[40]) in cases involving non-EU countries.[41]

The two procedures differ in several aspects, among which the most important are:

a scope of application: the procedure under (1) is applicable with reference to transfer pricing litigation only, while the procedure under (2) is applicable to all matters covered by the specific treaty (including transfer pricing);

b mandatory result: in principle, in the procedure mentioned in (1) there is a mandatory arbitration phase, after two years of unsuccessful negotiations between the litigating countries; in contrast, in respect of the procedure under (2), the majority of the current tax treaties signed by Italy[42] do not stipulate mandatory arbitration, consequently the dispute might not be resolved if the litigating countries are unable to reach an agreement; and

c interactions with the domestic litigation procedure:[43] the procedure mentioned at (1) is an alternative to domestic litigation, meaning that the result is binding both for the taxpayer and tax administrations; in contrast, in principle, any agreement reached pursuant to the procedure under (2) is not binding for the taxpayer, who can decide to refuse it and elect to go through the domestic litigation procedure.[44]

39 The domestic definition of a permanent establishment was recently amended to make it consistent with BEPS Action 7; moreover, a new specific tax provision regarding digital transactions ('web tax') was introduced by the 2019 budget law (replacing the web tax previously introduced by the 2018 budget law). See footnote 52 for additional details.

40 Most of the tax treaties signed by Italy are still based on the 2008 OECD Model Tax Convention and they do not include a mandatory 'arbitration clause' in case the contracting states are not able to find a positive solution to the MAP request.

41 On 9 April 2020 the OECD released the document *Making Dispute Resolution More Effective – MAP Peer Review Report, Italy (Stage 2)*. This document reports the 'state of the art' relating to the implementation in Italy of the Minimum Standard required by Action 14 of the BEPS project.

42 Only a few treaties in force among Italy and foreign countries include an arbitration phase, which can be either discretionary or mandatory (e.g., Armenia, Canada, Chile, Croatia, Hong Kong, Jordan and the United States).

43 The matter is analysed in depth in Circular Letter No. 21/E issued by the Italian Revenue Agency on 5 June 2012.

44 If this is the case, particular attention has to be paid to the expiry of the terms within which the assessment must be challenged if it is to be disputed before the national courts (for more details, see Section VII).

In both cases (1) and (2), provisions regarding suspension of the domestic litigation procedure could apply,[45] and also the actual effectiveness of MAP procedures should be further improved through the adoption of EC Directive 2017/1852, whose text has been submitted for preliminary opinion of the parliament.

Further guidance is expected after the actual implementation of the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument or MLI). Italy was a member of the group that developed the OECD MLI and signed the agreement on 7 June 2017. As far as options are concerned, Italy has for the moment adopted a minimalist position, limited mainly to accepting the minimum mandatory changes, and during the ratification process the choices made may still be subject to amendments. Thus, it is worth noting that, under the MLI version presently adopted by Italy, the arbitration phase will be mandatory and the positive outcome of a MAP procedure should be implemented notwithstanding domestic statutory limitations.

Reductions are also considered in double taxation cases, pursuant to the new Article 31 *quater* of Presidential Decree No. 600/1973 (see Section I). More specifically, Letter (c) of the new Article allows ITA to grant unilateral corresponding downward adjustments where a foreign tax authority makes a primary adjustment under the arm's-length principle. On 30 May 2018, the Director of the Italian Revenue Agency issued Decision No. 108954/2018 on practical provisions regarding the application procedure for filing requests under Letter (c). To commence this procedure, the following conditions must be met:

a the primary adjustment in the foreign country must be final (or at a final stage);

b the primary adjustment in the foreign country must be compliant with the arm's-length principle; and

c the jurisdiction where the primary adjustment is set must be a party to a double-tax treaty with Italy that provides an adequate exchange of information.

In the initial filing, the taxpayer must also choose a suitable instrument for the resolution of international disputes concomitant with the requested downward adjustment (i.e., MAP, EU Arbitration Convention or other instrument, including mechanisms provided by the Tax Dispute Resolution Directive,[46] once implemented in Italy), as a precaution against the unilateral adjustment not being granted directly by ITA. The request shall be filed within the specific deadline established by the instrument selected.

The Italian Revenue Agency may invite the taxpayer to further discuss the issues examined or may require additional documentation when examining the matter. The procedure should be concluded within 180 days with a recognition or denial of the unilateral corresponding adjustment. In the case of recognition, the Italian Revenue Agency notifies the tax administration of the foreign country of the downward adjustment. After the acquisition of a certificate issued by the foreign tax authorities or similar documentation proving that the (foreign) upward adjustment is final, the central Revenue Agency office issues a statement of recognition of the downward adjustment as corresponding to a definitive adjustment performed by foreign tax authorities. The Revenue Agency then notifies its decision to the competent local Revenue Agency office, which then implements the decision through the necessary further procedure.

45 Article 39, Paragraph 1 *ter* of Legislative Decree No. 546/1992.

46 Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union.

Bilateral or multilateral APAs provide alternative means to prevent double taxation; ITA is currently encouraging these types of agreement and the number of cases submitted to the competent revenue office has recently increased. It should be noted that within the current framework there are countries with which a bilateral agreement cannot be reached (e.g., China), according to ITA feedback, and also that bilateral and multilateral APAs take longer to be concluded than unilateral APAs.

Following the entry into force of Legislative Decree No. 32/2017, Italy has engaged in the exchange of APAs with foreign tax authorities. To this effect, 'new rulings' (issued, modified or revised as of 1 January 2017) are automatically exchanged and 'old rulings' (issued five years prior to 1 January 2017) are exchanged under certain conditions only.[47]

iii Consequential impact for other taxes

Pursuant to the applicable law, the VAT-taxable base is generally represented by the contractual consideration due.[48]

In general, adjustments made for transfer pricing purposes can take the form of either price adjustments (difference affecting the prices of specific products or services sold, purchased or rendered by the company) or profitability adjustments (difference on the companies' margins so as to align them to the benchmark profitability). In the first case, the adjustment can have an impact on value added tax (VAT) (both for products sold and services rendered); in the second case (profitability adjustments), the adjustment should be excluded from VAT and from the customs-taxable base, in line with the VAT Expert Group working paper VEG No. 071 REV2. Italian legislation does not expressly address the VAT impact of such adjustments; however, in a recent request filed by a taxpayer (Ruling No. 60/2018) ITA expressed a position aligned with that of the VAT Expert Group.

From a customs perspective, on 6 November 2015, Circular No. 16/D was issued by the Italian Customs Authority (Customs) to reconcile the OECD transfer pricing methods used for tax purposes with the methods provided by European customs legislation. After summarising the main provisions concerning the determination of customs value to be declared, the Circular states that the OECD methods are deemed acceptable by Customs especially with reference to the traditional transaction methods. However, profit-based methods (i.e., the TNMM) could also be acceptable should specific conditions be met.[49]

Further, the Circular proposed the use of two alternative procedures provided by European customs legislation (i.e., the European Customs Code and its implementing provisions) to handle the transfer pricing adjustments problem. These procedures are contained in the following legislation:

a Article 76(a) of the European Customs Code Customs Code and Article 254 *et seq.* of EU Commission Regulation (EEC) No 2454/93, according to which the business

47 Old rulings are exchanged only if they meet specific requirements, as provided in Directive 2011/16/EU: (1) if they were issued, amended or renewed between 1 January 2012 and 31 December 2013, the exchange shall take place under the condition that they were still valid on 1 January 2014; and (2) if they were issued, amended or renewed between 1 January 2014 and 31 December 2016, the exchange shall take place irrespective of whether they are still valid.

48 The arm's-length principle for VAT purposes is provided in exceptional cases only (Article 13, Paragraph 3 and Article 14 of the VAT Code).

49 During the meeting for the public consultation for the introduction of the Italian Guidelines, it was explained that new specific dispositions are expected with regard to VAT and customs matters.

operator can file a customs declaration, both for import and export transactions, omitting some elements or documents to be transmitted a second time and within a specific term; and

b Article 156 *bis* of Regulation (EEC) No 2454/93, stating the option for the business operator, only in import transactions, to make a lump-sum payment.

Both procedures have to be authorised by Customs; additional practical matters have been dealt with by Customs in Circular No. 5 of 21 April 2017.[50]

X OUTLOOK AND CONCLUSIONS

The increasing attention that ITA is paying to multinational groups and cross-border matters has entailed a greater focus on the tax risks deriving from transfer pricing matters. ITA has become more skilled in matters concerning transfer pricing, intellectual property and the OECD Guidelines, and moreover, particular attention has been paid to intangibles since the introduction of the patent-box regime.

On the other hand, domestic judicial procedures remain lengthy and uncertain, and international dispute resolution instruments are still ineffective; consequently, multinational groups often face a high risk of double taxation. The actual impact of the new Article 31 *quater* of Presidential Decree No. 600/1973 is unknown as yet, as it is a new instrument and there is no public case law available to date.

In these circumstances, the importance of APAs has grown, such that they are now being used with a degree of assurance, even though timing remains a material issue.[51]

The new Italian Guidelines have aligned Italian tax practice with the 2017 OECD Guidelines and further provisions are expected to clarify practical issues. Moreover, following the release of the OECD's final guidelines concerning the transfer pricing issues related to financial transactions, a new Circular Letter is expected to be issued by ITA in respect thereof, since the applicable rules governing Italian practice are very limited and date back to the above-mentioned Circular No. 32/9/2267 from 1980.

With respect to the Inclusive Framework on Pillar One and Pillar Two, except for wide discussions within the community of Italian tax practitioners, no official position from ITA is presently available.[52]

50 As regards transfer pricing, VAT and customs, a recent Circular (Circular 1/2019) issued by Assonime, the association of Italian joint-stock companies, states that, even if efforts have been made by authorities, further aspects should be clarified with regard to: (1) valuation of goods in customs and transfer pricing rules, which often lead to the recognition of different values for the transactions; and (2) additional coordination on transfer pricing adjustments and VAT and customs matters, to allow companies to set consistent transfer pricing policies for the purposes of direct and indirect taxation.

51 See footnote 41.

52 Starting from 1 January 2020, a new tax on digital services (Italian web tax) is applicable. The Italian web tax is equal to 3 per cent and it applies to revenues deriving from the supply of certain digital services by those business entities which, individually or as a group, in the previous calendar year obtained revenues exceeding certain thresholds. Revenues subject to the Italian web tax do not include positive items of income from services provided to entities that are controlled by or control the taxable person and such items provided to entities controlled by the same controlling entity. The tax will be abolished when any international agreements on the taxation of the digital economy are adopted.

Finally, considering that currently enterprises are facing hard challenges worldwide due to the emergency caused by covid-19, specific transfer pricing considerations shall be due in the near future to find out the proper way to split the exceptional losses (or, in certain cases, exceptional profits) involved; an accurate functional and risk analysis shall of course be the starting point, but specific guidance both from the OECD and national authorities is expected.

Appendix 1

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