The Transfer Pricing Law Review

Sixth Edition

Editors
Steve Edge and Dominic Robertson

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SIXTH EDITION

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PREFACE

It has been a great pleasure to edit this sixth 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 is considering aligning its TP rules with the OECD norm by 2024. 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 advance pricing agreements). Therefore, transfer pricing practitioners cannot simply assume that the OECD Guidelines contain all the answers but must engage with their detailed application within each country.

Given their economic importance, transfer pricing rules will be high on the corporate tax agenda (and the broader political agenda) for many years to come, and they are continuing to evolve at a rapid pace. Over the next few years, we expect the following to be among the main areas of focus.

First, as many of the chapters make clear, litigation over transfer pricing disputes is expected to increase (almost) everywhere over the next few years, as tax authorities become more confident in their interpretation of transfer pricing guidelines, and ever more alert to public pressure to make big business pay its 'fair share'. Some countries have a long record of transfer pricing litigation, and have resolved many of the procedural hurdles in asking a court to rule on exactly where value is created in a multinational; for example, the approach to handling (often conflicting) expert evidence, and the challenge of developing factual evidence in a proportionate but comprehensive way. However, it is clear that asking for a ruling results in lengthy – and costly – hearings before the tax tribunals, and many other countries will find themselves grappling with transfer pricing litigation for the first time soon.

Second, some of these disputes will concern 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 have recently held 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. In contrast, the Canadian courts ruled, in the *Cameco* case, that TP recharacterisation was permitted only where the underlying transactions were ‘commercially irrational’.

Third, many countries are strengthening the requirements for contemporaneous transfer pricing documentation, either aligning with the OECD master file or local file model (as in Israel and Portugal), or potentially going beyond this (as the United Kingdom has proposed).

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to progress apace (at least within the OECD itself), with consultations on aspects of the two pillars being launched (seemingly) weekly, normally with absurdly short deadlines for comments. In particular, Pillar One marks a pivot away from the arm’s-length standard for large and highly profitable multinationals, under which a portion of their profits (above a 10 per cent hurdle rate) would automatically be reallocated to market jurisdictions. This would, of course, be a radical shift away from the traditional arm’s-length standard, but the arm’s-length principle will continue to play a crucial role for large businesses and tax authorities. First, it is not yet clear whether Pillar One, in particular, will ever become law, and the prospects of the US Congress approving it seem limited in the current political circumstances there. Furthermore, even if (or where) Pillar One becomes law, the arm’s-length standard will continue to apply (1) to the vast majority of businesses that fall outside the reallocation rule, either because of size or profit margins; and (2) to the majority of the profits of those businesses that are subject to the reallocation rule.

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 2022

Chapter 9

ITALY

Franco Pozzi, Stefano Grossi, Luca Consalter and Pierangelo Baffa[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 281–284 of Law No. 147/2013.[2] There are no separate rules for capital transactions.

Article 110, Paragraph 7 states that an enterprise's income-statement items that derive from transactions with non-resident subjects 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 based on 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 arises.[4] Reductions in taxable income are allowed only in specific cases expressly indicated by Article 31 *quater* of Presidential Decree No. 600/1973.

Guidelines for the application of transfer pricing principles are included in the Decree of 14 May 2018 (the Italian Guidelines), which aimed 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.

In respect of the applicable version of the OECD Transfer Pricing Guidelines, as a general rule, the Italian Tax Administration (ITA)[5] 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.

1 Franco Pozzi is a partner, and Stefano Grossi, Luca Consalter and Pierangelo Baffa are associates at Studio Legale e Tributario Biscozzi Nobili Piazza.
2 Transfer pricing rules apply to companies resident in Italy and permanent establishments of foreign companies.
3 Note that entities controlled by the same individuals are within the scope of the provision.
4 Legislative Decree No. 147/2015 states that transfer pricing rules do not apply when both parties who are involved in an inter-company transaction, even if they belong to the same group, are resident in Italy for tax purposes.
5 Namely the Italian Revenue Agency and the Italian Finance Police.

Recently, the implementing provisions of the Italian penalty protection regime[6] (Decision of the Commissioner of the Italian tax authorities of 29 September 2010 and by Circular letter No. 58/E of 15 December 2010) have been replaced by the Decision of the Commissioner of the Italian tax authorities No. 360494 (the New Decision) issued on 23 November 2020 by the Italian Revenue Agency and by Circular letter No. 15/E of 26 November 2021.

The New Decision introduces material changes to the structure and the substance of the 'compliant' transfer pricing documentation that must be prepared to support the application of the arm's-length principle to controlled transactions, to benefit from the Italian penalty protection regime.

In particular, the New Decision is part of the process aimed at aligning the Italian transfer pricing legislation to the OECD standards (Chapter V of the OECD Guidelines as of July 2017).[7]

In Italy, when 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 public data for transfer pricing analysis. In addition, management data can be used to obtain a breakdown of the P&L accounts for areas of business, but the taxpayers should be able to produce a reconciliation with the statutory data. Finally, 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, and the proper identification of the relevant profit level indicator (PLI) in respect of transfer pricing analysis.

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. Furthermore, if the documentation complies with the New Decision, the taxpayer is entitled to benefit from the penalty protection regime provided for by Article 1, Paragraph 2 *ter* of Legislative Decree No. 471/1997.

The New Decision requires that the 'compliant' documentation includes both the local file and the master file.

Regarding the master file, relevance is attributed to the identification of the key value-drivers of the group's profitability, operating structure and value chain. From a structure perspective, detailed information must be shared in relation to activities aimed at developing intangibles, the intra-group financing activities, requiring the inclusion of information concerning the group's financing structure, the identification of any entity within the group that carries out central financing activities, and the description of the transfer pricing policies regarding the controlled financial transactions. The New Decision also requires the group

6 Introduced by Law Decree No. 78 of 31 May 2010.

7 The New Decree requires a master file, local file and the documentation for low-value-adding services substantially consistent with Annex I (Master File) and Annex II (Local File) of Chapter V and Paragraph D3 (on low-value-adding services) of Chapter XVII of 2017 OECD Guidelines, respectively.

to show consolidated income statements, as well as a list of any advance pricing agreement (APA) and other tax rulings entered into with the tax authorities of the countries in which the group operates.

The local file shall now include (in addition to other previous contents):

a a description of the reporting lines for the HR personnel in each local business unit;
b an explanation of the reasons for performing a multi-year analysis and of any comparability;
c indication of the principal 'critical assumptions' adopted for the application of the transfer pricing method;
d further information on economic financial data; and
e a copy of the unilateral, bilateral or multilateral APAs and of the cross-border rulings to which the resident entity is not a party but that is connected to the inter-company transactions indicated in the local 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 the penalty protection, the documentation must be compliant from a substantial and formal point of view, strictly following the structure of the New Decision.

From a formal point of view, the New Decision requires the documentation in an electronic format, the electronic signature (for both the master file and the local file) of the legal representative or his or her delegate, jointly with a digital timestamp[8] that must be executed before the filing of the relevant tax return.[9] The documentation must be prepared in Italian, except for the master file, which can also be in English, and it is referred to each fiscal year (including the economic analysis).

The New Decision introduces the option to adopt a 'cherry-picking' approach, by allowing the taxpayer to prepare the documentation exclusively in relation to certain (instead of all) inter-company transactions. In such a case, the penalty protection regime will be applicable solely to 'covered' transactions, to the extent information provided is considered as 'compliant' by ITA.

The documentation must be provided to ITA within 20 days. Tax auditors may also request additional information or documentation, which should be provided within seven days from the request (or within a longer period depending on the complexity of the transactions under analysis). In the case that these terms are not met, ITA is not bound to apply the penalty protection.

The New Decision requires additional specific documentation relating to low-value-added services,[10] which should contain information concerning the description of intra-group services, service supply contracts, the valuation of operations and the related calculations.

8 The timestamp is an essential requirement for a 'compliant' transfer pricing documentation and also attachments) that must be certified with the timestamp.
9 A grace period of 90 days is granted for the filing of a tax return later than the statutory deadline, and therefore the TP documentation would also be compliant if the timestamp is executed within the same additional term. Notably, under specific circumstances, the transfer pricing documentation, which is properly prepared and compliant under all formal provisions, is considered valid even if the taxpayer, for a mere material mistake, has not communicated its possession in the relevant tax return (*remissio in bonis*).
10 This information is requested as a fundamental requirement for applying a simplified approach and the application of a lump sum 5 per cent markup on related costs, for low-value-adding services.

Finally, domestic provisions also require the filing of the country-by-country report (CbCR), in accordance with 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 presents to operators and so profit-based methods (especially the transactional net margin method (TNMM)) are accepted.

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 often based on the median value of the set of comparables resulting from the benchmark analysis; notwithstanding the fact that the Italian Guidelines provide 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.[11]

Since ITA uses the databases provided by Bureau van Dijk, taxpayers also tend to use them, except for financial transactions or operations involving intangibles (e.g., royalties), for which different databases are used in addition to or instead of the databases provided by Bureau van Dijk. ITA has also 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, stressing 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. For confidentiality reasons, audit results are not published.

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

11 Regional Tax Court of Lombardy, No. 5005/2018 and Provincial Tax Court of Milan, No. 5445/2018 recognised this principle as stated in the Italian Guidelines.

the benchmark analysis. The procedure for acquiring the information usually starts from the analysis of transfer pricing documentation (if available), agreements in force and a breakdown of their figures. Face-to-face interviews can be held with the process owners.

In complex cases, and when the audit is carried out by the Finance Police, the tax auditors can look for evidence of 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.

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.

Under Italian tax rules, the use of expert witnesses is not explicitly outlined.

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. Notably, under the New Decision, detailed information must be shared, in the master file, in relation to the group's intangible assets, such as a full list of the group's intellectual property-related intra-group agreements with particular focus on the IPs exploitation or utilisation (or both) in the transactions that have taken place between associated enterprises. The list of 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, 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 described, 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[12] 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.

In an addition to transfer pricing regulations, as of 2015, Italian taxpayers who perform R&D activities may elect for a 'patent-box' regime; under new patent box provisions applicable from FY 2021, taxpayers are entitled to an additional deduction (110 per cent) of the R&D costs actually incurred for the creation of copyrighted software, patents, designs and models. Notably, taxpayers, who have already put in place a patent box procedure in accordance with the previous regime, are entitled under certain conditions to choose the previous calculation criterion, which was based on the contribution of eligible intangible assets to their own profitability. In this latter case, the main methods that are considered acceptable by ITA are derived from transfer pricing criteria (CUP or profit split).

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

Note also that, regarding arm's-length remuneration for the use of intangible assets, Circular No. 32/1980 still 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).[13]

V SETTLEMENTS

General rules regarding settlements among taxpayers and tax authorities are applicable to transfer pricing assessments too. The most common 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,[14] taxpayers have 60 days to challenge the assessment before the tax court or to submit a request to ITA aimed at reaching an agreement (*accertamento con adesione*). During the 90 days subsequent to the settlement request,[15] 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.[16] 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[17] 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).

In principle, until FY 2017, a final settlement cannot be disregarded either by ITA or by the taxpayer and it cannot be overturned either wholly or partially by an MAP procedure.

13 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.

14 After investigative activities have been 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.

15 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.

16 An instalment payment plan can also be granted.

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

However, 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.

Starting from tax audits related to FY 2018, taxpayers are allowed to claim for an MAP procedure, in accordance with Legislative Decree 49/2020 (implemented under Italian law EU Directive 2017/1852-1), even if a settlement procedure[18] has already taken place.

VI INVESTIGATIONS

Tax auditors involved in transfer pricing investigations have ordinary and broad audit powers provided by law (see Section III.ii).[19] Law No. 212 of 27 July 2000 provides taxpayers with several rights and protections during tax inspections and audits (see Article 12). A tax audit could take several months to be completed, but there is a time limit.[20]

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, based on the general 'principle of inherence'[21] rather than based on transfer pricing provisions (consequently with a 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 negative consequences for taxpayers (no penalty protection regime available, access to MAPs and arbitration is excluded and, under certain conditions, criminal penalties could be applicable).

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 TP 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]

18 Conversely, court settlements (*conciliazione giudiziale*) do not allow access to MAP.

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

20 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 additional 30 days only.

21 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.

22 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.

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, Italy uses a three-tier litigation process, which involves the following steps:[24]

a challenge before the tax court of first instance (represented by the provincial tax court of reference for the taxpayer's domicile) within 60 days of the notification[25] of the tax assessment;

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

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 (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;[26]

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.[27]

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.[28] Partial payments are imposed by law during the judicial procedure;[29] in the event that the taxpayer is the winning party, these payments are reimbursed by ITA.

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

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

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

27 ibid.

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

29 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

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 or to enter into a MAP procedure, rather than bear the risk of an adverse decision.

The most recent 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).[30] As far as 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.[31] Otherwise, in practice, it is sometimes transferred to the taxpayer based on the assumption that the latter has a closer and deeper knowledge of the facts.[32]

The historical position of the Supreme Court[33] was to consider transfer pricing provisions as general rules, applicable even to transactions between resident entities: the issue has finally been clarified by Legislative Decree No. 147/2015,[34] which expressly excludes the application of transfer pricing provisions to domestic transactions. Such a position was recently confirmed by the Supreme Court in Decision No. 8176/2021.

Finally, the Supreme Court position confirmed that costs deriving from intra-group services 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.[35]

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 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.

30 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, Supreme Court No. 5646, 2 March 2020; Supreme Court No. 11837, 18 July 2020.

31 See, for example, the following decisions: Supreme Court No. 22539, 10 August 2021; Supreme Court No. 1374, 28 January 2022.

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 the decision of the Supreme Court No. 13850, 20 May 2022.

VIII SECONDARY ADJUSTMENT AND PENALTIES

In Italy, there are no specific provisions for secondary adjustments and, in practice, they are not applied.[36]

With specific reference to financial transactions or transactions involving intangibles (or both), primary adjustments may have a consequent effect on withholding taxes. In particular, in the case of outbound interest or royalties on which no withholding tax (based on the EU Interest and Royalties Directive) or a reduced withholding tax (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 domestic 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 by ITA not to be compliant[37] with the New Decision, ordinary administrative penalties are applied, ranging from 90 per cent up to 180 per cent of the assessed higher income. However, where transfer pricing documentation is considered to be compliant, the 'penalty protection' grants the non-application of the above-mentioned penalties. The penalty protection also applies for withholding taxes purposes, in the case of assessment based on the arm's-length value.

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, digital sales taxes 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 that they are related to activities performed in Italy – to IRAP.

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 because they are enforceable even in the absence of controlled transactions.

36 Nevertheless, secondary adjustments deriving from MAP procedures are acceptable under Italian practice.

37 The New Decision establishes that tax auditors must explicitly provide reasons for compliancy, without prejudice to the power of the assessment office to make the final administrative decision. In particular, it specifies that the documentation shall be considered 'compliant' when it provides the tax authorities with the information necessary to execute an analysis of the transfer pricing policy applied by the taxpayer, notwithstanding the fact that the transfer pricing method or the selection of transactions or benchmarks adopted by the taxpayer are different from those identified by the tax administration.

38 With the exception of individuals.

39 The domestic definition of a permanent establishment was recently amended to make it consistent with BEPS Action 7.

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

The Digital Service Tax (DST) was introduced by Law Nr. 145/2018 and entered into force on 1 January 2020; the implemented provisions and interpretations are contained in the administrative regulation Nr. 13185/2021 and the Circular letter Nr. 3/2021 (collectively IDST[40]) issued by ITA. The DST is due at the rate of 3 per cent on gross revenues (net of VAT and other indirect taxes) generated from B2B and B2C activities in a given calendar year on digital services that are within the scope of the Italian DST, that is, for any user who is located in Italy.[41]

The IDST does not interact with transfer pricing issues because inter-company revenues are excluded from its taxable base.

State aid investigations have been neither launched nor threatened by the European Commission against Italy in relation to the application of transfer pricing rules, or of an EU ALP.

ii Tax challenges arising from digitalisation

Currently, Italy has not implemented the OECD/Inclusive Framework recommendations on Pillar One and Pillar Two, or taken an official position in relation to the introduction of them.[42] Nevertheless, Italy has announced[43] that consideration is being given to 'a more robust approach for zero tax jurisdictions in the context of the EU list of non-cooperative jurisdictions' (i.e., the 'black list'). In this regard, Italy has added that the European Union may either lead or act multilaterally, noting that Italy is awaiting further response from the OECD Global Forum on Harmful Tax Practices and the Inclusive Framework. Additional ongoing tax initiatives include:

a measures to tackle the use of shell companies in order to avoid tax benefits being granted to EU companies with no or minimal economic substance (DAC 3 Directive); and

b expanding the mandate of the Code of Conduct Group by pushing for higher transparency on large companies' effective tax rates, strengthening administrative cooperation for information exchange, dealing with debt and equity distortion, and promoting the proposal for a new common corporate tax base (BEFIT) in the European Union.

40 The IDST has given an overview of the various provisions laid down in the DST, and has confirmed that the DST applies to taxpayers (whether Italian resident or not) satisfying – either standalone or at a group level – both of the following requirements for the calendar year prior to the one in which the DST becomes due (i.e., for the first time, 2019 with respect to 2020): (1) the amount of worldwide revenues reported at consolidated level is at least equal to €750 million; and (2) the amount of revenues, generated in Italy, from qualified digital services is at least equal to €5.5 million.

41 In October 2021, Italy and five other countries (Austria, France, Spain, the United Kingdom and the United States) announced that they entered into an agreement for the transition, starting from 2023, from the current taxes on digital services to the new BEPS multilateral solution (Pillar One).

42 Except for the position described in the previous footnote.

43 We refer to introductory remarks by Commissioner Gentiloni at the European Parliament's Subcommittee on Tax Matters, 30 November 2021.

iii Transfer pricing implications of covid-19

Currently, Italy has not issued any guidance on the transfer pricing implications of the covid-19 pandemic, or taken an official position in relation to the application of OECD guidance of December 2020.

iv Double taxation

Double taxation represents a very critical issue for multinational enterprises in Italy because international dispute resolution instruments are not always effective. In principle, at the moment there are three different applicable procedures:

a the EU Arbitration Convention, in the case of disputes concerning cross-border issues involving other EU countries;

b the Legislative Decree 49/2020[44], implementing the EU Directive 2017/1852-1 (ITA Implementation); and

c MAPs provided by bilateral treaties (mainly based on Article 25 of the OECD Model Tax Convention[45]) in cases involving non-EU countries.[46]

The three procedures differ in several aspects, among which the most important are as follows:

a scope of application: the procedure under (a) is applicable with reference to transfer pricing litigation and attribution of profit to PE only, while the procedures under (b) and (c) are applicable to all matters covered by the specific treaty (including transfer pricing);

b mandatory result: in principle, in the procedure mentioned under (a) and (b), there is a mandatory arbitration phase, after two years of unsuccessful negotiations between the litigating countries; in contrast, in respect of the procedure under (c), the majority of the current tax treaties signed by Italy[47] do not include 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:[48] the procedure mentioned at (a) is an alternative to domestic litigation, meaning that the result is binding both for the taxpayer and tax administrations, while the procedure mentioned at (b) is not an alternative to domestic litigation and is applicable also in the case of activation of the

44 Entered into force 25 June 2020 for disputes on and after FY 2018, applicable, in addition to (1) also in relation to individuals.

45 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 that the contracting states are not able to find a positive solution to the MAP request.

46 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.

47 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).

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

settlement procedure by the taxpayer (e.g., settlement or other agreements with ITA in the case of tax audit), meaning that if the outcome of the MAP is not considered satisfactory, the taxpayer can still continue the domestic litigation procedure.[49]

In contrast, in principle, any agreement reached pursuant to the procedure under (c) is not binding for the taxpayer, who can decide to refuse it and elect to go through the domestic litigation procedure.[50]

In all three cases, provisions regarding suspension of the domestic litigation procedure could apply,[51] but only according to ITA implementation. Under Legislative Decree 49/2020 such suspension could be claimed as early as at the time of its submission, without waiting for the notification of the admissibility of the same by ITA. In this regard, suspension of domestic litigation leads to the automatic suspension of the tax claim by the tax authorities.

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 the minimum mandatory changes; however, during the ratification process the choices made may still be reviewed. Thus, it is worth noting that, under the MLI version presently adopted by Italy, the arbitration phase will also be mandatory under procedure (c) and the positive outcome of a MAP procedure should be implemented notwithstanding domestic statutory limitations.

Another way of avoiding or resolving double taxation is possible pursuant to Article 31 *quater* of Presidential Decree No. 600/1973 (see Section I). More specifically, letter (c) of the 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), 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 selected instrument.

49 Attention has to be paid to the expiration terms to challenge an assessment before national courts (see Section VII).

50 See previous footnote.

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

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.

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.[52] Notably, within the current framework there are countries with which a bilateral agreement is very difficult to be reached (e.g., China), according to ITA feedback. Thanks to a recent amendment,[53] taxpayers are allowed to ask for a roll back of APAs for all the fiscal years that are still subject to assessment at the date of signature of the agreement, with no penalties (in case of bilateral or multilateral APAs, this opportunity is subject to approval by the foreign authority).

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.[54]

v Consequential impact for other taxes

Pursuant to the applicable law, VAT-taxable base is generally represented by the contractual consideration due.[55]

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 specific request filed by a taxpayer (Ruling No. 60/2018), the position of ITA was aligned with that of the VAT Expert Group. This is also confirmed by the answers provided by the ITA in the request for clarifications No. 884, issued in December 2021.

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52 Following the entry into force of the Budget Law for 2021, under the provisions set forth in Article 31 *ter*, Paragraph 3 *bis* of Presidential Decree No. 600/1973, taxpayers are requested to pay a lump sum ranging from €10.000 to €50.000 (the amount is linked to the total turnover of the relevant group to which the taxpayer belongs) to start an APA procedure with the ITA. See also Protocol No. 2021/297428.

53 Article 1, Paragraph 1001 of the Law No. 178 of 30 December 2020 (2021 Budget Law).

54 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.

55 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).

From a customs perspective, Circular No. 16/D/2015 issued by the Italian Customs Authority (Customs) 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.

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

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. Particular attention has been paid by ITA to intangibles since the introduction of the patent-box regime.

However, domestic judicial procedures remain lengthy and uncertain, and international dispute resolution instruments are sometimes ineffective, notwithstanding the strong effort of ITA during the past years that materially reduced pending MAP cases. The actual impact of the provision regarding unilateral downward adjustments is unknown as yet because it has recently been introduced and there is no public case law available to date.

The new Italian Guidelines have aligned Italian tax practice with the 2017 OECD Guidelines and further provisions are expected to clarify certain 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.

Finally, despite specific guidance issued by the OECD, the Italian tax administration has still not yet formulated covid-19 practical transfer pricing instructions.

Appendix 1

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