



New arm's length range is set for transfer pricing

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Introduction

The Italian Tax Agency has issued instructions, through Circular Letter No. 16/E of 24 May 2022, with respect to the correct and practical application of the "arm's length range" for the application of the transfer pricing rules as set forth by article 110(7) of the Corporate Tax Act and international tax treaties.

The circular letter clarified various principles that have already been adopted in the case of advanced pricing agreements and by most taxpayers, but that have sometimes been disregarded by local tax offices in the case of tax audits. The guidelines under discussion should be considered under the framework of the domestic provisions of the Ministerial Decree of 14 May 2018. These provisions implemented the most recent principles adopted by the Organisation for Economic Co-operation and Development (OECD) guidelines, in which a range of figures must be considered consistent with the arm's length principle if consisting of financial indicators (to be selected by applying the "most appropriate method") of independent parties, assumed as comparable to those participating in the controlled transaction.

Under the described scenario, the Italian Tax Administration confirmed the following main issues:

- The arm's length principle (and the most appropriate method applicable case by case) usually triggers a range of comparable/financial indicators that should be equally reliable and differences in the range are caused by the fact that the application of the arm's length principle produces an approximation of conditions that would have been agreed among independent enterprises or by the application of different prices for comparable transactions (see paragraph 4 of the circular letter).

- Transactions between independent enterprises that have a limited degree of comparability should be eliminated from the final benchmark set, as set forth also by paragraph 3.56 of the OECD guidelines.
- Other comparability mismatches should be eliminated using "statistical tools" (eg, the interquartile range) or the application of more than one method. In such a case, each range could be used to define an acceptable range of arm's length figures or to reconsider the accuracy of the adopted methods (see also paragraph 3.57 and 3.58 of the OECD guidelines).
- A substantial deviation among the data included in the benchmark could suggest that some of them are not reliable, therefore requiring a further analysis of the set of comparables.
- Transactions or comparable enterprises realising exceptionally high profit or losses (so-called "outliers") could have a material impact on the adopted financial indicator. Therefore, a further analysis is required and such enterprises shall be excluded from the final benchmark set where the results are not consistent with normal business conditions or reflect a level of risks not comparable to those associated with the controlled transactions.
- Loss-making transactions or enterprises should not be rejected out of hand but should be assessed on the basis of specific facts and circumstances and therefore need further in-depth analysis (see paragraphs 3.63 - 3.65 of the OECD guidelines).

Criteria for reassessment of arm's length range

In the case of a tax audit, the taxpayer shall provide proper supporting documentation to demonstrate that the controlled transaction satisfies the arm's length principle. If the taxpayer does not provide such evidence, the tax administration is allowed to assess a new arm's length value within the arm's length range considering the following guidelines:

- If the benchmark includes comparables of equal and high reliability, the financial indicator is adjusted by positioning the price at the lower or higher range value (the so-called "full range").
- Where the benchmark was subject to adjustment, the "full range" is considered as not applicable since it is not sufficiently reliable, and the first interquartile or third interquartile shall be considered as reliable positioning of the arm's length range.
- The use of a central value within the range (the median) shall be advisable to limit discrepancies deriving from a limited comparability between the controlled transaction and the relevant benchmark.

Comment

At the end of the day, the Italian Tax Agency acknowledges that all the figures within the range could be applicable, should specific conditions be met. Where statistical formulae are used for comparability adjustments, the figures within the restricted range should be applicable and the application of the median shall be based on strong arguments and limited to cases where the benchmark seems to not include a wide range of comparable subjects or transactions.

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