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secondary transfer-pricing
adjustments under Italian
tax practice**



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The case

The case concerns a domestic company which, following an adjustment under article 110, paragraph 7 of Italian Income Tax Code (ITC) concerning transfer pricing arm's length value of royalties for the use of intangible assets paid to its Swiss parent company ("*primary adjustment*"), received also a withholding tax dispute ("*secondary adjustments*") from the Italian Tax Authority ("ITA").

The Italian Tax Authority denied the application of the reduced treaty withholding tax rate on the consideration exceeding the arm's length value of the royalties paid to the Swiss parent company; instead, the domestic withholding tax rate (30%) should apply, since the higher value deriving from the transfer pricing "*primary adjustment*" must be attributed to a transaction of the same nature (i.e. royalty).

The company challenged the tax assessment before the First Instance Tax Court of Milan.

Preliminarily, the company pointed out that it had submitted a request for a Bilateral Advance Pricing Agreement – BAPA (Italy-Switzerland) to settle the transfer pricing policy applied by the company in relation to transactions with its Swiss related party in respect to fiscal years 2017 to 2020. The BAPA was signed, confirming the transfer pricing policy applied, but adjusting the application of the royalty rate related to certain licenses.

Afterwards, the Italian Tax Authority notified the company of an assessment notice for corporate income tax purposes (for both IRES and IRAP), which was not

challenged by the company. At the same time, another notice of assessment was served for withholding tax purposes, against which the company lodged an appeal, considering the claim to be groundless since, in the absence of a specific domestic rule in respect to “secondary adjustments” allowing for the classification of the portion exceeding the arm's length value as “royalties,” the same would not be taxable in Italy.

Furthermore, even if the excess royalty were recognized as taxable, it would still be exempt from taxation, since it should be considered a “*business income*” under the Article 7 of the Italy-Switzerland Double Taxation Treaty.

Lastly, the taxpayer objected to the prohibition against double taxation provided for both by domestic law (Article 163 of the TUIR) and by treaty provisions, since the Italian Tax Authority, on the one hand, denies the deductibility for tax purposes (for both IRES and IRAP) of the royalties exceeding the arm's length value where, on the other hand, it taxes the same income with a domestic withholding tax rate of 30%.

The Tax Court, while agreeing that the application of the reduced treaty withholding tax (under the Italy-Switzerland Double Taxation Treaty) on “*secondary adjustments*” is a complex and controversial issue, upheld the company's appeal, confirming in principle the appellant's arguments.

Firstly, the Tax Court noted that the application of domestic withholding tax would not be consistent with paragraph 12.25 of the OECD Commentary; in fact, based on the rationale of the OECD guidance, the excess royalties resulting from “primary adjustments” are unrelated to the right to exploit an intangible asset, as they represent a transfer of wealth without price and therefore it cannot be classified in the same income category as the primary adjustment, being more properly a cash payment that must have another nature. Such an interpretation comes from the fact that, unlike other jurisdictions, Italian tax law does not provide any provision on secondary transfer pricing adjustments; therefore, in the absence of a “violated rule,” the Italian Tax Authority is not entitled to consider the excess consideration as a royalty payment and to tax the excess amount as such.

Furthermore, even if the excess royalty assessed in accordance with the “primary adjustment” were to be kept in the same income category, the application of the domestic withholding tax would violate Article 12, paragraph 6, of the Italy-Switzerland Double Taxation Treaty, which requires verification of whether there are other provisions in the Double Taxation Treaty applicable to such excess consideration. The Tax Court identifies these requirements in Article 7 of the Italy-Switzerland Double Taxation Treaty, which governs “business profits” and requires, in the at hand that no withholding tax be levied on the excess royalty, as such profits are only taxable in the recipient's country, i.e., Switzerland, since the recipient is a Swiss commercial company without a permanent establishment in Italy.

In conclusion, Italian Tax Authorities are not allowed to impose secondary adjustments, as there are no specific provisions to this effect included in Italian tax law. Hence, transfer pricing adjustments should affect items included in the tax return only, consistently with recommendation of EU Joint Transfer Pricing Forum,

where Member States were also recommended to refrain from assess secondary adjustments, if they are not compulsory and when they lead to double taxation.