Italy

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Italian Transfer Pricing Legislation: An International Perspective

The author, in this article, examines key features of Italy's domestic transfer pricing regime. An analysis of domestic legislation, administrative practices and relevant case law is undertaken to determine consistency and possible misalignment with the arm's length principle as endorsed by the OECD. The article concludes with the author suggesting that domestic legislation should be redrafted.

1. Introduction

Transfer pricing is arguably one of the most important international tax issues faced by governments and multinational enterprises (MNEs). This is due to the fact that, on the one hand, countries try to protect their tax base against artificial cross-border transfers of profits, whilst limiting to the greatest possible extent economic double taxation. On the other hand, MNEs are free to organize their business operations as they see fit, acting in their best economic and commercial interests. As such, the tax authorities do not have the right to dictate to an MNE its structure or where to locate its business operations.[1]

Consequently, striking a balance between these two apparently conflicting interests is a major challenge for stakeholders involved in transfer pricing. Italy is no exception, and is trying to cope with the challenges posed by transfer pricing in an effective way.

This article first analyses the domestic legislative framework and existing administrative practices on the topic. Reference is made to relevant case law as an important source of construing the legislative environment. The purpose is to evaluate the extent to which Italian domestic legislation complies with the international interpretation of the arm's length principle. To this end, reference is made to: (1) the OECD Transfer Pricing Guidelines ("the TP Guidelines") as updated by the proposed Revision of Chaps. I to III ("the Revised TPG"); and (2) the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings. The article concludes with some suggestions for redrafting the current Italian domestic provision.[2]

2. The Domestic Framework

2.1. Introductory remarks

Recent developments suggest that transfer pricing stands high on the agenda of the Italian tax authorities. Audits concerning the proper application of the arm's length principle in intercompany relationships have increased over the last five years and the matter is becoming more and more important.[3] In this regard, Administrative Circular No. 20/E of 16 April 2010, providing directives and instructions (*indirizzi operativi*) for the 2010 audit programme, should be noted. In particular, Sec. 2.1.(b) highlights the need to focus audit activities on international issues, with an explicit reference to transfer pricing. Such an approach appears to be instrumental in pursuing an ambitious and focused tax audit programme and is coupled with the increasing expertise of the tax authorities on the topic. Indeed this section specifically relates to audits of large business taxpayers and, therefore, the focused approach indicated appears to be consistent with the recent reorganization of the Italian Revenue Agency, with the creation of regional tax offices in charge of the assessment of large business taxpayers.

Given this scenario, it is rather odd that the current transfer pricing system, which dates back to the 1980s, is, based on the strict wording of the domestic provisions, not entirely consistent with the notion of the arm's length principle as embodied in Art. 9 of the OECD Model Tax Convention ("the OECD Model").

2.2. Legislation – in general

2.2.1. Initial comments

Arts. 110(7) and 9(3) of the Income Tax Code (ITC) are the relevant domestic legislative provisions dealing with transfer pricing in the Italian legal system.[4] To this end,

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1. Para. 196 of the OECD Discussion Draft, "Transfer Pricing Aspects of Business Restructurings", 19 September 2008.
2. In order to avoid any overlap, issues regarding the application of the arm's length principle in the context of internal dealings between a foreign head office and its PE in Italy are not addressed in this article. For further details regarding this, see C. Romano and R. Russo, "Italian Tax Consequences of Permanent Establishments", *Bulletin for International Taxation* 8/9 (2010), p. 456 et seq.
3. See also Administrative Circular No. 13/E of 9 April 2009, providing details on the instructions field auditors should follow. It particularly focuses on the approach competent offices should adopt in dealing with transfer pricing issues.
4. For a thorough analysis of the Italian transfer pricing legislation, see G. Maisto, *Il transfer price nel diritto tributario italiano e comparato* (Padua: CEDAM, 1985); R. Cordeiro-Guerra, "La disciplina del transfer price nell'ordinamento tributario italiano", *Rivista di Diritto Tributario* 4 (2000), p. 2170 et seq.; S. Mayr, "Normativa anti-elusione e rapporti intercompany", *Corriere Tributario* 50 (1991), p. 3717 et seq.; M. Micheli, "Transfer Pricing interno: traslazione di reddito tra tipi diversi di societa", *Il Fisco* (2000), p. 371 et seq.; C. Rotondaro, "The Application of Transfer Pricing Rules and the Definition of Associated Enterprises", *International Transfer Pricing Journal* 6 (1999), p. 259 et seq.; and G. Maisto, *The Tax Treatment of Transfer Pricing: Italy* (Amsterdam: IBFD, online), available at www.ibfd.org.

Art. 110(7) of the ITC states that income derived by a resident enterprise from transactions entered into with non-resident companies that either: (1) directly or indirectly, control the enterprise; or (2) are controlled by it or by the same company that controls the enterprise, must be valued on the basis of the "normal value" of the goods transferred, services provided or services or goods received if a corresponding upward adjustment in taxable income is thereby derived. This provision also applies if the result is a downward adjustment in taxable income, but only insofar as it is the outcome of binding agreements concluded with the competent authorities of a contracting state pursuant to a mutual agreement procedure provided for by international tax treaties.

Further, Art. 110(2) of the ITC states that the "normal value" of the goods transferred or services rendered or received must be determined on the basis of the principles set forth by Art. 9(3) of the ITC.

The latter provision provides the statutory mechanism instrumental to determining the arm's length value of an intercompany transaction. Art. 9(3) of the ITC stipulates that the "normal value" corresponds to the average price or consideration paid for goods and services of the same or similar type, adopted in free market conditions and at the same level of commerce, at the time and place in which the goods and services were purchased or performed, or, if there is no exact time or place, at the time and place nearest thereto. In particular, in determining the "normal value", reference must be made to professional tariffs, taking into account normal discounts. Furthermore, as far as price control is concerned, reference must be made to the applicable regulations in force, if any.

Accordingly, these provisions require that two key criteria be met, one (1) subjective, the other (2) objective, to justify their application to a cross-border transaction[5] between two or more associated enterprises. As to (1), transfer pricing provisions only apply to the extent that a *control* relationship is found among the parties to the transaction under scrutiny; as to (2), the price of the controlled transaction between associated enterprises must correspond to the "normal value" of the goods (tangibles or intangibles) transferred or services rendered. The objective and subjective criteria are analysed in 2.2.3. and 2.2.4., respectively.

2.2.2. Regulatory framework

In addition to the legislative provisions, the Ministry of Finance issued Circular letter 32/9/2267 on 22 September 1980 ("the Circular") following the release of the 1979 OECD Report on "Transfer Pricing and Multinational Enterprises" ("the 1979 OECD Report").[6] The intention of the Circular was to provide guidance in interpreting the legislative provisions that governed transfer pricing matters prior to the enactment of the ITC.[7] The Circular, which is divided into six chapters, not only shed light as to when a control relationship is deemed to exist and how to construe the concept of "normal value", but also indicated the methods to be used for each type of transaction. Despite not being legally binding, the Circular is acknowledged by both the tax authorities and taxpayers and is still (at least formally) the primary interpretative tool in respect of transfer pricing issues.[8] The Ministry of Finance provided additional guidance in Circular letter No. 42 of 12 December 1981, which implemented minor amendments to the current transfer pricing regime.

2.2.3. The notion of "control"

The first chapter of the Circular addresses the notion of "control". Interestingly, this criterion is autonomous and peculiar to the transfer pricing legislation, i.e. it is tainted neither: (1) by the general definition as embodied in Art. 2359 of the Civil Code (CC); nor (2) by that used for anti-tax haven legislation purposes.[9] According to the Circular, the definition of control in Art. 2359 of the CC cannot be used for transfer pricing purposes, as its scope is too narrow – the latter provision encompasses only cases of corporate control. To this end, it is useful to underline that the control tests, as referred to in Art. 2359, Nos. 1 and 2 of the CC, relate to the entitlement of a company to exercise voting rights at shareholders'

5. According to: (1) the prevailing interpretation by leading scholars; and (2) existing case law (see the end of this footnote for further references), the scope of application of the Italian transfer pricing provision as embedded in Art. 110(7) of the ITC is restricted to transactions taking place between a resident and a non-resident enterprise. However, due to the peculiar features of the Italian market economy, in the past, the tax authorities challenged structures whereby a reduction of the overall tax liability at the group level could be achieved by taking advantage of tax incentives granted on a territorial basis to taxpayers domiciled in certain economically depressed areas of the country (for example, such objective was pursued by setting intra-group prices allowing the entity located in the economically depressed region to obtain increased profit margins). This is likely the reason why Circular letter No. 32/9/2267 of 22 September 1980 (see 2.2.2. for details) states that, although the law addresses the arm's length principle as an irrebuttable presumption only for cases falling within the scope of Art. 110(7) of the ITC, tax officials may be authorized to apply it in cases other than those specifically addressed by the latter provision. In such cases, according to the Circular letter, the presumption becomes rebuttable. This approach has been strongly criticized by the most prominent Italian scholars as going against the underlying rationale of the domestic transfer pricing provision. Accordingly, cases of alleged profit shifting between associated enterprises both resident in Italy for tax purposes should not be challenged by means of Art. 110(7) of the ITC either through an extended interpretation of the provision or by analogy, as the provision *ex se* does not aim to include domestic transactions in its scope of application. For further references on the topic, see D. Stevanato, "Rettifiche dei corrispettivi infragruppo e transfer pricing interno", *Rassegna Tributaria* 1 (1999), p. 236 and F. Gallo, "Limiti e caratteristiche degli acquisti con prevalente finalità fiscale", in various authors, *Acquisizioni di società e pacchetti azionari di riferimento* (Milan: Giuffrè, 1990), pp. 33-58. For case law on this issue, see Provincial Tax Court of Milan (*Commissione Tributaria Provinciale*), Decision No. 577, 18 March 1998.

6. OECD, "Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises" (Paris: OECD, 1979), loose-leaf.

7. Arts. 53 and 56 of Presidential Decree 597 of 1973 referred to the definition of "normal value" as embodied in Art. 9 of the same Decree.

8. It should be noted that, although the 1995 OECD Guidelines have not yet expressly been implemented in Italy, the tax authorities tend to adopt a dynamic interpretation so as to follow them consistently. In this respect, point No. 2 of the Italy Country Profile regarding Transfer Pricing and posted on the OECD website (www.oecd.org) states that "... since 1995 tax auditors are instructed to follow the updated TP Guidelines when applying the arm's length principle".

9. Leading scholars who share this view are Maisto, *Il transfer price*, supra note 4 and R. Cordeiro Guerra, "Prime osservazioni sul regime fiscale delle operazioni concluse con società domiciliate in paesi o territori a bassa fiscalità", *Rivista Diritto Tributario* I (1992), p. 297.

meetings, which is arguably a criterion applicable to corporate entities only.

Against this background, the Circular suggests that the concept of "enterprise", as the subject of the domestic transfer pricing regime, should be interpreted broadly, i.e. as encompassing any person who professionally carries out an economic activity organized for the production and exchange of goods and services, without restricting such interpretation to corporate entities. As a result, individual entrepreneurs and permanent establishments (PEs) of foreign corporations operating in Italy fall within the scope of the transfer pricing regime.

In short, the Circular deems that the decisive factor in assessing the existence of a "control" relationship consists in the ability of one party to influence the business decisions of the other party. It can also result from de facto relationships among entrepreneurs, i.e. based only on factual circumstances. As a result, the Circular states that the notion of "control" relevant for transfer pricing purposes encompasses all cases of economic influence, both actual and potential. In this respect, a number of circumstances are listed by the Circular as relevant for purposes of judging the existence of a "control" relationship, the most relevant being the situation where an actual or potential influence is exercised over the entrepreneurial decisions of an entity within the group.

Nevertheless, the identification of the existence of one of these elements does not imply that, in every case, the enterprise is "related" for transfer pricing purposes. The Circular, in fact, acknowledges that the tax authorities have discretion as to whether or not any of the factual circumstances included in the list are the result of the economic influence of one enterprise over the business choices of the other.[10]

The notion of "control" for transfer pricing purposes has not, to date, frequently come before the Italian courts.[11] However, in the author's opinion, this control test is so broad that it is likely that a number of cases may arise wherein the enterprises involved in the transaction(s) are deemed to be "associated" for transfer pricing purposes.

Against this background, the domestic notion of "control" as endorsed in the Circular does not seem to conflict with the wording of Art. 9(1)(a) and (b) of the OECD Model, as the latter provision does not specify what is meant by "control". Accordingly, each country, as is the case with Italy, is granted the freedom to adopt its own domestic definition as to which scenario meets the definition of "control".

2.2.4. *Art. 9(1) of the OECD Model vs. Art. 9(3) of the ITC*

Art. 9(1) of the OECD Model (included in almost all bilateral tax treaties entered into by Italy) states the following:

> Where ... *conditions* are made or imposed between two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly. (emphasis added)

Accordingly, since its inception, the reason for including a provision similar to Art. 9(1) of the OECD Model in tax treaties is to: (1) prevent economic double taxation;[12] and (2) avoid artificial profit transfers by realizing an equitable allocation of taxing rights between the states in which the associated enterprises are resident. Specifically, the arm's length principle refers to the proper allocation of profits between two associated enterprises by comparing the *conditions* made or imposed on their commercial and financial relationships with those (that would have been) agreed between independent third parties. Interestingly, the provision does not expressly refer to prices as the decisive criterion in determining whether or not the arm's length standard is met, price being only one of the conditions of the controlled transaction to be taken into account, but not the exclusive one.

In other words, the wording of Art. 9 of the OECD Model requires an exhaustive analysis of the terms and conditions agreed on by associated enterprises in controlled transactions involving the supply of goods or the provision of services. Arguably, the pricing of a transaction falls within this set of terms and conditions. However, the 1995 TP Guidelines require a thorough analysis of five comparability factors to ascertain whether or not the *conditions* (either a price or gross or net margin) of the controlled transaction are at arm's length.

Based on this premise, the fundamental issue is to determine whether or not the "normal value" concept, as embodied in Art. 9(3) of the ITC, complies with the concept of the arm's length principle as endorsed in Art. 9 of the OECD Model. In order to properly answer this question, the author deems it necessary to investigate the origin of the domestic transfer pricing provision. To this end, the author doubts that, as it was originally conceived within the Italian corporate tax system, Art. 110(7) of the ITC was introduced so as to serve the primary purpose of transfer pricing rules, i.e.: (1) guaranteeing a proper allocation of taxable income among countries; and (2)

10. However, the Circular continues by stating that the existence in a particular case of several of the listed actual circumstances may be regarded, in combination with each other, as sufficient evidence for a "control" relationship between the enterprises involved in the transaction(s).

11. The only notable position on the notion of "control" was expressed by the Provincial Tax Court of Alessandria (*Commissione Tributaria di primo grado di Alessandria*) in Decision No. 170 of 11 December 1995, in which the court held, rather surprisingly, that no "control" relationship existed between an Italian limited partnership operating in the pharmaceutical industry and a UK limited company despite the fact that the former held 50% of the share capital of the latter and that exclusive distribution contracts between the parties were in place. For a comment on this decision, see Rotondaro, supra note 4.

12. This view is shared by the prevailing literature on the topic. In this regard, see M. Carroll, *Global Perspectives of an International Tax Lawyer* (Hicksville: Exposition Press, 1978), p. 38 et seq.; A. Eigelshoven, "Article 9", in K. Vogel and M. Lehner, *Doppelbesteuerungsabkommen* (5th ed.) (Munich: Beck, 2008); and P. Baker, "Article 9", in *Double Tax Conventions* (London: Sweet & Maxwell, 2002).

eliminating economic double taxation. Rather, the domestic provision seems to have been conceived as a sort of peculiar anti-avoidance provision.

In detail, Art. 110 of the ITC contains a number of different provisions regarding the valuation of items of income that are to be taken into account for purposes of the computation of business income. As far as transfer pricing is concerned, the provision refers, in Para. 7, to a peculiar criterion – that of "normal value" – which supersedes the general principle of Italian tax law, and which provides that, for the purposes of computing the tax base, income should reflect the amounts reported in the profit and loss account (the principle of "payments actually performed" (*principio della effettività dei corrispettivi*).[13]

As a result, the ultimate issue is whether or not Art. 110(7) of the ITC is a provision: (1) that introduces an irrebutable presumption in the Italian tax system; rather than (2) requiring the substitution of the price as negotiated contractually with that of the "normal value"; or (3) requiring the conditions of the transaction to be replaced with those that would have been agreed to at arm's length.

In other words, does the criterion of "normal value" automatically apply, with the only possibility for the taxpayer being to prove that the proper amount is the one negotiated contractually rather than the one challenged by the auditors?

Apparently, the Circular clarified this point by stating that "[the domestic transfer pricing provision] introduces the concept of normal value by attributing to such notion the status of an irrebutable presumption" (author's unofficial translation).[14] This statement appears to imply that the objective pursued by the Italian legislator when the provision was enacted was primarily to counter avoidance structures.[15]

Historically, the Italian transfer pricing provision has focused on dealing with transactions between related parties, thereby ultimately resulting in the erosion of the tax base in Italy.[16] In this respect, the predecessor to the current Art. 110(7) of the ITC, Art. 113 of Presidential Decree 645 of 1958, stated that:

> [i]n the determination of the taxable income of foreign entities carrying out their activities in Italy through a local establishment or a subsidiary, the amounts paid to the foreign entity or association via commissions, sharing of profits, etc. will be subject to tax in Italy. (author's unofficial translation)

This explains why some scholars contend that the Italian transfer pricing provision in Art. 110(7) of the ITC should be regarded as a norm that, if construed exclusively on the basis of domestic law, acts as an anti-avoidance provision.[17] Consequently, in the author's view, there is a conceptual discrepancy between the purpose of the domestic transfer pricing provision, as introduced in the Italian tax system, and the ordinary purpose of transfer pricing rules as embodied in Art. 9 of the OECD Model. In this regard, it is useful to recall the OECD statement in the 1979 OECD Report[18] that, "transfer pricing issues should not be confused with problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes".[19] As a result, the author contends that attributing *ex se* an anti-avoidance nature to transfer pricing rules goes against the real objective of these provisions, which is enhancing international trade by preventing international economic double taxation.

Having identified the origin of Art. 110(7) of the ITC, it is now necessary to analyse whether or not the two notions of: (1) "normal value" in Art. 9(3) of the ITC; and (2) the arm's length principle as endorsed by Art. 9 of the OECD Model can be reconciled. The Circular attempts to bridge the gap between the two concepts by means of the pricing of the transaction. In particular, the Circular states that:

13. For a detailed analysis of the underlying rationale of the Italian transfer pricing provision in comparison to the principles of the Italian tax system, see F. Gallo, "Accertamento e garanzie del contribuente: prospettive di riforma", *Diritto epratica tributaria* I (1989), p. 55; L. Tosi, "Il requisito della effettivita", in various authors, *Acquisizioni di società e pacchetti azionari di riferimento*, supra note 5 and F. Moschetti, *La capacità contributive* (Padua: Giuffrè, 1973), p. 101.
14. Circular, p. 12.
15. Another interesting application, particularly by tax courts, of the notion of "normal value" relates to the disallowance of costs for centralized services charged by non-resident companies to their Italian PEs or associated entities. In this regard, the tax assessments are based on the view that such expenses are not inherent to the business activity carried on in Italy. Accordingly, tax assessments are issued on the basis of domestic provisions that refer to the "benefit test" (*principio di inerenza*). In this regard, there might be an overlap between the latter principle and that of "normal value". The author believes that the two principles should not interact, as: (1) the benefit test does not apply to transactions between related parties; and (2) it does not affect the *quantum* of the expense. However, it should be emphasized that the Supreme Court (Tax Chamber, Decision No. 12813 of 17 May 2000 regarding the deductibility of directors' fees) stated that the clear overcharging of an expense may constitute evidence that the expense is not related to the business activity of the taxpayer. For details regarding case law on the topic, see Decision of the Provincial Tax Court of Milan of 28 June 2005 with commentary by N. Saccardo, "Provincial Tax Court Decision on Documentation Supporting Cost Sharing Agreements", *International Transfer Pricing Journal* 2 (2006), p. 91 et seq.
16. On this point, see P. Pistone, "I prezzi di trasferimento", in A. Pistone (ed.), *L'Ordinamento Tributario*, Vol. III (Padua, CEDAM, 1986), p. 121 et seq.
17. G. Zizzo, "Regole generali per la determinazione del reddito d'impresa", in various authors, *Giurisprudenza sistematica di diritto tributario*, Vol. II (Turin: Utet, 1996), p. 378. Along the same line of reasoning, see A. Manzitti, "Nuove norme contro l'abuso dei paradisi fiscali", *Le società* 3 (1992), p. 16 et seq; Mayr, supra note 4, p. 3717; and P. Adonnino, "Stati e territori aventi regime fiscale privilegiato e loro concreta identificazione", *Diritto e pratica tributaria* I (1993), p. 504 et seq.
18. OECD, "Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises", supra note 6, Para. 3.
19. The OECD reiterated this position in Para. 7 of the Preface to the 1995 TP Guidelines by stating that "these international taxation principles have been chosen by OECD Member Countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimizing conflicts between tax administrations and promoting international trade and investment". In this regard, it is useful to recall the position stated by the European Joint Transfer Pricing Forum on the true nature of transfer pricing provisions. In particular, in the Draft produced by a group of experts led by G. Maisto on the issue of transfer pricing and penalties it was held that "... the most important feature [of the OECD study] on the subject is the debate on the relationship between transfer pricing and tax avoidance. The variety of situations in the different Member States is indeed also related to the perception and appreciation of transfer pricing which in some Member States is regarded as a tax avoidance technique so that such characterization influences the penalty regime applied by the tax administration of such State in the event a transfer pricing adjustment is made". For further details, see G. Maisto "Review of Penalty Regimes within the EU regarding Transfer Pricing Documentation and adjustments: the Transfer Pricing Penalties Report" of 14 November 2005, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/13th-Maisto.pdf.

> ... the notion of "normal value" as defined by tax law already includes the principle of an open market price, as recommended by the OECD for calculating the transfer price; that is, the price that would have been fixed for similar transactions by independent enterprises. (author's unofficial translation)

The author does not fully agree with this view for the following three reasons:

(1) Based on a strict interpretation of the domestic provision, theoretically, Italian tax law would only allow for the application of the comparable uncontrolled price (CUP) method, preventing the application of indirect methods (such as the cost-plus, resale price and the transactional profit methods). Indeed, the application of such methods refers to profit elements (such as gross or net margins), reference to which cannot be directly retrieved from the current wording of the domestic provision. Based on this view, the wording of Art. 9(3) of the ITC would prevent the application of methods other than CUP by not referring to the "conditions" of the controlled transaction. For the time being, this is an issue relevant only from a theoretical standpoint. Indeed, the tax authorities recently issued their first International Standard Ruling Report ("the Ruling Report").[20] This document is the first report on Italy's advance pricing agreement (APA) programme, providing details concerning applications that were submitted to the International Ruling Office of the Central Directorate for Tax Assessment from 2004 to 2009. The Ruling Report showed significant figures with regard to the percentages of application of transactional profit methods as opposed to traditional transaction methods. Transactional profit methods were adopted in 79% of cases,[21] while traditional transaction methods (CUP, resale price and cost-plus) accounted for the remaining 21%. This implies that the tax authorities are rightfully disregarding the limitations imposed by the strict wording of Art. 9(3) of the ITC. This dynamic interpretation of the Revised TPG is of relevance as it avoids conflicts with the application of Art. 9 of the OECD Model as implemented by Italy and its treaty partners.

(2) Art. 9 refers to a presumption, contained in Art. 109(2) of the ITC, as to the time at which consideration should be deemed received or costs should be deemed incurred (for example, for the transfer of movable property, on the date of delivery or shipment, or, if later, the date on which the transfer of ownership or the creation of a property right becomes effective). The strict application of the above criteria might give rise to distortions in determining the appropriate arm's length price.

(3) The definition of "normal value" in Art. 9(3) of the ITC refers to the average price or consideration paid for goods and services of the same or similar type, adopted under "free market conditions". Accordingly, it appears that the only prices that meet the arm's length principle are those determined in unregulated markets. The author does not share this view, as the arm's length principle also applies in regulated markets, such as with regard to oil and gas or the pharmaceutical industry.

As a result, it appears that the statutory definition of "normal value" as embodied in Art. 9(3) of the ITC does not fully reflect, at least from a legal standpoint, the arm's length principle as endorsed in Art. 9 of the OECD Model. This might be explained by looking at the origin of the domestic provision, where the concept of "normal value" was not intended to apply *ex se* to intercompany transactions, but rather to serve a general anti-avoidance purpose.

Consequently, the author suggests that the current wording of Arts. 9(3) and Art. 110(7) of the ITC should be appropriately amended by introducing the term "conditions" within the norm to guarantee full consistency between the "normal value" and the arm's length principle.

2.2.5. *Tax treaties*

An equivalent article to Art. 9(1) of the OECD Model is included in the vast majority of Italy's tax treaties. Only in some of those treaties concluded after 1977[22] has the text of Art. 9(2) of the OECD Model been included in the negotiations with Italy's treaty partners. In practical terms, the theoretical inconsistency explained above between the Italian domestic provision and Art. 9(1) of the OECD Model should not give rise to issues of economic double taxation. Indeed, the main purpose of Art. 9 of the OECD Model is the avoidance of economic double taxation – i.e. not being an ordinary allocation rule, it applies irrespective of whether or not it expands the taxing rights of a contracting state.[23] In any event, the issue of the expansion of taxing rights under tax treaty law would be superfluous with regard to a treaty provision authorizing transfer pricing adjustments. In this respect, in the absence of a provision based on Art. 9(1) of the OECD Model, the contracting states would be free to levy tax on residents according to their domestic tax law as long as the non-discrimination provision in Art. 24 is observed. Accordingly, in a transfer pricing context, the prevention of tax avoidance is entrusted to domestic tax law.

2.3. Documentation requirements – the burden of proof

In general, Art. 9 of the OECD Model does not create a legal requirement for taxpayers to meet documentation requirements to substantiate the setting and testing of transfer prices. Documentation requirements are a matter of domestic law and, therefore, are usually established by each country.

20. See 2.4.
21. Out of the 79% of cases where transactional profit methods were applied, the transactional net margin method (TNMM) was the preferred one in entering into an APA, as it was considered the most appropriate in 53% of cases. See Para. 6 of the Ruling Report.
22. The date of inclusion of the text of Art. 9(2) into the OECD Model.
23. See J. Wittendorf, "The Transactional Ghost of Article 9(1) of the OECD Model", *Bulletin for International Taxation* 3 (2009), p. 109.

The OECD, however, does consider that producing and keeping documentation on the taxpayer's controlled transactions is good practice as: (1) it can facilitate the dialogue between taxpayers and tax administrations; and (2) it provides guidance to assist taxpayers in identifying documentation that would be helpful in demonstrating that the arm's length principle has been respected.

Chap. V of the 1995 TP Guidelines appears to favour a flexible approach: some documents should always be submitted by the taxpayer, whereas the need for others should be determined on a case-by case basis. In this regard, it is worth noting the following principles outlined in Para. 5.28 of the 1995 TP Guidelines:

> taxpayers should make reasonable efforts at the time transfer pricing is established to determine whether transfer pricing is appropriate for tax purposes in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation in this process as a means of verifying compliance with the arm's length principle. However, the extensiveness of this process should be determined in accordance with the same *prudent business management principles* that would govern the process of evaluating a business decision of a similar level of complexity and importance... (emphasis added)

Another important issue regarding documentation requirements refers to the burden of proof. In this regard, the interaction between the latter and documentation requirements relies heavily on the legal system of each country.[24] This is acknowledged in Para. 4.12 of Chap. V of the 1995 TP Guidelines.

With regard to Italy, on 31 May 2010, the Italian government issued Law-Decree 78[25] introducing, for the first time, transfer pricing documentation requirements, the exact definition of which will be left to a Note by the Commissioner of the Italian Revenue Agency to be enacted within 120 days of the publication of Decree 78 in the Official Journal.

In particular, according to Art. 26 of this Decree, transfer pricing documentation will be required to avoid application of penalties (ranging from 100% to 200% of the additional tax due) if there is a misrepresentation in the tax reporting. The provision applies in the event of a tax inspection or audit leading to an income adjustment under Art. 110(7) of the ITC. Two elements of the new provision are worth highlighting. First, the new documentation requirements will be applicable starting from the first tax period after the date that the Decree enters into force. However, it will still be possible to mitigate the risk of penalties for earlier tax years open to tax assessment by notifying the tax authorities 90 days in advance of the issuance of the delegated regulations that transfer pricing documentation is available for those years.

Second, the preamble to Art. 26 of the Decree refers to the TP Guidelines. Since Chap. V of the TP Guidelines leaves the issue of documentation to domestic law, it seems that the Italian legislator meant instead to refer to the EU Code of Conduct on documentation requirements when drafting the new provision.

Prior to the enactment of the new provision, the Italian tax system lacked specific provisions on documentation requirements. General rules apply on the evaluation of evidence and documents as contained in the CC, the ITC and the procedural codes.[26] However, the tax authorities expect that taxpayers are able to support their transfer pricing methods and prove their compliance with the arm's length principle and the comparability analysis.

In this respect, Art. 52 of Decree 633 of 1972, the content of which is recalled by Art. 33 of Presidential Decree 600/1973, refers to circumstances in which the taxpayer refuses to produce financial books, records and relevant documentation.[27] If this is the case, a court would have to disregard their existence for purposes of the tax assessment during the administrative phase or in litigation.

More generally, the tax authorities appear to follow a rather formalistic approach regarding the documentation underlying intercompany transactions, as in a number of instances the focus of the tax auditors is on: (1) ascertaining the consistency of the contractual arrangements with the actual conduct of the parties; (2) proper accounting documentation on the computation and allocation of total costs, particularly in the context of cost sharing arrangements and rendering of intra-group services;[28] and (3) detailed documentation of the group structure (including organizational charts stating the functions performed by personnel) with regard to the activities of the group companies.

Further domestic guidance may be found in Circular No. 1/2008 of the Italian Tax Police (*Guardia di Finanza*). In this document, reference is made to a "Master and a Country file", which is the same as that described in the EU Code of Conduct on transfer pricing documentation, so as to enable extensive searches during a tax investigation.

With regard to the burden of proof, recent judgements by the Italian Supreme Court (*Corte di Cassazione*)[29] have held that the burden of proof lies with the tax authorities, i.e. the latter must prove the grounds on which the assessment of increased taxable income is based (for example, that the transfer prices were not at arm's length), and calculate the proper arm's length value. In this respect, a major role is played by Art. 2967 of the CC, which states the general principle that one who asserts a right in judicial proceedings must prove the

24. 1995 TP Guidelines, Para. 4.11.
25. To be converted into law within 60 days from the effective date of the Decree conversion law, whereas the delegated provisions should be enacted within 120 days of publication of Decree 78 in the Official Journal.
26. See Art. 1 of Legislative Decree 546 of 31 December 1992, which expressly provides for the applicability of the rules contained in the procedural code.
27. For purposes of the scope of application of the provision, "refusal" also means a declaration by the taxpayer that the books, records and documentation are not at its disposal.
28. Supreme Court Decision No. 5926 of 12 March 2009 stated that the balance sheet and its certification by an audit company represent sufficient evidence to prove the existence of deductible costs (in the case in question, costs incurred by the Italian PE of a non-resident company).
29. Supreme Court Decisions No. 22023 of 13 October 2006 (with commentary by G. Chiesa and G. Cottani, "Supreme Court Decision on Transfer Pricing: Burden of Proof, Anti-Avoidance Interpretation and Abuse of Law Principle", *International Transfer Pricing Journal* 3 (2007), p. 192 et seq.), No. 11205 and No. 11226 of 16 May 2007 and No. 4554 of 25 January 2010.

facts on which the right is based.[30] Conversely, the taxpayer has the burden to prove the existence of facts giving rise to deductible costs and that such costs relate to the activity carried on by the taxpayer.

In arriving at such a conclusion, the Supreme Court adopted an interesting line of reasoning. Specifically, the Supreme Court first construed the domestic provision of Art. 110(7) of the ITC as an anti-avoidance provision that originates from the EU law doctrine of abuse of law,[31] as well as other areas of domestic anti-avoidance legislation (Art. 10 of Law 408 of 1990). This means that the domestic rule is intended to counter cases where taxable income is transferred from Italy to a low-tax jurisdiction via intra-group transactions. The Supreme Court held that, insofar as the purpose of transactions is other than the creation of a tax advantage, the burden of proof should lie with the tax authorities.[32] To this end, the Supreme Court also referred to Para. 5.2 of the 1995 TP Guidelines.

Based on this, the Supreme Court held in favour of the taxpayer, concluding that: (1) the tax authorities should have demonstrated that the overall tax burden was greater than that in the states in which the related parties were located; and (2) the tax authorities should have recalculated the arm's length value of the transfers. As the tax authorities had done neither, there were no grounds for the Supreme Court to accept the assessment.

Although the author agrees with the outcome of these cases, it is questionable whether or not the interpretation provided is consistent with the true scope of a transfer pricing provision. In fact, the Supreme Court held that the burden of proof lies with the tax authorities, as the domestic transfer pricing provision is construed as an anti-avoidance provision. In this respect, Italian tax law does not contain a general anti-avoidance provision. Rather, tax avoidance is dealt with through specific provisions.[33] With regard to the latter rules, the burden of proof lies with the taxpayer, other than with regard to Art. 37-*bis* of Presidential Decree 600 of 1973. In addition, in these provisions, reference is always made to "valid economic reasons", the "existence of an industrial and commercial activity", and "a real business activity".

Conversely, the current wording of Art. 110(7) of the ITC does not include a reference to the transfer of the burden of proof to the taxpayer, nor to the existence of "valid economic reasons". It is also peculiar that the Supreme Court required the tax authorities to prove that the effective tax burden in the state to which the income was transferred was lower than that in Italy when the controlled transaction was entered into. The Supreme Court did not clarify what constitutes a lower effective tax burden, as the interpretation of this concept can be discretionary. It is, therefore, difficult to accept the reasoning of the Supreme Court that Art. 110(7) of the ITC is purely an anti-avoidance provision.

2.4. The Italian APA programme

The Italian unilateral APA programme was introduced in September 2003 by Art. 8 of Legislative Decree 269 of 30 September 2003, converted into Law 26 of 24 November 2003 ("the APA Law"). It became effective in February 2005 after receiving clearance from the Commission.

One of the key objectives of the APA Law is to enhance the cooperation between taxpayers and the tax authorities. In this way, the compulsory nature of taxes is turned into a form of "enhanced relationship", thereby resulting in a more immediate and precise quantification of taxes payable. Indeed, a proactive dialogue with taxpayers is a key issue for the tax authorities, which recently rolled out an audit review process for all large companies and listed transfer pricing, PEs and blacklisted transactions as first-tier audit objectives.

Under the APA Law, an international ruling can be requested by taxpayers that are "enterprises doing international business". As such, the APA Law does not discriminate between resident and non-resident enterprises. The APA Law does not specify the exact meaning of the phrase "enterprises doing international business". However, the Ruling Report clarified that, under Art. 8(1) of the APA Law, the scope of international rulings includes issues regarding: (1) transfer pricing, i.e. the transfer of tangible and intangible goods, the provision of services, cost sharing agreements, etc.; (2) the application of bilateral tax provisions regarding dividends, interest and royalties to real cases; and (3) the attribution of profits or losses to an Italian PE of a foreign enterprise or a foreign PE of an Italian company.

APAs are agreements that are binding on both parties for at least three fiscal years, starting from the year in which execution of the agreement takes place. APAs may be extended for an additional three-year period. During any of these periods, transfer pricing audits of companies participating in the programme are restricted, i.e. ordinary field inspectors cannot perform transfer pricing audits. APA teams may review the facts and circumstances pursuant to visits to the companies that are agreed to. If those facts and circumstances change during the three-year period, the conditions of the APA may be amended.

The Ruling Report included the following statistics:

– As of December 2009, 52 APA applications had been received, of which 19 had been executed, 17 were in progress, 9 were withdrawn, and 7 were rejected.

30. Supreme Court, Tax§ Chamber, Decision No. 10277 of 4 August 2000, in *Massimario Giustizia Civile* (2000), p. 1670.
31. The Supreme Court expressly cited the judgement of the European Court of Justice in Case C-110/99, *Emsland-Starke* (14 December 2000). For an in-depth analysis of the concept of abuse of law under the Italian tax system, see G. Maisto, *Elusione and Abuso del Diritto Tributario* (Milan: Giuffrè, 2009).
32. Such an interpretation was recently confirmed at a lower court level. See Provincial Tax Court of Milan Decisions No. 66-6-07 of 17 October 2007 and No. 87 of 13 March 2009. The only judgement going against such an interpretation was given by the Provincial Tax Court of Turin (*Commissione Tributaria Provinciale*), Decision No. 15/11/08 of 20 March 2008.
33. See Art. 37-*bis* of Presidential Decree 600 of 1973; the anti-tax haven legislation in Art. 110(10) and (11) of the ITC; the controlled foreign company legislation in Art. 167 of the ITC; and Art. 73(3) and (4) of the ITC regarding the residence of trusts and companies.

- The average processing time to complete an APA was 20 months, with actual processing times ranging from 5 months to 35 months, although one case exceeded 48 months.
- The industries covered by APAs included wholesale and retail consumer product manufacturers, chemical and pharmaceutical manufacturers, the makers of automotive and industrial products, telecommunications, transportation, information technology, insurance, and pension funds. The most interesting statistics, however, are those that relate to the fact that 10 APAs were executed under the transactional net margin method, representing more than half of all executed cases. Five APAs were instead concluded on a profit split basis, representing about one quarter of all executed cases. Lastly, three cases were resolved adopting the cost-plus method, and only one was completed under the comparable uncontrolled price method.

These percentages confirm the dynamic interpretation of the 1995 TP Guidelines by the tax authorities. This approach seems to suggest that the rigid hierarchy established by the Circular, favouring the selection of the traditional transactional methods, no longer applies.[34] On the contrary, the Ruling Report indirectly confirms that the tax administration favoured the approached suggested by the 1995 TP Guidelines, deeming the transactional profit methods acceptable, although as a last resort and under exceptional circumstances only.

Probably, an additional conclusion based on the Ruling Report is that the Italian ruling system is consistent with the new approach of the Revised TPG, whereby a full hierarchy among the methods has been replaced by the criterion of the "Most Appropriate Method to the Circumstances of the Case".[35] This assumption can be enhanced by an in-depth analysis of the content of the APAs concluded by the Italian ruling team, subject to domestic confidentiality requirements.

2.5. Special considerations regarding intangibles

Chap. V of the Circular addresses the issues and the methods to be used in determining the arm's length price for transfers of intangible assets. In this regard, the Circular acknowledges that, in the majority of cases, a comparison with similar transactions will be very difficult, if not impossible, due to the uniqueness of the asset involved in the transaction. As a result, some valuation techniques are required that are tailored to the specifics of intangible property.

In particular, the three valuation techniques provided for by the Circular are as follows:

(1) a technical valuation method, whereby the arm's length royalty rate is determined, with regard to the licensor, based on the capital invested and on an adequate margin of profit and, with regard to the licensee, on the expected benefits arising from the exploitation of the intangible;
(2) a legal valuation method, whereby the proper measurement of an arm's length royalty rate is influenced by the extent of legal protection that can be enjoyed by the transferee with regard to the purchased rights; therefore, the tax authorities are expected to examine the various clauses of the agreement (such as the existence of an exclusive right, territorial limitations, etc.) which may influence the arm's length value of the transaction in question; and
(3) a valuation method based on the benefits obtainable by the transferee, whereby the existence of an expected, quantifiable benefit for the licensee is a compelling requirement in arriving at an arm's length royalty rate.

Based on the assumption that it is difficult to arrive at an arm's length value in transactions involving intangible property, the Circular makes reference to some examples regarding the determination of an arm's length royalty rate. In particular:

(1) royalties of up to 2% of sales may be accepted by the tax authorities when: (a) the transaction results from a written contract entered into before the payment of royalties; and (b) the utilization of the asset and the relationship between the cost incurred and the activity of the taxpayer are adequately documented;
(2) royalties of between 2% and 5% may be regarded as fair, subject to the following conditions (to be satisfied in addition to those in (1) for royalties of up to 2%): (a) "technical" data justify the higher rate (for example, the conduct of research and experiments, obsolescence of less than one year, technical life, originality, results obtained, etc.); (b) the higher rate is justified by "legal" data emerging from the contract (for example, an exclusive right, a right to sub-license, a right to exploit discoveries, development of the intangible asset, etc.); and (c) the effective usefulness for the licensee is duly proved; and
(3) royalties in excess of 5% of sales may only be accepted in exceptional circumstances, in view of the high technological level of the industry in question or other facts.

The author's opinion is that these rates are not compliant with a proper interpretation of the arm's length principle. In fact, only after a thorough analysis of the five comparability factors is it possible to arrive at an arm's length value regarding either: (1) a transfer of an intangible; or (2) a proper royalty rate. In contrast, the criteria employed by the Circular are highly subjective and not consistent with best international practices, as having safe-harbour rules regarding the valuation of intellectual property goes against the arm's length principle. Accordingly, the author suggests either deleting or amending this part of the Circular.

34. It is interesting to note that Chap. 3, Part I, of the Circular deems the internal CUP method as the preferred one in pricing an intra-group transaction. Parts II and III refer to the cost-plus method and the resale price method as "base" methods – i.e. methods that should be favoured in the event the CUP method cannot apply. The "global" profit split method and comparable profit method (the Circular does not refer to the TNMM) are to be selected only in the event the traditional transactional methods are not viable in light of the facts and circumstances of the case.
35. See Para. 2.1 of the 9 September 2009 Draft Revised TPG.

3. Conclusions

The purpose of this article was to evaluate whether or not the Italian transfer pricing legislation is consistent with the application of the arm's length principle as endorsed by the OECD. The outcome of such an analysis reveals that the current wording of the domestic provision, administrative practice and case law on the topic is at odds with its current enforcement by the tax authorities.

To this end, it appears that the notion of "normal value", as embodied by Art. 9(3) of the ITC, does not fully reflect the arm's length principle, as endorsed by Art. 9 of the OECD Model, due to the absence of the term "conditions".

In practical terms, the theoretical inconsistency between the Italian domestic provision and Art. 9 (1) of the OECD Model should not give rise to issues of economic double taxation. Indeed, the main purpose of Art. 9 of the OECD Model is the avoidance of economic double taxation (i.e. not being an ordinary allocation rule, it applies irrespective of whether or not it expands the taxing rights of a contracting state). Yet, for the sake of consistency between theory and practice, the author suggests the inclusion of the latter term into domestic law in order to provide full legal recognition to the application of traditional methods (other than the CUP), as well as transactional profit methods.

Consequently, the author suggests the term "conditions" be included to establish the legal grounds for the application of transactional profit methods, as well as traditional methods.

The author also suggests repealing the administrative Circular and replacing it with a new one: (1) granting full recognition of the new approach endorsed by the Revised TPG regarding the selection of the most appropriate method in the circumstances of the case; and (2) repealing the current safe-harbour rules with regard to the determination of an arm's length value in respect of transactions involving the transfer of intangibles. This is required not only to enhance certainty in the relationship between taxpayers and tax authorities, but also to align the legislative framework with the best practices already adopted by the tax authorities and taxpayers in their approach to transfer pricing.