D.A.C.6 – THE ITALIAN WAY

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INTRODUCTION

In the context of the various initiatives in the field of tax transparency, the European Union ("E.U.") issued E.U. Council Directive 2018/822 of 25 May 2018 ("D.A.C.6" or "Directive"), which introduced a broad mandatory reporting obligation for intermediaries and taxpayers involved in cross-border arrangements that meet certain features, commonly referred to as "Hallmarks."

The Italian Government implemented D.A.C.6 with Legislative Decree no. 100/2019 (the "Legislative Decree"). The Legislative Decree follows the wording of the Directive, Annex I to the Legislative Decree includes the list of Hallmarks to be considered for identifying reportable cross-border transactions, which matches Annex IV of the Directive.

On November 17, 2020, the Italian Ministry of Finance published a decree containing specific clarifications for certain key aspects, including definitions of terms used in connection with the Hallmarks (the "Decree").

On November 26, 2020, the Director of the Italian Tax Authority (the "I.T.A.") issued Regulation no. 364425/2020 providing for technical rules and procedures.

On February 10, 2021, after the first reporting deadline of January 31, 2021, the I.T.A. issued Circular no. 2/E (the "Circular") which provides certain clarifications regarding who must report, the scope of the report, and several interesting examples of cross-border arrangements that are reportable. Because the Circular was published after the first reporting deadline passed, no penalties are applied where complete reports have been filed by February 28, 2021.

Both the Legislative Decree and the Circular specify that the absence of any action by the I.T.A. in response to a report of an intermediary or taxpayer does not mean that the underlying transaction has been accepted as compliant with substantive provisions of Italian tax law. That determination can be made only after the completion of an I.T.A. examination. Similarly, the filing of a report under D.A.C.6 by an intermediary or taxpayer should not be viewed as an admission that an abusive arrangement has taken place.

This article provides a brief overview of the Italian implementing regulations and focuses on recent clarifications contained in the Circular with respect to Hallmarks contained in Categories A, B, C and E.

WHO IS REQUIRED TO REPORT?

In principle, the new mandatory reporting obligation lies with both intermediaries and taxpayers. Intermediaries have the primary obligation to report. The reporting obligation lies with the taxpayer only when the intermediary is exempt or does not have access to all information.

Intermediaries

According to the Legislative Decree, the intermediary is the person who

- designs, markets, organizes, or makes available for implementation or manages the implementation of a reportable cross-border arrangement (the "Promoter"); or
- provides, directly or indirectly, assistance or advice in relation to the reportable cross-border arrangement (the "Service Provider").

The Circular clarifies that the term of "intermediary" encompasses (i) financial entities subject to reporting obligations under the Common Reporting Standard, such as banks, insurance companies, and fund asset managers and (ii) advisors already subject to anti-money laundering regulations, such as lawyers, accountants, and notaries. Based on the clarifications contained in the Circular, the reporting obligation is fundamentally the same for the Promoter and the Service Provider, but the latter is required to report a cross-border arrangement to the extent that it appears to be "reportable" on the basis of its experience and the available information, without an obligation to collect further information. This is commonly referred to as the "standard of knowledge."

To be subject to the reporting obligations under D.A.C.6, the intermediary must meet at least one of the following territorial requirements:

- It is resident in Italy for tax purposes.
- It has a permanent establishment in Italy through which it provides services in respect of the reportable cross-border arrangement.
- It is incorporated in Italy or is regulated by Italian laws.
- It is registered with an Italian professional providing legal, tax or consultancy services.

Where more than one intermediary meets the above-mentioned territorial requirements, the obligation to file the report on the cross-border arrangement lies with all intermediaries involved in the same reportable cross-border arrangement.

As to the Service Provider that advises or assists a client in relation to a reportable cross-border arrangement that is already in place prior to the effective date of D.A.C.6, the Circular specifies that no reporting obligation exists to the extent that it does not participate in an update or an improvement of the existing arrangement.

Should the intermediary be an organization, the individual who must comply with the reporting obligation depends on the nature of the intermediary. Where the intermediary is a company or an entity with legal personality, the legal representative of the organization is obligated to file the report. Where the intermediary is an entity

without legal personality, the person who is in charge of the professional engagement relating to the reportable cross-border arrangement is obligated to file the report.

Intermediaries are exempt from the reporting obligation in several circumstances:

- The first is that they receive from clients or others relevant information on reportable cross-border arrangements while examining the client's legal position or providing legal assistance in connection with a proceeding before a judicial authority.
- The second is that they have evidence that a reportable cross-border arrangement has been reported by another intermediary and the report contains the same information that they would otherwise be required to file.
- The third is that filing it could trigger exposure to their own criminal liability (self-incrimination).

"According to the Legislative Decree, the definition of the term 'taxpayer' encompasses any person that implements a reportable cross-border arrangement or to which a relevant arrangement is made available."

Taxpayers

Taxpayers are required to report cross-border arrangements where (i) there is no intermediary, (ii) the intermediary is exempt from reporting and there are no other intermediaries, or (iii) the intermediary does not provide the taxpayer with the evidence that the same information has already been reported.

According to the Legislative Decree, the definition of the term "taxpayer" encompasses any person that implements a reportable cross-border arrangement or to which a relevant arrangement is made available. The Circular clarifies that, to qualify as a taxpayer, a person must know the key features of the arrangement.

To be subject to the reporting obligations under the D.A.C.6 regulations, a taxpayer must meet at least one of the following territorial requirements (the "Italian Taxpayer"):

- It is resident in Italy for tax purposes.
- It has a permanent establishment in Italy through which benefits are available from the reportable cross-border arrangement.
- It receives income or generates profits within the Italian territory, although it does not meet the foregoing requirements.
- It carries on its business in the Italian territory even if it does not meet the foregoing requirements.

Regarding the reporting obligation on a taxpayer that receives income or generates profits within the Italian territory, the Circular clarifies that the criteria for identifying income that is deemed to be originated or derived within the Italian territory are those set forth under Article 23 of the Italian Income Tax Code,[1] without taking into account the effect of any applicable Double Tax Treaty. Regarding the reporting obligation on a taxpayer that carries on its business in the Italian territory, the Circular specifies that a reporting obligation exists even where a nonresident person carries on its business in Italy without creating a permanent establishment in Italy.

[1] Presidential Decree no. 917 of 22 December 1986.

Where a reportable cross-border arrangement involves more than one taxpayer meeting the territorial requirement, the Circular specifies that the reporting obligation lies with the taxpayer that agreed to the arrangement with the intermediary or, absent the intermediary, with the taxpayer who managed its implementation. Should the Italian Taxpayer not be an individual, the reporting obligation is imposed on the legal representative, even if the taxpayer does not have legal personality.

As pointed out in the Circular, the distinction between an intermediary and a taxpayer may be blurred. In particular, the Circular clarified that a taxpayer may fall under the definition of "intermediary" if an entity belonging to a multinational group designs, organizes or makes available to another group entity a reportable cross-border arrangement for implementation by a sister company, in which case the entity designing the arrangement is a Promoter. Additionally, a taxpayer may be an intermediary if it provides assistance or advice to another group entity in relation to an arrangement, in which case the advising entity is a Service Provider.

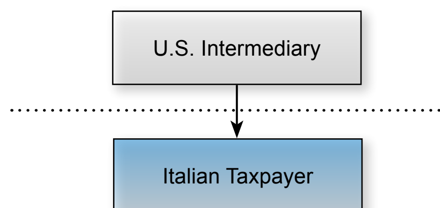
Taxpayers are exempt from the reporting obligation in two circumstances. The first is when they have evidence that the same information regarding a reportable cross-border arrangement has been reported by the intermediary. The second is where it could trigger their own criminal liability (self-incrimination).

WHAT ARE REPORTABLE CROSS-BORDER ARRANGEMENTS?

Identifying the arrangements that are subject to the reporting obligation requires an understanding of various provisions contained in both the Legislative Decree and the Decree.

First, the arrangement must relate to cross-border situations in order to be reportable. Consequently, it must be "a scheme, agreement or project concerning Italy[2] and one or more foreign jurisdictions," meaning that at least one of the participants (either an intermediary or the taxpayer) has a connection with the Italian territory.[3] At the same time, another participant or the same participant has a connection with another jurisdiction. This could happen in various ways, as illustrated under the following fact patterns.

- Not all the participants in the arrangement are resident in Italy for tax purposes. This is illustrated in the following diagram:[4]



[2] See Article 2, para. 1, letter a) of the Legislative Decree.

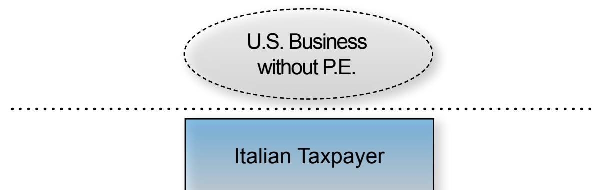
[3] See the territorial requirements illustrated in the previous section.

[4] It is based on the Example 2 contained in the Circular (page 29).

- One or more of the participants in the arrangement are simultaneously resident for tax purposes both in Italy and in another jurisdiction. This is illustrated in the following diagram:[5]

- One or more of the participants in the arrangement carry on a business in another jurisdiction through a permanent establishment situated in that jurisdiction and the arrangement forms a part or the whole of the business of that permanent establishment. This is illustrated in the following diagram:[6]

- One or more of the participants in the arrangement carry on an activity in another jurisdiction without being a tax resident of that jurisdiction or creating a permanent establishment situated in that jurisdiction. This is illustrated in the following diagram:



- The arrangement has a possible impact on the automatic exchange of information or the identification of beneficial ownership.

Second, for a cross-border arrangement to be reportable, it must include at least one of the tax avoidance risk indicators ("Hallmarks") contained in the five categories (Categories A through E) listed in the Annex 1 to the Legislative Decree which exactly mirrors the content of the Annex IV to the Directive. As illustrated below, the presence of certain Hallmarks is not always sufficient by itself to trigger reporting, but become so if a specific test is met.

As provided for by the Decree, Hallmarks under Categories A, B, C, and E trigger the reporting obligation only in cases where the transaction can result in a reduction in taxes[7] due by a taxpayer in one of the E.U. Member States or in another jurisdiction that signed an *ad hoc* agreement with Italy for the exchange of information for D.A.C.6 purposes.[8] In line with the scope of the Directive, the tax reduction feature covers all taxes, except for V.A.T., customs duties, and excise duties.

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5 It is based on the Example 4 contained in the Circular (page 30).

6 It is based on the Example 9 contained in the Circular (page 32).

7 See Article 6 of the Decree.

8 Please note that, at the time of this document, no specific agreements for the exchange of information for D.A.C.6 purposes has been signed by Italy yet.

“According to the Circular, the tax reduction is the tax advantage that it is expected to be derived from the cross-border arrangement.”

Regarding Italian taxes, the Circular refers to

- Italian corporate income tax (I.R.E.S.),
- Italian individual income tax (I.R.P.E.F.),
- regional tax on productive activities (I.R.A.P.),
- final withholding taxes and substitute taxes,
- local taxes,
- indirect taxes (such as the registration tax, stamp duty, mortgage, and cadastral taxes), and
- wealth taxes on financial assets held abroad (I.V.A.F.E.) and on immovable properties held abroad (I.V.I.E.).

According to the Circular, the tax reduction is the tax advantage that it is expected to be derived from the cross-border arrangement. It must be calculated as the difference between taxes payable as a result of the cross-border arrangement and taxes that would have been paid without such arrangement (the “Tax Reduction Test”). The Circular specifies that the tax reduction may result in (i) a reduction in the taxable income or resulting taxes, (ii) a relief from double taxation or an increase in that relief, (iii) a tax refund or an increase in the amount refunded, (iv) the deferral of a tax payment and (v) the elimination or a reduction of withholding taxes.

The Circular states that the existence of a tax reduction must be made without taking into account that the reduction may be offset by specific Italian tax provisions (such as C.F.C. rules and anti-hybrid rules). It is not clear that the mandate to ignore corrective provisions is valid. This was pointed out in a submission by the Association of Italian Joint Stock Companies,[9] which explained that entering into a transaction that results in the imposition of Italian tax under C.F.C. legislation or anti-hybrid rules does not appear to be potentially agressive within the meaning of D.A.C.6.

For Hallmarks listed under Categories A and B and several under C, transactions are reportable only if the tax reduction meets the “main benefit” test (“M.B.T.”). Under the M.B.T., no reporting is required if nontax advantages that are obtained from a transaction are viewed to be greater than the identified tax advantages. In that set of circumstances, it cannot be said that the main benefit of entering the transaction is the resulting tax benefit. Both the Decree and the Circular clarify that the M.B.T. takes into account only the tax advantage of an Italian Taxpayer, meaning that tax advantages that will be derived by a taxpayer resident outside Italy are not considered. Finally, the benchmark that is applied under the M.B.T. is that the tax advantage must exceed 50% of all the benefits to be derived by an Italian Taxpayer, including both tax and nontax advantages.[10] The M.B.T. does not require an analysis of the taxpayer’s intentions. Hence, it is an objective test rather than a subjective test.

To identify the nontax advantages deriving from the cross-border arrangement, the Circular clarifies that it is necessary to take into account reduction in costs or any

[9] Assonime, Consultation document no. 9/2018.

[10] See Article 7, para. 2 of the Decree.

increase in revenues. These advantages must be objectively quantifiable based on accounting and nonaccounting documentation, such as provisional budgets. In addition, the Circular clarifies that if a cross-border arrangement includes both a Hallmark for which the M.B.T. is required and a Hallmark for which the M.B.T. is not required, the arrangement must be reported under the last-mentioned Hallmark. Hence, the M.B.T. becomes irrelevant to the reporting obligation.

HALLMARKS

Category A - Generic Hallmarks Linked to the M.B.T.

Hallmark A1 applies to arrangements where at least one of the participants undertakes to comply with a condition of confidentiality that prohibits disclose of how the arrangement secures a tax advantage. For this Hallmark to apply, the Circular clarifies that it is sufficient that the confidentiality is required with regard either to an intermediary or the Tax Authority. In addition, this Hallmark applies even if the confidentiality is required of any person that is not involved in the arrangement.

Hallmark A2 applies to an arrangement where the intermediary is entitled to receive a fee or, remuneration for the arrangement, and that fee is fixed by reference to the amount of the tax advantage derived from the arrangement, even if no tax advantage is actually derived by the Italian Taxpayer. The Circular points out that this Hallmark applies only if an intermediary is involved in the cross-border arrangement.

Hallmark A3 applies to an arrangement that has substantially standardized documentation and/or structure and is available to more than one taxpayer without a need to be substantially customized for implementation. Regarding this Hallmark, the Decree clarifies that it does not cover standardized arrangements to obtain a specific tax incentive provided by Italian tax law. In this regard, the Circular specifies that this Hallmark does not cover the drafting of documentation to be used for requesting the refund of tax credits or withholding taxes or the application of any tax incentive.

Category B - Specific Hallmarks Linked to the M.B.T.

Hallmark B1 applies to an arrangement whereby a participant undertakes contrived steps which consist of (i) acquiring a loss-making company, (ii) discontinuing the main activity of that company and (iii) using the losses to reduce the acquiring company's tax liability in Italy or elsewhere. The Circular clarifies that

- acquisition of a company is determined by reference to the acquisition of the control of a company in accordance with Article 2359 of the Italian Civil Code,[11]
- the discontinuation of the main activity of the acquired company must be real, and
- Hallmark B1 covers cases where, *inter alia*, the losses are used in a jurisdiction other than the one where the losses have been originated.

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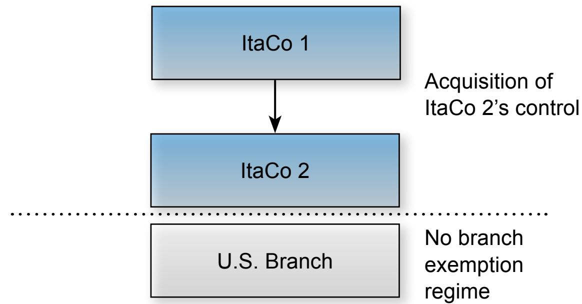
[11] Pursuant to Article 2359 of Italian Civil Code, "controlled companies" means: 1) companies in which another company has got the majority of votes exercisable in ordinary shareholders meetings; 2) companies in which another company has got sufficient votes to exercise dominant influence in the ordinary shareholders meetings; 3) companies that are under the dominant influence of another company by virtue of particular contractual arrangements.

In broad terms, Hallmark B1 is intended to cover the following fact pattern:

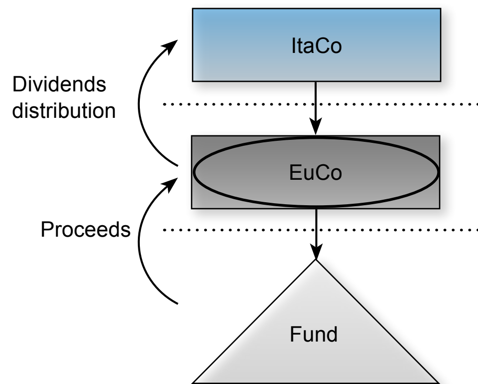
> ItaCo 1 is a company resident in Italy for tax purposes. It carries on its business in the U.S. through a loss-making permanent establishment. ItaCo 1 did not opt for the branch exemption permitted under Italian law. ItaCo 2, a company resident in Italy for tax purposes, acquires the control of ItaCo 1 in accordance with Article 2359 of Italian Civil Code. ItaCo 1 is merged into ItaCo 2, ItaCo 1's main activity is interrupted, and its losses are used to reduce ItaCo 2's tax liability.[12]



Hallmark B2 applies to an arrangement that has the effect of converting income into capital, gifts, or other categories of revenue that are taxed at a lower level or are completely exempt from tax.

In broad terms, Hallmark B1 is intended to cover the following fact pattern.

> ItaCo, a company resident in Italy for tax purposes, sets up EuCo, a fiscally transparent entity located in an E.U. Member State. ItaCo makes a capital injection into EuCo to allow the latter to invest in the Fund, a foreign collective investment fund. Since EuCo is treated as an opaque entity for Italian tax purposes, the proceeds distributed by the Fund flows through EuCo and arrive in the hands of ItaCo as dividends. In principle, 95% of the dividends are exempt from Italian taxation. If Fund's profits were distributed directly to ItaCo, the distribution would be fully subject to tax in Italy.

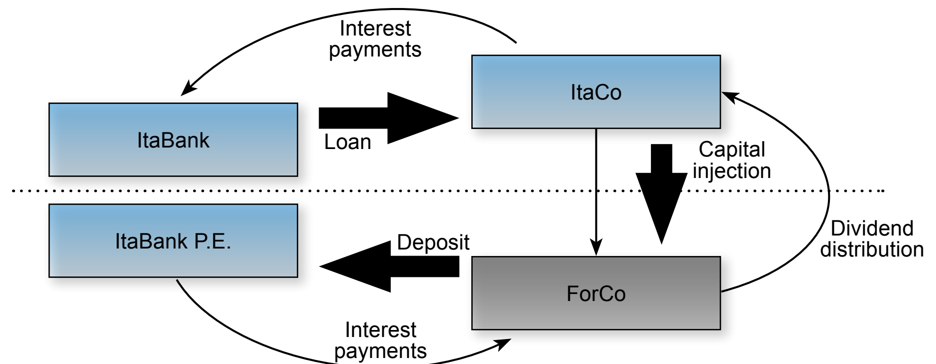


[12] It is based on the Example 9 contained in the Circular (page 77).

Hallmark B3 applies to an arrangement which includes circular transactions resulting in the round-tripping of funds, namely through (i) involving interposed entities without other primary commercial function or (ii) transactions that offset or cancel each other or that have other similar features.

In broad terms, Hallmark B1 is intended to cover the following fact pattern:[13]

> ItaBank, a bank resident in Italy for tax purposes, makes a loan available to ItaCo. ItaCo uses the borrowed funds to inject capital in ForCo, a loss-making foreign company. ForCo deposits the funds with ItaBank PE, a foreign branch of ItaBank, which pays interest to ForCo as remuneration. Interest income is offset with losses at the level of ForCo. The interposition of ForCo results for ItaCo in (i) the deduction of interest payments made to ItaBank under the loan and (ii) the 95% exemption from Italian corporate income tax of dividends received from ForCo.



Category C - Specific Hallmarks Related to Cross-Border Transactions

Hallmark C1 applies to an arrangement that involves deductible cross-border payments made between two or more associated enterprises where at least one identified condition occurs.

- The recipient is not resident for tax purposes in any tax jurisdiction.
- The recipient is resident for tax purposes in a jurisdiction, but that jurisdiction
  - does not impose any corporate income tax or imposes corporate income tax at the rate of zero or almost zero, meaning an effective corporate income tax rate that is less than 1%; in addition, the M.B.T. must be met in order for the arrangement to be reportable; or
  - is included in a list of jurisdictions that are noncooperative for E.U. purposes (the "E.U. List") or are noncooperative within the framework of the O.E.C.D. (the "O.E.C.D. List"). Since both lists are updated periodically, the Circular specified that the taxpayer/intermediary must refer to the list in effect when the reporting obligation arises, as discussed below.

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[13] It is based on the Example 15 contained in the Circular (page 84).

- The payment benefits from a full exemption from tax in the jurisdiction where the recipient is resident for tax purposes. In this regard, the Circular specifies that that the Hallmark applies when the payment received by the payee is not subject to tax in the payee's jurisdiction as a result of (i) a tax exemption, (ii) a set-off, or (iii) a tax credit. According to I.T.A., this Hallmark should not apply if the tax relief applies as a result of the tax exempt status of the payee under the laws of its jurisdiction; in addition, the M.B.T. test must be met regarding the arrangement in order for it to be reportable.

- The payment benefits from a preferential tax regime in the jurisdiction where the recipient is resident for tax purposes. The Circular clarifies that the term "preferential tax regime" refers to those harmful tax regimes illustrated in the O.E.C.D. B.E.P.S. Action 5 "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance." The assessments of preferential tax regimes carried on by the Forum on Harmful Tax Practices ("F.H.T.P.") periodically identify those tax regimes that, although they are "preferential," do not qualify as "harmful;" in addition, the M.B.T. test must be met in order for the arrangement to be reportable.

"The test used to judge the existence of associated enterprise for purposes of Hallmark C1 and E is the same as in the Directive. This test appears to be broader than the test that is relevant for Italian transfer pricing purposes."

For an arrangement to come within the scope of Hallmark C1, all the covered arrangements must take place between "associated enterprises." The test used to judge the existence of associated enterprise for purposes of Hallmark C1 and E is the same as in the Directive. This test appears to be broader than the test that is relevant for Italian transfer pricing purposes. Since Hallmarks apply also to transactions that are not subject to transfer pricing regulations, taxpayers will need to adopt different standards of identifying intra-group transactions, one for transfer pricing purposes and one for Hallmarks C1 and E.

For the application of the Hallmark C1, the Circular clarifies the definitions of the terms "payment" and "recipient" of the payment. According to the I.T.A., the concept of payment refers to any item that is deductible for tax purposes. In this regard, the definition also includes hypothetical or notional payments occurring between a permanent establishment and its head-office or between two permanent establishments of the same company. As to the definition of a recipient, a set of rules is adopted by the Circular.

- Where a conduit company is interposed between two associated companies, the interposed company is to be disregarded, even though it is the formal recipient of the payments and is not an associated company.

- Where the recipient is an entity that is treated as fiscally transparent under the laws of its jurisdiction, such as limited liability partnerships in U.K., or a C.V. in the Netherlands,

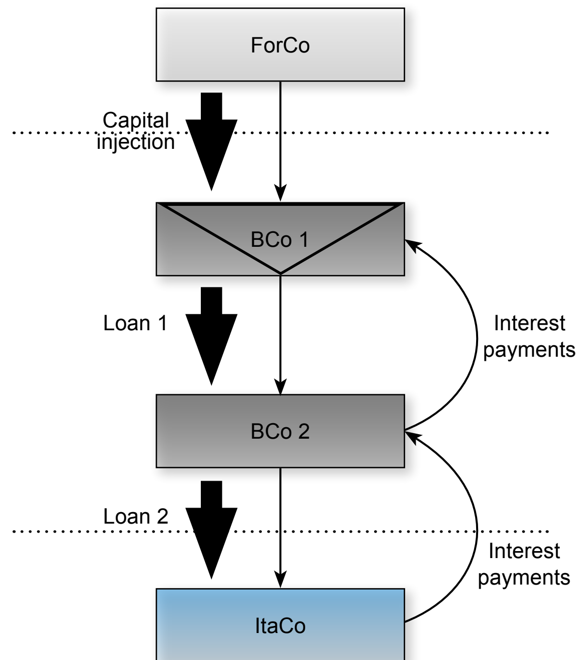
  - the recipient is its partner to the extent that the partner's jurisdiction qualifies the entity as fiscally transparent, or

  - the recipient is the entity itself to the extent that the partner's jurisdiction qualifies the entity as opaque for tax purposes. Should the entity's partners not be subject to tax in the entity's jurisdiction, the entity should not qualify as a resident for tax purposes in any tax jurisdiction. This case would fall under the first category of Hallmark C1 for which only M.B.T. is not applicable.

- In cases where a notional payment is made by the head-office to a permanent establishment for which the branch exemption regime has been opted, the recipient is the head-office to the extent that the jurisdiction where the permanent establishment is located does not recognize the separate existence of the permanent establishment. This case would fall under the third category of Hallmark C1, for which the M.B.T. must be met, also.

In broad terms, the first category under Hallmark C1 is intended to cover the following fact pattern.

> ForCo, a company resident outside the E.U. for tax purposes, wholly owns BCo1, a company resident in the Netherlands for tax purposes. BCo 1 is treated as tax transparent in the Netherlands while it is treated as opaque for tax purposes in the ForCo's jurisdiction (so-called "reverse hybrid"). ForCo injects capital into BCo1 which uses these funds to make available a loan in favor of BCo2, its subsidiary which is also resident in the Netherlands for tax purposes (the "Loan 1"). BCo 2 enters into a loan agreement with ItaCo, an associated enterprise being resident in Italy for tax purposes (the "Loan 2"). The Loan 2 mirrors the terms and conditions of the Loan 1. As a result, BCo 2 offsets the interest income received by ItaCo against the interest payments made to BCo 1. The overall structure produces a deduction of interest payments at the level of ItaCo without the inclusion of the related income in any jurisdictions.



Hallmark C2 applies when depreciation deductions are claimed for the same asset in more than one jurisdiction. According to the I.T.A., this Hallmark applies where differences in ownership concepts[14] exist for accounting purposes in two or more countries and those differences lead to the claiming of depreciation deductions more than once for the same asset. This Hallmark is not affected by the M.B.T.

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[14] Legal vs. economic ownership.

Hallmark C3 applies when relief from double taxation in respect of the same item of income or capital is claimed in more than one jurisdiction. The Circular provides the following example of an arrangement that is covered by Hallmark C3.[15]

> TaxCo is an intermediary that is resident in Italy for tax purposes. It advises on a structure applicable to ACo, which is a tax resident of State A, and BCo, which is tax resident of State B, ACo, enters into a securities lending agreement with BCo regarding the shares of CCo, which is a tax resident of State C. ACo is the lender and BCo is the borrower. The loan covers a period during which CCo pays a dividend. BCo collects the dividend net of the withholding tax that has been levied in State C and remits the amount to Company A without the imposition of withholding tax in Country B. Each of ACo and BCo claim a foreign tax credit for the withholding tax levied in State C.

Hallmark C4 applies when an arrangement provides for the transfer of assets between companies in two jurisdictions and a material difference exists in those jurisdictions between the transaction price payable for the assets and market value. The Circular clarifies the following requirements for application of Hallmark C4:

- The transaction price must be at least 10% lower than the arm's length market value.
- The arm's length market value is determined under concepts of transfer pricing regulations applicable to controlled transactions.
- The asset is not an operating asset, with examples being immovable assets (real property) and financial assets.

Category E - Specific Hallmarks Concerning Transfer Pricing

Category E encompasses certain Hallmarks applicable to cross-border, intra-group transactions which may be evaluated in ways that that are not consistent with arm's length transfer pricing principles due to complexity of the transaction or the nature of the assets involved. The Hallmarks contained in this category are not linked to the M.B.T. Consequently, the transactions falling under this category must be reported even if tax reduction is not the main benefit of the transaction.

Two grey areas exist for this category.

- The term "associated enterprise" is mentioned only for Hallmark E2. As a result, it is not clear whether transactions covered by the other Hallmarks under Category E apply when parties are not associated.
- As with Hallmark C1, the definition of "associated enterprise" appears to be broader than the definition that is relevant for Italian transfer pricing purposes, meaning that, since the Hallmark applies to transactions that may not be subject to transfer pricing regulations, taxpayers will need to adopt different standards of tracing of intra-group transactions.

Hallmark E1 applies to an arrangement which involves the use of unilateral safe harbor rules.

[15] It is based on the Example 21 contained in the Circular (page 97).

The Circular clarifies that “safe harbor” rules are a set of rules that operate as automatic presumptions of appropriateness for transfer pricing purposes and, if followed by a taxpayer, exempts the taxpayer from certain compliance obligations normally imposed by applicable transfer pricing regulations. These rules are unilateral when they depart from the O.E.C.D. Transfer Pricing Guidelines. According to the I.T.A., safe harbors rules may provide taxpayers with tax planning opportunities. For instance, if safe harbor rules apply to simple or small transactions, taxpayers may be tempted to divide larger transactions into a series of smaller transactions to come within the safe harbor rules.

“The Circular clarifies that ‘safe harbor’ rules are a set of rules that operate as automatic presumptions of appropriateness for transfer pricing purposes and, if followed by a taxpayer, exempts the taxpayer from certain compliance obligations normally imposed by applicable transfer pricing regulations.”

According to the I.T.A., the Hallmark also covers practices that result in a series of agreements systematically entered between Tax Authorities and taxpayers, having effects substantially similar to those of safe harbor rules. Examples include cost-plus mark-up percentages for distribution activities without any analysis of the actual activities performed and regardless of the actual profits generated by the taxpayer. The Circular does not address whether certain unilateral measures can be removed from coverage of the general rule for tainted safe harbors.

Hallmark E2 applies to an arrangement involving the transfer of hard-to-value intangibles. The term “hard-to-value intangibles” covers intangibles or rights in intangibles for which, at the time of transfer between associated enterprises (i) no reliable comparable exists and (ii) the projections of future cash flows or income expected to be derived from the transferred intangible or the assumptions used in valuing the intangible are highly uncertain. As a result, it is difficult to predict the level of ultimate success of the intangible at the time of the transfer.

Hallmark E2 encompasses all those transactions involving the transfer of ownership in intangible assets or rights to use intangible assets. This Hallmark applies to assets such as patents, trademarks, know-how, copyrights, and similar items, which by their nature are hard-to-value. The Circular uses as guidance the definition of the hard-to-value intangibles provided by the O.E.C.D. Transfer Pricing Guidelines.[16]

The Circular provides the following example of an arrangement that is covered by Hallmark E2.

> USCo, a company formed in the U.S., and for that reason a tax resident of the U.S. It is the sole owner of ItaCo, a company that is tax resident in Italy. USCo and ItaCo enter into an agreement of sale under which ItaCo transfers a hard-to-value patent to USCo. Immediately thereafter, USCo grants the right to use the patent to ItaCo through a license agreement.

Hallmark E3 applies to an arrangement involving an intragroup, cross-border “transfer of functions and/or risks and/or assets” (referred to as “Eligible Transfers”), where the projected annual earnings before interest and taxes (E.B.I.T.) of the transferor during the three-year period following the transfer are less than 50% of the projected annual E.B.I.T. of such transferor if the transfer had not been made. The Circular refers to Chapter IX of the O.E.C.D. Transfer Pricing Guidelines on business restructuring for guidance under this Hallmark. As a result, Hallmark E3 should cover business restructurings (such as mergers, demergers, etc.) that result in the actual relocation of functions and/or risks and/or assets.

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[16] See paragraph 6.190 of the O.E.C.D. Transfer Pricing Guidelines.

The Circular provides that the computation of E.B.I.T. begins with gross margins for operating companies and the spread between interest income and cost of funds for financial institutions. Interest costs of financial institutions that are unrelated to lending activity are ignored. For both operating companies and financial institutions, general and administrative costs are deducted, exclusive of interest and taxes. Financial statement information is to be used in making calculations.

Where the average E.B.I.T. of the seller during the three-year period following the transfer is negative whereas a positive average E.B.I.T. would have existed in the absence of the transfer, the Circular indicates that the Hallmark applies. On the other hand, if the seller projected a negative average E.B.I.T. in the absence of the transfer, but as a result of the transfer the average E.B.I.T. is positive or less negative than originally projected, the Circular indicates that the Hallmark will not be applicable.

Finally, the Circular does not address the relationship between the Hallmarks under category E. As a result, no guidance is given whether Hallmark E2 or Hallmark E3 applies where an Eligible Transfer involves a hard-to-value intangible.

WHEN MUST THE CROSS-BORDER ARRANGEMENT BE REPORTED?

Should an arrangement qualify as a reportable cross-border arrangement, the following rules apply regarding the deadline for filing a report with the I.T.A.

- For the Promoters, filing is required within 30 days from the day after the earlier of (i) the date on which the reportable cross-border arrangement is made available for implementation and (ii) the date on which implementation begins.
- For the Service Provider, filing is required within 30 days after the date on which assistance or advice is directly or indirectly provided regarding the implementation of the reportable cross-border arrangement.
- For the Italian Taxpayer, filing is required within 30 after the date on which the Promoter or Service Provider that is exempted from the reporting obligation informs the Italian Taxpayer that the reporting obligation lies with the taxpayer. The Circular clarifies that, in any case, the Promoter or Service Provider is required to advise the Italian Taxpayer of the duty to report within the applicable guidelines of the preceding bullets.
- Regarding marketable reportable cross-border arrangements, an intermediary is subject to follow-up reporting every three months after the first reporting takes place.

PENALTIES

Penalties for non-compliance with the D.A.C.6 mandatory reporting regime vary depending on the nature and the severity of the infringement. In the case of a failure to report within the abovementioned deadlines, penalties range from €3,000 to €31,500. If the reporting is filed within 15 days from the relevant deadline, penalties are reduced by 50%. In the case of an incorrect or incomplete reporting, penalties

range from €1,000 to €10,500. Again, if the correct reporting is filed within 15 days from the relevant deadline, penalties are reduced by 50%.

The Circular clarifies that, where the intermediary is a company or entity with legal personality, the penalties are imposed on the legal entity, itself. On the other hand, if the infringement is made by an entity without legal personality, the penalties are imposed on the individual who is required to report. That person is the individual who is in charge of the professional engagement relating to the reportable cross-border arrangement.

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