

NEW ITALIAN TRANSFER PRICING REGULATIONS AFFECT MULTINATIONAL ENTERPRISES

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Tags

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BACKGROUND

Italian transfer pricing documentation rules were introduced in 2010 by Article 26 of Law Decree 31 May 2010 No. 78 and implemented with the regulations issued by the Director of the Italian Revenue Agency on September 29, 2010 (“Existing Regulations”). The system gives taxpayers the possibility to obtain penalty protection in case of transfer pricing adjustments, provided that they timely prepare and maintain qualifying transfer pricing documentation.

On November 23, 2020, the Italian Revenue Agency issued Regulation No. 360494 (“New Regulations”), which entirely replaced the Regulations, introducing important changes that may have a relevant impact on multinational enterprises (“M.N.E. groups”).

REVISIONS CONCERNING GENERAL ASPECTS

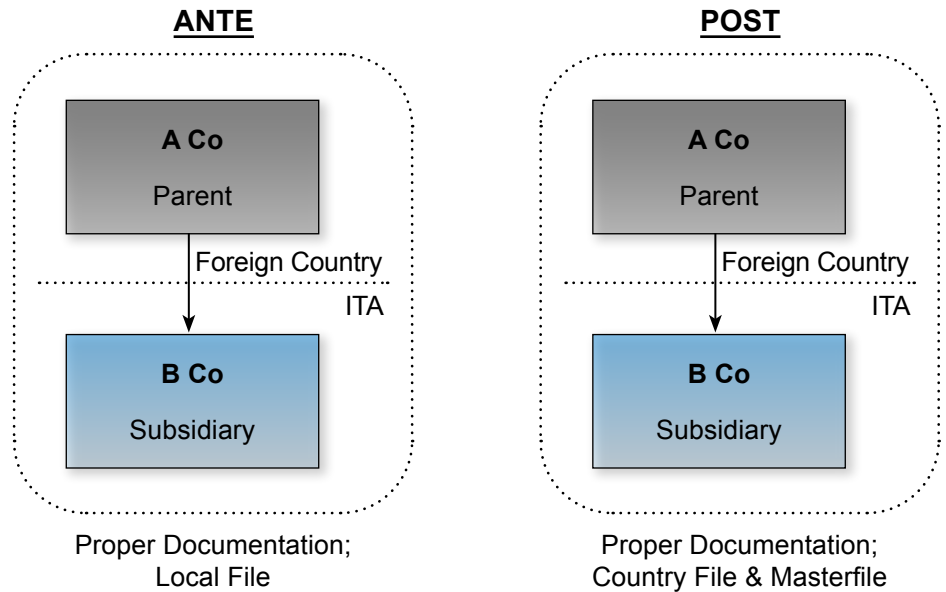
Broadening the Scope of Companies Required to Maintain a Master File

The system governing transfer pricing documentation under the New Regulations retains the same three-tiered structure of the consisting of

- a Master File containing information relevant for all M.N.E. group members,
- a Local File referring specifically to the local taxpayer, and
- a Country-by-Country Report for those M.N.E. groups having a turnover of €750 million.

However, the scope of companies required to maintain a Master File is broadened. In the previous framework of the Existing Regulations, maintenance of a Master File was required in order obtain penalty protection differed depending on whether an Italian company held foreign subsidiaries or simply was a subsidiary of a foreign M.N.E. group. In the latter case, the Italian company was not required to prepare a Master File if it did not own control shareholdings in non-Italian companies. This exception is deleted in the New Regulations. Now, all Italian subsidiaries of foreign M.N.E. groups that desire penalty protection arising from transfer pricing adjustments must maintain a Master File and a Local File, even when ownership or control stakes are not maintained in companies resident outside Italy. The new requirement applies also to permanent establishments of non-Italian companies when the permanent establishment holds shares in companies resident outside of Italy.

The difference in the requirement regarding the maintenance of a Master File is illustrated in the following diagram.



Reporting Exception for an S.M.E. Member of an M.N.E. Group

The New Regulations strengthen the requirements that must be met for a “Small and Medium Enterprise (“S.M.E.”) to qualify for tri-annual reporting when it is a member of an M.N.E. Group. Tri-annual reporting is permitted for certain S.M.E.’s when (i) the comparability analysis has been performed using publicly available information sources and (ii) the five comparability factors have not changed substantially. The five factors are the following:

- The contractual terms of the transactions
- The functions performed by each of the parties involved in the operations, taking into account the capital goods used and the risks assumed, including the way in which these functions relate to the broader generation of value within the M.N.E. group to which the parties belong, the circumstances that characterize the operation, and the customs of the sector
- The characteristics of the goods sold, and the services provided
- The economic circumstances of the parties and the market conditions in which they operate
- The business strategies pursued by the parties

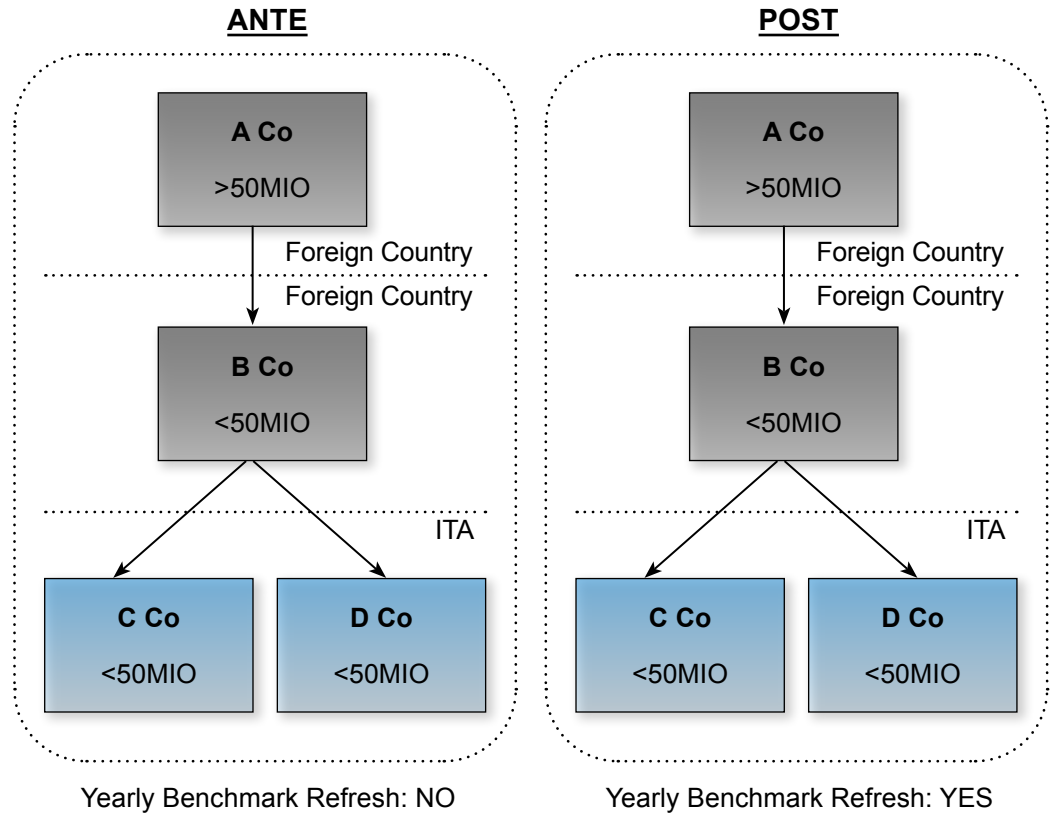
The Existing Regulations provide that where the foregoing conditions are satisfied, an S.M.E. qualifies for tri-annual reporting when the S.M.E. meets the following two requirements:

- It has an annual turnover not exceeding €50 million
- It does not control any company with an annual turnover exceeding €50 million.

The New Regulations introduce a third condition that must be met in order to qualify for the benefit. The S.M.E. cannot be controlled by a company with an annual turnover exceeding € 50 million. The additional condition begins with the 2021 fiscal

year. As a result, an S.M.E. owned by an M.N.E. likely will no longer qualify for tri-annual reporting. Benchmark analysis will need to be performed annually.

The difference in the requirement regarding annual benchmarking for an Italian S.M.E. owned by an M.N.E. is illustrated in the following diagram.



REVISIONS CONCERNING THE CONTENTS OF THE MASTER FILE AND LOCAL FILE

The New Regulations raises the level of information and data reporting in the Master File in order for an Italian company or permanent establishment to obtain penalty protection.

Master File

The Master File contains information relating to the M.N.E. group. The information must be presented in the manner provided by the New Regulations. Where the Italian company and the M.N.E. group carry on separate lines of business, with each line subject to its own specific transfer pricing rules, more than one Master File can be prepared. Where that occurs, taxpayers must submit the entire Master File for each business line in order to assure that an appropriate overview of the M.N.E. group's global business is provided. This requirement is consistent with paragraph 20 of B.E.P.S. Action 13.

Each Master File must contain separate sections, one for each of the group's (i) value chain, (ii) intangibles, and (iii) financial transactions. It must also include specific items of additional information.

Value Chain Section

The section on value chain must include the important drivers of business profit so that the economically relevant activities that allow the group as a whole to generate value are identified. Here, it is important for the Italian company to consider carefully the information that is included. The information and data provided in this section can be used by the tax authorities to apply a profit split method to the intercompany transaction.

In this regard, paragraph 2.173. of the O.E.C.D. *Revised Guidance Profit Split* states that the M.N.E. group's Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors. Indeed, the Master File should include information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles used to generate profit. Consequently, the value chain section should describe the supply chain relating to the first five products and/or services of the group by turnover, plus any other products and/or services whose turnover exceeds 5% of the overall group turnover.

Intangibles Section

A second area of scrutiny in the Master File is that of intangibles. A general description must be included that explains the global strategy of the M.N.E. group for the development, ownership, and exploitation of intangible assets, including the location of main research and development structures and of the management of research and development activities. The description must include a list of intangibles with indication of the legal owner and of the important agreements related to those intangible assets.

Financial Transactions Section

The last section of the Master File is that of financial transactions. It should provide a general description of how the group is financed, with indication of important financing arrangements with unrelated lenders. Also to be included in this section are details on who performs centralized financial functions and the transfer pricing policy adopted for this type of transactions.

Specific Additional Information

Taxpayers must include enclose the annual consolidated financial statements of the M.N.E. group for the fiscal year concerned and a list and a short description of the advance pricing agreements ("A.P.A.'s") and advance cross-border rulings in place. The New Regulations specifically require that the latter be categorized by country and that the description must include scope, subject and validity.

Local File

The New Regulations address the Local File, and provides important changes which, in some regards, differ from the provisions of B.E.P.S. Action 13.



The New Regulations require general information about the local entity. Included are topics such as history, recent occurrences, and a general overview of the relevant markets. The taxpayer must identify the individuals within the M.N.E. group who oversee local management, specifying the location where those individuals are based. The information contains risks for the M.N.E. group because it can be used by the Italian Tax as evidence of the existence of a hidden permanent establishment of the foreign affiliate in Italy merely due to the reporting lines. The risk is that the business belongs to the foreign affiliate and the Italian company, as a dependent agent, is carrying on the business of the affiliate, thereby creating a permanent establishment in Italy for that affiliate. The ultimate conclusion is that Italian tax may be imposed on the foreign affiliate regarding its revenue from Italy.

In this regard, the Italian Revenue Agency have ruled out the possibility that the functional reporting of an Italian company to a foreign affiliate is automatically relevant in determining whether the affiliate maintains a permanent establishment in Italy where the affiliate is responsible for the production, marketing, and distribution activities of the M.N.E. group.¹

The general section of the Local File also requires a description of the company's business and business strategy pursued including an indication as to whether the local entity has been involved in or affected by business restructurings or transfers of intangibles. A specific requirement of the Italian Local File is the request of information about the main competitors of the local entity, together with a description of the activities carried out by them.

The New Regulations request information that, in part, already is required by the Existing Regulations.² The taxpayer must provide the elements of the related party transactions, and the performance of the comparability analysis in order to accurately delineate the transaction. The elements of the transaction include the amount, parties, and any comparable third-party transactions. In addition, taxpayers must provide a description of the process for selecting the most appropriate method and related comparable transactions. In this regard, a multi-year analysis may be allowable. Italian practice has consistently allowed the use of multiple year data in order

¹ This is the position also taken by the Italian Tax Police in the Circular letter no. 1/2018.

[I]t may be * * * physiological that local entities, in addition to being subject to the power of direction and control of the parent company, receive directives and are also recipients of policy indications from other subsidiaries that limit their independence also in terms of their operational management. For these reasons, the findings regarding a hidden permanent establishment (being a fixed place of business or an agency), in the presence of a legal entity resident for tax purposes in Italy and belonging to a multinational enterprise, must be carefully weighed and cannot, in any case, be based on the mere management dependency or lack of economic autonomy of the subsidiary, since these characteristics, as mentioned, can constitute aspects that are completely 'usual' in highly integrated structures.

² A specific set of documentation is provided low value-added services. In order to use the simplified approach for the determination of arm's length charges in a controlled transaction involving low value-added services the taxpayer is required to prepare specific documentation which is consistent with that provided in the O.E.C.D. Guidance.

“A further change in the New Regulations allow the Italian Revenue Agency to request important assumptions made in applying the selected transfer pricing methodology and the indication of the effects deriving from their modification.”

to improve the process of selecting third-party comparables. However, the wording included in the New Regulations seems to allow for the use of multiple-year analysis also to obtain a complete understanding of the facts and circumstances surrounding the controlled transaction.³

A further change in the New Regulations allow the Italian Revenue Agency to request important assumptions made in applying the selected transfer pricing methodology and the indication of the effects deriving from their modification. The scope of this provision is not clear at this time. It may mean that the Italian Revenue Agency will seek information on any assumptions made in the context of transactions involving intangibles. Among the items of interest will be assumptions on valuation techniques, such as useful life of the intangible, projections of future revenue and future expense, and growth rate.

Finally, the New Regulations provide that the documentation should include copies of existing unilateral and bilateral/multilateral A.P.A.'s and advance cross-border rulings. In particular, A.P.A.'s and rulings must be attached even if they do not involve the local entity, but which are in any event related to the controlled transactions described in the local file. An example might involve an affiliate that licenses an intangible under the same conditions to both its Italian and Spanish subsidiaries, except that the license to the Spanish affiliate is the subject of a bilateral A.P.A. The potential downside of noncompliance with this provision is that it may result in the loss of protection from penalties added to a transfer pricing adjustment. Many advisers expect that a circular will be issued by the Italian Tax Authorities that limit the scope of the provision.

REVISIONS CONCERNING THE FORMAL REQUIREMENTS (LANGUAGE, ELECTRONIC FORMAT, AND TIME STAMP) AND DELIVERY DEADLINES

The New Regulations confirm that transfer pricing documentation must be prepared on an annual basis and in Italian except for the Master File, which may also be submitted in English. Once the Master File and the Local File have been completed, both must be signed by the taxpayer's legal representative or by a delegate by digital signature with time stamp affixed and date of submission of the tax return, which means that the documentation cannot be modified after submission. This documentation will need to be prepared by end of November. Several commentators have questioned whether subsidiaries of foreign-based M.N.E. groups will be able to acquire the necessary documentation on a timely basis prior to the date of filing income tax return.

³ This clarification could be relevant for the analysis of the effects of COVID-19. The Guidance on the transfer pricing implications of the COVID-19 pandemic published by the O.E.C.D. excludes the application of multiple-year data so long as

*** the data from independent comparables can be measured over a similar period in a consistent manner.” In the remaining cases, which are certainly the most frequent, the O.E.C.D. states that “the use of combined periods (that include both years that are impacted by the pandemic and years that are not impacted) may improve reliability.

It is unclear whether the time stamp must also be affixed to attachments, but arguments support a conclusion that attachments need not be stamped. In several places in the circular, the Italian Revenue Agency refer to the attachments as separate documents from the Master File and the Local File. This approach is consistent with a provision that prescribes a deadline of 20 days for the delivery of documents to the tax examiners. This time limit would be unnecessary as long as all the documents to be delivered are ready by the deadline for the tax return with the time stamp.⁴

All the documentation referred to in the present regulations must be submitted in electronic format.

PENALTY PROTECTION

The New Regulations specifies when the documentation is sufficient to protect a taxpayer from penalties arising from a transfer pricing adjustment. The documentation, data, and information must be sufficient for the tax examiners to conduct a transfer pricing analysis. In contrast with the Existing Regulation, the Italian Revenue Agency place emphasis on data and information regarding the accurate delineation of transactions and the comparability analysis, including functional analysis.

Any disagreement between taxpayer and the tax examiner on the selection of the transfer pricing method adopted and on the search of comparables do not automatically affect the penalty protection. Similarly, any omissions or partial inaccuracies not material to the examination conclusions also are not relevant.

Finally, the New Regulations introduces the possibility for the taxpayer to prepare the proper transfer documentation for only a part of the transfer pricing transactions carried out. In such case, the penalty protection regime is applied exclusively to the transactions expressly described.

CONCLUSION

The New Regulations conforms Italian tax practice to B.E.P.S. Action 13 in a manner consistent with Italian tax practice in general. A significant amount of data must be provided on a timely basis in order for a taxpayer to benefit from penalty protection.

⁴ Par. 5.2.1. of the New Regulations provides that the delivery of the documentation to the tax authorities must be made not later than 20 days from the relevant request.