



ARM'S LENGTH CHRONICLE

Recent Developments in the Application of the Arm's Length Principle in Italy Transfer Pricing Chambers Practice Guide's chapter dedicated to Italy - Trends & Developments

The 2017 reform of the transfer pricing framework reformulated the arm's length principle in Italian tax law, aligning the content of Article 110 paragraph 7 of the Income Tax Code with international best practices, and specifically with Article 9 of the OECD Model Tax Convention on Income and Capital. The OECD G20 project to counter base erosion and profit shifting (BEPS) introduced some relevant changes to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"). Following these changes, there was a need to update the existing legislative framework governing transfer pricing in Italy, and the 2017 reform delegated the Ministry of Finance to issue a decree to give specific guidance on the interpretation and application of the new transfer pricing rules according to the principles outlined in the OECD Guidelines and best international practices.

A Ministerial Decree (the "Decree") was then finally issued on 14 May 2018 containing the guidelines for the application of Article 110 paragraph 7, with the purpose of complying with the arm's length principle.

The Decree was followed by the publication of two administrative documents by the Italian Revenue Agency (IRA), namely Circular Letter No 15/E of 26 November 2021 and, more recently, Circular Letter No 16/E of 24 May 2022, in which the IRA provided some important indications regarding specific aspects of the Decree, that is, transfer pricing documentation and the application of the arm's length range.

These developments have also been reflected in several domestic judicial decisions published in recent years. Most recently, the importance of adequate and careful technical evaluations was also highlighted by a prominent judgment of the Supreme Court (Judgment No 15668 of 17 May 2022),

which emphasised the centrality of comparability analysis in the application of transfer pricing methods for the assessment of consistency to the arm's length principle in pricing and to conditions of intercompany transactions, making explicit reference to the new legislative framework introduced by the Decree.

The correct application of the concept of the arm's length range is analysed in the following, both in light of the newly expressed IRA position and as declined in some relevant domestic judicial cases issued last year.

The IRA's position on the arm's length range

Circular Letter No 16/E of 24 May 2022 (the "Circular Letter") provides some significant clarifications relating to the proper interpretation of the concept of the arm's length range, which was introduced by Article 6 of the Decree.

The most important development of Article 6 was that it mandates the use of a range of figures (and not a specific single figure) in order to verify the compliance of intercompany prices and conditions with the arm's length principle. This is in line with the OECD Guidelines, but is quite a breakthrough if compared with the common practice of adjustments to a specific single point in the range (often the one maximising the adjustment) typically applied by the Italian tax administration in their tax audits and assessments in the previous years. However, there was a need to provide further guidance to select the most appropriate positioning within the range in situations where the relevant conditions of the controlled transaction fall outside the arm's length range.

In general terms, the guidance provided in the Circular Letter reflects the principles stated in Chapter III of the OECD Guidelines.

The Circular Letter states that, pursuant to Article 6 of the Decree, when applying the most appropriate method to transactions between independent enterprises identified to be equally comparable with the controlled transaction, all the figures (financial indicators) included in the range of figures produced by such method are deemed to be in accordance with the arm's length principle. A controlled transaction is thus at arm's length if the relevant financial indicator falls within that range. Further analysis is then needed to evaluate the degree of comparability of the transactions identified as comparables. Starting with the assumption that they are all equally reliable (because if one uncontrolled transaction is determined to have a lesser degree of comparability, it should be eliminated), there are two possibilities, as follows.

- The comparability analysis performed is reliable and all the transactions identified have the same high degree of comparability with the controlled transaction: in this case, the full range of financial indicators resulting from the application of the most appropriate method will be considered.
- Even if the transactions identified can be considered to have all the same degree of comparability, some comparability defects that cannot be identified and/or quantified remain: in this case, if the range includes a significant number of transactions, it will be necessary to refer to statistical tools in order to narrow the range and enhance its reliability. In accordance with the OECD Guidelines, this means the use of central tendency indicators, such as the interquartile range or other percentiles, which will exclude extreme results, probably caused by the unidentified comparability defects.

In both cases, all figures contained within the relevant range can be considered to satisfy the arm's length principle and consequently, if the financial indicator falls within the range (full range or range narrowed by statistical tools), no adjustment should be made by the tax administration.

Selecting the most appropriate point in the range to make an adjustment

However, if the financial indicator falls outside the arm's length range identified by the tax administration, the taxpayer has the right to document why the conditions of the controlled transaction under analysis are indeed at arm's length, that is, to prove that the relevant range is different from

the one asserted by the tax administration. If the evidence provided is not satisfactory, the tax administration must then determine the point within the arm's length range to which it will adjust the condition of the controlled transaction.

The Circular Letter recommends that the financial indicator representing the conditions applied by the taxpayer in the controlled transaction must be aligned to the minimum or maximum figure of the identified arm's length range (either full or narrowed) that first intersects the taxpayer's calculated figure. In this case, there are two scenarios depending on the level of comparability of the set of comparable uncontrolled transactions identified, as follows.

- The comparability analysis performed is reliable and all the transactions identified have a high degree of comparability with the controlled transaction: in this case, the full range of financial indicators resulting from the application of the most appropriate method will be considered, because it can be argued that any point in the range satisfies the arm's length principle. The adjustment will then be made considering the minimum or the maximum figure of the full range, depending on which one is closer to the financial indicator of the taxpayer.
- If the transactions identified cannot be considered to have a high degree of comparability, being affected by some comparability defects that cannot be adjusted in a reliable manner, and the range includes a significant number of transactions, the adjustment will then be made using statistical tools such as measures of central tendency (eg, the interquartile range) in order to narrow the range. In particular, the tax administration will adjust the financial indicator of the taxpayer to the extreme of the narrowed range (the 25th or 75th percentile in the example above) that first intersects the figure of the taxpayer.

If the taxpayer considered the full range in its analysis, deeming all the transactions identified as highly comparable to the controlled one, but the tax administration challenges the comparable set highlighting some comparability defects (either excluding some comparable transactions or simply disagreeing on the level of comparability), the tax administration can disregard the use of the full range and make recourse to a narrower range using the appropriate statistical tools (eg, the interquartile range), thus adjusting to the closest point of the amended range.

Clearly, the position should be sufficiently argued, and the recourse to statistical tools to narrow the range should not be automatic, but limited to situations where the uncontrolled transactions in the set are affected by comparability defects that cannot be identified or cannot be adjusted in a reliable manner.

The interquartile range and its calculation

The interquartile range is defined in the OECD glossary of statistical terms as “the variate distance between the upper and lower quartiles. This range contains one half of the total frequency and provides a simple measure of dispersion which is useful in descriptive statistics.”

With the Circular Letter, the IRA officially took the position of specifying the formula to be used in calculating the interquartile range. This is one of the most useful indications of the new instructions, since several methods can be used to calculate the figure of the quartiles (or, more generally, the percentiles) of a distribution of figures, and so far, only a few tax administrations have shared detailed instructions on the calculation to be performed.

Regardless of the method used, the figure corresponding to the median (the second quartile, or 50th percentile) is always the one that leaves 50% of the observations under analysis before and after it. According to the IRA, in order to identify the interquartile range, the first and third quartiles (or 25th and 75th percentile) must be identified at the position $(n - 1) \times p + 1$ of the range of ordered figures, where n is equal to the number of comparables while p takes the figure of 0.25 if first quartile, or 0.75 if third quartile.

For example, for a set of 11 comparables, the position of the first quartile will be $(11 - 1) \times 0.25 + 1 = 10 \times 0.25 + 1 = 2.5 + 1 = 3.5$ (ie, the average between the third and fourth figure of the range of the ordered figures of financial indicators of the comparables identified). As in the example above, if the position is not exactly a figure of the set, it will be necessary to interpolate between two adjacent figures.

The Circular Letter also specified that if Microsoft Excel is used for the calculations, both the functions “QUARTILE” or “QUARTILE.INC” embedded in the software can be used to identify quartiles in line with the formula indicated by the IRA.

The arm’s length range in some significant domestic cases

The alignment of transfer pricing rules governing specifically the arm’s length range to the principles outlined in the OECD Guidelines was also reflected in some domestic judicial decisions published in 2022.

With Judgment No 694 of 14 June 2022, the Piedmont Second Instance Tax Court highlighted that, in principle, if the profitability of an intercompany transaction falls out of the interquartile range of the distribution of financial indicators of comparable transactions, the taxpayer should demonstrate that the relevant interquartile range to be considered in the specific case is a different one and that it includes the profitability of the challenged controlled transaction.

The case originated from a tax assessment in which the Italian tax administration applied the Transactional Net Margin Method (TNMM) as the most appropriate method to adjust the profitability of a minor intercompany transaction, for which no specific analysis was prepared by the taxpayer.

Regardless of the statements on the principles, in line with the new framework as established by the Decree and the Circular Letter, the Piedmont Second Instance Tax Court ruled in favour of the Italian taxpayer, concluding that no transfer pricing adjustment was necessary in this specific case due to other reasons not relevant in this discussion.

Another more relevant judgment is No 4097 of 26 October 2022, issued by the Lombardy Second Instance Tax Court. In this case, in order to verify respect for the arm’s length principle in intercompany transactions between an Italian company and its Chinese contract manufacturer, the Italian tax administration used the TNMM and prepared a specific benchmark analysis.

From the benchmark analysis prepared, it appeared that the financial indicator selected for the related Chinese company was within the interquartile range of the figures calculated for the comparables identified and, specifically, between the median and the third quartile.

The Italian tax administration, based on the above-mentioned analysis, proceeded to increase the taxable income in Italy by decreasing the profitability of the Chinese company, adjusting the financial indicator to the median figure of the set.

Both the Milan First Instance Tax Court and, later, the Lombardy Second Instance Tax Court, ruled in favour of the taxpayer. In particular, the Second Instance Tax Court entered into a detailed criticism from a technical viewpoint of the benchmark analysis prepared by the Italian tax administration and, more importantly, stated that considering only the median figure as the correct reference appeared to be contrary to the OECD Guidelines as implemented by the Decree (according to which, profitability that falls within the interquartile range should be considered in line with the arm’s length principle).

It is worth mentioning that in both judgments the references to the OECD Guidelines and the Decree are explicit and very detailed.

Conclusion

The Circular Letter contributes to give greater certainty to taxpayers in the definition of a range of figures (ie, financial indicators) of comparable uncontrolled transactions, to demonstrate their compliance with the arm’s length principle. The new instructions issued by the IRA also provide important operational indications to both the tax administration and taxpayers, hopefully contributing to reaching a more homogeneous application of the arm’s length principle and, consequently, reducing any controversy, claims and litigation on such technical issues.

The IRA document is also fully aligned with the best international practices in transfer pricing, directly implementing many concepts introduced in recent years with the updated versions of the OECD Guidelines.

Some domestic judicial decisions issued in 2022 provide evidence of the Italian tax courts' sensitivity in applying the transfer pricing principles in a manner consistent with the updated legislative tax framework and, more generally, with the OECD Guidelines.

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