ARM'S LENGTH CHRONICLE

Transfer pricing year-end adjustments to be reported for DAC6 purposes

The Italian revenue agency recently issued a Resolution providing clarifications on reportable cross-border arrangements for DAC6 purposes involving transfer pricing adjustments.
According to this interpretation, year-end transfer pricing adjustments made by Italian taxpayers in favour of foreign controlled entities may qualify as "reportable cross-border arrangements".
In the Italian revenue agency view, transfer pricing policy within a Group is a "legally binding arrangement" and transfer pricing year-end adjustments are actual "payments", i.e. *deductible negative items of income*. Thus, under specific circumstances, transfer pricing adjustments are to be considered cross-border arrangements to be notified.
While the Resolution gives additional guidance to taxpayers on how Authorities read Italian DAC6 obligations, providing some important clarifications on certain aspects never touched before, it may generate further consequences on how multinationals should consider all their intercompany transactions in certain circumstances with regards to mandatory disclosure rules.

DAC6 transposition in the Italian system

On 25 May 2018, the Council of the European Union adopted the DAC6 Directive (Directive 2018/822) as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements. Italy formally implemented it in the Italian legislative system on 11 August 2020 with the publication of legislative decree n. 100/2020 in the Official Gazette. The wording of the Italian legislative decree sticks to the wording of the Directive.
First clarifications on how the Italian revenue agency interprets the obligations to report potentially aggressive cross-border arrangements were included in a circular letter, issued on 10 February 2021 following a public consultation process.

Transfer pricing DAC6 obligations according to Italian rules

Hallmarks specifically related to transfer pricing are listed under category E of both the Directive and the legislative decree (please note that for DAC6 purposes the arm's length nature of the transaction is irrelevant for deciding whether an arrangement is reportable or not). A transfer pricing cross-border arrangement, i.e. a scheme, arrangement or project occurring among associated entities resident in Italy and in one or more foreign jurisdictions, qualifies as reportable when it meets one of the following hallmarks:

E.1 the use of unilateral safe harbor rules;
E.2 the transfer of hard-to-value intangibles;
E.3 the intragroup transfer of functions and/or risks and/or assets.

The above cross-border arrangements will trigger the reporting obligations only if they entail a tax saving in a EU state (or in a third state that signed a mandatory disclosure agreement with Italy).

Transfer pricing arrangements may also be captured by hallmark C1 which addresses mechanisms referring to "deductible cross-border payments" involving two or more associated enterprises. Such cross-border arrangements are reportable if at least one of the following conditions is met:

a. the recipient is not resident for tax purposes in any jurisdiction;
b. the recipient is tax resident:
  1. in a jurisdiction which does not impose any corporate income tax or imposes a corporate income tax at the rate of zero or almost zero (less than 1%);
  2. in a non-cooperative jurisdiction;
c. the payment benefits from a full exemption from tax;
d. the payment benefits from a preferential tax regime (e.g. a harmful tax practice).

As for hallmark E, also cross-border arrangements included in hallmark C1 will trigger the reporting obligations only if they entail a tax saving. In addition, with respect to points above under b.1, c, and d, also the main benefit test must be met to make the arrangement reportable. The main benefit test is satisfied when the economic value of the tax benefit represents more than 50% of the total tax and non-tax economic benefits of the transaction.
Both hallmarks C1 and E make reference to "associated entities". The definition of "associated entities" for hallmark C1 (as well as hallmark E2) deviates from the one provided under transfer pricing domestic rules, being wider and including cases where the participation in the capital, voting rights or profits of another enterprise exceeds 25%, versus the 50% threshold generally set for transfer pricing rules.

The Resolution and the reportable transfer pricing adjustments

Certain Italian taxpayers have requested the revenue agency to clarify whether year-end transfer pricing adjustments made to foreign associated entities (*i*) resident in a jurisdiction which does not impose any corporate income tax or imposes a corporate income tax less than 1% or (*ii*) resident in a non-cooperative jurisdiction, should be intended as reportable cross-border arrangements (i.e. hallmark C1, sub-points b.1 and b.2).
According to the revenue agency:

- the group transfer pricing policy (i.e. the guidelines that multinational groups set to define the arm's length prices to be applied in their intercompany transactions) is a legally binding arrangement concerning entities belonging to the same multinational group resident in different jurisdictions, even if not formalized by *ad hoc* agreements;

- transfer pricing year-end adjustments are “deductible cross-border payments”.

As a consequence, the above defined transfer pricing adjustments have to be treated as reportable cross-border arrangements if they entail a tax saving and, in case payments are made to an associated entity resident in a state which imposes a corporate income tax less than 1%, also the main benefit test is met.

Takeaways

The Resolution provides some aspects of interest, never examined so far. Firstly, the revenue agency indirectly confirmed that taxpayers are allowed to execute year-end adjustments to comply with the arm’s length principle. Such an interpretation does not appear fully aligned with what reported in the last update of the OECD Italian transfer pricing Country Profile (dated December 2021), where to the question “*does your jurisdiction allow/require taxpayers to make year-end adjustments*” the Italian tax administration only answered “*no*”, without providing specific details. This will make it harder for tax inspectors to challenge such kind of adjustments, although in practice we have seen very limited objections in this regard in recent years.

Moreover, from this resolution it is now clear that for the Italian authorities the term “payment” for hallmark C1 must be considered in a more widely accepted sense: in fact, although transfer pricing year-end adjustments are carried out by multinationals to comply with the arm’s length principle and are not immediately connected with a transfer of rights, they must be reported anyway if all conditions are met.

Finally, since the requests of the taxpayers were focused on hallmark C1, sub-points b.1 and b.2 only, authorities limited their answer to such issue: however, it is reasonable to expect that year-end transfer pricing adjustments (or even all payments to associated entities) may also be reportable cross-border arrangements when other conditions of hallmark C1 apply (points a, c and d).

DAC6 introduced burdensome compliance activities for intermediaries and taxpayers, often leaving grey areas such as the ones described above: this implies that multinationals must carefully monitor their cross-border arrangements.

GPBL's transfer pricing team is available to provide you with any further details on the above and support you in undertaking detailed analysis of specific cases.

Gatti Pavesi Bianchi Ludovici
Transfer Pricing
Paolo Ludovici paolo.ludovici@gpblex.it
Livio Zallo livio.zallo@gpblex.it