ARTICLE

Transfer Pricing Audits: Suitability of Transfer Pricing Documentation

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Article 26 of Legislative Decree No. 78/2010 introduced in Italy a rewarding regime related to the non-application of penalties involving intercompany transfer pricing adjustments in connection with taxpayer's submission to the Tax Authorities of 'suitable' *documentation to support taxpayer's transfer pricing policies. Assessment on the* 'suitability' *of such documentation by Tax Inspectors has given rise to a variety of critical issues in the last few years.*

1 Introduction

The latest Italian interventions on transfer pricing marked a clear-cut change with regard to the past, since a documentary regime on transfer prices was introduced for the first time in Italy, coupled with a rewarding regime to allow taxpayer – where deemed to be in compliance with the regime at issue – to obtain a favourable treatment which, in case of income adjustments, consists in the exemption from administrative tax penalties.[1]

Extremely significant interpretative sources are Circular No. 32 of 22 September 1980, (Protocol No. 9/2267) and Circular No. 42 of 12 December 1981, (Protocol No. 12/1587) since they provide an interpretation of the control concept (for the determination of intercompany transactions), basic guiding criteria to determine '*normal value*' (arm's length), as well as the most recent Regulation issued on 29 September 2010, by the Tax Authorities, subsequently followed by Explanatory Circular No. 58/E of 15 December 2010.

As a matter of fact, as of 2010, the option was introduced in Italy for multinational companies to compile any documentation that is relevant to Group transfer pricing policies: the said compilation has a two-fold and useful purpose, since – on the one hand – it allows multinational enterprises to benefit from the exemption regime provided for penalties deriving from the administrative violation set forth under Article 1, paragraph 2, of Legislative Decree No. 471/1997, which might be triggered by any transfer pricing adjustments that might have been adopted; on the other, it allows Tax Authorities to be provided with sound documentary support during audits in order to ascertain that there is effective consistency between prices in intercompany transactions entered into with associated enterprises, and such prices applied at '*arm's length*'.[2]

2 Article 26 of Law Decree No. 78/2010: Rationale Behind the Rule

The provision introduced by Article 26 of Legislative Decree No. 78 of 31 May 2010, converted with amendments by Law No. 122 of 30 July 2010, establishes exemption from tax penalties in connection with the

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[1] Art. 110, para. 7 of Presidential Decree No. 917 (TUIR, i.e. Italian Income Tax Code, hereinafter '*TUIR*'), dated 22 Dec. 1986 provides for the Italian transfer pricing regime which establishes that '*Income components deriving from transactions entered into with companies that are not resident in the State's territory, and directly or indirectly control the enterprise, are thereby controlled or are controlled by the same company that controls the enterprise, are assessed on a normal value (i.e. "arm's length value") basis of goods transferred, services rendered or goods and services received.*'
For further details on Italian legislation on transfer pricing matters, cf. P. Valente, *Manuale del Transfer Pricing* 349 et seq. (Ipsoa 2015).

[2] As highlighted in the Explanatory Report to Legislative Decree No. 78/2010, '*In view of such control being particularly complex, also from a technical perspective, the same – as known – appears to be difficult at present, given the absence of proper taxpayer's cooperation.*'
Cfr. on the arm's length principle, Y. Brauner, *Formula Based Transfer Pricing*, 42(10) Intertax 615–631 (2014); J. Wittendorff, *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010).

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determination of higher income figures as a consequence of the application of the transfer pricing regime, where taxpayer makes such suitable documentation available to the Tax Authorities pursuant to the relevant Regulation issued by the Tax Authorities (released on 29 September 2010, Protocol No. 2010/137654).

In effect, disclosure and/or submission of the documentation at issue is not mandatory: as such, failing to compile or give notice thereof to the Revenue Office does not constitute any violation of mandatory rules, which would therefore be subject to specific penalties. In that sense, one might consequently deem that there is no substantial innovation as opposed to the previous regime, except for the fact that compiling any (suitable) documentation grants taxpayer (and compels the Revenue Office to uphold) the disapplication of tax penalties in case a higher tax base were to be assessed (clearly solely for the part involving the restatement of transfer prices).

Further explanations as to the rationale behind the benefits connected with the above documentation may be found under Circular No. 58/E of 15 December 2010 as well as in subsequent Circulars that were issued by the Tax Authorities. In that respect, Tax Authorities Circular No. 25/E dated 31 July 2013 on operating guidelines for the prevention and the countering of tax evasion for the 2013 tax period, has called the attention to the fact that the Tax Authorities, when determining risk levels, must also take into account taxpayer's approach and the latter's willingness to build a cooperative relationship with the Tax Authorities, based on transparency and trust.

The goal envisaged by Article 26 of Legislative Decree No. 78/2010 is, in fact, to '*reward*' taxpayer's cooperative attitude and which:

> *has to be especially considered within a tutoring context, for risk assessment purposes of evasion/avoidance, as a transparency and cooperation index within the framework of relations established with the Tax Authorities. (…) In such context, it should be remembered that, during audits, a proper and balanced assessment of all documentation compiled by such taxpayers having adhered to the documentary duty regime should be carried out, in order to ascertain whether the enterprise is truly committed to produce a transparent process related to the determination of its own intercompany transfer prices.*[3]

It is quite evident that taxpayer's submission of transfer pricing documentation in the course of audits entails a number of advantages for Tax Authorities. The acquisition of documents provided by the investigated party affords the Tax Authorities the opportunity to avail themselves of a helpful frame of reference, for intelligence as well as for documentary (and hence, evidentiary) purposes. In fact, such documentation allows Tax Authorities to easily acquire information/knowledge regarding the methodologies and criteria adopted by the audited company, the selection and analysis of the comparables (transactions and/or entities used for assessing the normal value)[4] and, lastly, such criteria adopted to comply with or deviate from (and to what extent) the average values required by the rule on the determination of the '*arm's length*' value.

In other words, the Tax Authorities may easily '*lean*' on taxpayer's aggregate benchmark, challenging – if at all – the accuracy of all or some aspects and, ultimately integrating them with marginal or partial elements or, in any case, with the ones suggested by the analysis carried out by taxpayer himself. Even from an evidentiary perspective, activities to be carried out by Tax Authorities are considerably facilitated, given that the latter are not required to provide any evidentiary element on either facts or evaluations originating from the same taxpayer, save unless there is an intention to challenge them.[5]

A further systemic advantage that Tax Authorities might derive from the new rule is to allow them to create a '*database*' that may be progressively enriched and enhanced with comparative elements in the various product sectors, in order to build an evidentiary base to be merely updated and integrated for future audits and assessments.

3 Suitability concept expressed by regulation issued on 29 September 2010

The disapplication of penalties concerning transfer pricing adjustments of intercompany transactions is linked to taxpayer's submission of specific documentation, which must be deemed '*suitable*' by the Italian Tax Authorities in the course of audit procedures.[6]

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3 Cf. Circular No. 25/E of 31 July 2013. In that same sense, Circular No. 25/3 of 6 Aug. 2014, issued by the Revenue Office, addressed the issue of operating guidelines aimed at preventing and countering tax evasion for the 2014 tax period.

4 For further details on the topic of comparability analyses, cf. P. Valente, A. Della Rovere & P. Schipani, *Analisi di comparabilità nel transfer pricing: metodologie applicative* (Ipsoa 2013); Valente, *supra* n. 1, at 2331 et seq.

5 The analysis carried out by the taxpayer becomes thus, to all effects, the basis upon which the audit may be developed, except for Tax Authorities' resolution to reject taxpayer's allegations entirely (being compelled, however, to provide motivations for such rejection) and rebuild, *ex novo*, criteria, procedures and factual elements of the comparison.

6 From a formal standpoint, for the purpose of disapplying penalties for intercompany transfer pricing adjustments, taxpayer must notify – upon tax return filing – that he/she/it is in possession of the relevant transfer pricing documentation.

From a formal standpoint, suitability of the said documentation must, first and foremost, be ascertained on the basis of such documents that were compiled by taxpayer and their being effectively in line with the nature and structure of the documents required pursuant to the Tax Authorities' Regulation of 29 September 2010. The latter, in accordance with provisions established by the OECD Guidelines as well as by the EU Code of Conduct on transfer pricing documentation, provides that the set of documents should consist of a Masterfile and a National Documentation file.[7]

Furthermore, the 29 September 2010 Regulation sets forth a documentary duty that varies in accordance with taxpayer's typology. More in detail:

– holding companies must compile both sets of documents, a Masterfile and a National Documentation file;
– sub-holding companies must compile both sets of documents, a Masterfile and a National Documentation file;
– controlled companies must solely compile a National Documentation file.[8]

In order to establish whether the documentation is suitable, and consequently the rightful disapplication of the penalty regime, a significant aspect to be considered is the term set for the submission of transfer pricing documents. In that respect, Circular No. 58/E of 2010, while emphasizing how the disapplication of the penalty regime is based on the appreciation of taxpayer's behaviour of good faith and cooperation, calls the attention to how '*this arrangement is aimed at appreciating a spontaneous compilation of documents, in view of such documentation not being solicited by accesses, inspections, audits or other preliminary activities*'.

Therefore, the submission term for transfer pricing documentation, equal to ten (10) days from Tax Authorities' request as provided by the 29 September 2010 Regulation, meets the need to allow a regular time lapse granted by the Tax Inspectors for the compilation of such documents[9] Should there be a need – in the course of audits – to provide further information or to perform a supplementary analysis, the same shall be allowed an extension of seven (7) days (or, by agreeing on a longer term with Tax Inspectors, if such extension might be necessary due to the complexity of the analysis and the difficulties in retrieving such information) from Tax Authorities' request.

Such further extension to the term might be decisive in assessing the suitability of the transfer pricing documentation: in fact, within the context of debates, any gaps/loopholes that might be identified in the same in connection with omissions, or partial discrepancies, should be filled through a specific request by the Tax Inspectors to supply whatever documentation is missing or is to be supplemented.

4 Italian tax authorities' assessment of documentary suitability

There is considerable uncertainty in connection with the concept of '*suitability*' of documentation during inspections conducted by Tax Authorities[10]:

> *the documentation may be deemed 'suitable' if it can provide an informative framework that allows to establish compliance of transfer prices applied to the principle of arm's length, to ensure due consistency with the principles stated by the EU Code of Conduct and by OECD Guidelines. And this regardless of whether the said analysis were to produce a different value from the one identified by taxpayer.*[11]

In the course of inspections, Tax Authorities should be able to have a thorough understanding of whether the enterprise's transfer pricing policy has duly directed taxpayer to determine transfer prices that are in line with the arm's length principle, always bearing in mind

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7 For details on transfer pricing documentation duties, cf. S. Schnorberger, I. Gerdes & M. van Herksen, *Transfer Pricing Documentation: The EU Code of Conduct Compared with Member State Rules (Part 3)*, 34(10) Intertax 514–519 (2006); R. Fletcher, S. Pantelidaki, S. Schnorberger, J. Rosenkranz, T. Mkrtchyan, P.Y. Bourtourault, C. Maucour, G. Polacco & E. Della Valle, *Transfer Pricing Documentation: The EU Code of Conduct Compared with Member State Rules (Part 2)*, 34(8/9) Intertax 406–417 (2006).

8 Circular No. 58/E of 2010 specifies that '*As far as permanent establishments of non-resident enterprises in Italy are concerned, the Regulation sets forth for these latter a regime of duties that varies depending upon whether the non-resident subject to which the permanent establishment relates is qualified as either a holding, sub-holding or controlled enterprise. Also in such case, the principle repeatedly referred to is applicable, on which basis the documentary duty is specifically diversified by reason of the level of the enterprise's accessibility to information.*'

9 For details on transfer pricing documentation duties, cf. S. Schnorberger, I. Gerdes, M., van Herksen, Transfer Pricing Documentation: The EU Code of Conduct Compared twith Member State Rules (Part 3), 34(10) Intertax 514-519 (2006); R. Fletcher, S. Pantelidaki, S. Schnorberger, J. Rosenkranz, T. Mkrtchyan, P.Y. Bourtourault, C. Maucour, G. Polacco & E. Della Valle, Transfer Pricing Documentation: The EU Code of Conduct Compared with Member State Rules (Part 2) 34(8/9) Intertax 406-417 (2006)

10 The same opinion was expressed by Assonime (Association of the Italian Joint Stock Companies) in its Note No. 9/2014: '*In that regard, many uncertainties were brought to our attention, deriving from Auditors' – occasionally debatable – assessments, with regard to the alleged non-suitability of the documentation compiled to fulfill its purposes, with the consequent impossibility for enterprises to be effectively exempted from the penalties set forth for discrepant tax return.*'

11 Circular No. 58/E of 2010 points out how the '*suitability*' concept introduced by Art. 26 of Legislative Decree No. 78/2010 must not strictly involve a merely formal observance of the guidelines provided by the Regulation but should be viewed – rather – from a much wider and substantial perspective which purpose is to reward the aptness of the documentation compiled by taxpayer to provide the Tax Authorities with the necessary data and information to perform a thorough and exhaustive analysis of the transfer prices applied.

that such theme is characterized by evaluations and estimates that are extremely complicated. All of the above might affect the comparability analysis and nullify the interquartile range identified and the tested party's positioning within such range.[12]

As far as the relation between the challenges raised by the Tax Inspectors on the transfer pricing policy adopted by taxpayer, and the suitability judgment expressed by the them on the same, it is worth noting that any element that may lead Tax Authorities to deem, for example, that the subjects identified by taxpayer are '*not comparable*' and/or that both, the comparability analysis and the transfer pricing methods are inaccurate, such aspects should not be conducive to establish that there is an insufficiency with regard to the judgment of suitability of taxpayer's National Documentation submitted. After all, the rule's underlying rationale (Article No. 26 of Legislative Decree No. 78/2010 which introduced the documentary duty in Italy on transfer pricing matters (also as interpreted by the various Circulars published on a yearly basis by the Tax Authorities) is to provide the Revenue Office with the transfer pricing policies pursued by the taxpayer.

The rule seems to be clearly referring to an element that is objectively identifiable (even if appreciable also from a subjective standpoint) consisting in the '*suitability*' of the documentation compiled by taxpayer for the purpose of ascertaining compliance with the arm's length value of transfer prices applied within intercompany transactions.[13]

It is quite clear that this assessment does not pertain to the accuracy of the criteria applied by taxpayer and, hence, of the suitability of transfer prices applied, given that issues arise precisely in the case where assessments and audits are concluded with the rejection of such criteria and the adoption of new assessment criteria.

From the standpoint of substance and contents, it is deemed that suitability must be clearly and unquestionably (i.e. objectively) established just as the document's suitability to provide full evidence of the criteria adopted by the audited subject for the purpose of determining transfer prices. That is how the term '*riscontro*' (i.e. assessment), adopted by the rule under examination should be interpreted. In other words, the documentation must allow Tax Inspectors to carry out their assessment of the criteria adopted by taxpayer, not solely aimed at sharing their accuracy, but also at refuting the same.

As a result, whenever the documentation analysed has put the Tax Inspectors in a position to have a perfect understanding of the criteria pursued by taxpayer in determining transfer prices in all of their theoretical and applicative aspects, it might be rightly stated that such documentation is objectively '*suitable*' to facilitate auditing activities. The compilation of suitable documentation represents, therefore, an element in which taxpayer's '*good faith*' is concretely evidenced in this latter's relationship with the Tax Authorities, although it is not thereby entirely fulfilled, given also the need for an objective requirement (or, in any case, not solely the psychological one) of the suitability of the means to reach the end.[14]

5 Transfer pricing, documentation and criminal tax aspects

The wording and rationale underpinning Article 110, paragraph 7 of the Italian Income Tax Code (Testo Unico delle Imposte sui Redditi - TUIR) contain a significant margin of subjectivity with regard to assessments, where '*normal*' value is referred to, given that '*normality*' represents, in turn, an element based on calculation criteria (more precisely, of determination) of the normal (i.e. '*arm's length*') value as established by the law, ex Article 9, paragraph 3 of the TUIR, which represents the national

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12 *Transfer Pricing Physiognomy*
All benchmarks are likely, or at least they are so, theoretically speaking.
All benchmarks that are likely in theory are theoretically applicable in practice.
However, not all benchmarks that are theoretically applicable in practice are actually applicable to all concrete cases.
What's more: some benchmarks that are theoretically applicable in practice may be practically unlikely and may result as being actually inapplicable (in some given concrete cases).
The burden rests with the interpreter to discern whether a benchmark is likely from one that isn't, evaluate whether the one that is likely is possible, assess whether the one that is possible is likely (in specific concrete cases).
The debate between Tax Authorities and Taxpayers has the purpose of establishing a level of evident likelihood or a just as evident unlikelihood of the benchmark.
Balance and critical judgment support the ability to discern between what is an acceptable likelihood from an unacceptable unlikelihood.
The crux of the problem lies precisely in such antithetical interests that exist between Tax Authorities and Taxpayers to the extent that the unlikely becomes possible and the impossible becomes likely.
Be it likely or unlikely as it may.
And to raise – with an ever-increasing likelihood – that which is unlikely to the heights of that which is possible.
Cfr. Valente, *supra* n. 1, at 1286 ss.

13 Within the context of tax matters and the application of related penalties in particular, psychological elements – differently from criminal matters – are irrelevant. It is worth recalling that to such effect, in general terms, Art. 8 of Legislative Decree No. 546 of 31 Dec. 1992, establishes that the Tax Judge may rule not to apply penalties in the case where there are '*objective conditions of uncertainty*' on the bearing and application scope of the provisions they refer to. It is quite clear that, also in this case, the psychological aspect and good faith (even if provided and codified by Taxpayer's Charter of Rights is devoid of any and all concrete effects) are not relevant for the non-application of penalties. As far as the case at issue is concerned, it is deemed that the provision stated under Art. 1, para. 2-*ter* of Legislative Decree No. 471/97 represents a '*specialistic*' kind of application, circumstantiated and – within certain terms – mandatory, of the mentioned provision ex Art. 8 of Legislative Decree No. 546/92, which is, quite the contrary, extremely discretional.
For further details, cf. Valente, *supra* n. 1, at 923 et seq.

14 For further information, cf. Valente, *supra* n. 1, at 923 et seq.

law provision that (essentially) corresponds to the internationally acknowledged '*arm's length*' principle.

The criteria established by the mentioned Article 9 of the TUIR require the identification of the price applied within a free competition regime, i.e. the price that would have been agreed in similar transactions by independent enterprises (not bound by any controlling ties or connection in a broad sense).[15]

The reform of criminal tax penalties, ex Legislative Decree No. 74 of 10 March 2000, implemented with Decree Law No. 158 of 24 September 2015, has thoroughly overhauled the tax crimes system with a series of interventions aimed at restricting the criminally relevant purview to the advantage of administrative tax penalties. Such important reforming event could not possibly fail to have an impact on '*transfer pricing*'[16] issues, even if, it might be worth noting that already within the framework of the former system, criminal relevance of the said provision was rather restricted, and in any case jurisprudential applications on the subject were always rather limited.

The reason for such limited intervention of criminal justice in the transfer pricing area mainly arises from the essentially '*valuational*' nature of '*transfer pricing*' transactions and from the existence of a rule such as Article 7 of Legislative Decree No. 74/2000, which (original text) provided that '*no punishable facts arise, pursuant to Articles 3 and 4 (…) from the findings and value estimates in connection to which the criteria concretely applied were in any event disclosed in the Financial Statements*' (paragraph 1); '*in any case, no punishable facts arise, pursuant to Articles 3 and 4, for such value estimates that, when individually considered, are ten (10) per cent less than the accurate ones*' (paragraph 2).

The criminal tax reform, which has presently come into force, has significantly affected the above cases under various respects: firstly, by substantially increasing the quantitative punishability thresholds; secondly, by introducing interpretative criteria aimed at restricting the purview of criminal relevance strictly in the case of proven '*non-existence*' of some given elements, and not if '*fictitiousness*' (as was formerly the case) is debatable.

As to the new formulation of the '*discrepant tax return*', Article 4 includes a new paragraph 1-*bis*, based on which criminal relevance of behaviours is restricted as to certain behaviours , specifically excluding the relevance itself in cases where the '*evaluation of profit or loss elements that are objectively existent, regarding which the criteria concretely applied were in any case disclosed in the Financial Statements, or in some other documentation that is tax-relevant*' and of the '*non-deductibility of effective loss elements*'. A just as decriminalizing effect is provided by the new Letter d) of Article 4, which – moreover – by force of the expression '*anywhere present*', is of an absolutely general nature and: '*the word fictitious, wherever present, is replaced by the following: non-existent*'.

As a consequence of such substantial reform to criminal cases within the greater application scope of transfer pricing matters, the numerous issues involving the interpretative and applicative aspects connected to the transfer pricing system and its complicated technical rules, automatically exclude the above area from the criminal tax relevance sector, with the obvious consequence that exceptions related to the inaccurate application of technical transfer pricing criteria may no longer be subject to the lodging of a complaint to the Public Prosecution and, should this ultimately occur, a non-suit ruling by the Court must be issued.[17]

6 Conclusions

One may reasonably conclude that the documentation supporting transfer pricing policies might be deemed '*suitable*' if it:

– complies with the formal requirements set forth by the Tax Authorities' Director in the Regulation issued on 29 September 2010;
– puts the Tax Inspectors in a position to fully understand the policies adopted: the said circumstance may be corroborated by the fact that in the Official Records of Findings and in the Tax Assessment Notices, the Tax Authorities acknowledge their being fully acquainted with all of the relevant knowledge deriving from the acquisition of such documents as well as with the applicative rationale and techniques connected to transfer prices as adopted by taxpayer, even if only for the purpose of challenging them.

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[15] Normal value therefore consists in the price applied '*on the average*', for goods and services of the same or similar kind, under conditions of free competition and at the same distribution phase, at the same place and time.
The rule at issue further refers to transferor's or lender's price lists and tariffs, to market lists and to Chamber of Commerce price lists as well as to professional tariffs, while taking special discounts into account.
The rules contain a series of elements which, considered in and of themselves or combined between/among them, introduce elements of uncertainty and subjectivity, which – however – must be clearly evidenced in numerical figures (i.e. the determination of the value of tax-relevant transactions) agreed upon by the parties involved in the tax relationship, namely, that must be verifiable by the Judges whom the settlement of any controversy was referred to Cf. Valente, *supra* n. 1, at 1330 et seq.

[16] Cf. Valente, *supra* n. 1, at 1727 et seq.; P. Valente, I. Caraccioli & S. Mattia, *Transfer pricing: valutazioni estimative e irrilevanza penale*, (2) Corriere Tributario (2016).

[17] As a result of such thorough reform of the criminal tax system, the next step should be to review/revise interpretative criteria provided by the old Circulars of 14 Apr. 2000 by the General Headquarters of the Revenue Guard Corps, later supplemented by the so-called '*Maxi-circular*' No. 1/2008 of the same General Headquarters as above, as well as by Circular of 4 Aug. 2000 by the former Italian Minister of Finance, which – precisely – justified (not to say '*encouraged*') an ample scope of relevance of behavioural entrepreneurial data involving transfer pricing in connection with companies in which transfer pricing matters were evidently being applied to a considerable extent.
For further details, cf. Valente, Caraccioli & Mattia, *supra* n. 16.

The rule seems therefore to clearly refer to an element that is objectively sustainable (even if subjectively appreciable), which consists in the '*suitability*' of taxpayer's documentation as compiled to ascertain compliance with the '*arm's length*' value of transfer prices adopted within an intercompany framework.

In fact, '*suitable documentation*' and tax recapture may simultaneously exist in abstract and concrete cases as well. The existence of the former avoids the application of penalties, but not the recapturing of the higher taxable matter. Suitability is therefore not contingent on compliance of documentation contents to the provision of Article 110, paragraph 7 of the TUIR.[18]

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18 For further details, cf. Valente, *supra* n. 1, at 923 et seq.