

Dottorato di Ricerca in
“Diritto degli Affari e Tributario dell’Impresa”
XXVI CICLO
Coordinatore: Chiar.ma Prof.ssa Livia Salvini

Transfer Pricing Controversies: Remedies

- *Specific issues and evolving perspectives* -

(ENGLISH ABSTRACT)

Tutor
Professor Laura Castaldi

Candidate
Giovanni Paudice

Academic year 2013/2014

CHAPTER 1

Introduction

A persistent tax problem faced by multinational groups of companies (also MNEs) is the threat of double taxation as a result of price adjustments, by the tax authorities, as regards cross-border transfers of goods, services and intangibles such as copyrights, patents, licences, brand names, etc. from one group company to another (transfer pricing).

In particular, to a MNE as a whole, the transfer price does not make much difference as long as the goods or services do not leave the group. Indeed, a profit or loss to the group is realized only after the goods or services are sold to third parties. The essence of a MNE, its competitive edge as it were, is its ability to operate as a single entity in world financial and technological markets, thus achieving higher net revenues from its operations as a whole than could be achieved under separate management on an arm's length basis. On the other hand, national tax administrations scrutinize cross-border transfer pricing within multinational groups of companies, to make sure they get what they consider their fair share of the tax base, if necessary by unilateral adjustment of that pricing.

At this stage, although States adopt unilateral, bilateral or multilateral measures aimed at eliminating double taxation and solve transfer pricing controversies, the permanence, in practice, of double taxation cases, produces remarkable concerns: by increasing the tax burden. In this perspective, double taxation can become an obstacle to transnational business operations and creates a situation of legal uncertainty for taxpayers. The issue is that the current international tax system no longer reflects how MNEs operate. Current international tax rules assume that the different entities that constitute an MNE act independently from one another. The different entities that form a multinational group operate as a whole and follow an overall business strategy.

The current analysis, initially, focuses on unilateral, bilateral and multilateral measures provided by the Italian tax law in order to solve transfer pricing controversies as alternative to domestic litigation; in particular:

- I. The international standard ruling, as unilateral measure (following chapter 2);

- II. The Mutual Agreement Procedure (MAP), as bilateral measure (following chapter 3);
- III. The Arbitration Convention No 90/436/CEE, as multilateral measure (following chapter 4).

Following such analysis showing the limits of the above mentioned measures, the analysis moves to take into account new measures in order to solve transfer pricing controversies (following chapter 5).

CHAPTER 2

International Standard Ruling

As unilateral measure, the International Standard Ruling has been introduced by article 8 of Decree Law no. 269 of 30 September 2003, converted with amendments into Law no. 326 of 24 November 2003 and implemented with Regulation of the Director of the Revenue Agency of 23 July 2004.

The International Standard Ruling is addressed to “*enterprises with international activity*” which, as defined by article 1 of the Regulation, intend to agree in advance with the Italian tax administration the correct transfer pricing methodology applicable to the transactions carried out with related parties, as provided for by paragraph 7 of article 110 of Presidential Decree no. 917 of 22 December 1986. Specifically, although the international standard ruling should be classed under the *genus* of a tax ruling, it is characterised by certain unique features which distinguish it as a dialectical process compared with other forms of ruling under Italian tax law. As a result of this character the relevant procedure does not end with a unilateral decision by the tax administration, but with an agreement between the taxpayer and the tax authority regarding cross-border transactions, as provided for by article 2 of the Regulation. Broadly speaking, the international standard ruling is part of the tax compliance policy which aims to improve cooperation and dialogue between taxpayers and the tax administration. Moreover, it provides legal certainty to both of the parties, preventing legal disputes and reducing the risk of international double taxation.

The procedure is completed by the signing of an agreement which sets out the criteria and methods for calculating the normal value of the transactions to which the application refers to, or, in other cases, the criteria for application of the relevant legislation.

The international standard ruling agreement, which is binding for both parties, remains in force for five years starting from the tax period in which it is signed. During this period the Revenue Agency, and more specifically the International Ruling Office, verifies that the terms of the agreement are complied with and also ascertains whether any changes have occurred to the *de facto* or *de jure* conditions which constitute the premise on which the clauses of the agreement are based.

Through the implementation of the ruling procedure. Advance Pricing Agreements have been introduced into Italian law, representing a tool which is commonly available in the tax systems of OECD member countries. An APA is generally an agreement between the taxpayer and the tax administration in the taxpayer's country of residence, which makes it possible, in advance and for a set period of time, to determine the method for calculating the arm's length value referable to the transactions covered by the agreement. The OECD guidelines provide for "unilateral", "bilateral" or "multilateral" agreements. Indeed, a "bilateral" or "multilateral" APA, as a rule, ensures that income accrued to associated enterprises from transactions which fall within the scope of the agreement is not subject to double or multiple taxation, since the agreement is also accepted and signed by the competent authorities of the foreign jurisdictions concerned.

The International Standard Ruling is comparable to a unilateral APA in that it constitutes an agreement which binds the taxpayer and the Italian tax administration and accordingly is not adequate to solve double taxation issue for MNEs. Starting from 2010, the competent Italian Tax Authority can make it "*bilateral*" on request by the taxpayer, through a mutual agreement procedure as provided by Art.25 of the OECD Model (so called «*mutual agreement procedure-map-Apa request*»). In this perspective, it can become a more useful instrument of resolution of controversies in transfer price matters.

CHAPTER 3

MUTUAL AGREEMENT PROCEDURE (MAP)

Art. 25 of the OECD Model provides for a mutual agreement procedure aimed at the resolution of disputes that can arise in relation to the application of provisions contained in bilateral agreements against double taxation; accordingly also with reference to transfer prices controversies. According to what is provided for by paragraphs 1 and 2, competent authorities of contracting States shall endeavour to solve, through a mutual agreement procedure, situations in which taxpayers result in being subjected to a taxation which is not in accordance with what is provided for by the applicable double tax agreement.

The mutual agreement procedure entails for competent authorities a duty to negotiate; in particular the latter are under a duty merely to use their best endeavours and to achieve a result. This circumstance represents the major limit of mutual agreement procedure; in addition the other current critical areas are: i) a limited role of taxpayer which is not party of the procedure; ii) the duration of procedure (on this regard it is not established a time limit in order to reach an agreement by the competent tax authorities).

Among the modifications made in 2008, the most relevant one is, however, the introduction of a new paragraph 5 and of the corresponding Commentary, which establish the possibility of an arbitration procedure aimed at ensuring the effectiveness of the mutual agreement procedure: when, under paragraph 1, a taxpayer presented a case to the competent authorities of a Contracting State and the competent authorities are unable to reach an agreement within two years from the presentation of the case, every unresolved issue arising from the case shall be submitted to arbitration, if the taxpayer so requests.

The arbitration procedure, which takes place notwithstanding any authorization from the competent authorities, is however excluded when a decision on unresolved issues has already been rendered by judicial or administrative authorities of one of the two States. The arbitration decision shall be binding for the Contracting States and implemented independently from any temporal limit provided for by national regulations, unless a person directly affected by the case does not accept the agreement that implements the arbitral decision. The Commentary to OECD Model also specifies that the arbitration decision does not represent an alternative mechanism

with respect to the mutual agreement procedure: the arbitration procedure is an independent and preliminary phase which leads to the reaching of the mutual agreement and it represents an essential part of the latter. In this regard, also the Commentary underlines that the arbitration procedure concerns only specific issues, the definition of which is essential for the solution of the main case, while the latter is resolved in the wider context of the mutual agreement procedure.

The arbitration procedure should ensure more appeal to mutual agreement procedure, but at this stage it is not widespread in Double Taxation Treaties signed by Italy. In future perspective, it should be highly preferred to include such arbitration clause.

CHAPTER 4

The Arbitration Convention No 90/436/CEE

The Arbitration Convention No. 90/436/EEC establishes an arbitration procedure aimed at solving double taxation cases arising from diverging adjustments, made by Member States, of transfer prices applied between associated enterprises.

The Convention applies when profits which are included in the profits of an enterprise of a Contracting State are also likely to be included in the profits of an enterprise of another Contracting State. The Convention applies to taxes on income.

According to the Convention, when a Contracting State intends to proceed with the adjustment of profits of an enterprise, it is bound to communicate the intended action to the enterprise, so that the latter can inform the other associated enterprise, which can, in turn, inform the other Contracting State. The Convention acknowledges the possibility for the enterprises and for the corresponding Tax Administration to directly reach an agreement with a view to avoiding double taxation.

In the absence of such an agreement, within three years from the notification of the measure, the enterprise may present the case to the competent authority of its State of residence, so that a mutual agreement procedure can be carried out. If, within two years from the submission of the case, the competent authorities have not reached a mutual agreement, they shall initiate an arbitration procedure, by setting up an Advisory Commission, which, within six months, has to express its opinion concerning the modality for eliminating the double taxation in question.

Within six months from the date on which the Advisory Commission delivered its opinion, the competent authorities shall take a decision concerning the elimination of the double taxation: this

decision does not necessarily have to conform to the opinion expressed by the Advisory Commission. Nevertheless, if the authorities fail to reach agreement on the case, they are obliged to conform to the above-mentioned opinion.

According to Art. 8 of the Arbitration Convention, the competent authority is not obliged to initiate the mutual agreement procedure or the arbitration procedure when one of the concerned enterprises is liable to serious penalties arising from the acts that lead to the profits adjustments. A list of unilateral declarations, attached to the Arbitration Convention, illustrates the concept of “*serious penalties*” according to each Contracting State.

The Code of Conduct for the effective implementation of the Arbitration Convention, whose last version was approved in 2009, regulates the operational and procedural aspects of the Convention itself. In particular, the Code provides for rules on the following relevant matters.

- The scope of the Arbitration Convention, with a specific reference to the definition of the circumstances of triangular cases;
- Some practical and operational issues related to transparency of the procedures, to the modalities for exchanging working documents, to the composition and functioning of the Advisory Commission;
- Issues related to the collection of taxes and of the due interests during the dispute resolution procedures.

The Code of Conduct represents a political commitment and it does not affect the rights, the obligation and the respective spheres of competence of Member States and of the EU.

Although the Arbitration Convention provides for result unlike the mutual agreement procedure as provided by art. 25 OECD Model, it is not still widely used likely due to a certain complexity of procedure. On this regard, in future perspective, it should be highly preferred to implement the Arbitration Convention in accordance to recommendations provided by the Code of Conduct.

CHAPTER 5

Conclusions

It is increasingly difficult to apply the arm’s length principle.

In the first place, companies and markets become increasingly integrated as a result of, precisely, the single European market, and globalization in general. It will therefore become increasingly

difficult to find comparable independent transactions. In the second place, products and services keep reaching further levels of specialization. Even if comparable independent parties are available, they may not trade sufficiently comparable goods and services. The product or process traded may be patented and not provide by anyone else. In the third place, a very significant part of cross-border intragroup trade is in intangibles (patents, brand names, copyright, know-how, etc., and licences for the use of them), which are notoriously difficult to price.

In the fourth place, the arm's length principle starts from a totally fictitious idea of independence. In reality, associated enterprises are *not* independent of each other. From the group perspective, there may be valid commercial reasons *not* to behave "uncontrolled". Furthermore, some costs do not even exist outside groups of associated enterprise. It is difficult to tell, for instance, which part of head office overhead must be charged to which group company.

Unitary taxation would do away many of these problems.

In order for MNEs to be taxed according to their real nature, two measures should be introduced:

- MNEs should be required to submit a worldwide combined report, including consolidated accounts, to the tax authorities of each country in which they operate.
- MNEs should be required to provide a country-by-country breakdown of their employees, physical assets, sales, profits and taxes actually due and paid.

These two measures could be the basis of a tax system that would consider the total profits made by a MNE, rather than the profits made by any of its parts. It would then allocate these profits to the different countries in which the MNEs conducts its real business, according to transparent criteria. Each country would be free to decide what tax rates to apply to their corresponding tax base.

In nutshell, MNEs are to be taxed in a way that recognises what they really are – one single entity and accordingly an unitary taxpayer. On this regard, many countries such USA, CANADA and the European Union – through the Corporate Common Consolidated Tax Base (CCCTB) – are already implementing or exploring substantial modifications or alternatives to the Arm's Length Principle.

A unitary approach to the taxation of MNEs would not be problem-free. Some of the more salient challenges involve establishing what constitutes a unitary business, defining the MNC's global tax base, identifying formulas that split profits fairly among the different jurisdictions in which the company operates and agreeing how to adapt the system to the nature of different sectors.

However, even if it presents challenges that would need to be overcome through global cooperation, Governments could build on these experiences to gradually evolve towards a tax system that is coherent with how are currently MNEs, one economic entity.