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***La disciplina italiana in materia di prezzi di  
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evolutive***

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**Executive Summary: The evolution of multinational enterprises and need of a “*Copernican Revolution*” for transfer pricing legislation**

The current research aims at an in-depth analysis of Italian transfer pricing legislation as embodied in Section 110 and Section 9 of the Italian Tax Act (the latter being enacted with Presidential Decree No. 917 of 1986). In particular, the analysis carried out thereto proves that both from an objective and a subjective standpoint the domestic legislation is highlighting a number of inconsistencies with the key legislative reference on the topic, namely the OECD Transfer Pricing Guidelines of 1979 (substantially revised in 1995).

To this end, a crucial factor is the diverging approach arising from the interpretation of the key concept in transfer pricing: the arm’s length principle. For purposes of such analysis, it has thus been concluded that the so-called “*normal value*” concept enforceable under domestic law

refers exclusively to the price of the transaction, as it is considered “(...) *the average price or consideration paid for goods and services (...)*”.

In this respect, the findings of my analysis will reveal that, according to the current wording of Article 9 of the Italian Tax Act differ from Article 9 of the OECD Model Tax Convention in one main regard: unlike the latter provision, domestic provisions do allow the application of the transactional net margin or profit split methods as these do not result in the determination of an arm’s length price, whereas the former only permit the application of an arm’s length price to intra-group transactions.

In particular, due to the absence of any reference to the term “conditions” within the domestic provisions, in principle any application of a transfer pricing method that would look at profits (at the net or operating level) would be hampered in the event a bilateral tax treaty would not be in place or it would not be applicable.

As a result, the current research proposes to get rid (i) of the current hierarchy of the transfer pricing methods, acknowledging preference towards the so-called “traditional” methods, such as the CUP, Cost Plus and Resale Price Method and replace him with what I labelled as a “*Most Appropriate Method Rule*”

The origin of my proposal stems from the circumstance that regardless of products or sectors, multinational companies (MNEs) nowadays face the pressure of competition in a globalized economy. In fact, MNEs experience the need to examine the effectiveness of their business structures and adjust their business to the changing conditions on an almost continuous basis.

In this regard, the integrated multinational model entails that the group works across jurisdictions and legal boundaries. In fact, MNEs integrate either vertically or horizontally to form what is referred to as “unitary business”. Vertical integration occurs when an enterprise engages in two or more primary activities in the value chain (e.g. manufacturing and distribution), and the upstream segment supplies the downstream one with output. The downstream segment adds value prior to the final sale. This usually implies intra-group trade in intermediate products.

On the other hand, horizontal integration occurs when an enterprise manufactures the same product or product line in two or more plants in different locations, but uses the same suppliers or sells in the same markets. If the plants exchange output, horizontal intra-group trade occurs.

While vertical integration and intra-group trade are clear hallmarks of the modern MNE, it is only relatively recently that MNEs have started

shifting the intermediate production stages to other countries. Although in the early 1980s this shift was primarily in the form of worldwide procurement or contract manufacturing of intermediate goods, the business services boom of the 1990s has encouraged MNEs to start moving certain activities (e.g. software development, R&D activity relating to drugs in the pharmaceutical industry etc.) to countries such as China and India where there is low-cost, highly skilled labour available. In the meanwhile, a great number of MNEs have highly sophisticated R&D facilities outside their home countries, engaging in the bi-directional transfer of intangible property.

As a result of the above developments, the picture of the vertically integrated MNEs shifted from the straightforward one of trade in raw materials to one of more sophisticated, complex trades of semi-finished goods, services and intangibles throughout the “supply chain management” model. With the latter term I refer to a cross-functional internal organizational approach to managing the movement of raw materials and key entrepreneurial risk taking functions. The main features of this business model are the focus on operational processes, optimized delivery networks and centralized management and integration of process.

On the basis of the above, two additional factors need to be considered. First and foremost, due to integration processes, groups organize themselves in separate entities disposing of decision-making authority and responsibility as to specific results: the so-called “responsibility centres” mentioned in the management accounting literature. According to this theory, each entity, or more entities together, form a building block (or a component thereof) of the group’s overall value chain. One (or more) entity coordinates and manages the processes and the interactions. These types of entities are often labelled as principals and are entitled to the residual profit, i.e. the additional amount remunerating adding value functions.

Secondly, the most important change in the MNE’s way of organizing their business model is the shift of their funds towards businesses’ intangible assets (or intellectual property). Indeed, by outsourcing production and cutting back on stocks, funds are released to be applied to the added value of business. Think, for example, at the automotive industry, with the creation of technological advancement by means of R&D costs, motor vehicle design or even brand development. In fact, it is the combination of a number of intangibles, such as trade or marketing intangibles that renders a business successful.

It follows from the above that if we keep the objective of any arm's length pricing method in mind, it can be summarized in the fact that it tries to determine the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstance.

However, nowadays two circumstances commonly exist for large MNEs that may prevent such comparisons from being made reliably and thus may require use of what are currently considered "methods of last resort", such as the Profit Split or the TNMM.

In fact, there may be significant differences between the controlled and uncontrolled transactions that are attributable to economies of vertical integration within the controlled group. Therefore, in this (increasing) type of scenarios independent comparables are not available. The same goes for situations where both parties to a controlled transaction possess valuable, non routine intangibles or undertake entrepreneurial risks beyond those that are ordinarily comprehended in similar transactions between unrelated parties.

On the basis of the above, I submit to adopt the so-called "most appropriate" method rule, whereby the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case. For this purpose, it should take account of the respective strengths and weaknesses of each of the OECD recognised methods; of the appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; of the availability of reasonably reliable information (in particular on uncontrolled comparables) in order to apply the selected method and / or other methods; and of the degree of comparability of controlled and uncontrolled transactions including the reliability of comparability adjustments that may be needed to eliminate differences between them.

From the above two further consequences arise. First, Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length. As a result, where a traditional transaction methods and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to—the transactional profit methods. Moreover, the comparable uncontrolled price method (CUP) and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

There are situations where transactional profit methods are found to be more appropriate than traditional transaction methods. One example is where, considering the functional analysis of the controlled transaction under review and an evaluation of the comparable uncontrolled transactions, it is found that a net profit margin analysis is more reliable than a gross margin analysis, e.g. because there are operating expenses below the gross margin level for which the tested party is not responsible.

Another example relates to cases where the presence of significant unique intangibles contributed by each of the parties to the controlled transaction or the engagement in highly integrated activities makes a transactional profit split more appropriate than a one-sided method. Furthermore, where there is no or limited publicly available reliable gross margin information on third parties, traditional transaction methods might be difficult to apply in cases other than those where there are satisfactory internal comparables, and a transactional profit method might be the most appropriate method in view of the availability of sufficiently reliable information.

It is obvious from the above proposal that, within the major standing acknowledged to the comparability analysis in order to implement such a model, the functional analysis comes to play a pivotal role here. To this end, in order to arrive at a sufficient level of uniformity – necessary for applying the proposed methodology with consistency on a pan-European basis – it is important that functions are also analyzed looking at the significant people functions, i.e. at the economically significant activities entitling the performer to the residual profit. In practice, however it often turns out that many companies whereby the “idea owners” are often located in different jurisdictions, therefore rendering the economic and functional analysis more difficult.

The last part of the current research focused on the (mis)interpretation of the arm’s length principle as a specific anti-avoidance clause.

Departing from some recent domestic and foreign case law, I will be trying to prove that transfer pricing is a complex multidisciplinary phenomenon grounded on the arm’s length principle. The latter could be used only in pathologic situations as a legal instrument to challenge purported abusive structures entered into by the taxpayer, but in its very essence is neither a legal nor a tax principle, but an economic one. As a result, light of the above, it seems difficult to share the outcome reached by certain judges (including the Italian Supreme Court) in holding that transfer pricing provisions should be meant as a pure anti-avoidance tool. Rather it should be seen mainly as a provision related to the valuation of business income items aimed at properly ascertaining the taxable base. In the meantime, the

authors are of the opinion that transfer pricing provisions might be used as an anti-avoidance tool aimed at tackling abusive practices by means of shifting income to foreign jurisdictions.

Such an interpretation seems to be supported by the 1995 OECD Guidelines, which stipulate that the arm's length principle, as endorsed in transfer pricing regulations, serves the dual objective of "...securing the appropriate tax base in each jurisdiction and avoiding double taxation...". Thus, the Guidelines do not emphasize a true anti-avoidance meaning in transfer pricing provisions, although both the taxpayer and the tax authorities "should endeavour to make a good faith showing that their determinations of transfer pricing are consistent with the arm's length principle regardless of where the burden of proof lies".

The above considerations led me to two further considerations. First, it seems mature the time to introduce a general domestic-ant avoidance rule that would clear the path from the doubts recently arising with the increasing exploitation of the concept of abuse of law. It would also useful to clear the ground from situation of recharacterization of transaction on the basis of paragraphs 1.27 and 1.37 of the TP Guidelines.

In fact, when applying Art 9 (1) OECD MTC it is important to distinguish between two particular issues, i.e.

- (i) the issue of which "*conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations*", and
- (ii) the issue of whether these conditions "*differ from those which would be made between independent enterprises*".

Whereas issue (i) concerns the process of *establishing* the conditions of the controlled transaction, issue (ii) concerns the process of *testing* and, possibly, *adjusting* the conditions of the controlled transaction under the arm's length principle. As will be explained further below, issue (i) is not answered based on the arm's length principle (i.e. based on a comparison with the behaviour of independent parties), but rather based on an examination of (primarily) the written agreements entered into between the associated enterprises (if any), other written material shedding light on the terms of the controlled transaction (if such material exists) and the associated enterprises' actual conduct.

The same distinction between establishing the conditions of the controlled transaction and testing and adjusting them based on the arm's length principle applies under OECD Guidelines para 1.36. This paragraph provides that a tax administration's examination of a controlled transaction ordinarily should be based on "*the transaction actually undertaken by the associated enterprises as it has been structured by them*" and that this transaction should not be disregarded or substituted in other than exceptional cases. Before reaching the point where the question of disregarding or substituting the controlled transaction arises, it is necessary to establish the conditions of the controlled

transaction actually undertaken. This process is, of course, not restricted by OECD Guidelines para 1.36.

The wording of Art 9 (1) OECD MTC establishes a rather clear and straightforward distinction between the process of establishing the “*conditions (...) made or imposed*” in the controlled transaction and the process of adjusting/restructuring them based on the arm’s length principle, the latter of which requires a determination of whether these conditions “*differ from those which would be made between independent enterprises*”. The clarity provided by the wording is, however, blurred by the economic-substance references contained in different parts of OECD Guidelines Chapter I. More in specific: The economic-substance exception – the application of which clearly amounts to a restricted structural adjustment – applies if the “*economic substance*” of a controlled transaction differs from its form. At the outset one would therefore expect that in all cases where a discrepancy between form and economic substance exists and, as a result, the controlled transaction is re-characterised in accordance with its economic substance, this would amount to a structural adjustment which is restricted by OECD Guidelines para 1.36. As a corollary one would also expect that such a re-characterisation is not a matter of establishing the “*conditions (...) made or imposed*” in the controlled transaction.

However, in addition to using the phrase “*economic substance*” in their subsection on recognition of the actual transactions undertaken, the OECD Guidelines also use the phrase in their subsection on the comparability analysis. Due to this, the issue arises whether the phrase “*economic substance*” is used with the same meaning in both subsections and, if not, what is the difference.

A careful analysis reveals that the subsection on the comparability analysis uses the phrase “*economic substance*” partly with a different meaning than and partly with the same meaning as the subsection on recognition of the actual transactions undertaken. More in specific, such an analysis reveals that the OECD Guidelines’ notion of “*economic substance*” has two, distinctly different prongs. These prongs are as follows:

i) The factual-substance prong: This prong is dealt with in OECD Guidelines para 1.26 as well as in their paras 1.28-1.29. Under this prong, discrepancies between the associated enterprises’ written contracts (or other written material purportedly establishing the conditions of the controlled transaction) and the enterprises’ actual conduct are examined. Under this prong, if such a discrepancy exists, the associated enterprises’ actual conduct is deemed to express the actual conditions made or imposed between them. Further, this prong pertains to the issue of *establishing* the “*conditions (...) made or imposed*” in the controlled transaction.

ii) The arm's-length prong: This prong is dealt with in OECD Guidelines paras 1.27 and 1.37. Under this prong, discrepancies between the form of the controlled transaction and the form which independent enterprises would have adopted are examined. Under this prong, if such a discrepancy exists, a tax administration may be authorized to substitute the actual form of the controlled transaction with the form which independent parties would have adopted. Further, under this prong, the form which independent parties would have adopted is – somewhat unconventionally – referred to as the “*economic substance*” of the controlled transaction. Further, this prong pertains to the issue of *restructuring* the “*conditions (...) made or imposed*” in the controlled transaction.