The Shift in the Burden of Proof in regard to Transfer Pricing

In this note, the author discusses the development of the transfer pricing regime in Italy in the context of recent legislative and case law developments that, inter alia, clarify that the initial burden of proof in this area is on the tax authorities.

1. Introduction

Transfer pricing provisions were introduced in Italy some time ago.\(^1\) Art. 17 of the Law of 8 June 1936, No. 1231, provided that, in regard to:

\[\ldots\] the income of autonomous companies and share partnership companies that carry out their activity in the Reign [of Italy], on behalf of companies, firms or foreign associations \[\ldots\] all the amounts unduly indicated in the balance sheet in the form of price increases of raw materials, products and goods sold by the foreign entity or in the form of commissions, profit sharing \[\ldots\] are considered active.

This initial provision – which did not provide for adjustments to income but only to costs – was reiterated in Art. 113 of Law No. 645/1958 (the Tax on Income from Movable Capital Consolidation Act), which provided that the provision only applied to entities whose tax bases were determined on the basis of their balance sheets.

Subsequently, Arts. 53 and 56 of Presidential Decree No. 597/1973 introduced a comprehensive regime in regard to transfer pricing. It provides that:

1. the difference between the “normal value” (valore normale) of goods and services and the consideration paid in regard to sales and supplies to companies not having their legal or administrative seat or principal object in Italy, that directly or indirectly control the commercial enterprise or are controlled by the same company controlling the commercial enterprise, is also included in income;\(^2\) and

2. where the cost of acquisition of the goods sold and services supplied by the abovementioned companies was greater than normal value, the part exceeding the market value should be deducted from the profits.

The Italian regime began to be harmonized, from an international perspective, following the OECD Report on Transfer Pricing and Multinational Enterprises of 16 May 1979 (the OECD Transfer Pricing Report). The interpretations of the OECD Transfer Pricing Report were adopted by Circular Letter No. 32 of 22 September 1980 (protocol No. 9/2267)\(^3\) and Circular Letter No. 42 of 12 December 1981 (protocol No. 12/1587), and finally included in Art. 76(5) of Presidential Decree No. 917/1986 (Income Tax Consolidated Act, ITCA), which has been renumbered as Art. 110(7) ITCA.

2. Actual Regime and Recent Amendments

The actual transfer pricing regime provides that, in regard to international intra-group transactions, the tax authorities shall not apply the principle of valuation at historical cost. Instead, they must determine the value of goods and services on the basis of the normal value, if this leads to an increase of the taxable base.\(^4\) The tax authorities are entitled to make such an adjustment if both of the following requirements are satisfied:

- an Italian and a foreign company exist; and
- the Italian entity “controls” the foreign entity or vice versa.

The rationale of this specific anti-avoidance regime is to minimize a reduction to the tax burden through the manipulation of profits, by using group companies placed in tax-privileged jurisdictions.\(^5\)

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2. The concept of “normal value” was defined as, “the price or consideration usually applied for goods and services of the same or similar type, in conditions of free competition and at the same stage of commercialisation in the time and place where the consideration and proceeds are considered received and the costs and expenses are considered paid for determining the income […].” For determining the normal value, reference shall be made [\ldots] to the list prices or tariffs of the undertaking which provided the goods or services and, in the absence of such information, to the market reports and list prices of the Chambers of Commerce, the professional tariffs and Stock Exchange list prices [\ldots]” (Art. 9, Presidential Decree No. 597/1973).

3. The Tax Administration remarked that the concept of “normal value” defined by Presidential Decree No. 597/1975 reflected the arms length principle suggested by the OECD, which involves determining the transfer price for similar transactions amongst independent economic players.

4. Art. 110(7) ITCA provides that, “the income components deriving from transactions with companies not resident in the territory of the State, which directly or indirectly control the taxpayer, or are controlled by the same company controlling the taxpayer, are measured at the normal value of the goods sold, services supplied and goods and services received, determined according to paragraph 2. If there is an income increase: the same provision applies also if there is an income decrease, but only in executing agreements concluded with the competent authorities of foreign states in force under special ‘mutual agreement procedures’ provided by international double taxation agreements. This provision also applies to the goods sold and services supplied by companies not resident in the territory of the state on behalf of which the taxpayer undertakes an activity of sale or supply of raw materials or goods or an activity of manufacturing or processing.” For literature on this issue, see E. Della Valle, “Il transfer price nel sistema di imposizione sul reddito”, in Rivista di Diritto Tributario 2 (2009), Part I, p. 133 et seq.

5. In these terms, see E. Della Valle, “Transfer price ed elusione”, in Corriere Tributario 29 (2009), p. 2395 et seq.

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\(^{1}\) In these terms, see E. Della Valle, “Transfer price ed elusione”, in Corriere Tributario 29 (2009), p. 2395 et seq.
The onus to demonstrate the existence of such tax avoidance is on the tax authorities to the extent that they intend on making adjustments. In this respect, the Italian Supreme Court (ISC) held that, “the taxpayer is not required to prove the correctness of the transfer prices applied, if the tax authority did not prove prima facie the infringement of the normal value principle.” In doing so it recalled its longstanding case law in the field of specific anti-avoidance provisions. Since the purpose of the transfer pricing provisions is to avoid a situation where, within a group of companies, the profits are transferred for less than the normal price of the goods sold, with the specific aim of avoiding Italian taxation thereon in favour of foreign more advantageous tax regimes, the ISC believes that Art. 110(7) of the ITCA represents “an anti-avoidance clause rooted [...] in the EU principles of abuse of law”.

The burden to prove the existence of the requirements of the transfer pricing provision is on the tax authorities and the taxpayer only has to prove the correctness of the prices applied after the tax authorities have prima facie established a divergence from the arm’s length principle. Nevertheless, in practice, it is not clear what evidence the tax authorities are required to provide to demonstrate that the taxpayer has infringed the transfer pricing provision. According to some scholars, what is required is not actual proof but argumentation based on factual elements well known to the parties, interpreted differently. Therefore, the tax authorities must describe a sufficiently organic argumentative scenario, free from logical defects; the taxpayer then must highlight the inconsistencies and contradictions inherent in such reasoning.

According to the case law, the taxpayer shall demonstrate facts (i.e. deductible costs sustained in the business activity) that would reduce the tax liability. In particular, the onus of proof on the taxpayer mostly relates to the costs incurred by the taxpayer.

Art. 26 of the Law Decree of 31 May 2010, No. 78 (converted into the Law of 30 July 2010, No. 122) substantially amended the transfer pricing regime by introducing a “safe harbour” provision in regard to tax administrative sanctions for taxpayers that previously prepared pre-determined documents proving the transfer prices applied. This legislative amendment aims to align the Italian rules with the relevant OECD Directives and defines administrative penalty profiles in regard to infringement cases.

The regime provides that in circumstances where a transfer price adjustment is made by the tax authorities that results in higher tax or a credit difference, the penalty for tax return errors (from 100% to 200% of the higher tax or lower credit ascertained) shall not apply if:

1. during the access, inspection or tax examination, the taxpayer supplies to the tax officers the Transfer Pricing Documentation (TPD) that has been identified in a Decision of the Chief Commissioner of the Italian tax authorities, which is aimed at verifying compliance of transfer prices with the normal value; and
2. the taxpayer had already informed the tax authorities that it held such documentation.

The amendment does not specify what TPD is to be maintained, but – as outlined in its Explanatory Memorandum – indicates instead that the requirements would be in line with the Code of Conduct on transfer pricing documentation for associated enterprises in the EU and the OECD Transfer Pricing Guidelines.

3. The Requirements of the Tax Authorities

The Decision of the Chief Commissioner of the Italian tax authorities was enacted on 29 September 2010 (Protocol No. 137654/2010) and specifies the TPD that is required to enable tax officers to confirm whether or not the transfer prices are consistent with the normal value. Any discrepancies would, thus, justify administrative sanctions. In compliance with the EU Code of Conduct and the OECD Transfer Pricing Guidelines, the TPD must be:

- suitable and necessary to comply with the arm’s length principle;
- sufficient to prove ’reasonable effort’ and the absence of disproportionate costs in regard to the specific transaction;
- complete in terms of all information that is reasonably available at the time of the transaction; and
- in line with the prudent business management principle.

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The amendment enables the tax authorities to verify whether or not the prices used in intra-group transactions correspond with those used in a free market context by relying on a pre-defined standard of documentary evidence. The new provision provides that the taxpayer shall:

1. keep the Masterfile and the Country-specific documentation for intra-group transactions;
2. inform – periodically – the tax authorities of the existence of the TPD, in order to allow the tax officers to rapidly obtain the available TPD in the event of an examination.

The Masterfile, which is kept by the holding company, contains all the relevant information of the company group and the economic characteristics of the intercompany transactions to be monitored. According to the EU Code of Conduct, the Masterfile “should follow the economic reality of the business and provide a blueprint of the MNE group and its transfer pricing system that would be relevant and available to all EU Member States concerned”.

More precisely, the Masterfile shall contain:

1. a general description of the multinational group;
2. an outline of the structure of the group:
   - organization, list, legal form of the members and their shares; and
   - operative structure;
3. the general commercial strategy of the group;
4. the transactions carried out (described in a data flow diagram);
5. the intra-group transactions:
   - sale of material or immaterial goods;
   - supply of services;
   - supply of financial services;
   - services necessary to carry out the intra-group activity; and
   - agreements regarding the distribution of costs;
6. the company’s functions, assets and risks;
7. intangible goods, royalties, etc.;
8. the company’s transfer pricing policy and reasons why it complies with the arm’s length principle; and
9. an outline of its relationships with the tax authorities of other Member States regarding Advance Pricing Arrangements (APAs) and rulings on transfer pricing.

The country-specific documentation, which contains the information specifically related to the resident company involved in intra-group transactions, has the function of adapting the general description of the information provided in the Masterfile to the economic reality of the resident company. This document shall contain:

1. a general description of the company;
2. an outline of the areas of its business activity;
3. the operative structure of the company and of its business units;
4. general strategies of the company and changes from the previous business year;
5. intra-group transactions, including:
   - a description of the entities of the group with which the transactions are conducted;
   - a comparability analysis;
   - an indication of the transfer pricing method adopted;
   - application criteria in respect of that method; and
   - the results of the method adopted; and
6. the intra-group agreement for the distribution of costs.

In the event of an assessment, the tax authorities (knowing that the taxpayer has the TPD) shall ask the taxpayer to produce the TPD within 10 days. This term is shorter than the general one (15 days) and it is justified on the basis that the documents required are – in theory – available. However, the consequences of not meeting this deadline appear to be disproportionate in terms of the administrative sanctions that apply.16

4. Critical Remarks

The new provision is advantageous in that it identifies the TPD that the taxpayer must keep in order to be protected from tax administrative sanctions in the event of a subsequent tax assessment and it eliminates many practical uncertainties.17 In this respect, before this new provision was in force, the administrative practice did not provide certainty or clarity to taxpayers, since the only Circular Letters available were enacted in the 1980s. The new provision resolves the issues of taxpayers, in terms of uncertainty in relation to potential tax assessments, with significant consequences in terms of higher taxes and sanctions – and of the tax authorities – who now have the means available to discharge their prima facie burden of proof.

Nevertheless, the Italian Legislator has chosen to intervene only “indirectly” in regard to this complicated issue, since it has merely provided a justification that can be used to avoid tax administrative sanctions but has delegated to the tax authorities the issue of identifying the TPD. In fact, the decision to delegate this delicate issue to the tax authorities and to provide them with significant discreteness is questionable due to the lack of clear criteria provided to make this determination.

The ability of taxpayers to avoid sanctions by maintaining the prescribed TPD and communicating the TPD to the tax authorities is limited only to tax administrative sanctions. Since the transfer pricing provision in Art. 110(7) of the ITCA also refers to the criminal offence of filing a tax return containing discrepancies (dichiarazione infedele), according to Art. 4 of Law No. 74/2000,18 the new justification will hardly be a sufficient tool to detect trans-
fer pricing violations. This offence applies when quantitative thresholds are exceeded and does not require proof of fraudulent behaviour.

Another controversial aspect is that the non-application of the tax administrative sanction requires not only that the TPD be maintained, but also that the TPD be “suitable” according to the tax officers, since it should permit compliance of the transfer prices with the normal value to be determined. This aspect implies discretion on the part of the tax authorities to determine whether or not the TPD meets a certain degree of reliability, for example, in relation to information not updated or not complete. In other words, will the keeping of the prescribed TPD always lead to information not updated or not complete. In other words, will the keeping of the prescribed TPD always lead to non-imposition of tax administrative sanctions or will suitability for the justification be valued on a case-by-case basis? In the second scenario, it is clear that the “appeal” of the new discipline will be less than anticipated. In this regard, the tax authorities have confirmed that suitability of the TPD is subject to a discretionary evaluation of the tax officers. In the event of a disagreement, however, the issue shall be decided by the Regional Directorate or, for tax assessments higher than EUR 10,000,000.00 by the Central Assessment Directorate.

Finally, the new TPD onus for taxpayers may not be in compliance with EU law, according to which a Member State cannot impose compliance costs and administrative onuses that are so excessive that they represent a restrictive measure capable of jeopardizing the four fundamental freedoms. The risk is that taxpayers will not only have to cooperate by keeping the TPD, but that the burden of proof will shift back to them. In the EU context, however, this burden may be reduced in part if there is adequate exchange of information, in the sense that details concerning transfer prices in regard to EU companies forming part of the same group may be obtained through such exchange of information. For example, the ECJ decision in the Hein Persche case, although it did not address transfer pricing directly, made it clear that a higher level of administrative cooperation amongst tax authorities would allow for the effective enforcement of the fundamental freedoms.

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