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Global Tax Alert
News from Transfer Pricing

Italy issues new transfer pricing documentation requirements and proposes changes to APA procedure

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Executive summary

On 23 November 2020, the Italian Tax Authorities issued new instructions (New Instructions)[1] regarding the content and validity of the elective transfer pricing (TP) documentation available to Italian resident enterprises and Italian permanent establishments (PE) of foreign entities to provide administrative penalty protection in the case of a TP assessment.[2]

The New Instructions introduce significant changes to the mandatory contents of the TP documentation as defined under the previous instructions (2010 Instructions), in order to adopt the Base Erosion and Profit Shifting (BEPS) Action 13 deliverable and the associated revisions to the Organisation for Economic Co-operation and Development (OECD) TP Guidelines (OECD TPG) guidance on documentation.[3] The New Instructions introduce the possibility to cover only certain intercompany transactions and a window for amending the TP policy/documentation for earlier financial years (FYs) – upon certain conditions – without any penalty or interest.

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Detailed discussion

The New Instructions confirm that the set of TP documentation must include: (i) a Masterfile; and (ii) a Local country file, while introducing a new structure of the respective content. The Masterfile will become a mandatory document for all Italian taxpayers that want to access the elective Italian TP penalty protection regime (including subsidiaries for which, under the previous regime, no Masterfile was required).

Masterfile

The Masterfile must include information relating mainly to the multinational group as a whole and be structured as follows:

1. Description of the group structure
2. Description of the activities carried out by the group including information concerning:
    - 2.1. Main profit generator factors
    - 2.2. Transaction flows (five largest products and/or service offerings by turnover plus any other products and/or services amounting to more than 5% of group turnover)
    - 2.3. Main intercompany service agreements
    - 2.4. Main markets (for products and services referred to above)
    - 2.5. Brief functional analysis of the entities of the group describing their contribution to value creation
    - 2.6. Business restructuring transactions occurring during the FY
3. Description of the intangible assets owned by the group including information concerning:
    - 3.1. Group strategy for Research & Development (R&D) and Intellectual Property (IP) management
    - 3.2. Intangible assets relevant for TP purposes and their legal ownership
    - 3.3. Main agreements among associated enterprises concerning intangible assets including Cost Contribution Agreements (CCAs), R&D service and license agreements
    - 3.4. TP policies related to R&D and intangibles
    - 3.5. Significant intercompany transactions involving intangible assets occurring during the FY
4. Description of the intercompany financial transactions including information concerning:
    - 4.1. Financing sources of the group (including financial arrangements with unrelated lenders)
    - 4.2. Centralized financing functions (including indications on the country under whose laws the entity is organized and its place of effective management)
    - 4.3. TP policies concerning financial transactions
5. Description of the group financial reports for the FY including:
    - 5.1. Consolidated financial statements (to be attached to the TP documentation)
    - 5.2. List and summary of any Advance Pricing Agreements (APAs) and other tax rulings related to the cross-border allocation of income, organized by country of reference

Under the 2010 Instructions, taxpayers could prepare, in certain cases, a Masterfile only in relation to a subgroup, in order to avoid filing the group Masterfile. Such possibility no longer exists, given that the New Instructions refer only to group Masterfiles, consistently with the applicable OECD TPG guidance. Also, under the New Instructions, more than one Masterfile for each group could be prepared should it be possible to segregate in separate sets different operations and different transfer pricing policies that are applicable within the same group.

Local country file

The Local country file must include information relating to the Italian resident taxpayer and be structured as follows:

1. General description of the entity (history, market trends etc.) including information concerning the relevant:
    - 1.1. Operating structure (local organization chart and a description of the individuals to whom local management reports, including the countries in which they have their principal offices)
    - 1.2. Business strategies pursued and changes from the previous FY, including an indication of any business restructurings or transfers of intangibles and of the key competitors

2. Intercompany transactions (or groups of transactions pertaining to a same category that are material with regards to the overall amount of intercompany transactions), including a summary of all the transactions analyzed and the relevant amounts. This section can be divided into paragraphs and sub-paragraphs with the following information:

   2.1 For type "1" transactions:

   2.1.1. Description of the transaction, including amounts involved (received or paid), details of the counterparty, potential comparable uncontrolled transactions (internal and external) and the profit level indicators (PLIs) used in the analysis

   2.1.2. A detailed comparability and functional analysis, including an accurate description of the transaction and any changes compared to prior FYs

   2.1.3. The selected transfer pricing method, including the reasons for the selection and the full description of the analysis

   2.1.4. Results of the method applied

   2.1.5. Critical assumptions adopted

3. Financial information including:

   3.1. Individual financial statements

   3.2. Statements reconciling the PLIs used to apply the TP methodology with the figures in the annual financial statements

   3.3. Summary tables with financial data pertaining to comparables

4. Attachments:

   4.1. Copies of the contractual documentation for each covered transaction, including any cost sharing and CCAs

   4.2. Copies of APAs and other cross-border tax rulings of the Italian entity as well as the same APAs or rulings not concluded by the Italian entity but in any way linked to the transaction covered

Selective documentation

The New Instructions explicitly introduce the possibility of limiting the operations covered by the documentation to be prepared to achieve administrative penalty protection in the case of a TP assessment. In such case, the penalty protection will be granted exclusively with reference to the transactions described and for which the information provided is considered compliant with the requirements.

Small and Medium Enterprises (SMEs) definition

Similar to the 2010 Instructions, the New Instructions provide for a simplified approach for SMEs, which are still defined as entities with turnover not exceeding €50 million for the FY covered by the TP documentation. However, the New Instructions no longer include in the SME definition entities which directly or indirectly control or are controlled by an entity which does not qualify as an SME.

Further, the New Instructions confirm that SMEs are not required to update the economic data regarding the intercompany transactions in the Local country file during the following two FYs, provided that the comparability factors do not undergo significant changes in such two FYs and the comparability analysis is based on publicly available sources (as under the previous regime).

Clarifications on PEs

The New Instructions also apply to Italian PEs of nonresident enterprises as well as to Italian enterprises with foreign PEs.

Specific documentation for low value-added intercompany services

In compliance with the relevant OECD Guidance,[4] the 2018 Decree introduced the possibility to adopt a simplified approach for low value-added intercompany services by determining a 5% mark-up on costs as an appropriate arm's-length value of such services. The New Instructions now specify that, in order to apply the simplified approach, the taxpayer should prepare a dedicated set of additional documentation. However, based on the wording of the guidelines, it is not clear if it represents a third document different from the Masterfile and the Local country file. Also, based on the wording of the New Instructions, and pending any further clarification, some of the validity requirements described below might not be applicable to the TP documentation for low value-added services.

The documentation must include specific content including:

1. Description of intragroup services by category, including the identification of the beneficiaries, the reasons why the services are considered as low value adding, the expected or effective benefits received, and the allocation criteria used
2. Intercompany agreements
3. Value of the operations, including calculations for direct and indirect costs of the services, and
4. Calculations demonstrating the cost allocation

Drafting and validity requirements

1. Drafting of the TP documentation:
   a. The documentation set must be in Italian, while the Masterfile may be in English, subject to confirmation of what appears to be a revision typo in the New Instructions.
   b. Both the Masterfile and the Local country file must be signed by the Italian entity's legal representative or a delegated person by means of an electronic signature and a time stamp (so called *marca temporale*) no later than the date of filing of the relevant tax return.
   c. All the relevant documentation referred to by the New Instructions must be submitted in electronic format.
2. Timing for the provision of the documentation:
   a. The TP documentation must be provided to the tax authorities by an increased term of 20 days from the relevant request (rather than the 10 days provided under the 2010 Instructions).
   b. Any additional documents required by the tax authorities should generally be provided by seven days after the relevant request.
3. Validity of the documentation:
   a. The TP documentation covers only one FY and should be preserved until the relevant statutes of limitations have expired.
   b. In addition to the mentioned formal requirements about the structure and drafting of the document, the TP documentation is valid only if its content is complete and truthful.

Deadline to elect for the TP documentation

As under the previous requirements, the TP documentation election is made in the tax return related to the relevant FY (e.g., in the case of a calendar year company, the election for FY 2020 can be made with the relevant tax return filed in 2021). Where a taxpayer amends a tax return related to a prior FY to correct transfer prices in accordance with the arm's-length principle to increase its taxable income, the taxpayer may amend the respective TP documentation (documentation prepared for the original return) and an election for the TP documentation benefits can also be made with the filing of the amended tax return.

The New Instructions also introduce the option – upon certain conditions – to amend the tax returns of open fiscal years as of 23 November 2020, without application of penalties or interest, in the case of transactions non-compliant with the arm's-length principle implying an unfavorable TP adjustment for the Italian taxpayer. This option is linked to cases of so-called "legitimate expectations," (i.e., "bona fide") envisaged by the Taxpayers' Statute (Law no. 212/2000). However, the practical effects of such provisions require clarifications.

In order to clarify this last point as well as other provisions subject to interpretation, a Circular Letter from the Italian Tax Authorities is expected to follow the New Instructions.

APA highlights following the draft of the Budget Law for the year 2021

On 20 November 2020, the Italian Government issued an updated version of the draft of the Budget Law for the year 2021. The Italian Budget Law is currently under discussion within the Italian Parliament and is expected to be approved by the end of December 2020.[5]

The draft proposes an extension of the rollback of APAs available to international enterprises for managing in advance selected tax risks.

Moreover, an access fee would be required for the filing of a bilateral APA ruling request before the Italian tax authorities.

Endnotes

1. The New Instructions follow a Ministry of Finance decree of 14 May 2018 (2018 Decree) providing guidance on Italian transfer pricing rules.
2. Ministerial decree of 14 May 2018 provided updated guidelines for the application of the Italian TP provisions (Article 110, paragraph 7, of Presidential decree n. 917/1986) in line with international best practices. Article 8 of such decree consistently required that the Italian Tax Authorities issue an updated version of the instructions concerning TP documentation requirements.
3. See Chapter V OECD TPG.
4. See OECD TPG, Ch. VII, Section D.
5. See EY Global Tax Alert, *Italy publishes draft 2021 budget law*, dated 20 November 2020.

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