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TO
OECD Global Forum on Transfer Pricing, Steering Committee

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Sent via e-mail to: TransferPricing@oecd.org

Subject: **Public comments to the "Draft Handbook on Transfer Pricing Risk Assessment".**

Dear Steering Committee,

in reply to your invitation contained in the *Draft Handbook on Transfer Pricing Risk Assessment* dated 30 April 2013 (hereinafter also referred to the "Handbook"), we are pleased to submit to your attention the following.
The present contribution derives basically from our experience as advisors in transfer pricing and international tax matters dealing with MNEs, in the context of business (re)structuring projects, design of transfer pricing policies, relating compliance fulfillments and transfer pricing documentation maintenance.
In addition, of relevance is our assistance to clients in case of tax inspections carried on by Italian Revenue ("*Agenzia delle Entrate*") and Italian Tax Police ("*Guardia di Finanza*").

1. Introduction

Transfer pricing is one of the most relevant topics to be managed within multinational groups, notwithstanding the company size (i.e., small, medium, large), and needs in depth analyses to be kept under control in a constant balance between business, organizational and tax relevant matters.

This is particularly true nowadays due to the adverse economic environment in which multinational groups have been forced to operate in the last five years, facing – ultimately – remarkable shrinking in profit.
In such a situation, there are factors which contributed to put – probably more than in the past – transfer pricing in the "spot light" of many tax administrations, often the ones of mature and industrialized countries characterized, for example, by high production costs.
Among these factors, the following are worth to be mentioned:

(i) economic downturn;
(ii) business which are – by "nature" – characterized by low profitability;
(iii) difficulties in the selection of the most appropriate transfer pricing methodology;
(iv) administrative burden borne by MNEs in order to prepare and keep updated transfer pricing documentation in various countries; and
(v) lack of competencies in tax administrations concerning both transfer pricing technicalities and knowledge of the economic aspects of the industries the taxpayers audited belong to.

These aspects, by the way, are already mentioned in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (hereinafter "OECD Guidelines").
For instance, in relation to negative economic conditions, par 1.70 states that «Of course, associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavorable economic conditions, inefficiencies, or other legitimate business reasons. However, an independent enterprise would not be prepared to tolerate losses that continue indefinitely».

Further, considering business characterized by low marginality, we recall par. 1.71: «For example, an MNE group may need to produce a full range of products and/or services in order to remain competitive and realize an overall profit, but some of the individual product lines may regularly lose revenue. One member of the MNE group might realize consistent losses because it produces all the loss-making products while other members produce the profit-making products. An independent enterprise would perform such a service only if it were compensated by an adequate service charge». This situation, for instance, may become particularly critical in case both a fully fledge-manufacturer (e.g., the parent company) and the related distributor are in a loss position: where tax administration of both entities challenge the losses of each entity to be linked to non-arm's length prices, a double taxation issue may arise.

In addition , there are economic situations which require sufficient knowledge to be properly analyzed, especially by tax officers. This may be the case of market penetration strategies carried on by multinational groups. In this respect, par. 1.73 affirms that «Recurring losses for a reasonable period may be justified in some

cases by a business strategy to set especially low prices to achieve market penetration. For example, a producer may lower the prices of its goods, even to the extent of temporarily incurring losses, in order to enter new markets, to increase its share of an existing market, to introduce new products or services, or to discourage potential competitors».

Moreover, especially when economic crises strike fiercely business operators, relevance of costs (leading to *spending reviews* and *cost-cutting policies*) becomes priority and this cannot but have an impact also to resources devoted to administrative fulfillments and compliance regimes. The OECD Guidelines are totally aware also of this aspect. In fact, par. 5.6 states that «When requesting submission of these types of documents, the tax administration should take great care to balance its need for the documents against the cost and administrative burden to the taxpayer of creating or obtaining them. For example, the taxpayer should not be expected to incur disproportionately high costs and burdens to obtain documents from foreign associated enterprises or to engage in an exhaustive search for comparable data from uncontrolled transactions if the taxpayer reasonably believes, having regard to the principles of these Guidelines, either that no comparable data exists or that the cost of locating the comparable data would be disproportionately high relative to the amounts at issue. Tax administrations should also recognise that they can avail themselves of the exchange of information articles in bilateral double tax conventions to obtain such information, where it can be expected to be produced in a timely and efficient manner».

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All the above lead directly to the conclusion that *transfer pricing risk assessment* appears not only to be "strategic" for tax authorities but also for the same multinational groups that will be audited by the same officers.

In fact, especially the paragraphs of the Handbook dedicated to source of information (par. 92 and subsequent), potentially critical intercompany transactions (par. 87 and subsequent) and contemporaneous documentation (par. 98 and subsequent), may be used as "guidance" by multinational groups to prepare appropriate documentation files with those evidences that will be probably asked by tax officers during an inspection and – thus – that can be of help in order to demonstrate the arm's length nature of the transfer prices applied.

By the way, since the process of attribution of the risk profile takes into consideration many indicators like comparison with industry profit standards, recurring losses, fluctuation in revenues and/or profitability, relationships with related entities in low-tax jurisdiction, intra-group services, intangibles and others, it seems reasonable to affirm that the final picture that will be drawn from such

exercise will be a sort of tax risk assessment of the whole group structure, that – consequently – may go far beyond mere transfer pricing aspects.
Furthermore, in this regard, two considerations are worth to be at least mentioned:

(i) The results of the risk assessment said above can be expected to be divergent when the process is separately conducted by tax authorities on one side and by the taxpayer on the other side, due to their different standpoints;

(ii) The level of refinement and accuracy of the analysis conducted by a medium/large-size multinational group will be probably different compared to the so called "pocket" multinationals of small size. This can be inferred for instance from the difference that those types of enterprises have in the complexity of the transactions (not only the intercompany ones) as well as in the administrative and financial tools used.

2. Central Revenue: transfer pricing risk assessment and tax inspection

Finite resources, *dedicated personnel*, *judgment*, *specialization* and *experience*: these are among the most recurrent words within the Handbook and they can be deemed to summarize the critical aspects affecting the assessment process conducted by tax authorities in the attempt to identify the transfer pricing related risk of a taxpayer.
Likewise, they mirror the awareness of tax authorities that risk assessment is ultimately linked to collection of information and appropriate analysis and that its final result may have relevant consequences regarding tax avoidance politics both at single country and supranational level.

The risk of high standardization (and thus of misleading results) of the assessment procedures is well represented in the Handbook where we read that «risk identification process cannot be reduced to a set of mechanical rules» (par. 15): in fact, when a case displays some of the features associated with high transfer pricing risk does not automatically mean that a thorough, detailed examination is necessary or worthwhile.

Focusing on the approach followed by the Italian tax authorities, what is most relevant to be underlined is the fact that transfer pricing is usually (especially for small and medium enterprises which, by the way, represent more than 95% of the Italian companies) only one of the items taken into consideration in the context of risk assessment procedures whose goal is primarily to draw an overall tax risk profile of the taxpayer.
This can be easily inferred starting from the reading of the annual circular letters issued at least in the last five years, by the Central Revenue, providing guidelines to the local offices aimed at preventing and challenging tax evasion.

For instance, Circular Letter n. 6/E of 25 January 2008, among the most delicate and crucial areas to be assessed, lists the transaction of Italian companies with non-resident entities and in particular: (i) inter-company transactions and transfer prices according to the provisions of Art. 110 (7) of the Italian Income Tax Code (IITC); (ii) holding of controlling and/or related participating interests in entities located in privileged tax regime according to IITC provisions on controlled foreign companies (Art. 167 and Art. 168); (iii) application of Art. 73 (5-bis) and (5-ter) of IITC and the "place of effective management" concept embedded therein to transactions with companies non-resident in Italy; (iv) shocks and "anomalous" fluctuations of revenues in the short-medium period.

Following the same path, also Circular Letter n. 13/E dated April 9, 2009 and Circular Letter n. 20/E of 16 April 2010. In particular, the latter gives instructions as to focus the prevention of tax evasion mainly – among others – on: (i) international "arbitrage" (achieved also through the use of complex financial instruments); (ii) cross-border business restructurings; (iii) transfer pricing; (iv) relevant variations or anomalies in the yearly results; and (v) genesis of the tax losses. Against international tax evasion, there is the provision for specific operational activities relating primarily to the illegal transfer and/or possession of economic and financial activities abroad, and the transfer of tax residence abroad. With this aim, the Central Office for International Tax Illicit (UCIFI) was established.

The same approach has been confirmed also in the following circular letters (n. 21/E of 18 May 2011; n. 18/E of 31 May 2012; n. 25/E of 31 July 2013) which have been stressing the need to collect information to be systematically analyzed with the software implemented by the Central Revenue (for example, *Serpico*). The result of this scrutiny is the attribution of an "initial" risk indicator to the taxpayer that will be used by regional and local tax offices to list the taxpayers that should be audited first.

In order to accomplish this "mission", the following can be listed as the primary means and sources of information already in the hands of Italian tax authorities to collect relevant information to start a risk assessment:

- Questionnaires for the supply of tax information to tax offices: in some cases, they anticipate audits at the premises and offices of the taxpayer;
- Annual tax return: it discloses information regarding:
  - Amount of black-list costs incurred with entities (both related and third parties) located in low-tax jurisdictions;
  - Calculation of taxes to be levied on profit deriving from the application of CFC rules;
  - Declaration whether the entity is a controlling company or a controlled one;

  - Amounts of revenues and costs (of any types) deriving from intercompany transactions;
  - Possession of transfer pricing documentation following information requirement set by Central Revenue in order to benefit of the specific penalty protection regime introduced in 2010;
- Annual financial statement, relating explanatory note (so called *nota integrativa*) and relation of the board of directors (so called *relazione sulla gestione*): they provide information (both qualitative and quantitative) regarding operations conducted during the year and details on intercompany transactions. These documents have to be compulsory filed by corporations to the Registry of Enterprises held by the Chamber of Commerce: accordingly, they are freely available by anyone;
- Information deriving from (previous) tax inspections. In this regard, a specific mention has to be done to:
  - the "fiscal tutoring" (so called tutoraggio fiscale) introduced in 2009, that provides for periodical audits every two years (target) on large tax payers (namely, the ones turnover higher than EUR 100 mln); and
  - the implementation of a more strict cooperation (especially on large taxpayers) between tax offices and tax police with sharing of relevant information to better assess the potential tax risk.

In light of the above, it is clear that nowadays Central Revenue's approach is focused on an overall risk assessment of the taxpayer: in this process, transfer pricing in one of the items taken into consideration by tax offices when making a picture of the company. Of course, the importance and resources devoted to transfer pricing matters may vary according to the business structure of the enterprise, the relevance of inter-company flows and the industry it belongs to.

3. The taxpayers standpoint: factors influencing choices and critical aspects

After having provided few information and considerations concerning the approach of Italian tax authorities regarding the risk assessment process, it may be useful to share views deriving from the experience in assisting clients in transfer pricing matters.
In particular, there is a huge difference in the way small-medium companies (on the one side) and large enterprises (on the other side) usually manage transfer pricing and international tax topics, including multiple application of double tax treaties. Accordingly, among the factors affecting and characterizing the attitude (and consequent actions), the following can be identified:

a) Small-medium enterprises:

- Significance and materiality of intercompany transactions with respect to the overall business. This aspect is ever more relevant since – during the economic downturn, not ended yet – export has been growing in the Italian enterprises reaching up to 70% of the total sales;
- Management "culture" in addressing complex issues like transfer pricing and related matters (namely, of international tax, but also business and organizational wise). This is crucial since the need to enter new markets (see previous point) pushed companies to expand their organization and create local presence abroad (newly incorporated entities; branches; repo offices; etc.);
- Administrative costs for transfer pricing compliance: in cost-cutting periods, resources devoted to administrative fulfillments are often limited first. In this regard, the materiality of the intercompany transactions and the number of countries involved is relevant for the apportionment of resources.

b) Large companies:

- Management more accustomed to deal with international tax topics (including transfer pricing);
- Transfer pricing "design" is important part of the group structuring and development and may benefit of financial and administrative function within the group which are sufficiently developed;
- Often there are internal transfer pricing specialists in order to provide central coordination from parent company to local subsidiaries. This may help in providing instruments to limit compliance costs due, for instance, to external advisors' assistance and to limit the specific potential tax exposure vis-à-vis local tax authorities.

Considering the very different situations characterizing small-medium enterprises and large companies, the relations of both these players with tax administration become crucial.

In particular, as far as the matters of this discussion are concerned, often local offices in charge of tax inspections on small-medium enterprises are not sufficiently skilled on specific transfer pricing knowledge. Accordingly, there are consequences in terms of

(i) difficulties in making understand transfer pricing policies to the auditors;
(ii) therefore, disproportionate or even not-grounded tax challenges; and
(iii) potential limited chances to conclude tax settlement procedures so avoiding expensive and long-lasting judgments before tax courts. In this regard, it is worth mentioning also the possibility to make recourse to mutual agreement procedures, EU Arbitration Convention and rulings in general, as possible chances to find viable solutions able to avoid possible double taxation. Nonetheless, even if small-medium enterprises are beginning to familiarize with the Italian International Standard Ruling, international procedures in

general are still perceived as too complicated, "far" and not fitting small-medium organizations.

Differently, local offices in charge of tax inspections on large taxpayers usually have adequate knowledge on transfer pricing and, in general, on international tax matters. Nonetheless, and this happens especially (but not only) dealing with MNEs operating in peculiar industries (e.g., asset management, insurance, oil&gas), many discussions arise during tax inspections due to a lack of in depth knowledge of the industry. Therefore, tax officers have difficulties "entering" the dynamics and characteristics of the business the company belong to. Sometimes, there have been also cases in which tax authorities decided to focus their attention on players acting all in the same industry: this strategy – on the one hand – enabled officers to acquire, inspection after inspection, more skills and specific knowledge. But, on the other hand, the taxpayers that were audited first, did not have the possibility to benefit of the competences that the tax officers would have been able to display during last audits.
The risk is – again (even if in a limited percentage with respect to small-medium enterprises' case) – of disproportionate or even not-grounded tax challenges and of potential limited chances to conclude tax settlement procedure, so making unavoidable the appeal before the tax court and – eventually – the recourse to international agreement procedures. By the way, this is critical also in light of the fact that challenges on large taxpayers regarding transfer pricing may be of huge amount and ultimately affect (in case of negative outcome for the company) not only the ordinary course of business, but also undermine its capacity to survive.

4. Final observations

Finite resources, *dedicated personnel*, *judgment*, *specialization* and *experience*: these are the fundamental elements of a well-focused tax risk assessment and – thus – also of transfer pricing topics.
In addition to the comments presented in previous paragraphs, we would finally draw attention on the following elements and provide a few suggestions that may positively affect the relationship between taxpayer and tax authorities:

- At the level of Regional offices of the Central Revenue (which deal with large taxpayers), creation of teams dedicated to transfer pricing, developing tax, legal, economic, business and organizational competences with respect to specific industries;
- Tax cooperation and enhanced relationship between Central Revenue and taxpayers: Italian tax authorities recently launched a pilot project in this respect in the aim of identifying "best practices" concerning tax risk management procedures to be implemented. This initiative cannot be but welcome but – to be successful – it requires a deep change in the mindset

and approach in the relationship both from tax officers in the field and from taxpayers;

- The international debate concerning tax compliance within small-medium enterprises needs to continue and provide concrete operational guidelines. With regard to transfer pricing, a simplified set of documentation may be evaluated, for example, allowing the drafting only of a countryfile properly integrated with those relevant information that the exclusion of the Masterfile would loose;
- Due to the technicalities characterizing transfer pricing and considering that frequent is the recourse to the tax settlement procedures between taxpayer and tax office, Italian tax courts have not very long case history in terms of jurisprudence where to find indications and criteria potentially useful to solve the matters they are dealing with. Accordingly, in this situation, tax cooperation and enhanced relationship programs between tax administration and taxpayers have to be encouraged;
- Based on Italian provisions currently in force, transfer pricing challenges still fall (when above specific quantitative thresholds) within the scope of tax criminal law. This aspect is always under discussion and a change in the law is still awaited by all parts involved (mainly by taxpayers, their legal representatives and consultants but also by tax officers and courts). In fact, such thresholds are very low and can be easily passed when dealing with transfer prices, even in case of small-medium enterprises. Therefore, opening a debate at international level would be welcome, for instance within the OECD and EU Commission in order to provide Member States clear and harmonized indications, useful to amend local law provisions. This would imply – for example – a different treatment of those cases where complete documentation is made available in a cooperative and disclosure attitude, compared to those situations where taxpayers are not cooperative at all.

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Thank you and best regards.

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