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The IRAP is Italy's regional business tax. Established by Legislative Decree No. 446 of December 15, 1997 (the IRAP Decree), the IRAP is levied on the independent and regularly exercised activities of production or exchange of goods or provision of services. The tax applies to the value of the net production resulting from activities carried out in the region.

The IRAP regulation gives rise to some interpretative difficulties when transfer pricing issues are involved, especially during tax audits and assessments. This article illustrates some of these difficulties and demonstrates why Italy's transfer pricing regime is not applicable to the IRAP.

Transfer Pricing Regime

Italy's transfer pricing rules are set forth in article 110, paragraph 7 of the Italian Income Tax Code (Testo Unico delle Imposte Dirette, or TUIR), which requires that the prices charged in transactions between parties belonging to the same multinational group respect the arm's-length principle.

As also provided in article 9 of the OECD model tax convention, the tax authorities of a contracting state, to calculate the income tax owed by associated companies, may adjust those companies' profits if their books do not reflect the actual amount of taxable profits produced in that state.

Whenever transactions are carried out in compliance with the arm's-length principle, no adjustment of the related companies' taxable profits can be requested.

Italy in 2010 first required the preparation of documentation in support of the transfer pricing policy adopted, as well as the notification of tax authorities of the existence of such documentation.

This provision entailed a change in the system of tax-related administrative penalties through the addition of paragraph 2-*ter* to article 1 of Legislative Decree 471 of December 18, 1997. According to this amendment, penalties for fraudulent tax returns are waived if, in the course of the audit, the company documents the criteria adopted for determining the transfer prices of transactions with other nonresident companies of the group.

On September 29, 2010, the Italian Revenue Office's director issued the regulation included in article 26 of Decree-Law 78/2010.

The regulation explicitly refers to the provisions included in the Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the EU, adopted by the EU Council on June 27, 2006, and the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (in the version issued July 22, 2010).

This regulation identifies the types of transfer pricing documentation needed to obtain an exemption from the penalties normally applied to fraudulent tax returns. They are:

- a master file, which collects information about the multinational group and its transfer pricing policy as a whole; and
- national documentation, including information specific to intragroup transactions that the company or the permanent establishment intend to document.

Circular 58/E of December 15, 2010, provided the first clarifications on the subject of transfer pricing documentation, largely reaffirming the principles already expressed in the regulation.

The circular's main aim is to set a standard of documentation for verifying compliance with the arm's-length value of transfer prices charged in intragroup transactions. Therefore, it has a dual purpose:

- it enables multinational companies to take advantage of a system of exemptions from penalties for administrative breaches according to article 1, paragraph 2 of Legislative Decree 471/1997 (fraudulent tax return) resulting from potential transfer pricing adjustments; and
- it allows the tax authorities to have valid supporting documentation to verify the correspondence of prices charged in intragroup transactions between related companies with prices applied in the free market.

Transfer Pricing Adjustments

The application of transfer pricing regulations to the IRAP was confirmed by the Ministry of Finance's Circular 141/E of June 4, 1998. The circular established that regarding the computation of the production value, the positive difference between the arm's-length value of the goods supplied (or services rendered) and the accounted revenue contributes to the determination of the IRAP tax base.

The Financial Act 2008 (Law 244 of December 24, 2007) amended the IRAP Decree, focusing on the following aspects:

- the regionalization of the tax;
- the new standard tax rate;
- the tax structure, namely, the modalities for the determination of the tax base; and
- the modalities for the submission of IRAP tax returns.

The IRAP tax base is now determined based on the profits indicated in the statutory financial statements (the so-called principle of direct derivation, or *principio di derivazione diretta*). The previous tax regime, although including a statutory starting point for the calculation of the tax base, forced companies to apply the same tax adjustments normally envisaged for income tax purposes.

For IRAP purposes, tax adjustments applied to calculate the income tax are now irrelevant. The objective of these regulatory changes is to make the computation of the IRAP tax base better adhere to the criteria adopted in national accounting for the calculation of production value and value added across various economic sectors.

In light of these changes, transfer pricing adjustments are relevant to the computation of the IRAP only until December 31, 2007. As of January 1, 2008 (the date the Financial Act 2008 entered into force), the IRAP tax base is determined on the basis of the statutory financial statements.

Indeed, because of the repeal of article 11-*bis* of the IRAP Decree, the positive and negative components of income derive directly from the figures in the statutory financial statements and are no longer subject to the rules on corporate income mandated by the TUIR.

As a result of the repeal of article 11-*bis*, for example, the earnings derived from the intragroup exchange of goods or services are those reported in the income statement.

In some instances, the tax authorities may substantiate an effect of transfer pricing adjustments on the computation of the IRAP by referring to a recommendation included in Circular 58/E of December 15, 2010, in which the Italian Revenue Office stated:

> The benefit . . . is the non-application of the penalty for fraudulent tax returns provided for in paragraph 2 of Art. 1 of Legislative Decree No. 471 of December 18, 1997 (and, for the sake of consistency, of similar penalties related to IRAP).

This reference, although valid in substance, should be understood as referring to the tax periods in which article 11-*bis* of the IRAP Decree was still in force and for which, on the issue date of Circular 58/E/2010, the tax assessment deadline had not yet passed (under article 43 of Italian Presidential Decree 600/1973).

This formula should allow a taxpayer that prepared the appropriate transfer pricing documentation to also take advantage of the nonapplication of penalties for the purposes of the IRAP, which was not changed by the aforementioned Decree-Law 78/2010. ◆