Comparability analyses and criteria for selection: Why the Italian tax authorities need more evidence in court

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Transfer pricing has been the subject of a number of Italian court decisions recently with regard to the application procedure for comparability analyses with a view to an accurate reconstruction of the arm's length value.

These decisions have highlighted the tax authorities' duty to verify whether such value has been actually ascertained and to "provide any indication of a different and more suitable value that may be applicable within an arm's length context".

Ruling No. 52, issued February 26 2007 by the Provincial Tax Court of Pisa, refers to a case in which the tax authorities effected an inaccurate reconstruction of arm's-length prices, by basing their conclusions on data that were not consistent, and determining an improper application of the internal price comparison method.

In fact, pursuant to the ruling, the tax authorities disregarded some important elements that must be considered – along with the particular features of the goods – to fix the sales price.

They further compared the transactions entered into by the audited company vis-à-vis one of its subsidiaries with the ones carried out by the same vis-à-vis clients operating at different distribution stages from the ones in which the controlled company at issue operates, effecting therefore an inaccurate reconstruction of the arm's-length value.

On the other hand Ruling No. 25, issued April 14 2010 by the Piedmont Regional Tax Court, provided a ruling on transfer pricing adjustments performed by the tax authorities applying the external comparison method. In the case under examination, the tax authorities had identified a company, whose documentation on prices relating to comparable transactions was not available to the public, as one of the comparables.

Moreover, the said comparable was operating at a different distribution stage from the one of the audited company, and in a product sector that was substantially different, as further substantiated by a technical report submitted to the regional tax court by the audited company.

Basing their opinions on the above facts, the judges reached the conclusion that price adjustments applied by the tax authorities were effectively inaccurate and thus unreliable.

The Piedmont Regional Tax Court expressed its opinion through Ruling No. 580, of September 19 2011, on the proper selection procedure of an adequate set of comparables with reference to a case in which the Italian company determined transfer prices in such a way as to ensure a return on capital employed (ROCE) equal to 9%.

The Tax Authorities declared the said transfer prices inadequate, challenged the suitability of the ROCE as a determination criterion and proposed the TNMM (transactional net margin method) as an alternative method.

Following on from the judges of the Court of Second Instance, however, the tax authorities did not provide any evidence as to the existence of a possible link between the use of the ROCE index and the fixing of prices that were lower than the arm's-length value, nor that such prices were fixed for the purpose of allocating taxable matter to the foreign subsidiary and to dodge, thus, tax obligations or prohibitions.

The ruling also emphasised how the indicator adopted by the company is included among the ones provided by the OECD guidelines and that the TNMM method, proposed as an alternative by the tax authorities, must be based on the identification of comparables with features that are economically/functionally comparable to the ones of the audited company.

Upon identification of the set of comparables, the next step is to compute the operating margin on a three-year average and to determine a range of profit margin percentages with which to compare the one proposed by the audited company.

With regard to the case at issue, the Regional Tax Commission quashed the challenged audit, after having established that, since the tax authorities had identified as comparables companies that were operating in product sectors substantially different from the one in which the audited company operates, the same had not provided suitable data such to support their theory.

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