The Italian Supreme Court rules on preferring the “internal CUP method” over the “external CUP method”

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Federico Vincenti and Alessandro Valente of Crowe Valente/Valente Associati GEB Partners analyse the recent ruling that clarifies the most appropriate TP method for determining the arm's length principle.

With judgment no. 11625 dated 04/05/2023, the Italian Supreme Court reiterated several relevant principles regarding TP. The Italian Supreme Court has identified the incorrectness of the "external comparable uncontrolled price (CUP) method" used by the Revenue Agency for determining the arm's length transaction and the consequent legitimacy of the "internal CUP method". This pertains to the interest expenses deducted by an Italian company in relation to a loan granted by a German parent company.

As is well known, following the update of the OECD Transfer Pricing Guidelines in 2010, the so-called "hierarchy of methods" that provided, for the application of traditional methods and only, in case of their non-applicability, the use of transactional profit methods, was eliminated.

Since 2010, it is thus necessary to proceed with the selection and application of the so-called "best method" principle. This means that the most appropriate method must be selected for the specific circumstances of the case under scrutiny, taking into consideration the below:

- The advantages and disadvantages of the individual methods;
- The availability of reliable information; and
- The consistency of the method considered with the nature of the controlled transaction.

Paragraph 2.14 of the Transfer Pricing Guidelines defines the CUP method as follows: "The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances."

The internal CUP method is defined by determining the value of a transaction between a company and its related parties, as opposed to a comparable transaction between the same company (or the related party) and a third party. This method is readily applicable when it is possible to identify comparable intra-group transactions, compared to transactions with third parties.

If it is not possible to proceed with the internal CUP method, an alternative is to apply a comparison that refers to the same transaction, even if it occurred between two completely independent companies. This type of approach is referred to as the "external CUP method."

Ruling no. 11625 dated 04/05/2023 originated from the assessment conducted by the Revenue Agency. The assessment concerned the taxation adjustment for the 2005 tax year, whereby a portion of the interest expenses deducted by an Italian company relating to a loan granted by the German parent company was disallowed, based on a violation of the Italian TP rules (Article 110, paragraph 7, Presidential Decree 22 December 1986, No. 917 - TUIR).

The judges accepted some of the arguments presented by the taxpayer while considering all other issues as ancillary.

According to the Italian Supreme Court, judges of the first instance correctly identified the unfoundedness of the tax assessment notice based on two reasons:

1. The incorrect use of the criterion of the external CUP method by the Revenue Agency for the purposes of determining the price of the transactions at arm's length. Instead, the criterion considered correct was the internal CUP method. The judges deemed the approach adopted in the first-instance judgment as correct, stating that, from the analysis of Article 9 of Presidential Decree No. 917 of 1986, emerges a preference for the comparison of interest rates towards the internal comparison. The different approach of the external CUP method, adopted by the Italian Revenue Agency, should have been accompanied by appropriate motivation and argued with an assessment of the borrower's reliability, considering that the appellant closed its financial statements with a significant loss; and
2. The absence of income transfer from Italy to Germany. Consequently, the conditions for the applicability of Article 110, paragraph 7, of Presidential Decree 22 December 1986, No. 917 (TUIR) are not met.

According to the judges of the Italian Supreme Court, both of the reasons can be considered sufficient, on its own, to support the decision.

The choice of the appropriate method depends on the specific context and relevant economic characteristics underlying the transactions between related companies. It is thus necessary to carefully consider the principles of the OECD Transfer Pricing Guidelines to ensure a proper functional analysis that guarantees the correct application of the selected method. Although both the internal and external CUP methods are admissible, the former has certain advantages that, in some cases, may lead to it being preferrable:

- Greater access to internal information: related companies within a multinational group have direct access to information about internal transactions and incurred costs. Therefore, it is easier to obtain accurate and complete data for the application of the internal CUP method;
- Specificity of internal transactions: transactions between related companies can be highly specific and tailored to the needs of the multinational group. The goods or services provided internally may differ significantly from those exchanged in the open market. In such cases, the internal CUP method can provide a more accurate and appropriate evaluation of transfer prices; and
- Reduction of comparability risks: searching for comparable transactions among independent companies can be complex. There may be significant differences between internal and external transactions in terms of conditions, assumed risks, and other relevant variables. By using the internal CUP method, such differences can be better considered, reducing comparability risks and providing a stronger basis for determining transfer prices.

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