Year-end adjustments: the Italian perspective

In matters of transfer pricing, the terms "compensating adjustments" and "year-end adjustments" refer to the adjustments made by companies to align the transfer pricing criteria they adopted during the fiscal year with the actual year-end figures so that these are consistent with the arm's-length.

Generally, compensating adjustments are legitimate adjustments made by companies. They can be:

- ordinary, if they are stipulated by contract (for example, for the application of the TNMM);
- extraordinary, if they occur as a result of "unusual" or "exceptional" events that have an impact on prices of intercompany transactions.

These adjustments apply when:

- the preliminary results of a company in a given tax period are not in line with budgeted results for that period;
- the preliminary results of a company are not in line with the predetermined arm's-length range applicable to that company;
- the actual results of a company in a given tax period are not in line with budgeted results for that period;
- the actual results of a company are not in line with the predetermined arm's-length range applicable to that company.

Factors that generate differences between results can be:

- changes in the surrounding economic environment;
- decreases in sales volume (or prices);
- increases in operating expenses;
- the presence of new, not previously overlooked transactions.

Compensating adjustments are usually made in the last quarter of the tax period or the one immediately following it and are implemented through:

- a lump-sum payment to bring recipient company back into the benchmarked margin range;
- a reallocation of costs that increases profitability;

- the budgeting of new services (for example, marketing supports payments) to reduce excessive margins.

To justify an adjustment in the case of an audit by the tax authorities, it is necessary to keep adequate documentation (especially about the kind and timing of the transaction).

Furthermore, in the transfer pricing policies implementation phase, multinational groups should execute intercompany agreements containing provisions on the payment due by the various companies involved, on the calculation methods, and on any possible adjustments that must be performed periodically.

Since the time-limits laid down in intercompany agreements are a major indicator of compliance with the arm's-length principle, during an audit Italian tax authorities check if the terms established in the intercompany agreements coincide with those generally applied between unrelated third parties.

In June 2011, the EU Joint Transfer Pricing Forum (JTPF) sent a ten-question survey on compensating adjustments practices to the tax authorities of its member countries. However, Italian tax authorities stated not to abide by any specific guidance or administrative principle regarding these adjustments, as answered by the other countries surveyed.

Further, Italian tax authorities did not provide any information regarding the time required so that an adjustment is accepted.

Italian case law

The Italian Supreme Court (judgment No. 11949 of July 13, 2012) dealt with the issue of the burden of proof in transfer pricing in a case concerning the accounting of an intercompany end of year invoice.

Specifically, the company T. S.r.l. is wholly owned by the company H. S.A., headquartered in Switzerland, and is part of the US multinational Group T., of which it is the only Italian subsidiary, for the exclusive marketing of software products.

Such products are imported by the company T. S.r.l. through the UK-based company T. LTD (part of the same multinational Group), which is the only supplier of the products sold by the Italian subsidiary.

On October 31 2004 (last day of the fiscal year), the company T. S.r.l. registered an invoice issued on the same date by the British company T. LTD for the amount of £ 947,456 ($1.5 million).

This invoice, reporting a "price adjustment to product sold during FY 2003/2004" as a reason for payment, regards upward adjustments charged to the Italian company of the prices previously applied to some products purchased from T. LTD during the 2003/2004 financial year.

The tax authorities challenged this adjustment, considering it an avoidance practice designed to reduce the taxable profits of the Italian company through an abusive recourse to transfer pricing.

In support of their argument, the tax authorities noted that:

- the transaction took place on the last day of the tax period;
- the invoice was for an upward adjustment on prices already applied by the UK supplier company;
- prices deviated from the average price of the same products as paid by T. S.r.l.

The Supreme Court argued that transfer pricing legislation falls under the provisions against tax avoidance, and therefore the burden to prove that conditions of avoidance exist rests, in principle, with the tax authorities. However, given that the allocation of intercompany costs also relates to the existence and relevance of such costs, the burden to prove that the costs relate to the activity of the company, according to the Supreme Court, is on the taxpayer.

The tax authorities deemed the registration of the invoice at the end of the year (to adjust transfer prices previously applied) to be the means to manipulate intra-group transfer prices for tax avoidance purposes, with the aim of obtaining a tax advantage.

Conclusions

In conclusion, when a transfer price adjustment is necessary to restore the arm's-length principle, it should be applied to the price and not to the profit margin, and it should be properly documented.

To carry out such adjustment, the applicable agreement should contain a clause covering adjustments, specifying how they can be made.

Finally, it would be appropriate to periodically monitor transfer pricing. Price adjustments should be made on a quarterly basis, rather than at the end of the tax year.

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