

Transfer Pricing Litigation

Case History with Italian Tax Authority

21 February 2015



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1. Highlights on Italian TP Regulations

- OECD methods accepted
- Tax return disclosure
- TP documentation: not mandatory but necessary to obtain penalty protection
- Penalties on transfer pricing assessments: ordinary penalty regime from 100% to 200% of additional taxes, increased by 1/3
- Statute of limitations: four calendar years from the end of calendar year in which the tax return was filed (eight in the event of criminal infringements)
- APAs available

2. The Group

An Italian manufacturer of durable goods

2013 consolidated turnover: € 350 million circa

Cross Border Intercompany transactions: € 100 million circa

Company	Main Functions	Main Risks
Italian Holding Company	Manufacturing, R&D, Marketing, Sales, General services	Market, Inventory
7 European Distributors	Sales, After Sales	Credit
1 US Distributor	Sales, After Sales, Logistics	Credit, Forex
2 Chinese Companies	Manufacturing, Assembly, R&D (Specific)	Forex
1 Italian Subcontractor	Manufacturing and Assembly	

3.The Group Business Model/Transfer Pricing Policy

Transaction flow *	TP Method
Italian Holding Co to EU Distributors	Comparable Uncontrolled Price with internal comparables
Italian Holding Co to US Distributor	Cost Plus with internal comparables
Chinese Manufacturer A to Italian Hold Co	Resale Margin with external comparables
Chinese Manufacturer B to Italian Hold Co	Comparable Uncontrolled Price with external comparables

** Finished products only*

4. The Litigation

- Tax years under scrutiny: 2008 – 2010
- Assessment on the sales of finished products from one of the Chinese manufacturers to the Italian Holding Company
- Method adopted by the Tax Authority: Profit Split with Contribution Analysis
- Combined Profit to be split: Pre-tax Profit
- Driver for the allocation of the Combined Profit: operating costs
- Total TP assessment: **over € 4 million**

Tax Authority

Tested party must be the simplest one

Chinese Co role: toll manufacturer

Chinese Co profitability (EBIT) too high for a toll manufacturer

Profit Split: best method for highly integrated transactions

Lower tax rate in China (12.5%) as evidence of the elusive practice

Taxpayer

Simplest party to be tested: OECD recommendation, not obligation

Chinese Co role: Manufacturer with R&D functions

- No benchmark on Chinese comparable taxpayers available
- Taxpayer's mark-up on Made in China products > Made in Italy

Profit Split: last resort method at the time

- China tax rate irrelevant in TP
- Cost of profit repatriation and custom duty almost cancel the gap

Main points of the settlement:

- Profit Split with Contribution Analysis: accepted
- Combined Profit to be split: from pre-tax profit to EBIT
- Foreign Exchange Rate risk borne by Chinese Co considered
- Combined Profit allocation extensively reviewed
- TP Assessment: **from over € 4 million to approx € 1 million**

Why settle?

- A change occurred in the Group TP policy: method for setting Chinese Co pricing consistent with Profit Split
- Taxpayer listed on the stock exchange: potential tax liabilities no longer to be disclosed in public documents (trial to last for years)
- Settlement to be considered as an informal Advance Pricing Agreement
- Subsequent tax years (2011 – 2013) consistent with the arm's length range pursuant to the Profit Split method adopted for 2008 - 2010

- Very aggressive approach by the Tax Authority
- Removal of the «Hierarchy of methods» in 2010: applicable also for previous tax years?
- Foreign tax rate: relevant or not?
- Importance of TP Documentation for penalty protection
- Settlement driven mostly by «strategic» reasons

What is the situation in your jurisdiction?

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