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January 2021

New Transfer Pricing fulfilments

Expert's Opinion

Documentation required for "low value-adding services"

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Overview

Revenue Office Provvedimento dated 23 November 2020

Marina Vitale
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Focus on...

Transfer pricing documentation and suitability requirements

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The formal and substantial innovations introduced by the Provvedimento reflect an important evolution in the Tax Authorities' attitude towards transfer pricing, in addition to the intention of aligning the Italian documentary requirements to the most recent OECD recommendations (e.g. Action 13 of the BEPS Project, whose contents have been transposed in the 2017 version of the OECD Guidelines). The new requirements also seem to provide a definite answer...

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Supplemento Notizie flash n° 107 del 25 febbraio 1984

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Overview

Revenue Office Provvedimento dated 23 November 2020

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Starting from 2013 with the BEPS project, and specifically with action 13, the OECD has provided specific indications as concerns the documentary requirements for transfer pricing; such indications have subsequently been implemented in the 2017 OECD Guidelines.

Art. 8 of Ministerial Decree dated 14 May 2018 provided for the alignment of the existing regulations to the international standards contained in the OECD Guidelines.

On 23 November 2020, the Italian Revenue Office, with provision no. 360494 - the "Provvedimento" - implemented art. 8 of Ministerial Decree, thus updating the norms relevant to the Transfer Pricing Documentation (the "Documentation").

The new Provvedimento, entirely replacing the former one, introduces a series of innovations to the requirements that taxpayers have to comply with in order to be eligible for the so-called penalty protection regime starting from the fiscal year underway as at 23 November 2020, or from the 2020 fiscal year for taxpayer whose FY corresponds to the calendar year.

Adequate Documentation

For all taxpayers whishing to benefit from the penalty protection regime, the Documentation required includes both a Masterfile and a Local File to be prepared in Italian, with the possibility for taxpayers to prepare the Masterfile in English. Compared to the previous Provvedimento, taxpayers are no longer classified as holdings, sub-holdings and subsidiaries, with the possibility provided for the latter to prepare only the Local File.

Nowadays, all companies also have to prepare the Masterfile. Actually, the domestic regulation have aligned with the OECD Guidelines, which in turn implemented the provisions of Action 13 of the BEPS project which already included such indication.

The same requirements also apply to Italian permanent establishments of non-resident entities, as well as to companies resident in Italy with permanent establishments abroad.

Structure and contents of the Documentation

Aim of the Documentation is to provide evidence that intercompany transactions are consistent with the arm's length principle.

As anticipated, the Provvedimento aligned the structure and contents of the Masterfile and of the Local File to those contained in the latest version of the OECD transfer pricing recommendations. In general terms:

1. Masterfile

The Masterfile must contain information on the activities of the multinational group and on the global allocation of income among its various entities. Among the new provisions contained in the Provvedimento are:

- the description of the group's main factors generating income;
- the description of the production and/or distribution chain of the group's first five products and/or services in terms of turnover, together with possible other products and/or services whose turnover exceeds 5% of the group's total turnover;
- a specific focus on the group's intangibles and financial assets.

Should the multinational group carry out different business activities regulated by specific transfer pricing policies, then taxpayers are allowed to file different Masterfiles.

2. Local File

The Local File supplements the Masterfile with a focus on the local entity.

Such document contains specific information on the peculiarities of the local entity, as well as the transfer pricing analyses related to the transactions occurring between the latter and related parties located in different jurisdictions.

Among the new provisions introduced by the *Provvedimento* with reference to the Local File, it is worth mentioning the request of a specific documentation concerning financial information. In particular:

- the annual accounts of the local entities for the tax period under analysis;
- information and reconciliation spreadsheets showing how financial data used in the application of the selected method can be reconciled with the financial statements for the FY or with other equivalent documentation;
- a summary of relevant financial data of comparable entities used in the analysis and the sources from which these have been obtained.

As a final note, it is worth mentioning the request to include, in addition to the usual intercompany agreements, a copy of all existing bilateral/multilateral advance pricing agreements and of the cross-border rulings which the taxpayer is not part of, but which nevertheless are related to the intercompany transactions described in the Local File.

Electronic signature and time stamp

One of the main innovations introduced by the Provvedimento is the provision related to the electronic signature of the Documentation and the apposition of a time stamp.

In order for the Documentation to be considered as adequate, it will have to be signed electronically by the legal representative (or by a delegated substitute), with the apposition of a time stamp, so as to guarantee the Revenue Office certainty of the signing date, which must be prior to the tax return filing date for the relevant fiscal year. Failure to comply with this requirement will not allow the taxpayer to be eligible for the penalty protection regime.

In case of a tax audit, the Documentation must be submitted within 20 days from the request of the Tax Inspectors. Any additional information that may be requested during a tax audit has to be provided within 7 days. Such term can be extended depending on the complexity of the request.

Amendment of the Documentation and supplementary tax return

In order to be eligible for the penalty protection regime, the taxpayer must communicate to the Tax Authorities the possession of the Documentation upon filing the relevant tax return.

Should a supplementary tax return be filed in order to amend mistakes or omissions deriving from the non-compliance of the transfer pricing conditions and prices applied with the arm's length principle, the taxpayer is allowed to amend the Documentation. In this case, a specific notification needs to be submitted by filing an amended tax return.

Further clarifications are expected from the Tax Authorities on this topic.

"Partial" Documentation

According to the *Provvidemento*, taxpayers are entitled to report in the Documentation only specific intercompany transactions occurred during the relevant fiscal year.

In this case, eligibility for the penalty protection regime would apply only with respect to the documented transactions.

Simplifications for small-medium enterprises (SMEs)

According to the definition provided by the Provvedimento, a SME is a company with a turnover not exceeding 50 million Euros.

SMEs are allowed not to updated their quantitative and qualitative analyses referred to intercompany transaction described in the Local File for the two years following the one in which the initial analysis was carried out, provided that the following requirements are met:

- no significant changes in the comparability analysis have occurred in the period under analysis;
- the analyses were carried out relying on publicly available data.

A novelty has been introduced also with reference to this aspect. Entities directly or indirectly controlled by or controlling an entity with a turnover exceeding the 50 million Euro threshold actually do not fall within the definition of SME and thus do not qualify for the simplified documentation regime.

Low value-adding services

A major novelty concerns the so-called "low value-adding services". In order to apply the simplified approach provided by the OECD Guidelines and confirmed by art. 7 of Ministerial Decree, the Local File needs to be supplemented, as concerns this category of services, with a detailed quantitative analysis on the nature of services.

Said analysis must include a detailed description of the nature of the transactions and of the benefits obtained or expected by the recipients (i.e. benefit test). Furthermore, taxpayers are also required to include clear and precise details on the criteria applied to determine and allocate the amounts underlying the transactions.

Entry into force

As mentioned above, the new requirements introduced by the Provvedimento will apply starting from the tax period underway as at 23 November 2020.

Focus on...

Transfer pricing documentation and suitability requirements

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The formal and substantial innovations introduced by the Provvedimento reflect an important evolution in the Tax Authorities' attitude towards transfer pricing, in addition to the intention of aligning the Italian documentary requirements to the most recent OECD recommendations (e.g. Action 13 of the BEPS Project, whose contents have been transposed in the 2017 version of the OECD Guidelines).

The new requirements also seem to provide a definite answer to some issues subject of discussion over the years due to the lack of specific indications. Finally, the innovations introduced show the interest of the Tax Authorities for an increased taxpayers' commitment in managing transfer pricing compliance.

In line with past, preparing the Documentation remains optional for those taxpayers intending to benefit from the penalty protection regime, but the requirements for the Documentation's suitability have become stricter.

1. Suitable Documentation

The first novelty introduced by the Provvedimento is related to the norm providing that all taxpayers intending to benefit from the penalty protection regime have to prepare a set of documents including Local File and Masterfile, regardless of their qualification as holdings, sub-holdings or subsidiaries.

Compared to the past, the requirements according to which a different set of documents was required for different types of taxpayers no longer applies and the new provisions apply equally also to Italian permanent establishments of foreign entities and to foreign permanent establishments of Italian entities.

In line with the past, the Provvedimento requires the Documentation to be drafted in Italian, with the possibility for the Masterfile to also be filed in English. Further clarifications on this point by the Tax Authorities would be appropriate, in order to clearly identify the circumstances and ways in which it will be possible to make use of a Masterfile drafted in English.

The Local File and the Masterfile thus change, with a substantial alignment of their structure and contents to the recommendations on transfer pricing implemented in the latest version of the OECD Transfer Pricing Guidelines.

Both documents contain information useful to outline, in a more effective way compared to the past, the specific features of the multinational group to which the taxpayer belongs (the Masterfile) and the specific features characterising the business model and the operations of the local entity (the Local File), with a focus on those details aimed at identifying the substantial elements underlying the relations within the multinational group and the analyses carried out.

The Masterfile is the document aimed at providing a high level information framework on the multinational group to which the taxpayer belongs. It can be drafted considering the entire scope of operations of the multinational group, or by separately analysing each business area in which it operates, especially in those cases in which "*the group carries out different activities regulated by specific transfer pricing policies*".

In this latter case, it would advisable for the Tax Authorities to provide the necessary confirmations on their expectations on the scope of the analysis of a suitable Masterfile, specifically in those cases in which the taxpayer operates only in some of the business areas of the group it is part of and considering the possibility to prepare the Documentation limited to some operations involving the taxpayer. Among the new contents of the Masterfile are:

- details on economically relevant activities thanks to which the group generates value;
- details on the value chain relevant to (i) the first five products/services of the group in terms of turnover and (ii) the products/ services generating a turnover over 5% of the total turnover of the group;
- details relevant to corporate reorganisation operations, if any, carried out on the group during the year;
- details on the agreements for the provision of intercompany services;
- a major focus on intangible assets, on which a complete disclosure is required. The information required include a description of the groups' strategies as concerns intangibles, a complete list of intangible assets held and employed by the group with indication of the subjects having their legal ownership, the agreements, the transfer pricing policies, as well as significant transactions carried out during the year concerning intangible assets;
- a major focus also on the intercompany financial assets, aimed at clearly outlining how the group is financed, at describing the possible centralised treasury functions, as well as how the financial operations adopted are remunerated.

As concerns the Local File, the Provision also requires the adoption of an approach more focused on substance and on details compared to the past.

Taxpayers are required to provide evidence (i) of the relations existing with other entities of the group, also from an organisational point of view, providing details of lines of reporting and decision makers within the group; (ii) of the effects on the local entity of the implementation of specific strategies, extraordinary operations, transfer of intangibles, if any; as well as (iii) of the competitive context in which the taxpayer operates.

The most relevant novelties concerning the Local File requirements concern the level of detail required in the approach to the analysis of intercompany transactions in which the taxpayer was involved during the year.

In addition to the qualitative information already required with reference to transactions with related parties and those relevant to possible comparable transactions with third parties, taxpayers are also explicitly required to provide all useful details for a full understanding of the analysis carried out and the relevant underlying actions, as well as of any comparability adjustment made.

The section of the Provvedimento relevant to the application of the selected method also contains an explicit reference to the possibility to carry out multi-year analyses, illustrating the reasons of said choice. Clarifications by the Tax Authorities are awaited on this point.

In the light of the above, in order for a quantitative analysis to be considered as adequate, it should be fully replicable in case of a tax audit.

The analyses also need to be accompanied by the annual accounts of the foreign counterparties involved in the transactions analysed (together with the auditors' reports, where available), as well as by internal information and accounting spreadsheets allowing the reconciliation of data used to carry out quantitative analyses aimed at the evaluation of the compliance of the transfer prices applied to the transactions with the arm's length principle. The analyses relevant to transactions concerning the so-called low value-adding services are to be prepared according to the specific indications set forth in the Provvedimento.

2. Timestamp and timeframe for preparing and making the Documentation available

The most significant novelty included in the Provvedimento is the introduction of the electronic signature and timestamp. Such provision, in line with what provided for the patent box, is not surprising considering that the Italian regulation on documentary obligations on transfer pricing provides benefits for taxpayers preparing said documentation.

Besides the obligation to flag the dedicated box when preparing the income tax return, the timestamp requirement for the Documentation (prior to the income tax return filing date for the same tax period) makes the regulation even stricter. The Tax Authorities clarified an issue that gave rise to doubts and discussion in the past, i.e. the completion of the Documentation contextually with the submission of the income tax return. The time stamp is essentially aimed at demonstrating and confirming the truthfulness of what declared by the taxpayer to the Tax Authorities by flagging the income tax return, i.e. that it has prepared the Transfer Pricing Documentation and has it available.

The term for the submission of the Documentation when required by the Tax Authorities in case of a tax audit has been extended to twenty days (previously ten). The introduction of a longer term is of course welcome, but clarifications are awaited from the Tax Authorities in order to fully understand the ratio of the intervention considering the principle according to which no further amendment can be made to the Documentation after the apposition of a time stamp.

On the contrary, no change applies to the terms provided for the handling of requests of information by the Tax Inspectors in case of a tax audit: taxpayers will have to provide the required information within 7 days, a term which can be extended depending on the complexity of the request.

As a final note, the Provvedimento introduces the possibility, under specific circumstances, to amend the Documentations also after filing the income tax return, with the filing of a tax return adjustment. Operational indications are awaited on this point as well, allowing to clearly outline the circumstances and ways in which taxpayers can make use of this possibility, as well as if and in which situations could the possibility to file a supporting tax return be provided, even if only with reference to the flagging (after submitting the income tax return) relevant to the preparation of the Documentation.

3. Simplifications and specific cases

Small and medium enterprises

The Provvedimento confirms the possibility for small and medium enterprises, already provided in the past, to submit "simplified" supporting documentation.

Said regime grants the possibility to small-medium enterprises (defined as "companies whose turnover does not exceed 50 million Euros) not to update the quantitative analyses based on publicly available data for two years subsequent to the one in which the analyses were carried out, provided that the comparability analysis of the transaction did not undergo significant changes from one year to the other.

From a practical point of view, the simplified regime introduced by the Provvedimento currently provides the possibility not to update the entire analysis (comparability analysis and quantitative analysis) for the two fiscal years following the first one, upon condition that the comparability analysis does not undergo significant changes.

The extension of the simplification is nonetheless accompanied by the tightening of the scope of the beneficiaries of this provision, through a more stringent definition of small-medium enterprise. The Provvedimento actually sets forth that the category of small-medium enterprises includes taxpayers whose turnover does not exceed 50 million Euro, thus expressly excluding from the category all those entities which directly or indirectly control or are controlled by subjects not included in the category of small-medium enterprises as defined above. This clarifies one of the issues undetermined in the previous regulation and thus often subject of debate.

Partial documentation

The Provvedimento introduces, for the first time, the possibility for taxpayers to prepare the Documentation with reference to specific transactions and to benefit, also in this case, from the penalty protection regime for the sole transactions documented.

Of course, this being a new provision, the indications and operational clarifications which will be provided by the Tax Authorities will undoubtedly be useful to understand the circumstances and rules for the application of the norm for the preparation of a set of documents suitable, though partial.

Low value-adding services

Following to what provided for under the Ministerial Decree, the Provvedimento introduced documentary requirements for transactions involving low value-adding services. As better explained below, the analyses which taxpayers are required to perform with reference to this type of transactions are essentially aligned with what, under the OECD terminology, would be defined as benefit test, aimed at evaluating the inherence of a service (and of the relevant cost) and, only as a second step, its consistency with the arm's length principle.

Expert's Opinion

Documentation required for "low value-adding services"

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Manager Bernoni Grant Thornton

Defining "low value-adding services"

Para. 1, art. 7 of the Ministerial Decree provides for that, in order to evaluate an intercompany transaction consisting of the provision of low value-adding services, in compliance with the arm's length principle, taxpayers are allowed to adopt a "simplified approach". This consists in the aggregation of direct and indirect costs related to the provision of the service(s), adding a profit margin equal to 5% of said costs.

Art. 7 of the Ministerial Decree defines "low value-adding services" as those services which (i) have a support nature, (ii) are not part of the core business of the multinational group, (iii) do not require the use of intangible assets, and (iv) do not contribute to the creation of assets, or (v) do not imply the assumption or control of a significant risk for the service providing entity. The norm further provides for that services rendered by a multinational group to third parties cannot be considered as low value-adding services.

The norm is derived directly from the latest version of the OECD Guidelines dated July 2017, which the Decree refers to for interpretation reasons.

As concerns low value-adding services, the abovementioned OECD Guidelines contain a list of services which cannot be considered as such, i.e.:

- services which represent the group's core business;
- research & development services;
- production services;
- purchasing of manufacturing or production material;
- sales, marketing and distribution services;
- financial transactions;
- mining, exploration and natural resources management services;
- insurance and reinsurance services;
- corporate senior management services.

On the contrary, the same OECD Guidelines clarify that the following activities can qualify as low value-adding services:

- accounting and auditing;
- management of credit and debit accounts;
- human resources activities;
- sourcing of data relevant to health, safety, environmental and other standards necessary for the company;

- IT services, provided that they do not represent the group's core business;
- external communication and public relations services;
- legal services;
- activities related to tax fulfilments;
- general administrative or clerical services.

For the sake of completeness, we specify that the latest version of the 2017 UN Draft Manual on Transfer Pricing - international best practice reference for transactions with entities resident in developing countries - is wholly aligned with the OECD Guidelines as concerns low value-adding services.

The norms contained in the *Provvedimento*

In order to benefit from the so-called "simplified approach" for the purposes of the documentation needed for low value-adding services, the Provvedimento requires the preparations of an ad-hoc document (hereinafter, "LVAD Report") containing specific paragraphs, in addition to the Masterfile and Local File. We specify that the introduction of the LVAD Report was already planned, since the same art. 7 of Ministerial Decree made reference to a "specific documentation" in order to be able to adopt the so-called simplified approach.

In particular, under point 7, the Provvedimento provides for that the LVAD Report include the following sections:

1. *Description of intercompany services.* This section must contain a description of the categories of intercompany low value-adding services rendered, specifying for each service category: the identity of the beneficiaries; the reasons for which such services are considered as low value-adding in compliance with art. 7 of the Decree of the Minister of Economics and Finance dated 14 may 2018; the reasons underlying the provision of services within the multinational group; the benefits attained or expected; the income allocation criteria selected and the reasons for which said criteria are deemed to produce results which reasonably reflect the benefits attained. Moreover, a confirmation of the profit margin applied also needs to be provided.
2. *Contracts relevant to the provision of services.* This section must contain the contracts or written agreements for the provision of low value-adding services and the relevant amendments, showing that the parties involved agree on the application of the chosen income allocation criteria. Said contracts or written agreements can also be represented by contextual documents relevant to the period under analysis, identifying the parties involved, identifying and describing the nature of the services and the contractual terms based on which said services are provided.
3. *Valorisation of the transactions.* This section must contain evidence and an explanation of the calculation supporting the determination of the aggregated direct and indirect costs related to the provision of the service and the profit margin applied, with a detailed representation of all categories and all amounts of relevant costs, including costs relevant to every service provided exclusively to a sole entity of the multinational group.
4. *Calculations.* This section must include, also through annexed spreadsheets, calculations demonstrating the application of the allocation criteria indicated in section 1.

The submission of the LVAS Report is subject to the terms under point 5.2 of the Provvedimento (i.e. within and no later than 20 days from the relevant request by the Tax Authorities).

It is not clear whether the LVAS Report is also subject to time stamp duties, pursuant to art. 5.1.2 of the Provvedimento. Further clarifications are awaited on this point, to be contained in a Circular Letter to be issued by the Italian Revenue Office.

It is worth recalling that point 5.3.3 of the Provvedimento provides for that "(…) the document should be considered adequate in all cases in which it provides the Tax Authorities with all data and information necessary to carry out an analysis of the conditions and of transfer prices applied (…)". This general provision should also apply to the LVAS Report, in order for this to entitle to the application of the penalty protection regime, similarly to the Local File and Masterfile.

Closing remarks

First of all, it is important to notice the legislator's focus on intercompany services.

This transactions could, in some cases, not be immediately recognisable, thus the need of adequate documentary evidence in order to avoid abusive practices. The ratio underlying the provisions on intercompany services is therefore the avoidance of transactions characterised by payments which do not correspond to services actually rendered, or for which no actual benefit is obtained by the recipient (this also with reference to the so-called shareholder activities, i.e. services for which charges are considered non-deductible).

In practice, in case of a tax audit, the submission of invoices as evidence of the provision of a service, without supporting contracts or spreadsheets, is often interpreted as a lack by the taxpayer.

Opting for the adoption of the so-called "simplified approach" for low value-adding services allows taxpayers to be relieved from the obligation to carry out an economic analysis aimed demonstrating that their valorisation complies with the arm's length principle: should the conditions under art. 7 of the Ministerial Decree be complied with, upon the preparation of a LVAS Report, compliance of the transaction with the provisions of art. 10, para. 7 of the TUIR (Consolidated Text on Income Tax) is thus always recognised ex lege.

The provisions contained in art. 7 of the Ministerial Decree are thus to be considered as a safe harbour in our legislation. Nonetheless, it is also necessary to consider that since this clause originates directly from the 2017 OECD Guidelines, the provisions contained in the domestic norm under art. 7 of the Ministerial Decree have similarly been adopted by the tax administrations of all OECD member states.

Therefore, the reporting of a transaction involving low value-adding services for DAC6 purposes (a directive recently implemented in the Italian legislation) is not an applicable option, since such safe harbour is certainly characterised by "mutuality" between the tax administrations involved, which represents an exemption from reporting purposes.

Moreover, it is clear that considering the above as a "simplified approach" is misleading, as it clearly does not help simplifying: by adopting such approach, which is optional for the purposes of the supporting documentation regime, taxpayers have the further obligation to prepare a copious and in-depth documentation for a sole type of transaction, in addition to the certain obligation of preparing the Masterfile and Local File.

It is worth underlining that low value-adding services have been strictly analysed by the domestic Tax Authorities.

The provisions under art. 7 of the Ministerial Decree also apply to controlled foreign companies ex art. 167, para 4 of the TUIR. Furthermore, it is worth considering that, in case of payments for this kind of services, the transaction is in any case subject to the more general clause contained under art. 109, para. 5 of the TUIR concerning the concept of relevance, for the purposes of the deductibility of the cost from the domestic taxable base.

To this end, the information required to be included in section 1 of the LVAS Report need to include a qualitative description of the service, describing the benefits expected by the recipient.

In any case, the paragraph relevant to the expected benefits under section 1 is aligned to the so-called benefit test under OECD Guidelines, para. 7.6 and following paragraphs.

Such test usually implies an effort from taxpayers in terms of a careful analysis of the business carried out by the recipient of the service and a description of its organisational structure for the purpose of demonstrating the actual need of purchasing the low value-adding service from the foreign related company. This amount of information contributes to provide evidence of the cost deductibility, as well as of the compliance with the arm's length principle ex art. 110, para. 7 of the TUIR.

In conclusion, it is not surprising that the specific documentation required for low value-added services, to be drafted pursuant to the indications of the Provvedimento, can be of help also for other purposes beyond the documentary obligations required for transfer pricing purposes.

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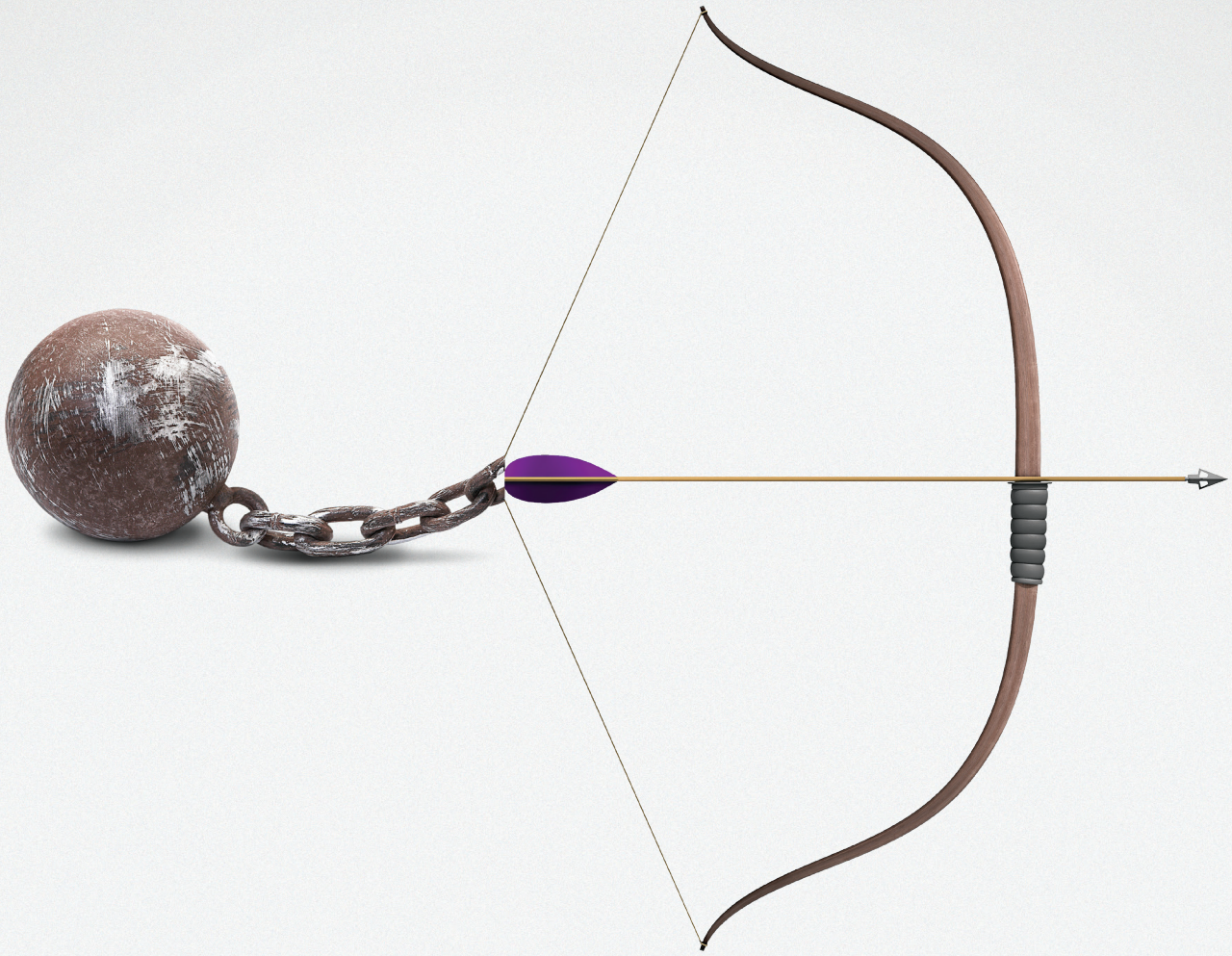

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