

Italian Supreme Court rules on uneconomical inter-company transactions

Federico Vincenti and Alessandro Valente of Crowe Valente / Valente Associati GEB Partners analyse two Italian Supreme Court decisions that deal with uneconomical inter-company transactions.



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In early 2021, two decisions of the Italian Supreme Court dealt with the issue of certain inter-company transactions that were not performed according to the arm's-length principle due to the existence of an overall advantage for the multinational group.

Decision No. 8176

According to Decision No. 8176 of March 24 2021, the inter-company transaction was carried out between two companies belonging to the same group both residing in Italy.

As expressly provided by the Italian law, transfer pricing (TP) regulations do not apply to transactions between entities belonging to the same group, if both reside in Italy.

However, the Italian law allows the tax authorities to examine the adequacy of the inter-company transactions' prices, by analysing whether the companies put in place uneconomical operations.

The decision of the Italian Supreme Court confirmed that, during the tax audits, the Italian Tax Authority could argue that the sale of goods among companies belonging to the same group, all residing in Italy, at a price which is not compliant with the arm's length principle may constitute, in principle, an uneconomical behaviour.

However, according to the Italian Supreme Court, the above-mentioned evaluation should take into account the 'group's strategy/advantages' by enhancing the potential balance between the general group's interest and the interest of each company.

In this case, an Italian company bought certain goods from another Italian company of the group at a price higher than the market price (for three months) and re-sold the goods to third parties by applying a price lower than the purchase price, hence achieving a negative margin.

According to the Italian Revenue Agency, the inter-company transaction was uneconomical. Therefore, it was necessary to understand and determine the revenue to be recognised to the company that sold the goods.

Even if the Italian Supreme Court recognised the opportunity of the Italian Tax Authority to evaluate whether a transaction may be considered uneconomical, it stated that the transaction shall also meet 'group's strategies/advantages' since it is part of a strategy aiming at achieving a result in the interest of all the companies belonging to the group (also considering that the transaction was performed within a limited period of time).

However, both the aspects of belonging to the group and the overall advantage for the group to perform a transaction which is not compliant with the arm's-length principle shall be evaluated carefully.

Decision No. 1232

The Italian Supreme Court has recently stated that the existence of a company policy at group level is not enough to waive the application of the arm's-length principle (Decision No. 1232 of January 21 2021).

In this case, an Italian company charged royalties to the foreign subsidiaries at a price that, according to the Italian Tax Authority, was lower than the one that would have been applied within free competition conditions.

According to the taxpayer, a royalty not in compliance with the arm's-length principle was applied to guarantee a greater competitiveness to the foreign subsidiaries on the target market.

For the Italian Revenue Agency, this approach would have been acceptable for a limited period, but not for an undefined period, since it could trigger a distortion of free competition.

According to Article 2497 of the Italian Civil Code, the existence of an overall group result may, on the one hand, sacrifice the interest of a single company belonging to the group and, on the other, determine an advantage at group level considering the increase of the overall value of the group to which the 'sacrificed' company belonged to.

As stated by the Italian Supreme Court, this principle cannot apply to tax matters. Instead, TP regulations, which guarantees the right allocation of the power to tax among the countries, should be taken into account.

As such, the application of prices which are not in compliance with the arm's-length principle justified by the implementation of a group policy should be carefully evaluated on a case-by-case basis.

However, it shall be noted that business strategy is one of the five relevant economic characteristics identified by the OECD and Italian laws which should be evaluated thoroughly within the analysis and management of TP policies.

Pursuant to Article 1.115 of the OECD Transfer Pricing Guidelines, business strategies could include market penetration schemes or actions to expand (or to defend) market shares that might temporarily entail higher costs for a certain time frame.

Furthermore, the timing of these strategies must be taken into account. Indeed, as supported by the above-mentioned decisions of the Italian Supreme Court, the tax authorities would be reluctant to accept uneconomical behaviours (that would have not been performed by independent companies) performed for a significant period of time.

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