Long duration of below the market pricing penetration strategy found not to be at arm's length by the Italian Supreme Court

Through decision ("ordinanza") no. 1232 of 21 January 2021, the Italian Supreme Court ruled on the application of the arm's length standard to royalties paid by a US resident affiliated to its Italian parent company.
The Court upheld the decisions of the lower-courts, confirming the upward adjustment made by the Revenue Agency and rejecting the taxpayer's argument that the below market royalty was explained by the need to enable its foreign subsidiary to penetrate more effectively the US market. The duration of the below market pricing strategy was found to have lasted too long and so did not meet the arm's length standard (i.e., beyond the period when US market sales have shown positive signs). The relevance of business strategy in determining the transfer pricing is endorsed by the lower courts (*e.g.*, Provincial Tax Court of Milan, decision no. 262 of 21 January 2021), as well as the OECD Transfer Pricing Guidelines, which expressly recognize the relevance of market penetration strategies for the purpose of setting transfer prices (*see* §§ 1.115-1.118 of the 2017 version). Therefore, the Supreme Court is not departing from this position as the judgment simply finds that business strategy needs to last for a limited period.

Interestingly, although the case dealt with the application of the arm's length standard to transactions concluded with a company residing in a non-EU Member State, the Supreme Court quoted the decision delivered by the Court of Justice of the European Union (CJEU) in *Impresa Pizzarotti* in October 2020 (C-558/19) which confirmed that the applicability of transfer pricing rules solely to cross-border transactions does not violate the EU freedom of establishment as it is justified by the need to "maintain the balanced allocation of the power to tax between Member States". It is worth noting that in its prior consistent case law relating to the subject (*SGI* and *Hornbach-Baumarkt*) the CJEU stated that compatibility of the transfer pricing rules required the domestic transfer pricing provisions to offer the taxpayer the opportunity to provide evidence of any commercial justification for an agreement on non-arm's length terms to include "economic reasons resulting from the very existence of a relationship of interdependence between the parent company resident in the Member State concerned and its subsidiaries which are resident in another Member State" (CJEU, judgment 31 May 2018, C-382/16, *Hornbach-Baumarkt*, §51). On this basis, the CJEU found that granting non arm's length loans to a subsidiary to permit the expansion of the business of a subsidiary could fall under the scope of the "commercial justification". More specifically, in *Hornbach-Baumarkt* the CJEU clarified that in a situation, such as the one in that case, where the expansion of the business operations of a subsidiary requires additional capital, due to the fact that the latter lacks sufficient equity capital, there may be commercial reasons for a parent company to agree to provide capital on non-arm's-length terms (§ 54). Hence, the case law of the CJEU concluded that the gratuitous granting of comfort letters containing a guarantee statement could be explained by the economic interest of the shareholder in the financial success of the foreign group subsidiaries (§ 56).

Although not relevant in the case reviewed by the Court, the Pizzarotti CJEU's judgment may find application in transfer pricing litigation involving companies residing in other EU Member States (the reasons for the quotation made in the order is most likely in response to the lower Court decision which expressly rejected the application of the group interest concept). The Supreme Court does endorse the conclusion taken by the Regional Court although it does not take a position on whether the "group commercial justification" concept developed by the CJEU could have some merit where EU law applies (i.e. where the transactions are undertaken with affiliates residing in other EU Member States). By all means, the quotation shows the attention which the Supreme Court may pay in the future to the CJEU's case law on the subject. It is an interesting development as the CJEU's case law seems to restrict the ability of transfer pricing adjustments where the below market condition is justified by a group's interest well beyond the conduct of an arm's length relationship. This is odd if one considers the rationale of the transfer pricing rules. Support of subsidiaries for instance would be a "commercial" justification as it is in the interest of the group and therefore prevents a transfer pricing adjustment. This is different from the application of the arm's length standard as endorsed by the OECD Guidelines which restricts the permissible advantage to the (more) limited situations where a company supports the business of an independent contractor (e.g. a distributor) only in cases where it has a (even indirect) benefit (such as an increase of sales of manufactured products). For that reason, a long-term benefit to the subsidiary could be permissible under the CJEU case law whilst the OECD Guidelines would require the taxpayer to document, in addition to the facts and circumstances leading to the re-negotiation, how long an independent party would have supported and granted benefits to another independent contractor.

For further information: **Maisto e Associati**

Milan
Piazza F. Meda 5
20121
T: +39.02.776931

Rome
Piazza d'Aracoeli 1
00186
T: +39.06.45441410

London
2, Throgmorton Avenue
EC2N 2DG
T: +44.207.3740299