

Functions, risks and the margin of the trader

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The CUP method determines the price of the commodity, but it does not by itself answer the question of how much profit the Swiss trading company may keep. Take a group with a producer in one country, a trading company in Lugano and distributors in other countries. The trading company's margin is the difference between its purchase price from the producer and its sale price to customers. If both prices are quoted market prices with appropriate adjustments, the margin reflects the value of the trader's functions. These are origination, the matching of supply and demand, the organization of freight, insurance and financing, the management of price risk through hedging and the bearing of credit risk.¹ Tax authorities in producing countries have argued that such trading companies perform few functions and should earn only a service fee, while the Swiss trading company argues that it performs the strategic functions and bears the risks.

The 2017 revision of Chapter I of the Guidelines, following Actions 8 to 10, requires a careful delineation of the actual transaction. It allocates risks to the party that controls them and has the financial capacity to bear them.² For a trading company in Lugano this has a practical meaning. The traders who decide on positions and hedges, the risk managers who set and monitor the limits and the financial staff who arrange the bank lines must actually be in Lugano and exercise these functions there. A Lugano company whose employees execute instructions from the group's head office in Milan, Istanbul or Moscow will not be allowed to keep the residual profit of the trading activity. The transfer pricing analysis thus leads directly to the substance questions examined in the last sections of this chapter.

1 The Italian view and the documentation regime

For trading companies with Italian group members or Italian customers, Italian transfer pricing law applies on the other side of the transaction. Article 110 paragraph 7 of the Consolidated Income Tax Act (*Testo unico delle imposte sui redditi*, TUIR) covers transactions with non-resident companies that directly or indirectly control, are controlled by or are under common control with the Italian enterprise. The income components arising from them are determined by reference to the conditions and prices that independent parties acting at arm's length would have agreed in comparable circumstances.³ The Ministry of Economy and Finance implemented the rule by a decree of 14 May 2018 based on the OECD Guidelines. The Italian Revenue Agency has set out documentation requirements whose fulfilment protects the taxpayer from administrative penalties in the event of an adjustment.⁴

The Italian tax authorities have taken a particular interest in goods sold by Italian producers to Swiss trading or distribution companies of the same group. These companies resell the goods to customers elsewhere, including back to Italy. Such arrangements, which were widespread in the steel and fashion industries, raise both transfer pricing questions and the question whether the Swiss company is in reality managed from Italy or constitutes a permanent establishment there. The Kering case examined in Chapter F.III, in which the Italian authorities challenged the role of a Swiss distribution company in Cadempino, shows how these questions combine.⁵ A Lugano trader buying from an Italian related party should therefore document the arm's length character of the purchase price under both Swiss and Italian standards. It should be prepared for an Italian audit that examines the substance of the Swiss company together with the price.

For the practitioner. Transfer pricing documentation for a Lugano trading company should contain at least: - a functional analysis that identifies where decisions on positions, hedging, counterparties and financing are taken and by whom; - the price-setting policy for each commodity, with the quoted price, the adjustments for quality, freight, insurance and timing, and the pricing date as agreed at contract conclusion (OECD TPG paras 2.18–2.22); - evidence of the conduct of the parties consistent with the written pricing terms, in particular dated confirmations and hedge records; - an analysis of related-party financing against the ESTV safe harbour interest rates; - for transactions with Italian related parties, documentation compliant with the Italian rules under Article 110 paragraph 7 TUIR.

2 Notes

1. Practitioner's description of a trader's functions. On the transfer pricing of commodity transactions generally see Grant Thornton International Ltd, BEPS Action 10: Discussion draft on the transfer pricing aspects of cross-border commodity transactions (2015), https://www.grantthornton.global/globalassets/1.-member-firms/global/services/tax-pdfs/7.-beps-actions-10_commodity-transaction.pdf (response of 16 December 2014 to the OECD discussion draft; commodity traders named among the participants in the sector). ↩
2. OECD TPG 2022, Chapter I, Section D.1.2.1 (allocation of risk; control over risk and financial capacity). ↩
3. TUIR, Art. 110 para. 7, text and annotations at Brocardi.it, <https://brocardi.it/testo-unico-imposte-redditi/titolo-ii/capo-ii/sezione-i/art110.html>. ↩
4. Decree of the Ministry of Economy and Finance of 14 May 2018 (guidelines under Art. 110 para. 7 TUIR, whose last sentence provides for such a decree, Brocardi.it, above); Provision of the Director of the Revenue Agency of 23 November 2020 on transfer pricing documentation. ↩
5. See Chapter F.III on the Kering settlement of 2019. ↩

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