The Italian approach to intercompany loans

06 Oct 2014

By Piergiorgio Valente, Valente Associati GEB Partners

The Italian tax authorities have been intensifying their focus on transfer prices involving financial intercompany transactions such as loans.

Multinational corporations frequently resort to such transactions to optimise and rationalise the financial management of the entire group.

In certain cases, the said optimisation tools pertaining to intercompany financial resources may become authentic tax planning instruments.

Transfer pricing rules, and the arm's length principle in particular, may also be applied to such kinds of transactions, having special regard to the adequateness of interest rates applied and to the verification of remunerations, on the basis of which the relevant decisions on intercompany prices of the financial services were made.

In the last few years, intercompany financial transactions have notably increased, in view of both the economic trend, which causes any recourse to external loans to be rather undesirable, and because of the various opportunities and advantages that taxpayers may attain through such kinds of transactions.

As a consequence, litigation cases involving financial intercompany transactions are also on the rise, in view of the discretionary judgment applied to their assessment and the high value of the transactions themselves.

To determine the proper interest rate that is applicable to an intercompany loan, it is first necessary to identify the relevant market.

To such effect, Tax Authorities Circular No. 32/1980 identifies the lender's market as the relevant one.

In particular, the Italian Circular establishes that "in compliance with the arm's length principle, in order to guarantee the identity of compared transactions, by and large, the relevant market must necessarily be (especially for sales involving material goods) the market of the Recipient of the goods to which the transaction relates. With regard to loans, on the other hand, it is the lender's market that must be deemed relevant".

Pursuant to provisions of the above Circular, the "lender's market" concept must be "interpreted from a substantial perspective, in that, the market to be taken into consideration is the one in which the funds pertaining to the loan were actually collected: a market that does not always coincide with the country of residence of whomever (…) is qualified as lender".

It is worth pointing out that jurisprudence is partially contrary to the theory advanced by the tax authorities through their Circular No. 32 of 1980.

In that sense, through Decision No. 113 of 31 October 2012, issued by the Provincial Tax Court of Bolzano, the subject-matter of which (partially) referred to

the ascertainment of the adequateness of interests applied to an intercompany loan, granted by an Italian company to a Luxembourg company, the Judges of First Instance asserted that, for the interest rate to be deemed at arm's length, it "must be identified with the arm's length price - with the interest rate that would have been agreed for the loan - within the same term and place, by independent Italian enterprises towards companies having offices in Luxembourg, taking also into account the amount of the loan, the security's duration, the nature and subject-matter of the transaction, lender's financial position, guarantees and average rates applied in Luxembourg in the year 2006".

Decision No. 22010 of September 25 2013, issued by the Supreme Court, voiced its opinion once again on the issue: the subject-matter of the decision relates to a controversy ensuing from an assessment notice served by the Italian tax authorities, through which deducted interest expenses were recaptured, by reason of their having been deducted as a consequence of a loan that was issued by the German parent company S.G.L. CA to its controlled Italian company S.G.L. C. S.p.A.

Pursuant to the Italian tax authorities, the interest rate applied to the intercompany loan is to be deemed "considerably higher than the average rate applied on the German market, as the official bulletins relating thereto disclose".

The taxpayer filed an appeal against the said assessment notice, which was upheld by Milan's Provincial Tax Court. Second Instance Judges reversed the former ruling of the Provincial Tax Commission because they deemed the approach adopted by the tax authorities to be appropriate and ruled, therefore, that the deducted interests were actually non-deductible, establishing that the loan was to be considered a transfer pricing transaction aimed at reducing profits in Italy.

The taxpayer filed an appeal with the Supreme Court, which rejected it maintaining that, for application purposes of the transfer pricing regime provided ex Article 110, paragraph 7 of the TUIR, the so-called "normal value" (the arm's length value), pursuant to Article 9 of the TUIR (Italian Income Tax Code, hereinafter "TUIR") must necessarily be identified.

The Supreme Court's position deems, therefore, the tax authorities' approach to be appropriate because it verified the tax rate applied to the intercompany transaction, by referring to the so-called "Lenders market", on the basis of official bulletins issued by the German Bundesbank.

As a consequence of the said debate, the tax authorities ascertained that "the average interest rate applied on the financial-credit market - of the Lender' State of residence - is lower than the one adopted for the loan transaction at issue": therefore, pursuant to the tax authorities, such costs, represented by interests deriving from intercompany loans, are to be considered as having been "marked-up for the purpose of increasing the profits of the German Parent company, by decreasing the ones of the Italian sister-company in order to avoid their being liable to national taxation, in manifest violation of Article 110, paragraph 7" of the TUIR.

By means of Decision No. 231-06/2014 of February 3 2014, the Provincial Tax Court expressed itself, on the other hand, as to the possibility of the Italian Tax Authorities to re-qualify the omitted charge of the interests in relation to "omitted or late payments of the goods" within the context of "intercompany loans".

In particular, the auditors recaptured interest income that was not charged and quantified within a yearly 5.25% measure calculated on the amount of the commercial credits, taking as a point of reference the percentage applied to an intercompany loan carried out between the petitioning company (plaintiff) and another group company.

The judges deemed the said requalification to be unlawful with regard to sales transactions within the context of loan transactions, by pointing out how the sales transaction had actually occurred and that no dissimulating behavior had been adopted.

In the second place, pursuant to the judges, the plaintiff company, substantiated that the delayed (and never omitted) payment of sums contractually agreed was caused by objective financial difficulties of the controlled company: objective financial difficulties confirmed by the fact that the company did not succeed in achieving a business turnover that was sufficiently adequate so as to reach the so-called "break-even point" (as clearly documented by the company in its financial statements).

Piergiorgio Valente: p.valente@gebnetwork.it

Valente Associati GEB Partners
Viale Bianca Maria, 45
20122 Milano
Tel 39 02 7626131
Fax 39 02 76001091
(www.gebpartners.it)