

Intercompany loans in Italy: Beyond the arm's-length principle?

Stefano Bognandi and Elena Baron of LED Taxand considers recent Italian case law and compliance with the arm's-length principle.

On May 20 2021, the Italian Supreme Court (Italian Supreme Court, decision No. 13850/2021) was called to decide upon a dispute concerning the compliance with the arm's-length principle – stated by Article 110 (7), of the Italian Income Tax Code (ITC) – of non-interest bearing intercompany loans (the decision). The conclusions reached are somewhat innovative in the Italian jurisprudential landscape and may seem prima facie deviating from the arm's-length principle.

Similar principles – with slightly different shades – have been stated by the Italian Supreme Court (Italian Supreme Court, Decision no. 1374/2022) more recently on January 18 2022, although with reference to a different case (together, the decisions).

The decision

In the decision, the Italian Supreme Court dealt with a non-interest bearing intercompany loan granted by an Italian limited company (the company) to a foreign limited company aimed to acquire a controlling participation in a Chinese entity; according to the taxpayer defense, the granting of the loan was necessary due to the impossibility for the company to have a direct participation in a Chinese firm.

More precisely, the original agreement provided for an interest to be paid by the borrower. However, the agreement was subsequently amended to exclude the interest payment, notwithstanding the fact that the company had in place other similar interest bearing intercompany loans.

In other terms, the company applied different pricing policies in similar intragroup financing transactions.

Given the above background, the Italian Supreme Court first highlights – recalling previous jurisprudential decisions – that non-interest bearing intercompany loans could be assessed by the Italian Tax Authorities (the ITA) based on transfer pricing (TP) rules, even in the (obvious) absence

of any income/cost flow. Indeed, it would be unreasonable to conclude that only the provision of interest rates below the arm's-length value is liable of assessment by the tax office.

Even more interestingly, the Italian Court further states that 'commercial reasons', connected to the role that the parent company assumes in support of other companies of the group, may actually explain the deviation from the arm's-length principle.

The Italian Supreme Court way of thinking leads to the conclusion that a taxpayer may alternately prove that the intragroup conditions do not differ from those which would be agreed between independent enterprises or, whether this is not the case, that there are 'commercial reasons' behind the absence of an interest charge.

In a more recent case concerning the pricing of goods in intragroup transactions, the same Court again uses the 'commercial reasons' argument, but the stated principle leads to a substantially different conclusion. In such case, according to the court, the 'commercial reasons' could be considered relevant to assess the arm's-length nature of the prices applied. In other words, the appeal to the existence of effective 'commercial reasons' could be appropriate to support the adherence to the arm's-length principle (and not the divergence from it).

The decisions in light of the European context

The concept of 'commercial reasons' is not that new in the European jurisprudential landscape and, on closer inspections, the Decisions seem in fact inspired by the past Court of Justice of the European Union (CJEU) judgments.

Indeed, the CJEU ruled in similar terms in the well-known Hornbach-Baumarkt case (CJEU, Hornbach-Baumarkt AG C-382/16) where the German parent company provided gratuitous comfort letters to the bank for the financing of its foreign subsidiaries which needed funds to continue their business operations.

In that occasion, the CJEU concluded that there may be a commercial justification for the deviation from the arm's-length rule by virtue of the role of the parent company as shareholder in the foreign group companies and such funds were essential for the continuation and expansion of the operations of those companies.

Some time later, in *Impresa Pizzarotti* judgment (CJEU, *Impresa Pizzarotti & C SPA Italia C-558/19*) regarding the granting of non-interest bearing loans by the Romanian branch to its Italian parent company, the CJEU reached similar conclusions stating that a tax payer must be given the opportunity to provide evidence of any commercial justification (or 'objective reasons') that may have been for that transaction.

The CJEU seems then to admitting that even a non-arm's length situation could be legitimate and should not be *a priori* disregarded from a transfer pricing perspective.



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It should be finally noted that following the Hornbach-Baumarkt decision, the German tax authorities has revised their practice clarifying that the 'commercial reasons' which could justify the deviation from the arm's-length rule should be limited to avoid situations of financial deficit or bankruptcy of the foreign controlled entity.

The decisions in light of the OECD framework

While Chapter X – relating to the transfer pricing aspects of financial transactions – does not directly deal with the issue, there are some interesting food for thought in the OECD Transfer Pricing Guidelines (the OECD TP Guidelines).

Firstly, the OECD TP Guidelines emphasise in Chapter I the importance of identifying the commercial or financial relations within the MNE group and the conditions and economically relevant circumstances attaching to those relations with the aim to accurately delineate the transaction(s) and compare the same with the behaviour of independent enterprises.

In this regard, economic circumstances and business strategies pursued by the parties play a role. The OECD TP Guidelines clearly state that the parties well could follow market penetration schemes or seek to enter a new market or expand its market share and for these reasons achieve lower profit levels than other taxpayers operating in the same market.

However, the OECD TP Guidelines clarifies as well that it must be assessed whether an independent party operating



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at arm's-length "would have been prepared to sacrifice profitability for a similar period under such economic circumstances and competitive conditions". This sounds aligned with the most recent Italian Court decision no. 1374/2022 in the way that specific business strategies and economic reasons could be relevant in order to assess the arm's-length nature of the intercompany transaction.

In addition to the above, it cannot be ignored the section of Chapter X relating to the interactions existing with Chapter I (OECD TP Guidelines, Chapter X, Section B). In particular, it is expressly stated that the arm's-length principle is also relevant in determining whether a loan can be actually regarded as a loan or should be regarded as a

contribution to equity capital. In the assessment of the actual nature of the lent funds, the obligation to pay interest is considered a useful indicator.

The Italian Supreme Court does not seem to be in the dark of such principles: indeed, in the decision the Italian judges make express reference to the OECD Report on Transfer Pricing Guidance on Financial Transactions (now included in the last release of OECD TP Guidelines 2022) explaining the importance of the accurate delineation of the transaction.

However, the conclusions reached by the court in the decision seem 'unglued' to the above principles since it is not even evaluated the possibility that the non-interest bearing intercompany loan under assessment should in truth be regarded as a contribution to equity capital.

Conclusion

It is still not clear neither predictable what will be the impact of the principles stated by the Italian Supreme Court on the ITA practice in relation to the non-interest bearing intercompany loans matter. What can be probably said is that the Italian Court is at least trying to apply the principles expressed in the international panorama that, must be said, is not that crystal-clear.

The concept of 'commercial reasons' connected to the role that the parent company assumes in support of other companies of the group is quite ambiguous and could lead to the conclusion that the arm's-length principle could exceptionally be disappplied because of the prevailing of a group interest. However, such conclusion increases uncertainties for both taxpayers and tax authorities.

Existing commercial reasons the Italian Supreme Court refers to, should be better contextualised in the OECD TP Guidelines principles, also considering that the Ministerial Decree dated May 14 2018, which sets out the general guidance for the proper application of the arm's-length principle, makes explicit reference to the same. In this regard, commercial reasons can surely play a role in TP analyses, but should be relevant in supporting and justifying the arm's-length nature of the prices applied in intragroup transactions.