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by Piergiorgio Valente

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PRACTITIONERS' CORNER

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Piergiorgio Valente is managing partner of Valente Associati GEB Partners in Milan.

By means of Ruling No. 22010 of September 25, 2013, on the treatment of interest rates deriving from intercompany loans, Italy's Supreme Court emphasized how, for application purposes of the transfer pricing rules set forth under article 110(7) of the Italian Income Tax Code (Testo Unico delle Imposte sui Redditi, or TUIR), reference should be made to article 9 of the TUIR, which contains the factors that determine whether a transaction is at arm's length.

The ruling also provides useful indications on the theme of the burden of proof; the tax authorities are exclusively required to provide evidence regarding the existence of intercompany transactions that are not at arm's length.

Transfer Pricing and Intercompany Loans

Tax authorities are intensifying their focus on transfer prices involving financial intercompany transactions, such as loans.

Multinational enterprises frequently employ these kinds of transactions in order to optimize the group's financial management as a whole.

In some cases, the tools adopted to optimize financial intercompany resources may turn into authentic tax planning instruments.

For example, as a result of the raising of loans payable with a foreign subsidiary having offices in a low-tax country, companies subject to higher tax rates might transfer, under the form of payment for interest payable, part of their own profit margins to enterprises subject to more favorable tax regimes.

Transfer pricing regulations — and the arm's-length principle in particular — are also applicable to these kinds of transactions, with special reference as to the adequacy of interest rates applied and the ascertainment of the motivations underlying the decisions adopted in connection with intercompany transfer prices.

In the last few years, financial intercompany transactions underwent a significant increase of both an economic trend that discouraged any recourse to external loans that proved to be restrictive and the various opportunities and advantages that taxpayers could attain.

As a result, this also led to increased litigation linked to financial intercompany transactions, because of the discretionary power in evaluations and the high value of transactions.

In order to determine the applicable interest rate to an intercompany loan, the relevant market must first be identified.

The tax authorities' Circular No. 32/1980 identifies the lender's market as the relevant one. In particular, the circular establishes that:

> in compliance with the arm's length principles, in order to ensure the identity of transactions compared, generally the relevant market must be (especially for the sale of tangibles) the one of the receiver of the goods relating to the transaction. With regard to loans, on the other hand, it is the lender's market that must be deemed as the ''relevant'' one.

According to the circular, the concept of the lender's market must be:

> interpreted substantially, meaning thereby the market in which the funds pertaining to the loan were actively collected: a market which does not always coincide with the Country of residence of whomever . . . is qualified as ''Lender.''

Note that some of the courts disagree with the theory stated by the tax authorities in Circular No. 32/1980.

To that effect, in Ruling No. 113 of October 31, 2012, issued by the Provincial Tax Court of Bolzano, relating to the ascertainment of the adequacy of interest rates applied to an intercompany loan from an Italian company to a Luxembourgian company, the court of first instance established that the interest rate, in order to be deemed at arm's length:

> must be identified with an interest rate that would have been agreed within the same term length and location for the loan by independent Italian enterprises towards companies having offices in Luxembourg, also bearing in mind the amount of the loan, the duration of the security, the nature and the subject-matter of the transaction, the lender's financial position, loan guarantee facilities granted and average rates applied in Luxembourg in 2006.

The position adopted under Circular No. 38/1980 must be construed within the same currency and financial context of when it was written. Italy was still using its own currency and considered the potential depreciation rate of single currencies. When the circular was written, rates paid by Italian entrepreneurs for a loan raised in lire were about 20 percent. Obviously, any indebtedness in another currency was less expensive, given the lower risk of that other currency's depreciation. If the debt in dollars costs only 6 percent, any Italian enterprise that would have incurred a debt in that currency would have had to do so on the basis of New York terms and conditions (that is, 6 percent) and not on the basis of Milan's terms and conditions (that is, 20 percent).

Supreme Court Ruling No. 22010

The subject matter of the ruling is a controversy that originated from an assessment notice served by the Italian tax authorities, in which they indicated that the interest deducted (€267,621.86) through a loan granted by the German parent company S.G.L. CA (''the German company'') to its Italian subsidiary S.G.L. C. S.p.A. (''the taxpayer'') was actually subject to tax.

According to the tax authorities, the interest rate applied to the intercompany loan is to be deemed ''considerably higher than the average one applied on the German market, as the relevant official bulletins indicate.'' The taxpayer filed an appeal against the assessment notice and the appeal was upheld by the Provincial Tax Court of Milan.

The court of second instance reversed the decision of the Provincial Tax Court, deciding that the behavior of the tax authorities was appropriate and that, as such, the deducted interest was nondeductible ''in the presence of an obvious transfer pricing transaction'' carried out ''in order to abate — by deducting the relative cost — profits produced in Italy.'' The taxpayer filed an appeal with the Supreme Court, maintaining that the court of second instance deemed existent, in the case at issue:

> a transfer pricing transaction, which purpose was an increase of corporate costs obtained by the Italian taxpayer, recognizing interest payable to the German lending company at a rate higher than the market rate, without — moreover — assessing, for the purposes of establishing whether the transaction involved any avoidance, if taxation in Italy had indeed been higher, at the time the loan was issued, than the one in force in Germany, Country of residence of the lending party.

The usual question arises as to whether the onus to prove that the group's tax advantage is derived from the shifting of profits in a low-tax country rests with the tax authorities.

The Supreme Court rejected the taxpayer's appeal, stating that in order to apply the transfer pricing rules in article 110(7) of the TUIR, the so-called ''normal value'' (or arm's-length value) under article 9 of the TUIR must first be identified.

The provision defines normal value as:

> the price or consideration applied on the average for goods and services of the same or similar kind, under arm's length conditions and at the same identical phase of distribution, at the same time and place in which the goods and services were purchased or loaned and, in the absence of the foregoing elements, at the time and place that are nearest.

Moreover, article 9 of the TUIR establishes that in order to determine the arm's-length value, it is necessary to refer to:

> price lists and tariffs of the party that provided the goods and services, and in the absence thereof, to markets reports and to price lists issued by the Chamber of Commerce as well as to professional tariffs, while taking special discounts into account.

The Supreme Court's position is that the tax authorities acted properly when they ascertained the interest rate applied in the intercompany transaction by referring to the lender's market on the basis of official bulletins issued by the German Bundesbank.

The tax authorities verified that the ''average interest rate applied on the financial-credit market, or rather of the State of residence of the lending party, is lower than the one applied for the loan transaction at issue.'' Therefore, according to the Revenue Office, costs represented by interests deriving from the intercompany loans are to be deemed to have been ''increased for the purpose of boosting the German parent company's profits, while decreasing those of the associated Italian company in order to avoid national taxation, in clear violation'' of article 110(7) of the TUIR.

Regarding the burden of proof, the Supreme Court stated that the burden rests with the tax authorities, which must restrict the scope of evidence solely to the existence of transactions entered into by related parties and of any gap between intercompany prices actually applied and market prices, without the further necessity to prove that the transaction was designed to avoid taxation.

However, the taxpayer has the burden to substantiate:

> not only the existence and relevance of costs deducted, but also any other element that might enable the Revenue Office to regard the transaction as having been effectively carried out on the basis of values to be deemed at arm's length.

The Supreme Court clearly pointed out how the taxpayer failed to provide any element that could contradict the tax authorities' theory in order to substantiate that the consideration agreed by the parties involved (that is, the taxpayer and the German company) — in terms of payable interest deriving from intercompany loans — might have been in line with the average interest applied on the lender's market. ◆