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Italian Supreme Court issues decision on interest-free intercompany loan

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Federico Vincenti and Carola Valente of Valente Associati GEB Partners/Crowe Valente analyse a significant addition to Italy’s case law on the application of transfer pricing regulations to interest-free loans between related parties

Intercompany financial transactions are increasingly carried out by multinational groups to manage and plan the financial needs of group companies.

The Italian Supreme Court, with judgment No. 7361, dated March 19 2024, has revisited the applicability of Italian transfer pricing regulations to interest-free intercompany loans.

From a business perspective, the provision of an interest-free loan by a resident company to a related party is a completely legitimate choice that may stem from reasons unrelated to tax planning dynamics. Generally, opting for an interest-free loan to support a subsidiary can be attributed to situations such as startup ventures involving substantial investments and an expected significant loss in the related party's income statement, or as part of a turnaround plan being implemented by the related party itself.

From a tax perspective, the aforementioned business decision does not present any drawbacks if made towards a resident subsidiary, provided that the non-profitable nature of the financing is documented and there are no presumptions of profitability.

However, when an interest-free financing transaction occurs between an Italian parent company and a foreign subsidiary, doubts may arise regarding the potential applicability of transfer pricing regulations (Article 110, paragraph 7 of the Income Tax Code). This would require the Italian taxpayer – providing the interest-free financing – to declare, within its business income, the notional interest income that would have accrued from the financing, calculating the arm's-length rate. This means the interest rate that would have been applied if the financing transaction had taken place between independent parties.

The Supreme Court's methodology

The Supreme Court has previously expressed varying opinions on this matter.

Some jurisprudence has emphasised the legitimacy of interest-free loans, deeming it unnecessary from a tax standpoint to include an income component (interest rate). Conversely, other jurisprudence has pointed out that no company would finance an independent third party without interest. Therefore, even intra-group financing should involve an interest rate.

The latest judgment aligns with the orientation that, although such transactions fall under the scope of transfer pricing, taxpayers are allowed to demonstrate the 'internal commercial reasons' within the group, connected to the role the parent company assumes in supporting other group entities, justifying the use of interest-free intercompany loans.

Firstly, the Supreme Court establishes the principle of specificity of transfer pricing regulations, which cannot be derogated by agreements stipulating the non-profitability of the financing or interest rates not compliant with the arm's-length principle.

Secondly, the Supreme Court refers to the judgment of the European Court of Justice (case C-558/19, dated October 8 2020), affirming the compatibility of transfer pricing regulations with EU law. Following such principles, the differentiation of transactions with foreign companies compared with domestic ones is justified by the need to ensure a correct allocation of taxing powers among states, provided that the taxpayer is given the opportunity to demonstrate any internal commercial reasons underlying the determination of the intercompany pricing policies.

Consequently, interest-free intercompany loans (or with an interest rate not compliant with the arm's-length principle) cannot be challenged per se, as taxpayers can demonstrate the economic reasons that led to financing related parties not following market conditions.

From a methodological standpoint, the Supreme Court highlighted the need to verify whether the existence of a financing transaction from the resident parent company to the foreign subsidiary has been proven, or whether it constitutes a capital contribution.

With reference to the case at hand, according to the Supreme Court, the trial judges did not adequately evaluate the insolvency conditions of the borrowing companies. Indeed, the judges had merely stated that, in such cases, comparable conditions should be sought in "financing with independent enterprises", in order to identify an arm's-length interest rate.

Implications of the Supreme Court's ruling

Following the Supreme Court's decision, trial judges are required to verify that the interest rate determined by tax authorities was calculated considering:

· Loans with/between independent parties with comparable economic characteristics (i.e., the credit rating of the borrowing companies); and

· Internal commercial reasons strictly related to the intercompany loans.

Therefore, considering the principles established by the Supreme Court, to determine a transfer pricing policy compliant with the arm's-length principle, it is necessary to conduct a thorough analysis of the following economically relevant characteristics that may affect the pricing under review:

- Contractual terms;
- Functions performed, risks borne, and assets used by parties involved in the transaction;
- Characteristics of the financial instruments;
- Economic circumstances; and
- Business strategies.

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