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Intercompany Loans and BEPS: Focus on Italy

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If the BEPS Project is considered formally concluded with the signature of the Multilateral Instrument, the war against base erosion and aggressive tax planning is still ongoing, with many battles remaining to be won. In this context, each and every transaction that can potentially serve aggressive tax planning is key target for policy-makers at the international level as well as for executive authorities at the national one.

Intercompany loans and financial transactions could not but attract the attention as well. Groups of companies often resort to such kinds of transactions for the purpose of optimization of the financial management of the group as well as due to the high cost of lending from third parties. Nevertheless, where implemented cross-border by multinational corporations, intercompany loans can permit manipulation of the taxable base of local group entities, i.e. base erosion and profit shifting.

Following a brief overview of the developments from an international perspective, this paper seeks to outline the stance taken on the matter in Italy in the last few years that have been marked by the launch, evolution and implementation of the BEPS Project.

In the international arena, September 2018 saw the conclusion by the OECD of a public consultation on a discussion draft on the transfer pricing aspects of financial transactions, released earlier the same year. The matter has been touched in the framework of the BEPS Project in a number of different actions. Of critical importance are Action 4 which focuses on interest deductions and financial payments and Actions 8-10 centered on transfer pricing, while Action 3 on CFC rules and Action 6 on treaty abuse are also relevant. In the EU, the Anti-Tax Avoidance Directive (Directive 2016/1164/EU), which introduced anti-BEPS measures at the EU level, included specific rules to limit interest deductions in Article 4.

While the international discussion on the most appropriate rules is ongoing, inter-company loans

have engaged the attention at national level, with the introduction of special legislation as well as with the conduct of targeted investigations. Italy provides an illustrative example.

Italian Legislative Framework

In terms of legislation, the interest rate to be applied to an intercompany loan between an Italian and its foreign related company must be determined, in principle, considering the interest rates in the market of the lender (Circular N. 32/1980 of the Ministry of Finance). It is specified that "market of the lender" should be understood as "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 whoever (…) is qualified as 'lender'".

Furthermore, the Italian provision including the arm's length principle (Article 110 paragraph 7 of the Italian Income Tax Code – TUIR) has been recently amended to be fully in line with the OECD standards.

As regards the deductibility of interest, Italian taxpayers may fully deduct interest expenses to the extent they equate to interest receivables. However, where interest expenses exceed income from interest, they may be deducted up to 30% of the EBITDA (Article 96 TUIR). By virtue of a 2018 amendment (in line with the aforementioned Anti-Tax Avoidance Directive) and with retroactive effect from 1 January 2017, for the purposes of this calculation, EBITDA cannot include dividends from foreign subsidiaries (Budget Law 2018).

Italian Practice and Jurisprudence

In terms of practice, the Italian tax authorities keep providing several opportunities to Italian courts to apply and clarify the above legislation. In fact, intercompany loans to Italian subsidiaries are often subject to investigation, with many cases resulting before the courts, even of last instance. Nevertheless, there seems to be still margin for clarifications.

To begin with, it is clear that the interest rate applicable to intercompany loans must be priced at arm's length. By way of an example, a 2012 decision at first instance regarding an outbound loan to a related company resident in Luxembourg held that suitable interest rate would be "…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". The assessment should take into account the following:

(i) amount of the loan,

(ii) duration of the security,

(iii) the nature and subject-matter of the transaction,

(iv) lender's financial position,

(v) guarantees and average rates applied in the market of the lender in the relevant tax year (*Decision N. 113/31.10.2012 of the Local Tax Court of Bolzano*).

Furthermore, unreasonably high interest payments to a foreign related company – borrower may be recaptured. This has been upheld by the Supreme Court, deciding on an inbound loan from a German parent company (*Decision N. 22010/25.09.2013*). The Court underlined the adequate evidence produced by the Tax Authorities for the calculation of the interest rates in the market of the lender (Germany), on the basis of official bulletins issued by the German Federal Bank. It went on to declare the abusive purpose of the transaction and the violation of the Italian transfer pricing legislation.

More vague seems to be the situation regarding interest-free intercompany loans. In 2015, the Supreme Court considered an interest-free outbound loan, where according to the Italian Tax Authorities, correct application of the arm's length principle would imply charge of interest. Specifically, the Italian borrowing company had granted a cross-border loan without the application of interest – which is allowed from a civil law perspective. The Italian Tax Authorities considered that the loan should have been granted with interest and sought to recapture the relevant amounts. However, the Supreme Court considered that the arm's length principle was not applicable in this case, highlighting that the interest-free character of the loan could be deemed an indicator that it was not abusive (*Decision N. 15005/17.07.2015*).

One year later, in 2016, the Supreme Court considered a slightly different scenario. It was called to decide on outbound interest-free payments to related companies that were justified as payments in advance for future capital increases. In this case, the Court affirmed the re-qualification of the transaction made by the Italian Tax Authorities, emphasizing that relevant was the economic substance. The Court clarified that the fact that the re-qualified loan would be interest-free did not suffice in itself to exclude the application of the arm's length principle (*Decision N. 7493/15.04.2016*).

Summing up, inter-company loans set forth interesting questions not only for legislators, policy-makers and tax authorities but also for multinationals. While they constitute a key instrument for group financing, they involve serious risk to be used as base erosion tool. Relevant legislation and practice may be expected to evolve further in the upcoming years, necessitating close monitoring by multinationals and regular update of their practices.

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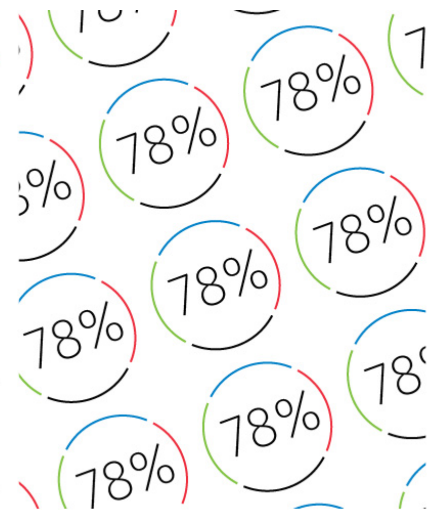

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