Italy: Transfer pricing of financial transactions – proper classification and recharacterisation risk

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Federico Vincenti and Carola Valente of Valente Associati GEB Partners/ Crowe Valente examine how the Italian tax authorities scrutinise financial transactions and cash pooling arrangements, with potential recharacterisation risks under transfer pricing rules

In recent years, the Italian tax administration has shown increased attention to intragroup transactions involving financial instruments – such as cash pooling arrangements and financial loans – and their proper classification.

With regard to cash pooling arrangements, the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the OECD Guidelines) highlight that such agreements enable a multinational group to offset the cash balances of participating entities, thereby improving the efficiency of the group's short-term liquidity management. Participation in a cash pooling arrangement can, on the one hand, reduce the group's reliance on the banking system and, on the other hand, allow it to achieve a higher return on the aggregated current account balance in the event of a liquidity surplus.

That said, the OECD Guidelines go on to examine several issues related to the accurate delineation of cash pooling transactions.

The guidelines emphasise that such analysis must consider the fact that independent third parties would not typically engage in similar arrangements. It is also important to recognise that, as a general principle, no participant would enter into a cash pooling arrangement unless it offered greater benefits than those available from realistically accessible alternative options.

Additionally, the assessment should evaluate whether any cost savings can be attributed to group synergies arising from deliberate and coordinated actions.

A common example of a benefit generated by cash pooling – typically subject to allocation among participants after deducting appropriate remuneration for the pool leader – is a reduction of interest expenses or an increase in interest income resulting from the consolidation of debit and credit balances across group entities.

Another critical aspect in the accurate delineation of a cash pooling transaction involves participants that consistently maintain creditor or debtor positions. If such positions remain unusually stable over time, this may indicate that the arrangement does not represent a genuine cash pooling relationship – which, by nature, involves short-term fluctuations – but a different financial arrangement, such as a medium- or long-term loan. In such cases, it becomes difficult to determine what maximum duration of a financial position remains compatible with a cash pooling arrangement. On this point, the OECD Guidelines clarify that: "As cash pooling is intended to be a short-term, liquidity-driven arrangement, it may be appropriate to consider whether the same pattern is present year after year and to examine what policies the MNE group's financial management has in place, given that yield on cash balances is a key financial management issue."

Italian Supreme Court case considers zero-balance cash pooling arrangements

In its ruling No. 998/2024, the Italian Supreme Court addressed several key aspects of the so-called zero-balance cash pooling arrangement, offering important insights for multinational groups that adopt centralised treasury management structures.

The case heard by the Italian Supreme Court originated from a tax audit in which the national tax authorities recharacterised an existing zero-balance cash pooling agreement between an Irish parent company and its wholly owned Italian subsidiary as a medium-to-long-term loan.

This requalification was based on several factual elements identified during the audit, including:

- Throughout the period under review, the Italian subsidiary did not utilise intercompany credit facilities but instead transferred only its surplus cash to the centralised treasury;
- Transfers to the treasury did not occur daily but at longer intervals; and
- During the effective term of the cash pooling agreement, the Italian entity maintained sufficient funds in its own account to operate autonomously.

Based on these factors, the tax authorities concluded that the arrangement deviated materially from what was formally declared and effectively constituted a medium-to-long-term financing by the Italian subsidiary to its Irish parent company.

Consequently, they adjusted the taxable base by imputing additional interest income, calculated at arm's length pursuant to Italian transfer pricing regulations using average yields on fixed-income securities as a benchmark.

In its reasoning, the Supreme Court stated that the agreement in question could not be considered a genuine cash pooling arrangement. It emphasised that:

- Transfers were not made on a daily basis but at longer intervals;
- Only excess funds were transferred by the Italian company to the Irish parent company;
- The Italian entity never accessed credit from the Irish parent company; and
- The Italian entity consistently retained sufficient liquidity to operate independently.

The recharacterisation of shareholder loans as equity

Another issue addressed by the Italian tax administration, related to the application of the arm's-length principle to financial transactions, concerns the recharacterisation of interest-bearing loans as equity contributions for tax purposes.

Italian tax authorities may recharacterise a shareholder loan as equity when certain objective indicators are present, such as:

- The repayment of principal and the payment of interest are deferred until after the full repayment of principal and payment of interest owed to third-party lenders;
- The financial ratios defined in the financial covenants, which establish the conditions of default, do not include shareholder loans and related interest in the definition of debt and interest; and
- The payment of interest and the repayment of principal are subject to the same restrictions as dividends and reductions of share capital or capital reserves.

Such a recharacterisation is exceptional in nature and cannot be based on mere presumptions; it requires a concrete analysis of the specific case, clearly evidencing the role of the funds in dealings with independent third parties.

On the other hand, it is essential for taxpayers to structure the financial transaction by adopting conduct that is genuinely consistent with the main features of the chosen financial instrument, clearly explaining any business or market reasons that may have led to a deviation from the conduct typically observed between independent third parties.

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