Italy

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Italian Tax Consequences of Permanent Establishments

This article considers some of the main features of Italy's tax policies and practices regarding the taxation of permanent establishments (PEs). Specifically, the article discusses the definition of PE in domestic law and tax treaties and sets out Italy's approach to attributing profits to PEs.

1. Introduction

The authors, in this article, examine some of the main features of Italy's tax policies and practices regarding the taxation of permanent establishments (PEs) in Italy. The article only deals with PEs in Italy of non-resident companies. It also discusses the definition of PE in domestic law and tax treaties and sets out Italy's approach to attributing profits to PEs, referring to the relevant case law and administrative practices. The article ends with some conclusions from the authors.

2. The Existence of a PE

2.1. In general

The question "Is there a permanent establishment?" is probably the most frequent treaty issue that advisers, government officials and courts have to deal with. These words, which opened the general report of the 2009 International Fiscal association (IFA) Congress,[1] are also true for Italy.[2] The existence of a PE of a non-resident taxpayer in Italy has several implications, which may be summarized as follows:

- the business income derived through the PE is deemed to be derived from Italy (for income tax purposes and, if the PE exists for at least three months, also for purposes of the regional tax on productive activities);
- the existence of a PE affects the withholding tax applicable on payments attributable to it, as payments made to an Italian PE of non-resident persons are normally not subject to Italian withholding taxes;
- various items of income (for example, interest, royalties and pensions) paid through the Italian PE to non-resident persons are considered to be sourced in Italy;
- it obliges the non-resident to act as a withholding agent on payments borne by the PE;
- it may extend Italy's taxing rights to certain items of income not attributable to the PE (the "force of attraction" principle);
- it may allow the rollover relief for capital gains arising from cross-border merger and acquisition transactions, including transfer of residence abroad;
- it allows the non-resident to act as head entity of a domestic tax group when the participations in the controlled companies are part of the PE's net equity;
- it entitles the non-resident to apply for an advance pricing agreement (APA);
- it creates an obligation to prepare financial statements to determine the total taxable income of the non-resident and the obligation to file an annual tax return; and
- it creates other accounting and regulatory obligations.

Finally, the relevance of the existence of a PE in Italy from an EU law perspective – in particular, in relation to the freedom of establishment,[3] non-discrimination principles and EU Directives – cannot be ignored.

2.2. Treaty versus domestic definition

The domestic notion of a PE was introduced with effect from 1 January 2004. This was based on a Parliamentary delegatory law,[4] which provided that the PE definition should be based on the criteria in Italian tax treaties (which generally follow the 1963 OECD Model Tax Convention, "the OECD Model"). Consequently, apart from some specific features of the domestic concept, the interpretation of the PE definition should not dramatically differ in domestic as compared to treaty situations.

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1. "Is there a permanent establishment?", *IFA Cahiers de droit fiscal international*, Vol. 94A (Amersfoort: Sdu, 2009).
2. On the definition of PE under Italian law, see E. Della Valle, "La nozione di stabile organizzazione nel nuovo Tuir", *Rassegna Tributaria* 5 (2004), pp. 1597-1661; L. Favi, "Italy", in *IFA Cahiers de droit fiscal international*, supra note 1, pp. 393-410; M.Iavagnilio, "La nozione domestica di stabile organizzazione", *Corriere Tributario* 12 (2004), pp. 896-900; S. Mayr, "Riforma Tremonti: la definizione di stabile organizzazione", *Bollettino Tributario* 18 (2003), pp. 1291-1293; E. Pedrazzini and R. Russo, "Permanent Establishments under Italian Tax Law: an Overview", *European Taxation* 8/9 (2007), pp. 389-397; L. Perrone. "La stabile organizzazione", *Rassegna Tributaria* 3 (2004), pp. 794-803; and C. Romano , "Subsidiaries as Permanent Establishments: The *Philip Morris* Case", *European Taxation* 9 (1998), pp. 315-320.
3. It should be noted that, in Case C-337/08 *X Holding BV* (25 February 2010), the ECJ confirmed (Para. 38) its previous case law, according to which "Permanent establishments situated in another Member State and non-resident subsidiaries are not in a comparable situation with regard to the allocation of the power of taxation as provided for in an agreement such as the Double Taxation Agreement, and in particular in Articles 7(1) and 23(2) thereof. Whereas a subsidiary, as an independent legal person, is subject to unlimited tax liability in the State party to such an agreement in which that subsidiary is established, the same does not apply in the case of a permanent establishment situated in another Member State, which remains in principle and in part subject to the fiscal jurisdiction of the Member State of origin."
4. Legislative Decree 344 of 12 December 2003.

In this article, the authors only highlight the main differences, where relevant. As the question of the existence of a PE is more a matter of facts rather than a question of law, the authors also refer to cases dealt with by the Italian Supreme Court (*Corte di Cassazione*) or the Italian tax authorities.

It should be noted that, in this respect, domestic income tax law provisions can apply, regardless of treaty provisions, whereas the former are more favourable for the taxpayer than the latter, according to Art. 169 of the Income Tax Law (ITL). This may be important where the activities carried out in Italy constitute a PE under the relevant tax treaty, but not under Art. 162 of the ITL.

2.3. Fixed place of business PE

2.3.1. Definitions

Under domestic tax law, a PE is defined as a fixed place of business through which the business of the non-resident enterprise is wholly or partly carried on in Italy.[5] Consequently, in order for a PE to be deemed to exist in Italy, there must be: (1) a place of business; (2) which is permanent from a geographical as well as a temporal perspective; and (3) through which its business is carried on.

In some old rulings, the tax authorities also argued that to have a PE in Italy the place of business should be functionally autonomous from its head office, also from a managerial perspective, and should have a productive character per se.[6] This position, which was influenced by the Civil Code (CC) definition of "secondary establishment with permanent representation" contained in Art. 2506 of the CC, was definitively denied by the Supreme Court in *Philip Morris*.[7]

With regard to specifically the permanency requirement, the noted German pipeline case, where a German Court held that the part of the pipeline of a Netherlands company within the German territory represented a PE,[8] has its Italian companion in a ruling by the tax authorities where a railway track and a railway station in Italy of a Swiss company used to carry out the company's activities were deemed to be a PE.[9] It should be noted that, along the same line of reasoning, in a more recent ruling dealing with a foreign place of business regarding the recognition of a foreign tax credit in Italy, the tax authorities recognized that a gas pipeline in Tunisia may constitute a PE.[10]

The geographical permanency of the place of business was expressly dealt with by the Supreme Court in a case concerning a Liechtenstein company that purchased real estate in Italy to carry out its tourist business. The Supreme Court held that the real estate could give rise to a PE in respect of the activities, which are carried on in Italy, when the immovable property is instrumental in the carrying-on of the business or is the object of the activity.[11] Temporal permanency has also been dealt with in some Italian court decisions where it has been specified that the duration of a place of business should be considered in the light of the activities effectively carried on.[12]

The business of the enterprise must be carried on through the fixed place of business, which must be at the disposal of the non-resident enterprise. With regard to the concept of disposal, the Supreme Court considered a non-resident doctor to have a PE in Italy, as he used a space in an Italian hospital where he regularly conducted his medical activity.[13] This view also appears to have been adopted by the tax authorities, which considered that a US bank could have a fixed place of business in Italy, if it had at its disposal offices within US military bases located in the Italian territory.[14]

2.3.2. Examples

Art. 162, Para. 2 of the ITL contains a list of examples of PEs. These are: (1) a place of management; (2) a branch; (3) an office; (4) a factory; (5) a workshop; and (6) a mine or an oil or gas well, a quarry or other place for the extraction of natural resources, including areas outside the territorial waters in which, in accordance with customary international law and the relevant domestic legislation on the exploration for and the exploitation of natural resources, Italy can exercise its rights upon the seabed, the subsoil and its natural resources.

The list of examples contained in Italian domestic law is also generally found in Italian tax treaties, though with some deviations. In particular, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources are noted as examples of PEs only in a minority of the Italian tax treaties,[15] whereas some additional examples – such as a farm, a plantation, a sales installation and a warehouse – may be found in some other tax treaties.[16]

Italy considers the examples to be a priori PEs, in line with the observation contained in the Commentary on Art. 5 of the OECD Model.[17] This observation indicates

5. Art. 162, Para. 1 ITL.
6. Ruling No. 460196 of 13 December 1989.
7. Supreme Court Decision No. 10925 of 25 July 2002, also referring in this respect to previous Supreme Court Decisions Nos. 8815 and 8820 of 27 November 1987 and No. 5580 of 19 September 1990. Various Supreme Court judgements on both corporate income tax and VAT issues, and for different fiscal years, are dealt with in *Philip Morris*, such as Supreme Court Decisions Nos. 3367, 3368 and 3369 of 7 March 2002; No. 431926 of 26 March 2002; Nos. 7682 and 7689 of 25 May 2002; No. 10925 of 22 September 2002; and No. 17373 of 6 December 2002.
8. *Bundesfinanzhof*, Munich, II R 12/92 of 30 October 1996.
9. Resolution No. 282 of 11 December 1995.
10. Resolution No. 83 of 7 March 2008.
11. Supreme Court Decision No. 9580 of 19 September 1990. Other more general remarks may be found in Supreme Court Decision No. 8815 of 27 November 1987.
12. Supreme Court Decision No. 9580 of 19 September 1990 and Central Tax Court (*Commissione Tributaria Centrale*) Decision No. 765 of 1 February 2001.
13. Supreme Court Decision No. 3731 of 14 March 2001.
14. Resolution No. 141 of 10 April 2008.
15. This is the case for the tax treaties concluded with Bangladesh, Belarus, China (People's Rep.), Croatia, Denmark, Estonia, France, Germany, Greece, India, Indonesia, Ivory Coast, Kazakhstan, Kenya, Libya, Lithuania, Malaysia, Mexico, New Zealand, Norway, Saudi Arabia, Sri Lanka, Syria, Tanzania, Turkey, the United Kingdom, the United States and Vietnam.
16. This is the case with the tax treaties concluded with Algeria, Australia, Bangladesh, Greece, India, Ivory Coast, Kazakhstan, Malaysia, Pakistan and Saudi Arabia.
17. Para. 43 of the Commentary on Art. 5 of the OECD Model reads as follows: "*Italy* does not adhere to the interpretation given in paragraph 12 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting *a priori* permanent establishments".

that, in Italy's view, the conditions required by Art. 5(1) of the OECD Model are presumptively considered to be met, unless the taxpayer gives proof to the contrary. In other words, in interpreting Italian tax treaties and domestic law, the OECD's positive list should be considered to be a list of deemed PEs rather than a list of mere examples.

2.3.3. Construction PE

Art. 162, Para. 3 of the ITL provides that a building, assembly or installation site, or supervisory activities connected therewith, are considered to be a PE, provided that such site, project or activities last for a period of more than three months. This provision is normally included in the list of examples (corresponding to Art. 5(2) of the OECD Model) in Italian tax treaties. The provision is drafted along the lines of Art. 5(3) of the OECD Model, with two main differences: (1) the three-month period; and (2) the express reference to supervisory activities.

Whereas in the OECD Model the minimum duration is of 12 months and in Italian tax treaties the minimum duration varies from 3 to 36 months, a very short period has been chosen for the domestic PE definition. This is clearly intended to widen Italy's taxing rights, but may also have repercussions for the purposes of granting double taxation relief to Italian construction enterprises operating in non-treaty states.

With regard to supervisory activities, only a minority of tax treaties concluded by Italy expressly includes supervisory activities within the definition of a construction PE.[18] It should be noted that, in a few Italian tax treaties, the provision of services (including consultancy services), by an enterprise through employees or other personnel connected to the site is also deemed to constitute a PE.[19]

2.3.4. Excluded activities

One of the most debated issues in the definition of PEs is the scope of the list of excluded activities. This list is contained in Art. 162, Para. 4 of the ITL, which is based on Art. 5(4) of the OECD Model. Contrary to the domestic and the OECD list of excluded activities, tax treaties concluded by Italy do not contain a provision according to which "the maintenance of a fixed place of business solely for any combination of the activities stated in (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character" is excluded.

Although it could be argued that, in theory, this provision restricts the PE concept, the authors believe that in practice the lack of the previously noted provision is not relevant as far as the overall character of the combined activities remains of a preparatory or auxiliary nature. In relation to the scope of the list of excluded activities, it should be noted that these provisions are considered to be exceptions to the general rule. Consequently, in line with a general unwritten principle of Italian law, which is, however, judicially implemented in a consistent manner, provisions containing exceptions to more general rules should be interpreted literally and in a narrow way.

Through the application of this general principle, in some old rulings, a PE was identified in the maintenance of an office in Italy by a Swiss resident company for the purpose of purchasing goods in Italy where, however, 10% of these goods were manufactured, processed and packaged in Italy.[20] In *Philip Morris*, the Supreme Court also stated that control and supervision over the performance of a contract between a resident and a non-resident cannot, in principle, be considered to be an auxiliary activity. In another case, a PE was considered to exist in relation to the purchasing of receivables and related credit collection activities carried out in Italy, directly or through unrelated professionals, by a San Marino company.[21] On the other hand, the tax authorities considered that no PE existed in a case where advertising, market surveys and quality control activities were carried out in Italy in the name and on behalf of a UK entity.[22] Finally, in another ruling,[23] the tax authorities affirmed that: (1) the storage of the goods and/or merchandise; (2) quality control and arrangement of the lots of goods and/or merchandise; (3) the delivery of goods and/or merchandise to the head office or to its clients through third-party carriers; and (4) the provision of information related to sales and orders are activities of an auxiliary nature, do not give rise to a PE.

2.3.5. Server PE

Art. 162, Para. 5 of the ITL provides that the disposal of electronic processors and auxiliary equipment that enable the collection and transfer of data and information for the purpose of selling goods and services does not, in itself, constitute a PE. This provision appears to be in line with the Commentary on Art. 5 of the OECD Model. The tax authorities identified a PE in an Internet server of a French company located in Italy, through which the French company was selling online video games to Italian customers. Although the activity was organized directly from France, the server was owned by, or in any case was at the exclusive disposal of, the French company, and located in the same place for a significant period of time.[24]

2.3.6. Agency PE

Art. 162, Paras. 6 and 7 of the ITL contain the definition of agency PE, mirroring that of Art. 5(5) and (6) of the 1963 OECD Model. According to Art. 162, Para. 6 of the ITL, subject to Para. 7, a resident or non-resident person that habitually concludes contracts in Italy in the name of a non-resident enterprise, different from the purchase

18. This is the case with the tax treaties concluded with Algeria, Australia (including an assembly project), China (People's Rep.), Estonia, Indonesia, Israel, Ivory Coast, Kazakhstan, Kenya, Lithuania, Mexico, Pakistan, the Philippines (including consultancy activities), Saudi Arabia, South Africa, Turkey and Vietnam.
19. This is the case with the tax treaties concluded with the Philippines and Saudi Arabia.
20. Resolution No. 533 of 21 July 1983.
21. Resolution No. 41 of 9 March 2007.
22. Resolution No. 501504 of 7 December 1991.
23. Resolution No. 21 of 27 January 2009.
24. Resolution No. 119 of 28 May 2007.

of goods, constitutes a PE in Italy of the non-resident enterprise. Under Art. 162, Para. 7 of the ITL, the mere fact that a non-resident enterprise exercises its activity in Italy through a broker, general commission agent, or any other agent of an independent status does not create a PE, provided that those persons act in the ordinary course of their business.[25]

In contrast to the OECD definition of an agency PE, which refers to any activity carried on by the agent on behalf of the non-resident enterprise, Italian domestic law only refers to the conclusion of contracts in the name of the enterprise (as noted in 3., this may have an effect on the attribution of profits to such an agency PE). In addition, different from the OECD definition of agency PE, under which a dependent agent does not give rise to a PE if the activities are of an auxiliary or preparatory nature, the Italian domestic provisions do not exclude all activities that are of a preparatory or auxiliary nature, but only the purchase of goods.

Case law and the rulings of the tax authorities are available with reference to the definition of PE in some tax treaties concluded by Italy. In some old rulings, the tax authorities held that the fact that an agent is acting on behalf of a single principal is evidence of dependence and that agents acting as exclusive representative of one enterprise should not be considered to be independent agents acting in the ordinary course of business.[26] In *Philip Morris*, the Supreme Court held that the participation of officers or representatives of an Italian company (even if with no power of representation) in phases of the negotiation or conclusion of contracts formally executed by other non-resident companies, should be considered to be evidence of an authority to conclude contracts in the name of a foreign company for the purposes of assessing the existence of an agency PE in Italy. The Supreme Court also held that the Italian company was not acting in the ordinary course of its business when providing services to the non-resident companies, which were not included in its statutory business purpose, and were performed without any formal mandate by the non-resident group companies. It should be noted that, in the course of the 2005 update of the OECD Commentaries, Italy made the following observation with regard to the Commentary on Art. 5 of the OECD Model: "Italy wishes to clarify that, with respect to paragraphs 33, 41, 41.1 and 42, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs...."[27]

In a recent case dealing with an agent of a Swiss resident company, the Supreme Court confirmed its previous case law, according to which no decisive relevance may be attributed to the 2005 modification to the Commentary on Art. 5 of the OECD Model. The Supreme Court also stated that, in the Italian interpretation of the term, evidence of the existence of an agency PE can also be inferred when: (1) the agent, although having representative powers, has no decision powers over the terms of the contracts concluded in the name of the foreign company; or (2) he participates in negotiations, even if he has no representative powers.[28]

2.3.7. Group companies and PEs

Art. 162, Para. 9 of the ITL states that the fact that a non-resident enterprise, with or without a PE in Italy, controls or is controlled by a resident enterprise, or that they are both controlled by a third party, does not, in itself, result in either enterprise constituting a PE of the other. The scope of this provision appears to be wider than the similar provision contained in Art. 5(7) of the OECD Model, as it refers to enterprises, whereas the OECD Model refers to companies, and explicitly notes the situation of companies subject to a common control, which the OECD Model does not explicitly refer to (though it refers to any company forming part of a multinational group in Para. 41.1 of the Commentary on Art. 5).

In a case concerning inheritance tax, the Supreme Court held that the circumstance that a company of a contracting state controls or is controlled by a company of the other state does not constitute autonomous evidence of the existence of a PE, but should be evaluated in light of the other circumstances of the case.[29] The Supreme Court also held in *Philip Morris* that an Italian company of a multinational group may be considered to be acting in Italy for the benefit of the several companies within the group, regardless of the relationships between the Italian company and each single non-resident group company. In particular, the Supreme Court stated that the activities of an Italian resident company may give raise to a PE of several foreign companies belonging to the same group and pursuing a common business strategy. In this case, the assessment of whether or not the activities performed in Italy have an auxiliary character should be made in the light of such a common business strategy of the whole group.[30]

3. Attributing Profits to a PE in Italy

3.1. General rules

The taxable income of non-resident companies operating in Italy through a PE is subject to corporate income tax (IRES) at a rate of 27.5%. The regional tax on productive activities (IRAP) at a rate of 3.9% also generally applies, provided that the non-resident company maintains a PE in Italy for at least three months.

25. Art. 162, Para. 8 of the ITL contains a special provision on agency PE, which provides that the mere fact that a company carries on business through a maritime agent or maritime mediator with authority in respect of the commercial or operational management of the company's shipping vessels, including on a continuous basis, does not constitute a PE.
26. Resolution No. 350300 of 21 January 1957. See also Circular letter No. 7/1496 of 20 April 1977.
27. E. Cacciapuoti and R. Russo, "Multinational Enterprises and Permanent Establishments: the *Philip Morris* Case", in R. Russo and R. Fontana (eds.), *A Decade of Case Law* (Amsterdam: IBFD, 2008), pp. 88-124 and C. Innamorato, "The concept of a Permanent Establishment within a Group of Multinational Enterprises", *European Taxation* 2 (2008), pp. 81-84.
28. Supreme Court Decision No. 8488 of 9 April 2010, also referring to Decision No. 17206 of 28 July 2006.
29. Supreme Court Decision No. 13579 of 17 April 2007.
30. See the discussion in 2.3.6. regarding the 2005 changes to the OECD Commentaries and the observations inserted by Italy into Paras. 33, 41 and 42 of the Commentary on Art. 5(7) of the OECD Model.

Italy adopts the "separate entity" approach to determine the profits attributable to a PE.[31] Accordingly, the PE must be treated as a separate and independent enterprise in its dealings with the other parts of the enterprise of which it is a part. Specifically, according to Art. 152, Para. 1 of the ITL, the income attributable to an Italian PE of a non-resident enterprise should be calculated on the basis of the same rules applicable to resident companies, on the basis of a separate profit and loss account of the PE. Further, Art. 14 of the Tax Assessment Law states that non-resident enterprises with a PE in Italy are required to provide separate documentary evidence of the activities carried out through that PE, determining separately the results of each branch of activity.

The great majority of the tax treaties entered into by Italy are generally based on Art. 7 of the OECD Model. The Italian tax treaties with Algeria, China (People's Rep.) and Turkey are, however, based on the UN Model Tax Convention ("the UN Model"), thereby expressly denying the relevance of internal payments made by a PE to its head office and vice versa (other than the reimbursements of actual expenses incurred) in the form of royalties, fees or other similar payments for the use of patents or other rights or commissions for services rendered or for a management activity or, except in the case of a banking establishment, of interest on amounts lent to the head office of the enterprise or any of its other establishments.

It is worth noting a tendency of the tax authorities to use presumptive taxation to determine the profits attributed to "hidden" PEs and to start from the total turnover of the non-resident enterprise as appears in the latter's VAT return. The application of presumptive taxation methods to attribute profits to PEs is quite widespread in Italy and abroad.[32] This is generally understood to be in line with Art. 7 of the OECD Model, at least in cases where no separate accounts are available, as generally happens in the case of "hidden" PEs. The consistency with Art. 7 of such methods is generally based on Art. 7(4) of the tax treaties based on the OECD Model, although some consider that this can be based directly on Art. 7(2) and (3), without any need to refer to Art. 7(4).[33]

3.2. Force of attraction

Italian domestic law is rather peculiar regarding the application of the "force of attraction" principle. Specifically, under Art. 23 of the ITL, business income derived by a non-resident is deemed to be derived from Italy and is, therefore, taxable in Italy, but only if such income is derived through a PE located in Italy. On the other hand, Art. 151, Para. 1 of the ITL states that the total taxable income of non-resident companies includes all the items of income derived from Italian sources, except for income subject to a final withholding or substitute tax. Art. 151, Para. 2 of the ITL specifies that income is deemed to be derived from Italian sources according to the sourcing rules applicable to income derived from abroad by resident companies, taking into account, in the case of business income, also: (1) capital gains or losses on assets used for business purposes in Italy, even if not effectively connected with an Italian PE; (2) dividends distributed by resident companies; and (3) miscellaneous income derived from activities in Italy or related to assets located in Italy, including capital gains on the sale of certain participations in Italian companies.

The tax authorities appear to take the position that no "force of attraction" should apply. Accordingly, income from assets not effectively connected with the PE should not be treated as business income attributable to a PE, but, rather, retain its nature and be taxed accordingly.[34] In any event, most Italian tax treaties are based on the OECD Model[35] and would, therefore, prevent the application of such a force of attraction principle, which could, however, be invoked by the taxpayer if more favourable – for example, to claim an exemption on dividends paid by Italian resident companies, even though not attributable to the PE in Italy of the non-resident recipient.[36]

3.3. Allocating functions, assets, risks and free capital to PEs

There is no specific guidance on how to hypothesize the PE as a separate and independent enterprise, in particular, with regard to the allocation of assets (including free

31. For an analysis of the attribution of profits to a PE and of the "separate entity approach", see P. Baker and R. Collier, "2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments", *Bulletin for International Taxation* 5/6 (2009), pp. 199-203; P. Baker and R. Collier, "The attribution of profits to permanent establishments", *IFA Cahiers de Droit Fiscal International*, Vol. 91b (Amersfoort: Sdu Fiscale & Financiële Uitgevers, 2006), pp. 21-67; B.J. Arnold, "Fearful Symmetry: The Attribution of Profits 'in each Contracting State'", *Bulletin for International Taxation* 8 (2007), pp. 312-337; M. Bennett, "The Attribution of Profits to Permanent Establishments: The 2008 Commentary on Art. 7 of the OECD Model Convention", *European Taxation* 9 (2008), pp. 467-471; M. Bennett and R. Russo, "OECD Project on Attribution of Profits to Permanent Establishments: An Update", *International Transfer Pricing Journal* 5 (2007), pp. 279-284; R. Russo, "Application of Arm's Length Principle to Intra-Company Dealings: Back to the Origins", *International Transfer Pricing Journal* 1 (2005), pp. 7-15; R. Russo, "Tax Treatment of 'Dealings' Between Different Parts of the Same Enterprise under Article 7 of the OECD Model: Almost a Century of Uncertainty", *Bulletin for International Fiscal Documentation* 10 (2004), pp. 472-485; and R. Russo, *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-Company Dealings* (Amsterdam: IBFD Publications, 2005). For an analysis of the attribution of profits to PEs and the application of the "separate entity approach" under Italian law, see M. Antonini, "Italy", in "The attribution of profits to permanent establishments", *IFA Cahiers de Droit Fiscal International*, Vol. 91b (Amersfoort: Sdu Fiscale & Financiële Uitgevers, 2006), pp. 423-444; A. Fantozzi and A. Manganelli, "Qualificazione dei redditi prodotti da imprese estere in Italia: applicabilità della normativa sui prezzi di trasferimento nei rapporti tra stabile organizzazione e casa madre", in *Facoltà di Giurisprudenza, Università di Genova* (ed.), *Studi in onore di Victor Uckmar* (Padua: CEDAM, 1997); M. Gazzo, "Attribution of free capital to permanent establishment of a bank: a vexed issue, a general overview and the Italian 'state of the art'", *Intertax*, Vol. 37, No. 11 (2009), pp. 647-653; M. Iavagnilio, "La tassazione delle stabili organizzazioni", *Corriere Tributario* (2001), p. 1168; and G. Maisto, *Il 'transfer price' nel diritto tributario Italiano e comparato* (Padua: CEDAM, 1985).

32. Baker and Collier, *IFA Cahiers de Droit Fiscal International*, supra note 31, p. 41.

33. Para. 24 of the Commentary on Art. 7 of the OECD Model.

34. Circular letter No. 165 of 24 June 1998.

35. Tax treaties based on the UN Model, thereby allowing a limited force of attraction, include those with India, Indonesia, Kazakhstan, Kenya, Mexico, Pakistan, Turkey and Uzbekistan.

36. Italy still has a reservation on Arts. 10, 11 and 12 of the OECD Model, according to which it reserves the right to subject dividends, interest and royalties to the taxes imposed by its law whenever the recipient has a PE in Italy, even if the asset that generates the income is not effectively connected with such a PE. In view of this position of the tax authorities, it is not clear why this reservation is still there.

capital) and risks. It can safely be stated, however, that, if the PE accounts reflect the underlying economic substance, they are respected by the tax authorities.

With regard to the determination of the free capital of the PE, in a recent ruling the tax authorities appeared to refer to both the "capital allocation approach" and the "thin capitalization approach", without taking a decisive position on which of the two methods should be applied.[37] In practice, it appears that a quasi-thin capitalization method is often used for PEs of regulated enterprises.

3.4. Intra-company dealings

3.4.1. Initial comments

According to the wording of Art. 110, Para. 7 of the ITL, dealings between non-resident companies and their Italian PEs clearly fall within the application of the transfer pricing rules. This interpretation has been previously confirmed by the tax authorities.[38] In 3.4.2. to 3.4.5., the authors analyse the different types of dealings that could occur between an Italian PE and the rest of the enterprise of which it is a part.

3.4.2. Transfer of assets

Transfers of assets (trading stock or capital assets) from an Italian PE to its head office abroad must be made at arm's length. Transfers of assets (trading stock or capital assets) from a non-resident company to its Italian PE should be taken into account at "market value" for purposes of determining the income attributable to the PE.

3.4.3. Intangibles

Although there is no clear guidance in this respect, it appears that an Italian PE should include in its taxable income notional royalties deemed to be paid by the foreign head office for the use of intangibles that have been acquired and/or developed through the PE. The arm's length price of notional royalties paid by the Italian PE to its foreign head office should be deductible from the PE's taxable income. These conclusions are based on the general application of the arm's length principle to PEs, as provided for under domestic law. They have not, however, been expressly confirmed by the tax authorities and may be limited by the application of a relevant tax treaty.

3.4.4. Services

The same principles and criteria used in the case of intra-group services should be applied here. The tax authorities have dealt specifically with the provision of intra-company services and distinguished between services provided only for the benefit of the Italian part of the enterprise and those that were carried out by one part of the enterprise, but for the benefit of the enterprise as a whole.[39] In the first case, the arm's length price for the service provided must be directly attributed to the Italian part of the enterprise. With regard to the second case, the tax authorities have concluded that only the actual expenses, without a markup, must be allocated to the PE, using an apportionment method based on the percentage of the global revenues generated by the Italian PE.

Previously, the allocation and deductibility of head office expenses gave rise to uncertainties, especially considering the tax authorities' position, which often denied their deductibility for lack of connection with the activities of the PE.[40] More recently, the tax authorities have allowed the deduction, subject to their effective existence and the appropriateness of their allocation.[41] It has also been acknowledged that the allocation of head office expenses could be done through formulas that take into account the benefits which each part of the enterprise derives.[42]

The courts have also acknowledged the deductibility of the expenses in question, thereby clarifying that, in the event of disputes with regard to the allocation factor, the taxpayer bears the burden of proving that the services in question have been provided, are inherent to the production of revenues, and are priced in accordance with the arm's length principle.[43] In a recent decision, the Supreme Court stated that the tax authorities may only disregard accounting firms' reports and audited financial statements when they are in the position to prove that such documents are erroneously or improperly drafted. Accordingly, a deduction for expenses allocated to the PE, if properly reported in its books, should be allowed.[44]

3.4.5. Interest

The tax authorities have expressly stated that the arm's length principle applies to notional interest deemed to be paid by an Italian PE to its foreign head office.[45] The tax authorities have also held that sums received by an Italian PE from its foreign head office could be treated as loans, rather than as deemed capital contribution, and that such deemed loans would generate interest expenses at their "normal value". It is unclear whether or not this is still the position of the tax authorities.[46] Once the free capital has been determined, a deduction is allowed for an amount of interest that an independent party would have paid. With regard to the case of an Italian PE transferring funds to its head office abroad, the administrative practice appears to recognize notional interest payments and, therefore, an arms' length notional interest should be included in the PE's taxable income. Again, this may be limited by the application of the relevant tax treaty.

37. Resolution No. 44 of 30 March 2006.
38. Circular letter No. 32 of 22 September 1980.
39. Ministerial Resolution No. 9/2555 of 31 January 1981.
40. Circular letter No. 90 of 17 July 1995.
41. Circular letter No. 271 of 21 October 1997.
42. Resolutions No. 59266 of 11 July 2000 and No. 135102 of 9 August 2002.
43. Central Tax Court Decision No. 1992 of 1 May 1995; and Supreme Court Decisions No. 5225 of 29 May 1999; No. 10062 of 1 August 2000; No. 11770 of 5 September 2000; No. 11648 of 6 September 2000; and No. 3861 of 15 March 2002.
44. Supreme Court Decision No. 5926 of 12 March 2009.
45. Circular letter No. 32 of 1980.
46. Resolution No. 44 of 30 March 2006. Strangely, the Resolution states that it merely clarifies the position contained in Circular letter No. 32 of 1980 and at the same time quotes the paragraph of the 2005 Commentary on Art. 7 of the OECD Model that provides for a prohibition on the deduction of notional interest payments.

3.5. Attributing profits to an agency PE

The same rules as apply in determining the income attributable to other types of PE, apply in the case of agency PEs. A functional and factual analysis must first be performed, so that the arm's length principle can be applied to determine the profits that an independent party, carrying on the same activities, would have derived. In a recent lower court decision,[47] the court, inter alia, stated that, once the dependent agent was remunerated at arm's length, no further profits could have been attributed to the agency PE. The court expressly quoted the OECD approach in this respect. It is the authors' opinion, in light of the reference to the OECD work on the subject, that this decision was very much based on the specific facts and circumstances of the case.

In general terms, the underlying principle is that some of the activities carried out by the agent on behalf of the non-resident company may generate a risk that is likely to be allocated to the PE (because the significant people functions are carried through the PE) and that is not remunerated at the level of the agent, i.e. by the fee paid to the agent. It follows that, in such a case, further profits would be attributable to the agency PE. It should be noted that the issue is also linked to the definition of PE contained in Italian tax treaties and domestic law, which may very well have an effect. Specifically, whilst the current OECD Model definition refers to any activity carried on by the agent on behalf of the non-resident enterprise in the definition of agency PE, Italian domestic law limits the definition to the conclusion of contracts in the name of the enterprise, thereby appearing to narrow down its scope. If this is true, activities carried out by a dependent agent on behalf of the non-resident enterprise, other than the conclusion of contracts in the latter's name, are not part of the agency PE under the Italian domestic law definition. It follows that the profits arising from these activities could not be considered as attributable to the PE.

It is important to note, however, that Para. 31 of the Commentary on Art. 5 of the OECD Model states that:

> The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

It, therefore, appears that the textual difference should not affect the substance of the matter.

4. Conclusions

If a general trend can at all be identified, this certainly goes into the direction of using the PE definition as a counter-measure to profit-shifting structures that are often based on the stripping of risks and assets from functions carried out in high-tax jurisdictions. This applies not only with regard to Italy, but also beyond. It is no coincidence that almost 20 years ago Arvid Skaar, in his doctoral thesis on the concept of PE, wrote:

> To counteract tax planning through related companies, tax authorities in some countries have adopted special versions of the unitary allocation method. In some cases the authorities have claimed tax jurisdiction over the foreign headquarters of the group, under the assumption that it has a permanent establishment in the country through the domestic subsidiary there....[48]

In the authors' view, two main principles should be kept in mind when applying the existing rules: (1) fairness (in allocating taxing rights on cross-border business profits); and (2) certainty (for cross-border investors). An excellent tool in this respect is that of advance rulings.[49] Although in Italy advance rulings (or, more precisely, APAs) are currently generally concluded only in relation to the transfer pricing aspects of a multinational enterprise's business operations, it would be a positive development if these could also be extended to issues such as the existence of PEs.[50]

According to the Bulletin published on 21 April 2010 by the tax authorities, only two APAs out of the 19 agreements concluded between 2004 and 2009 dealt with the attribution of profits to Italian PEs.[51] No agreement has been concluded in relation to the attribution of profits to foreign PEs of Italian resident companies.[52]

Advance rulings are always based on a functional analysis that allows both the taxpayer and the tax authorities to set a common ground on which they can discuss the remuneration to be attributed to the different entities involved, based on their functions, assets and risks. Such a functional analysis could also be used to give to the taxpayer certainty that, if the economic substance of the business activities does not change, not only the transfer prices will not be challenged, but also no PEs will be deemed to exist because of the activities of the different entities involved. Having such a type of agreements bilaterally or multilaterally ratified by the competent authorities of the other countries involved would certainly contribute to achieve the two principles noted previously: fairness and certainty.

47. Tax Court of First Instance of Rimini (*Commissione Tributaria Provinciale*) Decision No. 26 of 12 March 2008.
48. A.A. Skaar, *Permanent establishment: erosion of a tax treaty principle* (Deventer-Boston: Kluwer Law and Taxation Publishers, 1991).
49. C. Romano, *Advance Tax Rulings And Principles Of Law: Towards a European Advance Tax Rulings System* (Amsterdam: IBFD, 2002).
50. Whilst in 2007 (Ruling No. 41 of 9 March 2007) the tax authorities held that the existence of a PE is a matter of facts that could not be clarified in the context of an ordinary advance ruling procedure, which is instead intended to explain the correct interpretation of the law, and that such an assessment of facts could be made through the international advance ruling procedure, in 2008 (Ruling No. 141 of 10 April 2008) the tax authorities denied the possibility to follow the international advance ruling to have a binding position of the tax authorities on the existence of a PE in Italy.
51. Italian Revenue Agency, "International Standard Ruling Report", 21 April 2010.
52. For an analysis of the international ruling procedure, see C. Romano, "Il ruling internazionale", in Zanichelli (ed.), *Imposta sul reddito delle società (IRES)* (Turin: Zanichelli 2007), pp. 991-1031.