A NEW DEFINITION OF PERMANENT ESTABLISHMENT IN ITALIAN DOMESTIC INCOME TAX LAW

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Effective January 1, 2018, Italy's 2018 Budget Law[1] significantly amended the domestic definition of permanent establishment ("P.E.") and implemented certain O.E.C.D. guidelines set forth under B.E.P.S. Action 1 (Addressing the Tax Challenges of the Digital Economy) and Action 7 (Preventing the Artificial Avoidance of P.E. Status). The law revised the definitions of both the "Fixed Place P.E." and the "Agency P.E.," by amending the text of Article 162 of the Italian Income Tax Code ("I.I.T.C.").

As regards the Fixed Place P.E., the main changes are (i) the introduction of a new item in the list of cases that are presumed to constitute a Fixed Place P.E., (ii) the modification of the specific activity exemption, (iii) the repeal of Art. 162 (5) of the I.I.T.C. regarding electronic equipment, and (iv) the introduction of an anti-fragmentation rule.

The Agency P.E. rules were changed in compliance with B.E.P.S. Action 7 recommendations concerning *commissionaire* arrangements.[2]

THE OLD RULES

Prior to the 2018 Budget Law, the definition of P.E. for Italian income tax purposes – contained in Article 162 of Presidential Decree no. 917 of 22 December 1986 (I.I.T.C.) – was modelled on the current O.E.C.D. Model Tax Convention definition.

Fixed Place P.E.

For the purposes of Corporate Income Tax ("I.R.E.S.") and Regional Tax on Productive Activities ("I.R.A.P."), Italian domestic tax law defined a P.E. to be a fixed place of business through which the business of a nonresident enterprise is wholly or partly carried on in Italy (a Fixed Place P.E.).[3]

Certain fixed places of business were presumed to constitute a P.E. in Italy, unless the taxpayer could provide evidence to the contrary:

- A place of management
- A branch
- An office

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1 Law No. 205 of 27 December 2017.

2 See, in detail, "O.E.C.D. Issues Proposed Changes to Permanent Establishment Provisions Under Model Tax Convention," *Insights* 9 (2017).

3 Art. 162 (1) of the I.I.T.C.

- A factory
- A workshop
- A mine, an oil or gas well, a quarry or other place for the extraction of natural resources[4]

On the other hand, a fixed place of business was not deemed to be a P.E. in Italy if it was used only to perform certain preparatory or auxiliary activities. These exempt activities included the following:

- The use of an installation solely for the purpose of storage, display, or delivery of goods belonging to the enterprise
- The maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display, or delivery
- The maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise
- The maintenance of a fixed place of business solely for the purpose of purchasing goods or collecting information for the enterprise
- The maintenance of a fixed place of business solely for the purpose of carrying on any other preparatory or auxiliary activity for the enterprise
- The maintenance of a fixed place of business solely for any combination of the activities indicated above, provided that the overall activity of the fixed place of business, resulting from this combination, is of a preparatory or auxiliary nature[5]

In addition to the exceptions listed above, the rules provided that the maintenance of electronic processors and auxiliary equipment used for the collection and transfer of data and information for the purpose of selling goods and services did not, by itself, constitute a P.E.[6] This provision was intended to clarify that the mere ownership and use of a server or similar equipment in Italy did not constitute a P.E.

Agency P.E.

In comparison to the lists of conditions that constitute or preclude the existence of a Fixed Place P.E. in Italy, the old rules provided that a person that habitually concludes contracts in Italy in the name of a nonresident enterprise was deemed to be a P.E. of the nonresident enterprise (an Agency P.E.).[7] One exception was provided when the person's activity was limited to the purchase of goods. Another exception was provided when the person concluding contracts in Italy was a broker, general commission agent, or any other agent of an independent status. Such persons did not constitute a P.E. when they would act in the ordinary course of a business that was carried on independently in Italy.[8]

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4 *Id.*, Art. 162 (2).

5 *Id.*, Art. 162 (4).

6 *Id.*, Art. 162 (5).

7 *Id.*, Art. 162 (6).

8 *Id.*, Art. 162 (7).

THE NEW RULES

The "Digital P.E." as a Fixed Place P.E.

The 2018 Budget Law introduced a new concept of Fixed Place P.E. enacted in the context of tax measures for the digital economy. In time, the new definition may impact other businesses as well.

Under the amended text of Art. 162 (2) of the I.I.T.C., a foreign entity's significant and continuous economic presence in Italy may constitute a fixed base that could give rise to an Italian P.E. even if it does not result in a substantial physical presence.

This new P.E. definition is based on the nexus rules proposed for the digital economy by B.E.P.S. Action 1 and, in particular, on the notion of "significant economic presence," so that nonresident digital companies can trigger taxable presence in a country in ways that are not uncommon in the digital economy. These include (i) the earning of revenues from customers situated in the country, (ii) the presence of a local digital platform, (iii) the frequency of digital transactions, and (iv) the number of users.

"A fixed place of business will not constitute a P.E. if the taxpayer can prove that any and all activities – and not only their combination as under the old rule – have a preparatory or auxiliary nature."

At the same time that this new Digital P.E. concept was introduced into law, Italy introduced a Web Tax, designed to be an alternative to the income tax that applies when a foreign company does not have an Italian P.E. The Web Tax is a 3% tax on the amount realized (net of V.A.T.) for digital services supplied electronically. It will apply as of 2019 to services supplied by resident and nonresident taxpayers that carry out more than 3,000 digital transactions in a calendar year and will be levied on the recipient of the services such as Italian business taxpayers but not private individuals.

As consequence of the introduction of this new regime, Art. 162 (5) of the I.I.T.C. on servers as Fixed Place P.E.'s became redundant and was repealed.

The Specific Activity Exemption for Fixed Place P.E.'s

The list of exempting activities has been rephrased to provide that a fixed place of business will not constitute a P.E. if the taxpayer can prove that any and all activities – and not only their combination as under the old rule – have a preparatory or auxiliary nature with respect to business of the foreign entity. The amendment applies to any business activity. It may be particularly relevant for digital enterprises based abroad that maintain a stock of goods in Italy to provide prompt delivery to customers. As a consequence, the maintenance of a local warehouse and the storage of goods in the warehouse might be regarded as a core activity for digital enterprises focused on retail purchases. For these businesses, storage would not fall within the preparatory and auxiliary exemption.

The Anti-Fragmentation Rule in the Definition of Fixed Place P.E.

The 2018 Budget Law introduced the so-called anti-fragmentation rules – proposed in B.E.P.S. Action 7 – aimed at preventing foreign companies from splitting up a business into smaller units or using other related legal entities or P.E.'s to benefit from the preparatory or auxiliary exemption. In substance the new rules are designed to take into account not only the activities carried on by the same enterprise at different locations but also of the activities carried on by closely related enterprises at the

same or different locations.

To this end, the new Art. 162 (5) of the I.I.T.C. now provides that the specific activity exemption shall not apply to a fixed place of business that is used or maintained by the foreign enterprise if certain conditions are met:

- The same enterprise or a closely related enterprise carries on business activities at the same location or another location in the Italian territory.
- The location(s) constitutes a P.E. for either enterprise under the provisions of Art. 162 of the I.I.T.C., or the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the enterprise(s) at the two locations, are not of a preparatory or auxiliary character.
- The business activities carried on by the two enterprises at the same place, or by the enterprise(s) at the two locations, constitute complementary functions that are part of a cohesive business operation.

Though this new provision will bring more clarity in applying P.E. identification rules, it is worth highlighting that Italian case law already applied an anti-fragmentation approach. The Italian Supreme Court Decision No. 20597 of 7 October 2011 ruled that it is irrelevant whether activities are carried out in Italy via several distinct entities, rather than by a single entity, for the purpose of ascertaining whether nonresident parent companies have a P.E. in Italy. Instead, the determination will be made by reference to facts and circumstances demonstrating whether the entities carried on business as parts of an economically integrated unitary structure that achieved an overall business purpose of the group with regard to activities in Italy.

The New Definition of Agency P.E.

Under the new Art. 162 (6) of the I.I.T.C., a P.E. is deemed to exist when a person acts in Italy on behalf of a foreign enterprise, and in so doing, habitually concludes or is involved in the conclusion of contracts that are routinely approved by the foreign company without material changes. Contracts covered by the new rule must be either (i) in the name of the enterprise, (ii) for the transfer of ownership or the right to use property owned or used by the enterprise, or (iii) for the provision of services by that enterprise.

In such cases, an Italian P.E. is deemed to exist unless the activities performed under the contract signed by the person acting in Italy on behalf of the foreign enterprise are limited to exempt activities described above. Consequently, agreements that are negotiated and signed by a person that are not binding until accepted abroad will be attributed to a P.E. and taxed in Italy as if the contract were legally binding prior to acceptance abroad.

New Art. 162 (7) of the I.I.T.C. provides an exception to the P.E. rule when the person acting in Italy on behalf of a foreign enterprise carries on its own business in Italy as an independent agent and acts for the enterprise in the ordinary course of that business. Note, however, that where a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person will not be considered to be an independent agent with respect to any such enterprise.

For the purposes of identifying an independent agent, a person is considered closely related to an enterprise if, based on all the relevant facts and circumstances, one controls the other or both are under common control of a third person or enterprise. In any event, the requisite degree of control will exist when (i) one person or enterprise directly or indirectly possesses more than 50% of the beneficial interest in the other or, in the case of a company, more than 50% of the aggregate vote and value of the issued and outstanding share capital; or (ii) another person directly or indirectly possesses more than 50% of the beneficial interests in both persons or enterprises or, in the case of a company, more than 50% of the aggregate vote and value of the share capital in both companies.

Ultimately, these changes to the Agency P.E. definition may not have a material impact on Italian business and administrative practices, since existing Italian case law contains a broad interpretation of the Agency P.E. concept. The most relevant judicial case is *Phillip Morris*,[9] where the Supreme Court affirmed, *inter alia*, the following principles:

- The participation of officers or representatives of an Italian company in phases of the negotiation or conclusion of contracts on behalf of a related company abroad constituted an Agency P.E. even if it was not granted a formal power of representation. If, under a formal grant of authority, other nonresident companies would ordinarily execute the function of the controlled Italian company, an inchoate grant of authority would be deemed to exist, resulting in an Agency P.E. in Italy. In this respect, the Court observed that the Italian company was not acting in the ordinary course of its business when providing services to related nonresident companies that were not included in its statutory business purpose and were performed without any formal mandate by the nonresident group companies.
- A national structure carrying on management of business transactions for the benefit of a nonresident company should be deemed to constitute a P.E. in Italy, even though only one area of the nonresident's business was managed by the domestic structure.
- Factors indicating the existence of a P.E. in Italy, including dependence and the authority to conclude contracts, should be assessed on the basis of the substance rather than exclusively on the basis of the mere legal form of the business transactions.
- A company situated in Italy may be deemed to be a P.E. of multiple foreign companies within the same group that pursue a common business strategy. In such instances, the nature of the activities performed in Italy will be assessed in light of the common business strategy of the group. In the view of the Court, regardless of the relationship between the Italian company and each single nonresident group company, the Italian company would be viewed to act in Italy for the benefit of the whole group. The legal and contractual relationships between the various group companies with reference to the activities performed in Italy should not be analyzed separately but should rather be considered as a whole.

[9] Supreme Court judgments 3367, 3368, and 3369 of 7 March 2002; 431926 of 26 March 2002; 7682 and 7689 of 25 May 2002; 10925 of 22 September 2002; and 17373 of 6 December 2002.

- Group companies that are subject to a unified strategy aimed at maximizing Italian profits for all nonresident companies involved have an Agency P.E. in Italy, and it is misleading to consider each fragment of the strategy separately. The Court referred to the wording of Paragraph 24 of the Commentary to Article 5 of the O.E.C.D. Model Income Tax Treaty, stating that a domestic structure could act as management office of the group in a way that has international ramifications.[10]

As a reaction to this interpretation, the O.E.C.D. amended the Commentary on Article 5 in 2005; however, Italian representatives at the O.E.C.D. inserted the following observation, "*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 . . .*" Therefore, notwithstanding the fact that under Italian income tax law and constitutional law tax treaty provisions take precedence over Italian domestic provisions when they are more favorable to the taxpayer, Italian judicial interpretations of Agency P.E. override tax treaty provisions on a *de facto* basis.

ADVANCE RULINGS REGARDING AN ITALIAN P.E.

Because the Italian Tax Authorities quite aggressively audit the Italian operations of M.N.E.'s, it is advisable for an M.N.E. to seek advance clearance from the Italian Tax Authorities on the existence of and profit attribution to an Italian P.E. Several ruling procedures are available. Included are (i) advance tax rulings for international companies and (ii) advance tax rulings on new investments. The latter is reserved for investment projects with a significant impact on employment levels and worth at least €30 million. It would be shameful for management of an M.N.E. to invest substantial funds in Italy only to find out retroactively that a newly formed Italian subsidiary caused various group members to have a P.E. in the country.

[10] In the view of the Court, the domestic structure exercised "supervisory and coordinating functions for all the departments of the enterprise located within the region concerned."