tax notes international
Volume 67, Number 7 ■ August 13, 2012

Italian Taxation of Hidden Permanent Establishments

by Piergiorgio Valente

Reprinted from *Tax Notes Int'l*, August 13, 2012, p. 675

PRACTITIONERS' CORNER

Italian Taxation of Hidden Permanent Establishments

by Piergiorgio Valente

Piergiorgio Valente is managing partner with Centro Studi Internazionali GEB Partners in Milan.

The Italian Income Tax Code (Testo Unico delle imposte sul reddito, or TUIR) in article 162 defines permanent establishment as a ''permanent place of business by means of which the non-resident enterprise entirely or partially exercises its activity on the State's territory.'' That definition is similar to the one provided by article 5 of the OECD model tax treaty.

Therefore, for there to be a fixed place of business, the following aspects must exist:

- a permanent structure (premises, materials, equipment, and machinery);
- the carrying out of an economic activity by means of the said structure; and
- functional independence regarding its parent company.

Even when a permanent structure is lacking, a PE may exist when the nonresident entity ''avails itself of people that carry out the activity in its name to habitually use and exercise the power to sign agreements in the name and on behalf of the enterprise'' (the agent PE).

Based on prior decisions issued by Italian courts,[1] the PE of a foreign entity in Italy must meet these conditions:

- the organization must participate in an activity being regularly carried out in Italy by a foreign entity;
- the organization must be permanent;
- the size and structure of the organization are inconsequential; and
- the activity of the PE may be secondary or necessary to the one carried out by the foreign company.

Decision 44/2/11

In the Regional Tax Court of Ancona's Decision 44/2/11 of June 10, 2011, the Italian tax authorities challenged a Luxembourg company (International Fashion Factors SARL) regarding the existence of a PE at the offices of an Italian company (22 SRL),[2] which, according to the Italian tax authorities, distributes the Luxembourg company's products.

The tax authorities believe that the group was established in order to achieve tax savings by using the following scheme:

- the Italian company purchases finished products from third parties and resells them to its sole client, the Luxembourg company (the transaction is not subject to VAT);

[1]Supreme Court, Tax Section, Decisions 3367 and 3368 of December 20, 2001, filed on March 7, 2002; Decision 7682 of December 20, 2001, filed on May 25, 2002; and Decision 10925 of December 20, 2001, filed on July 25, 2002.

[2]During their inspection, the tax authorities reconstructed the de facto Bikkembergs group, incorporated by the Dutch Holding Cobalt BV, which holds 100 percent of the controlled companies International Fashion Factors SARL (Luxembourg), 22 SRL (Italian), and International Heros BV (Dutch).

- the Luxembourg company resells the goods bought in Italy or abroad, achieving profits that are subject to lower taxation in Luxembourg; and
- such profits, net of royalties paid to the company that owns the trademark, ''bounce back'' to the group, without paying any withholding tax because of the application of the EU parent-subsidiary directive.

The tax authorities identified a PE that exists in Italy and carries out distribution functions and activities relating to the Luxembourg company's products, because:

- the Italian company had been granting the Luxembourg company the use of its own premises (fixed place of business) from 2002 to 2006 to distribute the Luxembourg company's products;
- orders of the Luxembourg company were also being managed by the Italian company;
- a current account in the name of the Luxembourg company was opened with an Italian bank in the same municipality where the fixed place of business was situated, with banking transactions amounting to €90 million;
- sales personnel (that is, employees of both the Italian and the Luxembourg company) were present at the premises of the Italian company;
- price lists of the goods distributed by the Luxembourg company were identified at the premises of the Italian company;
- a company server was physically located at the premises of the Italian company; and
- on the premises of the Italian company was an IT application used to collect the orders of sales agents of the Luxembourg company.

The Luxembourg company lodged an appeal before the Provincial Tax Court of Pesaro against tax authorities findings, maintaining that:

- no material PE could be identified, because the activity was actually carried out in Luxembourg;
- no agent PE could be identified, as the Italian company could not be considered a dependent agent acting on behalf of the Luxembourg company; and
- income assessed by the Italian Revenue Office at the alleged Italian PE of the Luxembourg company was not properly determined, in that it did not take into account costs incurred.

The court agreed with the tax authorities that the Italian employees were entrusted with ''the responsibility and the discretional power regarding all accounting management in the name and on behalf of the Luxembourgish company, representing thus the interests of the said company.''

The taxpayer appealed the decision, and the Regional Tax Court of Ancona partially amended the lower court's decision.

The regional tax court paid special attention to the fact that the company's server was used by the Italian company from May 2005 to November 2006, and determined that the software used by the server was developed in Italy.

However, the justices maintained that even though some elements substantiated the existence of a hidden PE, based on the findings of the tax authorities, there was no evidence that the four employees of the Italian company actually performed all the corporate duties, from production to sales, in Italy.

In its appeal, the taxpayer reconstructed a taxation scenario for corporate activities and functions carried out in Italy: The taxable amount, determined based on article 7 of the Italy-Luxembourg income tax treaty, was equal to 3 percent of the sales of the Luxembourg company, based on the assumption that the Italian PE carried out ''solely a high brokerage activity, meaning above the one generally due to the sales agents network.''[3]

The regional tax court ruled that the Italian company did not merely carry out a brokerage activity, as there were clear indications that other activities (for example, management of orders on account of the Luxembourg company and distribution of the Luxembourg company's products) were being carried out by the PE.

For this reason, the Italian PE was assigned a share equal to 5 percent of the sales volume achieved from May 2005 to November 2006 — the period in which the functions and activities were supported by the presence in Italy of a structured IT platform.

The above percentage was net of costs and represented the taxation to be applied, for income tax and VAT purposes, for those functions and activities carried out by the PE. ◆

[3]Regional Tax Court of Ancona, Decision 44/2/11 of June 10, 2011.