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PRACTITIONERS' CORNER

Permanent Establishment and Jurisdiction to Tax: Debates in Italy

by Piergiorgio Valente

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In the last few months, major European governments have struggled with the issue of the taxation of multinational enterprises. Governments, along with the OECD and the European Commission, are attempting to adopt coordinated measures that ensure that MNEs pay their fair share of tax.

The G-20 meeting held February 15-16, 2013, in Moscow focused on the taxation of multinationals. In particular, the French, English, and German ministers of finance reiterated the difficulties deriving from the systematic minimization of the tax burden by multinationals.

Having voiced their appreciation for the OECD for its ''Addressing Base Erosion and Profit Shifting'' report (BEPS report), the G-20 stated its willingness to develop measures that will avoid taxable base erosion through profit shifting.

Regarding income produced by nonresident enterprises, the linking criterion with a state's territory is represented by the presence of a permanent establishment.

In Italy, the PE concept is defined in article 162 of the Italian Income Tax Code (Testo Unico delle Imposte Dirette, or TUIR) (in line with article 5 of the OECD model treaty), which provides a definition of a PE and outlines the main characteristics of an agency PE.

The identification of the necessary requirements to establish the existence of a PE of a nonresident entity (and of the required tax principles to attribute the profits to the PE) represents one of the most crucial topics of interest at an international level.

The BEPS report brought to the fore how the identification process to ascertain the existence of a PE encounters difficulties within the area of e-commerce. In particular, there might be some hindrances in identifying a ''place of business'' since the entrepreneurial activity is carried out through the network, and actually tracking a connection between an online transaction and a specific geographical location may be rather difficult.

Indeed, one of the main features of e-commerce is to allow the possibility to carry out transactions forgoing all material elements that, within the context of traditional commerce, link a particular transaction to a given territory. This feature could potentially void the traditional taxation criteria foreseen under international taxation: The developments introduced by the digital economy involve a rethinking of principles laid down in income tax treaties in order to align them with the current economic reality.

In particular, the considerable development of Internet-related technology and the escalating volume of business turnover achieved through e-commerce have highlighted how the PE concept, construed as a tangible presence of an enterprise in a country of reference or the carrying out of a business through a dependent agent, is neither adequate nor applicable for digital MNEs.

The international debate concerns the lawfulness of behaviors adopted by multinationals in exploiting existing distortions in the various regimes in order to optimize their tax burden. Where is the line between lawful tax planning and aggressive tax planning?

The BEPS report notes that some European governments have been soliciting a coordinated action plan to strengthen the fight against international tax evasion and to reinterpret taxation principles provided by treaty provisions.

In the U.K., HM Revenue & Customs have increased their attention toward transactions entered into by MNEs. One of HMRC's recent works showed how such enterprises don't pay their ''fair share of corporation tax on profits they make from their business with U.K. customers.''

The U.K. government resolved to focus on MNEs that produce sizable revenues in the United Kingdom but that are subject to limited taxation in the territory. The government stated that MNEs seem to organize their business structures, intercompany transfers, and payment of royalties to shift profits to low-tax jurisdictions overseas.

On January 18, 2013, the French government published ''Mission d'expertise sur la fiscalité de l'économie numérique'' (the French report) to identify key features of digital MNEs and to propose efficient taxation procedures.

The French report highlights how the digital economy presents features and follows rationales that are drastically different from those underlying traditional MNEs.

As a primary concern, the French report suggests that steps should be adopted to intervene:

- on the redefinition, based on an international scale, of the PE concept; and
- on the introduction of users' ''free work'' concept which, by providing their data, contribute to the realization of the main source of earnings of digital MNEs.

Italy's Action Plan

Regarding tax assessments performed on Google, on November 28, 2012, Italy's undersecretary of state, Vieri Ceriani, underlined the difficulties encountered by the tax authorities to act against digital multinational corporations that, through the exploitation of ''financial engineering consented by obvious loopholes in national and international regulations, succeed in dodging taxes in our country.''

In particular, Ceriani pointed out how:

> [U]pon delegation by the Local General Attorney's Office of the Italian Republic . . . the Tax Police Force of the Revenue Guard of Milan examined some employees regarding summary information of the company, Google Italy S.r.l., for the purpose of obtaining some further details pertaining to the administrative, financial, and commercial organization of the company. The aim of the initiative was to verify the proper interpretation and application of tax rules, with special reference to relations arising from the ''Marketing and Services Agreement'' entered into by and between companies incorporated under foreign laws such as Google Inc. and, subsequently, Google Ireland Ltd. as well as Google Italy S.r.l.
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> In May 2007, the Police Force activated a tax assessment against Google Italy S.r.l., which was subsequently extended to the above foreign subsidiaries. The inspection was primarily meant to ascertain the existence of regulatory requirements established for the existence — at the above Italian company's level — of a permanent establishment in Italy of the aforementioned foreign companies.
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> The auditors found the following:
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> - the existence in Italy of a specific place, consisting of a material establishment, through which Google Ireland Ltd. and Google Inc. carried out their own activity in an instrumental and not an ancillary manner;
> - that the availability of that place was undeniably continuous, to constitute the permanence of that activity on national territory;
> - that the organization consisting of means, in conjunction with the people employed in Italian territory, was suitable and created for the production of the whole income developed in Italy, through the stipulation of contracts with Italian clients; and
> - that liability to Italian taxation of revenues accrued in national territory was actually avoided through the contents of the general services agreement, which was entered into with the sole purpose of simulating the exercise by Google Italy S.r.l. of a mere ancillary and preparatory activity, which did not find any evidence of factual elements acquired.
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> The auditors concluded by stating:
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> [I]n light of the mentioned findings, the operating department deemed, therefore, that Google Italy S.r.l. was to be considered a permanent establishment of Google Inc. and of Google Ireland Ltd. (for the relevant tax periods subject to assessment), in compliance with provision of article 162 of the TUIR and of article 5(5) of the OECD model tax treaty, under the income tax treaties entered into between Italy and the U.S. and Ireland.

A further regulatory intervention on the taxation of MNEs through the identification of a PE is article 38 of Decree-Law No. 179/2012, which provides the definition for ''operating base'' for airlines that operate in the passenger traffic sector through an operating base system.

The purpose of article 38 is to prevent controversies by assimilating operating bases that are equipped with infrastructure and service personnel to a PE, and consequently, compelling those companies to comply with tax and national social security laws.

For income tax purposes, ascertainment in Italy of the presence of a foreign airline's PE should follow the criteria set forth in article 162 of the TUIR; when no PE has been identified, no tax should be due in Italy.

Further, for direct tax purposes, article 8 of the OECD model treaty pertains to income derived from activities carried out by watercraft and aircraft within the context of international traffic zones.

Article 3(1)(d) of the OECD model treaty defines ''international traffic'' as any kind of transport (whether by sea or air) carried out by an enterprise that has its effective place of management in a contracting state, except when transport by ship or plane strictly occurs between or among locations of the other contracting state.

Article 8(1) of the OECD model treaty generally provides that profits deriving from an international transportation activity, regardless of the means of transportation used, are liable to taxation in the state where the enterprise's effective place of management is located.

Therefore, for example, the income realized by an Italian PE of a foreign airline, which resided in Germany and that sells in Italy a passenger transportation service for the Germany-Italy or France-Italy lines, will be solely liable to taxation in Germany; only the income realized by the Italian PE for the sale of tickets for internal flights (that is, flights within Italy) will be subject to taxation in Italy.

Article (8)(1)(2) of the commentary to the OECD model tax treaty confirms that as an alternative, states are allowed the option to establish that those incomes be taxable in the enterprise's state of residence.

Article (8)(1)(3) of the commentary sets forth that states may choose for the adoption of a ''mixed'' criterion (effective place of management principle and residence principle), by virtue of which the state in which the place of effective management is located would have the right to tax the incomes; however, as far as the state of residence is concerned, article 23 of the OECD model treaty (regarding the elimination of double taxation) would apply.

However, some treaties entered into by Italy (for example, the Italy-U.S. treaty) set forth, under article 8, that:

> the profits of an enterprise of a contracting State deriving from the activity carried out by ships and aircrafts, within international traffic, are solely taxable in the said State.

Ultimately, note that the Italy-U.S. treaty, at point 6 of the supplementary protocol, provides that:

> [F]or the purposes of Art. 8 (maritime and air navigation) of the Convention and notwithstanding any other Treaty provision, the profits of a U.S. citizen not residing in Italy or of a U.S. company, arising from activities carried out by ships or aircrafts registered in accordance with U.S. laws, are exempt from taxation in Italy.

Article 38(1) of Decree-Law No. 179/2012 introduced a rule on which basis the definition of operating base for airlines is provided. Article 38(1) states that:

> [F]or the purposes of aeronautics law, the expression ''base'' identifies a combination of premises and infrastructures from which an enterprise carries out a permanent, habitual and continuous air transportation activity, by availing itself of subordinated workers (i.e., employees) whose core professional activity is carried out in such base, in the sense that they work on such premises, take up service therein, and return thereto upon having carried out their activity. An air carrier with a license to carry out its activity issued by a Member State of the EU other than Italy is deemed to be established on national territory when it permanently, continuously, or habitually carries out air transportation activities from a base such as defined under the foregoing paragraph.

The rule may mainly have implications for low-cost air carriers, which operate through the operating base system.

The difference between traditional carriers and low-cost airlines is that:

- traditional carriers have their traffic converge on large continental hubs and close their last night flights in various airports from which they take off again on the following day; and
- low-cost carriers organize their traffic starting from several operating bases from which all of the day's flights originate and close. Each base avails itself of a given number of airplanes, personnel, and ground service, but it is established that at the end of the day, both aircrafts and personnel return to the original operating base.

The introduction of article 38 of Decree-Law No. 179/2012, therefore, likens an operating base — equipped with the relevant infrastructure and personnel — to a PE, obliging airlines operating in national territory by means of operating bases to comply with tax requirements in Italy.

These regulatory steps manifest the intention of the Italian government to enhance its action against international tax evasion and avoidance, in line with the guidelines provided by the OECD and the European Commission.

Italian tax authorities restated their intention to monitor phenomena linked to important risk factors, including:

- (aggressive) international tax planning schemes;
- policies for the instrumental use of tax losses;
- arbitrage forms based on the exploitation of complex financial instruments; and
- transfer pricing policies that do not comply with the arm's-length principle. ◆