STUDIO BISCOZZI NOBILI
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ABSTRACT

Studio Biscozzi Nobili's Comments regarding OECD's "Additional Guidance on the Attribution of profits to Permanent Establishments".

1. Premises

On 22nd March 2017 the OECD issued the report "Additional Guidance on the Attribution of Profits to Permanent Establishments" (hereinafter referred as **"the Report"**). Such Report is contextualized within the BEPS ("Base Erosion and Profit Shifting") project and the related 15 Action Plans developed by G20 countries and OECD.

In order to ensure the implementation of the proposed measures, the OECD has recently issued two new documents:

- a new version of the Model of the Convention against double taxation (2017 Model Tax Convention, "**MTC**") and the related commentary;
- a framework of the Convention ("Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting", "**MLI**") aimed at modifying the already existing double taxation treaties.

2. Permanent Establishments ("PEs") definition and new implementations

The Report is a continuation of the measures already identified in the BEPS Action n. 7, concerning methods to prevent the artificial avoidance of the status of permanent establishment ("Preventing the artificial avoidance of permanent establishment status", Action 7, Report, OECD, 2015).

OECD's recommendations with regard to the amendments in the definition of PE have been implemented in the Italian legislation through the revision of article 162 of Italian Income Tax Code (in the context of Budget Law 2018).

The main amendments introduced can be summarized as follows:

a) the list of activities that do not configure a permanent establishment (i.e. *negative list*) has been aligned with the text of article 5(4) of MTC, the exemptions mentioned are applied if the activities, or their combination, have a "preparatory or auxiliary character";

b) the "anti-fragmentation rule" reported in article 5(4)(1) of MTC (and in article 13, par. 4 of MLI) is introduced and the recognition of a PE is possible also in cases of combination of activities performed in different places by closely related enterprises (provided that at least one of these activities, if individually considered, constitutes a PE or the combination of activities performed exceeds the "preparatory or auxiliary character");

c) dispositions reported in article 5(5) of MTC have been included, with regard to the requirements that configure a PE related to the activities of habitually concluding contracts by intermediaries on behalf of non-resident companies, with the exclusion of activities mentioned in the "negative list" and of "independent agents" that operate in the ordinary course of the business;

d) with respect to the recommendations provided in the BEPS package, the amendments reported in the Italian Income Tax Code do not consider the case of splitting-up of contracts, where the period of time needed to configure a PE (for example in the case of construction sites as reported in article 16 par. 3

ASSOCIAZIONE PROFESSIONALE
Corso Europa n. 2 - 20122 Milano
Tel. +39 02 7636931
Fax +39 02 780146 / +39 02 76369345 / +39 02 76015178
www.biscozzinobili.it
C.F. e P. IVA 12607090151

of Italian Income Tax Code) is fragmented into more contracts, also through more enterprises closely related, in order not to exceed the maximum allowed time;

e) article 162 paragraph 2, letter f bis, added a new case that constitutes a PE: “a significant and continuous economic presence in the territory of the country built in such a way as not to make its physical consistence in the territory”. This disposition appears not to have interpretative feedback, since it is not inspired from Action 7, nor MLI, but it is literally formulated with characteristics in some ways similar ("constructed in such a way") to an internal anti-abuse disposition, or to an anti-elusive provision such as the “principal purpose test” reported in the MLI (article 7).

3. Attribution of profits to the PEs – new indications

The Report under analysis reaffirms what was anticipated in Action 7:

- confirming that the rules and guidelines for the allocation of income to permanent establishments remain unchanged also following the extension of the notion contained in article 5 of the MTC, and therefore continue to be governed by the principles contained in article 7 of this model, as resulting from the revision made in 2010 (and, most recently, in 2017);

- the methodologies developed by the OECD remain unchanged with respect to the document issued on July 22, 2010 called "2010 Report on the attribution of profits to permanent establishments" **("2010 Report"**). As far as the general principle of “functionally separate entity approach” developed by the OECD in the 2010 Report ("Authorized OECD Approach" - **"AOA"**), it is based on a two-step analysis ("two-step analysis"), aimed at establishing the income that the PE would have been achieved if it had been a separate and independent entity carrying out the same activities with its head office. The *first phase* requires a functional and factual analysis, carried out in line with the transfer pricing guidelines ("OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" - **"TPG"**), on the assumption that the PE and its parent company are separate entities, each performing functions, using assets, assuming risks and entering into transactions ("dealings") between them, as well as with related companies and with third parties, identifying the significant activities and responsibilities assumed by the PE. In the *second phase* the remuneration of the dealing occurred between the parent company and its PE, assumed as separated companies, is then determined by applying by analogy the transfer price rules required for transactions between associated companies from article 9 of MTC, taking into account the functions performed, the assets used and the risks assumed, in accordance with the TPG.

The Report is therefore limited to retracing the guidelines already developed, providing general principles ("high-level general principles"), consistent with the previous ones, applicable to new cases of PEs, and illustrating some specific examples practical.

As far as Italy is concerned, the general principle of “functionally separate entity approach” is contained in the new version of article 152, paragraph 2, of Italian Income Tax Code, as resulting following the amendments made by the legislative decree 14/09/2015 No. 147 - "Internationalization Decree" - however sometimes differently formulated in the treaties stipulated by Italy, especially before the revision of the MTC of 2010.

4. Examples reported in the Report

Example 1: Warehousing, Delivery, Merchandising and Information Collection Activities

The first example proposed in the Report concerns the modification to the "exempted" activities provided by article 5 (4) of the MTC, and reported in the new article 162, paragraph 4-bis of Italian Income Tax Code, which do not constitute a PE on the condition that they have "preparatory or auxiliary" character.

The case is that of a non-resident company located in country R which sells goods directly to consumers in country S via an online platform; however, the company R has in country S (i) a warehouse for the storage of goods, the receipt of orders and the execution of deliveries and (ii) an office located in another place which is responsible for the merchandising of products and the collection of consumer information.

Both sites (the warehouse and the office) perform functions that, considered individually, do not constitute a PE given the exemption contemplated by the Italian Income Tax Code from article 5 (4) of the MTC.

The combination of the activities carried out on the two sites, having complementary functions forming part of a unitary combination of business operations, would exclude their preparatory or auxiliary character according to the "anti-fragmentation" rule referred to in article 5 (4) (1) of MTC, and thus originating two PEs of the non-resident entity in country S.

The AOA is applied to the case under analysis and an appropriate *arm's length* method is individuated.

The Report then illustrates further three examples applied to the new provisions on intermediaries referred to in article 162, paragraphs 6 and 7 of Italian Income Tax Code, in compliance with the new article 5, par. 5 and 6 of the MTC, referring to the following cases:

- sale of graphic components of a program ("widgets") by a commissionaire PE located in country S, also responsible for marketing and warehousing activities;
- marketing activities for the sale of advertising space on a site owned by the company located in country R, performed by a service provider PE located in country S; and
- procurement of "widgets" by a PE located in country S, in the name and on behalf of a company of country R whose "core business" consists of the purchase and sale of such widgets.

Example 2: Commissionaire structure (related intermediary)

Example 2 deals with the activity performed by a non-independent agent that habitually concludes contracts on behalf of the non-resident company. References can be made at article 162 paragraph 6 of Italian Income Tax Code and to article 5 (5) of MTC.

AOA analysis is performed and, under *step one*, functional and factual analysis shows that significant people functions relevant for the assumption of inventory risk and to the disposition of the inventory are performed by the commissionaire. In the light of this, the PE is deemed to be the "economic owner" of the inventory and the related inventory risk is therefore attributable to the PE. The commissionaire, being remunerated through a commission, does not own any credit right toward final customer. An internal dealing between the PE and its head office is recognized, consisting of the sale of goods from the head office and its branch.

Under *step two* of the AOA, the profits attributable to the PE with regard to the internal dealing of the sale of goods are recognized as the *arm's length* profits that the head office would have made with an independent entity performing the same functions and bearing the same risks as the PE. For tax computation purposes, the profit attributed to the PE is determined by considering the revenues from the sales of goods to the final customers minus the costs of goods sold as well as the commission paid to the PE and further additional expenses related to the PE.

Additional aspects to be focused that could implement the analysis performed are:

- legal aspects of the agreement between the head office and its PE and economic relationships with the PE (e.g. agency agreement, power of attorney, …);
- the remuneration of the PE after the reconstruction operated following the AOA principles as arm's length, considering both the head office and non-resident company side;

- if, as we believe, the performance of marketing and warehousing activities from the intermediary is a condition necessary to configure a PE (considering the requirements needed to recognize the existence of a "dependent agent", according to new definitions provided as outcome of BEPS Action 7 and the amendments inserted in the Italian Income Tax Code, including also the exemptions indicated for activities of "preparatory or auxiliary" character).

Example 3: Sale of advertising on a website (related intermediary)

Example 3 is related to the case of an intermediary who, on the basis of a service agreement, carries out marketing activities with respect to the sale of advertising space in the country of residence of the PE, deciding the amounts, types and forms of the activities advertising to be carried out.

The conclusions reached are the following:

- acting as principle in the routine conclusion of sales to final customers and without material modifications of the terms and conditions by the non-resident entity, a PE has to be recognized;
- functional and factual analysis shows that sales are carried out by personnel of the intermediary, who is also responsible for deciding the methods of advertising to be carried out, and consequently an internal dealing between the head office and its PE must be considered with regard to the sale of advertising space;
- the remuneration for the internal dealing is determined according to transfer price rules established by the TPG, as the prices that the head office would have obtained from an independent counterpart for the sale of advertising space; and
- for tax computation purposes, the remuneration for the internal dealing, the remuneration recognized to the intermediary for performing such service, as well as other operating expenses (if any) are deductible.

Example 4: Procurement of goods (related intermediary)

Example 4 is similar to the previous one, differentiating by the fact that the intermediary operating in State S is responsible for the conclusion of purchase agreements (widgets), and not for sale, in the name and on behalf of the principal.

The conditions for the existence of a PE are recognized and an internal dealing between the parent company and its PE is assumed, consisting of the sale of inventory from the second to the first; the *arm's length* remuneration related to the price follows the transfer pricing rules indicated in the TPG and takes into account - due to the fact that the warehouse management is carried out by intermediary staff - the assets used and the risks assumed in the performing of such function attributing them to the PE; in determining the income of the PE the costs for purchases of goods from third parties, the commission paid to the intermediary and the operating expenses of the PE are deductible.

5. Conclusions

To sum up, Italian legislation implemented new OECD's recommendations with regard to the amendments in the definition of PE in the Italian Income Tax Code, namely by way of a review of the definition of "Permanent establishment" contained in article 162.

More specifically, the new article 162 includes the *negative list* of activities that do not constitute a permanent establishment, the antifragmentation rule and the requirements that give raise to a PE as for the activities of intermediaries habitually concluding contracts on behalf of non-resident companies ("dependent agent" PE). Instead, new article 162 does not include, as provided by the BEPS package, the case of splitting-up of contracts, where the period of time needed to configure a PE is fragmented into more contracts. In addition, a new case in the definition of PE has been added, whereby a PE can also be deemed to exist when "a significant

and continuous economic presence in the territory of the country [is] built in such a way as not to make its physical consistence in the territory".

As for the profit attribution to permanent establishment, domestic provisions contained in article 152, paragraph 2, of Italian Income Tax Code transpose the OECD "functionally separate entity approach" whereby the arm's length standard applies under the fiction that the PE is a distinct entity, so that profits attributable to the PE are that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed.

Marco Abramo Lanza

Oliviero Eric Cimaz

Valentina Bertolini