taxanalysts
Respectfully disagreeable since 1970.

tax notes international

Italy's Domestic Definition of Permanent Establishment

by Luigi Perin

Reprinted from *Tax Notes Int'l*, 26 April 2004, p. 357

TAX NOTES INTERNATIONAL
Copyright 2004, Tax Analysts
ISSN 1048-3306

Correspondents

Italy's Domestic Definition of Permanent Establishment

by Luigi Perin

Luigi Perin is a partner with George R. Funaro & Co., P.C. in New York.

On 12 December 2003,[1] the Italian government introduced IRES (*Imposta sul Reddito delle Società*), the new corporate income tax, which replaced IRPEG (*Imposta sul Reddito delle Persone Giuridiche*), the former corporate income tax, effective 1 January 2004. Among the key features of IRES is the introduction of a definition of "permanent establishment" under Italian domestic law. As under IRPEG foreign persons are generally subject to IRES on business profits only if those profits arise with activities carried out in Italy through a PE.[2]

Prior Rules: OECD Definition of PE

Under prior rules, absent a definition of PE, the Ministry of Finance recognized the general applicability of the definition set forth in the OECD model.[3] As a result Italy granted nontreaty investors the benefit of a similar threshold level for taxation as the one granted to treaty investors.

For example, to establish whether the business profits of a foreign corporation were attributable to an Italian PE, a U.S. corporation needed to make reference to the PE definition contained in article 5 of the 1984 Italy-U.S. income tax treaty. A British Virgin Islands company needed to make reference to the similar PE definition contained in article 5 of the OECD model, regardless of whether the British Virgin Islands had entered into an income tax treaty with Italy.

New Rules: Domestic Definition of PE

Article 162 of the Italian Income Tax Code[4] introduces a definition of PE to income taxes and the regional tax on productive activities (*Imposta Regionale sulle Attività Produttive,* or IRAP). Income taxes include IRES and IRPEF (*Imposta sul Reddito delle Persone Fisiche*), which is the income tax on individuals. Article 162(2) does not indicate that the PE definition is applicable for VAT purposes.

With a few exceptions, the domestic definition of PE closely mirrors the definition contained in article 5 of the OECD model.

Article 162(1) defines PE as a fixed place of business, through which the business of a foreign person is wholly or partly carried on.

Consistent with the OECD model, article 162(4) contains exceptions to the general rule, listing a number of activities that may be carried on through a fixed place of business, but which do not create a PE. Also consistent with the OECD model, the Italian statute provides that a PE does not exist when the overall activity of the fixed place of business, resulting from a combination of exempt activities, is of a preparatory or auxiliary character. By inserting such a provision, Italy abandoned its long-standing unwillingness to commit that all or several of the exempt activities may be undertaken in combination without constituting a PE. Before, Italian authorities departed from the OECD model and reserved their right to judge actual cases on the relevant facts and circumstances as to whether the combination of activities constituted a PE.[5] As a result none of Italy's income tax treaties currently contains a

[1] *See Decreto Legislativo* 344 published in the *Gazzetta Ufficiale* 291 on 16 December 2003.

[2] Foreign persons are also subject to IRES on other categories of Italian-source income that do not constitute business profits, such as, for example, dividends, interest, royalties, real estate income, and capital gains.

[3] *See Circolare Ministeriale* 7/1496 dated 30 April 1977, and *Risoluzione Ministeriale* 9/2398 dated 1 February 1983.

[4] *Testo unico delle imposte sui redditi, Decreto del Presidente della Repubblica* 917 dated 22 December 1986 (ITC). Article references are to the ITC, unless otherwise noted.

[5] In the past, at least in one situation the Italian authorities ruled in favor of the taxpayer regarding this issue. A U.K. entity's offices in Italy that carried out advertising, market research, and quality control services for the head office in London did not constitute a PE. The activities fell within the definition of exempt activities under the Italy-U.K. income tax treaty. *See Risoluzione Ministeriale* 501504 dated 7 December 1991.

provision stating that a combination of exempt activities retaining preparatory or auxiliary character does not constitute a PE.

The primary departures from the OECD model are outlined below.

Definition of Place of Extraction of Natural Resources

Consistent with the OECD model, article 162(2) enumerates a list of typical examples of fixed places of business constituting a PE: a place of management; branch; office; factory; workshop; mine; oil or gas well; quarry; or any other place of extraction of natural resources.

Some domestic exemptions from PE status are broader and others are narrower than the ones provided by the OECD model.

Unlike the OECD model, article 162(2) goes on to state that places of extraction of natural resources include places located outside Italian territorial waters over which Italy may exercise exploitation rights in accordance with domestic or international law.

Definition of Building Site

Article 162(3) provides rules to determine whether a building, assembly, or installation site constitutes a PE and states that the site does not create a PE unless it lasts for more than three months. In contrast article 5(3) of the OECD model provides a threshold of 12 months.

The Italian statute includes supervisory activities connected to the site as part of the activities potentially giving rise to a PE. While the plain text of OECD model article 5(3) does not contemplate supervisory activities connected to the site as activities potentially giving rise to a PE, paragraph 17 of the OECD model commentary to article 5 indicates that onsite planning and supervision of the erection of a building are covered activities.

E-Commerce Exception

Article 162(5) provides that a foreign person having at its disposal computers and auxiliary equipment located within the Italian territory that enable it to collect and transmit data and information for selling goods or services does not per se create a PE. The plain language of the statute would seem to grant a rather broad exemption from PE status to foreign persons doing business in Italy through computer equipment, as compared to the exemption provided under the OECD model. The commentary to the OECD model[6] does not exclude the possibility that a PE may exist through the mere use of computer equipment located at a fixed place in the host state that is at the disposal of the foreign person.

Purchasing Agent Exception

Consistent with the OECD model, the Italian statute provides that a dependent agent of an enterprise is deemed to be a PE of the enterprise if the agent has, and habitually exercises, an authority to conclude contracts in the name of the enterprise. However, article 162(6) provides that if the agent's activities are limited to the purchase of goods or merchandise for the enterprise, the agent is not a PE of the enterprise.

The way that exception is formulated is narrower than the OECD model's. The latter provides that the agent is not a PE of the enterprise if its activities are limited to the exempt activities, which, if exercised through a fixed place of business, would not make this fixed place of business a PE. The exempt activities include *but are not limited to* the purchase of goods or merchandise for the enterprise.

Maritime Agent Exception

Consistent with the OECD model, articles 162(6) and (7) specify when activities carried on by an agent on behalf of a foreign person create or do not create a PE of that foreign person.

Article 162(8) provides that a foreign person is not deemed to have a PE in Italy merely because it carries on business in Italy through maritime brokers or representatives as defined under Italian law.[7] That provision departs from the OECD model and from all Italian tax treaties.

Consistent with article 8 (shipping and air transport) of the OECD model, Italy's income tax treaties generally contain provisions under which profits derived by an enterprise of one country from the operation in international traffic of ships or aircraft are taxable only in that country, regardless of the existence of a PE in the other country. The maritime agent exception to the PE definition contained in the Italian statute seems to have a different and, in some ways, broader scope than article 8 of the OECD model. While the

[6] *See* paragraphs 42.1 through 42.10 of the commentary to article 5.

[7] The statute exempts activities carried out through a *raccomandatario marittimo*, within the meaning of Law 135 dated 4 April 1977, or through a *mediatore marittimo*, within the meaning of Law 478 dated 12 March 1968.

latter applies only to income from the operation of ships (or aircraft) in *international* traffic, Italy's domestic law exemption from PE status for certain categories of maritime agents would seem to apply to *domestic* traffic as well.

Conclusions

Italy's domestic definition of PE provides a few departures from the OECD model. As discussed above some domestic exemptions from PE status are broader and others are narrower than the ones provided by the OECD model. To the extent the domestic exceptions from the definition of PE are broader than the ones provided under the OECD model, Italy's negotiating power is diminished to current and prospective treaty partners. By the same token, a narrow domestic definition of PE may provide an incentive for foreign businesses that do not have a presence in Italy to locate assets or activities there.

As under prior law, the new law has the effect of granting nontreaty investors the benefit of a similar threshold level for taxation as the one granted to treaty investors. To the extent domestic exemptions from PE status are broader than the ones provided under the applicable tax treaty, a treaty investor will seek to apply the more favorable domestic provisions.[8] ✦

[8]Article 162(1) states that the definition of PE is subject to the provisions of article 169, which provides that if the domestic law of Italy provides a more favorable treatment than a tax treaty, the taxpayer may apply the provisions of domestic law.