1. Guidelines issued by the Italian Tax Police (Guardia di Finanza)

Annex 2 to Notice no. 114153/2018\(^1\); clarifications and recommendations on the recent amendments to the definition of permanent establishment

The Italian Tax Police have provided clarifications on the amendments made by the 2018 Budget Law to the definition of permanent establishment (PE) (see our Tax Alert of 16 January 2018 and our Tax Alert of 6 December 2017). The most important points are outlined below.

— The purpose of the reform as a whole is to give taxing rights to the state where value is created. This also means the establishment of a new nexus for companies operating in the digital economy.

— The 2018 Budget Law has introduced a new form of fixed place PE\(^2\), i.e. a 'significant and continuous economic presence in the territory of Italy, built in such a way that it will not result in a physical presence in Italy'. This new definition, which implements certain recommendations made in the OECD BEPS Action 1 Report, should overcome the limitations of the former PE definition, which required a physical presence in the territory of the state. Moreover, it should lead to the taxation in Italy of activities carried on through intangibles only, such as those of MNEs operating in the digital economy. Likewise, due to the abrogation of the fifth paragraph of article 162 ITC\(^3\), the installation in Italy of computers or similar systems that allow electronic collection and delivery of data may now give rise to a PE.

— The occurrence of one of the activities in the ‘negative’ list is no longer sufficient to exclude a PE. Now the taxpayer must also prove the preparatory or auxiliary nature of those activities. The Tax Police notice clarifies that, in compliance with the OECD approach, an activity has a preparatory character when is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole, i.e. its core business; it has an auxiliary character when it is carried on to support, without being part of, the core business of the enterprise.

\(^1\) Issued on 13 April 2018.
\(^2\) ‘Contained in article 162 (2) (f-bis) of the Income Tax Code (ITC).
\(^3\) According to which, ‘the availability of computers and other auxiliary systems that enable the collection and transmission of data and information for the sale of goods and services does not constitute, of itself, a permanent establishment’.
— The anti-fragmentation rule means that officers must now scrutinize each single activity carried on by all group companies in Italy, even through entities that are not formally set up or identified there for tax purposes. Business processes and functions that are integrated with each other must be grouped together and the preparatory/auxiliary character of the combination of activities must be evaluated.

— The 2018 Budget Law has extended the agency PE definition to a person who ‘furthers the conclusion of contracts by the foreign enterprise with no material modifications’. For instance, this is the case of a resident commissionaire who does not formally conclude contracts in the name of the foreign enterprise but plays a decisive role (by, for instance, defining the main conditions) in the conclusion of contracts which are signed by the foreign enterprise without any substantial modifications. Whether the contract is concluded in the name of the commissionaire or in the name of the foreign enterprise will no longer be relevant: attention must be paid to how the negotiations are actually conducted. Therefore, during inspections it will be necessary to look beyond the legal aspects and formalities, carefully ascertain what functions and powers the commissionaire actually has, and evaluate the commissionaire’s actual capacity to decisively influence the conclusion of an agreement.

— The 2018 Budget Law has also altered the extent to which an agent must be independent, legally and economically, in order to exclude an agency PE. Persons who operate exclusively or almost exclusively on behalf of one or more enterprises to which they are closely related can no longer be considered independent.

— In the absence of clarifications, the amendments should apply from 1 January 2018 and not retrospectively.

— The new domestic PE definition is an alternative to that contained in the double tax treaties in force with Italy, which will prevail over the domestic definition if it is more favourable to taxpayers.

Notice no. 1/2018: guidelines on assessments regarding hidden permanent establishments

The Tax Police have provided operational instructions to their offices on how to tackle ‘hidden PEs’ (i.e. PEs hidden within a subsidiary) belonging to a multinational group.

The notice confirms, by suggesting specific databases that can be used to identify the control chain of an Italian company, that the control that a foreign enterprise exercises over its Italian subsidiary may be a risk factor, i.e. a symptom that the latter is a dependent agent of the first. It also lists a series of indicators of a possible PE hidden within a local subsidiary. Some examples are given below.

— Involvement of the Italian company’s personnel in the conclusion of contracts, or in the negotiation that leads to the conclusion of contracts, even if they do not hold powers of representation.

— Documents from which it is clear that the local entity is under a series of obligations and constraints and that it serves the non-resident enterprise.

— Documents, emails etc. from which it can be inferred that the group intends to separate the actual conclusion of contracts by the Italian taxpayer from their formal conclusion by the non-resident enterprise, with a view to concealing the existence of a PE in Italy.

— Factual evidence and declarations by the local entity’s employees (of crucial importance when investigating the real nature and scope of relations with the foreign enterprise).

On the other hand, the notice downsizes the importance of economic and legal dependence, with particular regard to multinational groups that operate in the digital economy and centralize certain activities (e.g. marketing, purchasing, administration) within a few subsidiaries. In this case, the local entities are highly specialized and therefore their direction and control by the parent and other related entities, which may limit their independence, may be justified and not automatically symptomatic of an agency PE. In such cases, officers are invited to first assess the fairness of the transfer prices and, only where it is clear that the local entity is performing functions totally different from those officially stated and pertaining instead to the core business of the foreign group, raise the issue of the possible existence of a PE.

2. Case Law

Supreme Court judgment no. 12237/2018: permanent establishment for VAT purposes

The existence in Italy of a place of management of the foreign enterprise is not sufficient to trigger a PE for VAT purposes. As also clarified by the EU Court of Justice, ‘in order to be considered an establishment to which the supplies of goods and services by a taxable person are connected, an establishment must possess a sufficient degree of permanence and a structure adequate, in terms of human and technical resources, to carry out the transactions under consideration on an independent basis’. In the case in question, the court decided that the foreign enterprise had no PE in Italy because, even though its managers held meetings there, it did not have an adequate structure, with both human and technical resources in Italy.

Supreme Court judgment no. 2407/2018: main business and place of management in Italy

The Supreme Court decided that a company resident in Germany and operating in the timber sale business had a PE/was considered resident in Italy, where its main business and place of management were located.

(4) Issued on 27 November 2017.

(5) Handed down on 18 May 2018.

(6) See, for instance, judgment in Case C-323/12 of 2014, E. ON, paragraph 46.

(7) Handed down on 22 January 2018.
The following factual evidence was considered relevant.

— The only shareholder of the German company was an individual resident in Italy, where he also owned an Italian company, engaged in the same timber sales business and formally an agent of the German company.

— The German company realized most of its turnover from the sale of timber in Italy.

— The contracts with Italian clients were concluded in Italy.

— The German company had a cash account in Italy, where cash from timber sales was deposited.

— Accounting, commercial and banking documentation was found in Italy at the premises of the shareholder.

— The German company had no operational structure or employees, and used those of its Italy-based agent.

Regional Tax Court of Milan judgment no. 4871/2017:
sales support

A company resident in Italy provided sales support to a company resident in the UK (not belonging to the same group as the Italian company) and operating in the software business. The court decided that there was no agency PE hidden within the local entity because an agency PE presupposes that the agent (i) has the power to conclude contracts in the name and on behalf of the non-resident entity or (ii) plays an essential role in the negotiations that lead to the conclusion of a sales contract. The fact that the Italian entity was subject to the stringent directives and control of the UK company was not considered sufficient to trigger a PE, as these are typical features of the software business. Moreover, the work done by the employees of the Italian entity for the UK company (e.g. visits to local distributors to collect information, occasional customer support, drafting of reports, attendance at promotional and press meetings, without any involvement in the definition of prices and discount policies) was considered to be merely preparatory and auxiliary.

KPMG’s comments

The first Tax Police notice is important because it is the first official clarification on the new definition of PE, introduced by the 2018 Budget Law in order to align domestic law with the OECD BEPS Action 7 Final Report and with the 2017 OECD Model. In reality, this new definition applies only to cases where there is no double tax treaty in force with Italy, as double tax treaty provisions, which are based on the pre-BEPS OECD Model and thus are generally more favourable to taxpayers, prevail over the domestic ones.

Remarkably, the second Tax Police notice seems to recognize the specific nature of multinational groups, by inviting officers not to claim automatically that a resident subsidiary is an agency PE, but to try first to evaluate whether transfer prices have been correctly applied (transfer pricing cases, in contrast with PE ones, do not have criminal penalty implications). This clarification is important as assessments of hidden PEs of multinationals are particularly frequent in Italy.

The Supreme Court’s judgment no. 2407 is one of a number of Italian court decisions in which the concepts of deemed residence and PE overlap, while the two notions should be kept separate, as one excludes the other: there is deemed residence only in the specific cases indicated by law and if a company is considered to be resident in Italy it cannot, by definition, have a PE in Italy.

The Regional Tax Court judgment is interesting because, on the one hand, it reveals the aggressive attitude of the Italian tax authorities, which will claim that there is a hidden PE even in cases where the non-resident enterprise is an independent third party on whose behalf the local subsidiary has no authority to conclude sales contracts. On the other hand, the court has ruled in favour of the taxpayer and confirmed that sales support, without any involvement in negotiations or price definition, is merely a preparatory/auxiliary activity and does not give rise to a PE. With particular respect to the agency PE definition, case law must be taken into consideration, due to an Observation made by Italy on the OECD Commentary.