The Italian “Web Tax”: The New Administrative Procedure for Multinational Enterprises to Disclose Hidden Permanent Establishments in Italy

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This article will first analyse the (improperly defined) Italian “web tax” procedure and will proceed to focus on the current and future legislative framework governing the PE status, followed by an analysis of the criteria and methodologies that may possibly be chosen (including within the web tax procedure) in order to determine the fair profit share to be attributed to the disclosed PE.

1. Introduction

In the evolving international economy, one of the main issues faced by governments is defining and maximizing their domestic tax shares, with a tendency to consider multinational enterprises (MNEs) more in relation to their presumed recourse to aggressive tax strategies rather than acknowledging their contribution to the social and business environments.[1]

Major MNEs are being increasingly targeted by tax authorities by means of disputes that are often grounded on the alleged artificial avoidance of the permanent establishment (PE) status rather than on presumed profit shifting that constitutes a breach of the local transfer pricing legislation.

This is a pressing theme that is especially relevant for MNEs that are active in the “digital economy”, given their peculiar business models which often end up physically concentrating the main part of their presence in a few jurisdictions. Local structures in the various countries where the products or services are sold and provided may indeed assume an exclusively supportive role.

In this regard, a preliminary issue arises if there is an attempt to impose some boundaries on the concept of the digital economy. The European Commission has stated that “defining what constitutes the digital economy has proven problematic, because of the ever-changing technologies of the ICT sector and the widespread diffusion of the digital economy within the whole economy”.[2]

Such a phenomenon has been addressed by the BEPS Project in Action 1 (Addressing the Tax Challenges of the Digital Economy) and Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) which will lead to significant changes in at least the interpretation of article 5 of the OECD Model on PEs.

Several commentators have considered the signing of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) in June 2017 as a milestone in the struggle to actually implement the work done within the OECD. Although it has been signed by 68 countries, some main jurisdictions (such as Brazil, the Cayman Islands, Panama, the United Arab Emirates and the United States) have not entered into the MLI.

In this framework, some countries are already at the forefront of implementing measures seeking to counter questionable practices, particularly in relation to the (presumed) avoidance of the PE status.[3]

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1. For a broader opinion on the overall economic situation, refer to M. Herrington & C.H. Lowell, *The Evolving World of Global Tax Planning: Part I*, 24 Intl. Transfer Pricing J. 1 (2017), Journals IBFD; and M. de Wilde, *Taxation of Multinational Enterprises in a Global Market: Moving to Corporate Tax 2.0*, 70 Bull. Intl. Taxn. 3 (2016), Journals IBFD.
2. European Commission, *Report of the Commission Expert Group on Taxation of the Digital Economy*, para. 11 (28 May 2014). *See also* Blum, who notes that: “even if the BEPS initiative, especially the work on Action 1, very prominently places the nexus concept of art. 5 of the OECD Model under scrutiny, the underlying conceptual discussion is not that new. Specifically, the OECD in the Commentary on Article 5 of the OECD Model (2008) inserted an optional service PE provision, which would provide for the establishment of a PE due to the mere provision of services exceeding certain temporal thresholds, but without, any fixed location in the source state whatsoever”. D.W. Blum, *Permanent establishment and action 1 on the digital economy of the OECD Base Erosion and Profit Shifting Initiative – the nexus criterion redefined?*, 69 Bull. Intl. Taxn. 6/7 (2015), Journals IBFD.
3. UK: Finance Act, 2016, National Legislation IBFD. As an example, *see* the Diverted Profits Tax (DPT), introduced in the United Kingdom with the objective of countering aggressive tax planning by multinational enterprises to transfer their profits abroad by way of business structures that prevent the characterization by the tax authority of a PE in the United Kingdom. For more details, *see* R. Tomazela Santos, *The United Kingdom’s Diverted Profits Tax and Tax Treaties: An evaluation*, 70 Bull. Intl. Taxn. 7 (2016), Journals IBFD.

During recent years, Italian politicians have been calling for better solutions to fight the alleged avoidance of income taxes by digital companies. Many proposals have been subject to discussion in the Italian parliament but have failed to achieve any concrete results.[4]

Over the past few years, the Italian tax authority (*Agenzia delle Entrate*) has (finally) made a successful attempt to "attack" the main players of the digital economy active in Italian territory. In most cases, the disputes have ended with the signing of extrajudicial settlements for which the original claims were somewhat redetermined.

In such a context, the Italian parliament[5] has implemented the new provision in question, which aims for the disclosure – through an ad hoc administrative procedure with the Italian tax authority – of possible hidden PEs of MNEs acting in Italian territory.

Even though the above procedure has been labelled as a "web tax", it is not actually a tax itself, but rather a procedure more consistent with a form of tax amnesty. It does not just apply to the MNEs of the digital economy, but – under the relevant conditions – to any MNE, irrespective of the business sector.

It goes without saying that the web tax procedure is not a definitive solution; as stated by the Italian Ministry of Economy and Finance,[6] it is meant to act as a "transitory" rule to be in place until sharper tools become available to the competent authorities to challenge artificial structures.

As will be extensively discussed below, the MLI shall in fact introduce some tighter provisions (at least in the signatories' jurisdictions) to counter the most aggressive schemes.

The short-term goal of the Italian web tax procedure is actually to incentivize groups that feel like they are at risk to spontaneously settle their position in light of the most recent OECD interpretations,[7] and in doing so, benefit from reduced administrative penalties and a waiver from criminal charges.

For the sake of completeness, one should note that the MLI is expected to come into force within a generous timeframe, only after the complex and sophisticated ratification procedure has come to an end.

For more details on the application of the provision and its effects, an ad hoc provision by the *Agenzia delle Entrate* is expected to be issued at a later date.

2. The New Italian Cooperative Procedure for the Disclosure of Hidden PEs

Article 1-*bis* of Law Decree 50 of 24 April 2017, converted into Law 96 of 21 June 2017, introduced a specific "procedure of enhanced cooperation and collaboration" (*procedura di cooperazione e di collaborazione rafforzata*) with the aim of intercepting the income derived by non-resident entities (part of larger multinational groups) from the sale of goods and/or the provision of services in Italian territory, either directly or with the support of an Italian entity belonging to the same multinational group, by means of a hidden PE in Italy.

The subjects affected by the new provision are non-resident companies and entities[8] that: (i) are part of multinational groups with a consolidated worldwide turnover higher than EUR 1 billion per year;[9] (ii) sell goods or provide services in Italian territory for an amount higher than EUR 50 million per year;[10] and (iii) benefit from the support of other Italian resident[11] subjects (including any pre-existing PE in Italy[12]) that are part of the same multinational group.[13]

As already mentioned, a main point of the provision is that any MNE can enter into this procedure regardless of their business activity, which means that companies from other sectors can also benefit from it. All entities that meet the previously mentioned conditions (in terms of overall group turnover and the revenue threshold in Italy) can benefit from the procedure of enhanced cooperation and collaboration in the case that their business model prompts the existence of a PE in Italy.

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4. V. Perrone, D. Stevanato & R. Lupi, *Ulteriori riflessioni sulla "web tax": estendere i criteri di collegamento o il concetto di stabile organizzazione*, Dialoghi tributari No.1/2015.
5. *See* declarations released by the President of the Treasury Commission at the Chamber, Francesco Boccia, who underlines how the control activity carried out by the Italian tax authority on one of the most important actors in the digital economy shall actually be used as "guidance" for the implementation of the new provision. "It is meant to offer MNEs (…) the possibility to avail of the procedure of enhanced cooperation and collaboration, on the basis of the work carried out to date by the Financial Police, the Public Prosecutor's Office and the tax authority" *Bollettino delle giunte e delle commissioni parlamentari* (22 May 2017).
6. For a comment on the rationale of the new rule, ***see*** M. Mobili & G. Parente, *Web tax, l'Italia gioca d'anticipo: Accordo su opzione con i big della rete*, Il Sole 24 Ore, 11 May 2017.
7. C. Romano & D. Conti, *La fiscalità della "digital economy" all'indomani degli studi BEPS*, Corriere Tributario, No. 4/2016.
8. Specific reference is made to art. 73(1)(d) of the Italian Tax Code (ITC), which defines non-resident subjects liable to tax in Italy. The range of subjects mentioned in the definition is very wide and includes any company and entity of any kind with or without legal personality, including trusts which, under Italian tax law, are deemed non-resident in Italian territory.
9. Art. 1-*bis*(3) clarifies that the calculation of the consolidated worldwide turnover shall take into account the higher value of the sale of goods or provision of services stated in the consolidated financial statement of (i) the fiscal year preceding the filing of the request for the cooperative procedure and (ii) the two previous fiscal years.
10. Art. 1-*bis*(4) clarifies that the calculation of the amount of the sale of goods or provision of services in Italian territory shall take into account the higher value of the sale of goods or provision of services stated in the Italian financial statement of (i) the fiscal year preceding the filing of the request for the cooperative procedure and (ii) the two previous fiscal years. Furthermore, for the same purposes, the sale of goods or provision of services rendered by resident and non-resident subjects that directly or indirectly control or are directly or indirectly controlled by the multinational enterprise (MNE) applying for the new procedure shall be taken into account (specific reference is made to the Italian transfer pricing legislation under art. 110(7) of the ITC in order to ascertain the conditions to consider the various subjects to be related parties).
11. The range of eligible subjects is defined under art. 73(1)(a) of the ITC.
12. The definition of a PE according to Italian Tax Law is provided under art. 162 of the ITC.
13. In order to ascertain if the EUR 50 million threshold is met, art. 1-*bis*(4) requires that reference is made to transactions carried out in Italy by the entire group to be identified pursuant to the conditions set forth by the Italian transfer pricing legislation of art. 110(7) of the ITC.

According to article 1-*bis*(2), should the relevant group or entity acknowledge that the venue through which the business is carried out in Italy entails the existence of a PE pursuant to the relevant legislation,[14] they may enter into the procedure.

In practical terms, the procedure of article 1-*bis* provides the possibility to ask the Italian tax authority for an opinion by means of filing a specific request (following the same procedural route already provided for in the cooperative compliance regime – "*regime dell'adempimento collaborativo*"[15]) in order to mutually ascertain whether the conditions to qualify for the PE status are met.

Such a procedure is actually carried out with the same intention as the previously mentioned cooperative compliance regime, recently introduced in Italy in 2015. This regime intends to promote the adoption of a wider communication and cooperation framework between companies and the Italian tax authority in order to prevent and easily resolve any tax disputes.[16]

In the case that the procedure results in the detection of the effective presence of a PE by the Italian tax authority (which one should assume is the case for those who enter into the procedure), the new regime allows the taxpayer to determine, together with the tax authority, the relevant tax underpayment of the hidden PE in relation to all fiscal years still "open to assessment".[17]

The settlement to be reached through the web tax procedure is made in the form of *accertamento con adesione*,[18] which generally permits the reduction of administrative penalties to one third of the minimum as stated by the law.[19]

In the context of the new provision, however, if the taxpayer promptly pays the sums agreed upon in the tax procedure (i.e. within 20 days of its conclusion), the following benefits are offered:

- a further 50% reduction of the administrative penalties.[20] Penalties should therefore expect to be levied within the web tax procedure in an amount equal to 20% of the tax due; and
- the non-application of the criminal penalties which are applicable in the case of failure to file the tax return.[21]

It should also be emphasized that if the adherence to the procedure of enhanced cooperation and collaboration results in an agreement on the criteria to be adopted for the attribution of profits to the Italian (formerly hidden) PE for the years still open to assessment, the same enterprise may enter into an additional administrative procedure for the purpose of formally applying the same criteria for future years.

The mentioned alternative administrative procedure occurs with the alternative to the "international ruling" (*accordo preventivo per le imprese con attività internazionale*) set forth by article 31-*ter* of Presidential Decree 600 of 29 September 1973 (Decree 600/73), which gives MNEs the possibility to reach an advance agreement with the Italian tax administration on the tax treatment of specific cross-border matters,[22] including, inter alia, the attribution of profits to the Italian PE.[23]

Given this framework, the combination of the Italian web tax with the aforementioned international ruling procedure should allow MNEs to reach the comprehensive goal of rectifying the past and setting rules for the future.

From a different perspective, it should be taken into account that – as stated by article 1-*bis*(11) of Law Decree 50, cited above – the web tax procedure is not available when the relevant subjects (including the related parties) have already received notification of inspections, tax audits or any other administrative or criminal procedures by the competent authority regarding any potential hidden PEs.

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14. As further described *infra*, the definition of a PE under Italian law practically arises from the coordination with art. 5 of the double tax treaties in force with other countries and is based on art. 5 of the OECD Model.
15. As generally provided for under art. 1-*bis*(2), the request should be sent to the *Direzione Centrale Accertamento* (which is deemed to be the competent office within the Italian *Agenzia delle Entrate*, or Italian tax authority) through an online procedure in the same manner provided for under the "cooperative compliance" programme (specific reference should be made to art. 7 of Legislative Decree 128 of 5 August 2015). In any case, further and more specific details on the application for the procedure are expected to be provided by an ad hoc regulation to be issued by the Italian tax authority.
16. The cooperative compliance programme – as regulated under Legislative Decree 128 of 5 August 2015 – aims at promoting and enhancing the cooperation between the Italian tax authority and enterprises in order to avoid tax litigation and to reach a higher degree of certainty in the application of tax rules. In general, the request to enter the programme can be filed by resident and non-resident entities with an Italian PE having a global turnover higher than EUR 10 billion. In addition, the applying subjects can also ask for admission to the cooperative compliance programme for their resident and non-resident entities having a PE in Italian territory and performing strategic direction functions in relation to the tax control framework, regardless of the amount of turnover or revenues. Once admitted to the programme, the enterprise benefits from several advantages such as (i) the 50% reduction of tax penalties and, in any case, their application in an amount not exceeding the minimum as stated by law and (ii) access to a "fast track" ruling procedure on tax matters which may be of interest to the enterprise.
17. The provision refers to "fiscal years for which the term for the filing of the tax return has expired". In this regard, refer to art. 43 of Decree 600/73 and art. 57 of Presidential Decree 633 of 26 Oct. 1972, as recently modified by Law 208 of 28 Dec. 2015.
18. The "*accertamento con adesione*" is a specific procedure – regulated under Legislative Decree 218 of 19 June 1997 (Legislative Decree 218/1997) – which consists of discussions between the Italian tax authority and the taxpayer in order to correct any mistakes regarding the declaration of the taxable base or its determination where no tax return is filed by the taxpayer. As provided for under art. 7 of Legislative Decree 218/1997, this procedure is concluded with a settlement deed drafted by the competent office of the Italian tax authority signed, in acceptance, by the taxpayer. It should be noted that this procedure carries several benefits for the taxpayer who decides to access it, such as the reduction to one third of the minimum as stated by the law of the applicable administrative penalties.
19. This benefit is provided for under art. 2(5) of Legislative Decree 218/1997, under which: "subsequent to the definition, administrative penalties object of the adhesion for tax violations committed in the fiscal year as well as for violation regarding the content of the tax return relevant to the same fiscal year, are applied in the measure of one third of the minimum provided by the law".
20. The taxpayer would therefore benefit from an overall reduction of up to one fifth of the minimum as stated by the law.
21. *See* art. 5 of Legislative Decree 74 of 10 March 2000. The criminal penalty for the specified crime is imprisonment from one year and six months up to six years, and is applicable when the evaded tax is higher than EUR 50 thousand per year.
22. For an opinion on this provision, *see* E.A. Palmitessa, *The new international tax ruling procedure*, 56 Eur. Taxn. 10 (2016), Journals IBFD.
23. In brief, the Italian international ruling (i) is binding for five years starting from the tax period in which it is signed and may apply retrospectively to the tax year in which the application was submitted if the facts and the circumstances on which the agreement relies were also present in the previous tax periods and the taxpayer requests that the advance pricing agreement (APA) be applied retrospectively, and (ii) prevents – for the period during which the agreement is valid – the competent authorities from carrying out tax inspections.

3. The Legislative Framework for PEs: The Italian and International Approach

In order to evaluate the possible alternative to the procedure, it is necessary to analyse the concept of PEs in more detail. In particular, the definition of a PE as stated in Presidential Decree 917 of 22 December 1986 ("Italian Tax Code", or ITC), the interpretations rendered by the Italian jurisprudence and the practice of the *Agenzia delle Entrate* will be analysed, followed by an analysis of the OECD efforts to modify article 5 of the OECD Model.

As will be described, the current framework *ex se* is in fact not tailored to accommodate the peculiarities of most modern business schemes, such as those pertaining to the digital economy, with the consequence that either the Italian practice or the relevant jurisprudence must rely on extensive interpretations of the provisions currently in force.

3.1. The Italian PE provision

The definition of a PE according to the Italian tax legislation was introduced in 2004 by Legislative Decree 344 of 12 December 2003, and ever since its establishment has never been amended.[24] In particular, article 162 of the ITC embodies the local legal framework for Italian PEs for the purposes of direct taxation. It should be noted, however, that such a definition mirrors the content of article 5 of the OECD Model (1963), generally found in Italian tax treaties.

As a general rule, a PE consists of a fixed place of business through which a non-resident enterprise wholly or partly carries out its business activity in Italian territory.

The current legal framework also provides a "positive list" of examples[25] that considers each of the following as constituting a PE:

- a place of management;
- a branch;
- an office;
- a factory;
- a workshop; or
- a mine or oil/gas well.

Notwithstanding the fact that the definition of a PE, as already mentioned, has never changed since its introduction, several interpretations have been provided by the Italian jurisprudence and by the Italian tax authority.

The most debated issue is generally the "negative list" of excluded activities, according to which a fixed place of business is not considered to be a PE, as follows:

a) a facility is used for the sole purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

b) the stocks of goods or merchandise belonging to the enterprise are maintained for the sole purpose of storage, display or delivery;

c) the stocks of goods or merchandise belonging to the enterprise are maintained for the sole purpose of processing by another enterprise;

d) a fixed place of business is maintained for the sole purpose of purchasing goods or merchandise or of collecting information for the enterprise;

e) it is maintained for the sole purpose of carrying on, for the enterprise, any other activity having preparatory or auxiliary character;

f) it is maintained solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.[26]

In addition to these conditions, it is also stated that the availability *ex se* of computers and relative auxiliary installations that permit the collection and transmission of data and information aimed at the sale of goods and services does not constitute a PE.

Notwithstanding the content of the latter provision, the Italian tax authority noted that "given its physical presence, a server can, under certain conditions, constitute a fixed place of business". This conclusion is to be reached, according to the relevant practice, every time the foreign enterprise carries out an activity of direct electronic commerce (characterized by the supply of goods or services that can be

24. It should be noted, however, that arts. 7 and 14 of Legislative Decree 147 of 14 September 2015 introduced several changes with regard to the regime applicable to PEs, even if to introduce criteria for the computation of the taxable income of Italian PEs. For more details, *see* G. Beretta, *New Rules on the Attribution of profits to permanent Establishments*, 70 Bull. Intl. Taxn. 6 (2016), Journals IBFD.
25. C. Romano & R. Russo, *Italian Tax Consequences of Permanent Establishments*, 64 Bull. Intl. Taxn. 8/9 (2010), Journals IBFD, in which the authors observed that "in interpreting Italian tax treaties and domestic law, the OECD's positive list should be considered to be a list of deemed PEs rather than a list of mere examples".
26. *See* art. 162(4) ITC.

downloaded directly from the computer) and all the contractual steps, including the acquisition and payment of the product, take place through the Internet.[27]

In a different case, the server was again found as constituting a PE in Italy ("even if limited to certain functions") of the foreign enterprise based on the fact that it supported the business carried out locally by the MNE managing the purchase orders and providing the sharing of the collected data and information with the same MNE.[28]

Continuing with the analysis of the provisions on PEs, there is also the case of the "agency PE", in which a resident or non-resident subject habitually concludes contracts on behalf of the non-resident enterprise. This subject then constitutes a PE in Italy of the non-resident company.

It is, however, stated that the mere fact that a non-resident enterprise exercises its activity in Italy through a broker, general commission agent or any other independent agent does not render it a PE, under the condition that they act in the ordinary course of their business.

With regard to the hidden agency PE, a particular decision by the Italian Supreme Court[29] deserves to be mentioned here as it stated that the power to conclude contracts has to be pondered making reference to the "real economic substance". In particular, such power to conclude contracts should be cautiously considered even if the agent only takes part in certain phases of the negotiation. In this particular case, the Supreme Court discovered the presence of a PE based on the fact that the foreign enterprise benefited from the support of non-independent agents (with representative powers and the power to conclude contracts), even if not acting under the instructions of the foreign enterprise, but rather intervening with the mentioned phases of the negotiations.

To conclude, it can be easily understood from this case how the current legal framework of PEs is obsolete when it comes to capturing the peculiarities of the modern business schemes, and even more so with reference to the peculiarities of the digital economy.[30]

It is for this reason that the Italian practice and jurisprudence quoted so far (being clearly just a very small portion of that available on the PE topic) had to struggle to bridge the gap by adapting the article 5 provision to frequently changing patterns.

Acknowledging these weaknesses, the international practice has introduced several changes to the OECD Model that are supposed to be implemented within a reasonable time frame once the MLI comes into force.[31]

3.2. Article 5 of the OECD Model in light of the most recent BEPS work

The definition of a "permanent establishment" under the current legislative framework relies on three main conditions that must be jointly met, which are (i) the existence of a place of business;[32] (ii) said place of business must be fixed; and (iii) the enterprise carries out its business through this fixed place.[33]

It is immediately evident that the "fixed place" condition is not compatible with the typical features of the digital economy. However, at the interpretative level, the international practice already clarified that, for instance, the mere presence of automatic equipment in the alleged place of business may constitute a PE even if the employees' activity is limited to "setting up, operating, controlling and maintaining such equipment".[34]

The Commentary on Article 5 of the OECD Model dedicates a specific paragraph to "electronic commerce". In particular, under paragraph 42.2, it is stated that an Internet website does not constitute a form of tangible property in itself, and therefore cannot constitute a PE. The same cannot be said, however, with specific reference to the server. The Commentary on Article 5 of the OECD Model indeed clarifies

27. *See* Resolution 119/E of 28 May 2007, in which an Internet video game provider installed two servers in Italian territory and based them from an Internet service provider (ISP). The Italian tax authority noted that if "the servers are of exclusive property – and use – of the non-resident company, and they are installed for an indefinite amount of time in Italy and through the same servers is carried out the business activity of the foreign enterprise, it should be considered that the services in question rendered to Italian customers are provided by a permanent establishment in Italy and, as such, they shall be subject to tax in the territory of the State".

28. *See Commissione Tributaria Regionale delle Marche* decision 44/2/22 of 24 June 2011, according to which even if the servers (situated at the seat of the Italian subsidiary) were merely used for the support and coordination of the activity in Italy, given the magnitude of support provided, the judges discovered the presence of a PE.

29. *See Corte di Cassazione* decision 8543 of 29 April 2016 and *Corte di Cassazione* decision 7682 of 25 May 2002.

30. *See* OECD, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD, in which the same international practice acknowledges the severe difficulties in attributing the taxing right to the jurisdiction in which the counterparties/clients of the MNE reside; in particular, Annex B provides that "State S does not tax the profits derived from these activities either because it has no right to do so under its domestic law or because the relevant double tax treaty prevents it from doing so in the absence of a permanent establishment (PE) of TCo in State S".

31. The MLI was signed by 68 countries in Paris on 7 June 2017. It should be noted that the timeline for the implementation of this instrument is long and complicated. Under the MLI, after the completion of the steps undertaken to sign the MLI, the signatories shall ratify the instrument in accordance with their domestic procedures. The MLI will then "enter into force on the first day of the month following the expiration of a period of three calendar months beginning on the date of deposit of the fifth instrument of ratification, acceptance or approval" (*see* art. 34 MLI).

32. Para. 4 of the Commentary on Article 5 of the OECD Model (2010) clarifies that the term "place of business" includes any premises, facilities or installations used to carry out the business of the enterprise whether or not they are used exclusively for that purpose.

33. Para. 5 of the Commentary on Article 5 of the OECD Model (2010) underlines that such a condition shall apply to any kind of situation in which the business activity is carried out, giving a "wide meaning" to the words "through which". According to the definition provided for by the OECD Model (2010), in order for a place of business to constitute a permanent establishment, the enterprise using it must carry on its business activity wholly or partially through it (*see OECD Model Tax Convention on Income and on Capital: Commentary on Article 5* para. 7 (22 July 2010), Models IBFD).

34. Id., at para. 10: "a permanent establishment may […] exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment".

that "the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a 'fixed place of business' of the enterprise that operates that server".[35]

The same conclusion is reached with regard to computer equipment placed at a given location. According to the Commentary on Article 5 of the OECD Model, in this case, the requirement to have a fixed place of business is met if the server is located at a certain place for a sufficient period of time so as to become "fixed" in accordance with the meaning of article 5(1) of the OECD Model.[36]

However, since 2010, the typical digital economy business models have evolved, and the questions arising from this evolution have changed drastically.

If one intends to focus on the scope of the aforementioned negative list, paragraph 42.7 of the Commentary on Article 5 of the OECD Model (2010) lists a number of activities that would generally have been regarded as preparatory or auxiliary, but in current times should be reconsidered in light of Action 7. This list includes:

- providing a communications link between suppliers and customers;
- advertising goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise; and
- supplying information.

In addition, the same Commentary on Article 5 of the OECD Model clarifies that if these activities form an essential and significant part of the business of the enterprise as a whole, a PE is deemed to exist.

Another question that should be of interest to digital players is whether Internet service providers (ISPs) hosting websites of digital enterprises on their own servers may constitute a PE under the definition of article 5(5).

As a matter of fact, one could argue that ISPs do not qualify as agents of digital enterprises because they do not generally have the authority to conclude contracts on behalf of these enterprises. ISPs usually act as independent agents in the ordinary course of their own business, and therefore a PE cannot exist.[37]

In essence, the current legislative framework ruling the status of a PE will have to be reconsidered in light of the clarification and changes brought about by the BEPS Project.

The main goal of the BEPS Project is indeed to apply the traditional concept of a PE to the digital economy and to understand whether such a concept is adequate in order to lead to a fair and enforceable allocation of taxing rights or if it needs to be radically reshaped.[38]

3.3. The future legal framework

One of the main solutions proposed in BEPS Actions 1 and 7 to tackle the digital economy tax peculiarities is to modify article 5(4) of the OECD Model to ensure that each of the exceptions included in the negative list is limited to activities that are otherwise of a "preparatory or auxiliary" character.[39] As a result, Action 7 proposed to add the following condition at the end of the mentioned list:

> Provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of preparatory or auxiliary character.[40]

In practice, since certain activities that were previously granted the benefit of these exceptions have become increasingly significant components of businesses in the digital economy, they will no longer be entitled to any such exception.

The proposed changes to paragraph 21 of the Commentary on Article 5 of the OECD Model (2010) clearly define the scope of this modification. It is in fact emphasized that "the preparatory or auxiliary character of activities carried on at a fixed place of business must

35. Id., at para. 42.2. Para. 42.4 then provides that "in order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning" of art. 5(1).
36. Id., at para. 42.4.
37. Id., at para. 42.10: "paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the websites belong, because they will not have the authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the websites of many different enterprises".
38. *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, *supra* n. 30, at para. 275, underlines how Action 7 analyses whether activities that are treated as preparatory or auxiliary under the definition of art. 5(4) may continue to benefit from the exceptions provided by the "negative list", given that in recent years they have become core components of the typical digital economy business models.
39. Id., at para. 215: "This work was identified by the Task Force on the Digital Economy (TFDE) as a key area of focus in order to ensure that BEPS risks in the digital economy could be addressed. The work therefore took into account the key features of the digital economy in developing changes to the definition of PE to ensure that artificial arrangements cannot be used to circumvent the threshold for exercising taxing rights". For a practical example of the inconsistency of the current provision vis-à-vis the digital economy, *see* id., at para. 344: "For example, if proximity to customers and the need for quick delivery to clients are key components of the business model of an online seller of physical products, the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers would no longer be entitled to an exception from PE status".
40. This proposal was then transposed in one of the options provided for under art. 13 of the MLI which is aimed at changing the content of the negative list within double tax treaties. In particular, in the exercise of its right of option, Italy chose to apply Option A under art. 13(1) deciding to implement this modification in its tax legal framework.

be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or closely related enterprises carry on in the same State".[41]

This approach is justified in light of the characteristics of the most recent developments in digital businesses. The increasing absence of physical elements, in respect of both the services offered and the operative functions necessary for the activity (such as marketing activity via the Internet and the collection of Internet users' data), is indeed incompatible with the rationale of the negative list as stated in the current OECD Model.

The international practice faces yet another deficiency in the current provision when it comes to the manner in which digital companies tend to conclude contracts with clients around the world. In this sense, for example, Action 1 provides that "where the sales force of a local subsidiary of an online seller of tangible products or an online provider of advertising services habitually plays the principal role in the conclusion of the contracts with prospective large clients for those products or services, and these contracts are routinely concluded without material modification by the parent company, this activity would result in a permanent establishment for the parent company".[42]

Therefore, with regard to the agency PE, the Final Report on Action 7 proposed to modify article 5(5) so as to extend the provision to a subject who "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise".[43]

In practice, the consequent modifications to the Commentary on Article 5 of the OECD Model (2010) state that the actions taken on behalf of the MNE are sufficient to prove the presence of a PE, as long as they result in the conclusion of contracts and go beyond mere promotion or advertising.[44]

In other words, a focus is introduced on the substantial role of activities that are carried out with the aim of concluding contracts, even if under contract law such contracts are deemed as concluded outside of the state of the local subsidiary.

A further solution to challenge abusive schemes is the proposed introduction of the "anti-fragmentation rule" in order to ensure that it is not possible to benefit from exceptions under article 5(4) through the fragmentation of business activities among closely related entities belonging to the same MNE. For example, "the maintenance of a very large local warehouse in which a significant number of employees work for purposes of storing and delivering goods sold online to customers by an online seller of physical products (whose business model relies on the proximity to customers and the need for quick delivery to clients) would constitute a PE for that seller".[45]

To conclude, the OECD work on Action 7 provides for some changes to be made to article 5 of the OECD Model, including the following:

- where the activities that an intermediary exercises are, substantively, aimed at the conclusion of contracts to be performed by the MNE, the latter should be considered to have a taxable presence in that country unless the intermediary performs those activities as part of an independent business; and
- it should not be possible to avoid a PE status by using the exemptions if the activities are not preparatory or auxiliary, or "by fragmenting a cohesive operating business into several small operations in order to argue that each party is merely engaged in preparatory or auxiliary activities that benefit from these exemptions".

The MLI signed in June 2017 represents, to a certain extent,[46] the means through which the 68 signatory countries will implement the modifications proposed in the BEPS Project to the existing double tax treaties.

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41. *See* OECD, *Preventing the Artificial Avoidance of Permanent Establishments – Action 7: Final Report 2015*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD, at 30.
42. *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, ***supra*** n. 30, at 12.
43. *See Preventing the Artificial Avoidance of Permanent Establishments – Action 7: Final Report 2015*, ***supra*** n. 41, at 16.
44. Id., at 17: "It would not have been in the interest of international economic relations to provide that any person undertaking activities on behalf of the enterprise would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise, can lead to a permanent establishment for the enterprise".
45. *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, ***supra*** n. 30, at 12.
46. A specific "opt-out" mechanism is provided for under the MLI in order to permit each signatory to decide which provisions shall be transposed in their double tax treaties. *See* OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2016), Treaties IBFD, at 4: "in a number of cases the Convention permits a Party to reserve the right to opt out of applying a provision to a subset of Covered Tax Agreements in order to preserve existing provisions that have specific, objectively defined characteristics. Except as otherwise provided, such reservations are not mutually exclusive. As a result, where a Party makes one or more such reservations, all such reservations will apply as between the reserving Party and all Contracting Jurisdictions to the Covered Tax Agreements that are covered by such reservations".

The changes to the PE legal framework in particular are transposed in articles 12 (Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements and Similar Strategies)[47] and 13 (Artificial Avoidance of Permanent Establishment Status through the Specific Activity Exemptions)[48] of the MLI.

With regard to the latter, article 13 refers to the modifications to the negative list with the addition of two different options aimed at strengthening the preparatory or auxiliary character and the contrast with the abusive alternative to the exemptions, i.e. the anti-fragmentation rule.

Concerning the modifications to the negative list, two options have been proposed (Option A and Option B), which actually differ in their formulation but should lead to the same result.

Specifically, Italy decided to apply Option A, under which:

> Notwithstanding the provisions of a Covered Tax Agreement that define the term "permanent establishment", the term "permanent establishment" shall be deemed not to include:
>
> a) the activities specifically listed in the Covered Tax Agreement (prior to modification by this Convention) as activities deemed not to constitute a permanent establishment, whether or not that exception from permanent establishment status is contingent on the activity being of a preparatory or auxiliary character;
>
> b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a);
>
> c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b)
>
> provided that such activity or, in the case of subparagraph c), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.[49]

Concerning the attempt to limit the abusive alternative to the exemptions of the negative list, the new anti-fragmentation rule states that:

> A provision of a Covered Tax Agreement (as it may be modified by paragraph 2 or 3) that lists specific activities deemed not to constitute a permanent establishment shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting Jurisdiction and:
>
> a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of a Covered Tax Agreement defining a permanent establishment; or
>
> b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,
>
> provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.[50]

Having described the main features of the new Italian web tax procedure (*see* section 2.) and the main legal framework to be referred to when evaluating the presence of a PE, both in light of the current legal framework (*see* sections 3.1. and 3.2.) and of the provisions to be adopted within a reasonable time frame under the MLI (*see* section 3.3.), the authors now offer some hypotheses of the methodologies to be practically observed when attempting to attribute profits to the (hidden) "digital" PEs, possibly within the context of the web tax procedure.

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47. Art. 12(1) of the MLI provides that "notwithstanding the provisions of a Covered Tax Agreement that define the term 'permanent establishment' […] where a person is acting in a Contracting Jurisdiction to a Covered Tax Agreement on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are: a) in the name of the enterprise; or b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use; or c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that Contracting Jurisdiction in respect of any activities which that person undertakes for the enterprise unless these activities, if they were exercised by the enterprise through a fixed place of business of that enterprise situated in that Contracting Jurisdiction, would not cause that fixed place of business to be deemed to constitute a permanent establishment under the definition of permanent establishment included in the Covered Tax Agreement (as it may be modified by this Convention)". It should be considered, however, that Italy reserved the right for art. 12 not to apply to its covered tax agreements.
48. Art. 13 of the MLI proposes two options to modify the specific activity exemptions under art. 5(4) of the OECD Model. For the sake of clarity, Italy exercised its right by choosing to apply to its existing double tax treaties the Option A, under which: "notwithstanding the provisions of a Covered Tax Agreement that define the term 'permanent establishment', the term 'permanent establishment' shall be deemed not to include: a) the activities specifically listed in the Covered Tax Agreement (prior to modification by this Convention) as activities deemed not to constitute a permanent establishment, whether or not that exception from permanent establishment status is contingent on the activity being of a preparatory or auxiliary character; b) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not described in subparagraph a); c) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) and b), provided that such activity or, in the case of subparagraph c), the overall activity of the fixed place of business, is of a preparatory or auxiliary character".
49. *See* art. 13(1) MLI.
50. *See* art. 13(4) MLI.

4. The Attribution of Profits to (Hidden) PEs of MNEs of the Digital Sector

The first methodological directions for the attribution of profits to the "hidden" PEs of MNEs provided for by the most recent international practice assume that the relevant MNE has a "significant presence" in the state.

With specific reference to the digital economy, BEPS Action 1, paragraph 7, provides that "a non resident enterprise has a significant economic presence in a Country on the basis of the factors that evidence a purposeful and sustained interaction with the economy of the country via technology and other automated tools".[51]

Aside from the circumstance that, according to the current (and future) legal framework, the mere "significant presence" condition is not *ex se* sufficient to attribute taxing rights to the source state, the following section will explore the main futures of the possible criteria for the attribution of profits to the hidden PE (clearly assuming that the relevant conditions set forth by article 5 of the OECD Model consent to ascertaining the existence of a PE).

4.1. The methods of attribution of profits to the PEs

One of the main characteristics of the digital economy is represented by the fact that the "significant presence" of an MNE in a state may not correspond to a physical presence – in terms of material assets and personnel – sufficient to carry out the routine functions of the business performed.

As a consequence, the common rules historically introduced by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations concerning the attribution of profit to PEs, which are based on the analysis of the functions, risks and material assets of the entity, may end up being obsolete.

Action 1 therefore suggests two innovative methods for such attribution, the first of which is the method based on fractional apportionment. This methodology consists of apportioning "the profits of the whole enterprise to the digital presence either on the basis of a predetermined formula, or on the basis of variable allocation factors determined on a case-by-case basis. In the context of a significant economic presence, the implementation of a method based on the fractional apportionment would require the performance of three successive steps: (1) the definition of the tax base to be divided, (2) the determination of the allocation keys to divide that tax base, and (3) the weighting of these allocation keys".[52]

The second of the two is the modified deemed profit method. This method should be used in cases in which a high proportion of costs related to the revenues of the alleged hidden PE is incurred in other jurisdictions. In these situations, the OECD suggests that one "regard the presence to be equivalent to a physical presence from which the non-resident enterprise is operating a commercial business and determine the deemed net income by applying a ratio of presumed expenses to the non-resident enterprise's revenue derived from transactions concluded with in-country customers".[53]

4.2. The critical factors associated with applying the methods of attribution of profits to the PEs, as suggested in Action 1

The methods for the attribution of profits to hidden PEs represent the first attempt by the OECD to formalize mechanisms to quantify the net profits of hidden PEs having a "significant presence" in one state. In doing so, the OECD aims to define attribution criteria capable of at least partially resolving the main issues related to the digital economy.

Some of these issues can be summarized as follows:

- peculiarities of the digital market: in the digital market, MNEs can operate in positions of natural leadership as a result of the "network economy". In some situations, natural leadership results in economic conditions of sale of services and information that differ from the general free market conditions;
- "intangible driven" business models: in the digital market, MNEs operate by means of "intangible driven" business models, which grant a competitive advantage over the other operators in the market. Given the scalability of the market, the competitive advantage leads, at least in the short term, to excluding competitors, in some cases allowing the relevant MNE to reach high profitability levels;
- research and development (R&D) costs: the "intangible driven" business models are characterized by a significant amount of R&D expenses. These expenses are borne by MNEs in countries where the R&D function is carried out, which leads to distortions in the process of allocating economic results; and
- the "routine functions": given the specificity of "intangible driven" business models in the digital market, the costs related to the "routine functions" are not significant, since the physical presence of hidden PEs is negligible.

Thus, it should be noted that the above-mentioned circumstances, which characterize elements of digital economy operators, are incompatible with the functional analysis criteria proposed to date.

51. *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, *supra* n. 30, at 107.
52. Id., at 112, sec. 7.6.2.2.
53. Id., at 112, sec. 7.6.2.3.

4.3. An alternative method

As an alternative to the methodologies proposed by the OECD, the profit and loss account of the (hidden) PE may be drafted following the "functionally separate approach" pursuant to the directions of article 7 of the OECD Model. These are based on the profits that the PE "might be expected to make, in particular in its dealings with other parts of the enterprise, as 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 by the enterprise through the PE and through the other parts of the enterprise". However, this should be done taking into account the directions provided for by Actions 8-10[54] regarding intangibles.

By way of example, the profit and loss account of the PE in question could be prepared according to the following:

- revenues could be determined having regard to the agreements concluded in the country in which the PE operates;
- operational costs should be assumed to be equal to those effectively borne by the PE, together with the costs for the use of intangibles (brand, software, algorithms, "key data", etc.);
- the costs for the use of intangibles (brand, software, algorithms, "key data", etc.) should be determined pursuant to the directions provided for by Actions 8-10 to be legitimately included in the profit and loss account[55] of the PE.

Operating in this way, the earnings before interest, taxes, depreciation and amortization (EBITDA) of the PE (in this case, the gross of the cost for the use of intangibles) should then be virtually in line with the EBITDA of the MNE (gross of the R&D costs) or of the relevant functional division. This relies on the reasonable assumption that the costs related to the routine functions of the intangible driven business models are generally negligible.

In essence, the net profits of the PE should largely depend on the cost chargeable to the PE by the MNE for the use of the intangibles in question.

In other words, based on the directions provided by Actions 8-10,[56] the cost for the use of the intangibles should be charged to the PE in an amount in line with the EBITDA of the PE net of the remuneration – under fair market conditions – of the "routine functions".

For an exemplification of the proposed method, *see* Table 1.

Table 1. Example of attribution of profits

Revenues of the PE	100
Operational costs	30
EBITDA of the PE	70
Routine profit (to be determined at arm's length)	5
Cost for the use of intangibles =	65 (70 – 5)
Before tax profit of the PE	5

In conclusion, the attribution of profits to the PE should mostly depend on (i) the estimate of revenues generated in the country in which the PE operates and (ii) the calculation of the remuneration, under fair market conditions, of the intangibles virtually granted to the PE by the MNE.

54. OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2015), International Organizations' Documentation IBFD, at 63 et seq.
55. Id., at 101 et seq., and sec. D.2.6.2. on the application of transactional profit split methods.
56. Id., at 61.