# The Italian Branch Exemption Regime in Light of the Most Recent Domestic and International Developments

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**Changes to the definition of a permanent establishment in Italian legislation, the OECD BEPS Project and the Multilateral Instrument have led to extensive discussions about the rules to be observed when attributing profits to a permanent establishment. In this light, the authors analyse the new Italian branch exemption regime.**

## 1. Introduction

Important developments regarding the "branch exemption" regime were provided in the widely anticipated regulation released by the Italian tax authority (*Agenzia delle Entrate*) on 28 August 2017, implementing and finally permitting the use of this regime.

As a preliminary note, the Italian Legislative Decree of 14 September 2015, No. 147 (hereinafter the Internationalization Decree)[1] introduced the branch exemption regime by means of the new article 168-ter of Presidential Decree 917 of 22 December 1986 (hereinafter Italian Tax Code, ITC),[2] with the aim being to align the Italian tax system with other jurisdictions[3] in terms of the remedies available to taxpayers to eliminate forms of double taxation of a foreign permanent establishment (PE).[4]

Under certain conditions, Italian enterprises can now opt for the "exemption of profits and losses of permanent establishments of resident enterprises".[5] As will be further discussed in section 2., this method constitutes an alternative option to applying the "foreign tax credit" method,[6] a method which has thus far been the instrument used in Italy to mitigate the effects of the worldwide taxation principle in cases where the same entity is also taxed abroad.

Despite the fact that the Internationalization Decree dates back to 2015, it required a specific regulation to be released by the Italian tax authority in order to provide for further guidance on the implementation of the branch exemption regime. A first draft of the regulation document was released for consultation on 25 February 2016. However, several aspects[7] had to be addressed and clarified further in the final version released in August 2017.

Welcomed by many commentators, this Regulation (*Provvedimento del Direttore dell'Agenzia delle Entrate*) of 28 August 2017 (hereinafter Regulation 2017)[8] provides the missing instructions required by Italian multinational enterprises (MNEs) to finally investigate opportunities to elect the branch exemption regime.

Despite the above, it should be noted that (especially in light of the most recent developments at an international level) the analysis of the Italian branch exemption regime requires dealing with the broader legal framework that regulates the qualification of the PE itself.

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1. IT: Legislative Decree no. 147 of 14 Sept. 2015 (*Disposizioni recanti misure per la crescita e l'internazionalizzazione delle imprese*), Official Gazette no. 220 of 22 Sept. 2015 [hereinafter Internationalization Decree].
2. IT: Presidential Decree no. 917 of 22 Dec. 1986, (*Testo Unico delle imposte sui redditi*), Official Gazette no. 302 of 31 Dec. 1986, Ordinary Supplement no. 126 of 22 Dec. 1986 [hereinafter ITC].
3. Branch exemption regimes are available in Australia, France, the Netherlands and the United Kingdom.
4. For a comment on the purpose and scope of the provision, *see* P. Mastellone, *Profits and Losses of Foreign Permanent Establishments: The Optional Branch Exemption Regime*, 57 Eur. Taxn. 1 (2017), Journals IBFD.
5. For comments, *see* A. Trabucchi & F. Cirulli Irelli, *Il regime opzionale di "branch exemption"*, Corriere Tributario 21 (2015) as well as E. della Valle, *La branch exemption nelle stabili organizzazioni estere di soggetti residenti*, il Fisco 46 (2015).
6. *See* art. 165 ITC.
7. *See* G. Gallo, *Foreign branch exemption – consultation launched* (29 Feb. 2016), News IBFD. For comments on the first draft, *see* G. Albano, *La bozza di provvedimento attuativo del regime di "branch exemption" tra conferme e novità*, Corriere Tributario 13_ (2016); and G. Formica & P. Formica, *Proposte di attuazione del regime di branch exemption*, il Fisco 13 (2016).
8. IT: Agenzia delle Entrate, Regulation of the director of the Italian tax authority (*Provvedimento del Direttore dell'Agenzia delle Entrate*), Protocol no. 2017/165138 [[hereinafter Regulation 2017].

Since Action 1[9] (Addressing the Tax Challenges of the Digital Economy) and Action 7[10] (Preventing the Artificial Avoidance of Permanent Establishment Status) of the OECD Base Erosion and Profit Shifting (BEPS) Project were drafted, the qualification of "permanent establishment" has become a subject under the spotlight of international tax forums. This is particularly so in the context of businesses in the digital economy, whose more modern business models have revealed inadequacies in the traditional definition of a PE; the relevant applicable rules are no longer fully in line with the new attitudes of MNEs.

Even if the signing of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (hereinafter MLI) in June 2017[11] brought significant changes to the definition of a PE, fully dematerialized business models are not tackled by the new provisions, the consequence being that some countries – among which, Italy – have adopted innovative measures.[12] In fact, according to a rigorous and stringent view, one may consider that article 5 of the OECD Model Tax Convention on Income and on Capital (hereinafter OECD Model (2017)),[13] as resulting from the amendments introduced by the MLI, still relies on obsolete pillars (i.e. the physical presence criterion) and cannot cover the dematerialized approach that characterizes the main digital economy players.

Relying on a potentially questionable approach, in December 2017, the Italian parliament approved some amendments to the local legislation for PEs in the 2018 Finance Bill[14], with the somewhat ambitious purpose of starting to (unilaterally) tackle the most burdensome practices. As will be further discussed in section 3., such amendments are, inter alia, aimed at transposing the provisions introduced under the MLI into Italian jurisdiction, as well as introducing an Italian definition of a "digital PE".[15]

Clearly, the changes made to the definition of a PE have led to extensive discussions concerning the rules to be observed, from a different perspective, when attributing profits to PEs.

Set within this fragmented landscape, this article will analyse the new Italian branch exemption regime, considering that, on the one hand, it is rooted in the definition of a PE which, in the context of the new dynamics and developments of modern businesses, seems neither clear nor suitable, and on the other hand, takes into account that it is an optional regime intended as an alternative to the "foreign tax credit" method.

## 2. The Non-Applicability of the Worldwide Taxation Principle

According to article 81 of the ITC, the overall business income of an Italian company[16] is relevant for Italian corporate tax purposes whether or not from a foreign source. In other words, Italian resident entities are subject to the "worldwide taxation principle",[17] under which, inter alia, income deriving from the foreign PEs of an enterprise is subject to Italian corporate tax.

In essence, the ITC provides for the "principle of levying taxes on income wherever such income is produced" (*see* articles 1, 2 and 3 of the ITC). As a direct consequence, Italian residents[18] are liable to tax (also) for income produced abroad. It is therefore self-evident how "juridical double taxation"[19] may indeed occur.

Article 23 of the OECD Model (2017) provides two different methods to mitigate forms of double taxation, namely:

- the "exemption method",[20] according to which, where a resident of a country derives income subject to taxation in another country, the former country shall, under certain conditions, exempt such income;[21] and

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9. OECD/G20, *Addressing the Tax Challenges of the Digital Economy – Action 1: Final Report* (OECD 2015), International Organizations' Documentation IBFD [hereinafter Action 1 Final Report].
10. OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report* (OECD 2015), International Organizations' Documentation IBFD [hereinafter Action 7 Final Report].
11. Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (7 June 2017), Treaties IBFD [hereinafter MLI (2017)]. For a wider comment on the MLI, *see* D. Kleist, *A Multilateral Instrument for Implementing Changes to Double Tax Treaties: Problems and Prospects*, 44 Intertax 11 (2016); and G.S.A. Hidalgo, *Reflections on Multilateral Tax Solutions in a Post-BEPS Context*, 45 Intertax 11 (2017).
12. *See* S. Zucchetti, A. Tardini & O. Lanfranchi, *The Italian "Web Tax": The New Administrative Procedure for Multinational Enterprises to Disclose Hidden Permanent Establishments in Italy*, 24 Intl. Transfer Pricing J. 5 (2017), Journals IBFD.
13. *OECD Model Tax Convention on Income and on Capital* (21 Nov. 2017), Models IBFD [hereinafter OECD Model (2017)].
14. IT: Law of 27 Dec. 2017, State budget for the 2018 Financial Year and Multi-Year Budget for the Three-Year Period of 2018-2020 (*Bilancio di previsione dello Stato per l'anno finanziario 2018 e bilancio pluriennale per il triennio 2018-2020*), Official Gazette no. 302 of 29 Dec. 2017, Ordinary Supplement no. 62 [hereinafter 2018 Finance Bill].
15. It should be noted that, clearly, where a double tax treaty (DTT) is applicable to a specific case, the definition of a permanent establishment (PE) contained therein shall prevail over the Italian definition.
16. Specific reference is made to art. 73(1)(a) and (b) ITC, which defines resident subjects as being liable to tax in Italy, irrespective of their income source. The range of subjects mentioned in the definition is very broad, and includes any company and entity of any kind, with or without legal personality, exercising commercial activities.
17. For broad comments on the worldwide taxation principle, *see* K. Vogel, *Worldwide vs. source taxation of income - A review and re-evaluation of arguments*, 16 Intertax 8/9, pp. 216-229 (1988); and R.J. Vann, *Taxing International Business Income: Hard-Boiled Wonderland and the End of the World*, 2 World Tax J. 3 (2010), Journals IBFD.
18. The fiscal residence criteria for companies and enterprises are set forth under art. 73(3) ITC. Under this provision, the elements for establishing the residence of a company or entity in Italian territory are the presence of (i) the head office; or (ii) the administrative office; or (iii) the object of the business activity, which must be alternatively present in the territory for the majority of the year (i.e. for more than 183 days). It is well known that, under the OECD Models, where a company is deemed resident in two countries under the provision of art. 4(3) (of the former version) OECD Model (2014), then "it shall be deemed to be a resident only of the State in which its place of effective management is situated". With the introduction of the MLI (2017), this paragraph was amended such that "the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors."
19. For a brief comment on the difference between "economic double taxation" and "juridical double taxation", *see* C. Garbarino, *Judicial Interpretation of Tax Treaties: The Use of the OECD Commentary*, p. 460 (Edward Elgar Publishing 2016).
20. *See* art. 23A OECD Model (2017).

– the "credit method",[22] according to which, where a resident of a country derives income subject to taxation in another country, the former country shall allow a deduction from the income taxes of that subject in an amount equal to the income tax paid in the other country.[23]

Given this international framework, the Italian tax legislation has (so far) only provided for the foreign tax credit method under article 165 of the ITC. In particular, paragraph 1 states: "If income earned abroad is included in the computation of aggregate income, taxes definitively paid abroad upon such income shall be allowed as credits against net tax in an amount equal to that part of the Italian tax which is proportional to the ratio between foreign source income and aggregate income, net of tax losses carried forward."[24]

In other words, under the ordinary rules, when determining the taxable income, the Italian enterprise (also) includes that of its PE(s) and, according to the relevant conditions, receives a tax credit to (fully or partially) recover the amount of taxes paid abroad.

The definition of "income earned abroad" is provided under article 165(2) of the ITC, according to which, income is deemed to be earned abroad when the same income would be subject in Italy for a non-resident in accordance with article 23 of the ITC. In other words, article 165(2) requires an *a contrario* interpretation of article 23 of the ITC, which provides for, inter alia, the definition of Italian-source business income subject to taxation in Italy for a non-resident.[25]

Therefore, before the introduction of the branch exemption regime, Italian-resident companies with foreign PEs could benefit only from the deduction of taxes paid abroad.

In practice, the regime at hand constitutes a mere alternative to the "ordinary" foreign tax credit method, representing a shift from "capital export neutrality" to "capital import neutrality".[26] Indeed, the branch exemption enables resident enterprises having PEs in a country with a lower tax burden to effectively benefit from the foreign state's lower tax rate (as if they were subsidiaries).

In essence, the new article 168-ter of the ITC implemented under Regulation 2017 finally rebalances the position of Italian companies that could previously only benefit from article 165 of the ITC (i.e. from the foreign tax credit)[27] as the sole remedy available to avoid double taxation, and in doing so, this new article aligns the Italian tax system with the most advanced jurisdictions.

# 3. The Status of "Foreign Branch": Current Framework and Future Developments

To properly evaluate the adoption of the branch exemption regime, first of all, it is necessary to analyse the legal framework of PEs. In this respect, paragraph 2.4 of the Regulation 2017 outlines that electing the regime is effective if a PE exists in the foreign country according to:

– the provisions of the relevant double tax treaty (DTT) in force between Italy and the foreign country; or

– where no DTT is in force, the criteria set forth under the Italian definition of a PE contained in article 162 of the ITC.

Additionally, it is stated that the regime does not apply "when the foreign Country does not recognize the existence of a branch under its domestic legislation".[28]

According to a literal interpretation of this sentence, one may consider that the existence of a PE under the legislation of the foreign country should represent sufficient conditions for the election of the branch exemption regime, therefore neglecting the role of the tax treaty and domestic provisions. However, it should be noted that such a view would be inconsistent with clarifications already provided by the Italian tax authority.[29]

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21. This method permits the realization of the so-called "capital import neutrality", according to which all investments in a given country pay the same marginal rate of tax, regardless of the residence of the investor. For a comment, *see* D.A. Weisbach, *The Use of Neutralities in International Tax Policy*, Coase-Sandor Institute for Law & Economics Working Paper No. 697 (2014).
22. *See* art. 23B OECD Model (2017).
23. This method permits the so-called "capital export neutrality", according to which, residents of any given country face the same tax burden, notwithstanding the country in which they invest. For a comment, *see* Weisbach, *supra* n. 21.
24. Art. 165 ITC. The current version of art. 165 ITC was introduced in the context of the broader reform of Italian income tax provided for by IT: Legislative Decree 344 of 12 Dec. 2003 (*Riforma Tremonti*). For a comment on the introduction of the current tax credit regime in the Italian tax system, *see* F. Aramini & G. Bochicchio, *New foreign tax credit regime*, 6 Derivs. & Fin. Instrums. 5 (2004), Journals IBFD. *See also* G. Andreani & A. Tubelli, *Requisiti del credito d'imposta per i redditi prodotti all'estero secondo l'Agenzia delle Entrate*, il Fisco 14 (2015) for a comment on the relatively recent instructions on the foreign tax credit released by the Italian tax authority with Circular Letter 9/E of 5 March 2015.
25. Under art. 23(1)(e) ITC, the definition of income taxable in Italy includes "profits deriving from business activities carried out in the territory of the State through permanent establishments". The other categories of income produced in the territory of the state by a non-resident and subject to income tax in Italy are (i) income from immovable property; (ii) capital gains paid by the state or by residents; (iii) income from employment in the territory of the state; (iv) income from self-employment produced by activities carried out in the territory of the state; (v) other income from activities carried out in the territory of the state and from assets located in the territory of the state; and, under certain conditions, (vi) capital gains from transfers of stocks held in resident companies.
26. *See* arts. 23A and 23B OECD Model (2017).
27. For a comment on the opportunities brought by the reform under discussion, *see* I. Vacca, *Internazionlizzazione, branch exemption: quale futuro?*, IPSOA Quotidiano (2015).
28. *See* para. 2.4 Regulation 2017.
29. *See* Assoholding, *Il regime di branch exemption*, Circular letter 16 (2017); and A. Saini, *La "branch exemption" mette sotto la lente la stabile organizzazione*, Il Sole 24 Ore (16 Oct. 2017. According to the latter commentator, this approach would not be consistent with the interpretation provided by the Italian tax authority with regard to the foreign tax credit regime. In particular, under IT: Circular Letter no. 9/E of 15 Mar. 2015; IT: Resolution no. 277/E of 3 July 2008; and IT: Resolution no. 104 of 3 July 2001. the taxpayer cannot benefit from the foreign tax credit where a PE is deemed to exist only according to the foreign legislation, but not according to the provisions

Furthermore, under paragraph 2.5 of the Regulation 2017, it is clarified that if the foreign country's legislation assesses the existence of a (hidden) PE, the Italian company can elect the branch exemption regime only if the branch is recognized under the applicable DTT or under the local provision set forth by article 162 of the ITC. Therefore, the fact that, in this case, the foreign PE shall (also) be "recognized" by either the Italian ITC or the applicable DTT should lead to the conclusion that, in general, the existence of a PE under the foreign country's legislation should be a necessary, but is not in itself a sufficient condition[30] for the purposes of the regime at hand.[31]

Given the priority to be assigned to the existence of the foreign PE (in accordance with either the Italian tax law or the DTT provision) for the election of the regime under discussion, the taxpayer has the possibility to file an ad hoc ruling with the Italian tax authority in order to obtain (in advance) the certainty that the foreign PE in question may be considered eligible for the branch exemption regime.[32]

Furthermore, one should also note that, as already outlined in section 1., the legal framework of PEs (rectius, article 5 of the OECD Model (2017)) *ex se* is, to a certain extent, inadequate in its ability to capture the peculiarities of most modern business schemes.

The signing of the MLI in June 2017 is surely a milestone in the work done by the OECD, especially the work carried out under Action 1 and Action 7 of the BEPS Project. The new version of article 5 of the OECD Model (2017)[33] therefore requires more attention, also for the purposes of the analysis in this article.

Firstly, the new version of article 5(4) of the OECD Model (2017) provides that the business activities included in the "negative list"[34] are not deemed to constitute a PE only if such activities are of preparatory or auxiliary character. The new Commentary on Article 5 of the OECD Model[35] (2017) clearly defines the scope of this modification and emphasizes that "the preparatory or auxiliary character of activities carried on at a fixed place of business must 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".[36]

Secondly, the new version of article 5(5) extends the agency PE 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".[37] Consequently, the amended version of the Commentary on Article 5 clarifies that actions taken on behalf of an 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.[38] In other words, the focus has moved to 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 having been concluded outside of the state of the local subsidiary.

The new version of article 5(5) as well as the commentary should counteract potential issues described under the BEPS Action 1 Final Report, such as the case "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",[39] which, in principle, should now result in a PE for the parent company.

Thirdly, a further solution to challenge modern economy schemes is the introduction of the "anti-fragmentation rule" to ensure that it is not possible to benefit from exceptions under article 5(4) of the OECD Model (2017) through the fragmentation of business activities among closely related entities belonging to the same MNE.

Finally, a specific anti-avoidance provision has been added to the Commentary on Article 5 in order to challenge artificial situations created purposefully by MNEs in order to bypass the specific 12-month period (under article 5(3) of the OECD Model (2017)) allowed to create PEs for building sites and construction or installation projects (the so-called "splitting-up of contract" provision).

Notwithstanding these fundamental steps, article 5 of the OECD Model (2017) (on the fixed PE) still relies on three main conditions, namely (i) the existence of a place of business; (ii) the said place of business is fixed; and (iii) the enterprise carries out its business

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of the applicable DTT or art. 162 ITC (in the absence of a DTT). In the authors' opinion, the clarifications provided with regard to art. 165 ITC are applicable to art. 168-ter ITC in light of the indirect reference contained under art. 167(4) ITC (which makes explicit reference to the foreign tax credit provision).

30. The same conclusion is shared by other commentators. *See* M. Piazza & Trainotti, *Branch exemption: definite le regole per l'applicazione del regime*, Il Sole 24 Ore, Norme & Tributi Mese, 10 (2017).

31. Finally, it is worth noting that no reference is made to art. 169 ITC. Under this article, in fact, "the provisions [of the ITC] apply, when more favorable to the tax payer, even if in derogation of the international double tax treaties". If this view is confirmed, the lack of reference to art. 169 could lead to the conclusion that, in the presence of a foreign PE both under the foreign legislation (necessary condition) and under the DTT, but not according to art. 162 ITC, it should not be possible to avoid the application of the branch exemption regime by the foreign PE (when the exclusion from the regime of foreign "loss making" PEs would be more favourable).

32. *See* para. 11 Regulation 2017. The ruling (*interpello qualificatorio*) is to be filed in accordance with IT: Law of 27 July 2000, Italian Taxpayer Bill of Rights (*Disposizioni in materia di statuto dei diritti del contribuent*) art. 11(1)(a), Official Gazette no. 177 of 31 July 2000 [hereinafter Taxpayer Bill of Rights].

33. However, the amendments to the existing DTT shall enter into force only after the ratification method provided for under art. 34 MLI (2017) is completed, and (mostly) only depending on the exercise of the right not to apply the amendments included in the convention of the signatory countries.

34. *See* art. 5(4) OECD Model (2017), which lists a number of business activities which, if carried out through a fixed place of business, are not sufficient for this fixed place of business to constitute a PE (the so-called "negative list").

35. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 5* (2017), Models IBFD.

36. *See* para. 58 *OECD Model: Commentary on Article 5* (2017).

37. Art. 5(5) OECD Model (2017).

38. *See* para. 83 *OECD Model: Commentary on Article 5* (2017): "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."

39. OECD, Action 1 Final Report, *supra* n. 9, at 12.

through this fixed place, which evidently make the provision ineffective in respect of fully dematerialized activities carried out by digital economy players.[40] In this respect, the OECD published a request for input, claiming how "the lack of a global consensus on how to respond to the direct tax challenges associated with digitalization presents an ongoing and increasing challenge, where an increasing number of countries have begun taking steps towards the implementation of unilateral and uncoordinated domestic measures aimed at taxing digitalized activities and highly digitalized business models".[41]

As mentioned in section 1., the Italian parliament introduced with the 2018 Finance Bill major amendments to the definition of a PE under article 162 of the ITC.[42] In more detail, the modifications included in the MLI (with the exception of the splitting-up-of-contracts provision) have been transposed into article 162 of the ITC which, as a result, now includes the anti-fragmentation rule,[43] a revised version of the commissionaire agreement provision[44] and the updated "negative list".[45]

# 4. The All-In Condition: How and When to Opt for the Branch Exemption Regime

The branch exemption regime is optional, involves all foreign PEs and is irrevocable.[46]

## 4.1. Optional

The timing for adopting the regime – the branch exemption regime being optional, since the taxpayer is entitled to also use the foreign tax credit method under the ordinary rules – varies depending on the date of establishment of the PE.[47]

Therefore, if the PE was incorporated either on or prior to 7 October 2015 (i.e. the date that the Internationalization Decree entered into force) or by the end of fiscal year 2016, it is possible to opt for the regime up to and including the date on which the deadline falls for filing the tax return related to the second fiscal year following the year in progress on 7 October 2015, with the underlying effects of electing to use this regime starting from the fiscal year related to the tax return in which this election is made.[48]

On the contrary, if the taxpayer set up a new branch from 2017 onwards, the branch exemption regime may be elected until the deadline for filing the tax return concerning the fiscal year of establishment.

## 4.2. The all-in, all-out principle

The branch exemption regime must be adopted with regard to all foreign PEs, with the sole exception of those subject to the Italian controlled foreign company (CFC) rules (*see* section 5.1.).

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40. For a wider comment on the matter, *see* G.W. Kofler, G. Mayr & C. Schlager, *Taxation of the Digital Economy: "Quick Fixes" or Long-Term Solution?*, 57 Eur. Taxn. 12 (2017), Journals IBFD. In order to supersede such difficulties, new nexus rules could be introduced specifically for the digital economy, as underlined in the Action 1 Final Report. In fact, "this option would create a taxable presence in a country when a non-resident enterprise has a significant economic presence in a country on the basis of factors that evidence a purposeful and sustained interaction with the economy of the country via technology and other automated tools" (*see* OECD, *Action 1 Final Report*, *supra* n. 9, at para. 7.6.1.). A concrete proposal provided by commentators can be found in Y. Brauner & P. Pistone, *Adapting Current International Taxation to New Business Models: Two Proposals for the European Union*, 71 Bull. Intl. Taxn. 12 (2017), Journals IBFD; and J.A.G. Requena & S.M. Gonzàlez, *Adapting the Concept of Permanent Establishment to the Context of Digital Commerce: From Fixity to Significant Digital Economic Presence*, 45 Intertax 11 (2017).
41. *See OECD request for input on work regarding the tax challenges of the digitalised economy*, 22 Sept. 2017. Italy, in this sense, is at the forefront of implementing measures not completely in adherence with the guidelines provided for by the OECD. As it will be discussed further in this section, the Finance Bill 2018 amended the definition of a PE under art. 162 ITC in order to capture the existence of PEs even in cases where foreign multinational enterprises (MNEs) do not have a physical presence in Italian territory. The most significant discrepancy with dealings currently under discussion at an international level, though, is the introduction (under article 1(1011) of the 2018 Finance Bill) of the "tax on digital transactions" (*imposta sulle transazioni digitali*). In principle, the new tax consists of a 3% levy on the amount of each single transaction regarding the provision of services via electronic devices. Several further provisions are required in order to complete the rules for its application, but, as of the current text of the provision, the tax referred to as the "web tax" will enter into force on 1 Jan. 2019.
42. *See* para. 1010, art. 1 2018 Finance Bill.
43. *See* art. 162(5) ITC, according to which, the "negative list" "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 State and that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this article, or 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 unitary complex of business operations".
44. Art. 162(6), (7) and (7-bis) ITC.
45. *See* art. 162(4) (providing for the "negative list") and (4-bis) ITC. According to the latter paragraph, the "negative list" provision does not apply when the business activity listed therein "is of a preparatory or auxiliary character". Moreover, the Italian tax lawmaker has made a further effort to tackle the digital economy phenomenon, extending the scope of application of the "positive list" by introducing a sort of digital nexus. More in detail, art. 162(1) ITC provides for a list of cases in which a PE is deemed to exist. The 2018 Finance Bill introduced art. 162(4)(f-bis) of the ITC. As a result, the Italian definition of a PE now includes "a significant and continuative economic presence in the territory of the State set in a way that no physical presence results in the same territory".
46. Art. 168-ter(1) and (2) ITC.
47. Para. 2 Regulation 2017.
48. *See* paras. 2.2 and 2.3. Regulation 2017. By way of example, where a PE was already in existence on 7 Oct. 2015 (or was incorporated for the first time in June 2016), the branch exemption regime can be elected either with the filing of the tax return for financial year 2016 (by 31 Oct. 2017) or financial year 2017 (by 31 Oct. 2018). In the former case, the relevant effects would have started, in principle, from 2016.

The all-in, all-out condition works in a way that once a decision to opt in has been communicated to the Italian tax authority, it must apply to all (existing and future) PEs of the company.[49] In other words, it is not possible for a head office to nominate one PE that will be subject to the regime but use the foreign tax credit for the others.[50]

## 4.3. Irrevocability

Concerning the irrevocability of the branch exemption regime,[51] the Regulation 2017 provided some relevant clarifications to be closely analysed.

In fact, while the reason behind this limitation is clear – i.e. to prevent the taxpayer from opportunistically deciding to access and exit the regime[52] – the initial idea of the functioning of such a mechanism was that once the taxpayer decided to opt (or not to opt) for the branch exemption regime, the same taxpayer would not have the possibility (at any time during the life of the company) to amend it.

The Regulation 2017, however, made this option less rigid, as follows:

- with reference to adopting the regime, as mentioned in section 4.1., the taxpayer may decide to opt into the regime when a new PE is incorporated, regardless of whether the taxpayer has not opted into the regime in the past (at the time of establishing previous branches).[53] As a consequence, if a company decides not to opt into the regime at the time of incorporation of the (first) PE, it does not mean per se that this choice can never be amended; it is sufficient that a new PE be incorporated in order to reverse the initial decision and opt into the branch exemption regime (of course always bearing in mind that the "all-in, all-out approach" applies); and
- with reference to exiting the regime, this will cease to be effective at the moment of "dissolution" of the last existing "exempt PE".[54] From a practical perspective, the latter clarification means that, in the case of incorporation of a "new" PE after the "dissolution" of all of the previous ones, it will be possible to decide whether (or not) to opt for the branch exemption regime without being bound to the initial decision.[55]

However, in order to limit abusive conduct, a sort of "cooling-off" provision has also been introduced. In this respect, the incorporation of a new branch (that does not opt for the branch exemption regime) within the same country in which an "exempt branch" existed during one of the last three fiscal years will be scrutinized by the Italian tax authority under the Italian general anti-avoidance rule (GAAR) set forth in article 10-bis of Law 212 of 27 July 2000.[56]

Finally, it is relevant to mention that there could be situations where the regime ceases to have effect due to the transfer of the "exempt branch", since, as stated in the Regulation 2017, it will be at the discretion of the transferee to decide whether or not to continue applying the regime.[57]

# 5. The (Full) Taxation of Income Produced through Branches Located in Low-Tax Jurisdictions

In order to avoid disparities between the treatment of foreign subsidiaries and foreign PEs, the application (by analogy) of two specific anti-avoidance provisions has also been introduced for PEs subject to the branch exemption regime that are situated in low-tax jurisdictions.

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49. *See* art. 168-ter(1) ITC and para. 2.5 Regulation 2017.
50. As a matter of fact, this possibility would have been much too favourable for the taxpayer, who would have chosen to apply the regime only to profitable PEs, allowing the tax losses deriving from loss-making PEs to be immediately "repatriated" and offset against the income of the overall enterprise according to the worldwide taxation principle. Notwithstanding this restriction, if the taxpayer is able to forecast the future trends of its foreign businesses, it could be possible to perform some further reasoning. By way of example, the taxpayer may decide to allocate profitable PEs and loss-making PEs to two different entities belonging to the same group, since the regime limits the "all-in, all-out" approach at a single entity level (and not at a group level). However, this kind of structuring, which falls within the more comprehensive study of the feasibility of adoption of the regime, should always be performed bearing in mind the Italian general and specific anti-avoidance provisions.
51. Art. 168-ter(2) ITC.
52. In this respect, it must be noted that this feature, along with the "all-in, all-out" one, is consistent with the underlying rationale of the provision under discussion, which intends to introduce the exemption at hand as a mere alternative to the foreign tax credit method.
53. Para. 2.7 Regulation 2017.
54. Paras. 3.1 and 3.2 Regulation 2017.
55. In other words, this clarification acknowledges the possibility to "go back" to the ordinary regime in relation to further branches (incorporated after the dissolution of (all) of the previous branches), even if the enterprise opted (in the past) for the branch exemption regime in relation to the previous branches that have ceased to exist. This clarification makes obsolete those concerns according to which the only way to amend the initial decision to adopt the regime was the liquidation/dissolution of the whole enterprise (*see* T. Gasparri, *Il nuovo regime di branch exemption per le stabili organizzazioni all'estero*, p. 2448, il Fisco 25 (2015); and C. Galassi, *"Branch exemption": un istituto ancora da conoscere*, Fiscalità & Commercio Internazionale, No. 10 (2015), as well as Trabucchi & Cirulli Irelli, *Il regime opzionale di "branch exemption"*, p. 14, Corriere Tributario 21 (2015).
56. In relation to this matter, the taxpayer is, however, entitled to file an anti-avoidance tax ruling, pursuant to art. 11(1)(c) of the Italian Taxpayer Bill of Rights with the Italian tax authority.
57. Para. 10.1 Regulation 2017. In the case of a neutral transaction from an Italian tax standpoint (such as a merger, demerger or the contribution of a going concern), if the transferee decides to opt for the branch exemption regime (or to continue with it if it has already opted for it), the assets transferred will keep their original tax value. In the case of a non-tax neutral transaction (such as the disposal of the branch) occurring between entities (i) belonging to the same group; and (ii) not having the same regime (i.e. a transfer from branch-exempt to non-branch-exempt entities and vice versa), the tax value of the assets will have to be determined in accordance with arm's length conditions.

In particular, reference is made to (i) the taxation (by way of transparency) of the income of CFCs;[58] and (ii) the (full) taxation of dividends deriving from low-tax jurisdictions.[59]

## 5.1. CFC rule

PEs subject to the CFC rule are not allowed to benefit from the branch exemption regime.[60] In such a case, therefore, the income of the foreign PE is taxed in Italy by way of transparency in the hands of the head office, without having the possibility to be added to/ compensated by the income of the head office itself.

In relation to the functioning of the CFC rule in the context of the branch exemption regime, it is relevant to mention that the Regulation 2017 provided several clarifications with reference to the application of the CFC rule in the presence of 'multiple' permanent establishments within the same foreign country (rather than a single permanent establishment per country).[61]

In more detail, the Regulation 2017 clarifies that the concept of a single PE (per country) should switch to that of multiple "operative sites" per country (given that, in any case, the relevant site in the foreign country must constitute a PE).[62]

The applicability of the CFC rule, therefore, has to be verified for each single "operative site". Where the operative site qualifies as being subject to the CFC rule, it will be individually taxed by way of transparency. If the operative site qualifies as not being subject to the CFC rule, its income will benefit from the branch exemption regime jointly with the other sites that qualify as such.[63]

### 5.1.1. The attribution of a participation held in a subsidiary subject to CFC legislation to an exempt PE[64]

In such a case, the Regulation 2017 clarifies that the income generated by such a subsidiary will be taxed, by way of transparency, in the hands of the head office (even if the PE to which the participation is allocated would be exempt from taxation). In such a case, however, the PE will not lose its status as an exempt entity. Figure 1. shows the case in which an exempt PE holds a shareholding in a blacklisted subsidiary.

**Figure 1**


### 5.1.2. The tax value of the assets and liabilities of the "CFC branch" at the time of the interruption of the branch exemption regime[65]

The Regulation 2017 clarifies that, in such a case, the CFC rule would automatically cease to apply and the "entry value" of the assets and liabilities of the branch, for the purpose of the ordinary tax regime (i.e. the worldwide taxation principle with the credit method), would be the same as that recognized for CFC purposes at the end of the last fiscal year in which the CFC regime was effective.

58. Art. 167 ITC. The Italian controlled foreign companies (CFC) rule, in brief, provides for a distinction between a "blacklist CFC", governed by art. 167(4), and a "whitelist CFC", governed by art. 167(8-bis). In particular, while the scope of application of the blacklist CFC expressly excludes entities (both companies and branches) located within the European Union and the European Economic Area, the whitelist CFC applies both to EU/EEA) companies and non-EU/EEA) companies (*see infra* n. 59).
59. Art. 89(3) ITC prescribes the full taxation of profits deriving from low-tax jurisdictions as per the definition provided under the blacklist CFC rule (*see infra* n. 60), unless either (i) the purpose was not to establish an investment structure in a low-tax jurisdiction from the beginning of the period of adoption of the branch exemption regime; or (ii) the profits have already been taxed by way of transparency under the CFC rule. The 2018 Finance Bill introduced an amendment which provides for 50% exemption of the profits deriving from investment structures which operate an effective commercial or industrial business in the foreign territory. The same profits may also benefit from the foreign tax credit on the corporate income taxes paid by the branch.
60. The whitelist CFC rule applies when both (i) the actual income tax paid in the foreign jurisdiction (i.e. the "effective tax rate") is lower than 50% of the Italian corporate income tax that would be applicable to the branch if it were resident in Italy (referred to as the "tax rate test"); and (ii) more than 50% of the revenues derive from passive incomes (referred to as the "passive income test"), unless the investment structure is not an artificial arrangement aimed at obtaining an undue tax benefit. The blacklist CFC rule applies when the PE is located in a country that has an ordinary tax rate lower than 50% of the Italian tax rate or benefits from a special tax regime, unless, alternatively, (i) the branch operates an effective commercial or industrial business in the foreign territory; or (ii) the purpose of the head office was not to establish the branch in a low-tax jurisdiction from the beginning of the period of adoption of the branch exemption regime.
61. Para. 8.2 Regulation 2017.
62. The concept of "multiple permanent establishments" is new for the Italian legislator, although developed by the Italian Supreme Court (many years earlier) with judgment No. 3368/2002 and No. 7682/2002, which stated that "a corporation having its legal seat in Italy may assume the role of a multiple permanent establishment of foreign companies belonging to the same group and pursuing the same strategy. In this case, its identification must be global and must refer to the programme of the group considered as a whole".
63. In other words, while all the "good" PEs will be (jointly) treated as a single PE, the "bad" PEs will be (severally) taxed by way of transparency.
64. *See* para. 8.6 Regulation 2017. The purpose of this provision is to avoid the attribution of participations located in blacklist jurisdictions (which would be subject to the CFC rule) to foreign PEs subject to the branch exemption regime (which would avoid taxation by way of transparency of the foreign income of the participating entity).
65. Para. 8.7 Regulation 2017.

## 5.2. Profits from low-tax jurisdictions

The purpose of this second anti-avoidance provision is to tax foreign profits that have benefitted from a "privileged" tax regime by not granting them the application of the exemption on dividends (rectius, on profits).

In relation to the functioning of this provision with specific reference to the case under discussion, the Regulation 2017 introduces a completely different approach in comparison with its initial draft.[66] In fact, while the draft provided for the full taxation of the profits in the hands of the shareholders of the enterprise, the Regulation 2017 states that such profits are taxed only at head-office level.[67]

As far as the timing of their taxation is concerned, the Regulation 2017 maintained the wording of the initial draft, which provided for the taxation of profits at the time of distribution by the head office to its shareholders.[68]

# 6. The Recapture of Losses and Internal Dealings of the Five Previous Years

The branch exemption regime provides for two mechanisms of "tax alignment" between companies that already have PEs which are willing to switch from the "credit method" to the "exemption method" and companies that are in the process of establishing a new branch and are willing to access the branch exemption regime:

- the recapture of tax losses;[69] and
- the tax treatment of internal dealings.[70]

These mechanisms have in common the "monitoring period" of application, which lasts five fiscal years starting from the one prior to the first fiscal year of the adoption of the regime. The taxpayer with an existing PE for more than five years should therefore bear in mind that an in-depth analysis of what has been done in the past between the head office and the PE will be needed.

## 6.1. Recapture of tax losses

With the aim being to avoid that taxpayers – who, at the time of electing the branch exemption regime, already have a foreign PE that registered tax losses in the previous five fiscal years – could benefit from the double advantage of (i) offsetting previous foreign tax losses against Italian taxable income; and (ii) exempting future foreign income from Italian taxation, a specific "recapture mechanism" has been introduced.

In particular, the "recapture of tax losses" provides for (i) the computation of the "net tax losses" of the foreign branch in the last five fiscal years; and (ii) the taxation (rather than the exemption) of the income generated by the *same* branch (i.e. in the same country)[71] up to this amount under the branch exemption regime (this is also termed the "recaptured amount").

In other words, the income realized by the branch after the adoption of the branch exemption regime will be exempt from taxation, but only for an amount higher than that equal to the "net tax losses" registered by the branch in the previous five fiscal years. If, on the contrary, after the adoption of the regime, the branch realizes tax losses, the "recapture" will be frozen and offset against the taxable income that the branch will record in the future.[72]

This recapture mechanism applies only to the net tax losses that have been "utilized" by the enterprise, i.e. tax losses that have been offset against the taxable income of the enterprise. On the contrary, the "net tax losses" that have not been "utilized" (i.e. tax losses pertaining to the PE that have been carried forward by the enterprise according to article 84 of the ITC) must be annulled (without, therefore, being subject to the recapture mechanism).[73]

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66. Para. 9 Regulation 2017.
67. Pursuant to para. 9.5 Regulation 2017 (and consistently with the aforementioned clarification on the taxation by way of transparency of a CFC entity assigned to an exempt PE), profits deriving from a CFC entity (also from its disposal) assigned to an exempt PE are qualified as blacklist profits and taxed accordingly (even if "intermediated" by an exempt entity).
68. In relation to the identification of the profits deriving from the branch, the Regulation 2017 clarifies that they are determined on the basis of the movement (i.e. reduction) of the endowment fund of the branches. In this respect, a favourable, unrebuttable presumption is introduced, according to which, the profits realized prior to the adoption of the branch exemption regime are considered primarily distributed.
69. Paras. 4 and 5 Regulation 2017.
70. Para. 6 Regulation 2017.
71. *See* para. 4.4 Regulation 2017, which states that "the recapture is computed assuming that a single PE per country exists even if this is divided among more operative sites".
72. In this context, under para. 4.2 Regulation 2017, it is specified that transactions aimed at postponing the profits (letting them fall under the exemption regime) and/or bringing forward the losses (letting them fall under the ordinary regime) that occurred near the date of adoption of the branch exemption regime will be carefully scrutinized in accordance with the Italian GAAR set forth by art. 10-bis Italian Taxpayer Bill of Rights. However, there is the faculty for the taxpayer to file an anti-avoidance ruling with the Italian tax authority pursuant to art. 11(1)(c) of Italian Tax Payer Bill of Rights.
73. To this end, the Italian tax authority also clarified that, in the case of the generation of tax losses by both the PE and the head office, the latter will be considered primary utilized, with the effect that the tax losses of the branch will not be subject to the recapture mechanism, since they must be annulled.

As far as the implications of this provision under the Italian fiscal unit regime[74] are concerned, the taxpayer may choose (i) either to apply the above-mentioned ordinary recapture mechanism, which provides for the annulment of the non-utilized net tax losses at a consolidated level; or (ii) as a matter of simplicity,[75] to consider as having utilized all of the tax losses not utilized by the head office.[76]

## 6.2. Internal dealings

The purpose of this provision is (once again) to prevent that taxpayers achieve tax deductions through the shifting of profits at the time of application of the branch exemption regime due to the incorrect application of the arm's length principle in valuing the internal dealings that occurred before the election of the branch exemption regime.

In this respect, it must be recalled that the previous draft of the Regulation 2017 provided for a more complex and (probably) less favourable mechanism, focused on the recapture of tax mismatches arising from, inter alia, depreciations and/or amortizations, devaluations or other accounting provisions, along with a specific rule concerning the transfer of profits between the head office and the branch.

As pointed out by Italian scholars,[77] this draft provision went far beyond the primary law, which introduced a mere recapture of tax losses under article 168-ter (7) of the ITC, as described in the previous paragraph. The Italian tax authority amended this provision, introducing into the Regulation 2017 a type of "kind reminder" for the Italian taxpayer who has registered transactions between the head office and the PE in the course of the last five fiscal years.

As a matter of fact, the Italian tax authority simply requests that taxpayers who have realized such transactions amend them, from a tax perspective, in case they have not been treated consistently with the law and, more precisely, in accordance with the arm's length principle set forth by article 110(7) of the ITC.

In other words, the head office (and the PE) has to adjust the tax value of those assets and liabilities, including revenues, as well as functions and risks that were not properly valued according to the arm's length principle at the time of transfer.

# 7. The Attribution of Profits to PEs: Criteria and Practical Examples

It is evident that the application of the branch exemption regime requires that the relevant profits be fairly attributed to the same branch, in line with the arm's length conditions. Section 7. will analyse the common practice to be considered in performing the profit (or loss) attribution to the foreign PE of the Italian enterprise.[78]

When dealing with foreign branches, one of the main issues the taxpayer has to deal with is the determination of the amount of profits to be attributed to each PE. In doing so, a precise and accurate method to establish the income (or loss) of the PE has to be implemented. In this regard, the OECD provides for a specific method under article 7 of the OECD Model (2017) (the Authorized OECD Approach, AOA), which has been amended from time to time in order to make it more suitable for new business developments and economic trends.[79]

As a matter of fact, especially in cases where a PE is deemed to exist under the agency clause,[80] rights and obligations resulting from the contracts entered into by the intermediary have to be properly allocated to the foreign branch, to the extent that the PE itself habitually plays the principal role leading to the conclusion of contracts.[81] To this end, the remuneration at arm's length of the intermediary services is one of the crucial elements that needs to be determined in calculating the profits attributable to the PE.

In such a scenario, the first step should consist of evaluating the relevant intercompany transactions incurred between the associated companies with the appropriate transfer pricing method according to the provisions in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines)[82], as provided for by article 9 of the OECD Model (2017).

The AOA should then be applied only in order to allocate the portion of the associated enterprise's arm's length profit to the PE. In particular, in line with article 7 of the OECD Model (2017), paragraph 7.1 of the Regulation 2017 provides that the income of the foreign PE has to be determined in accordance with the AOA, even if the applicable DTT does not include a relevant provision.

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74. Reference has to be made to art. 117 ITC, which, in general terms, provides for the possibility for two or more Italian entities belonging to the same group to opt for a domestic tax consolidation. Under this regime, the consolidating company determines the group taxable base by adding all the (positive and negative) taxable bases of the companies that are part of the fiscal unit regime as determined under the ordinary corporate income tax rules.
75. Therefore, without the need to verify the amount of tax losses brought at a consolidated level that have been effectively utilized.
76. Under this latter scenario, the net tax losses will be recaptured from the future income of the branch, regardless of the fact that they have been utilized (or not) at a fiscal unit level.
77. Assonime, Associazione fra le Società Italiane per Azioni, *Osservazioni alla bozza di provvedimento del Diretto dell'Agenzia delle Entrate sul regime di branch exemption*, Consultazioni 6 (2016).
78. Clearly, this topic and its related effects are also of interest in the case that there is no election for the branch exemption regime and the foreign tax credit applies.
79. *See* P. Baker & R. Collier, *2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments*, 63 Bull. Intl. Taxn. 5, p. 199 (2009), Journals IBFD; and R. Petruzzi & R. Holzinger, *Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era*, 9 World Tax J. 2 (2017), Journals IBFD. It should also be noted that, in light of the amendments introduced by the BEPS Project, the Committee on Fiscal Affairs of the OECD in July 2016 and June 2017 released two discussion drafts for public comments and held consultations with public commentators in October 2016 and October 2017.
80. *See* OECD/G20, *Public Discussion Draft – BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments*, para. 10 (OECD 2017), International Organizations' Documentation IBFD.
81. On the other hand, if, under the functional analysis, the enterprise itself concludes contracts with the foreign-country clients, no PE should be deemed to exist, notwithstanding the circumstance that the sales are performed on the same foreign market.
82. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2017), International Organizations' Documentation IBFD.

According to the above, for the purposes of the branch exemption regime, the profits to be attributed to a foreign PE are the profits it would have realized if it were a separate and independent entity engaged in the same or similar activities under the same or similar conditions. In order to evaluate the comparability of the activities carried out, one should take into account the functions performed, the assets used and the risks assumed by the PE. Furthermore, the "free" capital has to be determined in accordance with the AOA.[83]

When allocating profits to the PE, some further guidance provided for by the Regulation 2017 should be observed. In particular:

- profits and losses (P&L) attributable to (each single) exempt PE(s) shall result in the ad hoc account drafted according to the criteria provided under article 152 of the ITC. Coherently with the AOA, the results of such P&L assume relevance for tax purposes if, and in the measure that, they reflect the results of the factual and functional analysis of the activity carried out by the same PE;
- upward and downward adjustments for the PE shall be made in accordance with the income tax provisions applicable to Italian residents in order to determine the income or loss of the exempt PE;[84]
- income attributable to the exempt PE(s) derived from a transaction between the head office and the branch or between the branch and other PEs is indicated in the mentioned P&L account at fair market conditions; and
- in the case of transferring assets, liabilities, functions and risks from the exempt branch to the head office or to other PEs, the enterprise shall adjust such assets, liabilities, functions and risks at their fair market value by means of upward and downward adjustments in the Italian enterprise tax return.

More in detail, one may note that, according to the AOA as provided for under the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments,[85] the following two steps should be considered:

- a functional and factual analysis has to be undertaken in order to identify those activities (including transactions with independent enterprises, transactions with associated enterprises and dealings with other parts of the same enterprise), liabilities and risks attributable to the PE; and
- a pricing has to be made in accordance with the guidance in the OECD Transfer Pricing Guidelines regarding transactions with associated enterprises attributed to the PE.

With reference to the first step, one may obviously note that the assets attributed to the branch are not legally owned by the PE, but by the enterprise as a whole. Assets shall indeed economically be attributed to the PE in line with the functions/risks/assets existing in the foreign country. The proper attribution of "free" capital and financial liabilities shall then follow, since, at the date when the business activity commences, the PE should be provided with sufficient financial resources to support its functions/assets/risks.

With regard to the latter topic, the criteria for the capital allocation provided for under the OECD's 2010 Report on the Attribution of Profits to the Permanent Establishments consist of three different approaches:

(1) the capital allocation approach: under this approach, "free" capital is allocated to the PE on the basis of the proportion of assets and risks attributed to the PE under the relevant functional analysis. For instance, if the PE has 10% of the enterprise's assets and/or risks, it should receive 10% of the enterprise's "free" capital;[86]

(2) the economic capital allocation approach: under this approach, used in the banking context, "free" capital is allocated according to the relevant instructions provided for by the competent local authority;[87] and

(3) the thin capitalization approach: under this approach, the PE has the same amount of "free" capital as an independent enterprise would if it were carrying on the same or similar activities under the same or similar conditions in the country where the PE is situated.[88]

Under the second step for the correct application of the AOA, transactions with related bodies (as identified under the first step) shall be priced in accordance with the OECD Guidelines.

Given this framework, in order to exemplify the criteria set forth under the Regulation 2017, one could consider the case of an Italian enterprise operating in the online advertising industry which is willing to provide its services on a given foreign market. Following in this section, examples of the different business model schemes are described to show the hypothetical solutions that might be adopted in order to sell the aforementioned advertising services.

From a different viewpoint, it could be maintained that, depending on the function/risk/asset allocation, it is possible to select either a "lighter" structure (*see* Example 1 below), with a PE operating as a pure marketing company (and a head office performing the sale

83. Para. 7.2 Regulation 2017 specifies that "in case the foreign Country does not apply (even if consistently with the provision of a DTT with Italy) the criteria recalled in the previous paragraph (i.e. the Authorized OECD Approach), for the attribution of profits and losses to the PE, the [head office] may request to the Italian tax authority the total or partial recognition of those foreign criteria through the filing of a proper ruling in accordance with Art. 31-ter, Presidential Decree 29 September 1973, No. 600".
84. Para. 7.4 Regulation 2017 also states that "if a profit arises, this should be deducted from the profit or summed to the loss of the enterprise. On the contrary, if a loss arises, this should be summed to the profit of the enterprise or deducted to the loss of the enterprise".
85. OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), International Organizations' Documentation IBFD.
86. Id., at para. 121.
87. Id., at para. 128.
88. Id., at para. 129.

activity), or a "heavier" structure (*see* Example 2), with a PE operating as both a marketing company and a selling entity (with a head office receiving royalty income for the licensed intangibles).[89] Under Example 3, a scenario in which the AOA is applied to a "hidden" PE is detailed (ascertained by the foreign competent tax authority under the assumption that besides the marketing activity, the foreign subsidiary is deemed to sell advertising services under the agency clause).[90]

## 7.1. Example 1.: Italian entity with a foreign PE providing marketing services

Under this first scenario, the sale of online advertising for the foreign market is made directly by the Italian head office, while the foreign PE merely provides online marketing services to local clients. As a consequence, the P&L account of the PE should entail the following:

### Table 1: P&L account of the PE under Example 1

| Items to be included in the P&L account | PE |
|---|---|
| Revenues from the provision of marketing services (to the head office) | 12 |
| Marketing expenses (borne by the PE with third parties) | 10 |
| Operating income | 2 |

The revenues of the PE derive from intercompany transactions between the head office and its PE, while marketing expenses come from transactions that took place with third parties. The marketing services provided by the PE on behalf of the enterprise have to be priced "at arm's length". In the case at hand, the marketing services were priced by applying, by way of example, a 20% markup on total costs.

The P&L account of the head office should then report the following figures:

### Table 2: P&L account of the head office under Example 1

| Items to be included in the P&L account | Head office |
|---|---|
| Revenues from online advertising sales (from sales to third parties) | 100 |
| Expenses for marketing services (provided by the PE) | 12 |
| Intangible development expenses | 20 |
| Operating income | 68 |

The revenues of the head office derive from sales to third parties, marketing expenses derive from transactions with the PE and intangible development expenses derive from both the remuneration of internal research and development functions and third-party providers.

The aggregated P&L account of the head office and the PE should be drafted as follows:

### Table 3: Aggregated P&L account under Example 1

| Items to be included in P&L account | Head office | PE | Aggregate |
|---|---|---|---|
| Revenues from online advertising sales | 100 | – | 100 |
| Revenues from intercompany services | – | 12 | – |
| Expenses for intercompany services | 12 | – | – |
| Marketing expenses | – | 10 | 10 |
| Intangible development expenses | 20 | – | 20 |
| Operating income | 68 | 2 | 70 |

## 7.2. Example 2.: Italian entity with a foreign PE selling online advertising and providing marketing services

Under the second alternative, both the sale of online advertising and the provision of marketing services to foreign customers are made by a foreign PE.

The P&L account of the PE should entail the following figures:

89. This assumption is considered within the example under consideration of the recurrent recourse to intangibles generally economically attributed to the head office in the most recent business schemes.
90. As already illustrated, the income of the subsidiary shall be determined according to art. 9 OECD Model (2017), while the income of the PE is quantified pursuant to art. 7.

### Table 4: P&L account of the PE under Example 2

| Items to be included in the P&L account | PE |
|---|---|
| Revenues from online advertising sales (from sales to third parties) | 100 |
| Marketing expenses (borne by the PE with third parties) | 10 |
| Expenses for intangible royalties (borne by the PE with the head office) | 50 |
| Operating income | 40 |

Revenues and marketing expenses derive from transactions realized with third parties. For the sale of online advertising, the PE utilizes intangibles licensed by the head office. The licensing of these intangibles has to be priced at arm's length. In the case at hand, by way of example, a royalty of 50% has been applied on revenues.

The P&L account of the head office should be drafted as follows:

### Table 5: P&L account of the head office under Example 2

| Items to be included in the P&L account | Head office |
|---|---|
| Royalties from intangible licensing (received from the PE) | 50 |
| Intangible development expenses | 20 |
| Operating income | 30 |

The aggregated P&L account of the head office and the PE should be drafted as follows:

### Table 6: Aggregated P&L account under Example 2

| Items to be included in the P&L account | Head office | PE | Aggregate |
|---|---|---|---|
| Revenues from sales of online advertising | – | 100 | 100 |
| Revenues from royalties | 50 | – | – |
| Royalty expenses | – | 50 | – |
| Marketing expenses | – | 10 | 10 |
| Intangible development expenses | 20 | – | 20 |
| Operating income | 30 | 40 | 70 |

## 7.3. Example 3: Italian entity with a foreign subsidiary providing marketing services and a foreign PE selling online advertising

Under the third scenario, marketing services to foreign customers are provided directly by the local subsidiary, while the online advertising is sold by the "hidden" foreign PE.

The P&L account of the subsidiary should be drafted as follows:

### Table 7: P&L account of the local subsidiary under Example 3

| Items to be included in the P&L account | Local subsidiary |
|---|---|
| Revenues from marketing advertising (intercompany) | 12 |
| Marketing expenses | 10 |
| Operating income | 2 |

The revenues of the subsidiary derive from intercompany transactions between the local entity and the "hidden" PE, while the marketing expenses derive from transactions with third parties. The marketing services provided by the subsidiary on behalf of the PE should be priced at arm's length. In the case at hand, the marketing services have been valued, by way of example, by applying a 20% markup on total costs.

The P&L account of the "hidden" foreign PE should be drafted as follows:

### Table 8: P&L account of the PE under Example 3

| Items to be included in the P&L account | PE |
|---|---|
| Revenues from online advertising sales | 100 |
| Intercompany marketing services | 12 |
| Intercompany royalties on intangibles | 50 |
| Operating income | 38 |

The revenues of the PE derive from transactions realized with third parties. For the sale of the online advertising, the PE utilizes the intangibles owned by the enterprise and benefits from the marketing services provided by the local subsidiary. The intangible licensed by the enterprise and the services provided by the subsidiary to the PE have to be priced at arm's length.

In Example 3, by way of example, a royalty of 50% has been applied on revenues, while the marketing services have been valued by applying a 20% markup on total costs.

The P&L account of the head office should be drafted as follows:

### Table 9: P&L account of the head office under Example 3

| Items to be included in the P&L account | Head office |
|---|---|
| Revenues: royalties from intangibles (intercompany) | 50 |
| Intangible development expenses | 20 |
| Operating income | 30 |

The aggregated P&L[91] account of the head office, the local subsidiary and the PE should be drafted as follows:

### Table 10: Aggregated P&L account under example 3

| Items to be included in the P&L account | Head office | Local subsidiary | PE | Aggregate |
|---|---|---|---|---|
| Revenues from online advertising sales | – | – | 100 | 100 |
| Intercompany revenues for marketing services | – | 12 | – | – |
| Intercompany expenses for marketing services | – | – | 12 | – |
| Revenues from royalties | 50 | – | – | – |
| Expenses for royalties | – | – | 50 | – |
| Marketing expenses | – | 10 | – | 10 |
| Intangible development expenses | 20 | – | – | 20 |
| Operating income | 30 | 2 | 38 | 70 |

As may be noticed, the aggregate operating income under the three scenarios given in Examples 1-3 is the same (equal to 70). However, the operating income is allocated differently among entities (the PE, subsidiary and head office) and countries (Italy and the foreign country). This clearly depends on the functional and risk profiles of the entity through which the elected business model is organized. It goes without saying that the (possible) benefits of the branch exemption regime should therefore be pondered in light of the aforementioned allocation, given that the most crucial role in such an evaluation is attributed to the proper allocation of functions, risks and assets.

Finally, it should be considered that this conclusion is indistinctly applicable to any business model (e.g. "industrial" or "digital" models) and − as a common denominator − the absence of a clear framework regulating PEs may be a concern in the process of allocation itself.

# 8. The (Strongly Recommended) Possibility to Apply for an Advance Pricing Agreement (APA)

In light of the elements highlighted throughout section 7., it is clear that the regime at stake requires the most accurate and precise application of the transfer pricing legislation. It should also be noted that any future challenge to the implementation of the AOA by the Italian tax authority could essentially reduce the appeal of the regime.

91. Please note that the display of the aggregated figures is made exclusively for example purposes.

In this context, it is the authors' opinion that the election for the branch exemption regime should be viewed within the broader framework of an APA. In fact, under certain conditions, this instrument would definitely exclude the aftermath of the improper application of the transfer pricing legislation.

In general, under article 31-ter of Presidential Decree 600 of 29 September 1973,[92] MNEs could enter into regulated discussion with the Italian tax authority and reach a binding agreement with regard to the following issues:[93]

- the advance definition of transfer pricing methods in order to determine the arm's length price of intra-group transactions;
- the application of tax laws to a specific case related to the attribution of profits or losses to Italian PEs of non-resident entities or to foreign PEs of Italian resident entities;
- the advance assessment of the effective existence of PEs of non-resident entities on the Italian territory based on both domestic applicable rules and applicable DTTs; and
- the application to a specific case of treaty measures regarding dividends, interest, royalties or other kind of income received and paid to non-resident entities.

In essence, in light of the possible (i) uncertainty in the criteria to be applied for the recognition of a PE suitable for the branch exemption regime; (ii) difficulties in the quantification of the profits to be attributed to the same PE under the AOA; and, more generally, (iii) application of the transfer pricing rules, it would be recommended to start formal discussions with the Italian tax authority in order obtain an adequate level of certainty.

As mentioned, the above could be achieved through the filing of:

- a specific ruling (*interpello qualificatorio*): according to article 11(1)(a) of the Italian Taxpayer Bill of Rights, for the qualification of the foreign PE; or
- tax rulings (depending on the specific case): according to the aforementioned article 31-ter(1)(a) and (b) of Presidential Decree No. 600 (*see* section 8), for the correct application of the transfer pricing legislation within the group and the correct quantification of the profits to be attributed to the PE.

# 9. The Anti-Avoidance Provisions and the Abusive Schemes

The Regulation 2017 clarifies that events of "double deduction" or "double exemption" arising from mismatches between the laws of the jurisdiction of the head office and the laws of the jurisdiction of the PE shall be annulled in order to avoid any abusive erosion of the Italian tax base.[94]

Furthermore, the Regulation 2017 also clarifies that events of double deduction, double exemption or, in more general terms, all the events that are deemed to be of an avoidance nature will be published on the website of the Italian tax authority in the (presumably) near future, also taking into account the developments of the main practice at the EU and OECD levels.[95]

Given this picture and, above all, this very last reference to EU and OECD practice, one may expect that the cases with an avoidance nature will be in line with those that have been analysed within the OECD Report on Neutralising the Effects of Branch Mismatch Arrangements (OECD Report (2017))[96] andCouncil Directive (EU) 2017/952 (ATAD II).[97] Both documents provide recommendations/ minimum standards to prevent and censor hybrid mismatch structures involving (also) PEs.

92. This article was introduced by the Internationalization Decree. For comments, ***see*** F. Di Cesare, *New Rules on International Tax Rulings for Enterprises with International Business Operations*, 23 Intl. Transfer Pricing J. 4 (2016), Journals IBFD; and E.A. Palmitessa, *The New International Tax Ruling Procedure*, 56 Eur. Taxn. 10 (2016), Journals IBFD.

93. In case the international tax ruling procedure is concluded, in fact, the agreement reached is binding for both parties and would cover five fiscal years (beginning from the one in which it is signed), with the possibility to extend its effects up to the financial year in which the ruling is filed without the application of penalties.

94. *See* para. 12 Regulation 2017.

95. Para 12.2 Regulation 2017 states that "the web site will be updated periodically by the Italian tax authority".

96. OECD/G20, *Neutralising the Effects of Branch Mismatch Arrangements – Action 2* (OECD 2017), International Organizations' Documentation IBFD [hereinafter OECD Report (2017)]. This document, published by the OECD on 27 July 2017, is an extension of the more comprehensive report on hybrid mismatch arrangements (OECD/G20, *Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: Final Report* (OECD/G20 2015), International Organizations' Documentation IBFD [hereinafter Action 2 Final Report]). The purpose of this extension is to detail the specific recommendations dedicated to the neutralization of potential mismatches essentially arising mainly from the transactions concluded between the head office and the PE, or among PEs.

97. Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L 144/1 [hereinafter ATAD II]. The content of ATAD II, adopted on 29 May 2017, basically mirrors the conclusion reached at the OECD level. The relevance of this topic has also been addressed by the European Union, which, on the basis of the conclusions reached at the OECD level, has amended the first Anti-Tax Avoidance Directive (Council Directive (EU) 2016/1164 of 12 July 2016 Laying Down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market (Codified Version), OJ L 193/1, EU Law IBFD [hereinafter ATAD]), introducing, inter alia, some anti-avoidance provisions dedicated (also) to hybrid mismatches involving PEs.

## 9.1. Branch mismatch arrangements

In brief and general terms, the OECD Report lists five types of branch mismatches, which have (also) been generally acknowledged as such at the EU level.[98] It is therefore expected that the Italian tax authority, when publishing the relevant instructions on its website, will take into account (part of) the following aspects:

(1) Disregarded branch structure:[99] this issue is related to the conflict in the characterization of the PE between the two countries involved. This case may occur when the head office recognizes the existence of the branch in the foreign country while the latter jurisdiction does not. This mismatch is included in the so-called "deduction/non-inclusion" category.[100] This mismatch, however, should not be of particular concern for the Italian branch exemption regime since, as mentioned under section 3., the regime does not apply when the foreign country does not recognize the existence of a branch under its domestic legislation (and therefore, presumably, no local corporate taxes were levied).

(2) Diverted branch payment:[101] different than mismatch (1), here, both jurisdictions recognize the existence of a PE, but they have a conflict in the attribution of income connected with the deductible payment. In particular, while the jurisdiction of the head office attributes the income to the PE, the country of the PE attributes it to the head office. Therefore, against a deductible payment (coming from a third party), there is no corresponding taxable income. This mismatch also falls under the "deduction/non-inclusion" category.

(3) Deemed branch payments:[102] different than mismatches (1) and (2), but still under the "deduction/non-inclusion" category, this mismatch concerns internal dealings (not a deductible item coming from a third party). This mismatch arises when the country of the head office exempts the income of the branch (under a branch exemption regime) and the expense sustained by the PE (the related income of which should be taxed in the hands of the head office but is not due to a conflict in the allocation) is deductible under the PE jurisdiction against (another) local income that is not taxed in the head office jurisdiction (i.e. there is a situation of "non-dual inclusion income"). Mismatches (2) and (3) should not, however, in principle be applicable if full alignment with the AOA exists between the head office and the PE jurisdictions.

(4) Double Deduction branch payments:[103] conversely to the previous cases, this is not included among the "deduction/non-inclusion" category, but within the so-called "double deduction" category. This situation may happen regardless of whether or not a branch exemption regime is in place. As a matter of fact, if a branch exemption regime exists, the mismatch arises when the deductible expense attributable to the foreign branch is allowed to also be deducted (i.e. exceptionally) in the head office country.[104] In such a case, a situation of mismatch will be registered due to a double deduction (in the head office and PE jurisdictions) against a double non-inclusion of income (i.e. an item of income that, by way of example, is taxed only in the PE jurisdiction). On the contrary, if the credit method applies, due to the fact that the condition of the double deductibility of the same expense is per se verified (it being included in both the worldwide income of the head office and in the separate income of the branch), in order to register a double deduction mismatch it should only be verified that the expense of the branch is deducted against income which is not taxed in both jurisdictions.[105]

(5) Imported branch mismatches:[106] this may occur when a payment gives rise to an item of income that is not taxed due to being offset against a deductible payment that does not have a corresponding taxable element (i.e. against the imported branch mismatch).[107]

## 9.2. Five recommendations

Given the points made in section 9.1., in terms of possible "branch mismatches", the OECD provides for five recommendations – that have almost consistently been accepted at the EU level[108] – that should be followed in order to minimize such risks:

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98. For more details on ATAD II, *see* O. Popa, *Recent Measures to Counter Hybrid Mismatch Arrangements at the EU level*, 57 Eur. Taxn. 9 (2017), Journals IBFD.
99. OECD Report (2017), *supra* n. 96, at 14: "[A] deductible payment received by a taxpayer is treated, under the laws of the residence jurisdiction, as being made to a foreign branch (and therefore eligible for an exemption from income), while the branch jurisdiction does not recognise the existence of the branch and therefore does not subject the payment to tax."
100. This category includes situations where a deductible element does not correspond to taxable income.
101. OECD Report (2017), *supra* n. 96, at 15: "[T]he mismatches arise from the fact that the branch treats the deductible interest payment as if it was paid directly to the head office in Country A, while the head office continues to treat the payment as made to the branch."
102. OECD Report (2017), *supra* n. 96, at 16: "[C]ountry B attributes the ownership of those intangibles to the head office and treats the branch as making a corresponding arm's length payment to compensate A Co for the use of those intangibles. This deemed payment is deductible under Country B law but is not recognised under Country A law (because Country A attributes the ownership of the intangibles to the branch)."
103. OECD Report (2017), *supra* n. 96, at 17: "[D]ouble deduction branch payments can arise where the residence jurisdiction provides the head office an exemption for branch income *while permitting it to deduct the expenditures attributable to the branch.* Mismatches can arise where the rules for allocating income and expenditure in the branch jurisdiction also allow the taxpayer to claim a deduction for the same expenditure under the laws of the branch jurisdiction." (emphasis added)
104. Italy does not grant any "extraordinary deduction" to the head office in relation to the expenses sustained by the (exempt) branch.
105. A typical example of this mismatch involves a fiscal unit regime in the PE jurisdiction (joined by the PE), where the PE is allowed to the deduct the expense (deductible in both countries) against income of a third entity (that joins the fiscal unit regime) that is not taxed in the head office jurisdiction (this is a case of "non-dual inclusion income").
106. OECD Report (2017) *supra* n. 96, at 18: "[I]mported branch mismatches can arise where a person with a deduction under a branch mismatch arrangement offsets the deduction against a taxable payment received from a third party."
107. For a comment on the purpose and scope of the provision, *see* C. Allen, *The Difficult Imported Mismatch Rules: BEPS Action 2 Recommendations*, 19 Derivs. & Fin. Instrums. 6 (2017), Journals IBFD.
108. It is relevant to mention that the ATAD II, further to the rules on the elimination of cases of double deduction, deduction without inclusion and imported mismatches, provides for a specific rule on disregarded PEs (i.e. PEs that are subject to the branch exemption regime in the head office jurisdiction and are not recognized in the foreign jurisdiction), which states that "to the extent that a hybrid mismatch involves disregarded permanent establishment income which is not subject to tax in the

(1) Limitation to the scope of the branch exemption: the first recommendation concerns expressly (and generally) countries that allow the applicability of the branch exemption regime. As mentioned therein, this recommendation does not aim to be a "branch mismatch rule"; its goal is much wider, being, in substance, a GAAR.[109] Its aim is to minimize any possible double exemption situation, i.e. to avoid that (besides the head office jurisdiction, which applies the branch exemption regime) no further "exemption" exists under the branch jurisdiction.[110]

(2) Branch payee mismatch rule: the second recommendation states that the payer jurisdiction should not allow the deductibility of the expense having an untaxed corresponding income,[111] as in the cases of the "disregarded branch structure" and "diverted branch payment".

(3) Deemed branch payment rule: the third recommendation states that the payer jurisdiction should not allow the deductibility of the expense having an untaxed corresponding income, as in the case where "the payer jurisdiction allows the deduction to be set off against an amount that is not dual inclusion income"[112].

(4) Double deduction rule: the fourth recommendation states that the investor jurisdiction and, if not, the payer jurisdiction, should not allow the deductibility of the expense to the extent that [this is] "set off against an amount that is not dual inclusion income".[113]

(5) Imported branch mismatch rule: finally, the fifth recommendation states that the payer jurisdiction should not allow the deductibility of the expense if the corresponding income is taxed against an expense that, in turn, due to (an imported) branch mismatch, does not have a corresponding taxable income.

To conclude, all of the aforementioned mismatches identified at the OECD and EU level will be taken into account by the Italian tax authority in order to verify whether, in the Italian tax system, there are (already) anti-avoidance provisions and/or sufficient instructions and if they need to be strengthened.

Member State in which the taxpayer is resident for tax purposes, that Member State shall require the taxpayer to include the income that would otherwise be attributed to the disregarded permanent establishment. This applies unless the Member State is required to exempt the income under a double taxation treaty entered into by the Member State with a third country".

109. The first recommendation states that the "jurisdiction that provide[s] an exemption for branch income should consider limiting the scope and operation of this exemption *so that the effect of deemed payments, or payments that are disregarded, excluded or exempt from taxation under the laws of the branch jurisdiction, are properly taken into account under the laws of the residence jurisdiction*". (emphasis added)

110. With reference to the Italian branch exemption regime, this GAAR may find some similarities with the CFC rule described under sec. 5.1., which disregards the application of the special regime if the income of the branch is not "properly" taxed.

111. One difference between the OECD and EU recommendations for the elimination of the branch mismatch arrangement concerns "deduction non-inclusion" cases. In fact, while the OECD recommendation provides for the sole duty of the payer jurisdiction to eliminate the deduction/non-inclusion, the European Union, as a "defensive rule", obligates the payee jurisdiction to tax the (corresponding) income if the deduction is not eliminated by the payer jurisdiction.

112. *See* OECD Report (2017), *supra* n. 96, at 35.

113. Id., at 45.