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by Marco Rossi

Italy's Regional Tax Commission of Veneto (equivalent to the U.S. Circuit Court of Appeals) has issued a decision concerning when a local subsidiary might constitute a permanent establishment of its foreign parent under article 5 of the OECD model income tax treaty. (For prior coverage, see *Tax Notes Int'l*, Oct. 23, 2006, p. 270.)

The issue is still far from settled, despite the revision of OECD commentary on article 5 issued in response to the Italian Supreme Court's decision in *Ministry of Finance (Tax Office) vs. Philip Morris (GmbH)*, Corte Suprema di Cassazione, No. 7682/05, May 25, 2002.[1] (For discussion, see *Tax Notes Int'l*, Mar. 28, 2005, p. 1127.)

The Case

In judgment no. 17/14/06 (issued March 30, 2006), the Regional Tax Commission held that the Italian wholly owned subsidiary of a German company qualified as a permanent establishment of its German parent under article 5 of the Germany-Italy income tax treaty. The decision was based on the fact that, under the licensing and distributing agreement with its foreign parent, the subsidiary operates in a subordinate position and as an instrument of the foreign parent, with no real independent authority to conduct its business.

The case involved a German multinational group that had six different lines of business. Each line of business was operated through a German intermediate holding company that owned the entire stock of operating subsidiaries located in various foreign jurisdictions and was controlled by the ultimate German parent company of the group.

One line of business consisted of the manufacturing and sale of equipment for paper production and was carried out also in Italy, through a fully owned Italian subsidiary. The Italian subsidiary held a nonexclusive, nontransferable license from its German parent for the manufacturing and distribution of the equipment in the Italian market. As a consideration for the license, the Italian subsidiary paid to its German parent a royalty equal to 5 percent of the gross sale price of the products sold to its Italian customers. The Italian subsidiary purchased spare parts and components from various affiliated companies of the group, designed the equipment, contributed to the manufacturing of the equipment through the assembly of the components, and sold the equipment to Italian customers. It also offered postsale assistance to Italian customers.

The license and distribution agreement granted to the German parent company extensive authority over its Italian subsidiary, including a covenant not to compete and the power to determine the prices and the quality of the products sold on the Italian market. Executives of the German parent company sometimes worked at the Italian subsidiary, periodically revised the Italian subsidiary's records and accounts, and directed the Italian subsidiary's activity in two general meetings held each year in Germany. The Italian subsidiary's activities for its German parent under the license and distribution agreement accounted for about 98 percent of its total business activity.

Based on those facts, the Italian revenue agency argued that the Italian subsidiary was in a subordinate position to its German parent, and as a result of

[1] As an example of the most recent debate on this issue, we would like to refer to the David R. Tillinghast Lecture titled "Can a Subsidiary be the Permanent Establishment of its Foreign Parent" delivered by Professor Jean-Pierre Le Gall at NYU Law School on September 26, 2006, and a panel discussion at the recent American Bar Association Tax Section's meeting that took place in Denver, Colorado, on October 20, 2006, titled "The Shadow Presence in the United States."

its legal and economic dependence on the foreign parent, it should be treated as a PE in Italy of the German parent for Italian tax purposes.

The revenue agency denied the deduction of the royalty payments made by the Italian subsidiary to its German parent under the license agreement and the deduction of the value added tax charged by the German parent to the Italian subsidiary on the transfer of some goods or services to the Italian subsidiary, and it assessed additional corporate income tax and regional tax in the amount of €1,306,190.30 and VAT in the amount of about €140,000 on the Italian subsidiary.

The Italian subsidiary challenged the assessment before the local tax court, which held for the taxpayer in rulings no. 265 and no. 266 issued October 4, 2004. The revenue agency appealed the tax court's rulings before the Regional Tax Commission of Veneto.

Appeal

The issue before the Regional Tax Commission was whether a dependent subsidiary (that is, a subsidiary economically and legally dependent on its parent and subject to total or strict control and authority of the parent as to the conduct and management of its business) should be respected as a separate taxpaying entity or treated as a branch or PE of the foreign parent company for tax purposes.

The Regional Tax Commission examined the issue mainly in the context of article 5 of the OECD model income tax treaty, as reflected in article 5 of the Germany-Italy tax treaty of 1989.[2] (For the treaty, see *97 TNI 131-28* or *Doc 97-19689*.) It also referred to the Sixth Directive on VAT (77/288/CEE), which uses the concept of center of permanent activity. According to Italian tax courts, that concept must be interpreted consistently with the meaning of the PE concept used in tax treaties and regarding income taxes.

The Tax Commission emphasized that the analysis should be conducted not on the basis of formal criteria, but having due regard to the economic substance of the overall business relationship between the parent and the subsidiary (and the other members of the group). The commission referred to the Supreme Court's decision in *Philip Morris* as the authority in support of that approach. It also reiterated the principle, also from *Philip Morris*, whereby a subsidiary can constitute a PE of multiple foreign affiliated companies belonging to the same group and the subsidiary's activities should be examined in the context of the activities of the whole group.

The Tax Commission stated that the parent's control of the subsidiary, along with other circumstances showing substantial legal and economic dependence of the subsidiary, can serve as evidence that the subsidiary acted as an instrument of the parent.

The Regional Tax Commission focused on terms of the licensing agreement between the German parent and the Italian subsidiary that indicated a substantial dependence of the Italian subsidiary on its foreign parent. Those terms were:

- the obligation to agree with the parent on terms of the sale of the equipment in Italy;
- the inability to change equipment sold without the parent's approval;
- a covenant not to compete;
- the obligation to comply with the quality standards imposed by the parent;
- the obligation to agree with the parent on improvements to equipment goods and the duty to transfer any improvements, discovery, or new technology to the parent free of charge, even if procured by the subsidiary during the licensing contract at its own cost;
- the inability to change the terms of the license; and
- the obligation to refer any dispute arising from the licensing agreement to the president of the ultimate German holding company and the manager of the parent company with no recourse to ordinary courts or tribunals.

Similar licensing agreements were in place with other affiliated companies of the group.

The Tax Commission also noted that the Italian subsidiary employed 25 employees for design work and 5 employees for assembly and manufacturing (which was carried out mainly outside Italy), and it concluded that arranging design services for the benefit of the other companies of the groups was the real and dominant part of the Italian subsidiary's business.

The Regional Tax Commission concluded that the Italian subsidiary was to be recharacterized as the PE in Italy of its German parent as a result of its substantial dependence on the parent, the parent's extensive powers to control and direct the subsidiary's business activity, and the subsidiary's lack of independent authority and its own resources.

The Regional Tax Commission used a single taxpayer approach and denied the deductions for payments made to the parent and for VAT charged in

[2]Signed on October 18, 1989, ratified with law dated November 24, 1992, no. 459, and entered into force on December 26, 1992.

the parent's invoices, and it assessed additional taxes on the subsidiary-PE.

Analysis

The case substantially differs from *Philip Morris* concerning the rationale used to conclude that an Italian subsidiary constitutes a PE of its foreign parent. In *Philip Morris* that conclusion was reached based on the fact that the subsidiary had participated in contractual negotiations for the parent (even though it had no authority to conclude, and it did not conclude, any contracts on behalf of the parent) and had carried out supervision and managerial activities for the parent in Italy.

In this case, although the judges used a similar substance-over-form type of analysis, the holding is based on the subsidiary's legal and economic dependence and its status as servant or instrument of the parent.

A new concept would seem to emerge from this decision — that of a dependent subsidiary qualifying as a PE of the controlling parent. That concept may be placed midway between the concepts of fixed place of business PE and dependent agent PE, which are more directly addressed in tax treaties.

This new concept is not directly dealt with in the OECD commentary to article 5 of the model treaty. The decision appears to be a new precedent under Italian case law and to require additional planning by foreign investors who wish to establish subsidiary operations in Italy that run no risk of being recharacterized as PEs of the foreign parent or the group.

Foreign taxpayers will have to pay close attention to the contractual terms of the arrangements between their Italian subsidiaries and the foreign parent (or other foreign affiliated companies of the group) to ensure that those terms strike a balance between sufficient control and complete economic and legal dependence of the Italian subsidiary, which may lead to a PE recharacterization.

Although the Regional Tax Commission's ruling is not binding on other courts under Italian law and is subject to appeal to the Supreme Court, it should be taken into consideration by foreign taxpayers planning to establish business operations in subsidiary form in Italy. ◆

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