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Profits and Losses of Foreign Permanent Establishments: The Optional Branch Exemption Regime

The author, in this article, discusses article 14 of the Internationalization Decree, which allows taxpayers to opt for a branch exemption in respect of the profits and losses of a foreign permanent establishment as an exception to the credit method.

1. Introduction: The PE as a Territorial Connecting Criterion

According to the ordinary rules for allocating taxing powers over income produced by companies located in different states, the permanent establishment (PE) concept has historically been adopted, amongst other reasons, as a connecting criterion to affirm taxation in the source state. Such a link represents an "adjustment" to the principle of worldwide taxation applicable to business profits and is used as a guideline in tax treaties.

The strong economic link that connects the PE to the state in which it is located allows for the latter to tax its income,[1] while the state of residence of the company to which the PE belongs must – while theoretically retaining the power to tax the same income – apply a treaty remedy to avoid double taxation: the tax credit or exemption method.[2] In other words:[3]

> […] the permanent establishment (PE) concept is the basic nexus/threshold rule for determining whether or not a country has taxing rights with regard to the business profits of a non-resident taxpayer, although some types of profits may be taxed in a country even though there is no PE (for example, profits derived from collecting insurance premiums). Business profits of a non-resident that may be taxed by a country are only those that are attributable to a PE.

Once it is assessed that a PE of the non-resident company is operating in the source state, the latter may tax its business income on the basis of the territoriality principle: in this respect, under the approach of the OECD Model (2014),[4] the profits attributable to the PE are those that it would have had if, instead of doing business with the parent company, it had dealings with companies completely unrelated to its corporate structure at market prices ("separate entity approach"). In other words, for the purpose of determining income only, the OECD Model frames the PE not as an appendage of the foreign company, but as a third independent company that conducts business with the parent company.

The income attributed to the PE is to be calculated taking into account the various costs and benefits related to the latter, including those resulting from transactions with the parent company. This obliges the PE to keep simplified accounting books, aimed at recording the results of its transactions, and make its activities transparent and controllable by the state in which the establishment is located.

2. The Italian Approach to Foreign Branches: From Exclusively Applying the Credit Method to Allowing for the Possibility of an Exemption

2.1. Introductory remarks

Since the existence of the PE inevitably implies concurrent taxing powers of the source state and the state of residence of the parent company, both international tax law and domestic provisions have introduced specific mechanisms to prevent double taxation in this respect: i.e. either the tax credit or exemption method applies in respect of the foreign income.

Italy has always applied the tax credit method, however, article 14 of Legislative Decree No. 147/2015 ("Internationalization Decree")[5] has introduced a branch exemption regime (hereinafter BEX) as an exception, pursuant to which the taxpayer may opt for an exemption of profits and losses of the foreign PE.

This regime, which added article 168-ter of the Income Tax Consolidation Act,[6] was introduced in order to allow for cross-border business activities undertaken by resi-

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1. E. Reimer, *Article 5. Permanent Establishment*, in *Klaus Vogel on Double Taxation Conventions* p. 297 (E. Reimer & A. Rust eds., Kluwer Law International 2015), remarks that "the main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State".
2. This means that "the existence of a PE in the other contracting State excludes the tax monopoly of the State of residence". In this sense, *see* E. Reimer, *Permanent Establishment in the OECD Model Tax Convention*, in *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* p. 184 (E. Reimer, S. Schmid & M. Orell eds., Kluwer Law International 2014).
3. J.P. Owens, *The Taxation of Multinational Enterprises: An Elusive Balance*, 67 Bull. Intl. Taxn. 8, p. 444 (2013), Journals IBFD.
4. *OECD Model Tax Convention on Income and on Capital* (26 July 2014), Models IBFD.
5. IT: Legislative Decree 147 of 14 Sept. 2015, Provisions regarding measures for the growth and internationalisation of enterprises (147/2015), National Legislation IBFD.
6. IT: Presidential Decree No. 917/1986 (Income Tax Consolidated Act, ITCA), National Legislation IBFD.

Table 1: Tax Comparison

	Foreign branch		Subsidiary	
	Branch exemption regime	Ordinary regime (tax credit)[1]	Parent-Subsidiary Directive	Tax treaty
Profits post-taxes paid in Ireland (12.5%)	100	100	100	100
Withholding on the distribution of the net profit	–	–	0	-10
Corporate tax paid by the parent company	0	-27.50	-1.375	-1.375
Tax credit for taxes paid abroad	0	12.50	0	0.50
Total	100	85	98.625	89.125

1. For the sake of simplicity, it is assumed that the net profits are equal to the taxable income in Italy.

dent companies to benefit from more favourable foreign tax rates. For example, if a resident company has a PE in Ireland, where the corporate tax rate is 12.5%, exempting its profits in Italy would lead to a tax reduction of approximately 15% compared to the other mechanisms.[7] In this respect, the advantage is readily apparent in Table 1.

The BEX regime aims to make the Italian tax system more competitive for companies that carry out business activities abroad[8] and, for this purpose, the lawmaker looked to foreign legislation aimed at allowing for the same tax treatment in respect of foreign activities, regardless of the form used (i.e. branch or subsidiary).[9]

In particular, the UK legislation inspired the Italian BEX regime.[10] In this respect, Finance Act 2009 introduced an exemption applicable only to foreign dividends, which was not applicable to other forms of taxable income arising from foreign investment. Such an exclusion led to a serious asymmetry, since UK companies that invested abroad through a subsidiary qualified for an exemption in respect of the return on their investment (i.e. the dividends), while those companies that decided to invest abroad through a PE were always taxed according to the "arising basis taxation" concept (i.e. in the tax period of realization).[11] Schedule 13 (*Profits of foreign permanent establishments etc.*) of Finance Act 2011 modified the Corporation Tax Act 2009 by introducing new sections 18A (*Exemption for profits or losses of foreign permanent establishments*) to 18S. To sum up, the UK system, which entered into force on 19 July 2011, is structured as follows:

- the UK resident company must exercise the option to enter into the BEX regime, failing which it will continue to qualify for a tax credit;
- once the company has opted for the BEX regime, this will apply to all foreign PEs, including those established later (the "all in-all out" principle);[12]
- the option is irrevocable, so the UK resident company cannot revert back to the tax credit mechanism in determining the income of foreign PEs;
- the BEX regime starts to apply from the tax period following the exercise of the option;[13]
- if the foreign PE has produced losses in the six years preceding the exercise of the option and these were used to reduce the UK tax base, then such losses may continue to be used in this way after the option is exercised until the amount taxed in the United Kingdom coincides with the losses suffered by the foreign PE used in the six years preceding the option; and
- in calculating the exact amount of foreign profits subject to exemption, the following rules apply:
  (a) if there is a tax treaty between the United Kingdom and the other state, the profits of the foreign PE are determined according to the ordinary rules for distributing taxation powers;[14] and

7. *See* M. Pennesi, *Per le stabili organizzazioni estere possibile l'esenzione fiscale in Italia*, Il Sole 24 Ore Focus, p. 9 (30 Sept. 2015).
8. In this respect, Legislative Decree No. 147/2015 "is strongly affected by recent international developments […] and it takes inspiration from experiences already tested by foreign jurisdictions (by adapting them to the Italian reality, in order to make it more competitive, such in the case of the *branch exemption*)". *See* Senate of the Republic, VI Treasury and Finances Commission, *Audition of the Director of the Tax Authorities*, Rome, p. 5 (19 May 2015). [author's translation]
9. *See* E. Della Valle, *La* branch exemption *nelle stabili organizzazioni estere di soggetti residenti*, 39 Il Fisco 46, p. 4412 (2015).
10. A BEX regime is also available in France as a general rule (i.e. the profits and losses of foreign PEs are always exempted from the French tax base), the Netherlands (NL: Corporate Income Tax Law (*Wet op de vennootschapsbelasting*), 1969, art. 15e, National Legislation IBFD), Luxembourg and Australia.
11. "Remittance basis taxation" is the method applied to resident non-domiciled taxpayers. On this issue, *see* P. Mastellone, *Il trattamento impositivo dei "residenti non domiciliati" nel Regno Unito e la sua legittimità nel panorama internazionale*, 6 Diritto e Pratica Tributaria Internazionale 3, p. 1369 et seq. (2009).
12. As remarked by A. Miller, *United Kingdom*, in *Enterprise services* p. 701 (IFA Cahiers, vol. 97a 2012), Online Books IBFD, "the branch exemption election must apply to all foreign branches of the UK company and must be made in the period preceding that for which the election takes effect".
13. According to A. Miller & L. Oats, *Principles of International Taxation* p. 114 (Bloomsbury Professional 2014), this provision would serve to avoid UK companies adopting "a 'wait and see' approach, making the election only if the branch turns out to be profitable".
14. In this respect, B. Obuoforibo & S. Heydari, *United Kingdom – Corporate Taxation* sec. 7.2.1.1., Country Analyses IBFD (accessed 28 Nov. 2016) highlight that "where the territory in which the foreign PE is located taxes profits without requiring that these be attributable to the foreign PE, relief is granted in the United Kingdom by means of credit only, i.e. the exemption does not apply except to the extent that the profits are attributable to the foreign PE. Some treaties do not provide for attribution of profits to be made by the residence state, and do not provide for foreign tax credit to be computed by reference to the *same profits* as those by reference to which the *foreign tax* was computed. In such cases, in computing the "relevant profits amount" and "relevant losses amount", it is to be assumed that the treaty does actually contain such provisions. That said, in general terms, most treaties do actually provide that the attribution of profits should be made by *both contracting states*, so that the foreign tax credit granted is computed by reference to the same profits in respect of which the foreign tax was computed".

(b) if, in contrast, no tax treaty is in force, the profits of the foreign PE are determined according to the criteria laid down in the OECD Model (2010).[15]

2.2. The optional nature of the regime

Article 168-ter of the ITCA introduces a regime that makes all profits and losses of foreign branches virtually irrelevant. In addition to the general provisions of the rule, further operative rules were to be specified by a Determination of the Director of the Italian tax authorities. They issued such a Draft Determination on 25 February 2016 (DD),[16] which will be analysed in this article.

The BEX regime is subject to the exercise of an option by the resident taxpayer – which may be either an individual producing business income or a company subject to corporate tax – made "at the time the foreign branch is established" or, if already existing, within the second tax year following the year the new regime entered into force. The optional nature of the BEX regime clearly emerges from the wording of article 168-ter of the ITCA, which clarifies that "an enterprise resident in the State may opt for the exemption of profits and losses": this means that the exemption method is an alternative and not a substitute for the tax credit.

The choice made by the taxpayer is subject to stringent requirements, since it must be exercised by the second tax year after 2015 and, once exercised, is irrevocable. The latter implies that, before exercising the option, the taxpayer must carefully consider the consequence, i.e. that it will no longer be possible to use foreign losses to reduce its tax base. In this respect, it is worth reiterating that the Court of Justice of the European Union (ECJ) allows, in specific cases (for example, upon winding down a foreign PE or where there is a prohibition against carrying forward losses in the source state) for such tax losses to be reported.[17]

Once the taxpayer has opted for the BEX regime, the immediate consequence is that all foreign profits and losses are not recognized in Italy: this very stringent (perhaps excessive) legislative choice is probably justified by the need to avoid a situation in which resident companies with more foreign PEs may adopt strategies to improperly obtain a double advantage: an exemption of profits and a recognition of the respective losses for the purpose of reducing the tax base.

In order to avoid this possible abuse, the BEX regime is comprehensive and irrevocable, which nevertheless might undermine its attractiveness among taxpayers.

First, the irrevocable nature of the option (which needs to be elected for within the specified period of time) is a unique choice considering the context of the Italian tax system, which usually provides that optional tax regimes apply for a limited period of time (for example, the tax consolidation regime applicable to groups of companies, which lasts for three years). Irrevocability is particularly advantageous for resident companies that, in the long run, always have a positive net balance of income realized through all of its foreign PEs: this is intended to ensure that resident companies, after having benefited from the BEX regime for several years, do not decide to "switch" to the ordinary tax credit method once the foreign PEs start to incur losses. In this respect, it is not reasonable for companies to have to engage in an ex ante analysis in making a definitive decision on a tax regime that will be applicable for an indefinite period of time.

Secondly, article 168-ter of the ITCA reinforces the "all in-all out" principle, since it clarifies that the BEX regime cannot involve only *one* foreign PE, but necessarily *all* foreign PEs existing at the time the option is elected and also those that will be created in the future. Therefore, it is not possible for the resident company to opt for the BEX regime for certain foreign PEs and, at the same time, retain the tax credit mechanism for others depending on what is convenient ("cherry-picking"). In the absence of such a principle, the lawmaker feared that companies would opt out of the BEX regime for PEs located in "low-tax jurisdictions", while continuing to apply the tax credit method for PEs located in "high-tax jurisdictions" or in respect of PEs that usually produce losses.

This approach was criticized by scholars even during the parliamentary discussions prior to approval of Legislative Decree No. 147/2015, since it would be more appropriate to avoid the "all in-all out" principle by allowing the applicant taxpayer to pursue a preliminary ruling aimed at proving to the tax authorities the absence of any abusive purpose of such a "selective application" of the BEX regime.[18]

Nevertheless, it is apparent that irrevocability and the "all in-all out" principle apply to a single resident company, while, within the same group of companies, it is still possible to make different choices in order to achieve more flexibility under the BEX. As such, opting for the BEX regime may be convenient for large industrial or financial groups with many foreign PEs, since the benefits will likely outweigh the disadvantages in the long term.

15. *OECD Model Tax Convention on Income and on Capital* (22 July 2010), Models IBFD.
16. Agenzia delle Entrate, *Esenzione degli utili e delle perdite delle stabili organizzazioni di imprese residenti di cui all'articolo 168-ter del decreto del Presidente della Repubblica 22 dicembre 1986, n. 917 (TUIR). Definizione delle relative modalità applicative ai sensi dell'articolo 14, comma 3, del decreto legislativo 14 settembre 2015, n. 147*, Prot. no. 2016, available at www.agenziaentrate.gov.it.
17. *See* FI: ECJ, 18 July 2007, Case C-231/05, *Oy AA*, para. 55, ECJ Case Law IBFD; DE: ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronnl*, para. 52, ECJ Case Law IBFD, wherein the Court established that "where a double taxation convention has given the Member State in which the permanent establishment is situated the power to tax the profits of that establishment, to give the principal company the right to elect to have the losses of that permanent establishment taken into account in the Member State in which it has its seat or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States concerned".
18. *See* G. Maisto, *Audition before the Senate of the Republic – VI Permanent Commission (Finances and Treasury)*, Rome, 21 May 2015, p. 11, available at www.senato.it/application/xmanager/projects/leg17/attachments/documento_evento_procedura_commissione/files/000/002/762/Intervento_professor_Maisto.pdf, who considers the application of the "all in-all out" principle disproportionate.

In contrast, opting for the BEX regime (which implies renouncing the use of the losses of the foreign PE in Italy according to the tax credit method) might not be convenient at all for smaller or start-up companies because, at the beginning, their foreign PEs will likely produce losses and it is, therefore, possible that their predictions regarding the benefit of the exemption regime might turn out to be wrong.[19]

In order to avoid these criticisms of the new BEX regime, before the Draft Determination of the Director of the Tax Authorities was released, a time limit for its application was proposed in order to avoid abusive behaviour, subject to a possibility for the taxpayer to apply to renew the option. This proposal was rejected by the tax authorities on the basis that it would have led to confusion regarding the accounting values of active and passive items of income of foreign PEs prior to returning to the tax credit system. Moreover, some scholars proposed that the irrevocable nature of the regime be retained, but that the applicant taxpayer should be granted a limited possibility to recognize a PE's losses (and tax, in Italy, the PE's profits),[20] but this was not implemented because the tax authorities considered that such a "mixed" system would have complicated the regime and, in particular, make tax assessments more complex.

To sum up, the decision to exercise the option must be preceded by an analysis of the profitability of the BEX regime, which, in certain cases, might not be convenient. The branch exemption is, therefore, an optional tax regime that has the dual aim of eliminating double taxation and attracting (and keeping) productive investment in Italy.

2.2.1. Exercise of the option

Resident taxpayers opt for the BEX regime on their income tax return. All of the taxpayer's various foreign PEs and the state (or jurisdiction) of establishment must be indicated. Article 168-ter of the ITCA addresses two different situations depending on whether or not the PE is established at the time the option is exercised or already exists.

In the first scenario, the option is to be made "once the permanent establishment is created, with effect from the same tax period" (article 168-ter, paragraph 2 of the ITCA). The DD remarks that "the exercise of the option at the time the first permanent establishment is created binds those created subsequently, without it being necessary to exercise a new option for each of them".[21] The option must be made in the first income tax return following the creation of the PE: as such, in the 2017 income tax return for PEs created in 2016.

In the second scenario, i.e. PEs in existence at the time the option is made, there is a two-year transitional period before the BEX regime becomes fully applicable: resident companies, in fact, will be able to exercise the option by the second tax year following the year in which the new rules entered into force, with effect from the tax period during which the option is exercised (article 168-ter (6) of the ITCA): this means that companies may opt for the exemption by 2018 (i.e. in their income tax return filed in 2019).

Serious doubts have arisen in relation to the situation of a resident company that already has a foreign PE and wants to establish a second one in 2016: according to article 168-ter (2) of the ITCA and the "all in-all out" principle, the option must immediately and automatically extend to every PE. The problem is that, because of such an "extension", the benefit of the two-year transition period for existing PEs does not apply to such newly created PEs, which represents a significant disadvantage for taxpayers that established a foreign PE in 2016. The tax authorities have not provided a solution to this problem. In this respect, the public consultation promoted by the tax authorities, which ended in March 2016, yielded interesting comments from the Association of Industries (Confindustria) and the Association of Capital Companies (Assonime). They remarked that, in order to avoid ambiguity and disparities, the possibility to opt for the BEX regime in 2018 must be extended to resident companies establishing foreign PEs in 2016.[22]

2.2.2. Termination of the BEX regime

As remarked, once the resident company opts (or does not opt) for the BEX regime, the choice becomes irrevocable. Nevertheless, article 168-ter of the ITCA does not provide guidance on what happens if a company closes all its foreign branches and, subsequently, decides to open new ones: the lawmaker does not clarify if, in this scenario, the taxpayer remains bound by its initial choice.

Regarding this issue, the tax authorities have determined that once a resident company closes all its foreign PEs, the option no longer binds it and, therefore, each new PE will automatically be subject to the tax credit method and the BEX regime will only apply following the exercise of a further option.

To sum up, the tax authorities have clarified that the operation of the BEX regime may only terminate in two scenarios: following an extraordinary transaction (*operazioni straordinarie*) such as a merger, acquisition, etc. or the closure of all foreign PEs. This is probably the only convincing solution, since the period between the closure of foreign PEs and the opening of others might be very long and the business scenario of the resident company could be totally different.

19. In this sense, *see also* G. Albano, *Il nuovo regime della "branch exemption" tra obiettivi di competitività e difficoltà operative*, 39 Corriere Tributario 2, p. 92 (2016).
20. *See* Della Valle, *supra* n. 9, at 4413-4414 and A. Trabucchi & F. Cerulli Irelli, *Il regime opzionale di "branch exemption"*, 38 Corriere Tributario 21, p. 1617 (2015).
21. Author's translation.
22. *See* Confindustria, *Esenzione degli utili e delle perdite delle stabili organizzazioni di imprese residenti (branch exemption) – Bozza di provvedimento del Direttore dell'Agenzia delle Entrate. Le osservazioni di Confindustria in risposta alla consultazione pubblica indetta dall'Agenzia delle Entrate*, Rome, 31 Mar. 2016, *passim*; Assonime, *Osservazioni alla bozza di provvedimento del Direttore dell'Agenzia delle Entrate sul regime di* branch exemption, Rome, 2016, p. 2 et seq., available at www.assonime.it.

2.3. Scope of application

2.3.1. Objective

The BEX regime applies to the results (i.e. both profits and losses) of foreign PEs, while all other profits arising from the exercise of a commercial activity not connected with a PE (for example, consultancy services provided to foreign clients by specialized staff)[23] cannot benefit from the exemption.

Therefore, a resident company considering the BEX regime must first verify whether or not the business activity abroad is being carried out through a PE, which is to be assessed according to the tax treaties in force,[24] as well as article 162 of the ITCA: obviously, if Italy has signed a tax treaty with the state in which the PE is located, this will prevail over the ITCA.

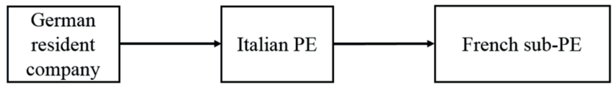
Once it is ascertained that the business activity is effectively carried out abroad through a PE, the resident company is able to opt for the BEX regime, however, in order to be absolutely sure of its analysis, it can apply for a "qualification" preliminary ruling (in Italian, *interpello ordinario qualificatorio*) from the tax authorities under article 11(1)(a) of Law no. 212 of 27 July 2000 (the Taxpayer's Bill of Rights, TBR).[25] Following this preliminary ruling, the tax authorities will provide a written opinion concerning the existence (or lack thereof) of the foreign PE on the basis of the information and documents provided by the taxpayer. This instrument is very useful, since it serves to avoid future tax claims regarding the income produced by the PE and excluded from the domestic tax base.

2.3.2. Who is entitled to opt for the regime?

Those entitled to opt for the BEX regime include not only companies and entities, according to article 73(1)(a)-(c) of the ITCA, but, in general, all resident taxpayers with business income (article 55 of the ITCA), including partnerships and individual entrepreneurs carrying out business activities. This represents a profound difference between the BEX regime and the UK legislation, which only applies to corporate entities.

Article 168-ter (1) of the ITCA provides that the option may be exercised by resident enterprises and this means – although the DD does not clarify this point – that a foreign resident enterprise operating in Italy through one or more PEs cannot apply for it. It is debatable whether or not the BEX regime applies to a situation in which the Italian PE of a non-resident taxpayer carries out a business activity in a third country (i.e. other than the country where the parent company or the individual entrepreneur is resident), as per Diagram 1, by means of a seat that qualifies as a PE: this is known as a "sub-PE" (i.e. a PE of a PE). Tax treaty practice does not unanimously accept the legal existence of such a "sub-PE".[26]

Diagram 1: How a "sub-PE" may be structured



Since the rule literally requires that the subjective requirement of "residence in Italy" be met, the tax authorities should clarify – in the final Determination of the Tax Authorities' Director – if, in such a scenario, it is possible to interpret the requirement expansively to allow the Italian PE to opt for the BEX regime in relation to its sub-PE in a third country.

Certainly the tax treaty non-discrimination provision favours the applicability of the BEX regime even to sub-PEs belonging to foreign companies.[27] In addition, it should be

23. Nevertheless, this example constitutes a PE according to art. 5(3)(b) of the UN Model Tax Convention on Income and on Capital (1 Jan. 2001), Models IBFD, which provides that "the term "permanent establishment" also encompasses: […] The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned". Such a provision is contained, for example, in the *Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* art. 5(3)(b) (16 Dec. 2008) (as amended through 2014), Treaties IBFD, as well as in the *Agreement between the Republic of Turkey and the Republic of Italy for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion* art. 5(2)(g)(II) (27 July 1990), Treaties IBFD.
24. *See* art. 168-ter (11) ITCA.
25. The new "qualification" preliminary ruling provided by art. 11 TBR (as reformed by Legislative Decree No. 147/2015) allows the taxpayer to make a formal request to the tax authorities for a determination of the "correct classification of situations in the light of the applicable tax provisions, when justified by objective conditions of uncertainty and the procedures of Art. 31-*ter* of Presidential Decree of 29 September 1973, no. 600 cannot be activated". [author's translation]
26. According to E. Fett, *Triangular Cases – The Application of Bilateral Income Tax Treaties in Multilateral Situations* p. 36 et seq. (IBFD 2014), Online Books IBFD:

    a sub-PE triangular case is similar to a typical PE triangular case, with the exception that in this case the recipient of the income has a PE in the source State which is a sub-PE of the PE in the PE State. That is, the income attributable to the sub-PE in the source State (or sub-PE State, "State SPE") is also attributable to the PE in the PE State. […] Sub-PE triangular cases are likely to be extremely rare, since they will only occur where income attributable to one PE is also properly attributed to another PE (i.e., the sub-PE) which somehow operates as an extension of the first PE. This could occur, for example, where a company resident in one State operates a regional headquarters through a PE in another State (the PE State) and also operates local offices in third States (through PEs) which fall under the responsibility of the regional headquarters (and are thus "sub-PEs"). In many cases a better analysis may be that the "sub-PE" is in fact just a separate PE of the enterprise as a whole and its income should not also be attributable to the PE in the "PE State". That is, there may be a PE in both States but they should each be attributed their appropriate share of the income and there should be no income that is attributable to both PEs. Sub-PE triangular cases should also be distinguished from cases where two source States disagree with respect to the attribution of certain income, and both consider it to be attributable to a local PE under their respective treaties with the residence State; such cases can better be resolved by determining which PE the income is more properly attributable to. Nevertheless, if a sub-PE triangular case does occur the applicable treaties will be:
    - the treaty between the residence State and the sub-PE state (the R-SPE treaty); and
    - the treaty between the residence State and the PE State (the R-PE treaty).
27. According to the *OECD Model Tax Convention on Income and on Capital: Commentary on Article 24* paras. 67-68 (26 July 2014), Models IBFD:

    […] in a related context, when foreign income is included in the profits attributable to a permanent establishment, it is right by virtue noted that the tax authorities have expressly recognized the applicability of a tax credit for taxes paid abroad in respect of Italian PEs of foreign companies, even though article 165 of the ITCA is silent in this respect, based on the combined application of articles 81 and 152 of the ITCA, as well as the non-discrimination principle.[28]

3. Calculation of the Income of the Foreign Branch Subject to the BEX Regime

3.1. General rules

A key aspect of the application of the BEX regime is the correct determination of the income attributable to the foreign PE, which – through a *fictio juris*, since the PE does not have its own legal personality – is autonomous from the income produced by the parent company. In order to achieve this result, the OECD suggests that the "functionally separate entity approach" should be applied, which considers the branch to be "fiscally autonomous" with the result that its business results are subject to the arm's length principle (article 7(2) of the OECD Model). This involves two different steps:

(1) considering the PE as a separate and independent enterprise; and
(2) determining the profits of the hypothesized separate and independent enterprise based on a comparability analysis.[29]

The DD highlights that if there is a tax treaty in force between Italy and the country in which the branch is established, the principles therein will be applied if more specific.[30] In addition, the tax authorities note that "profits and losses of the PE are determined according to the rules laid down for business income by the ITCA and on the basis of the financial statements",[31] in compliance with the rules provided for Italian PEs owned by non-resident companies.[32] Article 152 of the ITCA provides that the income of the Italian branch is determined according to the rules applicable to resident corporate tax subjects, based on financial statements drawn up in line with accounting principles provided for resident taxpayers with similar characteristics.

3.2. Coordination between the BEX regime and specific anti-avoidance provisions

3.2.1. BEX and the CFC regime

If the BEX regime is opted for, the foreign PE of the resident enterprise might still be subject to the provisions of article 167 of the ITCA, namely the legislation on controlled foreign companies (CFCs).

The BEX option cannot be extended to foreign PEs of a taxpayer to the extent that the CFC rules apply to such PEs. In this regard, article 168-ter (3)-(5) of the ITCA provides that if the PE is located in one of the "low-tax" jurisdictions included in the "black list", or if it is located in a "white listed" country with a level of taxation not exceeding half of that applicable in Italy and predominantly receives passive income (article 167(8) of the ITCA), the exemption scheme does not apply and, instead, the tax transparency provided by the CFC rules will prevail. In such situations, the PE's income will be determined according to the provisions of article 167(6) of the ITCA and the Ministerial Decree of 21 November 2001, which, in respect of PEs existing at the time the BEX option was exercised, uses the values recognized for tax purposes before entering into the CFC regime and, for those formed/acquired later, the values determined according to article 2(2) of the Ministerial Decree. In both scenarios, taxes paid abroad are deductible from the Italian tax base (article 165 of the ITCA).[33]

The DD, at paragraph 6.3., points out that ownership of a CFC PE "must be reported by the resident company in the Italian territory in its tax return".[34] Such a duty does not, however, apply if the enterprise has received a favourable tax ruling from the tax authorities regarding the application of the CFC rules: in other words, if all of the conditions of article 167 of the ITCA are met, no exemption will apply; nevertheless, if the taxpayer has received a positive response from the tax authorities or considers that it falls under one of the legal exclusions (*esimenti*) – situations that, therefore, render the CFC regime inapplicable – the branch exemption applies.

When the CFC rules apply to a branch, the BEX option may be exercised only if a legal exception that allows for the non-application of the CFC regime is operative (article 167(5)(a) and (b) of the ITCA and/or article 167 (8-ter) of the ITCA). In fact, in regulating CFCs located in blacklisted countries, the legal exceptions demand instead:

of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B), credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises as to the extension to permanent establishments of the benefit of credit provisions included in tax conventions concluded with third States. Whilst the permanent establishment is not itself a person and is therefore not entitled to the benefits of these tax conventions, this issue is relevant to the taxation on the permanent establishment. This question is examined below in the particular case of dividends and interest.

28. *See* Circular Letter of 5 March 2015, no. 9/E, para. 8.1.
29. *See* OECD, Report on the Attribution of Profits to Permanent Establishments (22 July 2010), International Organizations' Documentation IBFD, in particular p. 14 et seq. In the literature, *see* A. Rust, *"Business" and "Business Profits"*, in *The Meaning of "Enterprise", "Business" and "Business Profits" under Tax Treaties and EU Tax Law* p. 85 et seq. (G. Maisto ed., IBFD 2011), Online Books IBFD, and R. Bernales, *The Authorized OECD Approach: An Overview*, in *Taxation of Business Profits in the 21st Century: Selected Issues under Tax Treaties* p. 135 et seq. (C. Gutiérrez & A. Perdelwitz eds., IBFD 2013), Online Books IBFD.
30. Para. 5.1 DD, *supra* n. 16.
31. Author's translation.
32. Para. 5.1. DD, *supra* n. 16.
33. *See* G. Albano, *La bozza di Provvedimento attuativo del regime di "branch exemption" tra conferme e novità*, 39 Corriere Tributario 13, p. 986 (2016) and G. Formica & G. Galdieri, *Nuove opzioni di internazionalizzazione alla luce della* branch exemption, 40 Il Fisco 11, p. 1059 (2016), who remark that "apart from the existence of legal exceptions under Art. 167, para. 5, letters a) and b), and para. 8-*ter*, the profits of the said CFC branch, instead of being exempt in Italy and taxed only abroad […] are entirely taxed in Italy on a transparency basis at the time of their production and irrespective of their distribution, according to the same rules prescribed for profits of CFC subsidiaries (in the absence of legal exceptions)". [author's translation]
34. Author's translation.

(1) proof that the PE effectively pursues an industrial or commercial activity, as its main activity, in the market of such country; or

(2) that the parent company prove that the effect of such investments is not to locate income in states or territories other than those referred to in the Ministerial Decree issued pursuant to article 168-bis of the ITCA. Otherwise, for whitelisted CFCs producing passive income, the legal exclusion requires the parent to demonstrate that the foreign PE is not a "wholly artificial arrangement" aimed at achieving an undue tax advantage (article 167 (8-ter) of the ITCA).[35]

In any event, should a resident enterprise own more foreign PEs, the existence of one or more CFC branches (without legal exclusions) does not necessarily prevent the application of the BEX regime to other non-CFC foreign PEs. In this instance, the "all in-all out" principle will only apply in respect of the latter and this will lead to diversified taxation: Italian transparent taxation for CFC branches (provided there are no legal exceptions) and foreign taxation for all the others.[36] In this sense, the provision of the Italian legal system is completely different from the legislative choice offered in the United Kingdom, pursuant to which companies with one or more PEs in blacklisted countries cannot apply the BEX regime unless they successfully pass the motive test.[37]

The choice of the lawmaker to give priority to the "anti-abuse" needs expressed by CFC rules appears to be acceptable. In fact, the coexistence of the exemption in the country of residence and non-taxation (or inadequate taxation) in the source country may lead to an undesirable result of double non-taxation. Nevertheless, a strict application of the CFC regime results in a disadvantageous treatment when the option has not been exercised and the PE's income is included in the tax base of the resident enterprise. Although the foreign income is directly imputed to the resident entity, if CFC rules apply, the PE's income is subject to a separate tax treatment (*tassazione separata*) and, therefore, any foreign loss will not be offset against the overall tax base but only against future income of the PE itself. Under the ordinary regime, however, the losses of the blacklisted countries remain part of the tax base of the parent company.

3.2.2. BEX and the transfer pricing regime

The items of income attributable to the PE in respect of transactions with its parent company are to be determined by applying the transfer pricing rules (article 110(7) of the ITCA). The correct calculation of the PE's income is essential in applying the BEX regime: in this respect, paragraph 5.3. of the DD, which reproduces the rule in article 168-ter (10) of the ITCA, points out that income "shall be indicated separately in the tax return of the resident enterprise to whom it refers".[38] Therefore, resident parent companies, through their accounting records, are to provide separate evidence of the results and economic consistencies of each PE. This rule is based on the need for monitoring and control: the tax authorities have an interest in ensuring that the correct portion of overall income of the parent company and of its group is allocated to the foreign business activity, in the event certain transactions do occur between the PE and some companies in the group, as clearly expressed by the reference made to article 110(7) of the ITCA. The same regime also applies to "internal dealings" between a PE and parent company by virtue of a *fictio juris* according to which the PE is treated as a separate entity from the parent company for the purposes of determining the income from intra-group transactions**.**

Finally, paragraph 5.4. of the DD states that the resident enterprise, whether or not it intends to comply with the provisions of article 26 of Law Decree no. 78 of 31 May 2010[39] (with reference to foreign PEs), must fulfil all of the document requirements relating to transfer pricing. It is also clarified that if the Italian resident company is not part of a multinational group, "the documentation requirements are limited only to national documents"[40] and that, for the purpose of preparing these documents, "intra-group transactions" are all those carried out between the Italian parent company and each of its exempt PEs or those carried out between such PEs.

4. Distribution of Income

The Italian tax system, as a general rule, extends the partial exemption applicable to dividends from domestic sources to profits distributed by foreign companies.[41] For profits that stem from companies resident in "low-tax" jurisdictions, however, the partial tax exemption is not granted unless it can be demonstrated that the income of the subsidiary company has been effectively subject to a "fair" level of taxation.[42] By contrast, with regard to the non-

35. In this sense, *see* M. Bargagli, *Il regime (opzionale) di esenzione da tassazione dei redditi prodotti dalla stabile organizzazione*, 7 Bilancio e Reddito d'Impresa 5, p. 44 (2016).
36. According to S. Grilli & M. Busia, *Italy's Branch Exemption: A Competitive Boost for Italian Businesses Abroad*, 81 Tax Notes Intl. 8, p. 690 (2016):

    the branch exemption scheme does not apply to PEs resident or located in article 167(4) blacklisted countries and PEs that qualify as article 167(8-*bis*) blacklisted entities. The income and losses attributable to these PEs is subject to the Italian CFC rules and so is taxed in the hands of the Italian taxpayer. Consider the following example: Company X, an Italian resident company, has four PEs (A, B, C, and D) in four different countries (State A, State B, State C, and State D):
    - State A is not a blacklisted country for Italian tax purposes.
    - State B is an article 167(4) blacklisted country.
    - State C is an article 167(4) blacklisted country, but Company X has demonstrated that PE C carries out a business activity in State C, satisfying the active test.
    - State D is not a blacklisted country for Italian tax purposes, but PE D qualifies as an article 167(8-*bis*) blacklisted entity. Company X has demonstrated that PE D is not an artificial arrangement aimed at achieving undue tax benefits, satisfying the purpose test.

    If Company X opts in to the branch exemption regime, the income and losses sustained by PE A, PE C, and PE D will be exempt from Italian corporate income tax. The income and losses of PE B in State B, blacklisted under article 167(4), will be taxed on an accrual basis under the Italian CFC regime.
37. In this sense, *see* Formica & Galdieri, *supra* n. 33, at 1059-1060 (2016); C. Galassi, *"Branch exemption": un istituto ancora da conoscere*, 5 Fiscalità e Commercio Internazionale 10, p. 15 (2015).
38. Author's translation.
39. IT: Law Decree of 31 May 2010, No. 78, National Legislation IBFD.
40. Author's translation.
41. For intra-corporate dividends, *see* art. 89 ITCA.
42. *See* the legal exception provided by art. 167(5)(b) ITCA.

application of CFC rules under the legal exception provided by article 167(5)(b) of the ITCA, foreign dividends will be fully taxed in Italy once recognized by the resident company. Therefore, if the income is realized by enterprises in "low-tax" jurisdictions and not subject to a "fair" level of taxation, it will be taxed "for transparency" purposes in Italy in the name of the controlling company at the time of realization of such income (article 167 of the ITCA) or at the time the dividends are effectively received from blacklisted countries (article 89(3) and article 47(4) of the ITCA). In both instances, the tax credit for taxes paid abroad will be recognized.[43]

The DD, after emphasizing that profits and losses from exempt PEs do not contribute to the determination of the resident company's tax base, regulates the subsequent allocation of profits by the resident enterprise to its members.[44] Paragraph 7.2. states that if the resident enterprise distributes to its shareholders the profits of exempt foreign PEs (in respect of which taxation based on transparency under the CFC rules does not apply), these profits will be included in the taxable income of the shareholder in accordance with the provisions of articles 47(4), 59 and 89(3) of the ITCA, subject to recognition of the relevant tax credit:

(1) in the event the first CFC legal exclusion pursuant to article 167(5)(a) of the ITCA applies (i.e. proof of effective presence in the local market), tax on the PE's profits will be fully paid by/charged in the hands of the shareholders, subject to recognition of the relevant "indirect" tax credit;
(2) instead, if the second CFC legal exception pursuant to article 167(5)(a) of the ITCA applies (i.e. reasonable level of taxation), the distributed profits will be partially taxed in Italy (i.e. on 49.72% or 5% of the dividend paid, depending on the nature of the shareholder: i.e. whether or not the shareholder is subject to corporate tax).

The tax authorities also trace the profits that lead to the dividend distribution: an Italian parent company that distributes profits deriving from PEs based in blacklisted countries to its shareholders:[45]

> […] must communicate to its shareholders the portion distributed from the abovementioned States or territories, together with the relevant tax credit, if applicable. If such details are not provided, profits deriving from exempt PEs established in blacklisted countries are considered distributed to shareholders.

5. The Recapture Mechanism Regarding Foreign Losses

Article 168-ter of the ITCA also provides for a "transitional regime" in part to protect the domestic tax base, pursuant to which past tax losses can be recaptured. The purpose of this provision is to equate the situation of a company that, at the time of the constitution of its PE, opts – for the first time – for the BEX regime with that of a company that already has PEs and decides to switch from the tax credit to the exemption method: in the latter instance, in fact, the parent company would be in an advantageous situation, since in previous tax years (thanks to importing tax relevant losses that may be deducted from the parent company's taxable income), it paid less taxes. In order to "neutralize" these effects and restore a situation of equal treatment, both the primary rule (i.e. article 168-ter of the ITCA) and the tax authorities (i.e. in paragraph 3 of the DD) provide that the parent company, at the time the option is exercised, must recalculate the PE's income results in each of the last five tax years: if a net fiscal loss arises from this calculation, any profits subsequently produced by the same PE cannot benefit from the exemption up to the amount of such a loss.[46] Confindustria (2016), in its study, points out that it is necessary to clarify that the tax credit also applies in relation to income taxed pursuant to the recapture mechanism, in accordance with what happens in the five-year period before the BEX option is exercised, during which period the credit may apply without limitation.[47] All tax losses of the PE during the validity of the BEX option are not recognized.[48]

The necessary condition to apply the recapture is that the enterprise must have used the PE's losses to reduce its taxable income or transferred them to the consolidated tax group to which it belongs.

If both the parent company and the PE have incurred previous losses, those of the latter are considered to have been proportionally used and will, therefore, be "neutralized". With particular regard to this aspect, Confindustria notes that it would be more appropriate to introduce "a presumption of priority use of domestic losses, since this would simplify the application of the recapture and would be more consistent with the method for calculating the tax credit as provided in the consolidation regime under article 136, para. 3, ITCA".[49]

If the resident enterprise has more PEs, the recapture mechanism may be applied cumulatively in respect of all of them. Notwithstanding the fact that paragraph 3.5 of the DD states that the recapture is to be calculated "for each State or foreign territory", this is relevant only in calculating the tax credit according to article 165(6) of the ITCA. In fact, what is relevant for the reabsorption of tax losses is the total amount of the recapture, which is to be

43. *See* S.M. Galardo, *La "branch exemption" nell'ambito del metodo dell'esenzione*, 39 Corriere Tributario 15, pp. 1166-1167 (2016).
44. Para. 7.1 DD, *supra* n. 16. Since the PE and the parent company form the same legal entity, there cannot be a *stricto sensu* distribution of profits and, therefore, the only possible distribution is the one from the company to its shareholders. In the literature, *see* F. Di Cesare, *Il nuovo regime di branch exemption*, 3 La Gestione Straordinaria delle Imprese 6, p. 126 (2015).
45. Author's translation.
46. For example, Company Alpha wants to exercise, in tax year 2016, the BEX option in respect of its branch Beta. In recalculating Beta's profit results in the five-year period 2011-2015, Alpha finds out that the latter suffered losses of EUR 100,000 in 2011, EUR 45,000 in 2012, EUR 20,000 in 2013 and EUR 25,000 in 2014, while in 2015 it earned a profit of EUR 55,000. Therefore, the total net loss over the five-year period is EUR 135,000: until the entire amount is reabsorbed, all taxes on profits made by Beta from the 2016 tax year will continue to be paid by Alpha.
47. *Supra* n. 22.
48. *See*, for example, Albano, *supra* n. 33, at 987; Galassi, *supra* n. 37, at 19; T. Gasparri, *Il nuovo regime di branch exemptionì per le stabili organizzazioni all'estero*, 39 Il Fisco 25, pp. 2054-2055 (2015); Bargagli, *supra* n. 35, at 43.
49. Author's translation.

proportionally imputed to each PE that has contributed to the losses incurred.

According to article 168(10) of the ITCA, the company is required, in the tax return for the tax year in which it exercises the option, to indicate the profits and losses of each PE owned separately. In this respect, Confindustria believes that the overall recapture should be absorbed through various means, alternatively chosen by the resident company: in other words, a mechanism similar to that of the United Kingdom, where the enterprise may choose to distribute to certain PEs the amount to be reabsorbed (for example, to those that have room for the recovery of the excess foreign taxes).

6. Final Remarks

From the analysis of the newly introduced BEX regime undertaken herein it appears that – despite the declared intentions of the lawmaker – this is not a tax relief provision in a technical sense, but an optional tax regime aimed at eliminating double taxation through the use of a method that provides an alternative to the method traditionally available under the Italian regime (i.e. the tax credit method). In other words, such an optional tax regime may – depending on the case – result in a tax advantage for the applicant company.

The possibility to apply the exemption method to foreign branches undoubtedly represents a novelty in the Italian tax system and has the clear advantage of eliminating the previous "asymmetry" (*rectius* discrimination) between a tax exemption for income earned by foreign subsidiaries and taxation of such income earned by foreign branches.

Nevertheless, the choice made by the lawmaker, which is too prudent, puts the newly introduced tax exemption mechanism a notch below the "old-fashioned" tax credit, which remains the ordinary mechanism automatically applicable in the absence of an election by the taxpayer. The lawmakers' failure to fully equalize the two relief methods through Legislative Decree No. 147/2015 can perhaps be explained by the fact that the exemption method, although much simpler to manage than a tax credit, in principle might expose the country of residence (i.e. Italy) to excessive revenue losses.[50]

This has, therefore, led to the adoption of an exemption "imbued" with various limitations and protective measures, the most striking of which are its irrevocability and totality, in light of the application of the "all in-all out" principle. In this respect, it is quite surprising that the objective scope of application of the Italian BEX regime is not limited to corporations (which is so under the UK regime). Instead, it extends to all subjects having business income according to article 55 of the ITCA, including partnerships and individual entrepreneurs.

The rigidity that characterizes the BEX regime risks, however, undermining the attractiveness of the regime to potential applicant taxpayers, who may be discouraged from exercising the option due to its irrevocable nature, which implies that taxpayers will need to undertake a complex preliminary analysis in determining whether or not opting for the BEX regime will be worthwhile.[51]

50. This risk was clearly highlighted by Miller & Oats, *supra* n. 13, at 115.
51. *See* A. Silvestri, *Branch exemption senza ritorno*, Il Sole 24 Ore, p. 49 (23 June 2015).