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FEATURED PERSPECTIVES

Boston Scientific: Italian Supreme Court Rules on Permanent Establishments

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On March 9, 2012, the Italian Supreme Court issued a landmark decision in *Boston Scientific*,[1] one of the first Italian cases in which the Italian Revenue Agency had argued for an Italian commissionaire subsidiary to be recharacterized as a permanent establishment of its foreign principal.

The Supreme Court ruling follows the trend in the jurisprudence already developed in other European countries, such as *Zimmer*[2] in France and *Dell*[3] in Norway.

Facts

An Italian subsidiary of the Boston Scientific group was distributing products under a commissionaire agreement on behalf of its Dutch sister company. The Italian tax police audited the Italian company in 2005 and argued that it was a PE of the Dutch company. Based on the tax police audit report, the Italian Revenue issued tax assessments against the Dutch company by claiming it had a PE in Italy.

The taxpayer successfully challenged the assessment before the first instance tax court. The appeal by the Revenue was rejected. The Supreme Court confirmed the two prior rulings.

Comments

The *Boston Scientific* case is a very significant development and may be seen as best practice from several standpoints:

- all three judgments (from the court of first instance, the appeals court, and the Supreme Court) are very accurate and detailed;
- all the courts have deeply analyzed and assessed facts and circumstances by issuing clear rulings, although it should be taken into account that Supreme Court judgments are only on matters of law (facts and circumstances may only be analyzed by the Supreme Court and only to assess whether the court of appeal had failed to thoroughly judge on those facts and circumstances); and
- the characterization of a commissionaire subsidiary as an independent agent that should not be deemed a PE is convincingly outlined.

The Supreme Court rejected all the three motives of appeal by the Italian Revenue Agency, which are often raised against Italian subsidiaries acting for foreign group companies either as commissionaires or under comparable forms of limited risk activities, both on the distribution and the manufacturing businesses.

'Dependence'

The first argument raised by the Italian Revenue Agency against Boston Scientific concerned the alleged dependence of the Italian subsidiary on its Dutch sister company. In particular, the dependence argument was based on the following considerations:

- 99 percent ownership;

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[1]Corte di Cassazione, Mar. 9, 2012 (hearing of Feb. 29, 2012), Tax Chamber, Section V, Case No. 3769. For an unofficial translation of the decision, see *Doc 2012-7737* or *2012 WTD 72-18*.

[2]Supreme Administrative Court of France, Mar. 31, 2010, Case No. 304715.

[3]Supreme Court of Norway, Dec. 2, 2011, Case No. 2011/755.

- single principal;
- binding and specific business guidelines; and
- direction and control of local management.

The dependence argument was rejected on the ground that the Italian subsidiary was subject to economic risks in carrying out its activity by having its own sales force and fixed costs that could have affected its annual results on the basis of the volumes of sales and related sales commissions.

'In The Name Of'

The second avenue of appeal by the Italian Revenue Agency related to the meaning of the ''in the name of'' concept under paragraph 5(5) of the OECD model tax convention. Tax authorities have argued that the concept should be interpreted substantially by ascertaining whether the contracts concluded by the commissionaire were binding on the foreign enterprise regardless of whether executed in the name of the latter or in its own name by the local intermediary.

The Supreme Court rejected the second argument by highlighting that the court of appeal had analyzed the related facts and circumstances by concluding that the Italian commissionaire had acted in its own interest by selling products under its own name.

'Outside of Ordinary Course of Business'

The third argument by the Italian Revenue Agency was based on the claim that the Italian commissionaire had been acting beyond the ordinary course of business of such an intermediary in the products distribution. In particular, it was argued that the Italian commissionaire had also entered into product loans, strategic marketing, insurance, and receivables factoring transactions.

Even this argument was rejected on the ground that those circumstances had been identified as symptoms of independence of the Italian commissionaire by the courts of first and second instances.

The Ruling

Based on the above and by stating that the Italian Revenue Agency had failed to submit evidence of its reasonings, the Supreme Court dismissed its appeal by treating it as inadmissible. Facts and circumstances had in fact been ascertained thoroughly by the first instance and the court of appeal and, therefore, the Supreme Court concluded that the appeal had no ground to be further analyzed as a matter of law.

As the Supreme Court did not admit the Italian Revenue Agency appeal, the motives in the court of appeal ruling are of interest regarding the court assessment on the independence status of a commissionaire not to be deemed a PE. As the court of appeal stated in its conclusions, the Italian commissionaire:

> bears the entrepreneurial risks connected to the sale of Boston products independently; it has its own business organization and it supports the related costs alone, thanks to the profits of its activity. . . .
>
> Boston Scientific SpA may not be considered a mere permanent establishment of Boston BV but rather an independent entrepreneurial entity whose operating results will vary depending on the outcome of the business activities.
>
> In the light of the above considerations, this Tax Court believes that the Italian company is an independent entity and that the Tax Authorities' claim is consequently ungrounded even if the reasonings through which the Office has reached the decision of taxing the income (that has been calculated in a rather bizarre fashion solely on the basis of revenue without assuming the existence of any cost incurred) allegedly obtained in Italy by the Dutch company may prima facie seem evocative and reasonable in part.[4]

Italian tax inspectors have increasingly been challenging commissionaire agreements and similar limited-risk distribution arrangements from various standpoints, ranging from ordinary transfer pricing adjustments to exit taxation when a conversion from full-fledged to limited risk contracts is implemented, up to the recharacterization of Italian subsidiaries acting under such contracts as PEs, particularly when the foreign principal is located in a low-tax jurisdiction rather than in an EU country.[5]

Raising PE claims against local subsidiaries acting under commissionaire and similar arrangements puts pressure on foreign multinationals to reach settlements to avoid the uncertainty of court cases that may last more than a decade (the *Boston Scientific* case refers to fiscal year 1997) and may also cause criminal proceedings because, if a PE claim is made, the foreign entity is challenging the lack of filing an income tax return, which is per se deemed as a criminal offense.

Foreign multinationals may not be able to afford 10 or 15 years of uncertainty on their local tax position.

Challenging PE claims against multinationals acting in a given country through one or more subsidiaries is much ado about nothing when groups have arranged their affairs by relying on the use of distribution arrangements (such as the commissionaire contracts that

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[4]Commissione tributaria regionale of Milan, Chamber 34, Dec. 2, 2009 (hearing of June 10, 2009), Case No. 139.

[5]Indeed, even more draconian challenges are being made if local distributors act on behalf of blacklisted foreign entities by disallowing the whole purchase price of goods sold in the market by alleging either that no evidence of the active business of the foreign supplier has been given or that the local entity had not demonstrated its own specific interest to buy products from the former.

have widely been used for centuries domestically between independent parties). It is ironic that cross-border transactions that are common practice domestically are not respected as such.[6]

I hope that the *Boston Scientific* precedent will lead the Italian tax authorities to reconsider the best approaches to auditing cross-border transactions within multinationals by limiting the use of PE claims to very specific cases when no other challenge is possible — whenever transfer pricing rules may not be enforced. In the end, the technical analysis about commissionaire arrangements should not be affected if the principal is located in a high-tax or a low-tax jurisdiction and being dependent on actual functions, risks, and assets employed, although this may have an impact on the tax courts' decision-making process.

In the last decade, Italian case law has been important internationally for cases such as *Philip Morris*,[7] which was a landmark decision in Italy because of the size of the case and the controversial nature of some of the Supreme Court statements about it, in particular for the concept of multiple PEs (that is, that multiple companies could establish a PE through an Italian subsidiary). The OECD had to amend its commentaries on article 5 of the OECD model to address the uncertainty generated by the Italian jurisprudence.

The Italian Supreme Court's ruling a decade later in *Boston Scientific* is very welcome and will hopefully reestablish trust in the Italian tax policy regarding foreign investments.

The Italian government approved a draft bill to reform the Italian tax system on April 16, 2012, which includes as an objective the revision of current rules on cross-border taxation, including the definition of PE in view of reducing uncertainties on the taxable income basis and favoring the internationalization of businesses by persons acting in the Italian market.[8] It would be very welcome if the tax reform provides certainty about the use of commissionaire agreements and other similar arrangements based on a limited-risk business model.

Hopefully the time is ripe for a more in-depth legislative definition of the arrangements that may lead to a dependent agency claim, as narrow and specific as possible. Standard and common contractual arrangements should be respected, let alone specific cases of abuse of form over substance.

The tax reform package also includes a revision of the Italian ruling system, which now includes several procedures and different kinds of requests but does not allow filing requests of clearance on PE matters.[9] While material PE claims are pure matters of facts, agency PE claims such as the ones often raised on commissionaires and other limited-risk arrangements are very often matters of recharacterization of contracts and business models as shown in *Boston Scientific*. As a result, I hope that business restructurings and any service business models will be admitted for advanced ruling, let alone the rights of tax authorities to challenge any facts and circumstances inconsistent with the ones submitted for ruling clearance.[10]

We will see if the Italian government will be taking a clear position in the tax reform on topics such as the one raised in *Boston Scientific* by confirming that an ordinary commissionaire agreement does not give rise to a deemed agency PE even if it acts only for one foreign principal and only within the group. ◆

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[6]For my letter regarding the October 12, 2011, OECD draft on the interpretation and application of article 5 of the OECD model, see *Doc 2012-4232* or *2012 WTD 41-31*.

[7]Corte di Cassazione, Mar. 7, May 25, and July 25, 2002, Case nos. 3367, 3368, 7682, and 10925.

[8]Article 13(1)(b), Act No. 5291 currently under review by the Italian Chamber of Deputies. Act 5291 will need approval by both chambers of the parliament before the government will be able to release the regulations implementing the reform package. As Italy will have parliamentary elections at the latest by mid-2013, there are increasing uncertainties as to whether the reform package will eventually be approved before next election, although the government may decide to accelerate parts of the reform package through specific measures by means of other legislative measures implemented through law-decrees.

[9]Article 7(3), Act 5291.

[10]As those arrangements and business restructurings do qualify for advance pricing agreements from a transfer pricing standpoint in Italy, where indeed the analysis of functions, risks, and assets is a matter of fact, the current practice of not admitting matters of PE for advance ruling clearance appears illogical and will hopefully be revisited to provide foreign groups with an enhanced level of certainty in the current environment.

(Footnote continued in next column.)