

Tax Authorities Issue Ruling on Permanent Establishment

by Marco Rossi

Reprinted from *Tax Notes Int'l*, June 4, 2007, p. 1006

Tax Authorities Issue Ruling on Permanent Establishment

by *Marco Rossi*

Italy's tax administration, in Resolution 119 of May 28, has ruled that, under some circumstances, a foreign company's Internet server located in Italy constitutes a permanent establishment of the foreign company in Italy and that the foreign enterprise is taxable in Italy on a net income basis on the profits attributable to the business activity carried out through that server.

In the case at issue, a French company offers online video game services to Italian customers. The customer must subscribe to the service, open an account, and install a player, which is licensed free of charge with no right to copy, modify, or commercially use the games. At that point, the customer can download or use the games offered on the company's online list.

To facilitate the online connection and reduce connection costs, the French company installed two servers with an Italian Internet service provider (ISP). The French company owns the servers, and their configuration and operation, as well as the installation of the software applications and the delivery of the games to the customers, are carried out directly from France. Apparently, the French company has no personnel in Italy involved in the operation of the server.

The video games are offered partly directly through the servers and partly through the Italian service provider, and are divided into two categories: "Games on Demand," for which the customer pays a fee to obtain access to the games for a limited period, and "Buy and Download," in which the customer downloads the video games and uses them for an unlimited period.

The French company bills the customers directly for the games offered directly through its own servers. For the games offered through the Italian ISP, the French company issues an invoice to the Italian

provider for an amount equal to the royalty paid by the customer, less a fee payable to the service provider for its services.

The issue discussed in the ruling is whether the French company's servers constitute a PE of the company in Italy under Italian domestic tax law and the provisions of the France-Italy income tax treaty and whether the profits attributable to the games sold through the servers are subject to tax in Italy.

Italian tax law (specifically Tax Code article 162, paragraphs 1-9) provides its own definition of permanent establishment, which is modeled almost entirely on the definition in article 5 of the OECD model income tax treaty.

Under the general definition (article 162, paragraph 1), a PE is an office or another fixed place of business through which the business of an enterprise is wholly or partly conducted.

Under specific exclusionary rules (article 162, paragraph 4), a place of business is not a PE if it is used only for purchasing, displaying, storing, delivering or transforming goods; collecting information; or carrying out ancillary or preparatory activities.

One specific provision (article 162, paragraph 5) states that the use of electronic equipment or any other ancillary automated equipment that enables the collection and transmission of data and information for the sale of goods or services does not constitute, in itself, a PE.

The tax administration observed that a server, which is a tangible, physical property, can constitute a PE under specific circumstances, namely when:

- it is permanently available to the foreign enterprise (whether owned, leased, or otherwise);
- it is located in the same place for a significant period; and

- it is actually and directly used to carry out the foreign enterprise's trade or business.

According to the tax administration, when (as in the case at hand) the server is used to conduct electronic commerce aimed at the sale of goods and services downloadable directly from the company's Web site, and all the stages of the business, including the transfer of the product and the payment, are carried out electronically, the server is an integral and essential part of the business and constitutes a PE.

The tax administration cited the commentary to the OECD model income tax treaty (specifically treaty article 5, paragraph 42) as additional support for its conclusion. First, the commentary points out that a server is a piece of equipment with a physical location and that the location may therefore constitute a fixed place of business of the enterprise that operates that server. That is not the case for a Web site, which is a mere combination of software and electronic data and can never constitute a PE.

Consequently, a Web site hosted on the server of an independent ISP generally does not constitute a PE, whereas the location of a server available to and

operated by the enterprise, on which the Web site is stored and used, can constitute a PE if the other requirements are met.

The commentary then clarifies that a server at a particular location may constitute a PE if it is "fixed," meaning that it is located at a particular place for a sufficient period.

Finally, according to the commentary, to obtain PE status, the business of the enterprises must be carried out through the server, so that it can be said that because of the use of such equipment, the enterprise has facilities at its disposal where business functions are performed.

Most importantly, the commentary clarifies that the presence of the foreign enterprise's personnel at the location where the server is placed is not required.

The conclusion reached by the Italian tax administration in its May 28 ruling, and the argument offered in support of that conclusion, appear to be in line with the explanation provided in the OECD commentary and consistent with the position taken on the same issue at the OECD level. ♦

♦ *Marco Rossi, Marco Q. Rossi & Associati,
Genoa and New York*