

## *Philip Morris Case (2002)*

### **The concept of 'Permanent Establishment of a Group of Companies' in a recent case of the Italian Supreme Court (Corte di Cassazione)**

*Unofficial translation by Dr. Marco Greggi (MG). I'm grateful to Mr. Luca Dario (LD) for his outstanding support and fundamental collaboration.*

#### ABSTRACT

A company resident in Italy can be considered as permanent establishment of various foreign companies belonging to the same group and pursuing a unitary business strategy. In this case, the activity carried on by the national company must be unitary and related to the group's programme altogether considered in order to be qualified as auxiliary or preparatory to the latter.

The control activity on the exact execution of a contract between a resident and a non-resident company (the first being a third party company and the second a company belonging to the group) cannot be considered — in principle — auxiliary according to the article number 5, paragraph number 4, of the OECD Model.

The existence of a permanent establishment must be tested not only according to a formal approach, but also — and above all — by a substantial one: the second one must prevail even when the possibility to enter into contracts (autonomously or not) is considered as well.

Supreme Court, Tax Division, judgement n. 7682, December 20th 2001 — delivered on May 25th 2002.

*(Omissis).*

#### **3.1. The facts of the case**

From the reading of the reassessment by the Tax Office and of the papers delivered by the parties during the Appeal judgment [actually, second degree judgement in the Italian Tax process law, MG] is evident that the sentence of the Court of Appeal [according to Italian Tax law, the first degree judge deciding tax cases is the 'Commissione tributaria provinciale', Provincial tax tribunal, while the second degree tax judge is the 'Commissione tributaria regionale', Regional tax tribunal, being the Supreme Court the third, and last, degree judge. In the following translation I preferred to qualify the second degree judge 'Regional tax tribunal' as 'Court of Appeal' as far as it operates as such even if, in Italian law, the Court of

Appeal 'Corte di Appello' deals with Civil and Criminal cases only, MG] is lacking under several aspects being partially deprived of any motivation and partially founded on improperly interpreted rules (both national and derived from the Double taxation convention between Italy and Germany which is applicable to the circumstances of the case).

It is clear, first of all, that Intertaba s.p.a. [Intertaba s.p.a. is the company resident in Italy which belongs to the Philip Morris group and was considered to act also as a permanent establishment, P.E., of the whole group by the Tax Office, MG] has acted as a permanent establishment of the different companies of the Philip Morris group, in the framework of a unitary programme, thus not only on behalf of the Philip Morris G.m.b.H.

In this respect, it doesn't matter whether the assessment by the Tax Office has involved only Philip Morris G.m.b.H., and not to the other companies of the group.

Even though a group of companies can not be considered — according to the "State of the Art" of the Italian commercial law — as an independent legal entity which differs from the companies forming it, and even if this is also true in Tax law, however, it could happen that one or more companies belonging to the group could carry on a business activity ('management', in English in the original text, LD) operating a structure in the State of the source [Italy, in the case, MG] that could be considered as an integral part of a larger programme, making reference to the group. Therefore as far as the structure in the source State operates in favor of several foreign companies, these ones must be considered altogether for the tax purposes of this specific case. In this respect, it is not correct to test the existence of a permanent establishment in Italy for each one of them, being correct to consider them together and assess the existence of a P.E. for all of them. More to the point, to a certain extent, if there's evidence that the above mentioned structure operated as a P.E. for a foreign company, then this situation could be considered as an indication of the fact that the same structure operated as a P.E. for another company of the same group as well.

The OECD Model convention Commentary provides clearly (sub art. 5, § 4 - 24) that a national structure may assume the role of management office for a group with (inter)national ramifications.

Consequently, as a matter of fact, the evidence that demonstrates the qualified relationship between Philip Morris G.m.b.H. and Intertaba s.p.a. (the latter acting as a permanent establishment of the former) can be used also to demonstrate that

the Italian company was also as a permanent establishment of the other companies of the group while pursuing the same shared goals.

It is well known that the subsidiarity of a company to another (being Intertaba s.p.a. controlled by another one of the Group), is not enough to qualify the former as a P.E. of another, non resident, one. The mere existence of a company control is not, in fact, enough, in accordance with art. 5, § 7, of the OECD Model, which is exactly and correctly mentioned in the appealed sentence, to qualify the controlled company as a P.E. of the controlling one.

The fact that the OECD Model had expressly inserted the so-called anti-single entity clause or *Antiorganschaftsklausel*, unlike previous Double taxation conventions (see art. 11, § 1, of the DTC between Italy and France, dated 6th December 1965, ratified and made executive with the Act n. 766 passed on august 9th) must not, however, make the interpreter to underestimate that the phenomenon of hidden permanent establishments finds a most favourable environment in the multinational groups of companies. Here the unitary strategy of the group may adopt and implement ways of exploitation of the controlled companies in such a penetrating way as to transform them, although still independent legal bodies, in simple management structures of other companies.

**3.2** After these preliminary remarks, this Court considers necessary some clarifications on the notion of permanent establishment in direct taxation, in order to verify the correctness of the Court of Appeal reasoning, according to art. 384, § 2 of the Italian Civil Procedure Code [that is, a rule allowing the Supreme Court to amend the decision of a lower court regarding the interpretation of the law, LD].

It is well known that Italian Tax law now has a definition of permanent establishment [that was implemented in 2004, LD]. However in this specific case both the parties made reference to the OECD Model Convention on double taxation and to the Commentary to the Model: this point is not susceptible of re-examination by the Court. This is, therefore, the legal basis to be taken into account during the control that the Supreme Court has to exercise on the second degree one, as well as on the adequacy and logical coherence of the Court of Appeal reasoning. If further clarifications and explications are required, just like in this case, the Supreme Court can do this exercising its duty to safeguard the homogeneous interpretation of legal concepts across the Country [in Italy we define this activity as 'nomofilachia', nomophilaptic activity. It is taken from two words of Greek origin 'Nomos' (rule) and 'Philos' (passion, care, study): that is, care for the rule or, in other words, care for the correct interpretation of the rules. This activity

is of fundamental importance as far as it prevents Courts of Appeal to implement different definitions of same concepts across the Country, LD].

Regarding the notion of permanent establishment in direct taxation, it is first of all necessary understand that the cases mentioned in art. 5, OECD Model Convention (inspiring the conventions with Germany and with the USA, for example) clearly demonstrates that the notion is certainly less restrictive than that the one applicable for VAT purposes.

The different purpose of both the provisions is helpful in understanding the reasons of the distinction: the conventional rules are aimed at reciprocally reduce the direct taxing power of both Contracting States (in this respect there's no specific EU competence, according to art. 293- formerly art. 220-, § 2 of the Treaty). Uniform European rules are however applicable for VAT purposes, and are basically enshrined in the 6th EU Council directive 77/388/EEC, dated May 17th 1977 (now in 2006/112/EC Directive) and further amendments. These rules are — as the European Court of Justice repeatedly affirmed — unconditioned and sufficiently precise, and therefore 'self executing' in the national law systems. Article 9, n. 1 of the 6th Directive doesn't make reference to the concept of permanent establishment, but rather to 'fixed establishment' which requires, in the opinion of the ECJ (see, besides, the sentence 17th of July 1997, case C-190/95, *Arolease BV vs Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam*) the employment of human and material resources, not being sufficient the presence of equipments (like vending machines) in the territory where the transaction is concluded.

According to the specific circumstances of this case, we can refer to § 12 of the German general revenue law (*Abgabeordnung* 16th of March 1976), which 1st subparagraph contains the following general definition of permanent establishment (*Betriebstätte*) «... jede feste Geschäftseinrichtung oder Anlage, die der Tätigkeit eines Unternehmens dient ...» (every stable installation of business or factory that serves to the activities of a company). The definition, that refers to the concept of the so-called 'material permanent establishment', originating from the legal system of the Country where Philip Morris G.m.b.h. has its headquarters, may provide a useful model to the implementation of the same concept in our legal system. This effect is possible mainly because, even though concerning a discipline regulated by International conventions, the interpretation must always be consistent — according to the opinion of the ECJ — with the general principles and fundamental freedoms provided for in the European Community Treaty (particularly, the prohibition of discrimination and the right of establishment), above all when — like

in this case — the exercise of taxing power concerns companies having their headquarters in a Country Member of the EU.

It has to be excluded, besides, that the notion of permanent establishment should be identified with that of an autonomous production unit or company service unit, not being such notion — clearly more restrictive than that conventional one — based on any clear textual or systematic reference.

The case-law of this Supreme Court, in fact, has excluded many times (cases November 27th 1987, n. 8815 and 8820; September 19th 1990, n. 5580) that the organizational structure 'de qua' should be capable of producing income, or qualified by a management or accounting autonomy, conditions that must be met, however, by the secondary branches, as provided by art. 2506 Civil code, as far as they can be considered only a typical 'species' [only a kind, LD] of permanent establishment.

**3.3** The Court considers that in the appealed sentence it has been exactly reconstructed — at least approximately — the notion of permanent establishment contained in the Conventional provisions. Nevertheless the Court considers that it has not been made a correct application of this concept, and the decision is based on assessments and evaluations in relation to which an adequate justification is not provided.

After these considerations, it has to be verified whether the reasoning of the Court of Appeal is correct or not. It has to be considered, in other words, the different profiles raised in the appeal and the remarks formulated in the reassessment - excluding the non contested points of the sentence - such as the permanent nature of the establishment and its continuous activities that interest directly other companies of the Philip Morris group, including Philip Morris G.m.b.H., in the strategy sphere of the same group.

**3.4** Concerning the remarks pointed out in the reassessment, it is evident that the reasoning of the Tax Office is not entirely consistent. In fact, in relation with the elements that would demonstrate the existence in Italy of a permanent establishment of Philip Morris G.m.b.H and of others companies of the multinational group 'Philip Morris' the Tax office didn't provide an adequate motivation, so this Court is not able to exercise the control provided for art. 360, n. 5, Italian civil procedure code, on the decision by the Court of Appeal.

Besides, the reassessment has not been developed in a unitary form, and the different points of the decision contain mistakes concerning mentioned rules or legal principles applicable.

The Tax office has exactly pointed out that the appealed sentence has been limited to abstract enunciations, without elaborating the specific concept [of permanent establishment, MG] and without verifying the relevance of the different elements discovered.

A foreword is necessary: according to the Commentary to the OECD Model (sub art. 5, § 4-24) if a company has delegated to a local branch of it a management activity, although relatively to a limited area of operations of the group, the local branch becomes a place of management, according to the § 2, (a) of the Model Convention.

The existence of a hidden P.E. in the case depends therefore on the activity developed by the local brach of the non resident company. If this activity fall outside the scope of the brach main business (ordinary business) then a P.E. is considered to be existent, although not formally constituted. Concerning the circumstances of the case, the revealing elements of the existence of a permanent establishment should have been considered globally and in their reciprocal connection.

Aiming at an exact reconstruction of the figure of permanent establishment according to the conventional discipline, it is relevant moreover to analyse the art.9 of the OECD Model:

1. Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued,

may be included in the profits of that enterprise and taxed accordingly.

The analysis has to begin from the assessment by the Appeal Court which confirmed that the Italian branch of the foreign group actually ceased to operate in favor of the non-resident company and 'self restrained' to develop its own core business only. It was evident from the reading of the document delivered by the Tax office that the group of companies was aware that the Italian branch was operating in such a broader way as to qualify as a P.E. of the non resident company. The defendant of the case confirmed that this risk was tackled and the Italian branch implemented business ways and means consistent with its activity only. The Court of Appeal shared this view, but it is not clear the nature of these ways and means, nor it is possible to ascertain whether they have been effectively implemented or not.

On the contrary, it seems to emerge from the document delivered during the first two degrees of the judgement that the taxpayer tried to conceal the P.E. in Italy rather than to cut the business connection between the Italian branch and the non-resident companies. In other words, he tried to disguise the fact that the Italian company (i.e. branch of the non-resident ones) was also acting in the exclusive interest of the latter.

In order to properly qualify the activity carried on by Intertaba s.r.l. in the interest of the non resident companies it is fundamental to pinpoint the principles inspiring the OECD Model Convention.

The requirement to qualify a national structure or branch as non dependent (that is to say: to not to consider it as a P.E. of a non-resident company) is the economic and legal independence. When it acts in the interest of another company, it must do it consistently with its own core business or in other words in the 'ordinary course of his business' [in English in the text, MG] (point 37). According to the Commentary (point 38), there is an important criterion that characterizes the dependent structures: the refusal of the entrepreneurial risk for the activities exercised in the interest of the company.

Moreover, It should be pointed out that the Commentary while assessing the existence or not of a P.E. gives decisive importance to the substance of the phenomena, and not to the formal legal aspect.

**3.5** Bearing in mind these preliminary remarks, the Court doesn't share the Court of Appeal view where it considers the control activity of the correct execution

of the contracts by the A.A.M.S. [‘Azienda Autonoma dei Monopoli di Stato’, is the State owned and managed legal body operating the Monopolies, particularly the tobacco one, MG], that was exercised by Intertaba s.p.a., as merely auxiliary, so that it could not assume the role of permanent establishment of the foreign company.

For what concerns the motivation, it is important to observe that the sentence does not provide a clear description of the nature of such activity and of the content of the contractual clauses that regulated it.

Art. 5., § 4 OECD Model introduces a list of activities that that don’t give rise to a permanent establishment: amongst these, the preparatory and auxiliary activities in general. In the light of § 23 of the Commentary, the presence of this general clause doesn’t need an exhaustive list of such activities.

According to the Commentary, moreover, such activities do not give rise to a permanent establishment, even if exercised by a ‘fixed place of business’ [in English in the text, MG] because even if they contribute to the productivity of the enterprise they are so far away from the profit making activity that a link between these and the establishment is not possible. Examples of activities, which would generally be regarded as preparatory or auxiliary, include (sub art. 5, § 4 points 21 - 24): activity of advice, information gathering, scientific research aimed at patenting technologies or entering into contracts for the exploitation of a specific know-hows. From this category are excluded the functions that are ‘an essential and significant part of the business activity of the enterprise as a whole’. More in general, the Commentary provides for the case (sub art. 5, § 4, points 21 - 24) where a company with international ramifications attributes to a branch powers of control or in other words ‘supervisory and co-ordinating functions for all the departments of the enterprise located within the region concerned’ [in English in the text, MG], then in this the case, according to the Commentary, this structure can not be considered as an agent with an independent status. It has to be considered as an ‘office’, according to art. n. 5, § 2, lett. e) of the OECD Model, because it constitutes an essential part of the economic operations of the company.

After these necessary remarks, the qualification as merely auxiliary of the control activity on the correct execution of the contracts by A.A.M.S., attributed to Intertaba s.p.a., doesn’t seem, first of all, sustained by an adequate motivation. The Court of Appeal considered only formal elements to come to this conclusion, just like the absence of a material branch [‘material’ is added by the translator: in the Italian text probably the word is used in some cases in a broad sense, considering both material and personal P.E. while in others in a more restrictive sense,

encompassing only the first meaning, MG]. It doesn't take into account that the Commentary and the *communis opinio* (both doctrine and the international praxis) stress the substantial aspect of the phenomenon.

**3.7** Coming to the examination of the individual activities that according to the Tax office reveal that Intertaba s.p.a. also operated as P.E. of non resident companies, this Supreme Court is of the opinion that under the general principles inspiring the Italian legal system the activity of control on the regular execution of contracts can not certainly be considered as auxiliary, being closely related to the income production. The part of the Appeal sentence where the Court is of the contrary opinion is not only ill founded and motivated, but infringes legal principles and rules as well, as far as it hasn't taken into account nor has applied to the case the so-called 'business connection test' [in English in the text, MG]. In this respect it is necessary to consider the existence of various factors that are tightly connected to the maximisation of profits by a foreign company. These factors include: effective activities of transport, distribution, conservation of the tobacco products and the diffusion of the same products through an adequate quantity and appropriate location of the depots and stores. The Italian law reserves these activities to the State Monopoly Administration (A.A.M.S.) that is bound to perform them, according to standards provided by appropriate contractual clauses. An effective and dynamic control of the distribution of the products on the market constitutes, therefore, a primary interest of the seller or trademark's licensing society [Philip Morris, in this case, MG]. Considering the relevant dimensions of the Italian market, the employment of remarkable human and financial resources is of course needed.

It is, moreover, significant to point out that the activities of the so-called after sale organisation (retail of spare parts, customer service) are mentioned by the Commentary (sub art. 5, § 4, point 25) as adequate to give rise — from the functional viewpoint — to a P.E. They 'make an essential and significant part of a company services towards the clients'.

At the same time it can't be denied that this control activity represent the core of the company business, according to the Commentary guidelines, and therefore it can't be considered as a mere data collection activity.

It will be a duty of the Court of Appeal to assess, according to contractual clauses of the case and for the business praxis, whether this function of control had involved Intertaba s.p.a. in a marginal way or not.

**3.8** This Supreme Court doesn't share another point of the Court of Appeal sentence. It's the one concerning the participation of Intertaba's representatives

(who covered, at the same time, social charges in others companies of the group, Philip Morris G.m.b.H. included) to the negotiations with A.A.M.S., particularly in those related to the contracts (above mentioned) [last two words added by the translator, MG].

On this point, the Court of Appeal just expressed a generic and obvious judgement, without taking into account the indications of the OECD Model and of the Commentary.

According to art. 5, § 5 of the OECD Model, those branches having ‘an authority to conclude contracts in the name of the enterprise’ [in English in the text, MG] can’t be considered as independent subjects. Such authority, according to the Commentary (sub. art. 5, § 5 - 33) should not be considered only in the sense of a direct representation, but includes also the activities that have contributed to the conclusion of contracts, even if these have been entered into on behalf of the company.

According to an important international doctrine the expedient to separate the material activity of negotiating the contracts from the formal conclusion of them, or to ‘split-up of business responsibilities on the hand and legal authority on the other’ [in English in the text, MG] can be considered as ‘tax circumvention’ [in English in the text, MG] and must be interpreted according to the ‘substance over form’ principle, in application of § 5.

In other words, the verification of the authority to conclude contracts should be referred to the real economic situation, and not to the Civil law. The same approach should be followed also in the single phases of the contractual relation, such as the negotiations, and the above mentioned authority doesn’t necessarily need to include also the power to negotiate the clauses of the contract. In conclusion this Court is of the opinion that the Court of Appeal didn’t motivate adequately the sentence and didn’t consider the evidence delivered by the Tax office, particularly it omitted any evaluation of the elements gathered by the Guardia di Finanza [the Italian Tax Police, MG] in the light of the positions held by the parties during the trial. In this respect, the Court of Appeal violated and / or didn’t interpret correctly the rules and principles of the OECD Model Convention and implemented in the DTC between Germany and Italy.

This Court therefore accepts the appeal, reverse the appealed sentence and sends the case back to another section of the Court of Appeal of Lombardy for the final decision.

The Judges of the latter section will have to decide this case, after the careful reading of all the papers and documents delivered during the reassessment procedure and the different degrees of the controversy, following these legal guidelines:

I) A company resident in Italy can also operate as permanent establishment of various non resident companies belonging to the same group and pursuing a unitary business strategy. In this case the existence or not of the permanent establishment depends on the nature of the activity carried on by the Italian company, that is, its auxiliary or preparatory nature must be assessed according to the overall activity of the group. The business plans of the non-resident companies belonging to the group must be considered as one.

II) The control upon the regular execution of contracts between a non-resident company and a resident one can't be considered, in principle, as auxiliary, according to art. 5, § 4 OECD Model Convention and art. 5, § 3, lett. (e) of the Double taxation convention between Italy and Germany dated October 18th 1989 and implemented in Italy with the Act n. 459 on November 24th 1992.

III) The participation of representatives of a national branch or individuals appointed by the latter structure in a advanced contractual phase [the phase in which the contract is concluded, MG] between a non-resident company and a resident legal body can be considered as a part of the power to enter into contract on behalf of the non resident company [thus of acting as legal representative, MG], even if the power to represent the non resident company is not mentioned or attributed.

IV) The attribution by a non resident company to a national branch [to a national 'structure', according to a literal translation of the Italian word 'struttura', MG] of the power to manage the business in the Country, although limited to a specific segment of the overall business activity makes this branch a permanent establishment of the non resident companies for direct tax purposes.

V) The existence of a permanent establishment and of the requirements to consider a branch a permanent establishment (including the status of dependence and of the participation to the conclusion of contracts) must be verified according to a substance over form principle.

If the Court of Appeal shall decide that Intertaba s.r.l. had operated also as P.E. of the non resident company of the case, the Court of Appeal will also have to decide on the VAT aspects of the case, such as the alleged omitted invoicing, omitted

payment of VAT and on the other points raised in the Court and not decided here as far as they were overruled by the decision on the existence of the P.E.

The Court of appeal shall also have to decide on the expenses of this degree of judgement.

For these reasons

The Supreme Court accept the appeal; reverse the appealed sentence and send back the case for its final decision (including the decision on the expenses) to another section of the same Court of Appeal in Lombardy.

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