

Business profits and the attribution of profits

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Article 7 allocates business profits to the state of residence of the enterprise unless it carries on business in the other state through a permanent establishment situated there. In that case the other state may tax the profits attributable to the permanent establishment, determined as if it were a distinct and separate enterprise dealing wholly independently with the enterprise of which it is a permanent establishment.¹ Paragraph 3 allows the deduction of expenses incurred for the purposes of the permanent establishment, including executive and general administrative expenses, whether incurred in the state of the permanent establishment or elsewhere. Paragraph 4 permits the apportionment of total profits where that has been customary, and paragraph 5 states that no profits are attributed to a permanent establishment by reason of the mere purchase of goods for the enterprise. Paragraph 7 gives priority to the specific articles on other categories of income.²

The convention follows the wording of the OECD Model before 2010, which allowed the relevant business approach to the attribution of profits and did not prescribe the authorized OECD approach adopted in 2010. Neither state has amended the article. Italian domestic law treats the permanent establishment of a foreign enterprise as a separate and independent entity, taking account of the functions performed, the risks assumed and the assets used, and it prices dealings with the head office under the arm's length principle of Article 110 paragraph 7 TUIR, for which the Ministerial Decree of 14 May 2018 sets the guidelines.³ For a Lugano trading company that has been found to have an Italian permanent establishment, the decisive question is therefore how much of its trading margin the Italian tax authorities attribute to the functions performed in Italy. That depends on the documentation of functions, assets and risks that the company can produce, which Chapter F.II describes for trading houses.

1 Associated enterprises and the missing corresponding adjustment

Article 9 permits each state to adjust the profits of an enterprise where the conditions made or imposed between associated enterprises in their commercial or financial relations differ from those that would be made between independent enterprises.⁴ The article reproduces only the first paragraph of the OECD Model. It lacks the second paragraph, which obliges the other state to make a corresponding adjustment where it agrees that the primary adjustment is justified. Many older Swiss treaties share this gap, because Switzerland maintained a reservation against Article 9 paragraph 2 of the OECD Model until 2005. Since then it has accepted corresponding adjustments, also under Article 17 of the Multilateral Instrument, but that change reaches the treaty with Italy only once the Instrument applies to it.⁵

The absence of a corresponding adjustment clause does not mean that economic double taxation must be accepted. The competent authorities may still eliminate it through the mutual agreement procedure under Article 26 paragraph 3, which allows them to consult together for the elimination of double taxation in cases not provided for in the convention.⁶ Swiss practice accepts mutual agreement procedures in transfer pricing cases under older treaties, and Italian practice does the same. What the convention does not offer is an obligation to reach an agreement or an arbitration procedure to break a deadlock. For Italian groups with Lugano subsidiaries and Lugano groups with Italian subsidiaries, transfer pricing adjustments by the Italian Guardia di Finanza or the Agenzia delle Entrate therefore carry a real risk of definitive double taxation. The consequence in practice is a preference for advance pricing agreements, bilateral where possible, and for careful documentation under the Italian penalty protection regime, which excludes penalties for an inaccurate return where the taxpayer has notified the possession of a master file and national documentation and delivers them during the audit.⁷

2 Notes

1. Convention, Art. 7 paras. 1 and 2, text (above). ↩
2. Convention, Art. 7 paras. 3 to 7, text (above). ↩
3. TUIR, Art. 152 para. 2 ("La stabile organizzazione si considera entità separata e indipendente ... tenendo conto delle funzioni svolte, dei rischi assunti e dei beni utilizzati"), Brocardi.it,

<https://brocardi.it/testo-unico-imposte-redditi/titolo-ii/capo-iv/art152.html>; TUIR, Art. 110 para. 7 (arm's length principle; guidelines to be set by decree of the Minister of Economy and Finance), Brocardi.it,
<https://brocardi.it/testo-unico-imposte-redditi/titolo-ii/capo-ii/sezione-i/art110.html>; Ministry of Economy and Finance, Decree of 14 May 2018 on transfer pricing guidelines. ↩

4. Convention, Art. 9, text (above): conditions "diverse da quelle che sarebbero state convenute tra imprese indipendenti". ↩
5. Convention, Art. 9, text (above), which contains a single paragraph. Christoph Suter and Susanne Schreiber, "OECD BEPS: The Swiss Position", Mondaq, 19 March 2018, <https://www.mondaq.com/tax-treaties/683786/oecd-beps-the-swiss-position> (Switzerland traditionally upheld a reservation against Art. 9 para. 2 of the OECD Model and withdrew it in 2005; it accepts corresponding adjustments under Art. 17 MLI). ↩
6. Convention, Art. 26 para. 3, text (above) (consultation on interpretation and on cases of double taxation not provided for in the convention). ↩
7. Presidential Decree No. 600 of 29 September 1973, Art. 31-ter (advance agreements for enterprises with international activity, including transfer pricing; agreements following mutual agreement procedures with foreign competent authorities may extend to earlier years), Brocardi.it, <https://brocardi.it/disposizioni-accertamento-imposte-redditi/titolo-iv/art31ter.html>, and Art. 31-quater (downward adjustment under Art. 110 para. 7 TUIR in execution of mutual agreements, after joint controls or on request), <https://brocardi.it/disposizioni-accertamento-imposte-redditi/titolo-iv/art31quater.html>; Agenzia delle Entrate, Circular No. 15/E of 26 November 2021, https://www.lavoripubblici.it/documenti2021/lvpb4/circolare_26_11_2021_15_AdE.pdf (penalty protection under Legislative Decree No. 471 of 18 December 1997, Art. 1 para. 6, where the taxpayer delivers documentazione idonea, master file and national documentation, and has communicated its possession under the Provvedimento of 23 November 2020, prot. 2020/360494). ↩

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