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ARTICLE

Attribution of Free Capital to Permanent Establishment of a Bank: A Vexed Issue, A General Overview and the Italian 'State of the Art'

Massimiliano Gazzo*

The recent Italian experience shows how the attribution of profits to permanent establishments (PEs) is a very complex topic where international consensus is strictly required. After a description of the guidelines developed in the Organization for Economic Cooperation and Development (OECD) Report on attribution of profits to a PE, this article focuses on the allocation of the appropriate 'free capital' to PEs of banks with a specific highlight on the Italian experience arising from the recent tax audits carried out by Tax Authorities on the appropriateness and consistency of the 'free capital' of most of the Italian PE's of foreign banks. Authorized and accepted approaches will be commented, the consequences arising for the taxpayer will be analysed, and the 'state of the art' in Italy will be described.

1. Premise

Attribution of profits to a permanent establishment (PE) is a topic where international consensus is strictly required. Similarly to transfer pricing matters, the definition of profit to be attributed to a PE, in fact, involves more than one country – at least two, the host country, where the PE is located, and the home country where the taxpayer is tax resident. Hence, unilateral and unshared approaches among countries may cause unintended hypotheses either of double taxation or of double exemption.

Accordingly, this has been fully appreciated that authorized approaches have been developed by international and powerful organizations such as the Organization for Economic Cooperation and Development (OECD). In particular the task of the OECD has been to define an unambiguous interpretation of Article 7 of the OECD Model Convention on attribution of profits to PE or PEs.

The main rationale of developing a shared approach on the interpretation of such complex matter was to put order in the various countries' practices on this topic which have been built up over the last decades, so as to prevent double taxation issues, which in recent years have exposed taxpayers in many cases to significant unexpected and unjustified tax burdens.

After a long and difficult consultation process lasting ten years, during which several discussion drafts were published, on June 2008 OECD released the final Report on attribution of profits to PEs ('Report'). The Report consists of Part I (General Considerations), Part II (Banks), Part III (Global Trading) and Part IV (Insurance enterprises).

The Report has been used to add to and complete the previous content of the OECD Commentary to Article 7 of the Model Convention. OECD has however decided to postpone, until a redraft of Article 7 will be completed, the implementation of some of the conclusions reached in the Report which are in contrast with the content of the current OECD Commentary to said Article 7. This decision has been taken mainly to avoid uncertainty for tax administrations and taxpayers about the approaches taken in previous years to the attribution of profits to PEs.

This article focuses on one of the still highly debatable issues in the process of the attribution of profits to PEs of banks: that is, the allocation of the appropriate 'free capital' (fondo di dotazione).

In Italy, recently, this has become a burning issue after that Tax Authorities focused their recent tax audits mainly on the appropriateness and consistency of the 'free capital' of most of the Italian PE's of foreign banks. What seems to arise from the outcome of such audits is that Italian Tax Authorities are still evaluating, in a great detail, the approaches developed in the Report by testing them in complex operative environments, in order to identify which would be the official position to be taken towards such approaches and trying to lay down the operative guidelines to implement their view. The lack of any official position on such complex issue creates great uncertainty for foreign banks.

This contribution is aimed at providing an overview of this complex and subjective matter; in particular, after a brief description of the guidelines developed in the Report concerning the attribution of profits to PEs, it analyses the

Note

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debated issue. More specifically, authorized and accepted approaches will be commented by highlighting their ability to lead to a very different outcome; the significant consequences arising for the taxpayer will be described too. The 'state of the art' of the current Italian approach is also deeply analysed.

2. The OECD Report on Attribution of Profits to PEs: General Content

Article 7(1) of the OECD Model Tax Convention allows the host country to tax the 'profits of an enterprise', but only the amount which is 'attributable to' the PE. Much historical attention has been given to the issue of how to determine, the amount of profits attributable to a PE under Article 7(2).

Pursuant to the Report, the 'functionally separate entity approach' has to be preferred. Accordingly, the profits to be attributed to the PE are the profits that the PE would have earned if it were a 'distinct and separate' enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle. The 'functionally separate entity' approach permits profits to be attributed to the PE, even where no profit has been realized yet by the enterprise as a whole, for example when the PE finishes manufacturing goods and transfers them to another part of the enterprise for assembly or distribution.

2.1. Two-Step Analysis

Pursuant to the authorized OECD approach (AOA), the attribution of profits to a PE requires a two-step analysis.

First, a functional and factual analysis must be carried out in accordance with the OECD guidelines on transfer pricing discipline (OECD guidelines released in 1995, as subsequently amended – hereinafter 'TP Guidelines'). More specifically, the functional and factual analysis must be performed in order to:

(1) treat the PE and the remainder of the enterprise as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other; and

(2) attribute to the PE appropriate rights and obligations arising out of transactions between separate (related and unrelated) enterprises and the enterprises of which the PE is part.

The functional and factual analysis must therefore identify the economically significant activities and responsibilities undertaken by the PE.

More in detail, this analysis should consider the PE's activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise engaged in dealings with the PE.

Under the second step the remuneration of any internal dealings between the hypothetical enterprises (the Head Office and each of its PEs) is determined by applying the TP Guidelines by analogy, on the basis of the functions performed, assets used and risk assumed by each of them.

The remuneration of any transaction between the enterprise of which the PE is part and related enterprises is determined by applying directly the TP Guidelines.

These two steps make it possible to attribute to the PE the profits (or losses) from all its activities carried out in the country where it is located. Hence, under this approach, profits arising from (1) internal dealings (dealings with other parts of the same legal entity – the Head Office and/or other PE's of the same Head Office) and (2) transactions with separate (related and unrelated) enterprises, are appropriately attributed to the PE.

2.1.1. *Step 1: The Functional Analysis*

The functional analysis takes into account any functions performed, any assets used and any risks assumed by the PE to run the business in the country in which it is located. Particularly, under the AOA, the following should be attributed to the PE:

– risks and obligations (pertaining to the PE) arising out of transactions between the enterprise of which the PE is part and separate enterprises;

– functions performed by the people operating in the PE;

– risks assumed and/or managed by the enterprise by means of the functions performed by the people operating in the PE;

– the economic ownership of those assets the functions relevant for the acquisition, management (and use) of which are performed by the people operating in the PE.

In particular, under Step 1, the identification of significant functions of the PE is crucial (1) to attribute risks and economic ownership of assets to the PE, (2) to apportion the amount of free capital based on the assets and risks attributed to the PE and (3) to analyse risks and obligations pertaining to the PE arising out of the transactions with separate enterprises carried out by the enterprise of which the PE is part. Attribution of profits (or losses) to the PE, in fact, will be based upon all its activities, including transactions with separate enterprises and internal dealings with other parts of the same enterprise.

Hence, as for internal dealings, the functional analysis makes it possible to treat the PE and the remainder of the enterprise as if they were associated enterprises by attributing to the PE its own functions, assets, risks and capital. As for transactions with separate enterprises, the functional analysis makes it possible to attribute to the PE risks and obligations of enterprise's transactions with separate enterprises which should be treated as having been undertaken by the PE.

2.1.2. *Step 2: The Comparability Analysis*

The functional analysis must take into account that a PE is not the same as a subsidiary and is not in fact legally or economically separated from the rest of the enterprise which it belongs to. Dealings between a PE and the rest of the enterprise to which it belongs have no legal consequences for the enterprise as a whole as they would have if the same dealings were concluded between two different legal entities. This implies a need for greater scrutiny by the relevant tax administrations of relevant documentation either filed by the taxpayer (in the inevitable absence, for example, of legally binding contracts) or that might otherwise exist.

Where internal dealings are capable of being recognized, an arm's length remuneration for the functions, assets and risks of the PE is determined, applying by analogy the same transfer pricing guidelines and the same arm's length methods as those used in associated enterprise cases. In particular, an economic model is used to hypothesize its most appropriate separate enterprise characterization (e.g., distributor, agent, service provider) of the PE. Based upon the hypothesized characterization, a comparison between the internal dealings and uncontrolled transactions by applying the transfer pricing comparability factors directly or by analogy is then carried out.

Then, the most appropriate arm's length method is applied to determine an arm's length compensation for the PE (based on that characterization). Hence, in analysing the arm's length remuneration of recognized dealings for tax purposes, taxpayers must select the transfer pricing method that provides the most reliable results.

As to the enterprise's transactions with separate entities the PE profits (or losses) attributable for its hypothesized participation in these transactions, is computed (1) directly, in the case of transactions with unrelated enterprises, or (2) through direct application of the transfer pricing guidelines in the case of transactions with related enterprises (in both cases taking into account the effect of any PE's internal dealings carried out in relation to these transactions).

3. The Vexed Issue: Attribution of Free Capital

Step 1 of the analysis, necessary to determine the attribution of profits to PEs, involves, *inter alia*, the definition of the amount of appropriate *free capital* to be attributed to them. According to the Report the notion of free capital refers to any equity components which do not give rise to a return in the nature of interest deductible for tax purposes.

Under the OECD approach the attribution of appropriate free capital to the PEs shall specifically allow the PE in question to have sufficient capital to support functions, assets and risks attributed to it and ensure it has an arm's length attribution of profits.

In the absence of any legal obligation to have a minimum free capital, in fact, a PE could legally be entirely debt funded and consequently able to deduct, for fiscal purposes, an amount of payable interest higher than if it were a 'distinct and separate' enterprise performing the same or similar functions under the same or similar conditions.

Pursuant to the Report, the process of attributing capital to PEs is carried out in two stages: the first stage involves measuring the risks and valuing the assets attributed to the PE concerned through a functional analysis, while the second stage requires the definition of the authorized and accepted methods to determine the appropriate free capital needed to support the functions performed, risks assumed and assets attributed to it.

It is worth pointing out that, pursuant to Part I of the Report, the analysis of the attribution of profits to a PE must always include a definition of the appropriate free capital, regardless of the business sector where the PE is active.

However the attribution of capital issue is much more sensitive when the analysis refers to banks since they are generally subject to regulatory requirements obliging them to measure risk and financial assets and maintain a minimum amount of capital (not merely free capital but also semi-permanent interest-bearing capital treated as capital for regulatory purposes – Tier 1 and Tier 2).

3.1. Stage 1: Measuring and Valuing the PE's Assets

Pursuant to the Basel Committee standard regulatory system, banks are generally required to maintain an adequate amount of capital at consolidated level. Thus, no legal obligation requires banking groups to have a minimum amount of capital in each country in which they operate through a PE. This lack of a legal obligation does not affect the need to attribute an appropriate amount of capital to the PE for tax purposes in order to ensure an arm's length attribution of profits to the PE.

Under the AOA, free capital should be attributed according to the risks and assets attributed to the PE. This approach is consistent with the arm's length principle and with the role of the capital in the financial business; namely to support and cover losses arising from such financial business.

As mentioned above, banks are generally required for regulatory purposes to measure their risks, and the Basel Accord specifically developed complex and detailed approaches on how to do so. The approach developed in June 2004 (in its revised 2006 framework) Basel Accord to weight the financial assets according to credit and market risks has been considered as a valuable starting point for carrying out a free capital attribution. Specifically, the consensus reached with the Basel Accord provides an internationally agreed approach to weighting of risks, reducing significantly the risk of unilateral and unshared approaches which may give rise to double taxation.

Pursuant to the Report the main advantage of the 'standardized' approach to weighting credit and market risks adopted by the Basel Accord is the certainty of being accepted by all the countries involved in the attribution process.

In fact the use of an internal credit and market risks model developed at the level of each banking group is probably a more accurate way to measure risks requiring regulatory capital, but it has the disadvantage that it may be refused by countries involved in the process, thus increasing the risk of double taxation.

3.2. Stage 2: OECD Approaches to Attribute the Capital to the PE

Under Stage 2, after having weighted the risks requiring regulatory capital, it is possible to determine the amount of appropriate free capital to support these risks. The approaches developed by the OECD to do so are:

– the capital allocation approach;

– the thin capital allocation approach;

– quasi-thin capital allocation.

3.2.1. *Capital Allocation Approach*

This approach seeks to allocate the total free capital of the bank to the PE in accordance with the attribution of assets owned and risks assumed; basically, the free capital is allocated in proportion to the assets and risks of the enterprise attributed to the PE through functional and factual analysis. After having attributed assets and risks, one possible option is to measure risks requiring regulatory capital following the Basel standardizing regulatory rules. Particularly under the BIS ratio approach the entire free capital of the bank must be allocated amongst its different parts, in proportion to the risk weighted assets (RWA) of the PE and the RWA of the legal entity of which it is a part.

More in detail, to directly attribute the free capital to the PE,[1] the ratio obtained by comparing the RWA of the PE to the total RWA of the whole bank is applied to the amount of its free capital (corresponding to the total items treated for tax purposes as free capital by the host country of the PE) so as to define the amount of appropriate free capital to be attributed to the PE. Consequently the entire free capital and not merely the regulatory minimum is allocated to the PE.

It should be borne in mind that differences in the notions of capital, free capital and reserves between the residence country and the PE country may result in the attribution of more or less than the total amount of the entire capital of the bank.

Beyond some operational difficulties which may be encountered in this approach, OECD highlights its main strength; namely, the fact that the actual capital of the enterprise as a whole is attributed with the effect of distributing the benefits of the synergy within the whole enterprise amongst all its parts and thus, *in theory, of reducing as much as possible the likelihood of double taxation.*

As mentioned above it is possible to allocate the entire free capital of the bank through the internal model of the bank rather than with the standardized approach measuring credit and market risks (economic capital allocation approach), although it entails a higher risk of double taxation.

3.2.1.1. Thin Capitalization Approach

This approach requires the PE to have the same amount of capital as an independent enterprise carrying on the same or similar activities under the same or similar conditions in the country of the PE. The determination of an arm's length amount of free capital and debt is, therefore, influenced by the range of actual capital structures of independent host country enterprises carrying on the same or similar activities as the PE in question.

Under this approach a real transfer pricing analysis must be carried out, so a search of comparable banks meeting the comparability factors either directly or by analogy has to be undertaken. Search of comparables must take in consideration the differences existing between the PE and a bank operating in a market comparable to the one in which the PE operates. We refer particularly to the fact that the PE is not a legal entity and its financial activity as well as the risk of losses are funded and supported centrally at the level of the legal entity to which the PE belongs where all the consolidated financial risks are pooled and controlled. Other relevant factors must be taken into account in order to make the benchmarking analysis reliable such as the reputation management risk

Note

[1] An indirect way is also described by the Report to attribute exclusively free capital to the PE. This method entails the need to treat free capital as regulatory capital, attributing proportionally, through the BIS ratio, both Tier 1 and Tier 2 regulatory capital to the PE.

profile of the bank of which the PE is part. To underrate such differences could materially affect significantly the reliability of the results of such approach, unless reasonably accurate adjustments can be made to eliminate the material effects of such differences.

Pursuant to AOA a further main weakness of this approach is that the aggregate amount of free capital that will be attributed to individual PEs may be greater than the amount of free capital of the enterprise as a whole.

This can happen where a mere transfer pricing analysis is carried out focusing only on external conditions, without reference to and consideration of the internal structure of the bank of which the PE is part (namely its free capital and its regulatory capital).

3.2.1.2. Quasi-thin Capitalization/Regulatory Minimum Capital Approach

This approach requires the PE to have the same amount of capital required for regulatory purposes as would be required to an independent banking enterprise operating in the host country.

Under this approach the PE would be required to have at least the same regulatory minimum capital as an independent bank operating in the PE country.

The regulatory capital is however constituted by Equity or Tier 1 and Supplementary Capital or Tier 2 where (1) Tier 2 cannot exceed the amount of Tier 1 and (2) Tier 2 might be an interest-bearing 'capital'.

Pursuant to the Report 'under the arm's length principle, it will be necessary to take such capital' – i.e., the interest-bearing capital – 'into account in order that the PE can deduct the right amount of interest expense'. In particular, in order to do so, the Report identifies two different ways:

(1) the first would be to treat regulatory capital – other than 'free' capital – in the same way as 'free' capital. More in detail the PE would be required to have at least the same regulatory minimum capital – not just regulatory minimum 'free' capital – like an independent enterprise operating in the host country (for Italy only 4% Tier 1 and 4% Tier 2);

(2) the second would be to only attribute directly the 'free' capital provided for by the relevant regulations (In Italy only 4% corresponding to Tier 1).

OECD highlights that among the main weaknesses of this approach there is the fact that the aggregate amount of free capital that will be attributed to individual PEs may be greater or lower than the arm's length amount of the attributable free capital under the OECD authorized approaches. For this reason, this approach *is not recognized as an authorized approach but is regarded as an acceptable safe harbour approach as long as it does not result in the attribution of more profits to the PE than would have been attributed under an authorized approach.*

3.2.1.3. Analysis of the Output

In the light of the above, thin capitalization, under certain circumstances, and quasi-thin capitalization approaches share the same main weakness, being the tangible risk that their use may entail for the taxpayer either double taxation (if the aggregate amount of free capital attributed to the PE is greater than the amount of the entire free capital of the bank to which the PE belongs) or less than single taxation (if the aggregate amount of free capital attributed to the PE is lower than the amount of the entire free capital of the bank to which the PE belongs).

The Report recognizes that the different approaches for attributing 'free' capital to a PE are not an exact science and that any particular facts and circumstances are likely to generate *different arm's length results for the 'free' capital attributable to a PE*.

Different methods adopt, in fact, very different starting points for determining the amount of 'free' capital attributable to a PE, which put more emphasis either on the actual structure of the enterprise of which the PE is a part (the capital allocation approach) or, alternatively, on the capital structures of comparable independent enterprises (the Thin capitalization approach). Both of these approaches are identified by the Report as authorized approaches to attributing 'free' capital, in the sense that they are acknowledged to be approaches generally capable of producing probably different but arm's length results.

Similarly the Report acknowledges that the use of different approaches to attribute capital by the host country and the home country may give rise to double taxation.

Under AOA the solution given to avoid that result is that the home country shall accept, in computing the income attributable to the PE for double taxation relief purposes, the quantum of 'free' capital deriving from the application of the approach used by the host country, provided two conditions are cumulatively met:

– the difference in capital attribution between the PE state and the state of residence of the enterprise must result from the application of different domestic law capital attribution methods; and
– there must be agreement on that the state in which the PE is located has used an authorized approach to attribute capital and that approach produces a result consistent with the arm's length principle.

According to the new paragraph 48 of the Commentary, this result can be achieved through the domestic law of the state of residence of the enterprise, the interpretation of Articles 7 and 23 of the OECD Model or under the mutual agreement procedure of Article 25.

3.2.1.4. Italian Approach

Italy has not introduced any legal provision which (1) defines clearly which is the preferred method to attribute capital to a PE, or (2) issues guidelines on its applicability.

The only official document we can refer to is the Ministerial ruling (no. 44/2006) dealing with the allocation of equity capital to an Italian PE of a foreign financial institution in order to determine the amount of profits attributable to the PE for tax purposes. However the ruling does not provide for specific parameters on how to determine the equity capital to be attributed to a PE, but refers, merely, to the general principles stated in the OECD draft on the attribution of profits to a PE. In particular, the ruling pointed out that the capital to be allocated to a PE can be defined taking in to account the actual structure of the enterprise of which the PE is a part in proportion to the assets owned and risks assumed by the PE. A case-by-case analysis is expressly required to identify the actual conditions of the activity carried out by the PE.

Consequently, it can be said that, on the one hand, no domestic law provision states the preferred approach to be followed by the taxpayer in attributing capital to an Italian PE of a foreign bank and, on the other hand, the only official view seems to prefer the capital allocation approach.

The absence of any practical guidelines on the applicability of authorized and accepted approaches developed in the Report also creates significant uncertainty for both the tax administrations and taxpayers, thereby maximizing potential conflicts among different tax administrations and between tax administrations and banks with increased numbers of cases of costly litigation.

As for the Italian case, there is uncertainty connected to the applicability of the quasi-thin capitalization regime, which should represent, in principle, the easiest approach for attributing capital to the PE of a bank. As said above under this safe harbour approach the PE of a foreign bank must have the minimum amount of capital that the competent authority (in Italy Banca d'Italia)[2] would set for an independent bank operating in Italy, but in the absence of any practical guidelines, it is still unclear if the taxpayer should refer either merely to the regulations setting the amount of minimum regulatory capital (namely 8% of the RWA *reduced to 4% to consider merely Tier 1* which would represents the minimum regulatory free capital)[3] – as the author believes, or to all the regulations providing specifically for banks operating in Italy (and, hence, supporting its Italian business only with their capital), such as the rules preventing concentration of risks.[4] The results achievable are totally different, producing significant uncertainty for the taxpayers in the event assessment by the Tax Authorities.

The main consequences for a foreign bank are, therefore, (1) the risk of facing a challenge from the Italian Tax Authorities on the amount of income attributed to its Italian PE with the connected risk of higher taxes and penalties and (2) the risk of double taxation should the fiscal authorities of the home State not accept the approach used by the Tax Authorities of the host State to attributing capital to the PE.

In this scenario of uncertainty it is important to define some borders which cam be referred to by both foreign banks in the process of choosing the approach to be taken in attributing capital to their Italian PEs and Tax Authorities considering an assessment on such potential issue:

- Until a specific provision of law is introduced in Italy, which defines the authorized and/or accepted methods to be preferred, the taxpayer is free to adopt any of the approaches developed in the Report and included in the Commentary to Article 7 of the OECD Model convention.
- The adoption of an authorized approach by the taxpayers cannot be disregarded by Tax Authorities.
- The amount of capital defined and well documented through an authorized approach cannot be disregarded or supplemented by the Tax Authorities applying other authorized or accepted approaches.

3.2.1.5. Conclusions

Attribution of profits to PEs has been one of the more debated and complex issues to be dealt with in international taxation in recent decades. The task of the OECD of finding international consensus on such matter has been particularly tough but mainly achieved. The importance of such consensus has increased dramatically in recent years, whether the PE structures are used spontaneously

Notes

2 Bank of Italy Circular Letter no. 263, dated 27 Dec. 2006, which implemented in Italy Basel Committee on banking supervision in its 2006 framework.

3 This seems in line with the German Federal Ministry of Finance position, which in its binding decree of 29 Sep. 2004 published its view on attribution of capital to PEs of Banks, according to which the primary method to be followed to attribute free capital to a German PE of a foreign bank is the Capital Allocation Method, but when such method leads to unreasonable results, it is possible to refer to other reasonable arm's length criteria. However, the capital attributed to the PE with such other criteria cannot be lower than the amount determined under the quasi-thin capitalization approach. Particularly, under this approach the amount of capital attributed to the PE cannot be lower than 8.5% of RWA and market risks (regulatory minimum capital plus a premium of 0.5%), which amount (that) can be reduced to not less than 4.5% if the bank is able to prove the extent to which the regulatory capital is composed by free capital and/or other interest-bearing assets considered as capital for regulatory purposes (i.e., Tier 1, Tier 2 and Tier 3).

4 Risk concentration rules oblige banks to use only 25% (or 40% for banking groups) of its regulatory capital to cover the risk position versus the same counterpart. In details these rules provide that if a bank lends EUR 100 million to the same counterpart, it entails that the bank must have a minimum regulatory capital of EUR 400 million (EUR 250 million for banking group). This amount of minimum regulatory capital would allow the bank to use only the 25% (40%) of its regulatory capital as requested by the risk concentration rules.

or as consequence of challenge from Tax Authorities more and more by multinationals to efficiently define their presence in various countries.

Global banks are certainly the multinationals which typically use the PE structure to run the different markets since it allows banks to reduce the number of legal and regulatory requirements to be complied with in each country where they operate.

More detailed guidelines on the attribution of profits to PEs will help taxpayers and Tax Authorities to approach such complex issue and reduce some of the uncertainty created by unilateral and unshared approaches developed in each country. Thus, risk of double taxation issues should significantly decrease.

With specific reference to the consensus on the definition of the appropriate free capital to be attributed to PEs, the task of the OECD has been even more tough.

Specific authorized and accepted approaches have been developed, namely the capital allocation approach, the thin capitalization approach and the quasi-thin capitalization approach.

These approaches are generally capable of producing arm's length results.

It is clear to the OECD that such different approaches adopt very different starting points: one puts more emphasis on the internal structure of the enterprise of which the PE is a part (the capital allocation approach), while the other emphasizes the capital structures of comparable independent enterprises (the thin capitalization approach), so the results achieved can be very different. Therefore the use of different approaches to attribute capital by the host country and the home country may give rise to double taxation.

The solution given by the OECD to prevent the risk of double taxation is to oblige the home country to accept the quantum of 'free' capital determined by the host country in order to recognize a credit for the taxes paid by the PE (or to determine the exempted income of the PE). However two conditions are cumulatively required:

– the difference in capital attribution between the host country and the home country must result from the application of different domestic law capital attribution methods; and
– there must be agreement that the host Country has used an authorized approach to attribute capital and that approach produces a result consistent with the arm's length principle.

In the absence of one of the conditions required, OECD acknowledges that the risk of double taxation is still possible.

As for Italy, it is no longer possible for Italian Tax Authorities to postpone further the 'unveiling' of their official view on such matter. It arises clearly, from the outcome of recent tax audits on Italian PEs of foreign banks, that this situation is causing great uncertainty for banks operating in Italy through a PE structure. It is not useless to outline that their uncertainty is fully justifiable if it is also considered that the lack of a domestic law provision referring to capital attribution does not protect such banks from the actual risk of double taxation whenever the approach taken by Italian Tax Authorities will not be shared by the Tax Authorities of their respective home country.

In the light of the above, the Italian Government should not postpone any longer the adoption of a domestic law provision embodying its preference, and no longer leave taxpayers without further detailed guidance on the practical application of the preferred approach.

Only this course of action will increase the degree of certainty for foreign banks operating in the Italian territory minimizing risks of double taxation and related costly national and international litigations, thereby creating a better environment to enhance constructive relationships with taxpayers.