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To my dad, who always supports

and encourages me.

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INTRODUCTION

The value that a company produces can be compared to a cake: the assets, combined in a certain way, will create the value, which will then be shared between the debt holders and the equity holders, that is, among those who have financed the company. The choice of the type of financing has been the subject of many studies, starting with the economists Franco Modigliani and Merton Miller and their model.

The Modigliani-Miller theorem says that no matter how much relative debt capital and how much relative equity capital is brought in, the total value produced by the "ingredients" you have does not change. Theoretically, the conclusion that Modigliani and Miller reached with their 1958 model was that, under very particular conditions assumed to explain such model, the company's cost of capital is not affected by its capital structure. This means that, if the same "ingredients" are available or when the leverage is different from the initial situation but the total financed is the same, the value of the company will always be the same.

Such conclusions were possible only because the hypotheses did not consider the uncertainties and interferences[1] of the economic reality. The assumptions were in particular the following ones:

- Capital markets are perfect;
- There is no bankruptcy risk;
- There are only two financing alternatives, debt and equity, and if one type of financing is increased, the other must proportionally decrease;
- There are no taxes, nor business growth, nor issue or redemption costs when the internal capital structure is changed[2].

Afterwards, Modigliani and Miller developed an extension to their first theorem: given the previous hypotheses, taxes were introduced in the model[3].

It followed that the more debt the company borrows, the greater tax shield is generated, because the interest expenses on the debt are deductible from the tax base and it is as if,

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[1] G. Bertocco. *Teorema Modigliani-Miller, Imperfetta Informazione E Meccanismo Di Trasmissione Della Politica Monetaria.* Moneta E Credito 48.191 (1995): 391-420. Web.

[2] D. Watson, A. Head, G. Mantovani, & E. Rossi, (2017). Corporate Finance. Principles and practice in Europe.

[3] F. Modigliani, M. H. Miller. *Corporate income taxes and the cost of capital: a correction.* The American economic review 53.3 (1963): 433-443.

thanks to the debt, tax savings are generated. The optimal capital structure, therefore, would end up being entirely made of debt capital.
However, even this result does not reflect reality, so, in order to build a model that fits better the reality, it is necessary to take into account those factors that make the financing through only debt the not optimal solution for a company. These factors are the following ones: bankruptcy costs (so the greater the debt borrowed, the greater the risk of insolvency, the higher the interest rate on the debt granted); the restrictions imposed by debt capital lenders, who do not look favourably on risky investments; the inability of the company itself to take full advantage of the benefits of the tax shield when it does not produce enough profits[4]. Over time, many other researchers have thus studied the Modigliani-Miller theorem, by introducing many of the distortions found in reality. In this way, it has been shown that there is indeed a capital structure, or a particular limited range of leverage, which optimises the cost of capital of the company.
The cost of capital affects the value that a business creates: the lower the cost of capital, the greater the value the company will have. Afterwards this value is divided among those who have lent their capital to finance the company: one "slice" of the value is destined to repay the debt capital, what remains remunerates the equity capital.
In reality, the value generated is not only divided between debt holders and equity holders, but it must be divided into three shares: taxation allows to increase the total value through the tax shield, but it also binds one part of what has been created.
In this case the total value produced by the company must first satisfy the debt holders and the tax authority, and only later it can be distributed to the shareholders.
To ensure that shareholders receive more value, the management of the firm has the following three options:

- To enlarge the "cake" as a whole, and this depends all on the entrepreneur's ability to combine the factors available to him and obtain greater value, or to find new sources of growth;
- To change the debt/equity ratio, but with the risk of reducing the diameter of the value-cake;
- To reduce the impact of taxes on the total value, perhaps by transferring the business to a Country with a more favourable taxation.

[4] Watson, D., Head, A., Mantovani, G., & Rossi, E. (2017). Corporate Finance. Principles and practice in Europe. P. 323-325.

OECD data reveal that, for the year 2019, the average effective tax rate calculated on corporate tax rates applied in 73 Countries and jurisdictions is around 20%[5]. This means that 20% of EBT[6] will have to be deducted from the calculation of the free cash flow, or, in other words, this part of cash flows, although it has been produced, will not bring value to equity holders because it is not free to be distributed to them. Obviously, not all Countries have a 20% effective tax rate on corporate income; differences among States are considerable. For example, in 2019 India recorded an effective tax rate of 45.4%, while in the Cayman Islands the tax rate was 0[7].

The enterprise seeks the maximisation of shareholder value. Companies, therefore, not only wish to "enlarge the cake" so to have greater returns, but they also try to combine the width of the "slices" in the right way. It would therefore be a favourable condition if the corporate structure and the legal and economic environment allowed to reduce the amount of value produced that has to be allocated to repay debts and taxes, so that the remaining value is as high as possible, thus benefiting the shareholders (through dividends and capital gain).

Among the accounting items and incomes that are part of the tax base, one in particular is relevant for today's business strategy and for this dissertation: royalty income. Royalties are, in fact, the consideration for the exploitation of intangible assets, and the latter have gradually assumed greater economic importance for companies.

In the current economic context we are witnessing new scenarios. Thanks to globalisation, the new technologies and an increased competition, companies are now forced to create new business models.

If traditionally enterprises could choose between two alternative strategies (low cost-low prices; differentiation-premium price), today the *blue ocean strategy* presents itself as the third way that allows to obtain enormous returns, but at the condition of being able to create a completely new, unprecedented business model.

Other companies, on the other hand, use intangibles to create greater value. Not only do they develop and use the intangibles to differentiate themselves from competitors, but they can exploit them by granting them to third-party companies, thus implementing a

[5] Data processed from the table provided by the OECD at the link: https://stats.oecd.org/Index.aspx?DataSetCode=CTS_ETR# .

[6] Earnings before taxes. The FCFF is the cash flow that derives from operations carried out by the company, from which depreciation, taxes, working capital and capital expenditure are deducted. The information obtained from the company's income statement and balance sheet is used for the calculation.

[7] https://stats.oecd.org/Index.aspx?DataSetCode=CTS_ETR# .

marketing strategy to increase their sales and/or to produce and sell the goods more effectively.

Data show that, in addition to the exponential growth of intra-group trade, the licensing market grew by 3.2% in 2018, reaching a value of around $280 billion; brand owners earned $15 billion thanks to royalties, with a 4% increase[8].

This exponential increase in profits, consequence of the growth of companies, however, involves also a stop, because there is, at the same time, the increase in tax burdens: how do companies react? Some of them have exploited the international legal framework to their advantage so aggressively that it caused a reaction from the International Community. This is why the Base Erosion and Profit Shifting Project (BEPS) was established, even if definitive and decisive results have not yet been obtained.

The purpose of this thesis is to illustrate the topic of royalties and their taxation at national and international level, and to investigate how the International Community has decided to react so to limit the tax avoidance behaviours adopted by companies, especially multinational enterprises, that are implemented by exploiting the tax differences between the various Countries of the world. Some proposals for the improvement and the harmonisation of international taxation will be presented as well, but for the moment they have not yet found practical application.

[8] https://www.licenseglobal.com/industry-news/licensing-biz-grows-nearly-9-billion .

CHAPTER 1: DESCRIPTION OF ROYALTIES ACCORDING TO THE ITALIAN JURISDICTION

Nowadays, intellectual work, distinctive signs, technical and design innovations are increasingly perceived as an important strategic tool by companies, which use them to distinguish themselves from the competition and thus acquire a competitive advantage.
Given the economic importance of these assets, their use has been protected over time by specific legal institutions: the patent[9], the trademark[10], the industrial design right[11] and, last but not least, the copyright (and the other author's rights)[12]. These legal institutes give rise to the so-called intellectual property rights (IPR), that is to say, the author's moral right to be recognised as the author of the work, and the economic right to dispose of the economic exploitation of the intellectual work[13].
The patent is the legal institution that grants the owner a temporary monopoly to exploit an invention[14], that is, it grants the right to produce, dispose and economically exploit such invention, by prohibiting unauthorised third parties to perform these activities. The subject of the patent is all those new, licit inventions resulting from an inventive step and which are suitable for industrial application[15]. In order to patent an invention, it is necessary to file an application with the UIBM (*Ufficio italiano brevetti e marchi*), the office which will then evaluate all the conditions necessary to determine if it is possible to grant the patent. The patent allows a protection of 20 years on the patented object[16] (10 years if it is a utility model[17]) and it is valid in the Italian territory only if a national application has been filed. It is as well possible to submit a European patent application: in this case the patent is valid in the Member States of the European Patent

[9] Art. 45 c.p.i.
[10] Art. 7 c.p.i.
[11] Art. 31 c.p.i.
[12] Art. 1 l. 22 aprile 1941, n. 633.
[13] https://uibm.mise.gov.it/index.php/it/deposito-titoli .
[14] «*Il brevetto è un titolo in forza del quale si conferisce al titolare un monopolio temporaneo di sfruttamento di un trovato, per un periodo di tempo limitato*». https://uibm.mise.gov.it/index.php/it/brevetti .
[15] Art. 45, co. 1, c.p.i. et seq.
[16] Art. 60 c.p.i.
[17] Even utility models are in fact patentable, although the *codice della proprietà industriale* dedicate them a different section, separated from inventions. Art. 82-85 c.p.i.

Organization[18]. However, it is always possible to choose in which and in how many foreign States to register the patent by submitting individual national applications.

The trademark is a sign used to identify and distinguish the products of a certain company, or the services it offers, from the competition[19]. In order to be registered, a trademark must be new, licit and must have the strength to clearly distinguish the company's products from those of competing companies[20]. A registered trademark is valid for 10 years, which can be renewed[21], and the protection granted is limited to the Italian territory if an application for an Italian trademark has been submitted. The protection extends to all EU Member States in case of registration of a European trademark[22], or it extends to member countries of the Madrid System if an international trademark is requested[23]. However, it is possible to proceed with national registration of the trademark in each country where the company wishes to receive legal protection.

The industrial design is the appearance of an entire product or part of it as it results from the characteristics of the lines, colours, shape, surface structure or materials of the product itself or its ornament[24], provided that it respects the conditions of novelty, lawfulness and has an individual character, that is to say, as a whole it gives the informed user an impression of novelty compared to other previous designs[25]. The protection for a registered industrial design lasts 5 years, and can be renewed up to a maximum of 25 years[26]. The protection is valid only in the Italian territory if a national application is filed, or it is valid in the EU territory with a Community application, or in foreign countries by submitting individual national applications.

The owner of the work of human intellect cannot alienate the moral right to be recognised as its author, but he can, on the contrary, dispose of the economic rights

[18] https://www.epo.org/law-practice/unitary/unitary-patent/legal-framework.html .
[19] https://uibm.mise.gov.it/index.php/it/marchi .
[20] Art. 12 et seq. c.p.i.
[21] Art. 16 c.p.i.
[22] https://uibm.mise.gov.it/index.php/it/marchio-europeo-con-validita-su-tutta-l-ue .
[23] https://uibm.mise.gov.it/index.php/it/marchio-internazionale;
https://www.wipo.int/madrid/en/ .
[24] The industrial design is identified in the Italian jurisdiction as *disegni* and *modelli,* and they are described in the *codice della proprietà industriale* as «*l'aspetto di un intero prodotto o di una sua parte quale risulta dalle caratteristiche delle linee, dei colori, della forma, della struttura superficiale ovvero dei materiali del prodotto stesso ovvero del suo ornamento*». Art. 31 c.p.i.
[25] Art. 33 c.p.i.
[26] Art. 37 c.p.i.

deriving from it, through the direct economic exploitation of the work or its alienation or its granting to third parties.
When the owner of a trademark, or patent, or intellectual work, grants the commercial exploitation of such work to third parties, the compensation that he will receive is called royalty.
Therefore, the term royalty (or also *canone* in Italian) designates that payment in favour of the author of an intellectual work protected by copyright or of an invention protected by a patent or of a trademark, in exchange for the commercial use of that work[27].
Originally, the term "royalty" indicated the percentage of the net profits that the holder of the right to exploit mineral deposits had to pay to the State[28]; even today, the Italian legislation provides that the concessionary enterprises of mineral deposits located in the national territory pay royalties to the Italian State, the Regions and the Municipalities, on the basis of a tax rate scheme defined in Article 19 of d.lgs. 25 novembre 1996, n. 625 and subsequent amendments[29].
Over time, however, the term royalty has expanded to the current common sense. The definition of royalties found in the "interest and royalties" directive is as follows: «payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; payments for the use of, or the right to use, industrial, commercial or scientific equipment shall be regarded as royalties»[30].
Specifically, today we talk about royalties in the Italian legislation:

- when the mining company extracts oil and/or gas from the underground;
- when a patent, trademark, utility model or new plant variety is licensed;
- when a brand is granted in merchandising;
- in the franchise agreement;
- when copyright is exercised.

[27] http://www.treccani.it/enciclopedia/royalty/ .
[28] As the term probably originated in the Anglo-Saxon countries in the 12th-13th Century, it indicated precisely the payment made to the Crown for the exploitation of an asset owned by the King. M. L. Appendino, *La tassazione dei beni immateriali: analisi della disciplina nazionale, comunitaria e convenzionale* , Università degli Studi di Torino, 2013, p. 4.
[29] Art. 19 d.lgs. 25 novembre 1996, n. 625; Art. 7, co. 6, l. 11 maggio 1999, n. 140.
[30] Art. 2 directive 2003/49/EC.

Except in the case of mining concessions, there is no fixed standard for calculating the royalty, as the underlying contract is the result of the negotiation of the counterparties. Generally, however, this payment is calculated in proportion to the licensee's revenues or net profits[31].

In the next paragraphs, I will illustrate the various contracts that lead to the granting of the right to use intangibles and how the royalty is usually determined.

1.1 The licensing agreement

The licensing agreement is an ad hoc contract for the Italian law.

In fact, it has not been codified in the civil code, and thus it is often assimilated to the lease contract (*contratto di locazione*) or usufruct contract[32].

The license agreement is stipulated between the licensor, that is, the holder of a right on an intangible, and the licensee, namely, the one who acquires the right of economic exploitation of the intangible itself[33]. However, the ownership of the right remains with the licensor.

The object of the license agreement is, therefore, the transfer of the right of economic use of the intangible asset, that is, the patent, trademark or know-how[34].

Licensing contracts originated in Anglo-Saxon countries; later they were successfully imported also in Italy where, in the latest available survey, a market of $3.18 billion was recorded, placing our country in fourth place by licensing value in Europe[35].

The license agreement offers undoubted advantages for both parties. On one side, it allows the licensee to immediately take advantage of techniques and knowledge that would have taken considerable time to develop, such for example the brand image. On the other side, the licensor, in the event that he lacks an adequate organization such that he could not directly exploit the intangible, has the opportunity to see it economically and fully exploited[36]. The licensor can also have the opportunity to enter a new market

[31] https://uibm.mise.gov.it/index.php/it/brevetti/vita-di-un-brevetto/sfruttare-un-brevetto/2-non-categorizzato/2036031-concedere-in-licenza-un-brevetto .

[32] https://www.puntocartesiano.it/formazione/guides/il-licensing/la-licenza-dei-diritti-patrimoniali/ .

[33] M. Orlandi, *Accordi di licenza: aspetti civilistici, contabili e fiscali*, Fisco, 2011, 10 - parte 1, 1496.

[34] https://www.sagliettibianco.com/licensing/ .

[35] https://mgmtmagazine.com/licensing-di-un-brevetto-tu-inventi-gli-altri-fanno-il-lavoro-storia-di-stephen-key-3353637/ .

[36] https://www.sagliettibianco.com/licensing/ .

by limiting the risks of direct investments[37]. With this contract, the licensor can materialise inflows of royalties, even if there are very rare cases of free licenses.

The duration of the license agreement is established by the parties, but it is generally identified with the residual legal duration of the intangible[38].

The license agreement may provide for the exclusive transfer of the right to a single licensee (exclusive license and single license), or its transfer to multiple licensees (non-exclusive license)[39]. When the license is exclusive, only the licensee can use the object of the contract, while the licensor can no longer personally exploit it. In the case of the single license, on the other hand, both the licensor and the licensee have the right of exploitation. Finally, with the non-exclusive license, the right of exploitation is held by both the licensor and the various licensees.

The consideration in a license agreement can be both upfront and deferred, with advantages and disadvantages for both parties. If the payment is upfront, the parties negotiate a lump-sum, which can be in the form of a money consideration or in the form of an alternative payment, such as the case of sale of a share of the licensee's company or the opportunity to purchase a share of the licensee's firm for a reduced price[40].

If the payment is deferred, the parties usually agree on a periodic payment of royalties. Royalties can also be renegotiated at specific time intervals, or be proportional to particular economic factors, so to better protect the licensor in favourable economic circumstances[41].

In a license agreement, upfront payment is advantageous for the licensor as he immediately cash in the agreed sums, eliminating the risk of non-payment in the future. At the same time, this solution causes disadvantages for the licensee, who is forced to make a high cash outlay in advance without having guarantees of the success of the licensed asset. The licensor, in turn, will not be able to count on a periodic income that can be also linked to the success of the product.

[37] C. Dematté, E. Marafioti, F. Perretti. *Strategie di internazionalizzazione*. 2.nd ed. Milano: EGEA, 2008.
[38] M. Orlandi, *Accordi di licenza: aspetti civilistici, contabili e fiscali*, Fisco, 2011, 10 - parte 1, 1496.
[39] https://uibm.mise.gov.it/index.php/it/brevetti/vita-di-un-brevetto/sfruttare-un-brevetto/2-non-categorizzato/2036031-concedere-in-licenza-un-brevetto .
[40] G. Bertoli, B. G. Busacca, R. Graziano. *La determinazione del "royalty rate" negli accordi di licenza.* 9th International Marketing Trends Conference. Marketing Trends Association, 2010.
[41] Ibid.

In reality, lump-sum payments and royalties coexist, so as to balance their advantages and disadvantages for both parties.

1.2 The merchandising contract

As with the licensing agreement, the merchandising contract also does not have a specific discipline in the Italian legal system. It is in fact governed by commercial practice and by the rules of similar contracts[42]. However, being widespread in Italy, the doctrine affirms that this contract is atypical, but socially typified[43]. This means that in practice, the widespread use of this contract has led over time to the standardisation of its form and contractual clauses. During the signing of the contract, the will of the parties, the general rules on contracts and the specific rules on the object of the contract are taken into account.
In the merchandising contract, the licensor (called merchandisor) transfers the right to use his distinctive sign to the licensee (or merchandisee), in exchange for a consideration (royalty) [44].
Unlike the licensing agreement, in the merchandising contract the licensee can use the distinctive sign only in a different market segment than the original one where the merchandisor operates.
Objects of the merchandising contract can be the most varied types of brands, as long as they are particularly well-known. The doctrine groups them into the following three categories[45]:

- *brand merchandising*
- *character merchandising*
- *personality merchandising*.

Brand merchandising (also called corporate merchandising) is the merchandising contract par excellence. In this case, the transferred object is a particularly famous corporate brand. We can in turn distinguish three types of famous brands: those that recall luxury and refinement (status properties), those that recall adventurous lifestyles

[42] https://www.altalex.com/documents/altalexpedia/2018/03/14/merchandising .
[43] Ibid.
[44] https://www.diritto.it/il-contratto-di-merchandising/ .
[45] Ibid.

(personification properties) and those that are widely diffused and popular (popularity properties)[46].

In the character merchandising, the contract is stipulated to grant the rights to use the image or name of fictional characters, created, for example, by writers, designers and artists[47].

Finally, personality merchandising consists in the granting of the right to use the image of a famous person[48].

The advantages of the merchandising contract are largely similar to those of the licensing agreement: the merchandisee derives the appeal of the brand which is established in the market; the licensor obtains even greater visibility and expansion in other markets and derives a periodic revenue stream consisting of royalties[49].

1.3 The franchise agreement

The franchise agreement is a typical contract in the Italian law and is governed by the l. 6 maggio 2004, n. 129, where, in article 1, it is established that «the franchising is the contract, however called, between two legal entities, economically and legally independent, on the basis of which one party grants availability to the other, against consideration, of a set of industrial or intellectual property rights relating to trademarks, commercial names, signs, utility models, designs, copyrights, know-how, patents, technical and commercial assistance or advice, by inserting the affiliate in a system

[46] M Introvigne, *Merchandising*, Digesto delle discipline privatistiche. Sezione commerciale, IX (1993). The author explains that merchandising can be understood in a legal sense or in an economical sense. Legally speaking, the merchandising contract allows the licensee to use the trademark of the licensor in a completely different market; economically speaking, merchandising groups all the activities carried out for the marketing of the products, like for example market research and the distribution of the goods. Following this dualism, the author explains how today merchandising does not only include trademarks as they are, but more generally distinctive signs. Such distinctive signs can be identified with trademarks but also with other author's rights. The author concludes with the fact that the doctrine tends to link different cases of corporate merchandising to the rights on trademarks and brands; in the author's opinion, instead, merchandising is much more than corporate merchandising and not all the issues can be legally solved by citing the trademark law.

[47] Ibid.

[48] Ibid.

[49] http://www.diritto24.ilsole24ore.com/art/avvocatoAffari/mercatiImpresa/2014-07-17/sfruttamento-opera-ingegno-merchandising-105912.php .

consisting of a plurality of affiliates distributed throughout the territory, for the purpose of marketing certain goods or services»[50].

As we can see, the franchise agreement is not very dissimilar from the licensing agreement, with the addition, however, that the network of affiliates entails a standardisation in the marketing of products and/or services[51]. Art. 1 continues in paragraph 3 (sub-paragraph c) with the definition of royalty, that is «a percentage that the franchisor requires from the franchisee commensurate with the turnover of the latter or in a fixed amount, to be paid also in periodic fixed amounts»[52]. The franchise agreement cannot have a duration of less than 3 years[53].

The main advantages of entering into a franchise contract are the following:

- for the franchisor, to quickly expand its business, while at the same time reducing business risk and costs, which are shared with the franchisee;
- for the franchisee, to benefit from an already proven business model and from the assistance of the franchisor, obtaining a more effective promotion than working alone[54].

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[50] «*L'affiliazione commerciale* (franchising) *è il contratto, comunque denominato, fra due soggetti giuridici, economicamente e giuridicamente indipendenti, in base al quale una parte concede la disponibilità all'altra, verso corrispettivo, di un insieme di diritti di proprietà industriale o intellettuale relativi a marchi, denominazioni commerciali, insegne, modelli di utilità, disegni, diritti di autore, know-how, brevetti, assistenza o consulenza tecnica e commerciale, inserendo l'affiliato in un sistema costituito da una pluralità di affiliati distribuiti sul territorio, allo scopo di commercializzare determinati beni o servizi*». Art. 1, co. 1, l. 6 maggio 2004, n. 129.

[51] R. P. Dant, M. Grünhagen. "International Franchising Research: Some Thoughts on the What, Where, When, and How." *Journal of Marketing Channels: International Franchising Research and Practice: Past, Present, and Future* 21.3 (2014): 124-32. The authors exhaustively explain the history, the features and the literature of the franchise agreement. For example, franchising can be divided into traditional franchising and business format franchising. The traditional franchising focuses on the products of the franchisor, and the franchisees act as local and dedicated distributors of such products. The business format franchising, on the contrary, focuses on the business model itself, i.e. the franchisor provides the «way of doing business together with a comprehensive package of services and an operating manual that specifies details like standards of quality control and provisions of ongoing training, communication, and other operational supports». However, the authors argue that there is plenty of research that can still be conducted, in particular the franchising in the developing countries, but also research on franchising with new paradigms e.g. using the consumers' perspective, and research with data, samples and cross-cultural studies from outside the US.

[52] «*Nel contratto di affiliazione commerciale si intende [...] per royalties, una percentuale che l'affiliante richiede all'affiliato commisurata al giro d'affari del medesimo o in quota fissa, da versarsi anche in quote fisse periodiche*» Art. 1, co. 3, lett. c), legge 6 maggio 2004, n. 129.

[53] Art. 3, co. 3, legge 6 maggio 2004, n. 129.

[54] M. Mendelsohn, Franchising, *Uniform Law Review*, Volume 1, Issue 4, December 1996, Pages 679–692, https://doi.org/10.1093/ulr/1.4.679 .

1.4 The author's rights

Author's rights are a series of rights that are know in the Italian legal system with the name of *diritto d'autore;* author's rights are governed by the l. 22 aprile 1941 n. 633 and its subsequent amendments, the most recent of which is l. 3 maggio 2019 n. 37. The law protects the works of creative genius that belong to literature, music, the figurative arts, architecture, theatre and cinematography, whatever the mode or form of expression, without forgetting computer programs and databases[55]. It is not necessary to file an application for the recognition of author's rights, which arises automatically with the creation of the new and original work. The author's rights protect the rights of economic use of the work and the moral rights of the author.

Author's rights operate in a slightly different way from the previously described agreements, first of all because they do not arise from a contract. Furthermore, the author has the exclusive right to economically use his work in any form and way, and to receive a fee for any type of use of such work[56]. Therefore, in whatever form the work is used, whether it is a theatrical performance or the public reproduction of a piece of music, the author receives a fee.

Among the economic rights accruing to the author we count: the right to publish the work, the right to reproduce it, the right to transcribe it, the right to perform and represent it in public, the right to elaborate and modify it, the right to rent it and the right to receive a compensation for each of its subsequent sale[57]. These rights expire 70 years after the author's death[58].

Given the complexity and variety of areas in which author's rights are exercised, in Italy authors and publishers are protected through the SIAE[59], the company that manages the circulation of copyrighted works, collects the proceeds deriving from their licensing and

[55] «*Sono protette ai sensi di questa legge le opere dell'ingegno di carattere creativo che appartengono alla letteratura, alla musica, alle arti figurative, all'architettura, al teatro ed alla cinematografia, qualunque ne sia il modo o la forma di espressione.*
Sono altresì protetti i programmi per elaboratore come opere letterarie ai sensi della Convenzione di Berna sulla protezione delle opere letterarie ed artistiche ratificata e resa esecutiva con legge 20 giugno 1978, n. 399, nonché le banche di dati che per la scelta o la disposizione del materiale costituiscono una creazione intellettuale dell'autore.» Art. 1 l. 22 aprile 1941, n. 633.
[56] Art. 12 et seq. l. 22 aprile 1941, n. 633.
[57] https://www.siae.it/it/diritto-dautore/diritti-patrimoniali/i-diritti-patrimoniali .
[58] Art. 25 l. 22 aprile 1941, n. 633.
[59] *Società Italiana degli Autori ed Editori*.

then remunerates the authors[60]. This remuneration is identified as a royalty. The SIAE also plays the role of certifying the existence and authorship of a work, which is recorded in a special register[61].

In common law countries, *diritto d'autore* is identified with the copyright, but in fact the two notions are not perfectly comparable. In reality, the concept of copyright indicates only the economic component of author's rights, while the latter also focus on the moral aspects. Therefore, civil law *diritto d'autore* is founded on recognising the protection of the author's moral rights and economic rights to exploit the work, while copyright established by common law systems is based on the right of reproduction and marketing of the work. In both cases, the work is protected by prohibiting unauthorised reproduction.

1.5 The royalty rate determination

Having clarified the areas from which royalties arise, let's see how they are quantified.

First of all, the "assumption" from which the royalty arises is identified in the present value of the additional profit that the licensee obtains from the use of the intangible[62]. The doctrine on the subject agrees on this assumption, because essentially this is the advantage that the licensee company derives from the use of the asset and it is only on this advantage that the licensor company can claim the right of remuneration[63].

For this reason, the royalty value can only fluctuate over a certain range. The maximum limit that a royalty can reach is equal to the profit differential for the licensee company, i.e. the difference in profit for the licensee company between using and not taking advantage of the intangible[64]. If this limit were indicated in the license agreement as the actual royalty, all the value generated through the use of the intangible by the licensee would be redistributed to the licensor. Therefore, for the licensee there would be no advantage in terms of value between owning and not owning this asset, and he would hardly enter into a license agreement.

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[60] https://www.siae.it/it/chi-siamo/la-siae/la-missione-di-siae .

[61] Art. 103 l. 22 aprile 1941, n. 633.

[62] P. Dawson, *Royalty Rate Determination.* Journal of Business Valuation and Economic Loss Analysis 8.1 (2013): 133-61.

[63] Ibid.

[64] Ibid.

On the other hand, the minimum value that the royalty can take is equal to the marginal cost of transferring the knowledge of the intangible[65]. This is because it is in the interest of the licensor to ask at least the marginal cost of production of the asset as remuneration. In the case of intangibles this marginal cost is very close to zero[66], because intangible assets enjoy the property of non-rivalry, so spreading their knowledge or their simultaneous use do not reduce their utility; moreover, the incremental cost of producing one more unit of an intangible is very low if not zero[67]. However, it could be believed that, given the high costs incurred to develop the intangible itself, like for example the costs in R&D, these costs should be included in the calculation of the marginal cost. This is not the case: in fact, development costs are sunk costs and therefore irrelevant[68].

Thus, in summary, the value of the royalty for the licensor can range from 0 to the present value of the incremental profits deriving from the use of the asset. In each contract, the parties decide how to share this added value through the royalty rate. The royalty rate is ultimately the “price” of the transaction.

In reality, there are several methods used to find this rate, but the doctrine usually group them into the following two categories:

- income approach;
- transactional approach[69].

The methods belonging to the income approach focus mainly on calculating the differentials of price and quantity sold so to establish the increase in profits resulting from the licensing agreement, while leaving the subsequent distribution of profits to the bargaining power of the parties. In this way there is not an analytical approach that determines the actual royalty rate, and the company that has more alternatives or lower costs if the agreement fails would have greater negotiating capacity and would be able to secure a larger share of the differential profits.

In general, the optimal royalty rate is found with the following characteristics in mind:

- the uniqueness of the intangible;
- the number of possible licensees;

[65] Ibid.

[66] Ibid.

[67] A. Panno, *Intangible assets. Profili economici e aspetti valutativi*. G Giappichelli Editore, 2011, p. 89 et seq.

[68] P. Dawson, *Royalty Rate Determination*. op. cit.

[69] G. Bertoli, B. G. Busacca, R. Graziano. *La determinazione del “royalty rate” negli accordi di licenza.* Op. cit.

- the risks for the parties and their level of investment;
- rights and responsibilities of the parties deriving from the license agreement[70].

The critical issues that may arise from the application of income approaches are recognisable in the uncertainty of the incremental income flows and in the difficulty in quantifying them, as well as the difficulty in determining the right discount rate.

The transactional approach, on the contrary, bases the determination of the royalty rate on the royalty rate applied in other transactions, that are comparable in terms of characteristics of the parties, intangible object of the contract and type of transaction[71]. Hence, no particular attention is paid to whether and how much greater contribution the intangible will bring to the licensee, as well as if it is actually convenient for the licensee to enter the license agreement. The difficulty in applying transactional methods often lies in the inability to find comparable transactions due to the uniqueness of the intangible and contractual clauses, besides the fact that many comparable contracts are not made public or some contractual aspects are not disclosed, invalidating the reliability of the assessment.

A further rule that could be used to identify the royalty rate is the so-called "25% rule of thumb", which arbitrarily assigns 25% of the profits generated by the use of the intangible to the licensor and the remaining 75% to the licensee. In this way the licensee is paid more because he bears greater risks than the licensor, like for example the risk that the asset will not succeed in the market. This rule has been used in the past for its directness, but as it has no foundation on the level of profits nor on the contribution to the corporate business that can be brought by other intangibles within the company, it is now used in practice as a starting point, and rarely as the only method, for determining the royalty rate[72].

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[70] T. Heberden, *Intellectual property valuation and royalty determination.* International licensing and technology transfer: practice and the law, Wolters Kluwer Law & Business (2011).

[71] It should be noted that the transactions, in order to be comparable, must:

- Have the intangible that is comparable, including its stage of development, how successful it is in the market, its expected useful life;
- Come from a similar industry sector;
- Have the parties of the contract coming from Countries with similar jurisdictions and have the market of the product similar to that of the contract under analysis;
- Have used the same royalty calculation method;
- Have comparable contractual clauses, such as the duration of the licence.

T. Heberden, *Intellectual property valuation and royalty determination.* Op. cit.

[72] T. Heberden, *Intellectual property valuation and royalty determination.* Op. cit.

It is noted by the author that the calculation of the royalty rate is important not only for licensing purposes, but also for transfer pricing purposes, litigation purposes, strategic planning,

But a question has recently been raised: about the correctness of the assumptions on which the approaches used so far for identifying the royalty rate are based. A new approach to the problem has therefore been suggested: to place the customer at the centre of the analysis, because the success or failure of the new product depends on him, and to focus on the value that the latter obtains from the licensed asset. In this way, the analysis is released from the investments made by the companies involved and from the benefits they get from the license[73]. This approach is particularly relevant for those contracts that underlie the production of goods sold to final consumers or that have corporate brands as their object; it is thus not very useful for more "industrial" licenses, where the intangible has a more technical nature and is not directly involved in the customer appreciation. With this approach, therefore, the royalty rate is based on the contribution the parties make to the success of the license agreement. The analysis is carried out in the following way: the key characteristics that make the licensed good more attractive to potential consumers are identified through market analyses, that are also conducted through conjoint analysis; then it is established which of the two companies has brought such key characteristic. The royalty rate is therefore established on the basis of the contribution provided by the parties, both quantitatively speaking, on the basis of the characteristics identified, and the greater or lesser importance that these characteristics have for the final consumer. In this way, the agreed royalty rate would no longer be an exclusive result of the parties' bargaining power, but it would have a more "objective", fair and shared basis, designated by the value that the customer actually obtains. Nevertheless, as for traditional techniques, even this method has limitations, such for example the conjoint analysis that requires some functional and physical characteristics which are difficult to identify in intangibles[74].

In reality, therefore, it happens that in each contract the parties decide how to split the incremental profit generated by the use of the intangible on the basis of their bargaining power. The resulting percentage is then derived in such a way so to be able to express the agreed royalty rate as a percentage of the turnover of the licensee company[75].

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and valuation of the IP. Although the real royalty rate agreed between the parties is the result of a bargaining, it can be different from the royalty rate that emerges if it is calculated for different purposes. In fact, especially for litigations and transfer prices, the royalty rate calculations must be based on "objective" facts that can be economically proved.

[73] G. Bertoli, B. G. Busacca, R. Graziano. *La determinazione del "royalty rate" negli accordi di licenza.* Op. cit.

[74] Ibid.

[75] P. Dawson, *Royalty Rate Determination*. op. cit.

The agreed turnover can be the gross or net turnover, namely only the fraction that derives from the use of the intangible[76]. In some cases, however, the royalty can be established as a fixed sum chosen in advance, or a combination of fixed sum and percentage[77], as in the case of the minimum royalty payment[78] or the entry fee in the franchise agreement[79]. The choice of the type of payment, fixed or variable sum, and the basis on which the royalty is calculated, is important for achieving the Pareto efficiency of the parties[80].

Generally, however, the agreements prefer the percentage on the turnover, so the licensee company pays an amount which is proportionate to the actual performance of its business[81].

[76] https://www.royaltyrange.com/home/blog/how-royalties-are-calculated .
[77] Ibid.
[78] https://www.lexdo.it/d/contratto-licenza-di-uso/royalty-corrispettivi/ . The minimum royalty payment protects the licensor because he would receive an inflow in any case.
[79] https://www.diritto24.ilsole24ore.com/art/avvocatoAffari/mercatiImpresa/2019-05-15/franchising-entry-fees-royalties-prezzi-acquisto-e-rivendita-134010.php .
[80] T. Heberden, *Intellectual property valuation and royalty determination.* Op. cit.
[81] According to what P. Dawson writes in the article “Royalty Rate Determination”, a general “market value standard” is assumed, that is, the licensor and licensee have imperfect information on the intangible and its potential in the market. It is a realistic situation.

CHAPTER 2: TAXATION OF ROYALTIES IN THE ITALIAN LAW

After establishing the origin and quantification of royalties, let's now analyse how they are taxed from a national perspective.

According to the Italian law, there are two types of taxable persons who are required to pay taxes: natural persons and legal persons[82]. Depending on the taxable person, the tax provisions vary. In fact, according to what is reported in the TUIR (*Testo unico delle imposte sui redditi*), natural persons are subject to IRPEF[83], while limited companies, cooperatives, mutual insurance companies and public entities are subject to IRES[84]. Contrary to what one might think, for *società semplici*, general partnerships and *società in accomandita semplice* under ordinary accounting system, taxation does not take place through IRES, because their business income contributes to the formation of the IRPEF tax base of each shareholder, after the proportional distribution of profits and regardless of whether such profits have actually been distributed[85].

The Italian legislation considers a further subdivision in the taxation criterion. This subdivision derives directly from the territoriality principle: the State, within its territory, exercises its sovereignty in an original, exclusive and absolute way[86]; but, in the relations with other States it accepts limitations on its own sovereignty. Therefore, even incomes are subject to the State's tax authority if they are located within; on the contrary, the State does not have the right to tax those incomes that do not have a precise connection with its territory[87]. The doctrine[88] agrees in finding legitimacy to the taxing power of the State when the following criteria exist:

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[82] Art. 2 TUIR; art. 73 TUIR.

[83] Art. 1 TUIR; art. 2 TUIR.

[84] Art. 72 TUIR; art. 73 TUIR.

[85] Art. 5 TUIR.

[86] http://www.treccani.it/enciclopedia/territorialita-del-tributo_%28Diritto-on-line%29/ .

[87] Ibid.

[88] S. Gadžo, *The Principle of 'Nexus' or 'Genuine Link' as a Keystone of International Income Tax Law: A Reappraisal*, (2018), 46, Intertax, Issue 3, pp. 194-209, https://kluwerlawonline.com/JournalArticle/Intertax/46.3/TAXI2018022. The author explains how personal and territorial nexus are universally recognised as international customs. In fact, customary law is identified when a norm is uniformly and consistently applied, and this practice is resulting from the conviction of the Countries that they are following an established rule. If the first part of the above written definition can be easily demonstrated with regard to nexus criteria, because the same provisions can be read in the various DTTs, the obligation to comply with the customary law must be searched in the domestic tax law of the States. The author finds that such obligation derives from the justification to tax of the Countries, and it is proven also by several judgements.

- personal link criterion, that is, the person itself (subject), as he is fiscally resident or is a citizen of the State, represents the link for the subordination to taxation of all the incomes he receives, regardless of the place where they were produced;
- territorial nexus criterion, i.e. the State has the right to tax the income (object) because the latter was produced here, or the good or person from which the income is derived is located in the territory of the State.

From this, it follows that taxable persons can be both resident and non-resident persons in the territory. For resident subjects, the taxation of their income is based on the worldwide taxation principle, while non-resident persons are taxed on the basis of the source principle[89]. The Italian legislation therefore admits different tax treatments for these two categories.

After the description of the various cases into which the taxable persons can be divided, I am going to expose the specific provisions for each, listing them in the following paragraphs.

2.1 Provisions for resident IRPEF subjects

According to article 2 TUIR, persons who are registered for most of the tax period in the registries of the resident population, or have their domicile or residence in the territory of the State in accordance with the civil code, are considered resident in Italy for tax purposes[90]. Those who, unless proven otherwise, have transferred their residence to a Country that is included in the list of low-tax countries reported in the *Gazzetta Ufficiale* are also considered fiscally resident in Italy[91].

Under international law, the residence nexus implies that all incomes, regardless of where they were produced, is taxed in the country of residence, in this case in Italy.

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[89] «*L'adozione del doppio criterio di prelievo, in base al cd. utile mondiale del soggetto ed alla territorialità della fonte del reddito, [è] espressione della sovranità dello Stato sui cittadini e sul territorio*» http://www.cortedicassazione.it/cassazione-resources/resources/cms/documents/TRIBUTARIA_rassegna_I_sem_2019.pdf p.89.

[90] «*Ai fini delle imposte sui redditi si considerano residenti le persone che per la maggior parte del periodo di imposta sono iscritte nelle anagrafi della popolazione residente o hanno nel territorio dello Stato il domicilio o la residenza ai sensi del codice civile*.» Art. 2, co. 2 TUIR.

[91] The d.m. 4 maggio 1999 provides a list of the Countries and territories with privileged taxation; this list was amended with d.m. 12 febbraio 2014, where San Marino was deleted from the list and now it is no more considered as a low-tax State to be monitored.

The natural person residing in Italy is required to pay the Personal Income Tax, *Imposta sul Reddito delle Persone Fisiche* (IRPEF).
IRPEF is a direct, personal and progressive tax, in which the total income is given by the sum of the incomes of each category explicitly indicated by the TUIR. That said, on the basis of this list, royalties received by a natural person can fall into two distinct categories: "others income" or "self-employment income". Art. 67 TUIR clarifies that the income deriving from the economic use of intellectual property, industrial patents and processes, formulas and information relating to experiences acquired in the industrial, commercial or scientific field must be classified under the category "Other income" [92]. When the beneficiary of the royalty is at the same time also the inventor or the author of the work, this income must be classified as "Self-employment income"[93]. This exception is explicitly contemplated in the above-mentioned art. 67[94].
The TUIR considers that only one part of the received royalty contributes to forming the total income. This result is obtained through flat rate reductions, which replace the possibility of apply subsequent deductions on the same income.
When the royalty is identified as "other income", the law recognises a reduction of 25% of the total amount[95].
When, on the other hand, the royalty is "self-employment income", it contributes to the overall income:

- 75% of the royalty if the author is over 35 years of age;
- 60% of the royalty if the author is under 35 years of age[96].

We must take into account that these flat rate reductions cannot be applied when the rights on the intangible asset had been received by inheritance or by donation. In this case, IRPEF is due on the entire amount of the royalty.
In conclusion, reductions are allowed only when the rights of exploitation have been purchased for consideration, because only in this case they replace the possibility to

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[92] «*I redditi derivanti dall'utilizzazione economica di opere dell'ingegno, di brevetti industriali e di processi, formule e informazioni relativi ad esperienze acquisite in campo industriale, commerciale o scientifico*» Art. 67, co. 1, lett. g), TUIR.
[93] Art. 53, co. 2, lett. b), TUIR.
[94] «*Salvo il disposto della lettera b) del comma 2 dell'articolo 53*», Art. 67, co. 1, lett. g), TUIR.
[95] Art. 71 TUIR.
[96] Art. 54, co. 8, TUIR.

subtract the expenses for the production of the income when calculating the taxable base[97].

Royalties can also be cashed in by a company without legal personality. In this case, the taxable income is calculated according to the rules of business income[98], but it is taxed when the profit is attributed to the shareholders, through the income tax return of the single shareholders. This income falls under the item "Business income". The royalties therefore do not appear separate from the profit, just as the deductions of costs are not recognised on a flat-rate basis.

2.2 Provisions for resident IRES subjects

Companies and entities that, for most of the tax period, have:

- The legal headquarter[99]
- Or the place of effective management
- Or the main business purpose

in the territory of the Italian State, are considered resident for IRES purposes[100].

The doctrine indicates that the place of effective management is the place where the directors meet and take decisions regarding the direction to be given to the company, that is, where the decisions relating to the management of the company are based in fact, regardless of where they are formalised[101].

By main business purpose, the law means the essential activity carried out by the company to directly achieve the primary objectives, indicated by the certificate of incorporation or by the statute of the enterprise[102]. If the certificate of incorporation or the statute are not in the form of a public instrument or an authenticated private deed,

[97] Art. 71, co. 1, TUIR: «*costituiscono reddito per l'ammontare percepito nel periodo di imposta, ridotto del 25 per cento* se i diritti *dalla cui utilizzazione derivano* sono stati acquistati a titolo oneroso».

[98] Art. 56 TUIR.

[99] As identified in the certificate of incorporation of the company.

[100] Art. 73, co. 3, TUIR.

[101] According to what is indicated in the sentenza of the Corte di Cassazione 7 febbraio 2013, n. 2869, the place of effective management «*si deve ritenere coincidente con quella di sede effettiva (di matrice civilistica) intesa come il luogo ove hanno svolgimento le attività amministrative e di direzione dell'ente e si convocano le assemblee e cioè il luogo deputato e stabilmente utilizzato per l'accertamento dei rapporti interni e con i terzi degli organi e degli uffici societari in vista del compimento degli affari e dell'impulso dell'attività dell'ente*». G. Turri, *La residenza delle società in Italia*, Dir. e Prat. Trib., 2019, 2, 908.

[102] Art. 73, co. 4, TUIR.

the main business purpose is determined based on the activity actually carried out by the entity[103]. Even the doctrine underlines that «the object of the business must be identified with the actual exercise of the economic activity envisaged by the business purpose or object»[104] and «reference must be made to the place where the company's activity actually takes place»[105].

The Italian resident company is required to pay the corporate income tax, *Imposta sui Redditi delle Società* (IRES). IRES is a direct and proportional tax. Article 77 TUIR specifies that this tax is calculated on the total net income of the taxable person and its rate is 24%[106].

The TUIR provides that the total income is «determined by adding to the profit or loss, resulting from the income statement related to the year ended in the tax period, the increases or decreases resulting from the application of the criteria established in the subsequent provisions of this section»[107]. In this case there are no flat rate deductions, like in the case of natural persons; however, only the expenses inherent in the production of the intangible asset can be deducted from the tax base, to the extent indicated in article 83 and following of the TUIR.

2.3 Provisions for non resident taxpayers (in the absence of double taxation treaties)

Even non-resident subjects, under Italian law, are subject to taxation, under certain conditions. For example, income from not self-employment carried out in Italy or dividends paid to foreign persons by Italian companies which are resident here, fall within the category of incomes that are taxable in Italy even if earned by non-residents[108]. The motivation behind this decision lies in the source principle of taxation, in which the taxable person is considered as such not because he has a personal

[103] Art. 73, co. 5, TUIR.
[104] G. Turri, *La residenza delle società in Italia*, Dir. e Prat. Trib., 2019, 2, 908.
[105] Ibid.
[106] Art. 77 TUIR.
[107] «*Il reddito complessivo è determinato apportando all'utile o alla perdita risultante dal conto economico, relativo all'esercizio chiuso nel periodo d'imposta, le variazioni in aumento o in diminuzione conseguenti all'applicazione dei criteri stabiliti nelle successive disposizioni della presente sezione*» Art. 83 TUIR.
[108] Art 23 TUIR.

connection with the Italian territory, but because he receives an income that was produced in Italy.

By the way, as regards royalties, the Italian legislation defines that if a non-resident receives «compensation for the use of [intangible assets] paid by the State, by subjects residing in the territory of the State or by permanent establishments in the territory itself, [these fees] are subject to taxation»[109].

In calculating the tax base, there are no differences between individuals and companies[110]. In both cases, a 25% flat rate reduction is applied to the royalty[111]. Please note that this reduction does not apply to those incomes that belong to "others income" if the exploitation rights have been acquired free of charge[112], as already explained in the previous paragraphs.

However, the tax collection takes place through a withholding tax[113]. Currently, Italian legislation, in the absence of treaties against double taxation [114], establishes a withholding tax of 30% on the royalties paid[115], applied to the taxable amount of such income, that is to say, to the 75% of the royalty when the rights have been acquired against payment, or to the 100% of the royalty if the latter have been acquired free of charge[116].

In conclusion, although the taxable person is the non-resident person, the resident person who pays the income acts as a withholding agent and fulfils the tax debt of the taxable person.

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[109] «*Si considerano prodotti nel territorio dello Stato, se corrisposti dallo Stato, da soggetti residenti nel territorio dello Stato o da stabili organizzazioni nel territorio stesso di soggetti non residenti: [...]compensi per l'utilizzazione di i compensi per l'utilizzazione di opere dell'ingegno, di brevetti industriali e di marchi d'impresa nonché di processi, formule e informazioni relativi ad esperienze acquisite nel campo industriale, commerciale o scientifico*». Art. 23, co. 2 lett. c), TUIR.

[110] There is also no distinction between limited companies and partnerships. In fact, art. 73 co. 1 letter d) says that *«[sono soggetti all'imposta sul reddito delle società] le società e gli enti di ogni tipo, compresi i trust, con o senza personalità giuridica, non residenti nel territorio dello Stato»*. In this way, any type of foreign company, whether it is transparent or not according to the foreign jurisdiction, is considered not-transparent for the Italian law.

[111] Circolare dell'Agenzia delle Entrate n. 47/E del 2 novembre.

[112] Ibid.

[113] Art. 25 d.p.r. 29 settembre 1973, n. 600.

[114] The provisions in the case of double taxation treaties will be described in the following chapters.

[115] Art. 25 d.p.r. 29 settembre 1973, n. 600: «*I compensi di cui all'articolo 23, comma 2, lettera c), del testo unico delle imposte sui redditi[...], corrisposti a non residenti sono soggetti ad una ritenuta del trenta per cento a titolo di imposta sulla parte imponibile del loro ammontare*.»

[116] Art 71 TUIR.

The latter gets rid of the obligation and is not required to declare the income to the Italian State. However, it is understood that he must declare all his incomes according to the legislation of the country in which he is resident and he must fulfil the specific tax obligations.

2.4 The tax treatment of royalties for the right to use movable property

The provisions for non-residents are not limited only to the above-mentioned cases.
In 2005 the *Agenzia delle Entrate*, the Italian revenue agency, following the provisions of Directive 2003/49/EC "Interest and Royalties Directive", issued the circolare n. 47/E/2005, where it is specified that, in addition to copyright, patents, trademarks and industrial processes, industrial, commercial or scientific equipment also produce royalties when granted to use.
This so-called movable property is not defined in the TUIR, so the circolare identifies them as assets «intended for carrying out a business activity (industrial, commercial or service activity)» [117].
Some examples include:

- machinery for the production of goods (industrial robots);
- containers;
- construction machinery (cranes, concrete mixers);
- agricultural machinery (tractors, threshers);
- vehicles for the transport of goods and people (cars, trains, planes, ships) [118].

If the fees for the use of this equipment are paid to non-residents, the law provides that a withholding tax of 30% is applied, as in other cases of royalties to non-residents. However, the tax base is identified with the entire amount of the royalty paid, without the possibility of having recognised deductions, neither flat-rate nor analytically[119]. The aforementioned withholding tax is applicable only when the income of non-resident taxable persons derives from the grant in use of movable property located in the territory of the Italian State. It is therefore not necessary, as in the case of royalties from intangibles, that the person who pays the income is resident in Italy; on the contrary, it

[117] Circolare dell'Agenzia delle Entrate n. 47/E del 2 novembre.
[118] Ibid.
[119] Art. 25 d.p.r. 29 settembre 1973, n. 600.

is the movable property, which is the object of the contract, that must be located in Italy[120].

If the fees paid for the use of these movable assets are instead collected by resident individuals, they are considered "Other income"[121]; alternatively they are "Business income" if collected by legal entities. Also in this case, the provisions on royalties concerning the flat rate reduction of the taxable sum do not apply.

2.5 The rules concerning trademarks

Art. 67 TUIR cites the following sources of royalties that contribute to the IRPEF tax base:

- intellectual works protected by copyright;
- patents;
- industrial design and models;
- know-how.

Interestingly, there is no mention of trademarks and the income they generate. Yet, indications about this were contained in the provisions of the d.p.r. 593/73, where art. 49 par. b reported: «income deriving from the economic use of trademarks and brands and from the economic use of intellectual works, industrial inventions et similia, when they are not earned in the exercise of commercial enterprises or by partnerships or by limited partnership» [are considered self-employment income][122].

So how are the proceeds from the granting of trademarks treated?

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[120] G. Corea, *Aspetti fiscali della concessione in uso degli "industrial, commercial, scientific equipments" e degli altri beni mobili*, Rass. Tributaria, 2003, 5. The author emphasises how the contracts that have as object the use of industrial, commercial and scientific equipment can be the most diverse types; this means that the contracts grant whatever type of use on the object, as far as this object is the abovementioned equipment. Thus, in Italy we can have the *noleggio, locazione, affitto, leasing*, that are different contracts under a juridical point of view, even if the purpose and rights granted are almost the same. The irony that is also highlighted by the author is that the payments are subject to the treatment of the royalties only when paid to entities residing outside Italy. This discipline is not transposed in the internal jurisdiction among Italian residents and it is not even required by the conventional law. As it will be also described in the next chapter, in the OECD model, payments for the use of this equipment do not generate royalties and Italy had to reserve the right to treat them as royalties in its bilateral treaties.

[121] Art. 67, co. 1, lett. h), TUIR.

[122] «*Sono inoltre redditi di lavoro autonomo: [...] i redditi derivanti dalla utilizzazione economica di marchi di fabbrica e di commercio e dalla utilizzazione economica di opere dell'ingegno, invenzioni industriali e simili, quando non sono conseguiti nell'esercizio di imprese commerciali o da società in nome collettivo e in accomandita semplice*». Ex art. 49 dpr 593/73.

It should be noted that the regulatory gap only concerns royalties that are received by a private individual, for the licensing of a trademark outside the business or self-employment activity[123]. In fact, there are no problems related to taxation when the beneficiary is a company that has to pay IRES.
The legislative gap has led to three different currents of thought in solving the problem. Part of the doctrine believes that it is correct to apply what was provided for in the former art. 49 par. b d.p.r. 593/73, a case no longer envisaged with the introduction of the TUIR[124]. Another part of the doctrine dissociates itself from this thought and believes on the contrary that it is not possible to apply an article that is no longer in force. In particular, this last current of thought is not univocal, because the doctrine is divided within: on the one hand there are those who consider the arising income not taxable, and on the other hand there are those who consider it taxable as "Other income"[125].
These three views are conflicting. As there is no legislation on this topic, the Italian Revenue Agency tacitly considered, in two different resolutions, the last solution as more correct, that is, to consider these royalties as "Other income"[126].
Part of the doctrine judges this solution acceptable, at least as long as the legislator does not explicitly intervene with a new law[127].

2.6 Tax concessions: the Patent Box regime

Since 2015, there has been an optional taxation regime in Italy aimed exclusively at business income, and that is called the "Patent Box", which allows for tax relief and tax benefits[128]. It was introduced with the l. 23 dicembre 2014, n. 190 (*Legge di Stabilità 2015*), by virtue of the preferential regimes that were widespread in other European countries[129].

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[123] G. Rebecca, M. Ceccon, *Concessione in licenza di un marchio da parte dei privati: quale trattamento fiscale?,* Il Fisco, n.17 2014.
[124] Ibid.
[125] Ibid.
[126] Risoluzione dell'11 marzo 2002, n. 81/E; risoluzione del 16 febbraio 2006 n. 30/E.
[127] G. Rebecca, M. Ceccon, *Concessione in licenza di un marchio da parte dei privati: quale trattamento fiscale?*, op. cit.
[128] https://www.mise.gov.it/index.php/it/incentivi/impresa/patent-box
[129] Despite the widespread use of Patent Box regimes in Europe, the question has arisen as to whether these tax exemptions are not only subsidies aimed at increasing research and development, but mainly State aid. The European Commission has specified that this incentive

According to the Italian Ministry of Economic Development, the objectives of the Patent Box are, other than following the European trend, the following:

- make the Italian environment attractive for the placement of intangible assets that are currently held abroad;
- discourage the transfer of intangibles abroad;
- support R&D activity in Italy[130].

Therefore, the goal of increasing Italy's tax competitiveness and attracting intangibles from other jurisdictions is not hidden.

The introduction of this preferential tax regime by Italy took place in a context in which, within the OECD, there was a discussion about the admissibility of the existing Patent Box regimes in the Member States[131]. The OECD report published in 2013, in fact, saw in Patent Box regimes an incentive for profit shifting that had to be stopped. Consequently, the introduction of the "modified nexus approach", a fundamental requirement in order to reduce the arbitrariness of the application of these benefits, was deemed necessary so to transform the Patent Boxes that are "against" an acceptable tax competition into "not harmful".

The Italian Patent Box regime has thus seen, over time, a reduction in the extent of the benefits granted due to the more stringent rules imposed by the recommendations against harmful tax competition, by the discipline against State aid of the European Union and by the Action 5 of the OECD[132].

At the present time, the Italian Patent Box regime consists of an exemption of up to 50% on incomes derived from the use of the following intangible assets:

- copyrighted software;
- industrial patents;
- know-how;

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does not constitute State aid because it is not limited to a single industrial sector, and thus the majority of companies can benefit from it. Furthermore, supporting research and development activities would make it possible to achieve the objectives set by the European Union in the "2020 strategy"; the aim of this strategy is to increase the research, development and innovation expenditure. In the Italian case, although the current exemption regime has the characteristics of "State aid", it is however acceptable for the European standards because «it can be applied as an exception to the prohibition of State aid, pursuant to the provisions of par. c), no. 3, art. 107 TFEU, as it is aimed at achieving development objectives of a horizontal nature».
A. Vicini Ronchetti, *Regole europee ed incentivi fiscali allo sviluppo dei brevetti: prime considerazioni sulla patent box*, Rass. Tributaria, 2016, 3, 671.

[130] Ibid.

[131] M. Greggi, *Patent Box (diritto tributario)*. (2017): 284-293.

[132] Ibid.

- industrial design and models[133].

The first version of the Patent Box also included trademarks in the list of intangibles, but since 2017 they are no longer counted, in order to meet the OECD requirements[134]. In fact, Action 5 of the BEPS Project, aimed at avoiding harmful tax competition between Countries, does not admit brands and trademarks among the eligible intangibles[135].

On the contrary, in Italy all incomes deriving from the use of know-how are eligible for the Patent Box regime, unlike what the OECD advises, where this is only allowed for small and medium enterprises[136].

Anyone who owns business income can take advantage of the benefits of the Patent Box regime[137], without restrictions on the use of these assets. The entrepreneur can, in fact, opt for the regime regardless of whether he is the owner of the asset or has granted its right of use[138].

Permanent establishments located in the Italian territory of entities resident in Countries that have signed an agreement with Italy against double taxation can also opt for this preferential regime[139].

If a company chooses to adopt the Patent Box regime, this option will be irrevocable and will be valid for 5, renewable, tax periods[140].

A basic feature that makes the Patent Box regime applicable is the existence of the "nexus approach", that is to say, there must be a correspondence between the eligible

[133] https://www.ipsoa.it/wkpedia/patent-box# .

[134] «*In senso più generale, l'Action 5 ha inteso affermare il principio secondo cui le agevolazioni fiscali - riconosciute in modo trasparente dall'Amministrazione finanziaria - devono attrarre attività reali e non semplici basi imponibili e essere destinate, come tali, a redditi che, qualunque sia la loro natura, derivino da* substantial activities *effettivamente esercitate dal contribuente. [...]Le richiamate caratteristiche del* nexus *non si "sposano" con la specificità dei marchi, che ordinariamente sono creati prima delle attività destinate a promuoverli e valorizzarli, rendendo più sfuggente il collegamento tra profitti agevolati e attività.*» T. Gasparri, *Marchi d'impresa esclusi dal Patent Box*, Fisco, 2017, 24, 2335.

[135] O.E.C.D., *Action 5: Agreement on modified nexus approach for IP regimes*, 2015.

[136] It is not a common practice that all large companies, even though they have the economic means, protect their discoveries through patents. On the contrary, sometimes they prefer to keep trade secrets when it is more in line with their corporate policy. Consequently, the fictitious subdivision made by the OECD (where only small and medium enterprises can take advantage of tax relief on know-how) is discriminatory towards large companies. T. Gasparri, *Marchi d'impresa esclusi dal Patent Box*, Fisco, 2017, 24, 2335.

[137] Therefore, subjects included in the category are IRES subjects, natural persons holding business income and partnerships with the exception of *società semplici*.

[138] https://www.mise.gov.it/index.php/it/incentivi/impresa/patent-box .

[139] https://www.agenziaentrate.gov.it/portale/web/guest/schede/agevolazioni/patent-box/cose-patent-box-imprese .

[140] https://www.mise.gov.it/index.php/it/incentivi/impresa/patent-box .

income deriving from the intangible and the costs incurred to produce it. It follows that the entity, in order to obtain the tax benefits, must have actually carried out a substantial activity in the Country. With this provision, the legislator prevents companies that deal exclusively with the sale and purchase of intangible assets, without them carrying out an actual activity in the territory or that aim only at reducing the tax base, from benefiting from the exemption[141].

The eligible income is calculated by multiplying the income derived from the direct or indirect use of intangibles and the nexus ratio. In turn, the nexus ratio is the ratio between «the expenses incurred for research and development activities in the reference tax period and the total ones, which derive from the sum of the costs indicated in the numerator and the expenses for the acquisition of the intangible asset»[142]. It follows that not all the income derived from the use of the intangible is also eligible for the Patent Box regime.

The tax relief for the company consists of the exclusion from the tax base of 50% of the income generated by the use of the aforementioned assets[143]; incomes that originated from the joint use of such intangibles are also included[144].

It is also possible to exclude from taxation 50% of the income derived from the sale of these intangible assets, but only if 90% of the proceeds are reinvested for the maintenance of or for the development of other intangible assets[145]. This operation, however, in order to be recognised within the scope of the Patent Box, must take place within two years following the sale of the asset[146].

[141] M. Greggi, *Patent Box (diritto tributario)*. (2017): 284-293. The author depicts the Italian Patent Box regime as a complex one, basically because it wants to provide for benefits and incentives for the taxable persons, but at the same time it must avoid that the taxable persons abuse of it. Such complexity is also supported by the particular framework in which the Patent Box regime was established. The author recognises the Spanish Patent Box as a successful regime, because the European Commission approved it. The Spanish regime is based more or less on the same premises of the Italian regime. In conclusion, the author says that the Italian patent box regime is in line with what the EU and the OECD say.

[142] A. Frediani, G. Sbaraglia. *Patent Box: possibile "autodeterminare" il reddito agevolabile*, Fisco, 2019, 29, 2840.

[143] https://www.mise.gov.it/index.php/it/incentivi/impresa/patent-box .

[144] Ibid.

[145] Ibid.

[146] Ibid.

CHAPTER 3: THE TAXATION OF ROYALTIES IN THE LAW OF TREATIES

To analyse how royalties are subject to taxation, it is necessary to take a look at the law of treaties.

International law is largely based on customs and bilateral agreements between States.

The different national laws and internal regulations have always caused a certain obstacle to the free circulation of goods and services. In addition, taxation always involves a reduction in the taxpayer's earnings, who does not find an incentive for foreign trade since the lack of tax harmonisation involves the payment of even more taxes.

To solve this situation and to facilitate trade, the States have set the goal of avoiding the double taxation of cross-border incomes, that is, to prevent that such incomes are taxed in both States.

The coexistence of the principle of territoriality and the worldwide taxation principle leads to the rise of double taxation on cross-border incomes, which can take the form of double juridical taxation, that is, when an income of a single taxable person is simultaneously taxed in two different jurisdictions, or double economic taxation, that is, when two taxable persons are subjected to taxation in two different Countries but on the same income[147]. However, the even greater concern for national administrations is to avoid that incomes are not taxed in any Country: the concomitance of some rules can in fact cause some incomes to escape from the necessary taxation.

In essence, the States enter into agreements, mostly bilateral, to bring order and establish shared policies regarding the taxation of cross-border incomes. However, since these treaties are the result of the decision of the contracting States, each agreement is unique in itself. Still, there is a model, drawn up by the Organization for Economic Cooperation and Development, which attempts to provide guidelines and solutions for international taxation, which the contracting States are free to follow or to negotiate individually.

Since 1963, the OECD has, in fact, tried to harmonise and facilitate the bilateral negotiations between States, so as to also create a more uniform international framework for the benefit of national administrations and taxable persons. The

[147] https://www.oecd.org/ctp/glossaryoftaxterms.htm#D .

reduction of double taxation has facilitated cross-border trade and investment. Estimates from the OECD reveal that, over the years, the model convention has led to the signing of over 3000 bilateral agreements, based on it and still in force[148], thus revealing its effectiveness. In fact, bilateral agreements usually require long months of negotiations, but having a model as a starting point considerably reduces the time and effort in entering into agreements[149].

3.1 The OECD model: definition of royalty

The OECD model is divided into 31 articles, concerning the different incomes that may arise and the related provisions. One article in particular is entirely dedicated to royalties, unlike the Italian law which does not reserve a single specific rule.

So, in Article 12, the OECD describes which incomes must be considered royalties, how they should be taxed and the exceptions to this article: «Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State»[150].

And then art. 12 continues with: «Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience»[151] are considered royalties and thus they fall within the scope of the aforementioned article.

So article 12 is aimed at the payments for the use, or the right to use:

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[148] https://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm .

[149] Although international law does not oblige to follow particular procedures for the formation and conclusion of international conventions, international practice has over time developed the following phases for the conclusion of treaties: negotiation, signature, ratification (and any subsequent accession of other States), entry into force of the treaty. The negotiation phase, which does not in itself create any legal constraint for the parties, is used to carry out the negotiations which, if successful, allow the drafting of the text of the agreement with the rules of the treaty. It may happen that the negotiation is conducted by various organs of the Contracting States, such as the plenipotentiaries supported by technical experts; the negotiations can take place directly between the parties or through an international conference or through an international organization. The goal is obviously to draw up a text on which the participants agree. The negotiation ends with the adoption of the text of the treaty.
D. Carreau, F. Marrella. *Diritto internazionale*. Giuffrè, 2016, p. 110-118.

[150] Art. 12, par.1, OECD Model Convention.

[151] Art. 12, par. 2, OECD Model Convention.

- copyrighted works;
- patents;
- trademarks;
- industrial designs and models;
- trade secrets;
- industrial, commercial and scientific know-how.

Further indications for the identification of incomes covered by this article can be found in the commentary provided by the OECD itself. The correct identification of such incomes is very important, because only in this way incomes subject to art. 12 can be distinguished from those falling within the business profit[152] or the capital gain[153].

The commentary, therefore, expands the above description by specifying first of all that it is not necessary that the sources of royalties must be recorded in public registers; an example of this is the know-how, which is not directly protected by any legal institution. Also, those payments obtained as compensation for fraudulent copying or infringement of the law fall within the scope of art. 12[154].

In addition, payments deriving from the use or the right to use granted exclusively to the licensee are considered royalties. However, if this exclusivity results in a mere exclusive distribution right, the fees are no longer royalties, they are instead business income. This is because the fundamental definition of royalty is no longer valid, as, we recall, the royalty is the payment aimed at compensating for *the use or right to use* the intangible asset in question[155].

To avoid any misunderstanding, payments for the use of a third party right that are not paid to the holder of the right cannot be included in the notion of royalty either [156]. In addition, payments in exchange for the full ownership of the asset itself are not royalties, given that even in this case it would no longer exist the «use or the right to use»[157].

Similarly, even those payments made for the development of designs or models are not considered royalties, because in this case they are comparable to remuneration for the provision of services. On the contrary, if these designs or models are completed, that is,

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[152] Art. 7, OECD Model Convention.
[153] Art. 13 OECD Model Convention.
[154] Commentaries on the articles of the model tax convention (condensed version), p. 222, §8.
[155] Ibid. p. 224, §10.1.
[156] Ibid. p. 222, §8.1.
[157] Ibid. p. 222, §8.2.

they are used by third parties without making changes, then in that case the payments made by the third users are royalties[158].

Fixed and variable payments for working of mineral deposits, sources or other natural resources are also not contemplated as subject to art. 12, because in this case they are regulated by art. 6 "Income from Immovable Property"[159].

Compared to what has been said so far, when Italy stipulates its international treaties, it adopts some suggestions of the model in a partially different way. For example, payments relating to exclusive distribution rights are not excluded from the beginning from the application of art. 12. By reading the agreements signed by Italy, it emerges that when these rights are granted together with other rights that involve the identification of a royalty, it is necessary to assess on a case-by-case basis and according to the circumstances whether or not these payments should fall within the scope of art. 12[160]. A different interpretation with respect to what is provided in the commentary can also be found when there is a partial transfer of the ownership of an element attributable to royalty. While the commentary excludes the application of art. 12, the Italian interpretation recognises instead its scope of application[161].

In addition to what has been described so far, below I will report the particular cases which the Commentary refers to and that are not then put into practice in the conventions signed by Italy. I will also report some cases that have not been expressly referred to when I dealt with the internal legislation: fees deriving from leasing contracts, know-how contracts, mixed contracts and digital instruments.

3.1.1 The case of leasing

The OECD commentary pays particular attention to the treatment of the fees received in a leasing contract. It was also established by a special commission within the Organization, the Committee on Fiscal Affairs, that these fees cannot be considered royalties, and therefore they must be assimilated, by their very nature, to business profits[162].

[158] Ibid. p. 224, §10.2 .
[159] Ibid. p. 231, §19.
[160] Commentaries on the articles of the model tax convention (condensed version), p. 234, §27.1.
[161] Ibid. p. 234, §31.2 .
[162] Ibid. p. 223, §9.

In practice, however, what is indicated by the OECD is not followed promptly by several Countries. In particular, Italy, in its bilateral treaties, reserves the right to consider royalties those payments deriving from the leasing of industrial, commercial or scientific equipment, and also the payments for container leasing[163].

Therefore, the analysis of the various double taxation treaties stipulated by Italy proves that, in reality, the leasing fees on these movable assets are equally subject to art. 12[164].

3.1.2 The know-how contract

Know-how is that set of knowledge and experience of commercial, industrial or scientific nature, used by the entrepreneur in his business and which is exclusive and secret, that is to say, it is not of public knowledge[165]. This knowledge entails a competitive advantage for the company and is not recorded in public registers, either by choice of the entrepreneur or because it does not have the characteristics to be filed as one of the categories of intellectual property rights indicated by the legislator.

Know-how can be the subject of two different types of contract: the transfer agreement or the license contract. With the transfer agreement, the transfer of know-how takes place on a definitive basis, while in the license agreement, only the use of the know-how is transferred for a certain period of time[166]. In both cases, we have an entity who allows to teach his exclusive knowledge and experience to the other party, provided that they remain secret, and which receives a payment as counter-performance. This consideration is identified as royalty.

The OECD commentary is concerned to give a clear answer to those contracts that can be confused for license of know-how. In fact, the resulting cash considerations could be ambiguously considered royalties, when in reality they are just payments for services[167].

Therefore, the characteristics that a know-how contract must possess to ensure that it falls within the scope of art. 12 are the following ones:

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[163] «[...] Italy reserve[s] the right to continue to include income derived from the leasing of industrial, commercial or scientific equipment and of containers in the definition of “royalties” as provided for in paragraph 2 of Article 12 of the 1977 Model Convention.» Commentaries on the articles of the model tax convention (condensed version), p. 236, §41.

[164] G. Corea, *Aspetti fiscali della concessione in uso degli "industrial, commercial, scientific equipments" e degli altri beni mobili*, Rass. Tributaria, 2003, 5.

[165] http://www.enciclopedia-juridica.com/it/d/know-how/know-how.htm .

[166] https://www.altalex.com/documents/altalexpedia/2018/03/20/know-how .

[167] They therefore fall within the scope of art. 7.

- the information that is transferred must exist when the contract is concluded, that is, the licensor already has this information and does not have to develop it later or through the contract;
- the information transferred must be kept secret;
- generally, in the know-how contract the role of the provider of the information is limited to its transmission, while in the case of the provision of services the supplier would have a much more active role, with greater profusion of costs[168].

3.1.3 The case of mixed contracts

As the name implies, a contract is defined as mixed contract when it groups together characteristics of different contracts, thus creating a new contract that is autonomous from its individual parts[169].

The classic example of mixed contract is the franchise agreement. In this case, the franchisor offers his knowledge and know-how together with technical assistance and, in some cases, also financial assistance and supply of goods.

In such situations, the advice provided by the OECD commentary is to try to appropriately divide the cash consideration, hence to attribute its right share to the various services contemplated by the contract, and so to be able to apply the correct taxation. For example, the parties can agree on the supply of raw material and consulting services, together with the exploitation of the brand. The consideration for the exploitation of the brand will be treated as royalty, while the payments for the supply of goods and consultancy will be business profits[170]. The parties can also agree on issuing different invoices for each specific payment identified in this way.

It is also true that, if a share thus identified is also the main purpose of the contract (suggesting that the remaining parts have far lower importance in the contract), this

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[168] The commentary gives the example of «salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services». It also identifies some payments that are undoubtedly made for the provision of services: payments for after-sales services; for technical assistance; for legal or technical/administrative advice of lawyers, engineers or accountants, and so on. Commentaries on the articles of the model tax convention, p. 225, §11.3 – §11.4.

[169] http://www.treccani.it/enciclopedia/contratti-misti-e-contratti-collegati/ .

[170] K. Holmes, *International Tax Aspects of Income Derived from the Supply of Intellectual Property: Royalties vs. Business Profits.* The International Taxation System. Springer, Boston, MA, 2002. 181-205. P. 201.

division is no longer necessary, and all the income deriving from the contract is subjected to the same tax treatment[171].

3.1.4 Software and other digital instruments

The rapid and continuous development of software and digital instruments entails some difficulty in establishing fixed rules when distinguishing business incomes from royalties[172].

The OECD itself has had to amend its classification criteria several times in recent years and the debate in the doctrine is still open[173].

Nevertheless, the OECD tries to bring order by substantially outlining the following four types of transfer of rights:

- complete or partial transfer of copyright;
- complete or partial transfer of rights of a program copy, both on physical and digital media;
- transfer of know-how or secret formulas related to the object of copyright;
- granting of distribution rights.

In the first case, royalties arise when partial rights on the object of copyright are acquired, with the consequence that there would be a copyright infringement if these rights had not previously been acquired[174]. The justification for this choice is based on the fact that the aforementioned payments are paid because the contractor has the right to use the copyright in the program, or otherwise the right to exploit rights that would be the sole prerogative of the copyright owner.

In the second case, if the acquired rights are used to enable the user to operate the program or to reproduce it, (i.e. the copying operation only serves to make the program work), the payments are not considered as royalties by the OECD; on the contrary, they fall into the category of commercial income and are therefore treated as business

[171] Commentaries on the articles of the model tax convention (condensed version), p. 226, §11.6.

[172] The difficulty in establishing a sure dividing line has increased above all with the spread of the internet and innovative technologies that have contributed to the creation of new corporate businesses, for which national and international legislators have not yet defined adequate standards. F. Antonacchio, *La distribuzione di software esteri nelle nuove prospettive OCSE sull'economia digitale*, Fisco, 2014, 26, 2585.

[173] Commentaries on the articles of the model tax convention (condensed version), p. 227 §12.

[174] Ibid. p. 228 §13.1.

income[175]. The commentary justifies the choice by considering how, basically, the operation in question is a normal distribution agreement, regardless of the fact that to obtain this it is necessary to possess certain rights so that there is no copyright infringement.

In the third case, conversely, we have the exception to what has been said so far, because in some cases the parties may decide to also transfer part of the know-how, i.e. algorithms or programming languages, making the resulting payments fall into the royalty category. This is possible when this know-how cannot be registered separately from the software and the contractor acquires its use or the right to use it[176].

Finally, in the fourth and last case, the transfer of the distribution rights on a software only, with the possibility therefore of distributing its copies but not of reproducing it, does not generate royalties, and the resulting income is part of the remuneration for company profits. In fact, however, Italy partially frees itself from what the commentary says, because it does not fully exclude the compensation for distribution rights from the scope of Article 12, but rather provides for a case-by-case analysis of all the circumstances and the rights granted, to finally establish the real nature of the income[177][178].

Although the contract underlying the relationship is referred to as a "license", the correct classification and taxation of these incomes is based on the purpose of the contract itself, rather than on its mere definition.

3.2 OECD model: the beneficial owner

Another important element for the application of art. 12 of the OECD model is to define who are the parties that take part in the contract.

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[175] Ibid. p. 228 § 14.

[176] Ibid. p. 229, § 14.3.

[177] Ibid. p. 235, §31.2 .

[178] The position taken by Italy was clarified in the risoluzione n. 128/E 3 aprile 2008 of the Revenue Agency. In the case examined, the foreign supplier transferred part of the copyright to the Italian customer, through a limited right to distribute the software to the public. In the absence of such a license, the commercialisation of computer software would have entailed a violation of copyright, because the right would otherwise have belonged exclusively to the owner of the copyright. The Revenue Agency explicitly considered the remuneration paid to the owner of the intangible as royalty.
F. Antonacchio, *La distribuzione di software esteri nelle nuove prospettive OCSE sull'economia digitale*, Fisco, 2014, 26, 2585.

Recalling that the royalty is the payment made for the benefit of the counterparty for the granting of the economic use of an intangible, it would seem irrelevant to further specify who the counterparties are and their role when the income is taxed. Unfortunately, however, many entities have abused in the past the double taxation treaties to enjoy tax advantages. This has resulted in certain entities interposing companies with the sole purpose of obtaining tax benefits deriving from a conventional regime otherwise not due. To deal with this situation, since the 1940s some treaties and agreements provided for the figure of the beneficial owner as an anti-abuse method[179]. This clause was included in the OECD model only with its revision in 1977[180][181], and today it can be found, in addition to article 12, also in articles 10 and 11[182]. Nonetheless, the commentary does not clearly and unequivocally describe from the international point of view who the beneficial owner is, rather it literally says that «the term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance»[183].

In the past, the concept of beneficial owner has been widely debated in the doctrine, but even today, if you want to apply it to the practical case, it is necessary to look at the jurisprudence of the individual Countries[184]. The difficulty lies in the fact that in the

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[179] P. Baker, "Beneficial ownership: after Indofood." *GITC review* 6.1 (2007). The author remarks how the meaning of the beneficial owner shall be wide. In fact, if this clause is an anti-avoidance clause, it is questioned to which extent the benefits of the double taxation treaties can be denied. The paradox can be to deny the benefit of the DTT only because the dividends are distributed to shareholders resident in third countries. The author recalls the Indofood case and its consequences for existing tax structures. In fact, the Indofood case had a big impact also outside the parties involved because it was the first real case discussed by a court in which the meaning of beneficial owner was asked. Although the judgment had some bad aspects, overall it was a good basis, in the author's point of view, because it gave the beneficial owner an international meaning.

[180] Model Tax Convention on Income and on Capital 2017 (Full Version), section C-12, p. 785.

[181] The initiative of inserting the beneficial owner clause came from the United Kingdom, so to prevent abuse of the Convention.

J. Gooijer, (2014). Beneficial Owner: judicial variety in interpretation counteracted by the 2012 OECD proposals?. Intertax, 42(4), 204-217.

[182] Article 10 of the OECD model deals with dividends, while article 11 deals with interest.

[183] Commentaries on the articles of the model tax convention (condensed version), p. 220 §4.

[184] A. Righini expresses the following concept: «*La giurisprudenza delle varie Corti straniere potrebbe infatti tracciare un filone interpretativo uniforme in grado di definire finalmente con maggior certezza la nozione di beneficiario effettivo nelle Convenzioni internazionali*» and also: «*la dottrina ha evidenziato come le interpretazioni sviluppate dalla giurisprudenza e dalla prassi internazionale contribuiscono in maniera determinante alla formazione di un* international tax language *che conduca ad un'interpretazione uniforme delle norme di diritto*

international context there are two legal systems, the civil law system and the common law system, which think differently. For example, common law Countries do distinguish the legal owner from the beneficial owner, while this distinction does not exist in civil law countries. Many scholars have investigated the question and tried to explain otherwise irreconcilable concepts in a unitary way. Research has shown that, basically, both civil law and common law countries consider the problem of the beneficial owner as a legal issue that involves the research of the nature of the rights possessed by the parties involved[185]. Similarly, if we think of Jiménez's conclusions, the beneficial owner is a purely legal anti-avoidance concept and it is not necessary to resort to economic theories and explanations[186].

But what does the OECD model provide? «Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State»[187]. So the OECD suggests that art. 12 is applicable only when the royalty is paid to the beneficial owner resident in the other Contracting State; the beneficial owner is the person or company that receives the royalty flows, effectively exercises the powers of dominion and control on them and has the right to use and dispose of the royalties received[188]. The beneficial owner must demonstrate that he can

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internazionale. Sul punto si veda Vogel, Prokisch, General report, in Cahiers, vol. LXXVIIIa, 1993; Van Raad, International coordination of tax treaty interpretation and application, in Intertax, 2001, p. 212.» http://www.studiorighini.it/public/file/pubbl41-1308.pdf .

[185] C. P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties*. Amsterdam: I (chapter 4), 1999.

[186] A. Martín Jiménez, "Beneficial ownership: current trends." *World Tax Journal* (2010). The author tries to analyse the true meaning of the concept of beneficial ownership through judgements of several courts (Spanish, Swiss, English, French and Canadian courts). From these judgements, the author found out that the majority of the courts assigns an anti-avoidance role to the concept of beneficial ownership. Only the Canadian jurisdiction considers the beneficial ownership an attribution-of-income rule. However, the author argues that the beneficial ownership clause shall not be a general anti-avoidance rule, that is, the judge shall not apply a substance-over-form test, test that is used in most cases when applying the anti-avoidance clauses. Thus, all those economic aspects that are considered when finding the beneficial owner must be left aside. This is why the author remarks that «beneficial ownership is a legal issue», and also that it is sufficient a «legal interpretation»: he says that it is sufficient to analyse the legal relations between the parties and so to resolve a dispute. The author concludes that the true meaning of the beneficial ownership is to be a tool that attributes the income («which determines who the person is that should be taxed» and «it had more to do with an analysis of legal substance of ownership than with a clause aimed at finding the economic owner of dividends, interest or royalties»), while other internal anti-avoidance rules assist it if it is a matter of tax avoidance.

[187] Art. 12, par. 1 OECD Model Convention.

[188] http://www.diritto24.ilsole24ore.com/art/dirittoCivile/2019-01-25/la-corte-cassazione-clausola-pattizia-beneficiario-effettivo-oneri-probatori-rafforzati-103057.php .

enjoy and/or dispose of the royalties as he sees fit, without contractual obligations. In other words, the beneficial owner:

- holds the most intense right of control over the intangible;
- has the right to receive what arises from the intangible (royalties);
- actually bears the costs arising from the intangible, such as the risk that the intangible will lose value[189].

To identify the beneficial owner, two different approaches can be used[190].

The first approach is the legal one, in which the legal relationships between the parties are highlighted. This approach makes possible to identify any underlying contract such that the entity that receives the royalties is contractually obliged to entirely transfer them to a third party, thus being unable to enjoy or dispose of them.

The second approach is the economic one, based on the doctrine of “substance over form”, which instead, analyses the economic relations, facts and circumstances between the parties, so as to understand the real economic nature of the transaction.

It shall be pointed out that, although the economic approach does not always help to identify who the beneficial owner is, this method is used in most cases to settle disputes. Therefore, it is hoped that the concept of beneficial owner is not a simple opposition between legal and economic nature, but should instead be sought by combining the two approaches[191]: the legal approach is useful when, with this approach, the attribution of rights to assets or incomes is clear; the economic approach is useful in all those cases where direct attribution is difficult to apply and the concepts of enjoyment, use or utility on income are analysed in practice[192].

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[189] F. Antonacchio, *Royalties corrisposte a soggetti non residenti per lo sfruttamento dei diritti di proprietà intellettuale,* Fisco, 2011, 28 - parte 1, 4466.

[190] M. Bargagli, *Il regime fiscale delle royalties tra normativa interna e trattati internazionali sulle doppie imposizioni. Riflessioni sul Treaty Shopping*, Fiscalità Internazionale, 4/2008, p. 299.

[191] «Interestingly, the hybrid approach advanced in this article is not necessarily a novel conceptualization, but rather a recognition of the practice already applied in many countries vociferously adhering to the economic approach». A. Wardzynski, "The 2014 Update to the OECD Commentary: A Targeted Hybrid Approach to Beneficial Ownership." *Intertax* 43.2 (2015): 179-191.

[192] M. Kotlyarov, *The Concept of Beneficial Ownership in the OECD Model Tax Convention 2010: A Critical Analysis.* Yekaterinburg, 2015. The author says that OECD has made some progress in defining who the beneficial owner is, like for example by accepting some economic aspects of it or by saying that it must be an international concept not limited to a domestic interpretation, but in any case it fails in providing further (and necessary) interpretation. The author does not believe that the legal and economic aspects of beneficial ownership are so incompatible, and recognises that the economic aspect is important when resolving a case law. Moreover, he acknowledges the meaning of beneficial ownership as an anti-avoidance

However, there are cases, as explained in the Commentary, in which the subjects cannot in any case be considered beneficial owners. These entities are:

- the conduit companies;
- the agents;
- the nominees.

The commentary, by citing the report of the Committee on Fiscal Affairs, justifies this choice by recognising the fact that these companies usually have limited powers over the income received and act as a simple fiduciary or administrator on behalf of the interested parties[193]. They do not therefore have the full right to use and enjoy the royalties collected, but rather the only power they have over them is limited to the transfer of said incomes to another entity[194].

The Commentary, however, adds in the next paragraph that it is possible for agents and nominees to benefit from the provisions of art. 12 if the beneficial owner is resident in the other Contracting State; this clarification is freely left to be clarified in the specific bilateral negotiations[195].

3.2.1 The look through approach

If in a dispute it is highlighted that the recipient of royalties is not also the beneficial owner, it is not possible to apply the conventional rules between the contracting States relating to cross-border royalty flows. It follows that the "ordinary" rules must be applied, i.e., in the case of royalties coming from Italy, it is necessary to apply the 30% withholding tax, as seen in the previous chapter.

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technique. In fact, even from the analysis of the OECD text, it can be seen how the beneficial owner clause prevents the entity that is not the beneficial owner to access the benefits of the double taxation treaty. The author also recognises that it is not always possible to identify the beneficial owner only through legal tests, but it is necessary to perform a substance-over-form test, although the latter has not yet been fully developed by the OECD nor the doctrine. In conclusion, the author argues how the best method to identify the beneficial owner must be a combination of legal and economic approaches; he finds that the ultimate feature of the beneficial owner is bearing the risk of possessing the income or the asset from which the income is generated.

[193] «For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties», Commentaries on the articles of the model tax convention (condensed version), p. 221 §4.1 .

[194] Journal of Economic and Financial Sciences | JEF | April 2015 8(1), pp. 281-304.

[195] Commentaries on the articles of the model tax convention (condensed version), p. 221 §4.2.

However, recent jurisprudence[196] and practice[197] have indicated a further solution, that is considered more coherent by a part of the doctrine. This solution is called the "look through approach".
This principle consists in applying the principle of substance over form, i.e. by analysing the substance of the relationship between the parties that arose at the time of the payment of royalties. If, for example, company Alpha pays royalties to Beta, which in turn transfers them to Gamma (the beneficial owner), the look through approach would allow the application of the most favourable tax regime between companies Alpha and Gamma, thus excluding the intermediate step through Beta. In essence, it is correct to apply the more favourable rules contained in the double taxation treaty between the States of residence of Alpha and Gamma, if it exists.
The solution adopted is consistent with the very principle of beneficial owner, as this clause aims to prevent an undue tax advantage. However, this does not limit the possibility of applying a more favourable rule contained in a different agreement against double taxation, when it is found that the flow of royalties has only been "diverted" to a company which was established with the sole purpose of obtaining a tax advantage[198].

3.3 OECD model: the permanent establishment

The concept of permanent establishment is very important in the international scenario, because it allows to establish when a subject must be taxed in a Country even if he is not resident there [199]. According to what is reported in art. 5 of the OECD Model Convention, the permanent establishment is the «fixed place of business through which the business of an enterprise is wholly or partly carried on» [200]. This fixed place represents the link that gives to the State the right to tax the income of foreign subjects arising in its jurisdiction according to the source principle.

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[196] Sentenza 11 febbraio 2010, n. 14, Torino.
[197] Risoluzione ministeriale 7 maggio 1987, n. 12/431, risoluzione dell'Agenzia delle entrate n. 86/E/2006.
[198] G. Formica, P. Formica. *Le ritenute in uscita su interessi e canoni: la nozione di beneficiario effettivo e l'approccio look through*, Fisco, 2017, 10, 955.
[199] P. Consiglio e A. Nuzzolo, *La nozione di stabile organizzazione nel nuovo TUIR: analogie e differenze con il modello OCSE e con le convenzioni contro le doppie imposizioni stipulate dall'Italia*, Fisco, 2004, 33 - parte 1, 5120.
[200] Art. 5, par. 1, OECD Model Convention.

The permanent establishment can be identified in a material permanent establishment, such as a branch, office or factory[201]; or in a personal permanent establishment, i.e. an agent acting on behalf of the parent company[202]. The activity carried out by the fixed place of business must not result in mere preparatory, auxiliary or storage activities, unless these activities are related to the core business of the parent company[203].

Therefore, in the event that the presence of a permanent establishment on the national territory is ascertained, it is necessary to analyse whether the conditions to be able to apply art. 12 of the OECD Model on the royalties paid are still in place.

In fact, paragraph 3 of art. 12 says that, in the source Country, royalties are taxable *as part of the profits* of the permanent establishment, owned there by the beneficial owner who is instead resident in the other Contracting State, if they are paid in respect of the rights or property that is part of the assets of the permanent establishment or actually connected with that permanent establishment[204]. It follows that the provisions of art. 12 shall not apply.

To ensure that avoidance practices are not implemented[205], paragraph 21 of the OECD commentary specifies that, to be defined as permanent establishment:

- the permanent establishment must be used to carry out the company business;
- the flow of royalties received must be effectively connected to this permanent establishment, that is, its attribution must not be a mere accounting entry[206].

The *Attribution of Profits to Permanent Establishments* report cites the salient principles thanks to which this economic attribution can be identified: it is necessary to consider whether the rights and properties relating to the permanent establishment are comparable to the rights and properties of a separate and autonomous company[207][208]. If

[201] Ibid., par. 2.
[202] Ibid., par. 5.
[203] Ibid., par. 4.
[204] Art. 12, par. 3, OECD Model Convention.
[205] It can happen both the case in which income attributable to the permanent establishment is not recognised as such because in this way the more favourable tax of the international treaty is applied, and the opposite case of income unduly assigned to the permanent establishment so as to benefit from a more favourable internal taxation.
[206] Commentaries on the articles of the model tax convention (condensed version), P. 232 §21.
[207] OECD, *Attribution of Profits to Permanent Establishments*, Paris, 2010.
[208] I specify that the method use for attributing the income of the permanent establishment is defined as the “functionally separate entity approach” and has been recognised as the only method applicable in the Model convention after the publication of *Action 7 - final report* in 2015. The income components deriving from transactions with the parent company or other group entities are determined through transfer pricing.

this is the case, i.e. the company resident in a Contracting State carries out business activities wholly or partly through a fixed office in the other State, then we are in the presence of a permanent establishment[209] and all the income related to it is subject to art. 7 OECD model[210]. Consequently, such attributable incomes, identified by considering the permanent establishment as if it were an enterprise independent from the parent company, which carries out the same or similar activities under the same conditions, can be taxed in the source State[211].

In summary, therefore, in the case of a permanent establishment set out here, we have the following situation: the entity residing in a Contracting State pays royalties to a company residing in the other Contracting State. At the same time, however, the latter company has a permanent establishment in the Country where the entity paying the royalties is resident. If it is proved that the money flows are economically linked to the permanent establishment, that is, they are paid to rights or properties that form part of the PE's assets, then such royalties escape the application of art. 12 and can therefore be taxed in the source State, following the rules provided for in Article 7[212].

3.4 The solution chosen by the States: the withholding tax

The OECD's suggestion to tax the royalty exclusively in the recipient's Country of residence is however adopted in a small number of bilateral agreements[213]. In fact, the taxation of the fee only in the State of residence could favour elusive behaviour, so many States still reserve the right to impose a withholding tax. This withholding tax varies from agreement to agreement and usually provides for a lower percentage than the usual taxation in the source State. For example, Italian legislation provides, in the

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O. Salvini, *La nuova definizione di stabile organizzazione nel Beps*, Rass. Tributaria, 2016, 1, 67.

[209] Art. 5, par. 1 OECD Model Convention, with the following limitations and exceptions.

[210] «Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.» Art. 7, par. 2 OECD Model Convention.

[211] Art. 7, par. 1 OECD Model Convention.

[212] Commentaries on the articles of the model tax convention (condensed version), p. 232 §21.1.

[213] For example, the bilateral agreements signed by Italy with Cyprus, Ireland and Hungary.

absence of treaties, a 30% withholding tax on the taxable income[214]. Instead, in the bilateral agreement signed with Japan, this percentage is reduced to 10% of the gross amount of the royalty[215]. Or, in the case of the treaty between Italy and Germany, it is established that the withholding tax cannot exceed 5% of the gross royalty when the recipient is also the beneficial owner[216].

If the royalties are taxed both in the State of residence and in the source State, the State of residence may establish unilateral measures to mitigate double taxation, such as the tax credit or the tax exemption.

Italy, for example, has adopted the tax credit method as a solution to double taxation, and its discipline is governed by art. 165 TUIR[217]. The tax credit is applicable only for incomes produced abroad, which contribute to the formation of the total Italian tax base and on which the foreign tax has definitively been paid[218]. The maximum amount of foreign tax paid that can be deducted from the Italian tax base is given by the share of Italian tax corresponding to the ratio of foreign income and total income net of previous losses[219]. The results of this calculation can be two, and are the following ones:

- if the tax paid abroad is lower than the tax that should have been paid in Italy on the foreign income, the entire amount of foreign tax can be deducted;
- if the tax paid abroad is instead higher than the one which would have been paid in Italy, it is possible to deduct at most only what would have had to be paid in Italy; what has been paid in excess will not be deductible.

3.5 The UN model

The model convention provided by the OECD is not the only document developed to be used in the agreements against double taxation. Since 1979, the UN has also been

[214] The 30% withholding tax is applied on a residual basis, i.e. if the case does not fall under any treaty stipulated by Italy, nor in the case of the "Interest and royalties" directive.
[215] Convention between the Republic of Italy and Japan (1969).
[216] L. 24 novembre 1992, n. 459 "Convention between the Federal Republic of Germany and the Republic of Italy".
[217] Circolare n. 9/E, 5 marzo 2015, Agenzia delle Entrate
[218] Ibid. p. 7
[219] Art. 165, par. 1, TUIR; Circolare n. 9/E, 5 marzo 2015, Agenzia delle Entrate.
The formula deduced from the TUIR is the following:

$$\frac{Foreign\ income}{Total\ net\ income} \times Italian\ gross\ tax\ .$$

This formula can also be expressed as:

$$Foreign\ income \times Italian\ tax\ rate.$$

providing its version of rules against international double taxation. This is because, since the Paris Conference on International Economic Cooperation in 1963, the Organization has found that the flows of investments and private capital also aid to the process of economic development; unfortunately these flows can be directly and indirectly hindered precisely by the double taxation[220]. Therefore, thanks to its model, the UN intends to focus on the relations between industrialised Countries and developing Countries, so to ensure that, through bilateral agreements, the sacrifices that result from giving up part of the taxation are shared equally among the States[221]. In its original formulation, the Committee responsible for drafting the UN model took into account the commentary previously developed by the OECD, but it avoided considering it the only interpretation for the new model that was under development within the UN[222]. The result was a model that balanced the residence principle with the source principle, thus giving greater importance to the source principle than what the OECD model established[223]. The goal was to tax the net tax base by applying a rate that would not compromise foreign investments and at the same time that would let the Country, from which the investments originated, participate in the profits. The UN model allows for the use of tax credit and tax exemption to overcome the problem of double taxation[224].

Even the UN model dedicates an article entirely to the taxation of royalties, art. 12 like in the OECD model. By reading it, we also realise that the content is not that different. For example, the UN model recommends the imposition of royalties in the State of residence of the person who receives them[225], or, when defining the concept of royalty, it uses the same words as the OECD model, albeit with minimal different elements[226].

But contrary to the provisions of the OECD model, art. 12 of the UN model in the first paragraph indicates that royalties *may* be taxed in the State of residence when they *are paid* to a person residing in the other Contracting State. Furthermore, it does not state that these royalties must necessarily be taxable exclusively in the recipient's State of

[220] UNO, "*United Nations Model Double Taxation Convention between Developed and Developing Countries*" p. VI.
[221] Ibid.
[222] Ibid. p. X .
[223] Ibid. pp. XIII-XIV.
[224] Ibid.
[225] Art. 12, par. 1, *United Nations Model Double Taxation Convention between Developed and Developing Countries.*
[226] Art. 12, par. 3, UN Model Double Taxation Convention.

residence. In the second paragraph we find the first major difference with respect to the tax treatment reserved in the OECD model: source taxation is also allowed, but in the event that the consideration is paid to the beneficial owner resident in the other Contracting State, the withholding tax must not exceed a maximum percentage, established by mutual agreement of the Contracting States[227].

As in the OECD model, the UN model also exempts from the application of art. 12 the royalty economically linked to the permanent establishment located in the same Contracting State of the person making the payment[228]. It also adds this exemption for the royalties deriving from those activities carried out outside this permanent establishment[229], thus establishing a broader force of attraction rule on the incomes for the source State[230].

Art. 12 also deals with the reverse case, i.e. when it is necessary to identify the source State where the royalty arises. Generally, the source State is defined as the Country where the person paying the royalty is resident. If, on the other hand, the person who pays the royalty owns a permanent establishment in a Contracting State and the use of the intangible occurs only in this permanent establishment, the Country where the permanent establishment is located is considered the source State[231]. In this case, the so-called “place of use” rule is applied[232].

However, the application of these concepts can still lead to double taxation. Let’s see an example[233]:

- Company XX, resident in Country X, has a permanent establishment in Country Z.
- Company XX acquires the right to exploit an intangible from company YY resident in State Y, and pays royalties to it. At the same time, XX uses the intangible exclusively in its permanent establishment in Z.
- States X, Y and Z have entered into agreements against double taxation, with each other, on the basis of the UN model.

[227] Art. 12, par. 2, UN Model Double Taxation Convention.
[228] Art. 12, par. 4, UN Model Double Taxation Convention.
[229] UNO, “*United Nations Model Double Taxation Convention between Developed and Developing Countries*”, p. 195.
[230] Ibid. p. 97 .
[231] Art. 12, par. 5, UN Model Double Taxation Convention.
[232] UNO, “*United Nations Model Double Taxation Convention between Developed and Developing Countries*”, p. 196.
[233] UNO, “*Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties*”, p. 80-81.

Since the royalty is paid by XX, it is correct to assume that State X is the source State and therefore it has the right to tax the income.
Equally, State Z is also considered the source State, because the intangible is used in its territory and Z has therefore the right to tax the income.
This case leads to source double taxation and the UN model do not provide any way to eliminate it. It is therefore necessary that the dispute is resolved with specific provisions in the individual international agreements, as suggested by the UN itself[234].

[234] Ibid. p. 81.

CHAPTER 4: THE TAXATION OF ROYALTIES IN THE EUROPEAN LAW

Speaking of the taxation of royalties, one cannot overlook the European scenario, of which Italy is part.

Despite the intentions of the European Union, the harmonisation of direct taxation between the States of the Union has not yet been achieved[235], therefore each individual Country establishes its own rules and rates regarding the taxation of royalties, both national and transnational. In addition, the individual Member States have stipulated agreements against double taxation among themselves, and this entails further specific provisions, increasing the fragmentation of the European scenario.

But the European Union hopes for a more uniform scenario so to create a common internal market[236]; for this reason it has over time issued directives that could outline a homogeneous thought, while respecting the autonomous implementation of the individual Member Countries. Unfortunately, however, the legislative bodies of the Union have not yet found an organic solution to the problem of double taxation of royalties in the European scenario. The only attempt in this regard was Directive 2003/49/EC, subsequently referred to as the "Interest and Royalties directive". Contrary to what the OECD and UN models provide, this directive cannot be applied in all cases of double taxation on interest and royalties, but only in specific law's hypothetical base-situations. In particular, with this directive, the EU has only solved the problem of double taxation for associated companies. For this reason we can say that the directive 2003/49/EC is effective in a more restricted area than the OECD and UN models.

The transposition in the Italian jurisdiction of the European directive took place with the d.lgs. 30 maggio 2005, n. 143.

[235] M. Poulsen, "Treaty/directive shopping and abuse of EU law." *Intertax* 41.4 (2013): 230-251.

[236] https://europa.eu/european-union/topics/single-market_it .

4.1 The provisions of the "Interest and Royalties" directive

In 2003, the Council of the European Union decided to resolve the issue of double taxation of interest and royalties between companies belonging to the same group and, at the same time, resident in different Countries of the European Union.

The EU institutional bodies had in fact noted that the flow of interest and royalties between associated companies located in several States of the Union was considerable. Furthermore, there was the will to create a single common market. The combination of these two factors made it necessary to remove the double taxation on such incomes. This tax burden was in fact considered an unfair disadvantage towards those payments that were instead paid between residents of a single State, where simply the debtor deducted the cost of the royalty and the income was attributed to the creditor[237].

The directive therefore adopted the solution to permanently remove source taxation. Consequently, it is established that interest and royalty incomes are taxable only in the Country of residence of the company that receives them[238].

As a result, we are witnessing a shift of tax revenue to the benefit of capital and technology exporting Countries[239].

To take advantage of this tax concession, both the income and the individuals involved must possess certain characteristics:

- The entity receiving the consideration must be the beneficial owner;
- The consideration must be taxable both in the source State and in the residence State.

First of all, such incomes must necessarily be paid to the beneficial owner, to shun the possibility of tax avoidance[240]. Indeed, agents, trustees or other authorised signatories, who only act as intermediaries between the company that pays the royalty and the beneficial owner, cannot be given the preferential treatment granted by the directive[241].

The directive considers royalties the compensation deriving from the use, or the right to use, intangible assets, therefore patents, trademarks, designs, models, know-how,

[237] http://www.assonime.it/_layouts/15/Assonime.CustomAction/GetPdfToUrl.aspx?PathPdf=http://www.assonime.it/attivita-editoriale/studi/Documents/NS%2010-2020.pdf p. 10.

[238] Art. 1, par. 1, directive 2003/49/EC.

[239] N. Montuori e E. Vial, *Prime riflessioni sullo schema di decreto attuativo della direttiva interessi e royalties n. 2003/49/CE*, Fisco, 2005, 31 - parte 1, 4845.

[240] Art. 1, par. 1, directive 2003/49/EC.

[241] Art. 1, par. 4, directive 2003/49/EC.

software and copyrighted works[242]. This definition also includes fees for the use, or the right to use, industrial, commercial or scientific equipment[243].

The directive does not exclude, however, that additional rules can be applied in the national laws of the source States to prevent tax evasion or tax avoidance. Indeed, in the event of abuse, it authorises individual Countries not to apply the provisions contained in the directive itself[244].

4.2 "Interest and royalties" directive: the beneficiaries

Not all subjects who pay or receive royalties can also take advantage of the preferential regime indicated in the directive. The beneficiary entities must necessarily possess the following characteristics:

- They must be associated companies or permanent establishments;
- They must be resident in two different Countries of the EU;
- They must have been associated for at least two years.

With regard to the first bullet point, the directive can only be applied if the beneficial owner and the entity who pays the income are associated companies, or belong to the same group[245]. It can also be applied when said incomes come from permanent establishments and are directed towards a company or towards other permanent establishments of the same group[246]. If the royalties are paid by a permanent establishment, it is also necessary that they are recognised as tax deductible expenses; therefore it is not sufficient that the payment is attributed to the permanent establishment for accounting purposes only, but it must actually be linked to the activity of the permanent establishment[247].

For the second bullet point, both parties involved in the transaction must be resident in different States, but still part of the European Union[248]. The directive is only for the benefit of European companies, not for every enterprise in the world.

[242] Art. 2, lett. b), directive 2003/49/EC.
[243] Ibid.
[244] Art. 5 directive 2003/49/EC.
[245] Art. 1, par. 7, directive 2003/49/EC.
[246] Ibid.
[247] Art. 1, par. 3, directive 2003/49/EC.
[248] Art. 1, par. 8, directive 2003/49/EC.

Finally, to take advantage of the preferential regime provided by the directive, the entities in question must have been part of the same group continuously for at least 2 years[249].

But how is it possible to determine if two companies are associated? The existence of a holding by a company in the other company is verified, that is, if the first company has a majority stake in the share capital of the second or if it can impose its decisions in the ordinary meeting[250].

What is written in the directive is the following thought. For a company, to be recognised as associated with another company, it must have one of the following characteristics:

- The company has a direct minimum holding of 25% in the capital of the other company; the company that owns this stake can be both the company that receives the payment and the company that makes it, or, when the income comes from or is directed to a permanent establishment, that company has a direct stake in that permanent establishment[251];
- A third company with respect to the two companies under examination has a direct holding of at least 25% in the capital of both companies under investigation[252].

In the latter case, however, the text of the directive states the following: «holdings must involve only companies resident in Community territory»[253]. The sentence thus formulated, considering only holdings and not holding relationships, would therefore not exclude that the third company is resident outside the European Union[254].

However, the directive allows Member States, upon transposition of the directive in their internal legislation, to replace the criterion of minimum holding in the capital with the criterion of the minimum holding of voting rights[255].

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[249] Art. 1, par. 10, directive 2003/49/EC.

[250] https://www.brocardi.it/dizionario/3536.html .

[251] Art. 3, lett. b), par. i) and ii) directive 2003/49/EC.

[252] Ibid. par. iii).

[253] Ibid.

[254] It is noted by Montuori and Vial that the English text of the directive is clearer than the Italian version in this sense, because it only indicates that «holdings must involve only companies resident in Community territory». In the Italian translation of the directive it can be read «*Le partecipazioni devono comprendere soltanto le società residenti nel territorio della Comunità*», that can imply different interpretations. N. Montuori e E. Vial, *Prime riflessioni sullo schema di decreto attuativo della direttiva interessi e royalties n. 2003/49/CE*, Fisco, 2005, 31 - parte 1, 4845.

[255] Ibid.

In addition to the aforementioned mandatory characteristics, companies must necessarily be subjected to a tax regime as indicated in the text of the directive, or in any case corresponding to the corporate income taxation[256]. In the case of Italy, therefore, companies subject to IRES fall within this definition, namely «joint-stock companies, *società in accomandita per azioni*, limited liability companies and public and private entities that carry out industrial and commercial activities»[257]. Such companies thus identified must not be subject to exemption regimes.

As an alternative to companies, the directive recognises that permanent establishments can also be beneficial owners of royalties[258]. In this case, the permanent establishment, in addition to being effectively used as a permanent establishment, must prove that it is the beneficial owner, i.e. such incomes must be linked to it.

Additionally, if this permanent establishment is actually recognised as the beneficial owner or is the entity that pays the royalty in question, then, for the application of the directive, it is no longer possible to identify another beneficial owner/subject paying the same royalty in any other part of the same company[259]. This provision is aimed at excluding the possibility of recognising multiple source States to abuse the preferential regime.

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[256] Art. 3, letter a), par. iii), directive 2003/49/EC.
The directive requires that the company is subject to tax, but it does not specify whether this requirement should also be effective. This omission led to the separation of the doctrine into two currents of thought. A first interpretation sees the requisite as a simple possibility of applying the tax to the income in question. This interpretation, also supported by the substantive case-law, would, however, make it impossible for the State to oppose the preferential regime when the income is not actually taxed in the other State.
The second line of interpretation, on the contrary, argues that the income must actually be subject to double taxation; if this were not true, the basis for the application of the directive would be lacking.
M. Greggi, *La Direttiva 2003/49/CE e il regime di tassazione degli interessi e delle royalties,* Rass. Tributaria, 2004, 2. The author underlines how the directive removes the imbalances due to the time delay between the withholding tax is charged and the tax credit is actually applied. At the same time, however, the author notes how these measures had already been overcome, as they were already under updating at that time. The author welcomes the directive, although he is sceptical on some points, like how the norms will be translated in the Italian civil code or on the fact that the directive leaves the single governments too much room of manoeuvre on some aspects, thus undermining the competitiveness in the international scenario.

[257] «*Società per azioni, società in accomandita per azioni, società a responsabilità limitata ed enti pubblici e privati che esercitano attività industriali e commerciali*». Annex of the directive 2003/49/EC.

[258] As reported in the circolare of the Italian Revenue Agency, the company to which the permanent establishment belongs must equally comply with all the requirements of the directive, even if the incomes can only be linked to its permanent establishment, under penalty of non-applicability of the provision in question.

[259] Art. 1, par. 6, directive 2003/49/EC.

The directive allows the source State to withdraw the concession provided, in the presence of certain situations. In particular, it may happen that royalty payments are classified in the source State as a distribution of profits or repayment of capital[260]. If this fact is found, the concessions provided for by the directive must not be applied, because there is no case in point to which the directive aims, but it is just an attempt to abuse it[261]. In fact, when the distribution of dividends is passed for the payment of royalties, in addition to not being taxed by the specific taxation on dividends, it involves for the debtor an unjust reduction of his tax base[262].

In addition, the source State can exclude a portion of the royalty paid from the concession granted by the directive. This case occurs when the person who pays the royalty and the beneficial owner are linked by particular relationships, or one of these two parties has particular relationships with a third party[263].

The result is that the amount of the royalty is higher than the amount that would have been paid if the parties had been independent, that is, if such a relationship had not existed. Faced with this situation, part of the royalty falls within the scope of the directive and therefore is not subject to withholding taxes, while the other part is subject to the consistently identified tax[264]. The share on which the directive applies is determined according to the arm's length criterion, i.e. assuming that the beneficiary and payer are independent[265].

This situation, where the amount of the royalty is higher than what the market establishes by virtue of special relationships between the parties, is also contemplated in the OECD and UN models, respectively in paragraph 4 of art. 12 OECD Model and

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[260] Art. 4, par. 1, directive 2003/49/EC.

[261] The directive, which also deals with interest between associated companies, identifies further examples, in addition to the case mentioned in the text, where it is possible not to apply the provisions. However, these examples are only related to interest payments:

- «payments from debt-claims which carry a right to participate in the debtor's profits;
- payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits;
- payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue.»

Art. 4, par. 1, directive 2003/49/EC.

[262] https://www.businessjus.com/wp-content/uploads/2014/05/Il-trattamento-fiscale-degli-interessi-e-delle-royalties.-Profili-di-fiscalit%C3%A0-internazionale..pdf .

[263] The relationships in question can be both of a personal nature, as occurs for example in the husband-and-wife relationship, and of a legal nature, that is, for example, the link between a company that pays the royalty and the company that directly or indirectly controls it.
References can be found in the OECD Commentary (condensed version), p. 233.

[264] Art. 4, par. 2, directive 2003/49/EC.

[265] Commentaries on the articles of the model tax convention (condensed version) p. 233.

paragraph 6 art. 12 UN model. The taxation of the excess is determined according to its nature, so it is possible that the royalties' withholding tax is not applied, but other provisions are applied.

4.3 The transposition of the directive in the Italian law

When the European Union issues directives, these do not directly enter into force in the Member Countries, but each State has a certain period of time to implement them with internal laws; Directive 2003/49/EC also underwent the same procedure.
In Italy, the directive was implemented with d.lgs. 30 maggio 2005, n. 143, and was included in the new article 26-quater of the d.p.r. 600/73, but with some slight changes. The spirit and objectives of the directive have remained unchanged, but it is good to highlight the peculiarities of some requirements that are not perfectly aligned with the European dictate.
A first difference is found in the minimum holding period. While, we recall, the directive claimed that a minimum period of 2 years was necessary, the *decreto legislativo* lowered this threshold to 1 year, to reflect the same minimum period indicated by the d.lgs. 136/1993 [266] which implemented the "Parent-Subsidiary" directive on European cross-border dividends[267].
Furthermore, according to the Italian law, associated companies are identified through the holding of a minimum percentage of voting rights. This minimum threshold is identified with 25% of the voting rights, i.e. those rights that can be exercised in the ordinary shareholders' meeting provided for by articles 2364, 2364-bis and 2479-bis of the civil code[268].
The decision to establish the criterion of the minimum holding of voting rights was taken because, since the corporate reform in 2003, participation in the capital and voting rights are separated concepts[269].

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[266] This d.lgs. introduced art. 27-bis in the dpr 600/73.
[267] Circolare dell'Agenzia delle Entrate n. 47/E p. 17.
[268] «*I diritti di voto di cui alle lettere a), b) e c), detenuti nelle società ed enti residenti nel territorio dello Stato, sono quelli esercitabili nell'assemblea ordinaria prevista dagli articoli 2364, 2364-bis e 2479-bis del codice civile*». Art. 26-quater, co. 2, lett. d), dpr 600/73.
[269] D.lgs n. 5/2003 e d.lgs n. 6/2003.

Therefore, today there can be participation in the capital but without voting rights, as well as participation in the capital with double voting rights[270]. It is no longer implied that one share is equivalent to one right to vote.

This split of concepts has led the legislator to adopt the criterion of the holding of voting rights, because if a company has the relative majority of voting rights it can impose its decisions on the assembly and therefore exercise control; on the contrary, if this same company owned the relative majority of the shares, it is not equally certain that it also exercises control over the ordinary shareholders' meeting.

An important requirement for the applicability of the exemption is that companies and permanent establishments involved in the payment of royalties, when they are resident or located in Italy, must be subject to IRES[271]. At the same time, they must not benefit from any exemption regime.

However, in fact, even companies for which concessions are granted can still benefit from the exemption in article 26-quater, because, as explained in the accompanying report to the *decreto di recepimento*, companies must be *potentially* subject to IRES: «*Pertanto, la disciplina in commento deve ritenersi applicabile anche a tutte quelle società che, pur essendo potenzialmente soggette all'IRES (o alle corrispondenti imposte cui sono soggette le società e gli enti non residenti), godono, di fatto, di agevolazioni comunque compatibili con la normativa comunitaria*[272]».

Still, this condition is not sufficient for the Italian legislator. In fact, art. 26-quater paragraph 4 letter b) explicitly requires that the income (therefore interest and royalties) that can benefit from this favourable treatment must be taxed both in the State of residence of the beneficial owner and in the source State[273].

This is because the objective of the European directive is to avoid double taxation, which obviously does not take place if, by national law, such income is not considered taxable[274]. This condition is referred to as the *subject to tax clause*[275].

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[270] Artt. 2346 and 2351 c.c.

[271] This requirement is referred to as *liable to tax clause.*

[272] Circolare dell'Agenzia delle Entrate n. 47/E p. 14.

[273] Art. 26-quater, co. 4, lett. b), dpr 600/73.

[274] M. Casalini e A. Serafini, *Interessi e royalties: recepimento nazionale delle disposizioni comunitarie contenute nella direttiva n. 2003/49/CE ad opera del d.lgs. n. 143/2005*, Fisco, 2006, 28 - parte 1, 4324.

[275] N. Montuori e E. Vial, *Prime riflessioni sullo schema di decreto attuativo della direttiva interessi e royalties n. 2003/49/CE*, Fisco, 2005, 31 - parte 1, 4845.

There are no similar provisions in the treaties against double taxation; that is, when, in a treaty, the source State accepts limitations on its taxation, this does not exclude that the State of residence decides to grant a preferential regime on the same income afterwards[276].

Finally, the transposition of the directive made by Italy has categorically ruled out that, in the case of a third-party company that owns at least 25% of the voting rights in two companies resident in the European Union, that company can be resident outside the EU[277].

[276] http://www.assonime.it/_layouts/15/Assonime.CustomAction/GetPdfToUrl.aspx?PathPdf=http://www.assonime.it/attivita-editoriale/studi/Documents/NS%2010-2020.pdf p. 11.

[277] «*In tale fattispecie, il richiamo effettuato alla lettera a) del comma 4 esclude esplicitamente la possibilità che la terza società controllante possa essere residente in un paese terzo rispetto a quelli dell'Unione europea*.» Circolare 47/E Agenzia delle Entrate p. 16.

CHAPTER 5:THE PHENOMENON OF BASE EROSION

As a direct consequence of what has been so far explained, in this chapter it will be illustrated a topic that has the utmost importance when talking about the taxation of royalties, because we will elaborate what the application of miscellaneous directives, laws and tax reliefs created, even if all these rules were originally meant to reduce double taxation.

It has already been pointed out that the coexistence of the source principle and the worldwide taxation principle in most of the Countries around the world causes double taxation, and that double taxation undermines international trade by increasing the cost of capital and thus the economic sacrifice on investments[278]. In order to not restrict trade, agreements against double taxation and the harmonisation of the internal laws at the European level have mitigated this phenomenon on one side, but at the same time they have also paved the way for entities benefiting from these reliefs.

In fact, many taxable persons have noticed the flaws that have arisen and thus they have exploited them obtaining overall low if not zero tax debts. OECD called this phenomenon “BEPS”, an acronym that stands for Base Erosion and Profit Shifting, that is, all those actions international commercial players do in order to deliberately find the flaws deriving from the interaction between different regulatory systems, with the aim to shift their profits from a State to another or to erode their own tax base in the Country of residence.

Tax planning is not a bad action by itself. It is remarkable that a company is informed of its tax burden, and it is right that it takes advantage of all those benefits it can access to thanks to its intrinsic characteristics. The problem arises when there isn’t a true link between profits and performed economic activity: these are the cases when we witness the tax avoidance and tax evasion phenomena.

While tax evasion is an illegal behaviour that is criminally and administratively punishable, tax avoidance implies that the law is being circumvented thanks to perfectly legal stratagems[279].

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[278] P. Valente. *Attuazione delle misure BEPS, criticità e prospettive.* Strumenti finanziari e Fiscalità 25 (2016).

[279] In the definition provided by the Treccani encyclopaedia, we can read that tax evasion is that «*comportamento illegittimo con cui il contribuente mira a contrastare il prelievo tributario[...] mediante una diretta e immeditata violazione di norme tributarie, attraverso la rappresentazione esterna di una situazione di fatto non corrispondente alla realtà o una non*

As it will be further explored, such tax avoidance practices are usually implemented through techniques that enable the tax payer to take advantage of the tax imbalances between different legal systems and so to shift profits toward those Countries that have much more favourable tax regimes.

These strategies, whose only aim is the tax savings, are called aggressive tax planning[280]. Aggressive tax planning is a behaviour that must be fought, because it creates differences in the tax treatment between companies and, as a consequence, it leads to imbalances and distortions in the market[281]. In most cases, the entities that can put in place the profit shifting are large companies, usually multinational enterprises, whereas small and medium enterprises operating in local markets are inevitably subject to ordinary taxation. This means that small and medium companies must operate in a market where strategies of large multinationals dominate, and these strategies are made possible thanks to the undue tax savings that derive from the aggressive tax planning.

Tax authorities are thus seen as a merciless and unjust system that is better to avoid, therefore making the tax collection extremely difficult[282]. Moreover, profit shifting distorts the States' balance of trade[283]; governments fail to properly implement their tax policies and lose tax revenues.

In the entrepreneurial context, royalties are a very important tool for creating value, but they can also be used as a mean to implement strategies useful for tax savings.

Royalties are a very delicate income category under the fiscal point of view, precisely because it is very simple to exploit their peculiarities and transfer money so to evade tax authorities. In fact, they're classifiable, for the company that pays them, as costs for accounting purposes, and are equally considered deductible costs for the determination of the tax base by most of tax authorities[284].

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*corretta qualificazion*e giuridica della situazione medesima». On the other side, tax avoidance is that «*comportamento del contribuente che, pur rispettoso della lettera della normativa tributaria, tende a evitare il pagamento dell'imposta con costruzioni negoziali il cui solo scopo è quello di sottrarsi all'obbligo fiscale*». http://www.treccani.it/enciclopedia/evasione-fiscale/; http://www.treccani.it/enciclopedia/elusione-fiscale/ .

[280] However, it may also happen that certain transnational incomes are not taxed, but the tax payer didn't originally plan to avoid taxation.

[281] F. Antonacchio. *Tax governance e gestione dei rischi fiscali.* (2013).

[282] Ibid.

[283] T. R. Tørsløv, L. S. Wier, and G. Zucman. *The missing profits of nations*. No. w24701. National Bureau of Economic Research, 2018.

[284] IAS 18 Revenues: «*I ricavi che derivano dall'utilizzo, da parte di terzi, di beni dell'entità che generano interessi, royalties e dividendi devono essere rilevati secondo quanto previsto dal paragrafo 30 quando..*» http://www.revisorionline.it/IAS_IFRS/ias18.htm .

Moreover, the risk of an arbitrary charge of royalty costs increases when we are in presence of multinational groups, because the companies of the group are not independent, their interests are not in contrast and thus there is no guarantee that the value of the royalty has been found at arm's length[285].

As it has already been mentioned several times in the text, various international organizations and internal laws have focused on the opportunities of tax avoidance and, above all, of tax evasion, trying to find solutions so that incomes are correctly taxed, both with regard to the place where they were produced and for the amount of tax rate applied.

Unfortunately, the wide fragmentation of the international framework does not help to fight behaviours that are not so transparent.

In order to fight such behaviours, specific clauses have been imposed over time, like, for example, the beneficial owner clause; even the very concept of source-based taxation can also be understood as a method that limits tax avoidance[286]. Other anti-avoidance measures have been specifically developed over time within international organizations, with the aims of increasing citizens' trust in the equity and justice of the world's tax systems and of providing governments with effective solutions so that their tax policies are actually pursued[287].

In the following paragraphs, I will analyse the path that led to the creation of BEPS Project and its 15 actions, focusing in particular on those Actions that are related to royalties and other linked topics.

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[285] The transfer price of royalties can be easily changed, particularly when there is a lack of comparable transactions.

[286] In his comment to the OECD report, Valente (P. Valente, *Tax planning aggressivo: il rapporto OCSE "Addressing Base Erosion and Profit Shifting",* Fisco, 2013, 12 - parte 1, 1802) summarises and groups the internal countermeasures, adopted by Countries in order to prevent abuses, in the following categories:

• "*general anti-avoidance rules or doctrines*", that is, all those *ex post* rules that limit or refuse to recognise tax advantages obtained thanks to operations without a valid economic reason;

• "*controlled foreign company rules*", namely those rules that allow a State to tax the income of companies located in Countries with preferential tax regimes, but controlled by resident entities;

• "*thin capitalisation rules*", i.e. rules that limit the amount of passive interests that can be deducted;

• "*anti-hybrid rules*", that remove mismatches on hybrid instruments, by establishing common tax provisions;

• "*anti-base erosion rules*", that is, rules that establish high withholding taxes, or that do not allow certain transnational payments to be deducted.

These internal countermeasures can also be supported by specific rules established in Double Taxation Treaties, that limit the application of the treaties precisely to avoid their abuse or "treaty shopping".

[287] Ibid.

5.1 The establishment of the BEPS project

As it has previously been said, aggressive tax planning is the behaviour of a company through which it artificially shifts its profits in jurisdictions with a favourable taxation[288], so to reduce its overall tax burden.

Since the economic crisis in 2007, the attention of the International Community has turned to the phenomenon of tax erosion and aggressive tax planning, which aggravated the economic situation of the Countries by subtracting their legit taxes[289]. But it was with the G20 summit in 2012 that the awareness of having to face this serious problem was born, giving a mandate to the OECD to investigate the topic. In 2013, OECD presented the results through the publication of the study called *Addressing Base Erosion and Profit Shifting*, where the 15 actions needed to systematically address the problem were identified[290].

In particular, the study highlighted how the base erosion was an increasing reality, and that it created negative distortions for the economy.

According to OECD, studies carried out in 2013 on the phenomenon of tax erosion revealed that the annual loss of tax revenues is around 4-10% of the total of global corporate income tax, equal to approximately a non-collection of $100-240 billion per year[291]. This means that the negative impact on GDP is even more evident for those developing countries that make great if not exclusive reliance on this type of revenue[292].

In addition, BEPS causes an increasingly aggressive behavior by multinationals concerning tax planning; it aggravates the propensity of the companies to borrow new debt[293]; it misdirects foreign direct investments and reduces investments in necessary

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[288] P. Valente. *Attuazione delle misure BEPS, criticità e prospettive.* Strumenti finanziari e Fiscalità 25 (2016).

[289] You can note how much importance has been given in fighting the BEPS phenomenon, considering that 82 members of the OECD and G20 attended the first meeting held in 2016, while 135 members and 14 observers are now part of the BEPS Project. https://www.oecd.org/tax/beps/about/ .

[290] OECD. *Addressing base erosion and profit shifting*. OECD, 2013.

[291] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241343-en .

[292] Ibid.

[293] Excessive corporate debt: both internal rules and international rules tax debt capital less than equity capital. Companies that use more debt financing than equity financing are more facilitated. Financial leverage. P. Valente, *Tax planning aggressivo: il rapporto OCSE "Addressing Base Erosion and Profit Shifting"*, op. cit.

public works[294]. From the data deducible from the 2015 OECD report called "*Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*", on average multinationals recorded a global tax rate that was 2.5-5% lower than non-multinational companies. This tax saving reaches also 8.5%, if we take into account the shift in profits caused by the base erosion[295].

OECD admitted that it does not have a complete picture on the phenomenon of tax erosion, as the data collected so far are not exhaustive and do not represent the whole phenomenon. To remedy this, OECD developed specific indicators deemed useful for obtaining data that are more closely related to reality. Such indicators were collected in Action 11. The Organization undertakes to collect as much data as possible, especially with reference to multinationals, to improve the quality of its measurements and to better analyse the negative impact that tax avoidance has on economy and tax policies[296]. Among its indicators, OECD has used one in particular, which correlates the royalties received by a Country with its relative Research and Development expenditure. Such indicator can highlight an incorrect tax behaviour by identifying the possible imbalance between how many royalties a State receives and how much it spends on R&D. Logically, if this ratio is very high, it can be deduced that the intangibles were developed in a foreign Country (a high-tax Country) and they were later transferred to the Country with the very high indicator (the low-tax Country), with the sole purpose to legitimise the transfer of royalties. The results presented in the report also indicated how this practice has been used even more in recent years: if, in 2005, the States with this indicator greater than 50% had a ratio 3 times higher than the other Countries, in 2012 this ratio doubled[297].

The 2013 study therefore gave a boost to the OECD and G20 Member States to plan 15 actions, called BEPS Project, that are useful to battle the phenomenon.

It is good to specify that these 15 actions are guidelines and so they do not constitute binding legislation, not even for OECD Member States, even if they are the promoters. In fact, OECD is a supranational organization and the documents it issues can only serve as a path for national legislators; therefore, the Guidelines are only an example of

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[294] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, op.cit.

[295] Ibid. p. 102 §177.

[296] Data collection is also used to confirm whether the undertaken actions are useful to stem the BEPS phenomenon.

[297] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, p. 61-62.

what doctrine defines “soft law”, or an act without binding effect towards the entities to whom it is directed[298].

The ultimate goal of the BEPS Project is to limit the possibilities for multinational companies to use the geographical location of their subsidiaries or the transactions between them so that the total amount of taxes due by the enterprises is reduced.

In order to implement new rules and monitor the results, OECD uses reports, studies and discussion papers.

BEPS Project is based on the following three pillars:

- The first pillar deals with the introduction of internal rules so to coordinate the taxation of transnational activities (Actions from 2 to 5);
- The second pillar deals with the strengthening of substantial requirements on international standards so that taxation takes place because there is an effective value creation (Actions from 6 to 10);
- The third pillar deals with the increase of the certainty and transparency of the tax environment in which businesses and governments operate (Actions from 11 to 14)[299].

It should be noted that the first and last Actions of the Action Plan (the number 1 and number 15) have a “general” meaning, in the sense that they are not strictly related to a single pillar, but instead they derive goals from all three of them.

The 15 actions are carried out through changes in the internal rules and national practices, through the provisions written in new international treaties, and through the negotiation of a multilateral instrument so to immediately update the obsolete rules written in beforehand stipulated treaties (Action 15)[300]. The effort made to fight aggressive tax planning is not limited to what has already been decided, but continues with a constant coordination between States and with the monitoring of results[301].

Below, the full Action Plan developed by OECD:

1. Tax challenges arising from digitalisation
2. Neutralising the effects of hybrid mismatch arrangements

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[298] Contrary to hard law, where the binding obligation to respect the agreement goes together with the possibility to enforce it before a judge.

[299] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, op. cit.;
O. Salvini, *La nuova definizione di stabile organizzazione nel Beps*, Rass. Tributaria, 2016, 1, 67.

[300] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, op. cit.
Action 15 deals specifically with entering into the Multilateral Instrument.

[301] Ibid.

3. Controlled Foreign Company Rules
4. Limitation of interest deductions
5. Countering harmful tax practices
6. Prevention of tax treaty abuse
7. Permanent establishment status
8. 9. 10. Transfer pricing (which is declined in 3 separate actions)
11. BEPS data analysis
12. Mandatory disclosure rules
13. Country-by-country reporting
14. Mutual agreement procedure
15. Multilateral instrument to modify bilateral tax treaties[302].

These 15 actions are therefore a program to create a transparent global tax system, where the collection and free access to financial data of multinationals is combined together with the necessary internal and between Countries regulatory updates; in this way, companies should no longer be able to operate aggressive tax planning.

BEPS adversely affects competition between businesses; it also falsify the amount and allocation of debt and investments in intangibles, and it consequently causes expensive tax assessments. However, it has been verified that profit shifting has been effectively reduced in those Countries where anti-tax avoidance rules have been correctly applied[303].

To date, the implementation of the BEPS Project is not complete; however, many jurisdictions are endeavouring to implement minimum standards and other regulatory requirements[304].

5.2 Common strategies adopted by multinational enterprises to reduce their overall tax burden

With the profit shifting, multinational companies reduce their overall tax burden by taking advantage of the misalignment of the rules and tax rates among different States. In particular, they are able to maintain a lower tax base in high-tax countries, while they make sure that a higher tax base is charged to the State with lower taxation.

[302] https://www.oecd.org/tax/beps/beps-actions/ .
[303] OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, op. cit.
[304] See for instance the ATAD directive of the EU.

In the past, multinationals were lawfully able to obtain this, by allocating production plants in the most suitable Countries, and thus reducing costs; however, recently, thanks also to the development of new technologies and business models and the new global market, this strategy has become increasingly aggressive and arbitrary, free from a real connection with the production reality[305].

The mechanism exploited, therefore, is to attribute as many positive elements of income in low-tax Countries, so to increase the tax base, and at the same time to increase the negative elements of income in high-tax Countries to subtract tax base. The easiest way to do this (but it's against the international transfer pricing principle) is by using the accounting categories of revenues/costs, interests, dividends, and royalties[306].

Passive royalties are considered by most Countries to be fully deductible for tax purposes. This has recently raised criticisms, because being able to fully deduct the royalty costs favours multinational enterprises, and they are therefore facilitated in shifting their profits towards low-tax Countries. Doctrine has consequently developed alternative proposals, and limitations to the deductibility of intra-group royalties can be a possible and viable solution to the BEPS problem[307].

It often happens that, in order to achieve base erosion, *ad hoc* companies are established. These companies do not create real added value through business activities, but they are simply "empty boxes" used with the only aim to move capital and to exploit Double Taxation Treaties to the advantage of the multinational enterprise[308].

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[305] A. Roberti. *Royalties e delocalizzazione nel commercio globale.*

[306] Ibid.

[307] A new index measuring positive and negative spillovers has recently been released. This index is called "Corporate Tax Haven Index" and focuses on spillovers coming from the choices of single jurisdictions. Among the various indicators of which it is composed, one in particular analyses the externalities deriving from the limitation of the deductibility of passive royalties. The optimal solution presented would be to prohibit its deduction entirely, if royalties are paid for intra-group transactions. But no Country has implemented this radical solution yet; on the other hand, few Countries have implemented a partial limitation of deductibility. Among these jurisdictions, Germany allows deductions, but limited to the costs the company incurred for the development of the intangible; the USA, instead, introduced a 10% tax rate that's applied on a tax base where previously deductible costs are added again. In Europe, other States followed the German path: Austria, Greece and Poland have also introduced limitations on the deductibility of royalties.
L. Ates, M. Harari, M. Meinzer. *Positive Spillovers in International Corporate Taxation and the European Union,* (2020), 48, Intertax, Issue 4, pp. 389-402, https://kluwerlawonline.com/journalarticle/Intertax/48.4/TAXI2020035 .

[308] This is the case of conduit companies, P. Valente, *Tax planning aggressivo: il rapporto OCSE "addressing base erosion and profit shifting"*, op. cit.

It can also happen that, in order to further exploit this mechanism and obtain double non-taxation, specific companies are placed as intermediaries or certain hybrid instruments are used, so to obtain that particular income flows are treated differently in the different jurisdictions involved[309]. An hybrid entity is, for example, a company that is considered a transparent entity by a certain legal system, while the same company is considered a non-transparent entity in another legal system[310]. This double classification results in the following treatment: the passive income streams of the firm are not directly taxable in the first jurisdiction, while these same passive flows are entirely deductible in the second jurisdiction[311]. On the other hand, hybrid instruments are, for example, financial instruments that are considered equity investment in a jurisdiction, whilst they are considered debts in another jurisdiction[312]. This means that flows deriving from the financial instrument are taxable as dividends in the first Country, but they are considered passive interest (and thus deductible) in the second Country.

A multinational company can also take advantage of derivatives, such as forward contracts or swaps, and thus reduce its overall tax liability[313].

When an intermediary company is established with the only purpose of diverting royalties to a low-tax State, this is commonly referred to as a “royalty company”[314]. The multinational enterprise that controls this business transfers the ownership of its intangibles to it, so the monetary considerations can flow legitimately into the low-tax Country. It can be seen that the functions performed by this intermediary company do not include the carrying out of a real business activity, but they are limited to preserving the value of the intangibles, purchasing other intangible assets where appropriate, entering into license agreements, and collecting royalties.

In addition to inflating payments to foreign affiliates and taking advantage of regulatory mismatches, a multinational company can reduce its tax base by doing a business restructuring[315], that is the reorganization of the multinational group that reallocates

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[309] *Hybrid mismatch arrangements*; A. Roberti. *Royalties e delocalizzazione nel commercio globale.*

[310] P. Valente, *Tax planning aggressivo: il rapporto OCSE "Addressing Base Erosion and Profit Shifting",* op. cit. Examples of transparent companies are the partnerships and the *società di persone*.

[311] Ibid.

[312] Ibid.

[313] Ibid.

[314] A. Roberti. *Royalties e delocalizzazione nel commercio globale.*

[315] P. Valente. *Erosione della base imponibile e profit shifting nei Paesi in via di sviluppo.* Il Fisco 35 (2014).

functions, risks and assets among the various subsidiaries. It has been highlighted how this operation, which is legitimate, has often just an elusive purpose, and it is therefore not economically justified. When this is the case, tax authorities have difficulty in evaluating the multinational's work, because determining whether the transfer price used in the operation reflects the market conditions is a complex and uncertain task; that's why it is very difficult to ascertain if the transfer price is economically justified.

5.3 The action plan

Royalties are a crucial element when it comes to BEPS, because intangibles have become increasingly important in today's economy. Furthermore, the latter are difficult to evaluate due to the lack of direct comparables; consequently, even royalties deriving from their exploitation cannot be quantified with certainty. In addition, intangibles, given that they do not have a physical substance, can be moved very quickly and much more simply than the other physical goods, and thus they are the ideal asset for multinationals that want to carry out aggressive tax planning.

The BEPS report underlined that, in most of the tax structures built with the aim of eroding the tax base, profit shifting is achieved by mainly exploiting the operations related to the rights on intangibles[316].

Most of the actions identified with the BEPS Project can also be declined with reference to royalties. In particular, these actions are the ones from 1 to 3 and the ones from 5 to 8. Action 4 and the ones from 9 to 15 will not be discussed, as they are related to the deduction of interest expenses, the transfer price for capital and high-risk transactions, the reporting requirements useful for achieving the objectives of the third pillar, and the Multilateral Instrument.

5.3.1 BEPS action 1: tax challenges arising from digitalisation

The first action, with which the OECD opened its BEPS Project, focuses on the challenges that the digitalised economy has brought in recent years to the traditional concept of taxation[317]. In fact, in order to reduce the tax burden caused by double

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[316] P. Valente, *Tax planning aggressivo: il rapporto OCSE "Addressing Base Erosion and Profit Shifting",* op. cit.

[317] https://www.oecd.org/tax/beps/beps-actions/action1/ .

taxation, international taxation is based on two specific concepts: the link with the jurisdiction (source State) and the identification of the portion of income that was actually produced in that jurisdiction (arm's length principle). But with the advent of digitalisation, the traditional concept of multinational company, that is, a company that operates in multiple Countries through delocalised production plants in States where, for example, labour cost is lower, well that traditional concept is now outdated.

Nowadays, digitalisation allows enterprises to generate value in a different way: by creating economies of scale even without the aid of production plants, by using more and more intangible assets, and by giving greater importance to the collection of data. Digitalisation enabled the emergence of new business models, where it is no longer necessary to be located close to target markets and where it is possible to split the company's activities into value drivers and allocate them in different jurisdictions. As physical presence is no longer important, multinationals can now focus on optimising their overall tax burden. It is thus clear why many Countries fear such an easy tax erosion, where traditional taxation methods are no longer effective. This situation also creates a break between traditional businesses and digitalised businesses[318].

Members of the Inclusive Framework[319] have thus identified two macro areas in which measures are needed to address taxation in the digitalised economy:

- The reallocation of taxation rights between different jurisdictions, as for example by establishing a new nexus criterion that is not based on the presence of a permanent establishment, but is linked to the final consumers or end users;
- The determination of a mechanism that effectively combats tax erosion, like, for example, establishing a minimum tax rate on the global income of multinationals, so to also reduce the disparity between digitalised and traditional businesses[320].

The applicability of these solutions is not limited to Action 1 only, but it can also be extended to other Actions, in particular those related to the transfer price of intangible assets, the permanent establishment, the CFCs and the hybrid misalignments. The suggested guidelines for these latter actions, in turn, can be applied to solve the critical issues deriving from digitalisation.

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[318] Ibid.

[319] The Inclusive Framework is the working group that has the task of monitoring the States that takes part to the BEPS project.
https://www.sif.admin.ch/sif/it/home/multilateral/gremien/inclusive-framework-on-beps.html .

[320] https://www.oecd.org/tax/beps/beps-actions/action1/ .

5.3.2 BEPS action 2: neutralising the effects of hybrid mismatch arrangements

The issue of hybrid misalignment was first exposed in a discussion that took place within the OECD in 2010, when, following the economic crisis in which the world economy still found itself, tax risks related to losses in the banking system were discussed[321].

Two years later, the Organization prepared the report "*Hybrid Mismatch Arrangements: Tax policy and compliance issues*"[322], from which we can read what international tax arbitrage is and how it is exploited. Thanks to the internal work done by the OECD, and after the causes of this type of arbitrage were exhaustively identified, an additional report was compiled which collected all the measures that the Member States interested in the BEPS Project could adopt to solve this problem[323]. Finally, in 2017 the topic about the exploitation of hybrid instruments was completed with the inclusion of branches, through the report "*Neutralising the Effects of Branch Mismatch Arrangements*"[324]. In fact, even branches can be used in a similar way to hybrids.

According to the 2015 report, the tools used by multinationals to exploit the regulatory misalignments can be grouped as follows:

- Hybrid entities, that is, companies, permanent establishments or any other type of entity that is treated as a taxable person by the legal system where it is established, while it is treated as a transparent entity by the legal system in which the parent company is resident and therefore it is not subject to taxation;
- Entities with dual residence, when the entity is resident in both States due to the different tax residence criteria;
- Hybrid instruments, so those instruments that are treated differently for tax purposes by the two Countries involved, such as for example the previously mentioned financial instruments whose incomes are identified in one State as dividends and in the other as interest expenses;

[321] https://www.oecd.org/tax/beps/beps-actions/action2/ .

[322] OECD, *Hybrid Mismatch Arrangements: Tax policy and compliance issues,* OECD/G20 Base Erosion and Profit Shifting Project, OECD 2012.

[323] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2015). http://dx.doi.org/10.1787/9789264241138-en .

[324] OECD, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2017). http://dx.doi.org/10.1787/9789264278790-en .

- Hybrid transfers, i.e. contracts between people resident in different jurisdictions where the object of the contract is, for tax purposes, a transfer of ownership according to one State, while for the other it is a loan backed by a guarantee[325].

The exploitation of these hybrids can thus lead to the following situations:

- There is a double deduction;
- There is a deduction in one jurisdiction, without the subsequent imputation of a positive cash flow in the other jurisdiction[326];
- An artificial tax credit is created for income produced abroad[327].

But the OECD has found that branches and permanent establishments can also be used to erode the tax base similarly to what happens with hybrid instruments. Among the various mechanisms implemented by multinationals for this purpose, we can find the following ones:

- The permanent establishment is recognised by the parent company, but not by the Country where it is located. It is clearly not fiscally recognised as a taxable person in the source State;
- There is a misalignment in the attribution of the income to the permanent establishment. In this case, the Country where the parent company is resident considers certain incomes attributable to the permanent establishment, while the Country where the latter is located considers these same incomes attributable to the parent company;
- There is a unilateral recognition of deduction of costs arising from payments made between entities of the same enterprise (e.g. parent company – permanent establishment). The misalignment occurs when the tax deduction is recognised in a jurisdiction, while there is no consequent imputation of income on the tax base in the other jurisdiction;
- There is the double deduction of the same cost but for two different taxable persons (like in the case of parent company and permanent establishment);

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[325] D. Liburdi, L. Nobile, *Contrasto al disallineamento da ibridi: eliminazione dei benefici fiscali indebiti nei gruppi ed effetti sui soggetti terzi,* Fisco, 2018, 46, 4446.

[326] Or, in Valente's words, to «make income disappear». P. Valente, *Tax planning aggressivo: il rapporto OCSE "Addressing Base Erosion and Profit Shifting",* op. cit.

[327] D. Liburdi, L. Nobile, *Contrasto al disallineamento da ibridi: eliminazione dei benefici fiscali indebiti nei gruppi ed effetti sui soggetti terzi,* op. cit.

- A misalignment originally occurred between the parent company and the permanent establishment is transferred to another entity of the group residing in a third country[328].

The OECD found basically two solutions to cancel the effects of fiscal erosion caused by hybrids, and these solutions are the following ones:

- The payer cannot deduct the negative income that was artificially produced;
- Or the positive income is allocated to the beneficial owner[329].

Action 2 was translated by the ATAD-2 directive, and thus it was implemented in all EU Member States[330]. The directive does not prosecute the *hypothesis* of tax advantage resulting from misalignment, but only the actual case in which the mismatch has caused fiscal erosion. Moreover, the hypothetical base-situation in which the misalignment was caused by a particular tax regime introduced afterwards by a State is not included in this situation[331].

5.3.3 BEPS action 3: Controlled foreign company

The discipline of Controlled foreign companies aims to hinder the tax base erosion by allowing jurisdictions to tax the income produced by foreign subsidiaries, regardless of whether such income has been received by the controlling persons/parent company, and under certain conditions[332]. CFCs are companies, controlled and generally resident in low-tax countries, which rarely distribute dividends; in this way, incomes are not even taxable in the countries where shareholders are resident. CFCs do not therefore have an economic function.

The first rules against CFCs date back to 1962[333], but with the transformation of the economy and the new types of tax avoidance, the international community has realised how these provisions were mostly ineffective.

For this reason, in 2015 the OECD prepared the report called "*Designing Effective Controlled Foreign Company Rules*"[334]. This report indicates the best strategies to

[328] Ibid.

[329] Ibid.

[330] Directive 29th May 2017, no. 2017/952/EU; directive transposed in Italy with the D. Lgs. 29 novembre 2018, n. 142.

[331] D. Liburdi, L. Nobile, *Contrasto al disallineamento da ibridi: eliminazione dei benefici fiscali indebiti nei gruppi ed effetti sui soggetti terzi,* op. cit.

[332] G. Rolle, *La disciplina delle CFC fra nuovi oneri e semplificazioni*, Fisco, 2015, 23, 2239

[333] https://www.oecd.org/tax/beps/beps-actions/action3/ .

implement in order to combat the non-taxation of CFCs' incomes, that occurs precisely because tax regimes of the States of residence have almost zero rates or because of the long-term tax deferral of the incomes.

When dealing with foreign subsidiaries, it is necessary to assess that specific characteristics are respected. For example, it is necessary to clearly define when you are actually in the presence of a CFC, how to correctly calculate the income to be taxed and who is the taxable person, how to avoid the double taxation of this income.

Not all the States joining the BEPS Project have also committed to transpose the provisions on CFCs, but among these, it must be emphasised that all EU Member States have implemented the rules, after the ATAD directive was issued[335]. In Italy, the CFC discipline was modified in 2015 and 2016, to comply with the European and international regulations.

In order to illustrate the CFC discipline, we broadly see the Italian legislation. The Italian CFC discipline is governed in various articles of the TUIR[336], and no longer identifies the Countries where there is the possibility of having CFCs on the basis of the so-called "black list"[337]. The new CFC rules identify the firms through a series of objective characteristics. These characteristics must be present at the same time to ensure that the CFC discipline is automatically triggered.

So, the discipline is applied when non-resident controlled entities have the following attributes:

- They are subject to effective taxation lower than half of what they would have been subject to if resident in Italy;
- More than one third of their income falls into one (or more) of the following categories:
    1) Interest or any other income coming from financial assets;
    2) *Royalties or any other income coming from intellectual property*;

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[334] Ibid.

[335] Ibid.

[336] Art. 167 TUIR says that: «*tassazione per trasparenza del reddito societario in capo al soggetto controllante italiano*».

[337] The "black list" was the list of low-tax countries in which it was very likely to detect the presence of CFCs. Afterwards, the "white list" was also introduced, in which a subsidiary, even if it was based in a Country that was not part of the black list, was still subject to the rules of the CFCs because its effective taxation was less than 50% of the effective taxation applicable in Italy. Both lists have now been replaced by the objective criteria.
http://novitafiscali.supsi.ch/874/1/Paciello%20-%20Direttiva%20ATAD_%20nuovo%20regime%20CFC%20e%20modifiche%20alla%20tassazione%20dei%20dividendi%20black%20list.pdf.

3) Dividends and income deriving from the sale of equity investments;
4) Income from financial leasing;
5) Income from insurance, banking and other financial activities;
6) Income from transactions for the purchase and sale of goods with little or no economic added value, carried out with entities who directly or indirectly control the non-resident subject, are controlled by it, or are controlled by the same subject that controls the non-resident subject;
7) Income deriving from the provision of services, with little or no economic added value, carried out in favour of entities who, directly or indirectly control the non-resident subject, are controlled by it, or are controlled by the same subject that controls the non-resident subject; for the purpose of identifying services with little or no economic added value, account is taken of the indications contained in the *decreto del Ministro dell'economia e delle finanze* issued pursuant to paragraph 7 of article 110[338].

However, this regulation does not apply if it is shown that the subsidiary carries out a genuine economic activity[339].

As regards the concept of control, a CFC must be directly or indirectly controlled through a minimum holding of 50% of its capital, or the parent company directly or indirectly holds at least 50% of profit sharing[340].

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[338] «*La disciplina del presente articolo si applica se i soggetti controllati non residenti integrano congiuntamente le seguenti condizioni:*
- *sono assoggettati a tassazione effettiva inferiore alla metà di quella a cui sarebbero stati soggetti qualora residenti in Italia;*
- *oltre un terzo dei [loro] proventi rientra in una o più delle seguenti categorie:*
  1) interessi o qualsiasi altro reddito generato da attivi finanziari;
  2) canoni o qualsiasi altro reddito generato da proprietà intellettuale;
  3) dividendi e redditi derivanti dalla cessione di partecipazioni;
  4) redditi da leasing finanziario;
  5) redditi da attività assicurativa, bancaria e altre attività finanziarie;
  6) proventi derivanti da operazioni di compravendita di beni con valore economico aggiunto scarso o nullo, effettuate con soggetti che, direttamente o indirettamente, controllano il soggetto controllato non residente, ne sono controllati o sono controllati dallo stesso soggetto che controlla il soggetto non residente;
  7) proventi derivanti da prestazioni di servizi, con valore economico aggiunto scarso o nullo, effettuate a favore di soggetti che, direttamente o indirettamente, controllano il soggetto controllato non residente, ne sono controllati o sono controllati dallo stesso soggetto che controlla il soggetto non residente; ai fini dell'individuazione dei servizi con valore economico aggiunto scarso o nullo si tiene conto delle indicazioni contenute nel decreto del Ministro dell'economia e delle finanze emanato ai sensi del comma 7 dell'articolo 110». Art. 167, co. 4, TUIR.

[339] Art. 167, co. 5, TUIR.

[340] Art. 167, co. 2, TUIR.

If the presence of a CFC is ascertained, the subsidiary's income is taxed on transparency in Italy; this means that the portion of income attributable to the controlling shareholder (the attribution is based on his share of profits) is attributed to him, even if not actually received, and consequently is taxed according to the Italian dividend discipline[341][342].

However, in the Italian legislation there is also the possibility to opt for the branch exemption regime. This option can be chosen by the multinational enterprise if the conditions for the application of the CFC discipline do not exist. The branch exemption regime was introduced with d.lgs. 147/2015 and written in art. 168-ter TUIR. It excludes that the income produced abroad by a permanent establishment of a company resident in Italy is taxed here on transparency. The result is that if a company opts for the branch exemption regime, the incomes of its permanent establishments are taxed only in the foreign Countries where they are located, and not also in Italy[343]. However, this is only possible if the permanent establishment does not have to be taxed according to the CFC rules.

5.3.4 BEPS action 5: harmful tax practices

Action 5 of BEPS Project focuses on fighting the preferential regimes[344] that States grant to certain incomes in order to attract capital, but thereby damaging other jurisdictions.

Combating harmful tax practices is a minimum standard of the BEPS Project, that aims to remove tax mismatches, and which all the countries adhering to the Inclusive Framework have committed themselves to respect. The compliance with these requirements, their possible update, and the analysis of the current tax regimes takes

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[341] E. M. Bagarotto, *La disciplina in materia di Controlled Foreign Companies alla luce delle modifiche apportate dalla Legge di Stabilità 2016 e nell'attesa dell'attuazione della "Direttiva anti-beps"*, Dir. e Prat. Trib., 2017, 3, 954.

[342] G. Rolle, *Effetti su CFC, dividendi esteri e plusvalenze della nuova nozione di "regimi fiscali privilegiati",* Fisco, 2016, 9, 861.

[343] S. Furian, *Neutralità fiscale del conferimento d'azienda da una stabile organizzazione italiana*, Fisco, 2018, 39, 3759.

[344] It addresses the preferential regimes related to IP, and also other preferential regimes granted for other movable elements of the economic activity, such preferential regimes on loans or on holding companies. OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241190-en P. 38-40.

place constantly through the *Forum on Harmful Tax Practice*, a specific board established in 1998 within the OECD[345].

It has been established that, in order to take advantage of a preferential regime, a company must demonstrate that it possesses the *nexus approach*, that is, it exercises substantial activity in the country[346].

This nexus can be found in the R&D activity that leads to the development of an intangible and therefore legitimises the application of the preferential regime. In this way, it would be possible to avoid allocating revenue streams in certain Countries to take advantage of the preferential regime, without any real economic activity carried out there.

In order to be correctly implemented, Action 5 requires that States notify information regarding their taxation and any preferential regime they apply, so as not to hinder the work of the *Forum on Harmful Tax Practice* and not to cover any tax avoidance mechanism[347].

The purpose of Action 5 is not to establish a single tax structure or to provide the right tax rate to the Countries, but its aim is to reduce the distortions of "harmful tax practices" and encourage free and fair "tax competition"[348]. If on one hand this is useful because in recent years tax havens have opened up to transparency and to the exchange of information, on the other hand doctrine has wondered whether there is a difference between "harmful" and "non-harmful" tax competition[349]. Data confirm that tax competition occurs both by introducing exemption schemes and by lowering tax rates. By increasing the transparency and the exchange of information during the tax ruling, the situation has improved, but it has not completely resolved. There is an evident contradiction: OECD is fighting tax havens, but at the same time individual States still use tax leverage: they reduce their tax rates or introduce patent box regimes[350].

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[345] https://www.oecd.org/tax/beps/beps-actions/action5/ .

[346] OECD, *Countering Harmful Tax Practices More Effectively*, *Taking into Account Transparency and Substance*, op. cit.. The *nexus approach* is the specific requirement for IP regimes, while the substantial activity requirements must apply in order to take advantage of other specific regimes not concerning Intellectual Property. OECD, *Harmful Tax Practices - 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2019), https://doi.org/10.1787/9789264311480-en.

[347] OECD, *Countering Harmful Tax Practices More Effectively*, *Taking into Account Transparency and Substance*, op. cit.

[348] Ibid.

[349] S. Biasco, *I danni della concorrenza fiscale in Europa*, Rass. Tributaria, 2015, 1, 119.

[350] Ibid.

5.3.5 BEPS action 6: prevention of tax treaty abuse

The signing of bilateral treaties against double taxation is a very useful action to remove all those obstacles to international trade that double taxation causes, but this can also foster the non-imposition of some incomes precisely because of the abuse of such treaties. For this reason, Action 6 of the BEPS Project is used to introduce new rules in (new or already entered into) conventions, and to provide suitable recommendations to counteract this practice[351]. The prevention of tax treaty abuse, or *treaty shopping*, belongs to the category of minimum protection standards set by the BEPS Project.

Generally, treaty shopping consists of a taxable person residing in a State who, however, is able to take advantage of the benefits of a treaty concluded between two third Countries.

The solution to this problem is to grant the benefits of the double taxation treaty only to those who are residents in one of the two contracting States.

Over the years, being the actual beneficial owner of the income paid has also become a requirement against treaty shopping, which however does not affect the application of other more specific anti-abuse rules[352].

Other methods to avoid treaty shopping consist in relying on the "substance over form" rule, or in resorting to domestic anti-abuse measures[353].

The OECD is very concerned about treaty shopping, because it reduces the tax revenue in the Country of residence of the taxable person who operates it; it also violates the principle of reciprocity between the two contracting States because the benefits negotiated between them are extended even to subjects not considered at the time of the signing[354]. The OECD also states that, as a direct consequence, the Country where the entity operating the treaty shopping is resident could indirectly take advantage of the abuse of the law; therefore the State does not consider necessary to enter into a treaty with the Country that undergoes the treaty shopping in order to re-establish a mutual treatment for their taxable persons[355].

Action 6 requires that each Country belonging to the Inclusive Framework states the following:

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[351] https://www.oecd.org/tax/beps/beps-actions/action6/ .

[352] OECD. *Preventing the granting of treaty benefits in inappropriate circumstances, Action 6—2015 final report.* OECD/G20 base erosion and profit shifting project (2015).

[353] Ibid. p. 79 § 56.

[354] https://www.oecd.org/tax/beps/beps-actions/action6/ .

[355] Ibid.

- It declares to prevent tax avoidance; such declaration is usually written in the preamble of the bilateral treaty;
- It declares to apply one of the three methods to fight treaty shopping, that is to introduce the LOB rules, or the PPT rules, or both.

These two requirements can be achieved either through bilateral agreements or through the signature of the Multilateral Instrument[356].

The three methods to prevent treaty shopping provide the various jurisdictions room for manoeuvre for a more effective and tailor-made implementation of the standard. These methods are the following:

- LOB rules (Limitation-on-benefits provisions) or specific anti-abuse rules that limit the benefits of the treaty in which they are contained;
- PPT rules (Principal Purposes of Transactions or arrangements) or more general anti-abuse rules based on testing the main purpose of the treaty[357].

The application of Action 6 is also supported by Action 15, concerning the signing of the so-called Multilateral Instrument, which is used to "update" existing bilateral conventions to the new OECD standards.

Recent monitoring of the implementation of Action 6 shows that many States have committed to change their agreements, while the actual changes have not yet been introduced. It was also found that the Multilateral Instrument and other suitable agreements are the most used means to implement Action 6[358].

5.3.6 BEPS action 7: Permanent establishment status

As it has already been mentioned in the previous chapters, the existence of a permanent establishment in a Country makes the incomes of a foreign entity taxable in that jurisdiction; the right to tax is limited to the share attributable to this permanent establishment. If a permanent establishment is not identified, this can cause tax avoidance and base erosion, therefore the BEPS Project has spent an action exclusively on the redefinition of the description of permanent establishment.

[356] OECD, *Prevention of Treaty Abuse –Second Peer Review Report on Treaty Shopping,* OECD, Paris. (2020) www.oecd.org/tax/beps/prevention-of-treaty-abuse-second-peer-review-report-on-treaty-shopping.pdf.

[357] OECD. *Preventing the granting of treaty benefits in inappropriate circumstances, Action 6— 2015 final report*. Op. cit. p. 18-19; OECD, *Prevention of Treaty Abuse –Second Peer Review Report on Treaty Shopping*. Op. cit. p. 14.

[358] OECD, *Prevention of Treaty Abuse –Second Peer Review Report on Treaty Shopping,* op. cit.

One of the examples in which a permanent establishment may not be recognised as such is through a “commissionaire arrangement”. When a multinational company owns a subsidiary that operates as a distributor in a certain Country, by changing this agreement into a commission contract, the functions performed by the entity remain the same, but the resulting profit is no longer taxable in the jurisdiction where the sales took place. Its profit is now taxable only in the Country of residence of the parent company[359].

Hence, the risk for a Country is to have permanent establishments in its territory that carry out production activities, but which are not taxable in that Country because they are not recognised as permanent establishments, or they are taxable to a small extent because only part of the income can be traced back to them.

Action 7 therefore aims to clarify those requirements, written in the previous definition provided by the OECD Model Convention, that can be easily circumvented for the correct identification of the permanent establishment. In particular, the focus is on the characteristics of the personal permanent establishment and on the exceptions for the material permanent establishment. In fact, the definition provided by OECD listed in a drawn-out way all the cases of permanent establishment, but it included also several exceptions, which could be exploited by multinationals at the expense of source Countries. An example: the preparatory and auxiliary activities carried out by a factory represents the exception to the rule for identifying a permanent establishment. An activity is considered a preparatory activity when it is short-lived compared to the main activity, while an activity is an auxiliary activity if it supports the other essential activities of the multinational[360].

Multinationals have recently evolved in such a way that they can divide their value chain and the activities they carry out; then they can place them in different Countries to increase their productivity. In this way, many branches are no longer recognised as permanent establishments and source Countries thus see their tax revenues decrease[361].

To sum up, with Action 7, the BEPS Project aimed to:

- clearly define when an intermediary should be considered a PE, unless he is independent;

[359] https://www.oecd.org/tax/beps/beps-actions/action7/ .

[360] P. Valente, *Il nuovo Modello OCSE di Convenzione contro le doppie imposizioni: profili di novità.* Il fisco, 2018, 6.

[361] O. Salvini, *La nuova definizione di stabile organizzazione nel Beps*, op. cit.

- limit the application of certain exceptions regarding preparatory or auxiliary[362] or construction activities, preventing multinationals from dividing their business in such a way as to inappropriately take advantage of these exceptions[363].

An agent is identifiable as a permanent establishment when he is a dependent agent of the multinational company, that is:

- he carries out the activity of concluding contracts, without the foreign company substantially modifying them, and on behalf of the company;
- and the commission agreements must be concluded in the name of the non-resident entity[364].

On the contrary, an agent is considered independent if he does his job without the foreign company constantly controlling him; if such is the case, the agent is not a personal PE.

The clause that avoid the fragmentation of the enterprise's activities is called "anti-fragmentation rule" and allows to identify a permanent establishment even when the carried out activities are preparatory or auxiliary. This is possible when the auxiliary activities are complementary to the economic activity and are fundamental for the core business.

Part of the doctrine does not completely agree with these new internationally adopted rules, because they are just a compromise between the will of governments to increase their right to tax foreign entities' incomes and the desire of multinationals not to change their carefully studied tax plan[365]. This compromise dampens the innovative action that the new definition of PE should have brought.

Even for the implementation of the new rules on the permanent establishment, the Countries preferred to opt for the signature of the Multilateral Instrument; however, the changes have also been included in the new OECD Model Convention[366].

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[362] «*Un'attività ha carattere preparatorio quando viene svolta facendo riferimento a ciò che costituisce la parte essenziale e significativa dell'attività d'impresa nel suo complesso* ("core activities"). *Un'attività, invece, è considerata ausiliare quando è condotta per supportare, senza esserne parte, la parte essenziale e significativa dell'attività di impresa nel suo complesso. Un'attività che richieda l'apporto di una significativa parte di cespiti e lavoratori non può essere considerata come attività ausiliare*.» C. Garbarino, *L'impatto del progetto Beps sul concetto di stabile organizzazione*, Dir. e Prat. Trib., 2019, 2, 587.

[363] https://www.oecd.org/tax/beps/beps-actions/action7/ .

[364] O. Salvini, *La nuova definizione di stabile organizzazione nel Beps*, op. cit.

[365] Ibid.

[366] Art. 5 OECD Model Convention.

5.3.7 BEPS action 8-10: Transfer pricing

Thanks to globalisation, intra-group trade has grown exponentially within corporate groups[367]. In intra-group transactions, the attribution of the transaction price is subject to greater arbitrariness than in transactions between independent parties; therefore by manipulating the transfer price, which is the transaction price for tax purposes[368], the tax base is eroded. BEPS Project dedicates actions 8, 9, and 10 to the calculation of the transfer price, to ensure that the "fiscal" price is aligned with the value created by the subsidiary. The principle which ensures that the intra-group price is correct is called "arm's length principle", that is, it determines the price of the intra-group transaction under market conditions if the same transaction had taken place between independent parties in similar conditions and economic circumstances[369].

Applying the arm's length principle can be difficult if transactions do not have direct comparables in the market. For this reason, the BEPS Project focused on providing guidelines in the following three specific areas: transactions involving intangibles (Action 8), transactions involving intra-group financing and risk allocation (Action 9), other transactions with a high risk of tax erosion that can occur in multinational groups such as management fees (Action 10)[370].

The purpose of the new rules on transfer price is precisely to link more closely the price to the economic reality, and thus discourage and reduce the possibility for multinationals to allocate their income in "cash boxes" that do not contribute to the creation of value for the corporate group. What is most interesting for the purpose of this thesis is Action 8, about the correct evaluation of the intangibles.

The OECD has dealt with the evaluation of intangibles on several occasions: in 2015 with the report called *Aligning Transfer Pricing Outcomes with Value Creation*[371], which was followed in 2017 by the publication of its consolidated version entitled *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax*

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[367] https://www.oecd.org/tax/beps/beps-actions/action8-10/ .

[368] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (2015). http://dx.doi.org/10.1787/9789264241244-en .

[369] Ibid. p. 15.

[370] https://www.oecd.org/tax/beps/beps-actions/action8-10/ .

[371] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,* op. cit.

Administrations[372] and in 2018 with the *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles*[373], strictly focused on intangibles difficult to evaluate.

First of all, the assessments related to intangibles must be made keeping in mind the arm's length principle, the only method accepted by OECD in order to correctly combine the taxation aspect with the value created[374].

In order to proceed with the evaluation of the transaction, OECD recommends that the following verifications are carried out in advance:

- To identify the transactions that have been carried out and that concerns intangibles;
- To univocally identify the intangibles involved;
- To identify the owner of the intangibles and to identify who contributed to the creation of their value, that is, of those who contributed to their development, maintenance and protection[375].

With regard to transactions involving intangibles, the OECD guide identifies both the transfer of ownership and the transfer of specific rights only. In fact, the transactions between associated companies can involve both the sale and the sole exploitation of the intangible, and the fact that these transactions have an intangible asset as their object makes their valuation difficult.

On the second bullet point, or the univocal identification of the intangibles involved in the transaction, the report differs in part from the definition of intangible as commonly defined for accounting purposes. «The word "intangible" is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the

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[372] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris (2017), https://doi.org/10.1787/tpg-2017-en.

[373] OECD, *Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles-BEPS Actions 8-10*, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris (2018). www.oecd.org/tax/beps/guidance-for-tax-administrations-on-the-application-of-the-approach-to-hard-to-value-intangibles-BEPS-action-8.pdf .

[374] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,* op. cit.

[375] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017,* op. cit.

determination of the conditions that would be agreed upon between independent parties for a comparable transaction»[376]. The emphasis is not put so much on a precise definition of intangible, which may be too restrictive; instead it is put on identifying the conditions under which the contract was concluded, in order to identify when a situation requires the application of the transfer price. The guide specifies that the intangibles indicated in art. 12 OECD Model do not always require to be evaluated with the transfer price and vice versa. Synergies and specific market conditions can influence the comparability at market conditions of certain transactions.

Finally, before proceeding with the attribution of the value deriving from the transaction, it is appropriate to identify all the entities that have in some way contributed to the development, maintenance, protection of the intangibles considered, and to identify who legally owns them[377].

The concept of control is fundamental in order to attribute the value produced to a specific subject. If an entity assumes the risks, but does not actually control these risks or is unable to bear them, then part of the value produced cannot be attributed to the entity either. Thus it is necessary to go and look elsewhere (in another company of the group for example) who actually exercises control and assumes the risk, and only then to proceed with the correct assessment of the intangible[378]. This step is necessary because the person who exercises control over an intangible also controls its development, maintenance, protection, exploitation, all operations that must be financed. Funding an entity that demonstrates to carry out all these functions but without taking risks, would generate a risk-free return[379]. The OECD report recognises that the attribution of these risks, which is very uncertain at the time of the transaction, can be done through a functional analysis.

In short, in order to properly analyse the value of an intangible, it is necessary to do the following actions:

- To specifically identify the intangibles used or transferred in the transaction, and all the risks associated with development, protection, exploitation of the intangibles.

[376] Ibid. p. 67.
[377] Ibid. p. 73.
[378] OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports,* op. cit.
[379] Ibid. p. 64.

- To identify all the agreements made for the contract in question and the related contracts, so to identify the legal ownership, the risks and the obligations assumed.
- To identify all the parties that in some way contributed to the development, protection, exploitation of the intangibles.
- To establish whether there is consistency between the terms of the contract and the economic reality, in particular regarding the assumption of risks.
- If several parties are involved in the development of the intangible, it is necessary to determine their contribution and possibly the market price of the functions performed[380].

All the parties thus identified, depending on their contribution given to the intangible or the degree of risk they assume, are entitled to a share of the return derived from the use of the asset.

In conclusion, the OECD suggests the methods to be used for the calculation of the transfer price, to be chosen based on the circumstances of the specific case. These methods are the following:

- Comparable uncontrolled price method (CUP);
- Resale price method;
- Cost plus method;
- Transactional net margin method;
- Transactional profit split method[381].

The *comparable uncontrolled price method* is the method that best meets the definition of arm's length principle. It consists in determining the transfer price by using a real evaluation of a similar and independent transaction. The problem of applying this method is the difficulty in finding comparable transactions, given the uniqueness of the intangibles and the fact that all the functions and risks assumed in the independent transaction must also be similar to the ones in the transaction to be evaluated[382].

With the *resale price method*, the transfer price is derived from the resale price of the product to an independent company. In this case, we have a first transfer of the product within the corporate group, so an intra-corporate sale, followed by an extra-corporate

[380] Ibid. pp. 74-75.
[381] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017,* op. cit.
[382] Ibid. pp. 101-104.

sale, therefore between independent parties. Starting from this last sale, an adequate mark-up is subtracted; such mark-up should consist in the profit margin if the retailer were instead an independent third party. The difference is the transfer price of the intra-corporate transaction. The mark-up to be applied may be based on other similar operations that the multinational usually carries out[383].

The *cost plus method* consists in considering the costs incurred by the supplier in the intra-group transaction, adding to these an appropriate mark-up. The resulting price is the transfer price of the transaction. To determine the mark-up, the company can rely on the mark-ups it applies in similar transactions and with independent companies, or it can use as a reference the price of a comparable and independent transaction[384].

The *transactional net margin method* determines the transfer price through the net profit margin that derives from the intra-group transaction. For the application of this method, it is previously established that this margin is in line with the same net margin that would result from a transaction with a third party company, or it is similar to the net margin found in a comparable transaction between two independent companies outside the group. The margins used are the ratio between net profit (that is calculated taking into account only the elements with an operational nature that refer to the transaction in question) and costs, revenues or assets (the choice of the most appropriate denominator should reflect the part of the company that is quite independent from the controlled transaction under evaluation)[385].

Finally, the *transactional profit split method* considers the overall profits deriving from the controlled transaction, that have to be split among the companies that have concluded the intra-group transaction. This profit splitting should reflect the distribution of profits deriving from a comparable transaction concluded between independent parties. The OECD report identifies two methods of profit splitting, although it does not exclude that other allocations can be applied as long as they have a plausible economic basis. The two examples written in the report are the following:

[383] Ibid. p. 105-110.
[384] Ibid. p. 111-115.
[385] For example, the following margins may be used: net profit divided by the turnover; net profit divided by costs, directly or indirectly related to the controlled transaction; net profit divided by standard costs; net profit divided by operating assets. OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017,* op. cit., p. 123-130.

- The contribution analysis, where the distribution takes place considering the contribution offered by each company that concluded the transaction, that is, keeping in mind the assets used and the risks assumed by each business;
- The residual analysis, which splits the overall profits deriving from the controlled transaction between the companies of the group, but in two successive stages. In the first stage, profits are distributed using the traditional methods above mentioned, while in the second stage, the residual profit is attributed on the basis of facts and circumstances[386].

The choice of the most appropriate method must reflect the business reality.

It is necessary to consider the comparability of assets, risks and functions when analysing the comparable transactions.

5.4 Implementation of BEPS Project in the Member States: the ATAD Directives

Consistent with the provisions resulting from the BEPS Project, the European Union has enacted the following directives:

- Directive 2016/1164/EU, known as ATAD 1 (*Anti-Tax Avoidance Directive*);
- Directive 2017/952/EU, known ATAD 2, that added the hybrid mismatches to the previous directive.

The main purpose of these directives is to avoid the transfer of profits outside the EU, and at the same time to hinder aggressive tax planning that compromises the functioning of the internal market, by implementing the rules that have arisen in the Inclusive Framework. At the same time, the directives do not stop Member States from adopting measures that ensure a higher protection on these subjects, both with national rules and through bilateral agreements[387].

The directives address the following five topics:

- Interest limitation rules;

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[386] The *OECD Transfer Pricing Guidelines* contains very precise examples of how to correctly apply the residual profit split. OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017,* op. cit.

[387] V. A. Paciello, *Direttiva ATAD: nuovo regime CFC e modifiche alla tassazione dei dividendi black list.* Novità fiscali 2020.1 (2020): 27-35. http://novitafiscali.supsi.ch/874/1/Paciello%20-%20Direttiva%20ATAD_%20nuovo%20regime%20CFC%20e%20modifiche%20alla%20tassazione%20dei%20dividendi%20black%20list.pdf .

- Entry and exit taxation;
- General anti-abuse rule;
- Controlled foreign company rules;
- Hybrid mismatches[388].

As regards the deductibility of interest expenses, the directive aimed to incorporate the provisions of Action 4 of the BEPS Project, hence interest expenses can be deducted, during the tax period, only up to 30% of the earnings before interest, tax, depreciation and amortisation (EBITDA). This measure, in the intentions of the legislator and the OECD, should limit the base erosion caused by charging excessive interest expenses.

About the exit taxation, the purpose of the directive is to prevent the non-taxation of unearned earnings because the enterprise transfers its residence or its assets to a low tax country. The directive requires that assets, or the company, or the permanent establishment that are transferred to other Countries are subject to taxation based on their market value[389].

The general anti-abuse rule, also identifiable with the acronym GAAR[390], wants to include all the opportunities of abuse of the rights that have not yet been identified by national laws with specific anti-abuse rules. The general anti-abuse rule identifies "non-genuine" companies that do not have valid reasons to exist, apart from the abuse of tax laws and international treaties[391].

Finally, for CFC rules and hybrid mismatches, the directive complied with what emerged in the BEPS Project, as already discussed in the previous paragraphs.

The ATAD package has not been transposed in the same way in all European Countries because in some cases the national legal systems already had rules which guaranteed a minimum, if not higher, level of protection in some of the topics of the directive. For this reason, it was not necessary to introduce new rules to legislate on an issue that has already been effectively resolved; at most, slight modifications were sufficient[392].

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[388] A. Roberti. *Royalties e delocalizzazione nel commercio globale.*

[389] Art. 5 directive 2016/1164/EU.

[390] A. Roberti. *Royalties e delocalizzazione nel commercio globale.*

[391] P. Valente, *Il recepimento della direttiva ATAD I (come modificata dalla direttiva ATAD II) da parte dell'Italia,* La gestione straordinaria delle imprese 5/2018, DOTTRINA EUTEKNE, 2018 https://static1.squarespace.com/static/55a50b8ee4b00f4e23b93618/t/5bd17feff4e1fc658a19286.3/1540456437547/2018_25-10_GSI_PV_Il+Recepimento+della+Direttiva+ATAD+I.pdf

[392] https://www.ipsoa.it/documents/fisco/fiscalita-internazionale/quotidiano/2019/04/06/direttiva-atad-cambiamenti-imprese-azienda-europa .

Italy implemented the ATAD package in 2018 with the d.lgs. 142/2018; the text introduced new rules on hybrid mismatches, that had never been organically treated previously. Italy already had exhaustive rules for the other areas mentioned in the ATAD directive. For example, it was not necessary to change the general anti-abuse rule, as art. 10-bis of the l. 27 luglio 2000, n. 212 already complied with the text of the directive. On the contrary, about the rules on CFCs, the legislator deemed it necessary to simplify the already existing legislation and to align it with the ATAD package[393].

5.5 Current scenario: has anything changed?

Despite the interest and efforts of the OECD in preventing the BEPS phenomenon, recent studies show that tax avoidance has not drastically decreased[394]. In fact, although many States have signed the multilateral agreements established as per Action 15[395] and have updated their internal rules to comply with the new anti-abuse rules, they do not have given up on applying rates and laws that increase their competitive position in the international tax scenario, thus encouraging multinationals to open branches and transfer capital into their economic systems[396]. Therefore, even if States with ordinary taxation and various international organizations recognise that tax erosion has negative consequences on the economy in general, some Countries prefer to continue to adopt the fiscal lever so not to see the foreign investments of large multinationals reduced. Despite all, these Countries are still able to comply with the new limits imposed by the Action Plan.

An example above all, the case of Ireland. Ireland is known in the tax field for the so-called "Double Irish", an elaborate scheme of companies and license agreements, adopted mainly by several US multinationals[397] that, with the support of the Dutch legislation[398], allowed enterprises to create the so-called "Double Irish with a Dutch sandwich" and thus to decrease even more their tax burden.

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[393] https://www.assoholding.it/la-normativa-atad-contrasto-alle-attivita-di-erosione-del-mercato/ .

[394] F. Antonacchio, *Pianificazione fiscale aggressiva nell'era post-BEPS,* Fisco, 2020, 9, 854.

[395] Signing only the multilateral instrument does not also imply that the bilateral agreements are immediately updated, but it means there is only the future *commitment* to update them.

[396] F. Antonacchio, *Pianificazione fiscale aggressiva nell'era post-BEPS,* op. cit.

[397] Surveys have revealed how most tax avoidance mechanisms stem from multinational companies based in the United States. T. R. Tørsløv, L. S. Wier, and G. Zucman. *The missing profits of nations*. National Bureau of Economic Research, 2018.

[398] European "tax havens" are Ireland, Holland, Luxembourg, Belgium, Cyprus and Malta.

After this method was universally discovered (and known through the press) as a widespread tax fraud system, Ireland decided to put an end to it, declaring its removal by 2020.

Ireland has thus resolved one issue, but it has also opened another one: the newly issued rules have not made some aspects of the tax discipline more certain, clear and sure; on the contrary, the less clear aspects have indeed been cleverly exploited by multinational companies that in this way continue to save on taxes. These new tax planning schemes are known as Single Malt and Green Jersey.

It is very likely that other tax avoidance schemes are in place, but they have not yet been the subject of reports and investigations.

5.5.1 The previous "Double Irish with a Dutch Sandwich"

The most known elusive scheme, that was widely applied until its recognition led to the modification of some national rules[399], was the one renamed "Double Irish with a Dutch Sandwich", and it was used by multinationals, mainly based in the US, such as Google Alphabet and Apple[400]. The tax avoidance mechanism started at the multinational's headquarter in the US and involved two subsidiaries in Ireland, a conduit company in the Netherlands and an additional subsidiary located in a tax haven, like for example Bermuda Islands in the Caribbean. This latter company managed and controlled one of the Irish subsidiaries, which only had a registered office in Ireland [401].

The Double Irish with a Dutch Sandwich scheme worked as follows[402].

The US company and the latter Irish subsidiary enter into a license agreement: the US company receives not too high royalties, while the Irish company can manufacture and sell the licensed product. But this sale does not take place, because the Irish company enters into a sub-license agreement, on the same intangible assets, with the conduit company based in the Netherlands, which, in turn, enters into another sub-license agreement with the second company based in Ireland. After all, it is the latter company

[399] The Irish government has changed its internal rules, but Double Irish can still be applied until end of 2020. A. Roberti. *Royalties e delocalizzazione nel commercio globale.*

[400] Apple used the Double Irish until the corporate restructuring in 2014. Then, it developed the so-called "Green Jersey". M. Christensen, E. Clancy. *Exposed: Apple's golden delicious tax deals: Is Ireland helping Apple pay less than 1% tax in the EU?.* (2018).

[401] This company has been thus incorporated in Ireland but, as it is managed offshore, it is not an Irish tax resident.

[402] F. Antonacchio, *Pianificazione fiscale aggressiva nell'era post-BEPS*, Fisco, 2020, 9, 854.

that has a business structure so that it can produce the licensed product and can generate income.

The royalties that the Irish company pays to the Dutch company are suitably "inflated" in order to reduce the tax base in Ireland, where, however, the applied company tax rate is lower than the European average[403]. Moreover, thanks to the "Interest and Royalties" directive, these royalties are not subject to withholding tax.

In turn, the Dutch conduit transfers the received royalties to the Irish company that is managed offshore. Even this last flow of revenues is not subject to tax because:

- according to the Dutch law, the company to which the royalties are paid is Irish and not from Bermuda, therefore the "Interest and Royalties" directive can be applied and there is no source taxation in the Netherlands[404];
- the Irish law does not recognise the company as an Irish tax resident because it only has the registered office in Ireland;
- the tax haven taxes corporate income at low or zero rates.

In the end, through stratagems and financial transactions, profits finally are repatriated to the United States. Most of the times, however, they are not repatriated at all, since they would be taxed to a certain extent: so the profits remain indefinitely non-taxable and the multinational company uses them for new investments[405].

With this system, multinationals were overall able to pay a paltry global corporate income tax.

5.5.2 New abuses of law: "Single Malt" and "Green Jersey"

A new aggressive tax planning technique that was used until recently consists of a multinational company (US-based for example) that owns two Irish subsidiaries, one of which is incorporated in Ireland but resident in Malta for tax purposes[406].

The concept is similar to the Double Irish, but in this case the Irish company is managed offshore from another European country. Such planning, called "Single Malt", consists

[403] Ireland has a corporate tax rate of 12.5%. https://taxfoundation.org/corporate-tax-rates-europe-2019/ .

[404] J. Dine, M. Koutsias. *The Three Shades of Tax Avoidance of Corporate Groups: Company Law, Ethics and the Multiplicity of Jurisdictions Involved.* European Business Law Review 30.1 (2019): 149-182.

[405] S. Micossi, *La fiscalità d'impresa nel nuovo mondo globalizzato e digitalizzato*, Assonime 2017.

[406] F. Antonacchio, *Pianificazione fiscale aggressiva nell'era post-BEPS,* op. cit.

in the licensing of intangibles to the company fiscally resident in Malta, which in turn enters into a sub-license agreement with the other company resident in Ireland, which will eventually go on to produce and sell the good under licence. The outgoing royalties paid by the latter enterprise are not subject to withholding tax due to the "Interest and Royalties" directive. Similarly, the income of the receiving company is not taxed because the firm is not fiscally resident in Ireland and it does not even have the domicile in Malta.

This curious case in which a company is not fiscally resident in any Country was promptly highlighted, and pressure from the International Community urged Malta and Ireland to negotiate new arrangements to solve this problem. With the new agreements, now the intermediary company is identified as resident in Ireland[407].

"Green Jersey" takes its name from the Jersey Island, located in the English Channel, which is a British domain but not formally part of the United Kingdom; it is characterised by a corporate income tax rate equal to 0[408].

This elusive mechanism exploits a subsidiary company, which is resident in an offshore jurisdiction like Jersey, and the benefits provided by the Irish legislation with the industrial property regime[409]. It does not directly exploit royalty payments, but rather the costs related to the ownership of intangible assets.

Ireland has introduced, in fact, an IP regime that allows to deduct between 80% and 100% of the costs for the development or purchase of intangibles, limited to the expected depreciation rates, from the revenues derived from the use of these assets.

In this case, the ownership of the intangible initially belongs to the company located in the offshore jurisdiction[410]; in order to reduce the tax base, the development costs were also partially borne by the US parent company. The intangible is then sold to the Irish subsidiary, which can thus reduce (even almost totally) the taxable revenues deriving from the sale of the goods produced thanks to the deduction of the acquisition costs, and for different tax periods. To repay the intra-group debt that was contracted so to purchase the asset, the Irish firm repays the company on Jersey Island, which, among other things, had initially lent the money. These payments are therefore interest

[407] Ibid.

[408] https://home.kpmg/content/dam/kpmg/pdf/2014/05/jersey-2014.pdf .

[409] The term was coined after Apple adopted this mechanism by specifically establishing companies to be resident on the island. M. Christensen, E. Clancy. *Exposed: Apple's golden delicious tax deals: Is Ireland helping Apple pay less than 1% tax in the EU?*. Op. cit.

[410] This company does not need to be offshore, as long as it is resident in a tax haven.

expenses, and they are 100% deductible[411]. The company on Jersey Island, therefore, does not see the resulting capital gain subject to taxation.
The Green Jersey mechanism has been tolerated by Ireland so to facilitate multinational enterprises in replacing the Double Irish.

5.6 Specific issues on fighting profit shifting at a global level

The BEPS Project has 137 members, including States and dependent territories.
Not all Countries in the world join the program. Does this negatively affect the efforts of the OECD?
According to the doctrine[412], it is important that all States coordinate in applying the same anti-BEPS measures, otherwise the current misalignments would continue, and these would nullify the efforts made so far. In addition, unilateral countermeasures to aggressive tax planning should also be avoided, because they would only lead to fragmentation. International investors would also benefit from a uniform framework, as they would save on tax planning.
Unfortunately, we must admit that this vision is not reflected in reality, first because all the States of the world should be involved without exclusion, and second because these same States should find a common agreement. This is very difficult, since not all jurisdictions have the same needs and requirements. For example, the doctrine[413] recognises that developing countries have greater difficulties in applying the rules of the Action Plan, because these States have structural shortcomings and therefore require rules that are partly different and more suited to their characteristics. Furthermore, in these Countries it is much easier to evade the tax authorities, precisely because the law is not adequately enforced. These States do not have adequate tools to collect all the information necessary to combat tax erosion and their tax administrations have little experience in negotiating dispute resolution with taxpayers.
On the other hand, there is an undoubted tax advantage in having low-tax countries, which is difficult to give up. Existing global data show a high amount of profits flowing from high taxation countries to tax havens. It was found, for example, that, while the

[411] https://www.dublininquirer.com/2018/07/11/andy-from-the-double-irish-to-a-green-jersey-ireland-remains-a-tax-haven .
[412] P. Valente. *Attuazione delle misure BEPS, criticità e prospettive.* Op. cit.
[413] P. Valente. *Erosione della base imponibile e profit shifting nei Paesi in via di sviluppo.* Op. cit.

ratio of gross profits to wages in local companies is around 30-40%, for multinationals that operates profit shifting in Ireland this ratio even reaches 800%[414].
Such a situation benefits the governments of tax havens, because it has been found how these Countries have been able to collect, in percentage, higher taxes (compared to their national income) than high-tax countries [415]. Even the shareholders of the multinational enterprises obviously benefit from this, because they have more profits to distribute.
In the current scenario, therefore, low-tax countries and tax havens continue to exist. The doctrine[416] attempts to explain this fact in several ways. First of all, the main objective of a high-tax Country is to reallocate in its jurisdiction the profits that have been mistakenly attributed to another Country, but it does not matter whether these profits are repatriated from another high-tax Country or from a Country with low taxation. It would make no difference to the State if tax havens continue to exist, as long as the incomes are repatriated.
The data also show that there are more disputes for the repatriation of incorrectly allocated revenues coming from other high-taxation Countries, rather than coming from low-taxation ones.
But then, if profit shifting is a fact, why do the States, that would benefit most from repatriating incomes from tax havens, show that they are more interested in repatriating misallocated profits, which were perhaps misallocated with no express purpose of tax avoidance? Because it is easier for the tax authorities to repatriate the latter type of income.
Information on the consolidated financial statements of multinationals is easier to find; the multinationals themselves offer less resistance to the reallocation of their incomes, as they would not lose much from the difference in tax rates (the rates are very similar among high-tax Countries). Finally, high-tax Countries are generally collaborative and the dispute can be quickly settled with the dispute resolution agreements provided by OECD and EU. If a dispute arises for the repatriation of an income from a tax haven, it would be very difficult to find all the necessary data because they are conveniently classified and the State would be more reluctant to cooperate. Multinational enterprises would also oppose much more resistance precisely because if the dispute were resolved

[414] T. R. Tørsløv, L. S. Wier, and G. Zucman. *The missing profits of nations*. Op. cit.
[415] Ibid.
[416] Ibid.

with the taxation of their income in the high-tax Country, the cost would certainly be higher[417].

Furthermore, States are still tied to the concept that if costs for multinationals increase, the latter will reallocate their assets to other States, but not all the resources of the Country of origin can move with the same ease. For example, the workforce is not perfectly movable and Countries do not wish to face a high unemployment rate; thus sometimes they even make compromises with multinationals. The personal interests of some States therefore discourage the commitment to effectively combat profit shifting, as well as a more radical reform of the entire tax system[418].

The globalised world, created by digitalisation, has led to the establishment of new business models within multinational companies, creating the so-called "global enterprise". The peculiarity lies in the fact that for the multinationals of 20 years ago it was necessary to establish branches or subsidiaries in the target Countries, which performed the same functions of the parent company, functions that were necessary for the production of the core business asset.

Today, however, a company can enter a new market without the need to create a new branch; indeed, the various activities that constitute the value chain of the company can be separated and allocated in different Countries.

Today, each single part of the multinational can specialise in a specific activity, and only all the parts put together can achieve the main business. The multinational can no longer be seen as a group of independent businesses in which some parts can be removed, but it is a single entity where the various parts, even if scattered around the world, are all necessary to achieve the common purpose of the business activity[419].

The current tax model, instead, has not adapted to the new business models. A global enterprise, in fact, «produces profits on a global level, and they are difficult to connect to the markets on which the company is active»[420]; the taxation of its profits, on the other hand, takes place by dividing them according to the production sites (which are no longer correct to identify in this way) and using the arm's length principle (which is based on the comparison with independent companies; this concept is not correct either

[417] Ibid.
[418] Ibid.
[419] S. Biasco, *I danni della concorrenza fiscale in Europa,* op.cit.
[420] S. Micossi, *La fiscalità d'impresa nel nuovo mondo globalizzato e digitalizzato*, op. cit. p. 3

because it is no longer possible to identify a single part of the company as if it were an independent entity)[421].

The solution, shared by most of the doctrine, would therefore be to renounce applying the rules on the permanent establishment, on the CFCs, on the transfer price, and instead to calculate the global profit of the multinational, with slight adjustments for some items as already happens when the tax base is derived from the company's financial statements. The profit thus calculated would then be divided according to the characteristics of the Countries in which the multinational operates (for example, with the weighted criterion that takes into account sales, cost of personnel and tangible assets[422]); the individual shares obtained in this way would ultimately be taxed according to the various States.

Such taxation system would in any case allow the various Countries to apply the tax rates they deem most appropriate, without multinationals being able to shift their profits. The multinationals would rather align their taxation in the single Countries with the taxation of local businesses[423].

In this way, aggressive tax planning would be greatly reduced, though not completely eliminated. The multinational would be facilitated in the calculation of its overall tax base, given that in any case it must prepare the consolidated financial statement, and thus it would also reduce compliance costs[424].

This would be the best solution, but it cannot be applied because States have not yet achieved sufficient cooperation[425].

The European Union has also reached the same conclusion: in the past, it has made repeated proposals for a directive on the taxation of the digital economy, called Common Consolidated Corporate Tax Base. The initial proposal was to introduce a single and common system for the calculation of the tax base, which is subsequently divided among the States through shared criteria. But this proposal has been modified in a simpler redefinition of the concept of permanent establishment, as it is now meant.

[421] Ibid.
[422] S. Biasco, *I danni della concorrenza fiscale in Europa,* op.cit.
[423] V. Ceriani, G. Ricotti, *Riflessioni sul coordinamento internazionale della fiscalità d'impresa*, Rass. Tributaria, 2019, 1, 30
[424] Ibid.
[425] Ibid.

The concept of "significant digital presence"[426] was introduced in the proposal, while the common tax system was maintained.

However, this proposal has not yet been approved, as the unanimous consent of the Member States is lacking[427]. Some Member Countries have attempted to introduce in advance some regulations in accordance to the proposed directive, like in the case of Italy that in the recent budget law (2019) introduced the concept of "virtual permanent establishment"[428]; but it is necessary to reiterate once again that unilateral actions increase the fragmentation of the international scenario, create fiscal injustices and hinder the common internal market.

The issue still has no solution: the OECD is planning new meetings both to discuss the taxation of the digital economy and to review the BEPS Project.

Therefore, the path taken by the international community is the only viable way for the time being: the automatic exchange of information, the shared cooperation mechanisms, and the specific approaches to the phenomena that can cause base erosion and profit shifting, are a good starting point for combating the tax avoidance[429].

[426] A. Della Rovere, I. Viola. *Prospettive della digital economy in ambito internazionale, europeo e nazionale*, Fisco, 2019, 10, 947.
[427] S. Santoro, *La web tax. Profili di sistema*, Dir. e Prat. Trib., 2020, 2, 459.
[428] A. Della Rovere, I. Viola. *Prospettive della digital economy in ambito internazionale, europeo e nazionale*, op. cit.
[429] P. Mastellone, *Contrasto all'erosione nel diritto tributario internazionale*, Dig. disc. priv., sez. comm., Aggiornamento 8, 2017.

CONCLUSIONS

From what has been discussed, the importance of intangible assets is fundamental for companies wishing to increase their value, especially in the current global economic situation. The consequence of this is that the value of royalties exchanged between companies has risen significantly, making their use very profitable, not only from the point of view of technological innovation for businesses, but also as a tool for tax avoidance.

The delay of local administrations and international organizations in adapting to this new way of creating value, still anchored to concepts of territorial taxation and national sovereignty, and above all committed to developing tax competition rather than fruitful collaboration, has done nothing but encourage base erosion and unequal tax treatment.

Only in recent years there has been an attempt to move the state of being.

Doctrine’s change of thinking also contributed to this. If ,until recently, tax competition was considered legitimate and useful for the economy, it is now seen as a penalising factor. This mainly affects Countries which, despite having important productive activities, do not receive the legitimate and adequate tax revenues, to be used for social well-being and for further economic development.

In addition, tax avoidance increases the disparities between local companies and multinationals.

The discussions that took place within the BEPS Project are certainly not facilitated by the current tax system. From what emerged in the previous chapters, there are three levels of legislation: national, international and Community legislation.

Italian national legislation does not have a unitary discipline on royalties. This fact causes problems for taxable persons, who must, from time to time, check in the TUIR in which income category the royalties they receive fall under; furthermore, the perplexity arises as to why a single type of income should fall into different categories of income according to the person who receives them.

When analysing the law of treaties contained in the OECD and UN models, it is instead noted that the taxation of royalties must take place only in the Country of residence of the entity who receives them. This implies that in most cases, the source States decide to apply a withholding tax, in order not to lose taxes on the value that is produced in their Country. The result is that, obviously, doing so creates double taxation, and therefore

States are forced to enter into treaties against double taxation and grant tax credit. Furthermore, if the dictate of the OECD model was promptly followed, this would favour tax avoidance, since it is very simple to transfer the registered office of the beneficial owner to a low-tax Country. If, on the other hand, taxation at source were favoured over the taxation in the Country of residence, transferring the residence would be irrelevant for the source States, while the disadvantage would remain only for the original Country of the beneficial owner, which would probably see the tax residence of the latter transferred elsewhere. In this case, however, there would still be the double taxation, but this inconvenience would be a “secondary consequence”. The impression is that by favouring source taxation, the conclusion of double taxation treaties is more justified than in the current state of affairs, where source States apply the withholding tax to reduce tax avoidance and to participate in the profits derived from royalties arisen in their territory.

Finally, even when we analyse Community taxation, we realise that this occurs only in the State of residence of the beneficial owner, and without any withholding tax. Furthermore, the only directive adopted dealing with the taxation of royalties is aimed only at European corporate groups. This only deals, therefore, with a limited case in point, that is only companies, and in particular only associated companies, and does not regulate all cases of royalties. Not allowing source States to tax outgoing royalty flows, then, greatly favours tax avoidance, as previously stated.

We can see that the legislations are currently set up in a way that does not prevent multinational enterprises from eroding their tax base through royalties. However, the efforts of the OECD to fight the BEPS phenomenon have not substantially changed the weak links of the legislation in force. Even if many solutions recently introduced with the BEPS project have brought some benefits, the doctrine agrees with the fact that these solutions were simply limited to solve only the most pressing issues, without resolve the cause of the problem. However, it has been made clear that the best solution would be to completely revolutionise the international tax system, but unfortunately this is not feasible. The targeted changes that have recently been introduced, such as changes in the discipline of hybrid mismatches or CFCs, have been useful but, at the same time, not decisive. If, on an international level, only withholding taxation on royalty income were adopted, surely better results would be obtained and it would also align with the arm’s length rule, that is, what was produced would be taxed in the Country where it was produced.

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