Regulations Provide Further Guidance on the Application of the Authorized OECD Approach to the Attribution of Profit to Permanent Establishments

The author considers the recently issued Regulations on the application of the authorized OECD approach under existing German tax treaties, specifically for the allocation of profit to permanent establishments.

1. Permanent Establishment Profit Attribution Regulations Issued

On 13 October 2014, the Upper House (Bundesrat) adopted the “Regulations on the Application of the Arm’s Length Principle on Permanent Establishments in accordance with section 1(5) of the Foreign Tax Act (Aussersteuergesetz)” (Permanent Establishment (PE) Profit Attribution Regulations) (the Regulations).1 These Regulations were drafted by the Ministry of Finance and were adopted by the Upper House based on the delegated power in section 1(6) of the Foreign Tax Act granted by the parliament (Bundestag). The Regulations have the quality of law and, thus, are binding on taxpayers, the tax administration and the tax courts in Germany. They provide the long-awaited guidance for taxpayers on how they should apply, in practice, the authorized OECD approach under section 1(5) of the Foreign Tax Act, which is effective in Germany for all financial years commencing after 31 December 2012. The rules in the Regulations are effective for financial years starting after 31 December 2014. For taxpayers, this means that they must apply the authorized OECD approach from 2013, but must abide by the fairly prescriptive rules in the Regulations only as from 2015. Thus, taxpayers should invest time in their profit allocation of their permanent establishments in Germany and the documentation thereof in 2015 to prepare for the subsequent years.

At the same time, the application of the authorized OECD approach under the changed domestic law may be limited by German income tax treaties that do not contain the new wording of article 7 of the OECD Model (2010) or any other indication that the treaty partners intend to apply the authorized OECD approach from 2013, but must abide by the fairly prescriptive rules in the Regulations only as from 2015. Thus, taxpayers should invest time in their profit allocation of their permanent establishments in Germany and the documentation thereof in 2015 to prepare for the subsequent years.

2. Structure of the PE Profit Attribution Regulations

The Regulations are subdivided into the following seven parts with subparts:

- Part 1:
  - subpart 1, sections 1-3: General provisions;
  - subpart 2, sections 4-11: Allocation rules;
  - subpart 3, sections 12-15: Branch capital, other liabilities and interest and similar expenses; and
  - subpart 4, sections 16-17: Dealings;
- Part 2, sections 18-22: Special rules for permanent establishments of banks;

The German treaty landscape presents itself as follows as far as the incorporation of the authorized OECD approach is concerned (as at 31 December 2014):

- treaties with the old wording of article 7 of the OECD Model (treaties with extended interpretation of a PE as being independent of the head office, i.e. treaties ratified after 17 July 2008): Albania, Algeria, Austria, Bulgaria, Cyprus, Hungary, Ireland, Jersey, Malaysia, Malta, Macedonia, Mauritius, Mexico, Spain, Syria, Taiwan, Turkey, United Arab Emirates, United States and Uruguay;
- treaties with the new wording of article 7 of the OECD Model (treaties that include the authorized OECD approach, i.e. treaties ratified after 22 July 2010): Liechtenstein, Luxembourg, the Netherlands, Norway and the United Kingdom.

All other treaties entered into by Germany that were ratified before 17 July 2008 contain the old wording of article 7 of the OECD Model and, therefore, are interpreted as treating the permanent establishment as independent of the head office in a limited way.

Part 3, sections 23-29: Special rules for permanent establishments of insurance companies;
Part 4, sections 30-34: Special rules for permanent establishments of construction companies;
Part 5, sections 35-38: Special rules for permanent establishments of exploration companies;
Part 6, section 39: Special rules for agency permanent establishments; and
Part 7, sections 40-41: Final provisions.

Whereas Parts 1, 2, 3 and 6 reflect broadly the rules known from OECD publications on the allocation of profits to permanent establishments issued in 2008 and 2010, Parts 4 and 5 chart new territory, in that Germany develops special rules on the allocation of profits to permanent establishments of construction and exploration companies which are unparalleled in any other country and, therefore, may trigger controversies with such other countries.

The main reason for this expectation is that these rules show a tendency to allocate more profit to the head office than to the permanent establishment, assuming that the permanent establishment performs more or less routine activities with most of the know-how being provided from the head office.

This article focuses on Part 1 in particular (the so-called allocation rules) and Part 6 of the PE Profit Attribution Regulations (the Regulations).


3.1. Terminology

While section 1 of the Regulations reiterates the legal requirement under the authorized OECD approach provision in the Foreign Tax Act to perform a functional analysis and, on that basis, allocate people functions, assets, opportunities and risks, and, subsequently, branch capital, other liabilities and dealings with third and related parties between a head office and its permanent establishment(s), section 2 of the Regulations defines some important terms used therein, as follows.

A domestic enterprise, for example, is defined as an enterprise that has its place of management in Germany, whereas a foreign enterprise is defined as an enterprise that has its place of management situated outside of Germany. Thus, the registered seat of an enterprise, which is one of the two requirements that can trigger liability to corporate income taxes in Germany on worldwide income, is not relevant here. This seems to be in line with the concept of people functions that the OECD has introduced as a means to regulate, in a harmonized manner across jurisdictions, the attribution of profits to permanent establishments.

The very important term “people functions” is defined as a business activity that is performed for the enterprise by its own personnel. In particular, people functions are the

use [of an asset], the acquisition [of an asset], the manufacture [of an asset], the administration [of an asset], the disinvestment [of an asset], the (further) development [of an (intangible) asset], the protection [of an asset], the risk management [with regard to an asset] and the decision to change a risk position.

Own personnel within the meaning of section 2(3) of the Regulations refers to each individual who performs activities for the enterprise either on the basis of the articles of association (i.e. managing directors of a company) or on the basis of an employment contract. Beyond that, personnel that are seconded by another company to the enterprise would also be treated as “own” personnel of such enterprise. It is presently unclear whether or not personnel who perform activities for the enterprise on the legal basis of a service agreement, as opposed to a secondment agreement would also qualify as “own” personnel. In the absence of any contractual arrangement, an individual would still be treated as own personnel if such person is the entrepreneur or shareholder (e.g. of a partnership), or if the individual is a related person of such enterprise or the shareholder within the meaning of section 1(2) of the Foreign Tax Act.

A people function is significant (maßgeblich) if – in relation to people functions performed in other permanent establishments – it has the greatest importance with regard to the asset, liability, risk, dealing, etc. that must be allocated. People functions that merely have a supporting character or define the overall policy or guidelines for the enterprise as a whole, are not seen as significant with regard to the item that needs to be allocated.

Relevant assets (Vermögenswerte) are defined as assets (Wirtschaftsgüter) and advantages (Vorteile). Both terms, “assets” and “advantages”, are defined by case law and thus would either have to lead to a booking entry on the tax balance sheet or be concrete enough so as to be able to be identified as an advantage. Advantages, however, are not accountable for on the balance sheet for either commercial or tax purposes, so that assets within the meaning of the Commercial Code (Vermögensgegenstand) or the Income Tax Act (Wirtschaftsgut) are what must be allocated for the purpose of attributing profit to permanent establishment(s) with reference to the authorized OECD approach under the Regulations. As such, a taxpayer’s tax balance sheet and profit and loss account for tax purposes as of 31 December 2014 must be split into separate balance sheets and profit and loss accounts for each permanent establishment in an effort to implement the authorized OECD approach in 2015. Hence, such balance sheet and profit and loss account is the starting point for a taxpayer when implementing the authorized OECD approach. Among other things, tangible goods, intangible goods, shares and other investments are assets within that meaning.
3.2. Auxiliary calculation for attribution purposes

Section 3(1) of the Regulations requires that a taxpayer prepares a so-called auxiliary calculation at the beginning and at the end of each financial year, in addition to the commercial and/or tax balance sheet and profit and loss account. Such auxiliary calculation is meant to disclose, as a result, the income attributable to the respective permanent establishment under either section 34d, No. 2(a) of the Income Tax Act (foreign PE) or section 49(1), No. 2(a) of the Income Tax Act (domestic PE). Thus, the auxiliary calculation must be available at the time the tax return for the enterprise or the domestic PE is prepared.

Under section 3(2) of the Regulations, the auxiliary calculation must comprise all elements (Bestandteile) that must be attributed to the respective PE, i.e.:

- assets within the meaning of sections 5 through 8 of the Regulations;
- the branch capital within the meaning of sections 12 and 13 of the Regulations;
- other liabilities within the meaning of section 14 of the Regulations; and
- the income and expenses associated with these elements, including fictitious income and expenses from dealings within the meaning of sections 16 and 17 of the Regulations.

Technically, it appears as if the financial statements for tax purposes are rewritten or split between head office and permanent establishment(s). In this light, one could ask whether there is a need and/or sufficient authorization for such an auxiliary calculation if, essentially, it is the tax balance sheet and profit and loss account plus adjustments to develop the profit/loss according to the tax balance sheet to the taxable income. The law itself, however, is clear, in that it requires the taxpayer to prepare something which contains the defined information.

The German transfer pricing documentation rules in section 90 of the General Tax Code (Abgabenordnung) subject the profit allocation between head office and permanent establishment to the legal documentation requirements (section 90(3)(4) General Tax Code; section 7 of the Regulations with regard to the type, content and scope of the documentation within the meaning of section 90(3) General Tax Code (the Documentation Regulations)). In this context, section 3(3) of the Regulations provides that the transfer pricing documentation for a permanent establishment must include the reasons why the elements under section 3(2) of the Regulations, the dealings under section 9 of the Regulations, the opportunities and risks under section 10 of the Regulations and the hedging transactions under section 11 of the Regulations have been attributed to a specific permanent establishment, including the head office. Moreover, such documentation must contain the reasons why a taxpayer believes that there are indeed dealings within the meaning of sections 16 and 17 of the Regulations (fictitious transactions) between head office and permanent establishments, or between permanent establishments excluding the head office.

4. Allocation Rules

4.1. Allocation of people functions

The so-called allocation rules (Zuordnungsregeln) are at the heart of the German interpretation of the authorized OECD approach. They are fairly specific and thus go beyond the rather flexible approach outlined and promulgated in the 2010 OECD report on the attribution of profit to permanent establishments. These rules allow the taxpayer to split the joint tax balance sheet of an enterprise into parts representing the various permanent establishments, including the head office. And this is indeed the expectation of the legislature, namely that the taxpayer prepare or re-confirm a quasi-tax balance sheet and profit and loss account for each permanent establishment by allocating assets or groups of assets or balance sheet positions in their entirety, or parts thereof, to the various permanent establishments.

The starting point for this allocation exercise is the attribution of people functions under the rules defined in section 4 of the Regulations. Under section 4(1) of the Regulations, a people function must be attributed to a particular permanent establishment if the activities of such people function are actually performed (Ausführung) geographically in that permanent establishment. An attribution of a people function to a particular permanent establishment would not be acceptable, however, if such people function does not have any relationship (sachlicher Bezug) with the business activity in that permanent establishment and, in addition, would be performed in that permanent establishment for only less than 30 days in a given financial year.

If a people function is performed neither in a permanent establishment nor in the rest of the enterprise, or is not allocable under section 4(1)(2) of the Regulations, such function must be attributed to the permanent establishment in relation to which it has or shows the closest relationship (sachlich engster Bezug).

If a people function cannot be attributed unequivocally to one permanent establishment, an attribution must be made that would not violate the principles set out in section 4(1) and (2) of the Regulations. The materials made available by the Upper House in the legislative process suggest that the taxpayer has a certain degree of freedom to attribute people functions where it desires, based on appropriate documentation of the reasons and provided that such reasons are not in direct conflict with the rules defined in section 4 of the Regulations.

The attribution rules for people functions are illustrated in Figure 1.

4.2. Allocation of tangible assets

Under section 5(1) of the Regulations, a tangible asset must be attributed to a particular permanent establishment if the asset is used (Nutzung) in that permanent establishment. Thus, the use is the significant people function for tangible assets (maßgebliche Personalfunktion).

If a tangible asset is later used in a different permanent establishment for some time (auf Dauer), it would have to
be attributed to that different permanent establishment from that point in time onwards. In cases of frequent change of use, the respective tangible asset must be attributed to the permanent establishment having the business activity in which it is primarily used in comparison to the business activity in other permanent establishments.

Other than as mentioned in section 5(1) of the Regulations, a tangible good must be attributed to a different permanent establishment from where it is used if an (other) people function(s) performed in that different permanent establishment are unequivocally more important than the people function under section 5(1) of the Regulations, i.e. the use. Such other people function could be, in particular, the acquisition, the manufacturing, the administration or the disinvestment of the respective tangible good or group of tangible goods. Immovable property within which the business activity of a permanent establishment is being performed, however, would always be attributable to that permanent establishment.

If other people functions within the meaning of section 5(2)(1) of the Regulations are being performed in more than one permanent establishment at the same time, the tangible asset must be attributed to the permanent establishment that performs the other people function with the greatest importance for the respective tangible asset or group of tangible assets.

If a tangible asset cannot be attributed unequivocally to one permanent establishment, an attribution must be made that would not violate the principles set out in section 5(1) through (3) of the Regulations – which provides some degree of freedom to the taxpayer. 13

The attribution rules for tangible assets are illustrated in Figure 2.

### 4.3. Allocation of intangible assets

Under section 6(1) of the Regulations, an intangible asset must be attributed to a particular permanent establishment if the asset is created in (Schaffung) or acquired by (Erwerb) that permanent establishment. Thus, the creation or acquisition is the significant people function for intangible assets (maßgebliche Personalfunktion).

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13. Similarly, see section 3.1.
Other than as mentioned in section 6(1) of the Regulations, an intangible asset must be attributed to a different permanent establishment from where it is created or acquired if an (other) people function performed in that different permanent establishment is unequivocally more important than the people function in section 6(1) of the Regulations, i.e. the creation or acquisition. Such other people function could include the use, the administration, the further development, the protection or the disinvestment of the respective intangible good or group of intangible goods.

If other people functions within the meaning of section 6(2)(1) of the Regulations are being performed in more than one permanent establishment at the same time, the intangible asset must be attributed to the permanent establishment that performs the other people function with the greatest importance for the respective intangible asset or group of intangible assets.

If a tangible asset cannot be attributed unequivocally to one permanent establishment, an attribution must be made that would not violate the principles set out in section 6(1) through (3) of the Regulations – which provides some degree of freedom to the taxpayer. At the same time, the Regulations allow the partial allocation of intangible assets, whereas all other elements must be attributed to one or the other permanent establishment and, thus, may not be split-allocated. In this regard, German law deviates significantly from the 2010 OECD PE Report, which provides for a partial allocation irrespective of the underlying asset. At the same time, from a practical perspective, a taxpayer may not want to allocate assets partially to two different locations with deviating depreciation rules, etc.

The attribution rules for intangible assets are illustrated in Figure 3.

4.4. Allocation of shares, other investments and similar assets

Under section 7(1) of the Regulations, shares, other investments and similar assets must be attributed to a particular permanent establishment if the respective asset or group of assets is used (Nutzung) in that permanent establishment. Thus, the use is the significant people function for tangible assets (maßgebliche Personalfunktion). A functional relationship with the business activity is what is required under this allocation rule.

Other than as mentioned in section 7(1) of the Regulations, shares, other investments and similar assets must be attributed to a different permanent establishment from where they are used if an (other) people function performed in that different permanent establishment is unequivocally more important than the people function in section 7(1) of the Regulations, i.e. the use. Such other people function could include the acquisition, the administration, the risk management or the disinvestment of the respective asset or group of assets.

If other people functions within the meaning of section 7(2)(1) of the Regulations are being performed in more than one permanent establishment at the same time, the asset must be attributed to the permanent establishment that performs the other people function with the greatest importance for the respective asset or group of assets.

If such an asset cannot be attributed unequivocally to one permanent establishment, an attribution must be made that would not violate the principles set out in section 7(1) through (3) of the Regulations – which provides some degree of freedom to the taxpayer.

The attribution rules for shares, other investment and similar assets are illustrated in Figure 4.
4.6. Allocation of transactions with third or related parties

Under section 9(1) of the Regulations, transactions within the meaning of section 1(4)(1), no. 1 of the Foreign Tax Act which the enterprise has entered into with either independent third parties or related parties must be attributed to a particular permanent establishment if the people functions which caused the entering into of such transaction are performed in that permanent establishment. Thus, the activity that caused the entering into that transaction is the significant people function for such a transaction (maßgebliche Personalfunktion).

Other than as mentioned in section 9(1) of the Regulations, any other transaction must be attributed to a different permanent establishment if an (other) people function performed in that different permanent establishment is unequivocally more important than the people function under section 9(1) of the Regulations, i.e. the creation or acquisition. Such other people function could include the use, the administration, the risk management, or the disinvestment of the respective other asset or group of other assets.

If other people functions within the meaning of section 9(2)(1) of the Regulations are being performed in more than one permanent establishment at the same time, the intangible asset must be attributed to the permanent establishment that performs the other people function with the greatest importance for the respective other asset or group of other assets.

If any other asset cannot be attributed unequivocally to one permanent establishment, an attribution must be made that would not violate the principles set out in section 9(1) through (3) of the Regulations – which provides some degree of freedom to the taxpayer.

The attribution rules for other assets are illustrated in Figure 5.
4.7. Allocation of opportunities and risks

Under section 10(1) of the Regulations, opportunities and risks must be attributed to a particular permanent establishment if they have a direct relationship with an asset within the meaning of sections 5 through 8 of the Regulations or with a transaction within the meaning of section 9 of the Regulations which is allocated to that permanent establishment.

Those opportunities and risks that do not have any direct relationship with an asset or transaction must be allocated to the permanent establishment in which the people function is being performed that triggered these opportunities and risks. Thus, such people function would be the significant people function (maßgebliche Personalfunktion). If that significant people function is being performed in more than one permanent establishment at the same time, the opportunities and risks must be attributed to the permanent establishment that performs the people function with the greatest importance for these opportunities and risks.

Other than as mentioned in section 10(2) of the Regulations, opportunities and risks must be attributed to a different permanent establishment from where it is allocated under that section if an (other) people function performed in that different permanent establishment is unequivocally more important than the people function in section 10(2) of the Regulations. Such other people function or activities could include those associated with the administration, the risk management or the realization of opportunities and risks or decisions that lead to a change in the risk position.

If other people functions within the meaning of section 10(3)(1) of the Regulations are being performed in more than one permanent establishment at the same time, the opportunities and risks must be attributed to the permanent establishment that performs the other people function with the greatest importance for the respective opportunity or risk.

If opportunities and risks cannot be attributed unequivocally to one permanent establishment, an attribution must be made that would not violate the principles set out in section 10(1) through (4) of the Regulations – which provides some degree of freedom to the taxpayer.

4.8. Allocation of hedging transactions

Under section 11(1) of the Regulations, hedging transactions (Sicherungsgeschäfte) must be attributed to a particular permanent establishment if the respective hedging transaction is entered into to hedge specific risks of a people function, of an asset or a transaction if such people function, asset or transaction is allocated to that permanent establishment.

If one or more hedging transactions are entered into to hedge the above-mentioned risks which are allocated to several permanent establishments at the same time and if a direct allocation is impossible or would cause an unacceptably high administrative burden on the taxpayer, an indirect relationship between the risk and the hedge must be assumed. Such indirect hedges must be allocated partially to the permanent establishments to which the people functions, assets and transactions have been allocated.

An alternative allocation of hedges which deviates from section 11(1) and (2) of the Regulations would be acceptable only if it leads to a result (i.e. income of the permanent establishment) that better reflects the arm’s length principle.

Assets which hedge risks of other assets – even though this was not their purpose when acquiring them – must be allocated under the rules in sections 5 through 8 of the Regulations.
5. **Branch Capital, Other Liabilities and the Allocation of Interest Expense**

Under sections 12 and 13, the branch capital must be determined at the beginning of each financial year.

The branch capital of a domestic PE of a foreign enterprise must be determined by applying a capital allocation method by which the enterprise’s capital is allocated relative to the assets in the various branches, taking into account the associated risks (section 12). The tax administration may allocate higher capital under certain conditions, at a minimum, however, the capital that is disclosed on the balance sheet which is actually disclosed for commercial law purposes for that domestic PE. A significant change in circumstances (i.e. which would lead to a 20% change of the branch capital) throughout a financial year would lead to the need for an adjustment in that financial year.

The branch capital of a foreign PE of a domestic enterprise must be determined by applying a minimum capital approach, under which the foreign PE is allocated capital for tax purposes only if it is necessary from a commercial perspective (section 13). The taxpayer may allocate higher capital only if this would be in line with the arm’s length principle, although not more than the capital that would result from the application of the capital allocation method applied to the balance sheet items on the German commercial balance sheet. An even higher capital allocation may be required if this is legally required, e.g. for regulatory reasons, limited, however, to the capital disclosed for the branch on its balance sheet for commercial law purposes. As for a domestic PE, a significant change in circumstances (i.e. which would lead to a 20% change of the branch capital) throughout a financial year would lead to the need for an adjustment of the capital in that financial year.

The balance sheet would be completed with other liabilities (directly or indirectly allocated) or shortened depending on whether, after the branch capital allocation, assets and liabilities are in balance (section 14). Correspondingly, interest expense for the directly or indirectly allocated liabilities would be allocated to the PE or reallocated to the head office (section 15).

6. **Dealings and the Remuneration of the Treasury Function**

The Regulations would recognize dealings between a head office and PE whenever a reallocation would have to occur under sections 5 through 11 of the Regulations, or if independent entities would have entered into a transaction or would have insisted on their respective legal positions (section 16(1)). Such dealings would have to be priced at arm’s length and thus would create fictitious income or expense. By contrast, the use of funds by a PE normally would not qualify as dealing. The exception is a PE that hosts the treasury function or that generates funds which are made available to the enterprise as a whole, the latter being acceptable only for a period not to exceed one year. The Regulations assume that the treasury function would have to be remunerated as a routine service, i.e. with a cost-plus method, and would only exceptionally allow a treasury PE to charge a margin on its refinancing costs (section 17).

7. **Special Rules for Agency Permanent Establishments**

Section 39(1) of the Regulations provides that all provisions of the Regulations are applicable also to permanent establishments created by agents within the meaning of section 13 of the General Tax Code.

For agents in the legal form of a company, whether or not incorporated, which employs its own personnel, the Regulations assume that such personnel of the agent are to be taken to be personnel of the principal, in explicit contradiction of the rules defined in section 2(3) of the Regulations. By doing so, the Ministry of Finance and the legislature have attempted to create an argument that a profit element from the principal can be allocated to an agency permanent establishment in a country, even though the company that performs the agency activity is appropriately remunerated under the arm’s length standard with an arm’s length commission. Whether or not such assumption is lawful remains to be seen when cases are brought before the tax courts in Germany to test whether this rules violate basic taxation principles. The discussions around Action 7 on the BEPS Agenda are pointing in a similar direction.

8. **Conclusion**

The Regulations are very prescriptive and in many ways go beyond the rules that the OECD has developed in the context of the authorized OECD approach. Whether this fact renders these rules more vulnerable to dispute with taxpayers and other countries will very much depend on how the tax administration applies these rules in practice and the extent to which applicable treaty law will restrict the application of these rules. In this light, one could only suggest to the tax administration to carefully evaluate whether a position taken in a tax audit is reasonable, given all the facts and circumstances. Taxpayers, at the same time, should make sure that they invest time and effort at the start of the authorized OECD approach, i.e. in the 2015 financial year, in order to understand what the authorized OECD approach means for their business and in order to set up appropriate documentation right from the start. Otherwise, the risk of an unpleasant awakening in the tax audit covering years after 2015 or even 2013 is almost certain. The impact of the authorized OECD approach should not be underestimated, in particular not by taxpayers that do not have a separate set of accounts for their PEs.

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14. Capital would have to be determined according to German tax law, or exceptionally be the capital according to the head offices generally accepted accounting principles.

15. In principle, assets should be reflected with their market value, or exceptionally with their book values.