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7 February 2017

German Federal Ministry of Finance on Profit Allocation for PEs

http://docs.bepartners.pro/2016-12-22-BMF_BsGa.pdf

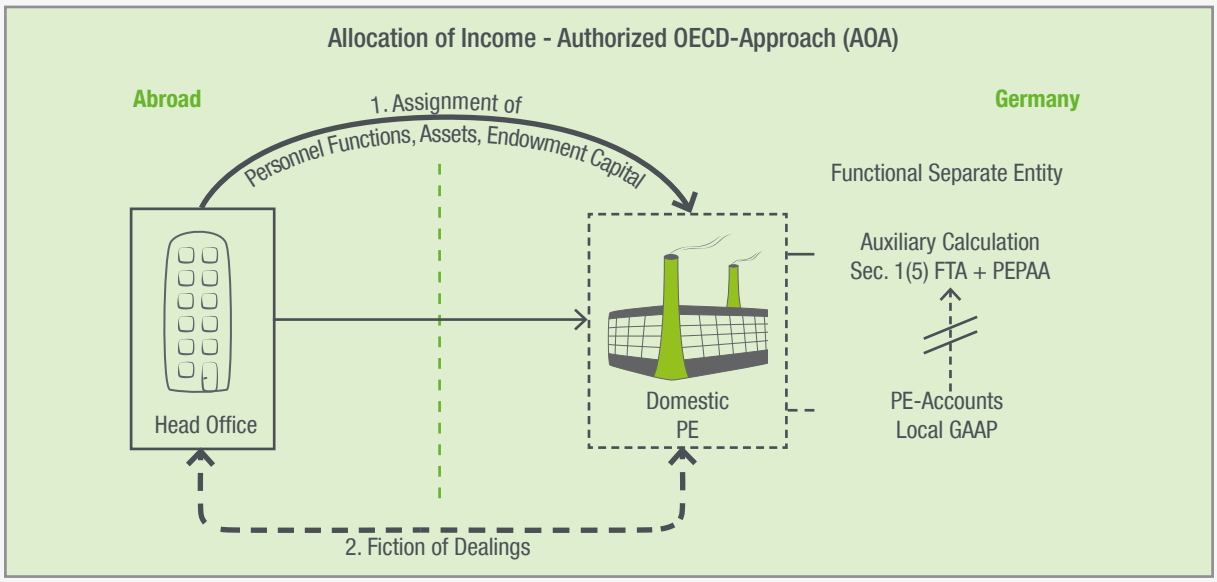
Shortly before Christmas 2016, the Federal Ministry of Finance issued the long-awaited administrative guidelines on the profit allocation for permanent establishments (profit allocation PE guidelines). The 186-page long guidelines intend to specify the application of the arm's length principle for permanent establishments implemented into law in 2013 as Sec. 1(5) of the Foreign Tax Act (FTA). Furthermore, the guidelines comment on the regulations of the Permanent Establishments Profit Allocation Act (PEPAA) issued in this context in 2014 and applicable to business years commencing after December 31, 2014.

If a company maintains a permanent establishment in a foreign state, the income will have to be allocated between its head office and such permanent establishment. According to Sec. 1(5) FTA, the arm's length principle has to be applied to business years commencing after December 3rd, 2012. In this regard, on the basis of the so-called "functionally separate entity approach", those profits, which the permanent establishment would generate if it were an independent and autonomous company, will have to be allocated to such permanent establishment. This rule is based on the so-called Authorized OECD Approach (AOA) and the OECD Report on the Attribution of Profits dated October 22nd, 2010.

The issued profit allocation PE guidelines, which are divided in 6 chapters, form the final part of the extensive implementation of the OECD standard regarding the profit allocation for permanent establishments into domestic law. In this Newsletter, the main provisions of such guidelines and their impact on the allocation and determination of the taxable income of domestic and foreign permanent establishments are briefly presented.

Permanent Establishment as Independent and Autonomous Company

Chapter one of the profit allocation PE guidelines illustrates the regulatory purpose and content of the legal provisions on the profit allocation with reference to the OECD Report on the Attribution of Profits. Furthermore, the scope of application and the system for the application of the arm's length prin-



ciple with regard to the cross-border determination of income from a permanent establishment are illustrated and certain relevant terms are defined. Thus, according to the AOA, such portion of income (which conceptually includes losses) has to be allocated to a permanent establishment, which income the permanent establishment would generate, in connection with its economic relations (so-called "dealings") with the other companies, if it were an independent and autonomous corporate entity. In this regard, the permanent establishment is largely treated as a related party. Therefore, it has to be determined which functions, assets, opportunities and risks of the company as well as which portion of equity of the company (endowment capital) has to be assigned to the permanent establishment. In the absence of legal independence of the permanent establishment, economic processes have to be assumed which result in fictitious contractual agreements.

Despite the extensive harmonization on the determination of income for permanent establishments and affiliated companies and/or related parties, substantial systematic differences remain due to the fact that the permanent establishment forms an inseparable part of the company according to civil law.

Scope of Application

The basic principles for verifying the application of the arm's length principle are applicable to all cross-border cases of so-called "ordinary permanent establishments", independent of the fact whether a double tax treaty (DTT) is applicable or not. However, please note that in the event there is a permanent establishment according to Sec. 12 of the German General Tax Code exists but not according to the applicable DTT, Sec. 1(5) FTA, the PEPAA and the provisions of the guidelines are not applicable as the income does not have to be determined in the absence of a permanent establishment under the DTT. Sec. 1(5) FTA and the PEPAA are solely income correction rules, which only can result in either an increase of domestic income from a taxable person subject to limited tax liability or a decrease of foreign income from a taxable person subject to unlimited tax liability and cannot establish a tax liability as such.

The guidelines are only applicable to permanent establishments within the meaning of Sec. 1(5) FTA, which are part of a company (ordinary permanent establishments). They do not apply to so-called co-entrepreneur permanent establishments, which are fictitiously assumed in the course of the taxable income determination for a partner of a partnership.

The income determination of taxable persons subject to limited tax liability, who do not maintain a domestic permanent establishment, are also not affected by the guidelines. For example, foreign corporations that hold domestic real property, which generally does not give rise to a permanent establishment, are not subject to the scope of application.

Specific Record-Keeping Obligations (Auxiliary Calculation)

Chapter 2 forms the main focus of the guidelines. The individual provisions of the PEPAA are commented and illustrated with examples.

According to Sec. 1 PEPAA, the starting point for the allocation of income to a permanent establishment is a function and risk analysis of the business activity of the permanent establishment as part of the company. Based on such analysis, a comparability analysis has to be conducted in order to calculate transfer prices for the transactions with related parties and the other companies in accordance with the arm's length principle. For the calculation of adequate transfer prices, all nationally and internationally accepted transfer pricing rules, including the basic principles as to cost allocation, are acceptable. Sec. 1(3) FTA states that the price comparison method, resale price method and cost-plus method are the preferred procedures to be applied.

The auxiliary calculation regulated in Sec. 3 PEPAA, which determines the taxable income of the permanent establishment, is of fundamental importance. Generally, such calculation has to be commenced at the beginning of the business year, continued throughout the business year and concluded at the end of the business year. At the latest, the calculation has to be finalized at the filing date of the tax return.

The PEPAA contains specific provisions for the assignment of the endowment capital and the remaining liabilities, which are set forth in Sec. 12 to 14 and which deviate from the regular provisions on the determination of taxable income. The calculation of the endowment capital to be assigned to a permanent domestic establishment generally has to be undertaken by applying the functional and risk-related capital allocation method. In the opposite case, generally the minimum capital equipment method has to be applied. The capital actually shown in the German GAAP accounts of a domestic permanent establishment only determines the minimum amount of the endowment capital to be assigned. In the opposite case, the capital actually shown in the foreign GAAP account of a foreign permanent establishment determines the maximum amount of the endowment capital to be assigned. The remaining liabilities generally have to be allocated using the direct method. Those liabilities, which are directly related to the assets or the opportunities and risks allocated to the permanent establishment, have to be determined. If the sum of remaining liabilities exceeds the residual amount, the directly allocable liabilities will have to be reduced proportionately. If there is a shortfall of directly allocable liabilities, the residual amount will have to be bolstered with remaining liabilities of the company using the indirect method.

An obligation to keep books or the voluntary keeping of books does not release the company from the obligation to set up an auxiliary calculation. According to the opinion of

the German financial authority, the financial accounting may be merely the basis for the auxiliary calculation and only in certain cases could directly correlate to such.

In addition to the assets to be allocated to the permanent establishment, the endowment capital and the remaining liability items form part of the auxiliary calculation. Due to the fictitious treatment as an independent company, it may be required to include items, which until now were not included in either the GAAP accounts or the auxiliary calculation, such as an immaterial asset and the related fictitious operating income and expenses created in the other company which have to be allocated to the permanent establishment or vice versa.

Furthermore, the basic principles as well as special aspects as to the assignment of personnel functions and different types of assets as well as the assignment of business transactions and opportunities and risks are addressed and illustrated by practical examples. Finally, the PEPAA's industry sector-specific provisions for permanent establishments of banks and insurance companies, construction and assembly permanent establishments and the permanent representative are discussed and illustrated by practical examples in Chapter 2.

Effective Date, Transitional Provisions and the Application of Former Guidelines

Chapter 3, in particular, contains the financial authority's view on the application of Sec. 1(5) sentence 8 FTA. The provision grants a preference to the applicable DTT provisions, provided the taxable person proves that the other state actually exercises its right of taxation on the basis of the DTT and the application of Sec. 1(5) FTA would therefore result in double taxation. Initially, a differentiation is made between DTTs containing a provision equivalent to Art. 7 OECD-MC and DTTs with OECD member states containing a provision equivalent to Art. 7 OECD-MC 2008 (old treaties). However, the German financial authority concludes in both instances that the other state follows the tax treatment in accordance with Sec. 1(5) FTA, the PEPAA and the current guidelines. In the case of old treaties, the German financial authority based its view on the assumption that it is accepted between the member states to interpret the applicable provisions in line with the OECD Report on the Attribution of Profits, as this interpretation is more consistent with the meaning and purpose thereof than the former OECD model commentary. Such conclusion is based on the so-called dynamical interpretation, despite the fact that this approach was rejected by the German Federal Fiscal Court (25 November 2016, I R 50/14, DStR 2016, pg. 954). Hence, Sec. 1(5) FTA and the PEPAA are applicable in both cases according to the view of the German fiscal authority. Thus, Sec. 1(5) sentence 8 FTA will not apply in DTT cases with OECD member states.

For DTTs with non-member states of the OECD, which contain provisions equivalent to Art. 7 OECD-MC 2008 or Art. 7 UN-MC, the German financial authority regularly assumes that the other state does not follow the tax treatment set forth in Sec. 1(5) FTA, the PEPAA and the related guidelines. In such cases, the declaration of income for a permanent establishment in accordance with the former interpretation of the DTT, which is regulated in the previous guidelines for permanent establishments for German tax purposes (Federal Fiscal Court Circular dated 24 December 1999, IV B 4-S 1300-111/99, BStBl. I pg. 1076), is acceptable. However, the tax declaration to be filed in Germany is supposed to be accompanied by the tax declaration filed and the tax assessment issued in the other contracting state. Additionally, the deviation from Sec. 1(5) FTA has to be pointed out in the tax declaration and the amount resulting from such deviation has to be quantified. If and to what extent such requirement is practicable and whether the additional efforts are reasonable will be left open at this point.

In addition, it is regrettable that previous guidelines for permanent establishments (see above) generally continue to apply. Such application is regulated in recital 460 et seq. The previous guidelines cease to apply only as far as Sec. 1(5) FTA, the provisions of the PEPAA, the current guidelines and the provisions of the DTT provide more recent provisions. Although it is very welcome in principle that, for example, Appendix 1 to the former guidelines regarding the comparability of international legal forms of organization continues to be valid, the parallel application of the two guidelines, which are each quite extensive already, however, makes the application thereof even more complicated. A consolidated version of the guidelines from the financial authority as to the determination of taxable income for permanent establishments or at least an overview specifying the provisions from the former guidelines that continue to apply would be desirable.

Initial Conclusion

Generally, it is encouraging that the financial authority has stated its view on the application of Sec. 1(5) FTA and the PEPAA in its detailed guidelines. It must be stated, however, that while the guidelines contain numerous explanations, clarifications and diverse examples, they generally exceed only to a small extent that what the PEPAA together with its explanatory statement already provides. The practical examples largely address only certain specified regulatory areas and are always greatly simplified. Additionally, in many cases the examples and analysis thereof are one-sided in favor of the financial authority and lack any instructions as to how potential exculpatory proof might be demonstrated.

be in touch: If you have any questions, please do not hesitate to contact us!

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