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By PwC Deutschland | 05 September 2013

Draft ordinance on permanent establishment profits

The finance ministry has published a draft of its ordinance on permanent establishment profits following the authorised OECD approach.

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June 2013 saw the enactment of a revision to the Foreign Tax Act adopting the “authorised OECD approach” (AOA) to the allocation of business profits to foreign permanent establishments. Essentially, this approach calls for the allocation of profits between the various parts of a legal entity based on the functions performed by each and by assuming their mutual dealings to have been settled at arm’s length as though they were independent enterprises. The German enactment applies from January 1, 2013, though with a rider accepting the continued application of the previous principles (excluding profit recognition within a legal entity and allowing deduction of attributable business expense regardless of where incurred) as necessary to avoid double taxation from the continued application of a traditional treaty clause in the other state in the traditional way. The federal finance ministry has been authorised to issue an implementing ordinance with the approval of the *Bundesrat* on the new approach. Its first published draft was dated August 5, 2013.

The new approach is based on an analysis of the functions and risks of the PE within the context of the entity as a whole. This is to be followed by a comparative analysis of third party data under the transfer pricing rules for associated enterprises in order to find the appropriate arm’s length remuneration for its activities. The primary emphasis is to be placed on the activities and responsibilities of the PE personnel. Once these have been established, the analysis extends to the allocation the assets, the risks and opportunities, the branch capital requirement, its share in the financing of the company, the allocation of income and expense, and the determination of the notional contracts to govern the dealings between the PE and the rest of the company.

The taxable income of the PE is to be established from memorandum branch accounts recording the transactions with outside and related parties as invoiced and those within the enterprise at their arm’s length price. These memorandum accounts are to be opened on the formation of the branch with the allocation of assets and liabilities at market value. The accounts are to be closed on dissolution of the branch with the transfer of the assets and liabilities to other parts of the entity, again at current market value. Assets are to be allocated according to the personnel using them. However, a different allocation of intangibles may be appropriate if employees in other units were or are substantially involved in their development, protection, administration or marketing. Similarly, the allocation of other assets, business dealings, opportunities and risks primarily follows the staff involved. Exceptions are possible, mainly to take account of the significant involvement of others.

Branch capital is discussed at some length. The main principle is to allocate the equity of the company in proportion to the assets it finances. However, if the company is a member of a group, an allocation of the group equity may be more appropriate. The minimum amount to be ascribed to a domestic branch is its formal allotment. The same measure of formal allotment is the maximum capital for a foreign branch. Subject to this, any foreign (non-tax) rules prescribing a minimum capital for a branch abroad are to be observed. Determination of the branch capital leaves the allocation of the outside liabilities of the company as the difference between the asset and capital allocations. The interest expense is to be allocated accordingly – based on the mean between the opening and closing balances for the year.

Dealings between a branch and the other units of the same company are to be governed by notional

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contracts similar to the contracts that would have been concluded between third parties in otherwise similar circumstances. This applies to changes in function or assets, trading transactions and to other events putting one party under an obligation towards the other.

The draft ordinance also discusses the special cases of a financing centre PE, bank and insurance branches (equating them with separate legal entities subject to German supervisory requirements), construction and assembly sites (with a strong preference for cost plus remuneration without attribution of equipment not intended to remain permanently on site) and for establishments prospecting for oil, gas or minerals.

Keywords

AOA, authorised OECD approach, ordinance, permanent establishment (PE)