



## Global Tax Update

Germany

Deloitte Tohmatsu Tax Co.

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### Germany Adopts Final Version of Regulation on Attribution of Profits to Permanent Establishments

The upper chamber of Germany's Parliament on October 10 adopted the final version of the regulation on the application of the arm's length principle to permanent establishments.

The branch profit attribution regulation includes a range of detailed rules on the application of the Authorized OECD Approach (AOA) in Germany, which was incorporated into German tax law last year.

The core idea of the AOA is to treat permanent establishments for tax purposes as if they were (nearly) fully independent and separate legal entities. This implies the consequent application of the arm's length principle to internal dealings between the permanent establishment and its head office, and between permanent establishments of the same company.

The branch profits attribution regulation has the stature of a law, and binds the taxpayer, the tax authorities, and the tax courts. It governs:

- The asset attribution and attribution of chances and risks to permanent establishments;
- The branch capital allocation;
- The recognition of "assumed contractual relationships" (dealings); and
- The application of the AOA to banks, insurance companies, and construction

- and exploration sites.

Germany generally follows the guidance provided by the OECD in the "Report on the Attribution of Profits to Permanent Establishments" of 22 July 2010. However, for some fact patterns the German branch profit attribution regulation provides more detailed rules than discussed by the OECD and reduces the range of alternative approaches available to the taxpayer. This is especially true for branch capital allocations, with regard to some refutable presumptions in the German regulation, which deviate from the OECD consensus, as well as with regard to the special provisions for construction, installation, and exploitation permanent establishments.

#### (1) Changes to August 2013 draft

In comparison to the draft version of the regulation dated 5 August 2013, the German Federal Ministry of Finance (MoF) has responded positively to some requests for changes made by industry associations and tax experts. In particular, the following changes are welcome:

- The attribution of people functions to a permanent establishment is also possible in cases in which the permanent establishment relies on seconded personnel;
- A clarification that no contemporaneous

documentation requirement is introduced for the profit attribution to permanent establishments;

- No assignment of people functions to a permanent establishment when those functions are performed in that location only for a short period of time (less than 30 days);
- The simplification of the attribution of macro hedging transactions; and
- Avoidance of the retroactive application of the new rules; the new rules are applicable for financial years commencing after 31 December 2014.

Unfortunately, with respect to the following issues, the MoF ignored heavy criticism formulated by business associations and in the tax literature on the following points:

- The fundamental differentiation between domestic and foreign permanent establishments, which from an EU perspective appears highly questionable. This is particularly relevant for the asymmetric approach prescribed for the branch capital allocation for industrial companies, banks, and insurance companies; and
- The allocation of insurance contracts to the general branch manager irrespective of his/her involvement in the underwriting process can be avoided only by a proper documentation of the facts and circumstances, which must be submitted to the supervisory authorities.

## **(2) The AOA's two-step approach**

In accordance with the OECD PE Report, the attribution of profits to permanent establishments is performed in a two-step approach. In the first step, the people functions performed by the permanent establishment are identified based on the activities of locally employed personnel. Next, the assets used and risks assumed that are associated with those people functions are attributed to the different parts of the enterprise. Finally, the branch capital is attributed to the permanent establishment, taking into account the functions performed and risks assumed by

the permanent establishment.

On the basis of this attribution, the internal dealings between the head office and its permanent establishment(s) and between permanent establishments of the same entity are identified, and an arm's length remuneration is determined. For this purpose, the provisions of the OECD transfer pricing guidelines apply by analogy.

## **(3) Auxiliary Calculation**

The branch profits attribution regulation also introduces the obligation for the taxpayer to prepare a separate balance sheet and profit and loss statement for the permanent establishment in accordance with the principles of the AOA (the "auxiliary calculation").

The auxiliary calculation comprises assets attributable to the permanent establishment, the branch capital, and other liabilities. Also, the fictitious revenues and expenses resulting from internal dealings must be recorded.

Taxpayers must open the auxiliary calculation at the beginning of each fiscal year, must record all transactions during that year, and then close it at the end of the fiscal year. The auxiliary calculation must be prepared at the latest when the permanent establishment's tax return for the pertinent fiscal year is filed. To avoid having this provision lead to a contemporaneous documentation requirement for the branch profit attribution, the new regulation states that the reasoning for the asset attribution and the identification of internal dealings must be documented in writing based only on the general transfer pricing documentation requirements. German law does not set a specific deadline for the preparation of transfer pricing documentation. However, the taxpayer must be able to provide transfer pricing documentation for its intercompany transactions within 60 days of a request by a tax auditor to avoid penalties for late submission. Notwithstanding this rule, it is advisable for taxpayers to appropriately document the reasons for the asset attribution when preparing their tax return, to ensure consistency between the submitted tax return

and the transfer pricing documentation.

#### **(4) Asset attribution**

The objective of the branch profit attribution regulation is to ensure the clear-cut of an entity's assets to its permanent establishments. Broadly speaking, the asset attribution must be based on the following people functions:

- Tangible assets: Usage
- Intangible assets: Purchase/creation
- Investments/financial assets : Functional relation with business activities
- Other assets: Purchase/creation
- Business transactions: Facilitation of business transaction
- Chances and risks follow the attribution of the assets or people functions they are associated with
- Hedging transactions follow the attribution of the assets they are intended to secure.

For all kinds of assets, escape clauses allow the attribution of assets to another people function, if the taxpayer can demonstrate that the other people function is more important for that asset.

A split attribution is generally not allowed, and may be applied only for intangible assets in exceptional cases when no direct attribution is feasible. However, a split attribution seems questionable against the background of domestic tax law and the principles of the AOA, which favor direct attribution to one permanent establishment and an arm's length remuneration of any supporting function or resulting dealing.

#### **(5) Branch capital allocation and attribution of financing expenses**

With regard to the branch capital allocation, the MoF's final draft of the regulation retains the asymmetric approach for domestic and foreign permanent establishments proposed in the draft regulation, which was severely criticized by many observers.

According to the new rules, the capital allocation method is the preferred method to determine the branch capital of domestic permanent

establishments of foreign companies. For this, the equity of the foreign company must be determined according to German tax law and attributed to the permanent establishments in relation to the assets, chances, and risks attributable to them. As a simplification rule, the taxpayer can work with the equity as shown in the foreign balance sheet, if this amount does not deviate significantly from the equity determined according to German tax regulations, or if appropriate adjustments can be performed in case of significant deviations.

Conversely, the regulation stipulates that for foreign permanent establishments of domestic companies the minimum capital approach must be applied primarily. This asymmetric approach stands in contradiction to the OECD PE Report, and clearly aims to maximize the German tax base. Thus, double taxation will most likely occur. If the taxpayer can demonstrate that another allocation method than the preferred method better reflects the arm's length principle, it is allowed to apply the other method with additional restrictions.

Based on the branch capital allocation, other liabilities and the associated financing expenses are attributed – preferably directly – to the permanent establishment until its balance sheet is balanced. If the financing expenses cannot be directly attributed, or if this would be disproportionately burdensome, the average financing expenses on all not directly attributable liabilities must be used. If the directly allocable liabilities exceed the liability amount attributable to the permanent establishment, even the directly allocable liabilities and, therewith, the associated financial expenses must be reduced proportionally. This decreases the amount of tax-deductible expenses.

#### **(6) Assumed contractual relationships**

According to the AOA, internal dealings ("assumed contractual relationships" according to German tax law) between the head office and its permanent establishment(s) and between permanent establishments of the same company must be remunerated at arm's length. The regulation says that any reattribution of assets to

another permanent establishment constitutes such an assumed contractual relationship (transfer of assets). Furthermore, any economic activity for which unrelated parties would have concluded a contract qualify as a dealing (for instance, the internal provision of services).

However, in accordance with the OECD PE Report, an internal loan relationship is excluded, unless surplus liquidity that has accrued in the course of a financial year at a permanent establishment is evidently used by another permanent establishment of the enterprise until the end of the financial year.

In general, financing permanent establishments -- permanent establishments that perform the enterprise's liquidity management -- are seen as service providers for the rest of the corporate group and should be remunerated using the cost plus method. The taxpayer can deviate from this presumption if it can demonstrate in an individual case that the financing permanent establishment performs activities of such significance that the financial assets should be attributed to the financing permanent establishment itself. Open balances on internal clearing accounts between the financing permanent establishment and the rest of the company do not bear any interest.

#### **(7) Special provisions for permanent establishments of banks, insurance companies, and construction companies**

The branch profit attribution regulation has separate sections for permanent establishments of banks and insurance, construction, and installation companies, as well as exploitation permanent establishments of mining, oil and gas companies. These sections deal with the specifics of those industries.

#### **(8) Banks and insurance companies**

The financial services sector is heavily regulated. Thus, the international profit attribution of banks and insurance companies must take into account regulatory requirements (such as those regarding capital endowment). Because the assumption of risks is the central business activity of banks (credit risks) and insurance companies (insurance risks), the OECD PE

Report attributes the credit and insurance contracts to the permanent establishment that has performed the key entrepreneurial risk-taking (KERT) function.

The German branch profit attribution regulation follows the OECD reasoning and defines the key entrepreneurial risk-taking function of banks as that function responsible for the creation of the credit contract. In deviation from the OECD PE Report, the ongoing risk-management function does not qualify in general as a KERT function in the traditional banking business. Therefore, the credit contract can be attributed to the risk-management function only if the taxpayer can show in individual cases that such approach better reflects the arm's length principle.

In the case of insurance companies, and fully in line with the OECD PE Report, the underwriting function is defined as the key entrepreneurial risk-taking function. However, if the underwriting is not performed in Germany, a domestic permanent establishment of a foreign insurance company must document:

- That the domestic insurance branch indeed does not perform the most significant role in the underwriting process;
- That the general branch manager has not outsourced the underwriting by active decision-making and does not control it; and
- Where the KERT function is actually performed.

In addition, the foreign insurance company must submit this information to the supervisory authorities in Germany and in its home country. If the taxpayer does not prepare this documentation, the insurance contracts and all associated chances and risk are attributed to the German branch.

With respect to the recognition of internal dealings, internal reinsurance is categorically excluded from the definition of dealing.

The attribution of the credit and insurance contracts decides further about the attribution of the associated risks, which have to be backed with sufficient capital. An appropriate share of the

“free capital” of a foreign bank and the surplus of a foreign insurance company must be attributed to a domestic permanent establishment based on the capital allocation method using riskweighted exposure amounts (in the case of banks) and technical reserves (in the case of insurance companies) as allocation keys. In contrast to this, for foreign permanent establishments of domestic banks and insurance companies the minimum capital approach is the preferred method.

While the new regulations regarding the branch capital allocation represent uncharted waters for insurance companies, the actual rules for banks remain nearly unchanged. The fact that the simplification rule for small banks (i.e., 3 percent of total assets) has been extended to banks with balance sheets totaling up to €1 billion is appreciated.

#### **(9) Construction, installation, and exploitation permanent establishments**

In the case of construction and installation companies, the branch profit attribution regulation stipulates a refutable presumption that the construction/installation permanent establishment renders a service to the rest of the company that must be remunerated using the cost plus method. If the construction/installation permanent establishment does not perform any significant people functions beyond the usage in connection with the deployed tangible assets (the machinery and construction material), these assets are attributed to the rest of the entity and are considered to be provided free of charge to the construction/installation permanent establishment. Thus, the expenses for these assets cannot be included in the cost base; in other words, the construction/installation permanent establishment is treated like a toll manufacturer.

If the construction/installation permanent establishment performs activities that go beyond mere routine activities, the application of the profit split method is prescribed, whereby the split factor shall be the costs.

The regulations for exploitation permanent

establishments follow along the same lines as the rules for profit attribution to construction/installation permanent establishments.

#### **(10) Effective date of new rules**

The detailed rules of the branch profit attribution regulation apply for all fiscal years commencing after 31 December 2014. By contrast, the general principles of the AOA are already applicable for all fiscal years that started after 31 December 2012. The MoF is currently preparing “Administration Principles for the Audit of the Profit Attribution to Permanent Establishments” that will be published next year and will provide further guidance on the application of the AOA in Germany. It has been announced that these administrative principles will also cover questions arising from the different application dates of the specific rules set by the branch profit attribution regulation and the general principles of the AOA.

#### **(11) Profit Attribution Health Check**

Taxpayers with permanent establishments in Germany should take action and check whether their international profit attribution is in line with the new detailed German rules. This is particularly true for:

- The attribution of assets, chances, and risks;
- The branch capital allocation and the attribution of financing expenses;
- The identification of assumed contractual relationships (dealings) and their arm’s length remuneration; and
- The preparation of the auxiliary calculation.

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