Taxpayers rights

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Taxpayers rights: the Dutch and the German approach of implementing the Authorized OECD Approach compared

1. Introduction

Rainer Prokisch and I first met some twenty years ago. At the time he was working on a book on the German approach to taxing permanent establishments[1]. I had defended my dissertation on the allocation of profits to permanent establishments in 1991[2] and, together with Rijkele Betten had set up the – at the time loose-leaf, nowadays electronic – publication "Permanent Establishments" for IBFD in 1993[3]. I remember interesting discussions we had on the topic. Therefore for my contribution to Rainer's liber amicorum concerns this topic.

A major development in this field took place in 2010: the OECD changed the wording of Art. 7(2) OECD. Practical experience had shown that there was considerable variation in the interpretation of these general principles and of earlier versions of Article 7. In order to provide more certainty to taxpayers, in 2008 the OECD, based on conclusions of its 2008 Report on the Attribution of Profits to Permanent Establishments, amended the Commentary on Article 7 to incorporate those conclusions that did not conflict with the previous version of that Commentary. A change in wording of Art 7(2) OECD was however needed to incorporate the "Authorized OECD approach" (AOA), which aimed at providing as guidance on how far the approach of treating a permanent establishment (hereafter PE) could be taken[4].
In 2010, the wording "taking into account the functions performed, assets used and risks assumed by the enterprise through the PE and through the other parts of the enterprise" was added in order to reflect that the attribution of profits to permanent establishments should take place on the basis of a two-step approach:

1. a functional and factual analysis;
2. a comparability analysis.

Under the AOA in principle all functions of a PE will be rewarded at arm's length taking into account the assets used and risks assumed, including not only internal deliveries of goods (as in the pre-2010 version of Art. 7(2) OECD), but also internal deliveries of services, transfer of material and immaterial assets, as well as financial transactions. "Dealings" between the PE and other parts of the enterprise of which the PE is a part should be treated in the same way as similar transactions taking place between independent entities[5]. The AOA attributes to the PE those risks and the PE economic ownership of assets for which the significant functions relevant to the assumption and/or management (are performed by people in the PE and capital, including "free" capital to the PE to support the functions it has performed, the risks assumed and assets attributed to it, based on either the capital allocation approach, the economic capital allocation approach or the thin capitalization approach. Art. 7(3) OECD Model was deleted to reflect that Art. 7(2) requires the recognition and arm's length pricing of all dealings through which one part of the enterprise performs functions for

[1] R. Prokisch, Betriebstättenbesteuerung 2004, Dokumentation mit Einfűhrung, Nűrnberg, Steuern und Recht, 576 pp.
[2] I.J.J. Burgers, The allocation of fiscal profits to branches of internationally operating banking enterprises". The commercial version of this dissertation was published by IBFD under the title "Taxation and Supervision of Branches of International Banks: A comparative study of Banks and other enterprises:, IBFD, Amsterdam, 1991, 570 pages.
[3] I.J.J. Burgers and Giulia **Gallo** (ed.), Permanent Establishments, Online Collection, IBFD, Amsterdam, electronic publication.
[4] OECD Report on the Attribution of Profits, Paris, 2010.
[5] Par. 24 of the Commentary to Art. 7(2) OECD 2017.

the benefit of the PE[6]. Moreover the OECD pointed out that the AOA does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE.

The OECD hoped to achieve international consensus on the, what it refers to as, functionally separate entity approach. However, this proved not to be the case.

First, the United Nations, decided not to change the wording of Art. 7 of its Model Tax Convention, the motivation being the AOA is in direct conflict with Art. 7(3) UN Model Convention, a rule the UN considered to be appropriate in the context of this Convention. From the perspective of developing countries this is understandable. These countries have an interest in maintaining the ban on deduction of interest (other than for financial enterprises) and royalties as these countries generally are the source countries[7].

Second, practice shows developed countries may also have an interest in maintaining the old wording of the OECD- Model. Several of the tax treaties concluded since 2010 between developed countries, including the Netherlands and Germany, contain the 2010-2017 version of Art. 7 OECD[8].

Third, differences in legal culture concerning the application of the dynamic or the static approach affect the application of tax treaties signed and therefore concluded between 17 July 2008 and 22 July 2010. In the Netherlands the Hoge Raad (Supreme Court) applies the dynamic approach[9]. In Germany the Bundesfinanzhof (Federal Tax Court) applies the static approach[10]. The result is that in the Netherlands the 2008 guidance provided by the OECD is applicable to tax treaties containing the pre-2010 wording of Art. 7 OECD and in Germany to tax treaties signed and therefore concluded between 17 July 2008 and 22 July 2010[11]. In both countries the 2010 guidance is applicable only to tax treaties containing the wording of Art. 7 OECD Model 2010-2017.

Fourth, domestic law practice deviates. Amongst others Germany included the OECD 2010 body of thought on PE profit allocation in their domestic law provision on "Taxation in case of Foreign relations" (Besteuerung bei Auslandsbeziehungen: § 1 Abs. 5(3) Außensteuergesetz (AStG: hereafter Foreign Tax Act)). In the Netherlands domestic law was not amended.

In this paper I compare the Dutch and German approach from the perspective of protecting taxpayers' rights to certainty and equality, including the prevention of double taxation.

I will first provide an overview of the provisions concerning PE-profit allocation in the Dutch Income Tax Act 2001 (ITA 2001), Corporate Income Tax Act 1969 (CITA 1969), the Decree for the avoidance of double taxation (Dadt 2001) (Section 2), tax treaties concluded by the Netherlands (Section 3) and an overview of the case law of the Dutch Supreme Court on PE-profit allocation (Section 4). Next I will answer the question why and how Germany included the AOA into its domestic law. Section 6

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[6] Par. 40 of the Commentary to Art. 7(2) OECD 2017.

[7] Nevertheless, some developing countries did accept the 2010 version of Art. 7(2) OECD Model in their tax treaties See amongst others the Netherlands-Ethiopia treaty (2012).

[8] See hereafter Section 3.2 and 5.2.

[9] HR 21 February 2003, BNB 2003/177 and BNB 2003/178.

[10] BFH 25 May 2011, I R 95/10, BFHE 234, 63; BFH 9 Feb. 2011, I R 54/10, BStBl. II, 106 (2012) and BFH 11. Juli 2018, I R 44/16, BFH/NV 2019 S. 149 m. w. N.

[11] Although as to Hentschel, Kraft and Moser, the German tax authorities apply a dynamic approach. Sven Hentschel, Gerhard Kraft and Till Moser, Permanent Establishment Taxation in Germany in a Post-AOA-Implementation Era: A Primer on Exceptions and Problem Areas, European Taxation February/March 2018, p. 81.

contains the answer to the research question which of the two approaches better protects taxpayers rights.

2. NL statutory law and case law

2.1 ITA, CITA and Decree on the avoidance of double taxation

2.1.1 Dutch resident taxpayer with PE in another country

The wording "*taking into account the functions performed, assets used and risks assumed"* was added to Art. 9(2) of the Decree on the avoidance of double taxation 2001[12] - providing for exemption with progression for PE-profits for individual taxpayers - in 2012. In the same year Art. 15e(6) CITA 1969 - providing for quasi-full exemption for corporate taxpayers resident in the Netherlands having a PE outside the Netherlands - was included in the Dutch corporate income tax act (Wet op de vennootschapsbelasting 1969)[13]. The law was amended in order to achieve that:

- Foreign PEs will be treated more similar to participations in associated companies being resident for tax purposes abroad[14];

- PE-losses no longer reduce the worldwide profits taxable in the Netherlands for corporate taxpayers, while at the same time – similar to what used to be the case before the amendment - the silent reserves of assets transferred from the head office in the Netherlands to its foreign PE will not be taxed at the time of the transfer[15].

2.1.2 Foreign taxpayer with PE in the Netherlands

For foreign corporate taxpayer having a PE in the Netherlands income tax will be levied on the taxable Dutch amount, that is the amount of total profits derived through an enterprise or part of an enterprise carried on through the PE in the Netherlands (Art. 17 CITA 1969). Neither the ITA nor the CITA contains wording similar to Art. 7(2) OECD old or new.

Remarkably parliamentary history does not provide for an explanation why the ITA 2001 does not contain wording similar to Art. 7(2) OECD old or new. What might explain why this wording was not introduced in the Dutch Income Tax Act is that the approach of the Dutch legislator in respect of taxation of business profits is to apply open norms to be filled in by judges. Judges can take into account the specific circumstances of the case. Thus the principle of equality is considered to be protected most, be it at the cost of certainty and efficiency.

3. Tax treaties

3.1 Memoranda on Dutch Tax Treaty Policy

The Dutch Secretary of State for Finance published a Memorandum on Dutch Tax Treaty Policy 1987, 1996, 1998, 2011 and 2020 in which he amongst others explains the Dutch policy towards PE-profit allocation.

In the 1987 Memorandum the Secretary of State explained the Netherlands is against provisions enabling force of attraction and in favour of a turnkey-provision in its tax treaties. In the 1996 Memorandum stated Dutch tax policy is amongst others to provide as much certainty as possible to

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[12] Besluit voorkoming dubbele belasting 2001.

[13] Besluit van 22 december 2011 tot wijziging van enige fiscale uitvoeringsbesluiten, Staatsblad van het Koninkrijk der Nederlanden 2011, 677.

[14] Kamerstukken II, 2011–2012, 33 003, nr. 3, p. 14.

[15] Similar to Art. 9(2) of the Decree on the avoidance of double taxation 2001 first worldwide profits will be calculated. Next exemption will be provided for the PE profits. For individual taxpayers the formula for calculating the exempted PE- profits is:
PE annual profits ÷ worldwide taxable profits × Netherlands corporate income tax on worldwide profits.
For corporate taxpayers this formula is:
PE annual profits ÷ worldwide taxable profits minus worldwide taxable losses carried forward × Netherlands corporate income tax on worldwide profits.

Dutch business actively operating in the country of the treaty partner and the tax treaty partners business operating in the Netherlands. The 1998 Memorandum states the Netherlands takes the separate entity approach as a starting point, in line with the OECD-policy and Dutch case law and that practical rules would be developed for PE-profits derived by Dutch resident wholesalers in flowers and plants operating in Germany, for agriculture and forestry, as well as for business parks partly situated in the Netherlands and partly in Germany[16].

In his Memorandum on Tax Treaty Policy 2011 the Secretary of State states that the Netherlands fully supports the 2010 OECD Report on the Attribution of Profits to Permanent Establishments, and considers Art. 7 OECD a correct and modern implementation of the principles that underlie this article since the first OECD Model Tax Convention concluded in 1963. The Netherlands therefore is prepared to apply, in consultation with the treaty partner, the principles described in the report (AOA) also in case a tax treaty is applicable that contains the pre-2010 version of Art. 7 OECD. The Secretary of State for Finance furthermore suggests that to include a provision that will enable the competent authorities to apply the AOA at a later moment in time in case the (potential) tax treaty party feels the application of these principles would be for now a bridge to far[17].

The tax treaty policy that the Netherlands approves of the international principles on the allocation of profits to PEs has been confirmed in the 2020 Memorandum.

3.2 Both new and old version of article 7 OECD included in Dutch tax treaties concluded since 2010

The new version of article 7 is included in most of the tax treaties concluded by the Netherlands since 2011, to wit in the treaties with EU-Member States Cyprus (not yet in force at the time of writing (December 2021)), Germany, Ireland, Liechtenstein, Norway and the United Kingdom, as well as in the Tax Agreements with Curaçao and Sint-Maarten. The treaties concluded as from 2011 with developing countries Algeria, Ethiopia (2013), Zambia (2015) and the treaty with Kenia which did not yet in force at the time of writing (December 2021)) contain the Art. 7 UN-provision which is similar to Art. 7 OECD pre-2010. So do the treaties with Bulgaria which entered into force 31 July 2021) and the treaties with Cyprus, Iraq and Kosovo, that have not yet entered into force at the time of writing (December 2021)).

Moreover, though article 7 of the treaty with China includes the old version of article 7, the new wording is used in the Protocol to that treaty stating that it is understood that in the case of profits from survey, supply, installation or construction activities, only so much of these profits should be attributable to a PE as resulting from the functions performed, assets used and risks assumed at or through a PE.

3.3 Two Decrees of the Secretary of State for Finance on PE-profit allocation of 15 January 2011

3.3.1 Decree of 15 January 2011, IFZ 2010/457M

The Memorandum of 2011 refers to the Decree of 15 January 2011, IFZ 2010/457M, for an in-depth discussion of the view of the Secretary of State for Finance in respect of profit allocation to PEs. In this Decree the Secretary of State for Finance indicates that:

- the Dutch policy has been to apply the arm's length-principle and the functionally separate entity approach for the allocation of profits to a PE. Internal deliveries, services and putting assets at the disposal should be rewarded at arm's length, unless this would not be in line with the Commentary to art. 7 OECD Model, the Decree on the avoidance of double taxation 2001 and/or the Dutch case

[16] Regarding the wholesalers and agriculture and forestry the Secretary of Finance issued a Decree on 16 September 2002, IFZ 2002/715M. By means of a Protocol an Annex regarding cross-border business parks was added to the treaty with Germany in 2004. The Netherlands concluded a new treaty with Germany on 12 April 2012 which entered into force on 1 January 2016, which contains the Annex regarding cross-border business parks. In his Decree of 5 December 2015, IZV 2015/1054M the Secretary of State announced that the rules regarding the allocation of profits derived through agriculture and forestry will remain in force, but that the Dutch and German competent authorities agreed to no prolong the rules for wholesalers of flowers and plants.

[17] Notitie Fiscaal Verdragsbeleid 2011, par. 2.6.4.

law;

- the Dutch tax administration will accept application of the PE-profit allocation principles set out by the OECD in the 2008 and 2010 Reports on the Attribution of Profits to Permanent Establishments for all treaties - also if these treaties contain the pre-2010-version of Art. 7 OECD - on the condition that these principles are consistently also applied by the taxpayer in the other contracting state;

- the 2008/2010 PE-profit allocation principles may (!, so not must) also be applied for the determination of the amount of PE-profits of a Dutch resident taxpayer to be exempted by the Netherlands on the basis of the Decree for the avoidance of double taxation, as well as for the amount of PE-profits of a foreign taxpayer that may be taxed by the Netherlands on the basis of domestic law in case no tax treaty is applicable. Moreover is of importance that the PE-Report and the Commentary to Art. 7 OECD Model are of great importance for the interpretation of domestic law and the Decree for the avoidance of double taxation, even though the Report, the Model and the Commentary to the OECD-Model are not of direct relevance for the application of domestic law or the Decree for the avoidance of double taxation, but are only directly relevant for the interpretation of tax treaties concluded by the Netherlands.

- in his view the capital allocation approach is preferable as the creditworthiness of the PE is similar to that of the enterprise of which the PE is a part and internal guarantees between different parts of an enterprise are not feasible;

- the fungibility approach is the preferable approach for the allocation of interest, as - similar to the capital location approach - a risk-weighted share in the total interest of the enterprise will be allocated to the PE. The alternative, the tracing method, to a lesser extent takes into account the specific circumstances of the PE. Such circumstances are taken into account in case – based on a functional analysis – a pro rata part of the interest paid by the enterprise is allocated to the PE. Such interest will approximate the interest that a non-related lender would charge for financing a similar non-related enterprise. The Dutch tax administration will apply the 'thin capitalisation approach', and thus make a comparison to the amount of capital of and the amount of interest paid by not-related enterprises comparable to the PE where the enterprise as a whole has not been financed in accordance with the arm's length principle.

- in case the allocation of capital and interest in the other Contracting State will deviate and thus there will be double (non-) taxation he is prepared to enter into a mutual agreement procedure;

- In case of the application of a tax treaty containing the pre-2010 version of Art. 7 OECD Model the Dutch tax administration will follow the approach of the state in which the PE is situated if:

a. the other Contracting state laid down a specific method of allocation of capital and interest in laws or regulations;

b. the other Contracting states approach is an Authorized OECD Approach;

c. this approach in the case at stake results in an allocation of profit that is arm's length.

- the starting point for the AOA is that the PE-profit allocation is as much as possible based on the arm's length-principle. Therefore it is highly likely that the terms 'significant people functions' and functions of the people exercising 'control over risk' in case of associated enterprises overlap to a large extent. The risk allocation to PEs to a great extent is comparable to the risk allocation to non-related enterprises that are similar to the PE in similar circumstances;

- taxpayers may allocate the costs of internal general and administrative services, if a similar service is not provided to third parties (the old OECD approach) or allocate the at arm's length price, if the Business Profits article in the applicable treaty is based on the OECD Model 2008/2010;

- in line with the AOA the Dutch tax administration will consider the use of a tangible asset as being decisive for the allocation of material assets. Referring to the decision of the Dutch Supreme Court of 23 January 1974, BNB 1986/100, in which the Supreme Court for the allocation of assets to a foreign PE of a Dutch resident taxpayer made a distinction between permanent and temporary use, the Secretary of State for Finance adds to the OECD's view that in the case of temporary use, an internal rent should be allocated;

- in line with the AOA both for internally developed as well as for acquired intangible assets is decisive which part of the enterprise on the basis of significant people functions takes the active decisions to take the risk and to actively manage the risk.

- in line with the AOA financial assets such assets will be allocated to the PE if it performs the significant people functions in respect of the acquisition and the management of these assets. The Secretary of State adds that, in the case of a planned acquisition or dividend distribution, the assets should be allocated to the PE only if the staff of the PE took the decision to use the funds for this purpose;

- contrary to the AOA that allows internal interest in respect of treasury activities internal interest can be taken into account if the loan allocated to the PE stems from a third party;

- in all circumstances the starting point for taking internal royalties into account should be as much as possible: achieving an outcome that is similar to similar situations in case of unrelated companies. The Commentary to the pre-2010 version of art. 7 OECD does not disallow internal royalties. Dividing the costs would not be appropriate if based on facts and circumstances it would be possible to apply the arm's length-principle and that principle would result in another outcome. Both for internally developed as well as for acquired intangible assets the criterion is which part of the enterprise on the basis of significant people functions takes the active decisions concerning taking the decision to take the risk and to actively manage the risk merely;

- no profits should be attributed to a PE of the principal in the country of the agent in case the fee of the agent is arm's length. Sole exception is if the staff of the principal fulfils the significant people functions in that state.

3.3.2 Decree of 15 January 2011, DGB 2010/8223M

In his Decree of 15 January 2011, DGB 2010/8223M the Dutch Secretary of State for Finance formulates the following conditions for the allocation of shares to a PE of a foreign enterprise that carries on a business in the Netherlands through a PE:

- the activities of the PE are performed by qualified staff in and from the Netherlands; and
- a direct relation between the business activities of the PE and the business activities of the company of which the shares are owned exists.

4. Case law

4.1 On domestic law

Given that the Dutch (corporate) income tax law does not provide for an indication whether the (functionally) separate entity approach or other approach should be applied in calculating the profits derived by a PE in the Netherlands one might expect the Dutch Supreme Court would have had to decide several times on the issue. Surprisingly this is not the case. Since 1931 (!) the Supreme Court (Hoge Raad) decided only seven times on this matter, to wit on:

- 13 November 1931, B 5085: A bond loan issued by a Belgium resident company should be allocated to the PE in the Netherlands as the bond was issued in order to acquire funding for the activities of the PE;

- 13 April 1955, BNB 1955/190: Expenses for training and travel of staff of a taxpayer resident in Indonesia working for the PE of the company in the Netherlands seconded to the head office that could not be remunerated by the head office due to exchange restrictions. These costs were directly related to the business activities in Indonesia and therefore were not deductible in the Netherlands;

- 4 December 1957, BNB 1958/11: Profits to be allocated to a PE in the Netherlands of a foreign taxpayer should be determined as if head office and PE were independent enterprises acting on an arm's length basis with each other;

- 27 April 1960, BNB 1960/167, V-N 1960, p. 347: Securities bought as investment of excessive liquid

assets derived through the activities of the PE in the Netherlands of a Belgium resident company in 1943 that could not be transferred to Belgium due to exchange restrictions should be allocated to the PE for three reasons:

1. Administrative argument: in the financial accounts and the tax return the assets were booked as PE-assets;

2. Causal argument: the securities were bought with liquid assets derived from the activities of the PE;

3. Actions argument: the action to invest in the securities was carried out in the Netherlands;

- 23 January 1974, BNB 1986/100: A partnership carried out a dredger work in Nigeria used a dredger owned by one of the partners, a Dutch resident taxpayer. Before attributing the profits to the partners in line with the partnership contract a rent was paid for this dredger to the Dutch resident partner. The Supreme Court decided that for the attribution of profits to the Nigerian PE the partnership contract was leading. The dredger fulfilled the same economic function for the taxpayer's part in the partnership as for the other partners. Thus the rent paid to the Dutch resident partner was taken into account in calculating the PE-profit to be exempted. No reference was made by the lower Court or the Supreme Court to the separate enterprise theory. Thus the fact that the dredger was put at the disposal by one of the partners to the partnership seems to be the sole reason why the Supreme Court decided that a rent should be taken into account;

- 7 May 1997, no. 30.294, BNB 1997/263: In 1984 the Dutch income tax allowed for a so-called "capital deduction". The Supreme Court upheld the decision of the Court of The Hague that the separate entity fiction is the starting point for the determination of the capital to be allocated to a PE in Ireland of a Dutch resident company and that Art. 5 of the tax treaty with Ireland does not limit the working of domestic law in this matter. But the Supreme Court did not uphold the decision that the ratio "equity to debt" of the PE should be based on the ration "equity to debt" of a similar third party as funds that were not borrowed for serving the activities of the PE would be allocated to the PE as a result of this. The Supreme Court decided those funds that are used by the entrepreneur for funding the activities of the PE that have not been acquired through a loan should in principle be regarded as free capital of the PE, just as would be the case with funds invested in an independent enterprise not acquired by incurring debts. The ratio "equity to debt" depends on the actual circumstances in which the company finds itself and the preference of the entrepreneur to finance the company with own funds or debt. The way similar companies are financed deviates considerably. Setting a norm for such ratio would not be appropriate. It would also not be appropriate to consider the "current account" between PE and head office as free capital of the PE. The books may be a starting point, but are not decisive for the allocation of capital and debt to a PE.

4.2 **On tax treaties**

The Dutch Supreme Court decided more than sixty times on the application of the business profits article in tax treaties since the 1930s. Below a summary of the in the context of this paper most relevant cases is provided for.

- HR 8 November 1989, BNB 1990/36: Though from a legal perspective a transfer of goods from the UK head office to its PE in the Netherlands does not result in a debt, such internal debt should be taken into account in determining the profits to be allocated to the PE. Foreign exchange fluctuation influence the amount of internal debt and thus the profit to be allocated to the PE on the basis of art. 8(2) of the tax treaty with the UK. Note the Supreme Court did not refer to Dutch domestic law;
- HR 7 May 1997, BNB 1997/211: Capital taxes should not be allocated to the PE in Switzerland of a Dutch resident enterprise, as such capital taxes are costs that are inherent to the legal form of the company;
- HR 7 May 1997, BNB 1997/264: The Supreme Court did not allow the Dutch resident taxpayer to take into account internal interest on the average of the balance between the Dutch head office and the UK PE at the start and the end of the book year. Funds that have arisen through the activities of a

PE should not be allocated to the PE if such funds do not serve the activities of the PE, which in respect of the current account was not the case;
- HR 20 December 2002, BNB 2003/246: A PE in the Netherlands of a so-called dividend mixer company resident in the UK had as function to declare, receive, mix and distribute group dividends that the UK parent was able to make the best use of the tax credits. Those shares should be allocated to the PE that serve the activities of the PE, while also is of relevance whether the employees working for the PE were independently authorized to exercise the rights attached to the shares;
- HR 25 November 2006, BNB 2007/117: The Supreme Court decided that the separate enterprise fiction in Art. 7 of the tax treaty concluded between the Netherlands and Belgium implies that financial assets of a Belgium resident banking enterprise having a PE in the Netherlands that serve the activities of the company should be allocated to the PE. Taxpayers are not free in their decision about the amount of free capital to be allocated to a PE. Internal loans may be taken into account only in exceptional cases, such as internal supplier credit or the "advances" between the different parts of a financial enterprise referred to in par. 19 of the Commentary to art. 7 OECD 2014. Tax accounts alone are not sufficient proof. If the taxpayer's only proof is the accounts, for a banking enterprise it is acceptable that the tax inspector takes the BIS-requirements as an indirect basis for checking the calculation of the PE-capital. It should be taken into account that the risks assumed through the activities of the PE may differ from those assumed by the worldwide banking enterprise;
- HR 3 June 2016, BNB 2016/171: A Dutch resident taxpayer payed royalties to its parent company, as of 1999 amongst others for the use of the trademark and other intangibles (the format) in Spain of the group in Spain where the PE of the taxpayer is situated. Without further going into the question on how to apply the applicable domestic law (art. 15(1) CITA 1969), the Supreme Court motivated its decision that internal royalties could not be taken into account on the Commentary to art. 7 OECD 1963 as art. 7 of the tax treaty Netherlands-Spain 1971 reads similar to that article. The fact that the royalties have been determined at arm's length is as to the Supreme Court not of relevance. The costs made by the taxpayer for the format should be taken into account in determining the PE-profit to be exempted, provided the intangibles serve the activities of the PE.

What stands out in comparing this case law to the view of the Dutch Secretary of State for Finance in his Decrees of 15 January 2011 and to the Authorized OECD Approach is that:

- Instead of "use" the Dutch Supreme Court considers "serving the activities of the PE" is decisive for allocating assets to a PE;
- The Dutch Supreme Court applied the tracing method for allocating debt in its decisions of 7 May 1997, BNB 1997/264 and 25 November 2006, BNB 2007/117.

. It remains to be seen whether the Supreme Court would judge similarly in respect of cases were the relevant tax treaty article would be based on Art. 7 OECD as it reads since 2010. Most of the cases summarized above were decided upon prior to the publication of the 2008 and 2010 OECD Reports on the Attribution of Profits to Permanent Establishments. Exception is HR 3 June 2016, BNB 2016/171. However, this decision does not give evidence on the Supreme Court's view on the AOA as the case concerned the application of the business profits article in a tax treaty concluded in 1971

5. The German approach

5.1 Why and how did Germany include the AOA into its domestic law?

As of 1 January 2013 Germany implemented the OECD 2010 body of thought on PE profit allocation in their domestic law provision on "Taxation in case of Foreign relations" (Besteuerung bei Auslandsbeziehungen. § 1 Abs. 5 Außensteuergesetz (AStG: hereafter Art. 1(5) Foreign Tax Act)). Both in respect of intra- and intercompany transactions a functional and comparability analysis should be applied[18]. Art. 1(6) Foreign Tax Act authorizes the Bundesfinanzministerium der Justiz und

[18] § 1 Abs. 5(3) Außensteuergesetz (AStG) reads: "Für die Bestimmung der dem Fremdvergleichtsgrundsatz entsprechenden Verrechnungspreise (Fremvergleichspreide) für eine Geschäftsbeziehung im Sinne des

Verbraucherschutz (Federal Ministry of Justice and Consumer Protection) to provide for more detailed rules[19]. The Bundesfinanzministerium published such - very detailed - rules on 13 October 2014, latest updated on 12 May 2021[20]. Moreover in 2016 - responding to critic in professional literature[21] - the German Ministry of Finance issued 186 pages of administrative guidelines, providing for numerous examples[22].
The rules only allow for an increase of the German PE-profit of non-resident taxpayers respectively for a reduction of the foreign-PE profit of German resident taxpayers. The rules and guidelines are not applicable in case according to German law a PE is present, in case no PE is present according to the applicable tax treaty[23].

The legislators' aim with the new subsections 1(5) and 1(6) was to consistently regulate the taxation of all cross-border activities of corporations, partnerships and PEs[24]. Moreover - though not mentioned in the Gesetzentwurf (Bill) as being one of the aims of the amendment of Art. 1 Foreign Tax Act - as Kempf and Jakob[25] point out, due to the extension of section 1 of the Foreign Tax Act to PEs, German exit tax rules on the transfer of business functions became applicable on transfers to a foreign PE of a German enterprise.

Section 1(4) Foreign Tax Act provides for a definition of what in the context of this Act is considered as "Geschäftsbeziehungen" (transactions) if such transactions take place between associated

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Absatzes 1 Satz 1 sind die tatsächlichen Verhältnissen maBgebend, die dem jeweiligen Geschäftsvorfall zugrunde liegen, insbesondere ist zu beruűcksichtigen, von welcher an dem Geschäftsvorfall beteiligten Person welche Funktionen in Bezug auf den jeweiligen Geschäftsvorfall ausgeűbt, welche Risiken diesbezűglich jeweils űbernommen, und welche Vermögensvorfall ausgeűbt warden (Funktions- und Risikoanalyse). Die Verhältnisse im Sinne der Sätze 1 und 2 bilden den MaBstab fűr die Feststellung der Vergleichbarkeit des zu untersuchenden Geschäftsvorfalls mit Geschäftsvorfällen zwischen voneinander unabhängigen Dritten (Vergleichbarkeitsanalyse); die diesen Geschäftsvorfällen zugrunde liegenden Verhältnisse sind in entsprechender Anwendung der Sätze 1 und 2 maBgebend, soweit die möglich ist. Abzustellen ist aud fie Verhältnisse zum Zeitpunkt der Vereinbarung des Geschäftsvorfalls". See https://www.buzer.de/gesetz/5491/a75265.htm

[19] § 1 Abs. 5(6) Außensteuergesetz (AStG) reads: "Das Bundesministerium der Finanzen wird ermächtigt, mit Zustimmung des Bundesrates durch Rechtsverordnung Einzelheiten des Fremdvergleichsgrundsatzes im Sinne der Absätze 1, 3 bis 3c und 5 und Einzelheiten zu dessen einheitlicher Anwendung zu regeln sowie Grundsätze zur Bestimmung des Dotationskapitals im Sinne des Absatzes 5 Satz 3 Nummer 4 festzulegen.

[20] Verordnung zur Anwendung des Fremvergleichsgrundsatzes auf Betriebsstätten nach § 1 Absatz 5 des AuBensteuergesetzes (Betribsstättengewinnaufteilungsverordnung – BsGaV) 13.10.2014; BsGaV § 12 i.d.F. 12.05.2021 Abschnitt 1: Allgemeiner Teil Unterabschnitt Dotationskapital Unterabschnitt 3: Dotationskapital, übrige Passivposten und Finanzierungsaufwendungen, https://datenbank.nwb.de/Dokument/475076_12/

[21] Michael Kumpf and Michael Jakob, Changes in the Taxation of Permanent Establishments in Germany, ITJP 2013, at 100.

[22] Grundsätze für die Anwendung des Fremdvergleichsgrundsatzes auf die Aufteilung der Einkünfte zwischen einem inländischen Unternehmen und seiner ausländischen Betriebsstätte und auf die Ermittlung der Einkünfte der inländischen Betriebsstätte eines ausländischen Unternehmens nach § 1 Absatz 5 des Außensteuergesetzes und der Betriebsstättengewinnaufteilungsverordnung (Verwaltungsgrundsätze Betriebsstättengewinnaufteilung – VWG BsGa) BEZUG TOP 4.4 der Sitzung ASt III/16 GZ IV B 5 - S 1341/12/10001-03 DOK 2016/1066571, BMF-Schreiber 22 December 2016..

[23] BMF-Schreiben 22 December 2016, at 9 and 10.

[24] Gesetzentwurf der Bundesregierung, Entwurf eines Jahressteuergesetzes 2013, 171000, p 36: „Um den international anerkannten Fremdvergleichs-grundsatz (OECD-Standard) uneingeschränkt auf internationale Betriebsstättenfälle anwenden zu können, ist die Schaffung einer innerstaatlichen Rechtsgrundlage in § 1 AStG notwendig. Außerdem wird diese Vorschrift zur Vermeidung von rechtlichen Risiken hinsichtlich ihrer Wirksamkeit für Sachverhalte unter Beteiligung von Personengesellschaften oder Mitunternehmerschaften ergänzt.

[25] Andreas Kempf and Michael Jakob, Changes in the Taxation of Permanent Establishments in Germany, International Transfer Pricing Journal March/April 2013, p.98.

companies or between a foreign enterprise and its PE in the other state. Art. 1(5) reflects the two-step functionally separate entity approach recommended by the OECD. However, in comparison to Art. 7(2) OECD 2010 – 2017 the German legislator added a condition: "es sei den, die Zugehörigkeit der Betriebsstätte zum Unternehmen erfordert eine andere Behandlung" (provided different treatment is required due to the fact that the PE is part of the worldwide enterprise).

What should be understood by functions, assets and risks is explained in Art. 1(5):

- Functions of the enterprise carried out by the enterprise through the PE's personnel (Personalfunktionen (instead of the term "significant people functions" used by the OECD!);
- Assets of the enterprise required to carry out the functions attributed to the PE;
- Opportunities and risks of the enterprise, which are assumed by the PE based on the functions and assets attributed to it; and
- An appropriate amount of equity (Dotationskapital).

Next Art. 1(5) Foreign Tax Act provides that the second step is to determine the kinds of transactions between the enterprise and its PE and the transfer prices for these transactions. In contrast to the OECD the German legislator uses "Geschäftsbeziehungen" (transactions) instead of "Handlungen" (dealings).
Art. 1(5) provides for an escape clause in case of potential conflict with tax treaties: in case the other state applies the tax treaty rules and this results in double taxation the tax treaty prevails.
Art. 1(6) Foreign Tax Act delegated to the Ministry of Finance the power to draft Regulations on the Application of the Arm's Length Principle for associated enterprises and PEs as well as for the allocation of the Dotationskapital to PEs. The Bundesrat adopted the – to both tax administration and taxpayers binding - Regulations on the Application of the Arm's Length Principle on Permanent Establishments in accordance with Art. 1(5) of the Foreign Tax Act (Verordnung zur Anwendung des Fremdvergleichtsgrundsatzeds auf Betriebsstätten nach § 1 Absatz 5 des AuBensteuergesetzes (Betriebsstättengewinnaufteilungsverordnung – BsGaV) on 13 October 2014. These Regulations contain extensive rules that reflect the body of thought of the AOA, however with several deviations and additions:

- Part 1, Subpart 1, sections 1-3: Allocation on the basis of a functional- and riskanalysis and a comparability analysis, definitions of the terms domestic enterprise, foreign enterprise, people functions, own personnel (which includes personnel seconded by another company, the entrepreneur or shareholder and persons related to the enterprise of the shareholder within the meaning of section 1(2) of the Foreign Tax Act), significant people functions and relevant assets (Vermögenswerte) and the obligations to prepare an auxiliary calculation at the beginning and end of each financial year comprising all elements (Bestandteile) that must be attributed to the respective PE, implying that;
    - the financial statements of the enterprise must be split between head office and PE(s);
    - the transactions between the different parts of the enterprise are documented on the basis of section 90(3)(4) General Tax Code (Abgbenordnung);
    - the reasons for the allocation of the assets, the transactions, the opportunities and risks and the allocation of the financial obligations;
- Part 1, Subpart 2, sections 4 – 11: Allocation rules for people functions, tangible and intangible assets, shares, other investments and similar investments, other assets, transactions with third or related parties, obligations and risks and of hedging transactions. Other than the OECD and the Dutch Secretary of State for Finance the German rules refer to people functions, instead of significant people functions. People functions should be allocated to a PE actually performing the functions, unless the people function has no factual relevance to the activities of the PE or is exercised in less than thirty days within a financial year in the PE. Moreover the German rules - contrary to the OECD and the Dutch Secretary of State for Finance - provide that the function must be attributed to the PE in relation to which

it has or shows the closest relationship in case such function is performed neither in a PE nor in the rest of the enterprise or is not allocable under section 4(1)(2) of the Verordnung. Similar to the OECD and NL approach "use" determines the allocation of immovable property. However, other tangible assets, as well as shares, other investments and similar assets must be attributed to the PE that uses the asset only if other people functions - such as acquisition, production, administration or sale - are not unequivocally more important than the function "use" [26]. The allocation changes if the asset is subsequently permanently used by another PE. Other than the Dutch Decree, the Verordnung does not provide certainty on whether in case of temporary use of a tangible asset an arm's length rent should be taken into account.

The German rules for allocating intangibles also differ from the AOA- and the Dutch approach, being that for:

- Internally created intangibles active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property is decisive;
- Acquired intangibles active decision-making relating to the taking on and management of risks such as the evaluation of the acquired intangible, the performance of any required follow-on development activity, and the evaluation of and management of risks associated with deploying the intangible asset is decisive;
- Marketing intangible those functions associated with the initial assumption and subsequent management of risks of the marketing intangibles, such as functions related to the creation of and control over branding strategies, trademark and trade name protection, and maintenance of established marketing intangibles is decisive.

The German rules require allocation of Intangibles to the PE where it is created or by which it is acquired, unless a people function performed in a different establishment – such as the use, the administration, the further development, the protection of the disinvestment of the respective intangible good or group of intangible goods - is unequivocally more important. The German rules moreover provide for a rule if the utilization of a tangible or intangible good frequently changes: the asset is attributed to the PE having the business activity in which the asset is predominantly used.

- Part 1, Subpart 3, sections 12 – 15: allocation of Dotationskapital, other liabilities and interest expenses. For the determination of Dotationskapital to a domestic PE the German rules require the application of the "Kapitalaufteilungsmethode", implying that at the start of the book year that part of the enterprise's capital should be allocated to the PE that represents its part of the assets and the opportunities and risks, valuated at arm's length. This approach is to a large extent similar to the capital allocation approach preferred by the Dutch Secretary of State for Finance. However, the German rules require that the amount of Dotationskapital should be at minimum the amount of capital of the PE disclosed on the PE's trade balance (inländischen Handelsbilanz). Moreover, other than the OECD and the Dutch Decree, the German rules provide that in principle the enterprise's capital should be determined on the basis of German law. For reasons of simplification under circumstances the amount of capital on the balance sheet of the foreign company may be used.

  The Dotationskapital of a foreign PE of a German enterprise - contrary to both the allocation method used to determine the amount of free capital of the German PE of a foreign enterprise and the OECD's capital allocation approach the German rules - is to be determined on the basis of the minimum capital approach (Mindestkapitalausstattungsmethode). Decisive is the amount of free capital needed for the activities of the PE. A higher amount may be allocated if this would be more in line with the

[26] For a more extensive overview of these allocation rules see Ulf Andresen, Regulations Provide Further Guidance on the Application of the Authorized OECD Approach to the Attribution of Profit to Permanent Establishments, International Transfer Pricing Journal, 2015, pp. 77 – 84.

arm's length principle, with a maximum of the amount of capital on the PEs trade balance. Both for domestic and foreign PEs a significant change in circumstances throughout the financial year would lead to adjustment.
The next step is to allocate the other liabilities that are directly related to the assets and opportunities and risks allocated to the PE. In case the amount of liabilities falls short allocation of this shortfall should take place on an indirect basis. In case of a surplus the amount of liabilities allocated to the PE should be reduced proportionally. Determination of the amount of interest expenses to be allocated to the PE takes place correspondingly directly, or if this is not possible indirectly. An arm's length interest will be allocated in case of internal financial transactions only in case:

- the PE fulfills the Treasury Function. Specific mention is made that these activities qualify as a service;
- funds generated by the activities of the PE are put at disposal of other parts of the enterprise for specific goals.

Part 2 , sections 18 – 22 and part 3, sections 23 – 29 of the Verordnung contain special rules for PEs of banks and insurance companies that resemble the OECD's body of thought laid down in. Other than the OECD 2008/2010 Reports on the attribution of profits to PEs and the Dutch Decree, Parts 3 – 7, sections 30 – 41 provide rules for construction companies, exploration companies and agency PEs, as well as Final provisions.

5.2 Both new and old version of article 7 OECD included in German tax treaties concluded since 2010

As early as 2006, by means of a Protocol, the functional and comparability approach has been included into to the treaty with the United States. Thus far (December 2021) the functionally separate entity approach also was included in the treaties Germany signed as of 2010 with Japan (2015) , Liechtenstein (2011), Luxembourg (2012), the Netherlands(2012), and by means of a Protocol into the tax treaties with Norway (2013), United Kingdom (2014) and Ireland (2014).

The old version of Art. 7 has been included in the tax treaties signed:

- between 17 July 2008 and 22 July 2010 Germany concluded tax treaties with Bulgaria (25 January 2010), Malaysia (23 February 2010) and Uruguay (9 July 2010) ;
- as of 22 July 2010 with Albania (2010), Armenia (2016), Bulgaria (2010), Australia(2015), China(2015), Costa Rica (2014), Cyprus (2011), Hungary (2011), Finland (2016), Hungary (2011), Israel (2014), Malaysia (23 February 2010), Mauritius (2011), Oman (2012), Philippines (2013), Taiwan (2011), Turkey (2011), Uruguay (2010) and the United Arab Emirates (1 July 2010). In the period.

6. The Dutch and German approach compared from the perspective of taxpayers rights

Comparing the Dutch and the German approach shows us Germany offers a lot more certainty to taxpayers on how to allocate profits to permanent establishments than the Dutch approach. Moreover, the German rules and administrative guidance, by offering more clarity, may result in more consistent taxation of cross-border activities of PEs, corporations and partnerships. At first sight this may lead to the conclusion that taxpayers rights are better protected in Germany than in the Netherlands. However, the comparison also teaches us that the German legislator decided to deviate from the OECD-guidance to some extent, which might result in double taxation in case the other state applies the tax treaty rules. The intention of the escape clause was to ensure that double taxation would be prevented. However, this aim is not fully achieved. An example is the allocation of free capital to the Dutch permanent establishment of a German enterprise. Whereas the Netherlands tax authorities will apply the capital allocation approach, the German tax authorities will apply the Mindestkapitalausstattungsmethod and thus will only allow allocation of free capital to the Dutch PE to the extent that the taxpayer proofs funds are used for the activities of the PE. Thus the PE-income exempted by Germany might be lower than the PE-income taxed in the Netherlands as

the interest deduction to be taken into account is higher than the interest deduction taken into account in the Netherlands. A mutual agreement procedure might solve this, but is costly. The escape clause of Art. 1.5(8) does not have any effect if the taxpayer is not able to provide the proof. Other than the German rules, the Dutch approach fully aligns with the AOA. Moreover the principle of equality may be better protected through open norms filled in by the tax authorities, judges and/or arbitrators, be it at the cost of certainty and efficiency. The flexibility of the Dutch approach moreover seems to offer more possibilities for achieving mutual agreement than the German approach. Finally, the Dutch approach provides more flexibility due to the fact that in case of future changes to the Commentary to art. 7 OECD Model (note no year has been mentioned) or the Dadt 2001 the policy laid down in IFZ 2010/457M will not be applicable if it is not in line with the changed versions. Most likely the Secretary of State in such circumstances will issue a new Decree. Thus, whereas in Germany legislation has to be amended, which may be time consuming, in the Netherlands quick adaptation is possible. All in all, both approaches have their merits and their cons from the perspective of protecting taxpayers rights.