

Implementation of AOA

Prof. Dr. Gerrit Frotscher



Implementation of AOA

Introduction:

- AOA (Authorized OECD Approach) is the new concept for allocation of profits to a permanent establishment as agreed by the OECD members

- „Functionally separate entity approach“

- Update 2010 of OECD Model Agreement:

Art. 7: Essential change of wording of paragraph 2:

„(2) For the purpose of this Article and Article [23A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.“

Paragraph 3 – 6 deleted

Implementation of AOA

Introduction:

- Substantial changes:

- Attribution of profits according to arm's-length-principle
- Yardstick: „functions performed, assets used and risks assumed“
- Deemed agreements between PE and Headoffice resp. Between 2 PE's („Dealings“)
- In principle, no allocation of costs (Art. 7 sec. 3 OECD-model deleted)
- „Indirect method (allocation by keys) not longer recognised (Art. 7 sec. 4 OECD-model deleted)

- Problem:

- How to implement AOA under (roughly) 90 German DTA's (including DTA Italy-Germany) which do not recognise the AOA (Art. 7 in the pre-2010-version)?

Implementation of AOA

New German Regulations:

- New Art. 1 sec. 4, 5 German Foreign Tax Act (AStG):
 - (Deemed) business transactions between PE and Head Office (assets transferred, services rendered etc)
 - Transactions require profit element as under third parties
 - Attribution of functions according to relevant people's functions
 - Attribution of assets according to the functions assumed
 - Attribution of chances and risks according to assumed functions and attributed assets
 - Attribution has to be documented by deemed agreements („dealings“)
- Further details in administrative law („Rechtsverordnung“):
 - Sofar only draft published
- Administrative Guideline announced but draft not yet published
- Applicable for business years beginning 1.1.2013

Implementation of AOA

Attribution of Capital:

- Arm's-length-principle not applicable
 - Capital allocation is not subject of dealings
- German PE of a foreign enterprise
 - Allocation of the total capital of the enterprise according to attributed functions, assets, chances and risks to the PE's
 - All PE's are provided with the same share of capital (contrary to situation of corporations where attribution of capital can vary – thin capitalisation approach)
- Foreign PE of a German enterprise
 - Minimum capital allocation: Taxpayer has the burden of proof what share of capital is necessary.
- Insurances, banks: regulatory rules can be applied
- Debt allocation: Balance of assets minus capital

Implementation of AOA

Documentation:

- Dealings have to be document in the same way as third-party-agreements (usually in writing)
- Same documentations rules as for transfer prices
- „Auxiliary books“ of PE:
 - Assets assumed including Intangibles and „other economic advantages“ (know-how? Chances not yet realised? Good will?)
 - Earnings and expenses of the PE
 - Description of functions and risks/chances assumed, reasons für attribution of functions, assets, chances and risks, capital

Implementation of AOA

Implementation

- New rules applicable irrespective of DTA's (Treaty override)
- Tax payer can prove that the other state raises taxes not in line with the AOA and that therefore double taxation occurs
 - Burden of proof rests with the tax payer

Issues:

- German rules allow only increase of income taxable in Germany, not decrease; therefore risk of double taxation
 - Different rules for capital allocation for PE's in Germany and abroad
- Rules for attribution of functions are very thing but clear and unambiguous
 - PE has a production function: own risk producer or toll processor?
 - PE has sales function: own risk trader or agent?
 - Importance of dealings: room for tax planning