54 The *country chapters* in this book list all essential characteristics of important bilateral DTCs, as far as they do not follow the OECD MC, in further detail. It is indispensable, however, to refer to the concrete DTC at issue (including its protocols and the relating memoranda of understanding, technical explanations, or exchange of diplomatic notes) in every single case.

[6] Methodology: The Interpretation of Articles 5 and 7 OECD MC

[a] Functions of the Methodological Rules on the Interpretation of Treaty Terms

55 Given the economic importance of PE issues, the demand for an efficient methodology of interpretation is possibly higher in a PE context than it is in other DTC-related issues. Whether a given facility or agent is a PE (cf. Article 5 OECD MC), and what part of the profit should be assigned to such PE (cf. Article 7 OECD MC) should be answered unequivocally in all States.

56 At first glance, this demand for a common understanding of Articles 5 and 7 OECD MC stems from the need for proper functioning of the bilateral DTC. Indeed, the tax administration of the source State and the tax administration of the State of residence should come to the same result when they examine whether a given facility does, or does not, constitute a PE, and if so, which part of the profit shall be assigned to this PE – otherwise, double taxation or double non-taxation would occur.

57 On second glance, however, the uniform decision of both contracting States does not necessarily require identity in the interpretation of the terms used in Article 5 or 7 OECD MC. Rather, a bilateral consistency might be achieved equally well, and maybe better, if it is the State of source alone who interprets the distributive rule(s) (e.g., Article 7 OECD MC and, in course of this interpretation, the PE definitions in Article 5 OECD MC, maybe with further recourse to its domestic law via Article 3(2) OECD MC), and if the State of residence which needs to apply Article 23 OECD MC only, is then bound to the positive 'self-assessment' made by the State of source. Under this approach (commonly labelled as 'the new approach on Article 23' for a number of years), the need for an advanced methodology is relatively low.[39]

58 Even in *triangular situations* (cases involving three different countries), a strictly uniform design and interpretation of Articles 5 and 7 is not required in all cases. Where all three States have entered into DTCs with one another,[40] and they follow the 'new approach' on how the State of residence should apply Article 23, double taxation as well as double non-taxation will be avoided even if the States are at variance with one another about what a PE is (cf. Article 5 OECD MC) and how the profit-assignment rules (cf. Article 7 OECD MC) should be understood. If not all States involved have

39. For details, *see infra* m.no. 86. It should be noted, however, that by far not all States follow this approach in their treaty practice. If they do not, the need for common interpretation of Arts 5 and 7 (as well as most other terms used in the distributive rules) is significantly higher.

40. A further condition is that the DTC between the State of residence and the State of the (potential) PE contains a clause like Art. 24(3) OECD MC.

concluded DTCs with each other, or if they do not follow the new approach, difficulties arise anyway, that is, even if both Articles 5 and 7 of the existing DTCs are interpreted uniformly.

59 Difficulties arise, however, as soon as *dual resident taxpayers* are involved. Where the enterprise is resident in two States (e.g., because it has its statutory seat in State A but its place of effective management is in State B), and maintains facilities in a third State (State C), there is a significant danger of double taxation as well as double non-taxation, as the case may be, if A and/or B apply the exemption method (Article 23A(1) OECD MC) in their DTCs between each other and with C and, moreover, if they (like the OECD MC) do not employ general subject-to-tax clauses or general switch-over provisions.

60 The outset is clear, though: vis-à-vis State C, both A and B apply the respective DTC which each of them has concluded with C. Between A and B, primary taxation is assigned on the basis of Article 7 OECD MC, or any other distributive rule. As these distributive rules function only where one single State of residence has been identified, they require the application of the tie-breaker rules in Article 4(2) or (3) OECD MC, as the case may be. However, as the following *examples* show, the DTCs between A and C (A/C) and between B and C (B/C) need to produce identical results in the characterization of the facilities located in C as a PE. If they do not, double taxation or double non-taxation arises.

61 (1) Where Article 5 of the DTC A/C follows the OECD MC while Article 5(3) of the DTC B/C provides for a minimum period for construction sites of only six months. The taxpayer can enjoy double non-taxation if he maintains a construction site in C for nine months. This is because:

- C has abandoned its right to tax in its DTC A/C (under Article 5(3) OECD MC, the minimum duration for a construction site PE amounts to twelve months).
- In the absence of a PE in A, State A is disallowed to tax the income from sources in C under, for example, the 1st sentence of Article 7(1) of the DTC A/B because B has 'won' the tie-breaker test under Article 4(2) or (3) of the DTC A/B.
- B, in turn, has assigned exclusive taxation to C, as the six-month period in Article 5(3) of the DTC B/C has been exceeded and B applies the exemption method.

62 Moreover, if the taxpayer suffers losses (rather than profits) in C, all three States might feel entitled to disregard these losses (given their duty to exempt corresponding positive income from any taxation). It should be noted, however, that country practice is by far not unanimous on this point – many States do consider losses even where corresponding profits are tax exempt under a DTC.[41]

41. For details as well as an EC law perspective, *see* Cordewener, A., et al., 'The Tax Treatment of Foreign Losses – Ritter, M & S, and the Way Ahead', *ET* (2004): 135 et seq. (Part I) and 218 et seq. (Part II).

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63 In contrast, the reverse case (i.e., Article 5 of the DTC A/C provides for a minimum period for construction sites of only six months while Article 5(3) of the DTC B/C follows the OECD MC) can be solved in a satisfactory manner, even if A, too, has accepted an unconditional obligation to exempt foreign income (cf. Article 23A(1) OECD MC) in its DTCs with B and C.[42]

64 (2) It is important to note that even where all DTCs involved have phrased the PE definition fully identical (e.g., in that they strictly follow the wording of Article 5 OECD MC), the same adverse effects as described in m.nos. 62 and 63 above may occur as a result of unanimous interpretation of terms used in Article 5 OECD MC. Examples with regard to Article 5(1) OECD MC include, for example, differences in the acknowledgement of roaming projects as one fixed place of business (*infra* part 2 at m.nos. 55 et seq.), the standards of tolerance for interruptions of the business activity (*infra* part 2 at m.nos. 80 et seq.), the acknowledgement of recurring activities as one homogeneous activity (*infra* part 2 at m.nos. 84 et seq.); the acceptance of joint control as sufficient under Article 5(1) OECD MC (*infra* part 2 at m.nos. 112 et seq.), or divergent views on which meaning should be assigned to the term 'through' in this provision (*infra* part 2 at m.nos. 120 et seq.).

65 It follows that uniform standards for the interpretation of PE clauses in DTCs are required not only between the two contracting States – here, substantive and procedural remedies are available – but, above all, for two or more 'neighbouring' DTCs which apply to one and the same (triangular or multi-angular) case. For these reasons, it is indispensable to observe some basic dos and don'ts of the interpretation of DTCs.

[b] Autonomous DTC Interpretation as the Starting Point

66 The starting point for the interpretation of every international treaty is this treaty itself. Wherever viable, and unless provided otherwise in the treaty at issue, the treaty shall be interpreted autonomously, that is, out of itself and according to the general principles of international law for treaty interpretation. Such prevalence of autonomous interpretation is crucial in many cases for the effective functioning of DTCs.

67 The general rules of treaty interpretation are contained in Articles 31 et seq. of the 1969 Vienna Convention of the Law of Treaties (VCLT[43]).

68 All of these rules of interpretation require a clear identification of the term which is to be interpreted. This may give rise to difficulties where a treaty (like most DTCs) has been phrased in *more than one language*. The following distinctions are required:

42. Here, C has abandoned its right to tax under the 1st sentence of Art. 7(1), read in connection with Art. 5(3) DTC B/C, which disallows source State taxation unless the construction site exceeds the twelve-month threshold. Like in m.no. 61 above, State A must not tax, due to the tie-breaker rule in its DTC with B. Now, however, State B keeps its taxing rights vis-à-vis C as the twelve-month period in the DTC B/C has not been exceeded. Consequently, profits from C are taxed exactly once (in B).

43. UNTS <http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf>.

(1) If the contracting States have agreed that only one language shall be authentic, there is no doubt that only the term(s) in this authentic language are to be interpreted, and that the other language term(s) are to be taken into account only under the preconditions set forth in Article 33(2) VCLT (i.e., if the treaty so provides or the parties so agree). If neither of the two preconditions has been met, the non-authentic languages shall be reconciled to the greatest possible extent. Remaining contradictions can cause the invalidity of the respective treaty clauses.

(2) In most cases, however, two (or even more) languages are equally authentic. As a rule, this makes them equally authoritative (Article 33(1) VCLT). To make sure that there is still only one *interpretandum*, Article 33(3) VCLT provides that the terms of the treaty are presumed to have the same meaning in each authentic text. For the determination of this meaning (or, more precisely, the range of potential meanings out of which one meaning will eventually be filtered out under Articles 31 and 32 VCLT), there is good reason to assume that the range of potential meanings is the overlap of the meanings under each of the two (or more) languages. In line with Article 31(1) VCLT, Article 33(4) VCLT makes it clear that the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

(3) However, the parties might have inserted a clause into the DTC according to which a third language shall prevail in cases of doubt or divergence (Article 33(1) VCLT). Where the States employ languages other than English or French as their official languages, one of these two languages functions as the authoritative language in cases of doubt or divergence.

[c] General Rules of Treaty Interpretation

69 According to Article 31(1) VCLT, a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. Even though all of these requirements show a high degree of uncertainty, they are authoritative for each contracting party, for their institutions (most notably, the tax authorities and the courts) and for all private entities and individuals who invoke the protection of, and claim the rights conferred upon them by the DTC as a self-executing treaty.

70 The essential cornerstone of interpretation is the *ordinary meaning* of a term. While the same term may have more than one ordinary meaning, it should be noted that the use of the singular (instead of 'ordinary meanings') basically excludes recourse by each of the contracting States to its own domestic law interpretations (for this aspect, *see infra* m.nos. 83 et seq.). Under the good-faith proviso (*supra* m.no. 70), the range of ordinary meaning(s) shall be identical in both contracting States. No State is entitled to suppose a meaning as 'ordinary' which, from the perspective of the other State, does not even fall in the range of potential meanings.

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71 An *important indicator* for the meaning of treaty terms can be derived from a comparison to the terms used by the *OECD Model*. Where a DTC uses French or English (exclusively, jointly, or jointly with one or more other languages) as the authoritative language(s) (*see supra* m.nos. 68 et seq.), a deviation from the corresponding clause of the OECD MC indicates a semantic deviation. Likewise, a comparison of this DTC with national treaty models (published or unpublished) or with other DTCs concluded by either contracting State might in some cases serve as a supplementary means of interpretation.

72 Where neither English nor French has been used as an authoritative language of the DTC, the OECD Model can still function as a point of comparison. As a refutable presumption, where one (or both) of the contracting States are member(s) of the OECD and where the DTC contains rules which are obviously translated from the OECD MC, the interpretation of the contracting OECD Member State(s) shall consider the meaning of the English and French versions of the OECD MC. Therefore, where the interpretation by the OECD Member State is decisive (maybe even for the other contracting State, for example, under the new approach to Article 23 OECD MC; cf. *supra* m.no. 58and *infra* m.no. 87 for details), the respective treaty term should be interpreted in a way which is compatible to the corresponding English and French terms used by the OECD MC.[44]

73 This refutable presumption is overruled, however, if homogeneous national concepts of both contracting States suggest an understanding differing from the one of the OECD MC. The presumption also does not apply if the respective contracting State has filed a reservation to the OECD Model, indicating that this State does not feel obliged to adopt the respective rule proposed by the Model.[45]

74 The *official Commentary* which the *OECD* has published (and updated regularly) has gained a high degree of authority in the determination of treaty terms.[46] Like the OECD MC itself, it comes as an OECD Recommendation,[47] thus forms part of the wide range of soft law obligations which the OECD has imposed on its Member States. Notwithstanding other provisions of Articles 31 and/or 32 VCLT, the Commentary guarantees a uniform understanding of both single treaty terms and entire provisions.[48] The same

44. Sasseville, J. & Skaar, A., General Report, *CDFI* vol. 94a (2009), at 24.
45. For the relevance of reservations to the OECD MC, *see* nos. 31 et seq. of the Introduction to the OECD MC Comm.; Kühner, R., *Vorbehalte zu multilateralen völkerrechtlichen Verträgen* (1986); Horn, F., *Reservations and Interpretative Declarations to Multilateral Treaties* (1988); Schmidt, J., *Vorbehalte zu multilateralen Verträgen unter dem Aspekt des intertemporalen Völkerrechts* (1992); Sucharipa-Behrmann, L., 'The Legal Effects of Reservations to Multilateral Treaties', 1 *Austrian Rev. Int'l & Eur. L.* (1996), at 67 et seq.; Redgwell, C., 'The Law of Reservations in Respect of Multilateral Conventions, in *Human Rights as General Norms and a States' Right to Opt Out* (1997), at 3 et seq.; Nawaz, M.K., 'Reservations to Normative Multilateral Treaties and Human Rights Treaties', 22 *AALCC Bull.* (1998): 1, at 19 et seq.; Kapoor, K.J.S.R., 'Reservations to Treaties', 22 *AALCC Bull.* (1998): 1, at 28 et seq.; for an economic analysis, cf. Greig, D.W., 'Reservations: Equity as a Balancing Factor?', 16 *The Austrl. Y.B of Int'l L.* (1995): at 21 et seq.
46. Full reprint in Reimer, E. & Rust, A. (eds), Klaus Vogel on Double Taxation Conventions, 4th ed. (2015).
47. Article 5(b) of the Convention on the OECD of 14 Dec. 1960.
48. As convincingly stated in nos. 28 et seq. of the Introduction to the OECD MC Comm.

holds true for a number of Reports and Guidelines which elaborate specific issues of tax treaty law in more detail than the Commentary.[49] Where these Guidelines and Reports, too, have been formally approved by the OECD Council as OECD Recommendations,[50] Member States are obliged to respect them and not to deviate without due reason.

75 However, it should be noted that there are a number of constellations in which the OECD Commentary (or certain versions thereof) as well as the OECD Reports have no interpretative authority. Like the OECD MC itself, the Commentary does not have any direct authority in non-Member States (cf., however, *supra* m.no. 73). Moreover, the Commentary has no relevance if clear statements of the contracting parties run counter to the provisions of the Commentary or a Report.[51] In particular, if the contracting States employ a wording (or entire provisions) that is different from the OECD Model, there is a strong presumption that they also wanted to avoid the interpretation of the Model terms/provisions in the Commentary.[52] Even if the Commentary is useful to fill any gaps in the DTC, neither State is bound to the respective clause in the Commentary if at least one of the contracting States has filed an observation to the Commentary.[53] Like reservations to the Model (*supra* m.no. 74), observations to the Commentary function as escape doors for OECD Member States which on the one hand cannot agree to the majority opinion in favour of a new clause, but on the other hand do not want to veto the clause. Instead they abstain from consenting to the OECD Commentary and, in so doing, make their own position even clearer.

76 Lastly, the Commentary can be left aside where its contents or any related meta rule (i.e., the rule that the Commentary be applied in a certain way) runs contrary to the original intent of the parties. In this connection, it is particularly the issue of *later changes of the Commentary* which has gained high practical relevance. The OECD has claimed that recent changes to the Commentary should be applied to existing bilateral DTCs.[54] Such *dynamic interpretation* of the treaty is admissible if the new Commentary fills gaps and settles uncertainties that existed before. In contrast, later changes of the Commentary are not binding with regard to those States which have filed a related observation to the Commentary.

77 The *context* mainly consists of the text of the DTC (including its title, preamble and annexes). Moreover, it includes any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty, as well as any instrument which was made by one party in connection with the conclusion of the treaty and accepted by the other party as an instrument related to the treaty (Article 31(2) VCLT).

49. Most notably, the OECD *Partnership Report* (1999), the OECD *Transfer Pricing Guidelines* (*infra* part 3 fn. 456), and the OECD *Report on the Attribution of Income to Permanent Establishments* (*infra* part 3 fn. 456).
50. *See supra* fn. 47.
51. *See infra* part 3 at m.no. 131 for an example.
52. Cf. no. 30 of the Introduction to the OECD MC Comm.
53. Cf. no. 30 of the Introduction to the OECD MC Comm.
54. Nos. 33 et seq. of the Introduction to the OECD MC Comm.

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78 In addition, there are a number of secondary means of interpretation which Article 31(3) VCLT places on equal footing with the context. These means and aspects include:

- subsequent agreements between the parties regarding the interpretation of the treaty or the application of its provisions;
- subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation (for an example, *see infra* part 2 at m.no. 458);
- relevant rules of international law applicable to the relations between the parties.

79 Interpretation may also be based on the *preparatory work* of the treaty, the *circumstances of its conclusion* or any *other subordinate means* of interpretation. The subordinate character of these aspects is stressed by Article 32 VCLT. According to this provision, these aspects function only as supplementary means of interpretation. This means that they may:

- *confirm* the meaning resulting from the application of Article 31 VCLT;
- determine the meaning when the interpretation under Article 31 VCLT leaves the *meaning ambiguous* or *obscure;* or
- determine the meaning when Article 31 VCLT leads to a result which is *manifestly absurd* or *unreasonable* (a case which will be covered by the good-faith clause under Article 31(1) VCLT).

80 In addition to all these aspects of systematic interpretation, the treaty terms are subject to different types of *teleological interpretation*. As a rule, such teleological interpretation shall be oriented towards 'object and purpose' (Article 31(1) VCLT), that is, aims and purposes in the outside world which have been specified in, and can be derived from, the rules themselves.

81 Under the *historical interpretation*, however, a mental (subjective) element gains relevance under Article 31(4) VCLT if it is established that the parties intended to attribute a special meaning to the respective term.

82 The *good-faith provision* in Article 31(1) VCLT restricts the range of potential meanings of a term or a clause to those meanings on which one can fairly assume that both parties would have agreed upon had they foreseen the concrete case at issue at the time when the DTC was concluded.

[d] Reference to Domestic Law as an Exception

83 Given the richness of *aides d'interpretation* contained in the above-mentioned means of interpretation (and, most notably, in the OECD Commentary), a treaty term can be, and thus has to be, interpreted autonomously in the vast majority of cases. It is *only where* all efforts to derive a convincing meaning through *autonomous interpretation* have *failed* (i.e., where these methods have not overcome the ambiguity or equivocality of a term), *recourse* may be had *to the domestic law* of either contracting State.

84 The DTC itself determines which domestic law applies. In non-PE-specific situations, various rules apply.[55] On the contrary, a domestic-law related interpretation of the terms used in Articles 5 and 7 OECD MC has to come from the domestic law of the State which applies the DTC according to *Article 3(2) OECD MC*.[56]

85 This *bifurcated reference* (each State applies its own law rather than to a common point of reference) may not remove the *ambiguity* of the treaty term concerned. On the contrary, such split interpretation may result in either double taxation or double non-taxation. This would run counter to the object and purpose of (the existence of) a unifying PE definition in Article 5 OECD MC proper. For this reason, the context of the DTC (i.e., the existence of a PE definition) 'requires' (cf. Article 3(2) OECD MC) that the DTC term 'PE' as well as the (sub-)elements used throughout Article 5 OECD MC be interpreted autonomously, i.e., without recourse to the domestic law of either contracting State (see supra m.no. 16).

86 There are indeed effective mechanisms in the treaty itself which can still guarantee a uniform application of the treaty. Under the innovative '*new approach*' of interpretation which has developed since the mid-1980s,[57] the *State of residence* may be *obliged to follow* the interpretation which *the State of source* (i.e., the State where the PE is located) has assigned to a treaty term (either by applying Article 3(2) OECD MC or by attempting to obtain an autonomous interpretation).

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87 This approach is based on a careful reading of Article 23 A and B OECD MC. Under both provisions, the State of residence[58] is obliged to grant relief from double taxation (by a foreign income exemption or a foreign tax credit, as the case may be) if and only if the taxpayer 'derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State' (i.e., the PE State). Whether the PE State may tax 'in accordance with the [. . .] Convention' is a question which this State can legitimately answer by way of recourse to its own domestic law (Article 3(2) OECD MC). If its domestic law supports an interpretation of the treaty term that results in the assignment of primary taxation to the PE State, this State is indeed entitled to tax these items of income 'in accordance with the [. . .] Convention'. This alone is sufficient to bind the State of residence under Article 23 A or B. In other words, Article 23 A or B prevents the State of residence from applying Article 3(2) from its own perspective. The State of residence is only entitled to test if the PE State, in its (the PE State's) own perspective, has applied both the DTC (including Article 3(2)) and its domestic law properly.

55. For them, *see* the reference rules in Arts 4(1), 6(2) or 10(3) OECD MC.
56. On the methodology of this rule, Lehner, M., Die autonome Auslegung von Doppelbesteuerungsabkommen im Kontext des Art. 3 Abs. 2 OECD-MA, in: Lüdicke et al., *Das Steuerrecht der Unternehmen. Festschrift für Gerrit Frotscher* (213): 383 et seq.
57. Cf. Déry, J.-M. & Ward, D., 'Canada. National Report', LXXVIIIa *CDFI* (1993): 259 et seq., 281 et seq.; OECD Partnership Report (1999), at nos. 94 et seq.; Vogel, K., in: Vogel & Lehner (ed.), *Doppelbesteuerungsabkommen*, 5th edn (2008), Art. 3 at m.nos. 112 et seq.; nos. 32.3 of the 2008 OECD MC Comm. on Art. 7; and *supra* m.no. 58.
58. Usually, the state where the head office is located. *See* Art. 4 OECD MC for details.

[7] *Approaches to Procedural Coordination*

88 The aforementioned attempts to achieve uniform interpretation through uniform rules of interpretation (including, most notably, the 'new approach' on the interpretation of Article 23 OECD MC; *see supra* m.no. 88) have brought about a considerable degree of common application of a DTC in a given case. For a number of reasons, however, these attempts need to be complemented by procedural methods of bilateral coordination. In addition, or sometimes as an alternative, to the filing of remedies under domestic law, international tax law has paved the way for several different procedures for the following bilateral or even international dispute avoidance or dispute resolution.

[a] *Advance Rulings*

89 The most effective and elegant, though sometimes extremely time-consuming way to avoid disputes on the interpretation or application of DTCs are requests of the taxpayer filed with domestic tax authorities for an advance unilateral ruling or an advance bilateral agreement on critical issues in the interpretation of a DTC clause and/or on the acknowledgement and evaluation of certain facts. Today, most countries offer corresponding procedures (often labelled as 'private letter rulings').

90 However, there are signification differences regarding the scope of such advance rulings. While some countries offer advance pricing agreements (APAs) only, others provide advance rulings for almost every issue arising under domestic and/or tax treaty law. Further variations concern the formal requirements for the application, the duration of the ruling procedure, and the costs. For details, *see* the country reports in Chapters 5 et seq. of this book.[59]

[b] *Article 25 OECD MC*

91 A more traditional tax treaty approach is the initiation of mutual agreement procedures (MAPs) under Article 25(1) and (2) OECD MC. On the basis of Article 25 OECD MC, almost all bilateral DTCs contain rules on mutual agreement procedures for all situations where double taxation cannot, or not sufficiently, be avoided by the (isolated) application of the DTC by each of the two contracting States.[60]

59. For further comparative material, *see* IFA (ed.), 'Advance rulings by the tax authorities at the request of a taxpayer', CDFI vol. 50b (1965); IFA (ed.), 'Advance rulings', CDFI vol. 84b (1999). General *Guidelines for Conducting Advance Pricing Arrangements under Mutual Agreement Procedures (MAP APA)* have been provided by the OECD as an Annex to its *Transfer Pricing Guidelines* (1995, with subsequent updates).
60. Cf. no. 4 of the 2008 OECD MC Comm. on Art. 7. A good overview is given by Zschiegner, H., 'Vorabzusagen über Verrechnungspreise (Advance Pricing Agreements – APAs)', IWB no. 24 of 23 Dec. 2009: at 1199 et seq. = *IWB* Fach 8 Gruppe 2: 1551 et seq.

92 As a rule, MAPs are consultations between the two contracting States of a DTC. The participation of the taxpayer is not self-evident.[61] He may indeed prompt or encourage the tax authorities of one or both States to discuss his case. There is no guarantee, however, that the MAP will settle a case, and even where a MAP results in an administrative agreement between the two contracting States, its implementation into the domestic legal order of the contracting States might be critical. Moreover, triangular and multiangular cases can rarely be solved efficiently through merely bilateral MAPs.

[c] *Compulsory Arbitration under Bilateral DTCs*

93 Since 2008, Article 25(5) OECD MC has provided for the introduction of a binding arbitration procedure between the two tax administrations involved. Arbitration shall be initiated if, after two years, a MAP has not settled the underlying problem in the application of the DTC. The taxpayer has a right to request the initiation of such arbitration procedure. The arbitration procedure may not be initiated if a decision on the pertinent issues has already been rendered by a court or administrative tribunal of either State.

[d] *EU Arbitration Convention*

94 For intra-EU disputes with regard to the allocation of profit, the 1990 EC (now, EU) Arbitration Convention provides an additional tool for the twenty-seven EU Member States and the taxpayer.[62] While the Convention has primarily concerned the adjustment of transfer prices between associated enterprises (cf. Article 9 OECD MC), it has been extended to PE cases.[63] Moreover, the Arbitration Convention was supplemented by a Code of Conduct on transfer pricing issues in December 2004.[64]

95 The Convention entitles the taxpayer to present his case to the tax authorities of his respective State of residence first. If the tax authorities cannot provide a solution on a unilateral basis, they have to make efforts to resolve the issue by way of a mutual agreement with the other State(s) involved.[65] If these attempts remain unsuccessful, the States shall set up an Advisory Commission charged with delivering its opinion on the elimination of the double taxation in question.[66] Subsequent to the opinion submitted by the Advisory Committee, the contracting States involved may take a decision which deviates from the advisory commission's opinion. If they fail to reach an agreement, they are obliged to act in accordance with the opinion.[67]

61. For details, *see* Koppensteiner, F., 'Der Status des Einzelnen im Rahmen des Verfahrens nach Art. 25 OECD-MA', 62 ÖStZ (2009): 549 et seq.
62. Convention 90/436/EEC, OJ EEC L 225 of 20 Aug. 1990.
63. Article 1(2) of the Arbitration Convention.
64. *See* Graf, M., Neuerungen beim EU-Schiedsübereinkommen, *Steuer und Studium* 2005, at 98 et seq.
65. Article 6(2) of the Arbitration Convention.
66. For the composition of this Commission, *see* Art. 9 of the Arbitration Convention.
67. Article 12(1) of the Arbitration Convention.

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96 While the procedures initiated under the Arbitration Convention are fully compatible with domestic remedies,[68] the relation between dispute settlement under the EU Arbitration Convention on the one hand and mutual agreement procedures (including arbitration procedures on the basis of bilateral DTCs) has not been clarified yet.

[e] *EU Dispute Settlement Directive*

97 The same is true for future dispute settlement under the new EU Directive on Double Taxation Dispute Resolution[69] that shall be implemented by the EU Member States by 30 June 2019. As far as EU Member States are concerned, the Directive supplements the EU Arbitration Convention. Yet, it contains some further guarantees and options for taxpayers. Most notably, the Directive endows taxpayers with a right to file an individual complaint.[70] Unlike the EU Arbitration Convention, it covers both taxes on income and taxes on capital. It covers both the arbitration and the preceding mutual agreement stage. It is not restricted to disputes on the allocation of profits (Articles 7(2) & 9 OECD MC) but is available for all DTC-related issues and MLI-related issues, including e.g., the existence of a PE. Decisions shall be made not only on the basis of the respective bilateral DTC but also of domestic and EU laws. Finally (at least to some extent), it also defines the relation between supranational and international dispute settlement on the one hand and domestic remedies on the other hand.

[C] European Union Law

98 From its conceptualization in tax treaty law, the PE notion has also become a decisive threshold in secondary EU law.[71] Moreover, the 28 January 2016 Anti-Tax Avoidance Package of the EU Commission enacted a formal Recommendation on a new design of the PE definition for new DTCs of the (currently) twenty-eight EU Member States.

[1] *Merger Directive*

99 Since 1990, both the Preamble and Articles 5, 6 and 10 of the Merger Directive has employed the PE concept in order to delimitate taxing authorities of different Member States and to prevent (though only to a limited extent) discrimination of PEs of foreign companies as compared to domestic companies.[72] Unlike the 1969 Draft of this Directive, however, the Merger Directive does not contain a PE definition.

68. Cf. sub-para. 2 of Art. 7(1) of the Arbitration Convention.
69. Council Directive 2017/1852 of 10 October 2017 on Double Taxation Dispute Resolution Mechanisms in the European Union, OJ L 265 of 14 Oct. 2017, p. 1.
70. Article 3 of the Directive (*infra*).
71. For a comparative analysis, *see* Müller, D., *Der Europäische Betriebsstättenbegriff – Unter besonderer Berücksichtigung des primärrechtlichen Zweigniederlassungsbegriffs* (dissertation, Heidelberg 2015, forthcoming).
72. Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225 of 20 Aug. 1990 at 1 (as amended).

[2] *Parent-Subsidiary Directive*

100 Dating back to 1990, too, the Parent Subsidiary Directive[73] applies to dividends received by the EU PE of an EU Parent company received from its subsidiary resident in a different EU Member State (cf. Article 1(1) of the Directive). It provides for a 95% tax exemption (alternatively, an indirect tax credit) of the aforementioned dividends (Article 4(1)&(2) of the Directive).

101 Unlike the Merger Directive, however, this Directive provides for a PE definition. According to Article 2(2) of the Directive, the term means 'a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on in so far as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of the relevant bilateral tax treaty or, in the absence of such a treaty, by virtue of national law'. The rule does not, however, include the concept of construction site PEs, agency PEs and the like. Neither does it carve out auxiliary activities from the PE definition. In all, it is less sophisticated and, at the same time, less precise than the PE definitions contained in most DTCs or in the treaty models (*infra* part 2).

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[3] *Interest Royalty Directive*

102 Under the 2003 Directive on the tax treatment of interest and royalties paid between associated enterprises,[74] too, PEs are placed on equal footing with associated companies. Interest and royalty payments can therefore be made between different EU Member States without any withholding taxes in the State of source (of the payor). Under Article 1(3) of the Directive, a PE shall be treated as the payer of interest or royalties insofar as those payments represent a tax-deductible expense for the PE in the EU Member State in which it is situated. Similarly, EU PEs shall be treated as the beneficial owners of interest or royalties under the preconditions laid down in Article 1(5) of the Directive.

103 In line with the Parent Subsidiary Directive, the Interest Royalty Directive contains its own PE definition. It is phrased even more simply that then aforementioned definition, however. According to Article 3(c) of the Interest Royalty Directive, the term designates any 'fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on'.

73. Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225 of 20 Aug. 1990 at 6 (as amended).
74. Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157 of 26 Jun. 2003 at 49 (as amended).

[4] *COM Recommendation of 28 January 2016 on the PE Definition*

104 As part of its ATAP, the EU Commission has released a formal Recommendation on the implementation of measures against tax treaty abuse on 28 January 2016. By way of a soft-law obligation, the Recommendation aims at bringing the twenty-eight Member States to use a more sophisticated PE definition in their future DTCs *inter se* as well as with third States. For EU Member States which are also Members of OECD, this Recommendation anticipates the (pending) update of Article 5 OECD MC that might not be finalized before summer 2017.

105 The Recommendation reads:

> 'Member States are encouraged, in tax treaties which they conclude among themselves or with third countries, to implement and make use of the proposed new provisions to Article 5 of the OECD Model Tax Convention in order to address artificial avoidance of permanent establishment status as drawn up in the final report on Action 7 of the Action Plan to address Base Erosion and Profit Shifting (BEPS).'

106 Given that the OECD MC, too, comes as a Recommendation, the 2016 EU Recommendation overrides the existing OECD Recommendation for the *inter se* DTCs between EU twenty-seven Member States. By contrast, new DTCs between EU Member States and non-EU OECD Member States are still subject to bilateral negotiations. The EU Recommendation does therefore not claim any outside effect or prevalence.

107 For details on the OECD draft on a modified Article 5(4) OECD MC, *see infra* part 2 at m.nos. 299 et seq. For the revised agency PE concept under a new Article 5(5)&(6) OECD MC, *see infra* part 2 at m.nos. 365 et seq.

[D] PE Taxation as a Subject of International Tax Research

108 Both parent-subsidiary schemes and unitary enterprises with PEs in more than one State belong to the best-covered topics of international tax law. However, the lack of private-law transactions between the head office and a PE, or between two (or more) PEs of the same enterprise, makes PE taxation certainly the more sophisticated concept, as compared to the taxation of transactions between a parent and its subsidiary or between two (or more) subsidiaries within the same group of companies. Numerous efforts of OECD's Committee on Fiscal Affairs reflect these difficulties.[75]

109 The International Fiscal Association (IFA) has frequently analysed PE issues during its annual international congresses. While early congresses took a comprehensive look at a wide range of PE topics (and have not been limited to DTC issues but included

75. Most notably, OECD Report *Attribution of Profits to Permanent Establishments* (2006).

comparisons between different domestic PE concepts[76]), any later approach has become more specific as IFA has covered either the PE definition[77] or the assignment of income between two or more PEs.[78]

110 The steady evolution of the OECD Commentary, the increasing density of a DTC network and of practical and academic exchange as well as the rising number of court cases on PE issues have inspired Commentators of the OECD Model and/or DTCs to present detailed and well-structured explanations of both PE definitions and the rules on the allocation of profits between PEs.[79]

111 A landmark in the academic analysis of PE problems was the 1991 monograph 'Permanent Establishment – Erosion of a Tax Treaty Principle' by Arvid Aage Skaar. More than any other treatise, this book has influenced critical reflection on the PE concept in general and has unveiled inconsistencies within Article 5 OECD MC, a large number of bilateral DTCs and their application.

112 In addition, scholarly literature on PE issues has been published in many countries and languages. Examples include a number of handbooks and guides written in the English language by international authors, or teams of authors, from a comparative perspective[80] as well as specific country perspectives. In this respect, the following key works have gained particular attention during the last two decades.

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76. 1957 (CDFI vol. 34a): The position of permanent establishments in national and international fiscal law; the concept of permanent establishments and allocation of capital and profits among the various permanent establishments of the same enterprise; 1967 (CDFI vol. 52): The development in different countries of the concept of a permanent establishment, notably from the point of view of the harmonization in future DTCs.
77. 1997 Seminar (IFA Congress Seminar series vol. 22a (1999)): The OECD model convention, 1997 and beyond – current problems of the permanent establishment definition; 2001 (CDFI vol. 86a): Taxation of income derived from electronic commerce; 2005 (CDFI vol. 90a): Source and residence: new configuration of their principles; and 2009 (CDFI vol. 94a): Is there a permanent establishment?
78. 1973 (CDFI vol. 58a): The taxation of enterprises with permanent establishments abroad; 1996 (CDFI vol. 81a): Principles for the determination of the income and capital of permanent establishments and their applications to banks, insurance companies and other financial institutions; and 2006 (CDFI vol. 91b): The attribution of profits to permanent establishments.
79. Korn, R. & Dietz, G. (eds), *Doppelbesteuerungsabkommen Kommentar* (loose-leaf) since 1955, now edited by Wassermeyer, F.; Vogel, K., *Doppelbesteuerungsabkommen. Kommentar* (1st edn, 1983; 2nd edn, 1990; 3rd edn, 1996; translations of the 2nd and 3rd edn of this Commentary have been published as *Klaus Vogel On Double Taxation Conventions* in 1991 and 1997 while updated German versions have been edited by Lehner, M., in 2003 (4th edn), 2008 (5th edn) and 2015 (6th edn; also available at <www.beck-online.de>); Vogel & Shannon & Doernberg & van Raad, *U.S. Double Taxation Conventions* (loose-leaf ed., 1989); Philip Baker, *Double Taxation Conventions* (loose-leaf, 3rd edn 2000) et seq.); Hortalá i Vallvé, J., *Comentarios a la Red Española de Convenios de Doble Imposición* (2007); Haase, F. (ed.), *Außensteuergesetz – Doppelbesteuerungsabkommen* (2009); Schönfeld, J. & Ditz, X. (eds), *Doppelbesteuerungsabkommen. Kommentar* (2013); Mathur, C. S. & Görl, M. & Sonntag, K., *Principles of Model Tax Conventions and International Taxation* (2013).
80. For example, Russo, R. (ed.), *The Attribution of Profits to Permanent Establishments. The Taxation of Intra-Company Dealings* (2005).

113 In *the English-speaking world*, authors from several countries have contributed to the elaboration of the PE concept, as used in the DTCs. John Huston, Lee Williams and Martin B. Tittle have collected detailed material, mainly from US resources.[81] An Australian scholar, Michael Kobetsky, and Patrick Faller from Germany have added further insight with a special view on banking PEs.[82] The geographical stability of PEs has been analysed by Jean Schaffner.[83] Since 2006, Radhakishan Rawal has provided detailed and knowledgeable analysis of PE issues from an Indian perspective.[84] The same perspective, though not restricted to PE issues, has been taken by the new three-volume work of C. S. Mathur, Maximilian Görl and Karl Sonntag.[85]

114 Similarly, *German-speaking authors* have paid much attention, and made substantial contributions, to the PE concept under tax treaty law during the last thirty years. Among the wide range of books and articles, a number of monographs on the assignment of profits and tax revenue between the different PE States deserve being mentioned: comprehensive treatises by Alfred Storck,[86] Alexander Hemmelrath[87] and Wolfgang Kumpf[88] date back to the early 1980s, later on followed by Uta Haiß' and Jörg Mödinger's profound analyses of the allocation of profits between PEs.[89]

115 Likewise, there are several collections of articles edited by German tax practitioners[90] and renowned scholars of the Vienna school of tax law.[91] Another Austrian perspective are the

81. Huston, J. & Williams, L., *Permanent Establishments – a Planning Primer* (1993); Tittle, M. B., *Permanent Establishment in the United States – a View Through Article V of the U.S.-Canada Tax Treaty* (2007).
82. Kobetsky, M., *International Taxation of Permanent Establishments: Principles and Policy* (2011); Faller, P., Attribution of profits to permanent establishments of banks within the lending business. *Hefte zur internationalen Besteuerung* no. 183 (2011). For an earlier comparative analysis, *see* the reports collected by IFA (ed.), Principles for the determination of the income and capital of permanent establishments and their applications to banks, insurance companies and other financial institutions, *CDFI* vol. 81a (1996).
83. Schaffner, J., *How Fixed Is a Permanent Establishment?* (2013).
84. Rawal, R., *The Taxation of Permanent Establishments – an International Perspective* (2006); *Ibid.*, *Analysing Article 7: Impact on PEs in Nine Major Trading Nations* (2007).
85. Mathur, C. S. & Görl, M. & Sonntag, K. (eds), *Principles of Model Tax Conventions and International Taxation* (2013), vol. 2 & 3.
86. Storck, A., *Ausländische Betriebsstätten im Ertrag- und Vermögensteuerrecht* (1980).
87. Hemmelrath, A., *Die Ermittlung des Betriebstättengewinns im internationalen Steuerrecht. Eine Untersuchung zur 'Selbständigkeit' der Betriebstätte gemäß Art. 7 Abs. 2 OECD-Musterabkommen* (1982).
88. Kumpf, W., *Besteuerung inländischer Betriebstätten von Steuerausländern* (1982).
89. Haiß, U., *Gewinnabgrenzung bei Betriebsstätten im internationalen Steuerrecht. Vermögens-, Aufwands- und Ertragszuordnung nach OECD-Musterabkommen und neuerem Betriebsstätten-erlass* (2000). The 2010 rules have been covered by Mödinger, U., *Internationale Erfolgs- und Vermögensabgrenzung zwischen Stammhaus und Betriebsstätte nach der Neufassung des Art. 7 OECD-MA* (2012). *See also* Rometzki, S., Betriebsstättengewinnabgrenzung im Wandel – die Behandlung von Innentransaktionen im deutschen Internationalen Steuerrecht, in: *Hefte zur internationalen Besteuerung* no. 160 (2008).
90. Piltz, D. J. & Schaumburg, H. (eds), *Internationale Betriebsstättenbesteuerung* (2001), Lüdicke, J. (ed.), *Neue Grenzen für die internationale Steuerplanung?* (2014).
91. Gassner, W. & Lang, M. & Lechner, E. (eds), *Die Betriebstätte im Recht der Doppelbesteuerungsabkommen* (1998); Aigner, H.-J. & Züger, M. (eds), *Permanent Establishments in International Tax Law* (2003); Brugger, F. & Plansky, P. (eds), *Permanent Establishments in International and EU Tax Law* (2011; collection of master theses).

2004 thesis by Clemens Nowotny on the allocation of assets and profits, a 2009 manual by Stefan Bendlinger and a monograph by Patrick Plansky,[92] while Michael Puls has analysed the PE concept from a German viewpoint.[93] At the same time, Xaver Ditz has published a thoughtful contribution on the approximation of Articles 7 and 9 OECD MC.[94] This book was followed by a 2006 handbook presented by Ditz and other leading tax practitioners on the PE definition as well as the allocation of profits,[95] a competing handbook edited by Ulrich Löwenstein et al. of 2011.[96] Peter Brülisauer wrote a similar handbook from a Swiss perspective.[97] Further monographs analyse single aspects or problems connected to the PE concept,[98] like triangular cases,[99] the treatment of PE losses,[100] dotation of PEs in general[101] and of banking PEs in particular,[102] or the transfer of assets or functions. In addition, there is a rich variety of books and articles comparing PE structures to group structures.

116 In the *francophone* parts of the world, the notion of a PE and the treatment of PEs in tax treaties has been covered by a number of comprehensive books on international taxation in general.[103] Further insight has been provided by national reports to a range of PE-related IFA Congresses.[104]

92. Nowotny, C., *Betriebstättengewinnermittlung: die Zuordnung von Wirtschaftsgütern im Recht der Doppelbesteuerungsabkommen* (2004); Bendlinger, S., *Die Betriebsstätte in der Praxis des internationalen Steuerrechts* (2009); Plansky, P., *Die Zurechnung von Gewinnen zu Betrieb-sstätten im Recht der Doppelbesteuerungsabkommen* (2011).
93. Michael, R. P., *Die Betriebsstätte im Abgaben- und Abkommensrecht* (2005).
94. Ditz, X., *Internationale Gewinnabgrenzung bei Betriebsstätten. Ableitung einer rechtsformneu-tralen Auslegung des Fremdvergleichsgrundsatzes im internationalen Steuerrecht* (2004).
95. Wassermeyer, F. & Andresen, U. & Ditz, X., *Betriebsstätten-Handbuch. Gewinnermittlung und Besteuerung in- und ausländischer Betriebsstätten* (2006).
96. Löwenstein, U. (ed.), *Betriebsstättenbesteuerung. Inboundinvestitionen, Outboundinvesti-tionen, Steuergestaltungen, Branchenbesonderheiten*, 2nd ed. (2011).
97. Brülisauer, P., *Gewinnabgrenzung zwischen Stammhaus und Betriebsstätte im internationalen Steuerrecht der Schweiz* (2006).
98. On DTC-related mismatches, Korff, M., *Abkommensrechtliche Besteuerungskonflikte beim Einsatz von Betriebsstätten in der internationalen Steuerplanung* (2011).
99. Helde, S., *Dreiecksverhältnisse im Internationalen Steuerrecht unter Beteiligung einer Betriebsstätte* (2000); Ribbrock, M., *Dreieckssachverhalte im Internationalen Steuerrecht. Probleme bei der Besteuerung von Betriebstätten mit Zinseinkünften aus Drittstaaten* (2004); and Britsch, M., *Dreiecksachverhalte unter Bezugnahme einer Betriebsstätte im Internation-alen Steuerrecht. Triangular Permanent Establishment Cases* (2011).
100. Zoll, S., *Grenzüberschreitende Verlustberücksichtigung bei gewerblichen Betriebsstätten und Tochterkapitalgesellschaften im Lichte nationaler und internationaler Besteuerungsprin-zipien* (2001); Kessler, W., *Inländische Berücksichtigung ausländischer Betriebsstättenverlus-te.* Schriftenreihe des Instituts Finanzen und Steuern Bonn, vol. 421 (2004); Karrenbrock, L., *Die steuerliche Berücksichtigung ausländischer Betriebsstättenverluste im Inland – eine Untersuchung unter dem verfassungsrechtlichen Aspekt der Folgerichtigkeit* (2013).
101. Mutscher, A., *Die Kapitalstruktur von Betriebstätten im internationalen Steuerrecht. Methoden zur Bestimmung der Kapitalausstattung im Rahmen der internationalen Einkunftsabgrenzung unter Berücksichtigung der Regelungen in der Bundesrepublik Deutschland und in den USA* (1997).
102. Buchholz, F., *Grenzüberschreitendes Kreditgeschäft durch Bankbetriebsstätten – Risikoorientierte Gewinnabgrenzung nach Art. 7 OECD-MA 2010* (2014).
103. For France by Melot, N., *Territorialité de l'impôt et mondialité de l'impôt* (2004); and Castagnède, B., *Précis de fiscalité internationale* (2006); for Belgium by Gouthière, B., *Les impôts des les affaires internationals* (2007), at 200 et seq.
104. *See supra* fn. 76–78.

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117 To a similar extent, *Russian* authors have addressed PE issue in the context of general overviews on the Russian tax treaty network.[105]

118 *Dutch* literature has addressed PE issues mainly in the extensive treatises on international taxation in general.[106] Special PE monographs are rare.[107] Many authors have published works on selected problems such as the definition of PEs[108] and/or the allocation of income to special types of PEs.[109] Other papers have critically analysed new OECD developments.[110] Case law – especially decisions of the Hoge Raad – has supplied important further aspects.[111]

119 A considerable number of important books and papers[112] stem from *Italy* or from Italian authors. In addition to paramount treatises on issues of international taxation,[113] particular attention should be paid to works published by Raffaele Russo,[114] Caterina Innamorato[115] and Maria Rosaria Viviano.[116]

120 *Spanish* literature, too, shows a broad spectrum of PE publications, both as parts of general treatises on international taxation as such or DTCs,[117] and of single monographs or papers.[118]

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105. Kashin, V. A., *Tax Treaties of Russia. International Tax Planning for Business* (1998); Konnov, O. Y., *Permanent Establishment in Tax Law* (2002); Polezharova, L. V., *Taxation of Profits and Income of Foreign Organisations in the Russian Federation* (2004); Baev, S.A., *Double Tax Treaties Between Russia and the EU Member States* (2007); Izrailevych, V., *Der Begriff der Betriebsstätte im deutschen und im russischen Ertragsteuerrecht und im deutsch-russischen Doppelbesteuerungsabkommen* (2018).
106. For example, Kavelaars, P. & de Graaf, A.C.G.A.C. & Stevens, A.J.A., *Internationaal belastingrecht* (2007), at 82 et seq.
107. *See*, however, Albert, P. G. H., *Vaste inrichting* (Fed brochure, 1994); and Pleijsier, A, *The Agency Permanent Establishment. De vaste vertegenwoordiger* (dissertation; Maastricht 2000).
108. Ghijsen, J.C., De uitvoering van werk in relatie tot de vaste inrichting, *WFR* 2004/925; van Weeghel, S., Vaste inrichting en winst uit onderneming, *TFO* 2005, at 70 et seq.
109. van Kesteren, H.W.M., Hoe zelfstandig is de vaste inrichting?, *NTFR* 6/47 of 24 Nov. 2005, at 1540 et seq.; Pötgens, F.P.G., Toerekening van winst aan een vaste inrichting, *NTFR Beschouwingen* 2008/52 of 13 Nov. 2008, at 17 et seq.
110. Pijl, H., 'Vaste inrichting en de voorgestelde wijzigingen van het OESO-commentaar', *WFR* 2002/6490, at 1047 et seq.
111. For example, Michielse, G.M.M., 'De vaste inrichting', *NTFR Beschouwingen* 1/7 of 30 Aug. 2007, 35 (regarding Hoge Raad decisions of 8 Feb. 2002, 36155, NTFR 2002/253; of 11 May 2007, 42385, NTFR 2007/944; and of 11 May 2007, 42386, NTFR 2007/910); Bruins Slot, W. und Gerrits, E.D.M., Vaste inrichtingen, *FP* 2006/13, blz. 12 et seq.; Schoenmakers, M., 'Werkzaamheden voor een buitenlandse vaste inrichting', *Loonzaken* 2008/2 of 29 Feb. 2008: 20 et seq.
112. Cacciapuoti, E., Italy [Country Report], in: *The Attribution of Profits to Permanent Establishments: The Taxation of Intra-company Dealings*, by Russo, R. (ed.) (2005); *see also infra* fn. 114 et seq.
113. For example, Fantozzi, A., *Il diritto tributario* (2003); Piazza, M., *Guida alla Fiscalità Internazionale* (2004); and Garbarino, C., *Manuale di tassazione internazionale* (2005).
114. Russo, R., 'Italian Ruling on Attribution of Profits to Permanent Establishments', 45 *ET* (2005): et seq. (2005); Russo, R. & Pedrazzini E., 'Permanent Establishments under Italian Tax Law: An Overview', 47 *ET* (2007): 389 et seq.
115. Innamorato, C., 'The Concept of a Permanent Establishment Within a Group of Multinational Enterprises', 48 *ET* (2008): 81 et seq.
116. Viviano, M. R., *Stabile organizzazione del non residente in Italia* (2007).
117. Most notably, Cordón Ezquerro, T., *Manual de Fiscalidad Internacional*, Vol. I (2007); and Hortalá i Vallvé, J., *Comentarios a la Red Española de Convenios de Doble Imposición* (2007).
118. Pallejá, P.M., *Impacto de la vinculación fiscal en las relaciones establecimiento permanente – casa central. La acreditación de los gastos de la casa central imputados* (2006); and Sáez, A. M., *Estudio de las operaciones realizadas entre casa central y establecimientos permanentes* (2008).

PART 2. IS THERE A PE? (ARTICLE 5 OECD MC)

1 The explanation of the term 'PE' in Article 5 of OECD Model shows a multi-level structure and can be read from more than one starting point. The text starts with a classical definition (paragraph 1) which is followed by positive (paragraph 2), mixed (paragraph 3) and negative (paragraph 4) examples. To some extent, these examples illustrate the exact meaning of the definition in paragraph 1. In part, however, they go beyond this definition and contain further specifications. The concluding paragraphs 5–7 provide guidance on the characterization of persons other than the taxpayer as PEs of the taxpayer (paragraph 5: dependent agents, paragraph 6: independent agents, paragraph 7: subsidiaries).

Article 5 OECD MC Permanent Establishment	*Article 5 OCDE CM Établissement Stable*
(1) For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.	(1) Au sens de la présente Convention, l'expression 'établissement stable' désigne une installation fixe d'affaires par l'intermédiaire de laquelle une entreprise exerce tout ou partie de son activité.
(2) The term 'permanent establishment' includes especially:	(2) L'expression 'établissement stable' comprend notamment:
a) a place of management;	a) un siège de direction,
b) a branch;	b) une succursale,
c) an office;	c) un bureau,
d) a factory;	d) une usine,
e) a workshop, and	e) un atelier et
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.	f) une mine, un puits de pétrole ou de gaz, une carrière ou tout autre lieu d'extraction de ressources naturelles.
(3) A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.	(3) Un chantier de construction ou de montage ne constitue un établissement stable que si sa durée dépasse douze mois.
(4) Notwithstanding the preceding provisions of this Article, the term 'permanent establishment' shall be deemed not to include:	(4) Nonobstant les dispositions précédentes du présent article, on considère qu'il n'y a pas 'établissement stable' si:
a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;	a) il est fait usage d'installations aux seules fins de stockage, d'exposition ou de livraison de marchandises appartenant à l'entreprise;

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cannot be applied. The indirect method can also be applied to insurance companies.[130] In cases where the indirect allocation method is acceptable, a ruling can be obtained from the Rulings Office to confirm the appropriate allocation key.[131]

130 It should be noted that the Rulings Office has already applied the OECD Report on Attribution of Profits to Permanent Establishments, which was approved in July 2008 and updated in July 2010.[132] This report provides for a two-step approach. First, a functional and factual analysis is performed to hypothesise the PE as a separate and independent enterprise. The second step relates to the arm's length pricing of dealings and allocation of profits between the PE and other parts of the enterprise. This two-step approach has become part of Belgian tax practice in the meantime. In principle, the Belgian tax authorities follow the OECD Commentaries and Reports, even in interpreting earlier Belgian DTCs that are based on the OECD MC.

[B] Mechanism of the Direct Allocation Method

131 Determination of taxable income. There is no fundamental difference between inbound or outbound cases when applying the direct allocation method. The only difference is technical: while non-resident companies are subject to non-resident income tax in Belgium on profit realized through Belgian (permanent) establishments,[133] Belgian-resident companies are in principle taxable on their worldwide profit, but the portion of profit realized through PEs outside Belgium is exempt under DTCs. Under most of Belgium's DTCs, profit of foreign PEs is exempt even if the profit was not effectively taxed abroad, but certain treaties only grant an exemption provided the profit was effectively subject to tax in the source state.[134]

132 The rules defining the tax base of Belgian-resident corporate taxpayers apply *mutatis mutandis* to Belgian (PEs of) non-resident companies.[135]

133 The profit of a Belgian establishment is usually determined by reference to the financial statements it is required to establish under Belgian accounting law (*see* paragraph 49) or that it voluntarily establishes for Belgian tax purposes. Other means of proof allowed under Belgian domestic taw law can also be used.[136]

130. See Com. DTC, 7/424.
131. See, e.g., Ruling No. 800.195 of 15 Jul. 2008, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 408e0efd-54f7-4f2a-b9b1-62729f9dfc97#findHighlighted>, 19 Jul. 2017.
132. Practice Note No. AFZ/2004/0053 (AFZ 5/2004) of 16 Jan. 2004, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 6f93d5f4-dfc6-49ba-bb1f-f60a55b694d9#findHighlighted>, 19 Jul. 2017; Ruling No. 2012.103 of 22 May 2012, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = a333defc-141b-47e0-a0e6-b4048f89bbf4>, 19 Jul. 2017.
133. See ITC, s. 228(2)(3°).
134. See, e.g., Belgium's DTCs with e.g., Hong Kong and Japan.
135. See ITC, s. 235(2°), subs. 2.3.2.
136. See Com.DTC, 7/418. In the absence of separate accounts, it is a generally accepted principle that an allocation be made of the profit that separate accounts, if kept by the PE, would have revealed. This allocation should then be made based on the terms of the domestic law of the State in which the PE is established. In such a case, it is accepted to calculate the allocation based on the accounts of the head office.

134 In the absence of valid accounts or other proof brought forward by the taxpayer or the Belgian tax authorities, the profit of a Belgian (permanent) establishment can be determined by means of a comparison with similar taxpayers or on a lump-sum basis.

135 For various industry sectors, the Royal Decree implementing the Income Tax Code sets out specific lump-sum tax bases that are calculated by reference to, say, the number of employees or the turnover of the Belgian (permanent) establishment. A minimum taxable profit of EUR 19,000 applies.[137] ECJ and Benelux Court case law has held that this lump-sum basis for non-resident taxpayers is discriminatory and is contrary to the EU and Benelux treaties.[138] Although the scope of the lump-sum taxation basis was broadened to include Belgian-resident companies, thus diminishing much of its discriminatory character, the tax authorities announced that they would refrain from applying it to residents of states with which Belgium has signed treaties that provide for freedom of establishment or non-discrimination in the field of taxation, such as the Benelux treaty and the EU treaty.[139]

136 Belgium's ruling practice shows that transfer pricing methods such as methodologies based upon costs are frequently applied to determine the profit of PEs.[140] In this respect note that profit allocation should take into account the increased focus on substance over form as well as taxation in line with value creation as a result of BEPS.

137 Allocation of assets, liabilities, income and expenses between the head office and the PE. Belgium's domestic tax law and DTCs do not provide specific rules for allocating assets between a head office and its PE. Generally, reference is made to the rule applicable in the field of personal income tax to determine the business assets of individuals. Under this rule, assets are considered to be allocated to a PE if they are used for the business activity of the PE and are subject to the PEs business risks.[141] In other words, the asset should be closely associated with the business of the PE.

138 In practice, the accounts of the PE will indicate which assets are allocated to it. The Belgian tax authorities in principle respect the allocation shown in the accounts of the PE provided it does against the facts.

139 The same rules apply to determining whether or not shares, receivables or intangible property are 'effectively connected' to a PE for the purposes of Articles 10(4), 11(4) or

137. See ITC, s. 342(2) and RD/ITC, s. 182.
138. ECJ, 22 Mar. 2007; Benelux Court, 19 Mar. 2007.
139. Practice note Ci.RH.863/575.551 (AOIF 40/2008) of 30 Oct. 2008, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 3fe9c407-bb29-4c70-b34a-ddf78ef2b1e4#findHighlighted>, 19 Jul. 2017.
140. See, e.g., Rulings No. 700.222 of 24 Jul. 2007 and No. 500.095 of 4 Aug. 2005, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = bbc3aa71-0975-4d3e-95cb-035e8b29412e#findHighlighted>, 19 Jul. 2017; <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = c7761bed-017f-4bc4-a86a-f478eee33692#findHighlighted>, 19 Jul. 2017; traditionally, the tax authorities consider this approach to be similar to the comparison method (Com. DTC, 7/417, para. 3).
141. See ITC, s. 37; S. Van Crombrugge, 'De winstbepaling van Belgische en vaste inrichtingen in het internationaal fiscaal recht', Actuele fiscale thema's 2007 (2008): 94.

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12(3) of the OECD MC.[142] Rulings regarding the allocation of shareholdings illustrate this. Shareholdings are allocated on the basis of two criteria: the allocation shown in the accounts and the place where the shareholdings are managed in practice.[143]

140 No specific rules exist regarding liabilities. The allocation of liabilities is traditionally addressed in terms of the deductibility of interest expenses (*see* paragraph 147).

141 However, with the transposition of the EU Merger Directive into Belgian tax law, the concept of the net equity of Belgian (permanent) establishments was introduced in order to define the tax impact of cross-border reorganizations thereon. The net equity of Belgian establishments includes three components: (i) tax-exempt reserves, (ii) taxed reserves, and (iii) branch capital placed at the establishment's permanent disposal by the foreign company. The law specifies that any borrowings by the foreign establishment on which the interest is deducted from the taxable profit of the Belgian (permanent) establishment should be deducted from its net equity.[144] However, the new rules do neither address the appropriate or minimum level of free capital for a Belgian (permanent) establishment in light of the arm's length principle as set forth in the OECD Report on Attribution of Profits to Permanent Establishments, nor are any rules laid down in relation to the allocation of branch capital to foreign establishments of Belgian-resident companies. In a ruling – dealing specifically with a (tax-free) cross-border merger of a Belgian company with a foreign company (that has as consequence that the foreign company will have a PE in Belgium), the question was raised how the equity of the Belgian PE needed to be determined. In this respect, the Rulings Office referred to the definition of net equity included in Belgium domestic law in combination with the OECD report on the attribution of profits to PEs to ensure that a fair and appropriate amount of capital is allocated to the PE taken into account the functions performed and risks undertaken by the PE (for tax purposes) (*see* paragraph 38).[145]

142 Income is allocated to a PE if it is realized further to the intervention, decision or activity of the PE.[146] The taxable profit of a PE includes not only profit from its business operations, but also income and capital gains deriving from assets allocated to it.

143 Belgium does not apply the force of attraction theory: profit realized without the involvement of the Belgian establishment is not attributable to the Belgian (permanent)

142. See Com. DTC, 10/208.
143. Ruling No. 600.524 of 19 Dec. 2006 and Ruling No. 700.310 of 24 Jul. 2007, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 9bf0e2de-15ee-4e77-ba19-4c41d401de3e#findHighlighted>; <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = e446b36c-38c5-483e-bfe2-6bca008f90cb>, 19 Jul. 2017. Ruling No. 2010.170 of 7 May 2013. <http://ccff02.minfin.gov.be/KMWeb/document.do?method = view&id = 4ad8db81-4c7f-4544-aafe-59fe7094e75b&documentLanguage = NL#findHighlighted>, 19 Jul. 2017.
144. See ITC, s. 229(4), introduced by the Act of 20 Nov. 2008 (Belgian Official Gazette of 12 Jan. 2009).
145. T. Wustenberghs/G. Boone, 'Van Belgische vennootschap naar inrichting: welke kapitaaldotatie?', Fiscoloog Internationaal 374 (2015).
146. S. Van Crombrugge, 'De winstbepaling van Belgische en vaste inrichtingen in het internationaal fiscaal recht', Actuele fiscale thema's 2007 (2008): 92. Ruling no. 2012.527 of 5 Feb. 2013 <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = bb80afb1-7192-4932-9d51-2eef4a3e76df&documentLanguage = NL#findHighlighted>, 19 Jul. 2017.

establishment.[147] This was clearly illustrated in a court decision regarding the Belgian (permanent) establishment of a Dutch company. The Belgian (permanent) establishment rented out immovable property in Belgium. The Dutch head office invested the cash generated by this activity in bank accounts in Belgium. As the decision to invest the cash was not made by the Belgian (permanent) establishment, the court held that the interest income was not attributable to the Belgian (permanent) establishment.[148]

144 Although allowed under Belgium domestic law, most of Belgium's DTCs do not allow profit to be allocated to a PE for mere purchases.[149]

145 Under Belgian domestic tax law, only expenses that specifically relate to a Belgian (permanent) establishment are tax deductible. This includes expenses incurred by a Belgian (permanent) establishment directly, as well as those incurred by the foreign head office in connection with the Belgian establishment.[150]

146 Overheads other than worldwide advertising expenses are disallowed, however.[151] Belgium's DTCs nevertheless deviate from this domestic tax rule and allow a portion of overheads to be deducted from the profit of a Belgian (permanent) establishment. An apportionment of overheads can be done on the basis of an allocation key, such as profit, turnover and so forth.[152]

147 Except for financial institutions, Belgium does not accept the deductibility of interest, royalties and rent charged to a Belgian (permanent) establishment in respect of financing or assets put at the disposal by its head office.[153]

148 Finally in line with the OECD Commentaries, Belgium does not allow a portion of the income of a PE to be allocated to the head office as remuneration for good management.[154]

149 Details on internal dealings and restructuring – From an economic point of view, transactions take place between head offices and foreign PEs, but these transactions are not recognized from a legal point of view.

150 Internal dealings – Belgian tax law does not lay down a consistent set of rules regarding internal dealings. As pointed out above, Belgium adopts the doctrine of restricted independence of a PE in its dealings with its head office.

151 A transfer of inventory or other assets by a Belgian PE to its foreign head office implies a deemed realization of profit upon the transfer, even if, in reality, no profit is realized

147. See Com. DTC, 7/106; a limited number of Belgium's DTCs recognize the force of attraction principle, but the application is restricted by the protocols (see e.g., the DTC and protocol with Mexico).
148. Ghent Court of Appeal, 1 Apr. 2003, Fiscale Koerier, 2003, 576.
149. See Com.DTC, 7/205.
150. See Com.ITC, 235/38.
151. See Com.ITC, 235/38.
152. See Com.DTC, 7/344.
153. See Com.ITC, 235/38, Com. DTC, 7/312-313; S. Van Crombrugge, 'De winstbepaling van Belgische en vaste inrichtingen in het internationaal fiscaal recht', Actuele fiscale thema's 2007 (2008): 115–120.
154. See Com.DTC, 7/336.

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by the company as a whole.[155] This rule has been greatly debated by legal writers,[156] but is now expressly confirmed in domestic tax law.[157,158]

152 It is nevertheless unclear whether a transfer of inventory or other assets by a Belgian head office to its foreign PEs can give rise to a tax charge. Taxation of a deemed capital gain may be justified on the basis of the arm's length provision of section 185(2) ITC, which is also applicable to such internal dealings.[159] However, there is a ruling suggesting that such a transfer is not taxable. Indeed, capital gains are only taxable under Belgian domestic tax law if the asset is transferred from a legal point of view.[160] Furthermore, as to the timing of the profit recognition, it could be argued that the taxable profit only arises in the hands of the Belgian head office when it is actually realized via the PE. From an accounting point of view, no profit is recognized for the company as a whole in respect of purely internal dealings.[161]

153 If a foreign PE transfers an asset to its Belgian head office for a value in excess of an arm's length consideration, the Belgian tax authorities could consider that profit is being artificially shifted to the foreign PE and cite the independence fiction to deny treaty exemption on that portion of the PEs profit.[162] If a foreign head office transfers an asset to its Belgian PE, the asset will be booked at its fair market value for tax and accounting purposes. If the asset is transferred above its fair market value, depreciations on the non-arm's length portion will in principle be disallowed for tax purposes.

155. In respect of shifts of profit in relation to inventory, see Com. DTC, 7/203.
156. I. Verlinden, A. Smits & X. Van Vlem, 'Head Office/Permanent Establishment Profit Allocation', Tax Planning International Transfer Pricing (2001).
157. Section 228(2)(3°bis), second indent, ITC, introduced by the Act of 20 Nov. 2008 (Belgian Official Gazette of 12 Jan. 2009).
158. The Anti-Tax Avoidance Directive of 12 Jul. 2016 (2016/1164) foresees in specific rules for exit taxation. Based on that, it is expected that Belgian domestic law would need to be adapted in case the Directive would be effectively implemented. More specifically, if the Directive would be implemented, the scope of the exit tax regulation would be enlarged because now s. 228 (2) (3°bis) only foresees in the specific case where the assets are withdrawn from the Belgian permanent establishment by the foreign head office. (P. Smet; D. De Wolf, 'De Europese Anti-Tax Avoidance Richtlijn: beperking interestaftrek', Fiscoloog 1463 (2016).)
159. Practice Note No. Ci.RH.421/569.019 (AOIF 25/2006) of 4 Jul. 2006, para. 3, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = d432bea4-45cd-4d3a-862c-11d495a1f71&documentLanguage = NL#findHighlighted>, 19 Jul. 2017; P. Cauwenbergh & A. Gaublomme, 'Nieuwe transfer-pricing bepaling: ook tussen hoofdhuis/VI', Fiscoloog Internationaal 267 (2006): 2; Ruling No. 400.222 of 24 Mar. 2005, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = d94effeb-2f51-48a8-91d4-15018c057711#findHighlighted>, 19 Jul. 2017.
160. Ruling No. 600.524 of 19 Dec. 2006, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 9bf0e2de-15ee-4e77-ba19-4c41d401de3e#findHighlighted>, 19 Jul. 2017; the ruling implicitly relies on the relative effect of DTCs: they cannot create tax liability or introduce new taxes that are not provided for by domestic tax law. Ruling No. 2013.174 of 11 Jun. 2013, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 7daae00c-d434-4e7a-8846-3b94863ee567&documentLanguage = NL#findHighlighted>, 3 Mar. 2016.
161. I. Verlinden, A. Smits & X. Van Vlem, 'Head office-permanent establishment profit allocation', Tax Planning International Transfer Pricing (2001); Commission for Accounting Standards Notice No. 172/1, <www.cnc-cbn.be>, 25 Mar. 2013.
162. See Com.DTC, 23/115 and 7/203.

154 Foreign currency gains and losses in relation to the amounts that a head office puts at the disposal of its PE are in principle considered as profit or loss of the head office.[163]

155 Restructuring – Following the recent implementation of the EU Merger Directive, Belgian domestic tax law provides for a tax-neutral regime for cross-border reorganizations (e.g., mergers, demergers, contributions) involving Belgian entities and or Belgian PEs (e.g., roll-over of capital gains, the NID and R&D credit (limited) preservation of tax losses available, etc.). In order to be eligible for the tax neutral regime, specific conditions need to be complied with.

156 One specific condition to be met in order for the cross-border transaction to occur tax-neutrally from a Belgian corporate income tax perspective, is that the Belgian elements transferred are permanently maintained in a Belgian PE[164] and contribute to constitution of the tax base in Belgium. The rationale behind this condition is to avoid erosion of the tax base in Belgium.

157 This condition applies to the following transactions:

- inbound mergers (section 211 ITC);
- outbound migrations (section 214*bis* ITC).

158 A contribution by a Belgian-resident company of a line of business or of its entire company assets by way of a universal transfer to an intra-European company (section 46 ITC);

159 A contribution by an intra-European company of a Belgian PE (or Belgian items) to a Belgian/intra-European company (section 231(2) ITC).

160 In case of a tax-free cross-border reorganization, specific provisions are provided to determine the 'equity' of the Belgian PE.[165]

[C] Mechanism of the Indirect Allocation Method

161 As explained above, the indirect allocation method is not a preferred method in Belgium. There is only in a few cases room for applying the indirect allocation method (see §3.04[A]).

[D] Details on the Transfer of Assets or Functions

162 Domestic tax law expressly mentions that a transfer of assets by a Belgian PE to its foreign head office implies a deemed realization of profit upon the transfer. Conversely,

163. S. Van Crombrugge, 'De winstbepaling van Belgische en vaste inrichtingen in het internationaal fiscaal recht', Actuele fiscale thema's 2007 (2008): 103–105.
164. See ITC, ss 231(2) para. 2 and 211(1) para. 4(3) second indent. On 29 Nov. 2011, the European Court of Justice delivered its decision in the National Grid Indus case (C-371/10). On the basis of this case one could argue that the requirement to maintain a PE in Belgium violates EU law.
165. For outbound mergers e.g., the taxed reserves and tax-free reserves of the Belgian absorbed company can be transferred to and qualify as such in the hands of the Belgian PE of the absorbing company.

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it is not clear whether a transfer of assets by a Belgian head office to its foreign PE can give rise to a tax charge (*see* paragraph 150).

163 The Belgian tax rules currently do not address the shift of functions between head office and PE. However, such a shift of functions might in itself trigger tax consequences.[166] Furthermore, it might impact the transfer pricing model applied by the company to determine the allocation of profit to its PE.

164 Note that the law of 1 December 2016 implemented a deferred payment regime (optional) in the context of Belgian exit tax on outbound cross-border relocation of assets, migration or restructuring and hereby brought the tax recovery in the context of Belgian exit tax in line with case law of the ECJ (partial implementation of Article 5 of the Anti-Tax Avoidance Directive of 12 July 2016 (2016/1164)). *In concreto*, the taxpayer can opt for a spread payment in case exit tax is due (over five years), a.o. in case of a transfer of assets/business from a Belgian PE to the company's head office, or to another PE of the company in another jurisdiction. To qualify, the head office or the transferring PE must be established/located in another EEA Member State (excluding Liechtenstein). In case of spread payment the tax authorities can require a guarantee if there is a risk of non-recovery. The taxpayer must each year complete a form with information related to the follow-up of the assets concerned. In certain circumstances, the remaining tax liability becomes immediately due.[167]

[E] Details on Losses

165 Inbound cases. Losses incurred by a Belgian establishment of a non-resident company can in principle be carried forward indefinitely. Carry-over losses of a Belgian establishment that was previously closed can be deducted from the profit of a new Belgian establishment of the same foreign company, even if the former Belgian establishment was closed a number of years before and even if it carried on a different kind of business or was located at a different address.[168]

166 Special rules are provided in relation to the carry-over of losses in the context of cross-border reorganizations involving Belgian establishments of non-resident companies.

166. Article 5 of the Anti-Tax Avoidance Directive of 12 Jul. 2016 (2016/1164) foresees in exit taxation when 'a taxpayer transfers assets from its head office to its permanent establishment in another (EU) Member State or in a third country in so far as the (EU) Member State of the head office no longer has the right to tax the transferred assets due to the transfer'. It is currently still unclear what the impact thereof would be in a Belgian context (on this topic see a.o. N. Lenaerts e.a., 'Belgische exit tax: nieuwe wetgeving knoopt aan bij Europese regels', Fiscoloog Internationaal 397 (2016)).
167. See ITC, s. 413/1. Note that the deferred payment regime has not been provided in a situation where a Belgian company transfers (relocates) assets from its head office in Belgium to a PE in another EEA Member State.
168. See Com.ITC, 235/53.

[1] *Tax-Free Mergers/Demergers*

167 Limitation of Belgian tax losses – tax losses existing before the reorganization at the level of the Belgian absorbing or beneficiary company (or PE) continue to be deductible according to a 'pro rata' calculated on the basis of the net fiscal value of the Belgian elements involved in the reorganization.

168 Transfer of Belgian tax losses – tax losses existing before the reorganization at the level of the Belgian absorbed or demerged company (or PE) are transferred to the absorbing company according to a 'pro rata' calculated on the basis of the net fiscal value of the Belgian elements involved in the reorganization.[169]

[2] *Migrations*[170]

169 Inbound migrations – the tax losses attributable to the previous Belgian PE of the migrating company can be fully transferred to the new Belgian company without limitation.

170 Outbound migrations – tax losses incurred before the transfer by the Belgian migrating company are fully tax-deductible in the hands of the Belgian PE after the transfer.

[3] *Contributions*

171 In case of a tax-free contribution by a Belgian-resident company of a line of business or of its entire company assets by way of a universal transfer, the tax losses of the Belgian contributing company are not transferred.

172 In case of a tax-free contribution by an intra-European company of a Belgian PE to an intra-European company with a pre-existing Belgian PE:

- the tax losses of the recipient Belgian PE (pre-existing Belgian PE) are limited to a pro rata calculated on the basis of the net fiscal value of the Belgian elements involved in the operation;
- in this scenario, the transfer of the tax losses of the contributed Belgian PE is not provided for. In the light of the new tax legislation, these tax losses should in principle be transferred. If the recipient company does not have a pre-existing Belgian PE, the tax losses of the contributed Belgian PE should be entirely maintained.[171]

173 In the case of a tax-free contribution of a Belgian PE (or Belgian items) by a foreign company[172] to a Belgian company:

169. This proportional transfer of tax losses is not applicable to contributions of assets covered by ITC, s. 46.
170. For transfers of the registered office of a company to another EU Member State.
171. See ITC, s. 206.
172. This transaction covers the contribution of a Belgian PE by an intra-European company or by a non-EU foreign company to a Belgian company.

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- the tax losses of the Belgian recipient company are limited to a pro rata calculated on the basis of the net fiscal value of the Belgian elements involved in the operation;
- the tax losses of the Belgian PE are transferred to the Belgian recipient company with a limitation according to a pro rata calculated on the basis of the net fiscal value of the Belgian elements involved in the operation.

174 Outbound cases. Belgium allows the deduction of losses of a foreign PE, even though it is tax exempt income. Losses incurred by a Belgian-resident company in a PE outside Belgium are first deducted from the treaty-exempt profit of PEs in other countries (if there are any) and the remainder is deductible from the profit of the Belgian head office.[173] Belgium's DTCs provide for recapture allowing Belgium to tax foreign PE profit to the extent that it is being neutralized by PE losses that have previously been deducted in Belgium.

175 Following the implementation of the EU Merger Directive, Belgian domestic tax law sets forth two recapture rules with respect to utilization of the tax losses incurred in a foreign PE located in a tax-treaty country in order to avoid a double deduction:

- to tackle carry-back in the foreign PE, the rule states that foreign PE tax losses can only be deducted from the Belgian tax base provided the taxpayer proves that these foreign tax losses have not been deducted from the tax base of the foreign PE (negative burden of proof lies with the taxpayer);
- to preserve carry-forward in the foreign PE the rule states that foreign losses that have been deducted from the Belgian tax base are added to the Belgian tax base (recapture) if these foreign tax losses are deducted from the foreign tax base or if the foreign PE is transferred at the time of a reorganization (burden of proof always lies with the taxpayer).

176 If losses are incurred by the Belgian head office and profit is realized by a PE outside Belgium, Belgian domestic law provides that the losses of the Belgian head office are set off against the profit of the PE outside Belgium.[174] As a consequence, no carry-over of the Belgian losses is available. The Belgian Court of Cassation has held that this rule is not contrary to Belgium's DTCs that provide for an exemption for PE profit. This is generally referred to as the 'Velasquez doctrine'.[175] However, the ECJ has ruled that this approach is contrary to EU law.[176] As a result, it is no longer applied to profit realized in PEs located in EU Member States.[177]

173. See RD/ITC, s. 75.
174. Ibid.
175. Court of Cassation, 29 Jun. 1984, FJF, 84/164 (Velasquez).
176. ECJ, 12 Sep. 2002, C-431 (AMID).
177. Parliamentary Question No. 555 of 11 Jan. 2001, Q&A House of Representatives, 2002-2003, No. 50-141, 17.838. <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=355acf0d-208f-4fca-a50f-5d9287f3ae5f&documentLanguage=NL#findHighlighted>, 19 Jul. 2017.

[F] Practical Considerations

177 In order to obtain certainty on whether a Belgian (permanent) establishment is present in Belgium and, if so, on the appropriate profit to be allocated to a Belgian (permanent) establishment, non-resident taxpayers can request a ruling from the Rulings Office. However, it is also possible to come to an agreement on both elements with the local tax inspector (*see* §3.02[D]).

[G] Implication of BEPS

178 As a follow-up on the work on BEPS Action 7, the OECD issued a (new) discussion draft on the attribution of profits to permanent establishments.[178] The impact thereof on Belgium is still unclear. As no final guidance has been published, the OECD 2010 Report on the attribution of profits to PEs (of 22 July 2010) has not yet been revised. The 2010 OECD report on the attribution of profits to PEs (of 22 July 2010) has become part of Belgian tax practice in the meantime. The Belgian tax authorities in principle follow the OECD Commentaries and Reports

§3.06 SUMMARY AND OUTLOOK

179 The PE concept is well developed in Belgian tax law, case law and ruling practice.

180 There is a saying stating 'Every permanent establishment constitutes a Belgian establishment, but not every Belgian establishment constitutes a permanent establishment.' Rationale behind this is that Belgian domestic tax law applies a broader definition compared to DTC dispositions. As DTCs prevail over Belgian domestic law, it is decisive to assess whether certain activities give rise to a PE as defined by the relevant treaty in order to determine whether the Belgian tax authorities will be entitled to levy taxes. It will also be important to monitor the final position of Belgium in relation to the articles on PEs in the MLI.

181 As from 1 January 2013, the concept of a services PE is introduced in domestic tax law. In this respect, special attention should be paid to those DTCs that contain a specific services PE definition as the amendment aims at the taxation of these specific service PEs. In addition an anti-abuse provision (for services PEs and construction PEs) is introduced to tackle artificial division of services by related parties to escape Belgian taxation.

182 The recent changes to the definition of PE under Belgium domestic law and the introduction of the 'catch-all' provision for the taxation of non-residents (that also applies if there is no PE in Belgium) show that there is a tendency in Belgium to broaden the

178. See discussion draft on attribution of profits to permanent establishments dd. 22 Jun. 2017 (https://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf), replacing the previous draft released on 4 Jul. 2016.

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Belgian taxable basis and increase the number of cases where Belgian as a source state is authorized to levy tax.

183 Some years ago, the Belgian domestic rules in relation to Belgian establishments changed significantly further to the transposition of the EU Merger Directive in Belgian tax law. The new law removes tax obstacles to perform cross-border restructurings in an EU context. In addition, the new law introduces the concept of equity of Belgian (permanent) establishments and sets forth comprehensive rules in respect of the carry-over of PE losses in case of cross-border restructurings.

184 In parallel, the OECD approach in respect of profit allocation to PEs evolved rapidly. Over the next years, it should become clear whether and how this complex approach will be implemented by the Belgian tax authorities. However, any inconsistency with the approach of foreign tax authorities increases the risk of double taxation in a PE context. In this respect, it will be important to monitor the final report of the OECD on the attribution of profits to PEs and the position of the Belgian tax administration in this respect.

185 PE issues have become a key focus point for tax authorities. In combination with increasing mobility within multinational groups and a potential lowering of the PE threshold through the implementation of the BEPS recommendations via the MLI, a PE risk will become a key risk for tax departments to monitor and manage.

Appendix

Legal Provisions

Income Tax Code

Administrative Guidelines

The Official Commentary on the Income Tax Code of 1992 ('Com.ITC') <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=726e3b66-19de-4fbc-9087-57af169ad450#findHighlighted>, 19 July 2017.

The Official Double Taxation Treaty Commentary ('Com. DTC'). (Partially outdated, no electronic version available).

Plan to Combat Tax Fraud

Plan to combat tax fraud of 3 December 2015, <http://vanovertveldt.belgium.be/sites/default/files/articles/Plan%20ter%20bestrijding%20van%20de%20fiscale%20fraude_2015.pdf>, 7 April 2016.

Circular Letters

Practice note no. AFZ/96-258 (AFZ 17/2003) dated 24 July 2003, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=a50053e0-5a3c-425f-a07f-28c29cb79319&documentLanguage=NL#findHighlighted>, 19 July 2017.

Practice note no. Ci.RH.421/574.945 (AOIF 36/2008) of 9 October 2008 <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=364f5b69-5ba7-4ada-85ee-aaaadd14fdae&documentLanguage=NL#findHighlighted>, 19 July 2017.

Practice note no. AFZ/97.0060 (AFZ 4/2005) of 31 March 2005, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=8b09d469-712d-4594-9c81-f9e0a679118f#findHighlighted>, 19 July 2017.

Practice note no. AFZ/2004/0053 (AFZ 5/2004) of 16 January 2004, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=6f93d5f4-dfc6-49ba-bb1f-f60a55b694d9#findHighlighted>, 19 July 2017.

Practice note Ci.RH.863/575.551 (AOIF 40/2008) of 30 October 2008, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=3fe9c407-bb29-4c70-b34a-ddf78ef2b1e4#findHighlighted>, 19 July 2017.

Practice note no. Ci.RH.421/569.019 (AOIF 25/2006) of 4 July 2006, paragraph 3, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=d432bea4-45cd-4d3a-862c-11d495ac1f71&documentLanguage=NL#findHighlighted>, 19 July 2017.

Practice note 2017/C/40 of 30 June 2017 <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=8f39c0a3-2848-4750-b3be-2c5f5efdf997#findHighlighted>, 19 July 2017.

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Belgian taxable basis and increase the number of cases where Belgian as a source state is authorized to levy tax.

183 Some years ago, the Belgian domestic rules in relation to Belgian establishments changed significantly further to the transposition of the EU Merger Directive in Belgian tax law. The new law removes tax obstacles to perform cross-border restructurings in an EU context. In addition, the new law introduces the concept of equity of Belgian (permanent) establishments and sets forth comprehensive rules in respect of the carry-over of PE losses in case of cross-border restructurings.

184 In parallel, the OECD approach in respect of profit allocation to PEs evolved rapidly. Over the next years, it should become clear whether and how this complex approach will be implemented by the Belgian tax authorities. However, any inconsistency with the approach of foreign tax authorities increases the risk of double taxation in a PE context. In this respect, it will be important to monitor the final report of the OECD on the attribution of profits to PEs and the position of the Belgian tax administration in this respect.

185 PE issues have become a key focus point for tax authorities. In combination with increasing mobility within multinational groups and a potential lowering of the PE threshold through the implementation of the BEPS recommendations via the MLI, a PE risk will become a key risk for tax departments to monitor and manage.

Appendix

Legal Provisions

Income Tax Code

Administrative Guidelines

The Official Commentary on the Income Tax Code of 1992 ('Com.ITC') <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=726e3b66-19de-4fbc-9087-57af169ad450#findHighlighted >, 19 July 2017.

The Official Double Taxation Treaty Commentary ('Com. DTC'). (Partially outdated, no electronic version available).

Plan to Combat Tax Fraud

Plan to combat tax fraud of 3 December 2015, <http://vanovertveldt.belgium.be/sites/default/files/articles/Plan%20ter%20bestrijding%20van%20de%20fiscale%20fraude_2015.pdf>, 7 April 2016.

Circular Letters

Practice note no. AFZ/96-258 (AFZ 17/2003) dated 24 July 2003, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=a50053e0-5a3c-425f-a07f-28c29cb79319&documentLanguage=NL#findHighlighted>, 19 July 2017.

Practice note no. Ci.RH.421/574.945 (AOIF 36/2008) of 9 October 2008 <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=364f5b69-5ba7-4ada-85ee-aaaadd14fdae&documentLanguage=NL#findHighlighted>, 19 July 2017.

Practice note no. AFZ/97.0060 (AFZ 4/2005) of 31 March 2005, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=8b09d469-712d-4594-9c81-f9e0a679118f#findHighlighted>, 19 July 2017.

Practice note no. AFZ/2004/0053 (AFZ 5/2004) of 16 January 2004, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=6f93d5f4-dfc6-49ba-bb1f-f60a55b694d9#findHighlighted>, 19 July 2017.

Practice note Ci.RH.863/575.551 (AOIF 40/2008) of 30 October 2008, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=3fe9c407-bb29-4c70-b34a-ddf78ef2b1e4#findHighlighted>, 19 July 2017.

Practice note no. Ci.RH.421/569.019 (AOIF 25/2006) of 4 July 2006, paragraph 3, <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=d432bea4-45cd-4d3a-862c-11d495ac1f71&documentLanguage=NL#findHighlighted>, 19 July 2017.

Practice note 2017/C/40 of 30 June 2017 <http://ccff02.minfin.fgov.be/KMWeb/document.do?method=view&id=8f39c0a3-2848-4750-b3be-2c5f5efdf997#findHighlighted>, 19 July 2017.

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Note

Note to debtors of professional withholding tax for payments to non-residents (section 228, (3) BITC), 23 July 2014; < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = d5cb6282-6ba3-43c8-bbc3-0600091a7c49&document Language = NL#findHighlighted > , 19 July 2017.

Parliamentary Questions

Parliamentary Question no. 1123 (Destexhe), 23 January 2001, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 8e2f390d-5e8f4224-b4bf-d84 51e032bf8#findHighlighted > , 19 July 2017.

Parliamentary Question no. 555 of 11 January 2001, Q&A House of Representatives, 2002–2003, no. 50-141, 17.838. < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 355acf0d-208f-4fca-a50f-5d9287f3ae5f#findHighlighted >, 19 July 2017.

Rulings

Ruling no. 2010.121 of 29 June 2010 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = d435dd6e-2abf-4c65-b5db-9b5f140775d8#findHighlighted >, 19 July 2017.

Ruling no. 2012.103 of 22 May 2012 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = a333defc-141b-47e0-a0e6-b4048f89bbf4&documentLanguage = NL#findHighlighted > , 19 July 2017.

Ruling no. 2012.360 of 23 October 2012, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = e434aed8-2e1f-4134-aabf-cfbc43893f1a&documentLanguage = NL#findHighlighted > , 19 July 2017.

Ruling no. 2013.300 of 24 September 2013 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = d0445bb8-400e-4e9e-abbc-af38d7c10e5f&documentLanguage = NL#findHighlighted > , 19 July 2017.

Ruling no. 500.274 of 27 April 2006 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 5c21679f-b412-4521-a2d5-bfc46552504a#findHighlighted >, 19 July 2017.

Ruling no. 900.440 of 22 December 2009 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 6466c874-f8f5-4612-ad00-8a7488410f17#findHighlighted > , 19 July 2017.

Ruling no. 700.051 of 29 May 2007 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 300f874a-fe64-4dbd-9656-b9239f2f11a8#findHighlighted >, 19 July 2017.

Ruling no. 800.195 of 15 July 2008 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 408e0efd-54f7-4f2a-b9b1-62729f9dfc97#findHighlighted >, 19 July 2017.

Ruling no. 700.222 of 24 July 2007 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = bbc3aa71-0975-4d3e-95cb-035e8b29412e#findHighlighted > , 19 July 2017.

Ruling no. 500.095 of 4 August 2005 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = c7761bed-017f-4bc4-a86a-f478eee33692#findHighlighted > , 19 July 2017.

Ruling no. 600.524 of 19 December 2006 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 9bf0e2de-15ee-4e77-ba19-4c41d401de3e#findHighlighted > , 19 July 2017.

Ruling no. 700.310 of 24 July 2007, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = e446b36c-38c5-483e-bfe2-6bca008f90cb > , 19 July 2017.

Ruling no. 500.063 of 7 October 2005, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 28229d3c-221d-4486-a6d4-fdb234d3f9ec#findHighlighted > , 19 July 2017.

Ruling no. 400.222 of 24 March 2005, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = d94effeb-2f51-48a8-91d4-15018c057711#findHighlighted > , 19 July 2017.

Ruling No. 2011.432 of 29 November 2011, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 028ce8f4-cf4a-4706-a360-0b191dc8b8a6#findHighlighted > , 25 March 2013. Ruling No. 2012.103 of 22 May 2012, http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = a333defc-141b-47e0-a0e6-b4048f89bbf4 > , 19 July 2017.

Ruling no. 2013.170 of 2 July 2013, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = c862a4e6-aoe2-40ec-afeo-f96183f210e8&documentLanguage = NL#findHighlighted > , 19 July 2017.

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Ruling no. 2010.170 of 7 May 2013, < http://ccff02.minfin.gov.be/KMWeb/document.do?method = view&id = 4ad8db81-4c7f-4544-aafe-59fe7094e75b&documentLanguage = NL#findHighlighted > , 19 July 2017.

Ruling no. 2012.527 of 5 February 2013 < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = bb80afb1-7192-4932-9d51-2eef4a3e76df&documentLanguage = NL#findHighlighted > , 19 July 2017.

Ruling no. 2013.174 of 11 June 2013, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 7daae00c-d42d-4e7a-8846-3b94863ee567&documentLanguage = NL#findHighlighted > , 19 July 2017.

Ruling no. 2015.023 of 17 March 2015, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 9ab3457d-df91-489d-91be-2612ddb17480#findHighlighted > , 19 July 2017.

Ruling no. 2014.730 of 10 February 2015, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = 0e99a9bf-48ae-48e4-90e9-e9d0b6d17124#findHighlighted > , 19 July 2017.Ruling No 2015.445 of 20 October 2015, < http://ccff02.minfin.fgov.be/KMWeb/document.do?method = view&id = f391d834-a604-48da-818d-8b9a663c8ec0&documentLanguage = NL#findHighlighted > , 19 July 2017.

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Brussels Court of Appeal, 18 February 1992, Fiscale Koerier, 1992, 352
Ghent Court, 15 May 2008, Fiscale Koerier, 2008, 560
Ghent Court of Appeal, 16 January 2007, Fiscale Koerier 07/487
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Ghent Court of Appeal, 1 April 2003, Fiscale Koerier, 2003, 576
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4 Since China became a member of the WTO, there has been a continuous effort to achieve a greater degree of transparency and consistency in applying the tax laws. However, for such a large country there are from time to time discrepancies between the tax laws enacted at the national level and its interpretation and implementation on the local level, and even assessing practice among different locations. Coupled with the existence of undocumented precedents and practice not consistent with Western norms make China's tax system still very complicated to Western business.

5 This especially, if one considers that China is attracting very high foreign direct investments (FDI). In 2016 FDI amounted to some USD 139 billion, up 2.3% compared to 2015.[5]

§4.02 BASIC PRINCIPLES

[A] Relevance of PEs

6 The term 'PE' ('常设机构 Chang She Ji Gou' in Pinyin) is not used in the Chinese domestic tax system. The former EIT/FEIT laws and the new CIT law[6] do however use the terms 'establishment' ('机构 Ji Gou' in Pinyin) and 'place' ('场所 Chang Suo' in Pinyin).

7 The term 'PE' may therefore only be found in tax treaties between China and other countries and the circular for the determination of PEs and other matters for the purpose of tax treaties.[7] This definition is generally based on the UN Model Convention as well as the OECD Model Convention.

8 Typically, foreign investors having their presence in China which may constitute 'establishment or place' are taking the form of Representative Office (RO), contracted projects or even servicing activities. Normally foreign investors start to explore the Chinese market with RO. Most ROs are being set up under a business license with a limited range of activities. As business grows, they may slowly extend its activities, which may make them exceed their limited business scope and therefore technically create a PE. Foreign investors undertaking contracted projects or servicing activities may or may not register their formal presence in China. Notwithstanding this, they may constitute 'establishment or place' for China tax purpose.

9 The economic relevance of PEs is high, mainly because China is still a market which receives a very high investment inflow. For foreign companies carrying on business with China (or may be in China), for example, selling goods into China, procuring goods from China, providing services in China, etc., PE is relevant in determining how these companies will be taxed in China.

10 In February 2010, the State Administration of Taxation (SAT) released a set of new measures for taxation of ROs and non-tax resident enterprises (Non-TREs) which are significantly different from the previous tax regulations and rules.

5. Invest in China, < http://www.fdi.gov.cn/1800000121_37_50732_0_7.html >, January 2016.
6. See the CIT 2007, Art. 3, Art. 5 Detailed Implementation Regulations (DIR) of CIT Law.
7. For example, Circular Guoshuifa [2010] No. 75 (the DIN).

11 Over the past couple of years, the Chinese government has substantially relaxed the threshold for Chinese enterprises to 'go abroad', which has boosted the growth of outbound investment.[8] While typically Chinese enterprises would acquire foreign companies to access the outbound markets, they would also carry out 'engineering, procurement and construction' (EPC) projects in overseas jurisdictions. Therefore, the relevance of PEs with regard to outbound business is expected to draw more and more attention.

[B] Legal Principles and Resources

12 Refer to the Appendix for an overview of the relevant Chinese legal principles and resources.

[C] Key Features of Taxation

13 Due to the rapid development of China's tax and investment regulations alongside with its economic growth, there are inevitably uncertainty and inconsistency in implementation around the country. Tax audits are often conducted with penalties and surcharges imposed on under-paid taxes and non-compliance. The current legal system has provided for an appeal process but it is not effectively used. Therefore, in practice, most tax uncertainties are being negotiated with the relevant authorities upfront on a non-binding and oral only basis.

14 **How many tax treaties has China concluded?** China has concluded a total of one hundred and six DTCs with one hundred and three countries and three regions as of October 2017. Generally speaking, these treaties cover almost all the important trading partners of China.[9]

15 Tax treaties are relevant to determine PE because most DTCs provide 'PE protection' clauses, which would relieve Non-TREs from being taxed in China in respect of the attributable profits to these establishments or places in China. However, tax treaties are only covering CIT but not other types of taxes in China, except for some specified industries such as shipping and transportation.

16 **Inbound cases.** According to the CIT Law in China, Non-TREs which have an establishment or a place in China shall pay CIT on income that is derived by such establishment or place in China from sources inside China as well as on income that, although derived from sources outside China, is effectively connected with such establishment or place.[10]

8. The outbound investment of 2016 amounts to USD170.11 billion, up 44.1% compared to 2015. < http://www.gov.cn/shuju/2017-01/17/content_5160475.htm >, January 2017.
9. The number of DTCs concluded is based on the information as provided by the Website of the State Administration of Taxation. < http://www.chinatax.gov.cn/n810341/n810770/ > Double tax arrangements have been concluded with the Special Administrative Regions of Hong Kong and Macau with effect from 8 Dec. 2006 and 30 Dec. 2003 respectively. The DTC with Taiwan was signed on 25 Aug. 2015 but has not come into effect yet.
10. See the CIT 2007, Art. 3(2).

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17 *Tax types and rates–* Under the new CIT Law effective from 1 January 2008, the standard tax rate is 25% for both FIEs and domestic enterprises (DEs). A lower tax rate of 20% is available for qualified small and thin-profit companies. Meanwhile, an additional 50% reduction of the 20% tax rate for another three-year period from 1 January 2017 to 31 December 2019 is also available to such enterprises if their annual taxable income does not exceed a certain threshold.[11] In addition, a reduced tax rate (15%) is granted to qualified high/new technological enterprises (HNTEs) across the country and for technology-advanced service enterprises in prescribed cities.[12] Apart from these 'industry-oriented' incentives, enterprises in encouraged industries in the Western Regions are entitled to a reduced tax rate of 15%.[13] Moreover, in recent years, the Chinese government also designated a number of new areas[14] in the country where companies in specific industries are entitled to a lower tax rate at 15%. Reduced tax rates are generally not available for PEs though.

18 In addition to the CIT, foreign investors also have to contend with a rather complex Chinese turnover tax regime, which includes a consumption-based VAT system,[15] an irrecoverable service tax called business tax (BT) and consumption tax. Since 2012, China has been undergoing a transformation from BT to VAT (the B2V transformation program) in stages. From 1 May 2016, the B2V transformation program has been completed and all industries which used to be subject to BT are subject to VAT going forward.[16] That is to say, BT, as a major local tax in China, is completely replaced by VAT from 1 May 2016.

19 Furthermore, payments to the foreign suppliers require them and the Chinese payers to go through tax-record filing procedures,[17] prior to each outward remittance. The in-charge tax bureau would review the documents submitted, so as to ensure that the remittances are legitimate and the relevant taxes are collected. Should they find that tax is underpaid, they can require the domestic payer or overseas recipient to make up for the under-paid taxes together with surcharges. More details will be discussed in [F] Practical Considerations.

20 If a PE is deemed to be created by a Non-TRE, the following major China taxes will be imposed:[18]

21 CIT of 25%

22 Turnover tax, which is:[19]

23 VAT of 17%/11% on sales of goods and provision of processing, repairing and/or replacements services; VAT of 17%/11%/6% on taxable activities under the B2V

11. Circulars Caishui [2017] No. 43.
12. Circulars Caishui [2014] No. 59 and Guohan [2016] No. 40.
13. SAT Public Notice [2015] No. 14.
14. Hengqin New Area, Pingtan Comprehensive Experimental Zone, and Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone.
15. It was transformed from a production-based system from 1 Jan. 2009 according to Guowuyuanling [2008] No. 538.
16. Circular Caishui [2016] No. 36.
17. SAT, State Administration of Foreign Exchange (SAFE) Public Notice [2013] No. 40.
18. If no service fee is charged by a PE to the service recipient, the Chinese tax bureau may assess a deemed service fee to levy VAT and CIT.
19. Even if a PE is not created, turnover taxes are still applicable on relevant taxable activities carried out by foreign investors.

transformation program;[20] zero-rated or exemption on export goods and certain qualified cross-border taxable services. From 1 May 2018, VAT rate of 17% and 11% will be adjusted to 16% and 10% respectively which applies to all taxable sales and import activities under the two brackets.[21]

24 Local surcharge on the turnover tax.[22]

25 For computing the CIT taxable income of the PE of a Non-TRE in China, the Non-TRE is required to maintain accurate and complete accounts to determine the actual profits arising from its PE in China (the so-called actual profit basis) which should be commensurate with the functions and risks of the PE in China. If a Non-TRE is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, the Chinese tax authorities shall assess the taxable income using one of the 'deemed profit methods', which are discussed further under §4.04 below.[23]

26 **Outbound cases.** Chinese TREs with a foreign PE are liable to CIT in China in respect of their worldwide income.[24]

27 *Tax types and rates–* Generally the standard CIT rate of 25% applies to the overall income (15% may apply to certain eligible HNTEs where conditions are met).[25]

28 *Double tax avoidance–* China adopts the foreign tax credit method with a credit limit. A Chinese TRE can enjoy direct and indirect (underlying) foreign tax credit for the taxes characterized as 'income tax paid abroad'.[26] Such term is defined as foreign tax paid in the nature of income tax in respect of income derived from sources outside China that is payable and actually paid overseas in accordance with the relevant foreign tax laws and regulations. However, the foreign tax credit limit is calculated based on the CIT payable in respect of that foreign income as calculated in accordance with the CIT Law while the excess may be carried forward for five years.[27,28] The credit limit is to be calculated on a 'country-basket' basis, without further limitation

20. For the scope of taxable activities under B2V transformation program, VAT rates ranges from 6% to 17%. Particularly, VAT of 11% on transportation services, postal services, basic telecommunication services, construction services, transfer of land use right, immovable property leasing services, and sales of immovable properties; VAT of 17% on lease of tangible movable properties leasing services; VAT of 6% on the rest of taxable items activities under the B2V transformation program, including financial services, consumer services, value-added telecommunications services, certain modern services (except immovable property leasing services and tangible movable properties leasing services), sales of intangible assets (except transfer of land use right).
21. Circular Caishui [2018] No. 32.
22. According to Guofa [2010] No. 35, domestic and foreign-invested enterprises and individuals are subject to urban construction and maintenance fee and education surtax from 1 Dec. 2010. In the meantime, there may be other kinds of surcharges or levies at provincial/city levels as well, such as local education surcharge according to Caizong [2010] No. 98.
23. Circular Guoshuifa [2010] No. 19.
24. See the CIT 2007, Art. 3(1).
25. Circular Caishui [2011] No. 47.
26. See the CIT DIR 2007, Art. 77.
27. See the CIT, Art. 23.
28. See the CIT DIR, Arts 77–81.

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per 'income basket'.[29] From 1 January 2017, a Chinese TRE is allowed to choose 'consolidated credit' basis with no limitation on either country basket or income basket for calculation of credit limit.[30]

29 The calculation formula on a 'country-basket' basis is as follows.[31]

30 **Credit Limit** = **Total tax payable on income sourced inside and outside China computed in accordance with the CIT Law and the Implementation Regulations** x **Taxable income sourced <u>from certain country (region)</u> Total China and foreign sourced taxable income**

31 **Legal and tax compliance in connection with a PE.** In most cases, PEs are triggered by a Representative Office (RO) or by a 'Foreign Contractor' relationship. Such PEs are according to the prevailing Chinese business registration system subject to the standard business registration procedures with the relevant local Administrative Bureau of Industry and Commerce (ABIC) followed by a subsequent tax registration with the in-charge tax bureau. These PEs are therefore registered for taxes and may hence file their tax returns locally in its own name for the income attributable to the PE.

32 In some cases, PEs are also triggered by a 'Foreign Service Provider' relationship. For this type of PE, it may be difficult to perform business registration procedures with the relevant local ABIC. But technically, a Non-TRE is still required to perform tax registration for this type of PE within thirty days from the date on which the contract is concluded and file its tax returns with the in-charge tax bureau at the location where the PE is constituted.[32]

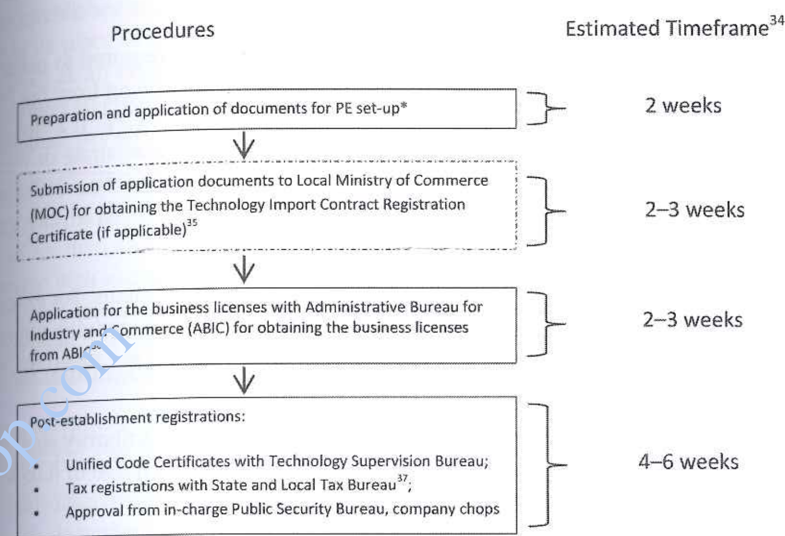
33 In addition, for foreign contractor / service provider PEs, the Chinese project owners / service recipients or the withholding agents are also required to perform registration of the contract with their in-charge tax bureaus within thirty days from the date on which the contract is concluded.

34 Non-TRE may in some cases have difficulties registering with the in-charge tax bureau due to various reasons (e.g., lack of business registration records etc.). In such cases, where technically a PE was constituted, the local tax authorities may for simplified administration purposes request the Chinese customer of the Non-TRE to act as the withholding agent to file and pay the Chinese taxes on behalf of the Non-TRE. The tax to be withheld would be calculated based on one of the three deemed profit methods,[33] with the full CIT rate of 25% applied on the calculated deemed profit.

29. 'Income-basket limitation' refers to credit limitation based on the types of foreign income.
30. Circular Caishui [2017] No. 84.
31. See the CIT DIR 2007, Art. 78.
32. SAT Order [2009] No. 19.
33. For details see below under §4.04.

35 The following flowchart shows the registration procedure, timeframe and the key document requirements for registering a 'foreign contractor' as one example of a PE that may be registered.

Figure 1 Flowchart of Registration Procedures of a Foreign Contractor



* Application Documents for Establishment of a PE:[38]

- power of attorney for signature, if applicable;
- application letter to local MOC;
- application letter to ABIC;
- letter of creditworthiness issued by the investor's local bank;
- appointment letter for the in-charge person of the PE; and
- CV of the in-charge person of the PE.

36 *Tax compliance of a PE*– As stipulated in the CIT Law and its DIR, a PE is subject to CIT and would therefore be required to pay the CIT to the in-charge tax bureau. However, as already stated above, it may in practice be difficult to file a business and tax registration for some PEs, which may make it difficult for a PE to pay the taxes due directly to the tax authorities. Certain cities have issued local circulars (e.g., Shenzhen[39]) to tackle these practical issues in respect to handling the compliance obligations of a PE. Also, a circular, namely SAT Order [2009] No. 19, was published in 2009 at national level which addresses the practical procedures for a PE to meet the tax compliance.

34. This is a rough estimate of the time frame. Actual time frame depends on circumstances of each case.
35. The MOC approval would only be applicable in Technology Importation cases.
36. SAIC Order [1992] No. 10 and SAIC Order [2016] No. 86.
37. Article 3 s. 5 Circular SAT Order [2014] No. 36.
38. Fee is needed during the registration, but it varies according to the rules of in-charge tax bureaus.
39. Circular Shendishuifa [2003] No. 320.

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37 Generally, ROs are required to keep proper accounting records to ascertain the actual revenue/profit and file turnover tax and CIT accordingly. The Chinese tax authorities shall adopt 'deeming method' for ROs which cannot accurately ascertain its revenue or costs, or calculate and file their tax liabilities on an actual basis. These 'deeming methods' include 'Expenditure-plus method' and 'Actual revenue deemed profit method'.[40]

38 Similarly, other 'Foreign contractors/service providers' are also required to maintain accurate and complete accounts to determine the actual profits arising from the PE in China which are commensurate with the functions and risks of the PE. If a Non-TRE taxpayer is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, the Chinese tax authorities shall assess the taxable income using one of the 'deemed profit methods', which are discussed further under §4.04 below.[41]

39 Moreover, for some industries/businesses, there are special requirements. For example, the RO of an insurance company is required to submit an annual activity summary to the supervisory government authorities and to have face-to-face meetings with authorities to address their inquiries.[42]

40 In case of non-compliance with the tax filing obligations, the tax authority shall have the right to impose penalties from 50% to 5 times as well as surcharge of 0.05% per day on the under-reported tax.[43]

[D] Tax Rulings

41 China does not have an advance ruling practice nationwide[44], except for advance pricing agreements with respect to transfer pricing. The Chinese tax authorities would therefore not issue advance rulings to address the question of whether the Chinese activities of a company have constituted a PE.

42 So far, the Chinese tax authorities are very selective with respect to the topics that may be agreed in an APA. There has been no APA to regulate the allocation method of earnings and expenses between an overseas head office and a PE in China or vice versa.

40. Circular GuoShuiFa [2010] No. 18.
41. Circular GuoShuiFa [2010] No. 19.
42. Circular Baojianhuilin [2006] No. 5.
43. The People's Republic of China Tax Collection and Administration Law (2001).
44. There is no advance ruling practice nationwide. However, SAT issued Circular Shuizonghan [2015] No. 208 to introduce ten innovative approaches to taxpayer services in Shanghai PFTZ, Guangdong PFTZ, Tianjin PFTZ and Fujian PFTZ, including advance tax ruling for certain taxpayers. In this regard, Guangzhou Nansha LTB (located in Guangdong PFTZ) issued Provisional Measures for the application of advance ruling on complicated tax matters (Trial) in specific areas under its administration.

§4.03 DEFINITION OF 'PE'

[A] Definition of PE According to Domestic Law: General Definition

43 The CIT law distinguishes enterprises into TRE and Non-TREs.[45] A TRE is one that is either established according to China law; or is established according to non-China law but has its place of effective management in China.[46] Effective management in China is defined as an establishment that exercises, in substance, overall management and control over an enterprise's business, personnel, accounting, properties, etc. in China.[47] A TRE shall pay CIT on income derived from sources inside and outside China.[48]

44 A 'Non-TRE', which has an establishment or a place in China shall pay CIT on income that is derived by such establishment or place in China from sources inside China as well as on income that, although derived from sources outside China, is effectively connected with such establishment or place.[49] According to the wording of this regulation the Chinese tax law does not require a 'PE', but just an 'establishment'. The Chinese tax law does not provide for a minimum requirement in terms of presence period of such 'establishment' in China.

45 An 'establishment' or a 'place' shall refer to establishments and places in China engaged in production and business operations, including:[50]

(1) management organizations, business organizations, RO;
(2) factories, farms, places where natural resources are exploited;
(3) places where labour services are provided;
(4) places where contractor projects, such as construction, installation, assembly, repair and exploration, etc. are undertaken;
(5) other establishments or places where production and business activities are undertaken.

46 It also includes a business agent which is engaged by a foreign company to carry out production and business activities in China, including regularly signing contracts or storing and delivering goods on behalf of the foreign principal.

[B] National Double Tax Treaties

47 **General deviations of China's DTCs from the OECD MTC.** In general, China follows the principle of the OECD Model as well as the UN Model in defining the term 'PE'. According to the < Departmental Interpretation Notes on the DTC between China and Singapore and the Relevant Protocols > (DIN)[51] issued by the SAT, 'PE' refers to a fixed

45. See the CIT 2007, Art. 2(1).
46. See the CIT 2007, Art. 2(2).
47. See the CIT DIR 2007, Art. 4.
48. See the CIT 2007, Art. 3(1).
49. See the CIT 2007, Art. 3.
50. See the CIT DIR 2007, Art. 5(3).
51. Circular GuoShuiFa [2010] No. 75 (the DIN).

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place of business physically exist with relatively fixed location and constant in time, and through which the business of an enterprise is wholly or partly carried on. 'PE' shall be deemed not to include the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity of a preparatory or auxiliary character.[52] Although the DIN was originally introduced with regard to the China-Singapore DTC, the circular also states that the interpretation provided by the DIN is similarly applicable to other tax treaties that China has concluded with other jurisdictions if the contents of the relevant articles are the same as that in the China-Singapore DTC and no other interpretation and implementation guidelines have been provided before. The term 'business' does not only include production and operating activities, but also general business activities carried on by non-profit making organizations. Accordingly, a non-profit making organization which is engaged in Chinese business activities via a fixed place shall be deemed to constitute a PE in China, unless such establishment carries on activities of a preparatory or auxiliary character. A 'Preparatory or auxiliary character' of activities usually have the following features according to the DIN:

(1) the fixed place does neither independently conduct business activities nor constitute a basic or important integral part of the business of the enterprise as a whole;
(2) the fixed place provides services solely for the enterprise itself rather than for other parties; and
(3) the services provided are routine activities in nature and not direct profit making.

48 If the fixed place does not only provide services to the head office, but also has business dealings with other parties, or if the nature of the business of the fixed place is consistent with the nature of the business of the head office and its business constitutes an important integral part of the head office's business, the activities of the fixed place may not be deemed to be of a 'preparatory or auxiliary character'.

49 For example, an oil company exploring oil resources in China should generally be regarded as having a PE in China. A PE may also be deemed to exist, if an oil company from another contracting state has a place of management in China.[53]

50 Notwithstanding the above and pursuant to the UN Model, China has adopted a wider definition of PE than the one reflected in the OECD Model Treaty. As a consequence, all of the DTCs concluded by China have adopted a definition of PE which generally includes – in addition to building sites, construction or installation projects – assembly and supervisory activities.[54] A PE is created, provided such activities last for more than six[55] months, which is a shorter period than foreseen by the OECD Model Treaty, which stipulates a twelve-month period.[56]

52. Circular GuoShuiFa [2010] No. 75 (the DIN).
53. Section 1 Circular CaiShuiYouZhengZi [1988] No. 3.
54. All China DTCs, including the newly concluded DTCs (Art. 5 s. 3).
55. This period ranges from six months (e.g., Art. 5 s. 3 China-US DTC) to twenty-four months (e.g., Art. 5 s. 3 China-United Arab Emirates DTC), according to different DTCs.
56. See the OECD Model Tax Treaty on Income and on Capital, Art. 5(3).

51 In line with the UN Model Treaty, the provision of services by a Non-TRE through its employees or other engaged personnel in China creates a PE if the duration exceeds six months in any twelve-month period.[57] Some Chinese DTCs have an even broader PE definition which does also include an installation, a drilling rig, ship or structure used for the exploration or exploitation of natural resources for a period ranges from one month to twelve months.[58]

52 China used to adopt 'six months' as the time threshold in most of the DTCs in determining a service PE. Circular Guoshuihan [2007] 403[59] (Circular 403), issued with regard to the China-Hong Kong Double Tax Arrangement (China-HK DTA), has given clarification on how to count a 'month'. It is stipulated that the specific number of days should be disregarded in calculating a month. If a foreign enterprise provides services in a certain project in China, the period from the month in which the first employee of that foreign enterprise arrived in China to provide services until the month in which the project was completed and the last employee of that enterprise left China would be taken as the relevant period. If, during that period, no service was provided by employees of that enterprise in China on that project for a period of thirty consecutive days, one month can be deducted. Based on this approach, the provision of services in China for only one day within one calendar month could be counted as 'one month'. Subsequent to Circular 403, the HK SAR Government and the Chinese Government signed a Second Protocol to the China-HK DTA which came into effect on 11 June 2008 replacing the term 'six months' by '183 days'. In January 2011, the SAT confirmed that the interpretation on how to count a 'month' under Circular 403 has been abolished.

53 Subsequent to the Second Protocol to the China-HK DTA, almost all DTCs which China has concluded or amended have adopted the '183 days' time threshold in determining a service PE. The DIN provides interpretation on how to count the '183 days'. It is simply counted based on the actual physical presence in China of the employees of that treaty resident in providing the services.

54 Notwithstanding the above, there are still many DTCs concluded by China before 2008 that have adopted 'six months' as the time threshold in determining a service PE. The existing 'six months' threshold for a service PE shall be interpreted as '183 days' in practice.[60]

55 **Deviations of China's specific DTCs from the OECD MTC.** In line with the OECD Model Convention, the term 'PE' is defined as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on' in the DTCs concluded by China. It especially includes:

57. This period ranges from six months (e.g., Art. 5 s. 3 China-US DTC) to twenty-four months (e.g., Art. 5 s. 3 China-United Arab Emirates DTC), according to different DTCs.
58. This period ranges from one month (e.g., Art. 5 s. 3 China-New Zealand DTC) to twelve months (e.g., Art. 5 s. 3 China-Croatia DTC).
59. 'Issues Relevant to the Interpretation and Implementation of Relevant Articles of the China-Hong Kong Double Taxation Arrangement'.
60. Circular SAT Public Notice [2018] No. 11.

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(1) a place of management;
(2) a branch;
(3) an office;
(4) a factory;
(5) a workshop;
(6) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources;

56 In the DTCs that China has concluded, there are no further definitions of 'a place of management,'[61] 'a branch',[62] 'an office',[63] 'a factory',[64] 'a workshop'[65] or 'a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources'.[66]

57 In addition, in certain DTCs concluded by China, the definition of 'PE' also includes:

(7) a warehouse, in relation to a person providing storage facilities for others;[67]
(8) a farm or plantation.[68]

58 These items are not covered under the definition of 'PE' in the OECD Model.

[C] Implication of BEPS

59 China has been playing an active part in the design, monitoring and review of the Base Erosion and Profit Shifting (BEPS) programme. Following the release of all the reports on 15 BEPS action plans in October 2015, China officially reiterated her support to the BEPS program and her stance that BEPS recommendations will be adopted locally by taking into account her own specific circumstances.[69]

60 In relation to Action 7, *Preventing the Artificial Avoidance of Permanent Establishment Status* (Action 7 report), the SAT expressed its view that China's domestic treaty interpretation rules in the DIN has already addressed a lot of issues discussed in Action 7 report. The DIN, released in early 2010, set out a comprehensive interpretation of articles in the China-Singapore DTC. The interpretation provided by the DIN applies to other DTCs concluded by China to the extent that the provisions of relevant articles in those DTCs are the same as those in the China-Singapore DTC.

61 It can be found that most of the suggestions put forward in Action 7 report coincide with the DIN. For example, the DIN requires the preparatory and auxiliary test to

61. 'a place of management' is '管理场所' in Chinese character and 'guan li chang suo' in Pinyin.
62. 'a branch' is '分支机构' in Chinese character and 'fen zhi ji gou' in Pinyin.
63. 'an office' is '办事处' in Chinese character and 'ban shi chu' in Pinyin.
64. 'a factory' is '工厂' in Chinese character and 'gong chang' in Pinyin.
65. 'a workshop' is '作业场所' in Chinese character and 'zuo ye chang suo' in Pinyin.
66. 'a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources' is '矿场, 油井或气井，采石场或者其他开采自然资源的场所'.
67. Art. 5 s. 3 China-Thailand DTC.
68. Art. 5 s. 3 China-Malaysia DTC.
69. Website of State Administration of Taxation of People's Republic of China, <http://www.chinatax.gov.cn/n810219/n810724/c1836574/content.html>.

be applied to all activities included in Article 5(4) of the standard DTCs.[70] The DIN also provides that the dependent agent provision may also apply in situations where contracts are not concluded in the name of the foreign enterprise, meaning that commissionaire arrangements would not shield the foreign enterprise from being regarded as a dependent agent.[71]

62 Notwithstanding the existence of the DIN, the SAT considered including recommendations contained in Action 7 report during the negotiation/re-negotiation of DTCs. The newly concluded China-Chile DTC in May 2015 has already included recommendations to prevent the artificial avoidance of PE status in the following areas:

- whether listed or not, the activity must meet the condition of being of a preparatory or auxiliary character in order to avoid constituting a PE;
- clearer and stricter definition of the dependent agent PE test; and
- more restrictive exemption from PE status for independent agents.

63 These inclusions are broadly in line with the recommendations in Action 7 report.

64 In relation to Action 15, *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties* (Action 15 report), On 7 June 2017, the commissioner of SAT together with representatives from sixty-seven jurisdictions attended the OECD signing ceremony on the Multilateral Convention (the MLI), aiming to swiftly modify bilateral tax treaties to implement the tax treaty-related BEPS recommendations. The provisional 'MLI position' for each country and jurisdiction are published on the OECD website[72]. China has opted out of all the provisions (Articles 12–15) of the MLI in the avoidance of PE section, there is no immediate impact on foreign companies' PE position in China in the near future unless bilateral negotiation results in amendments to the specific China-foreign tax treaties, as China's domestic treaty interpretation rules in the DIN has already provided similar provisions to address the BEPS concerns including agency PE, preparatory and auxiliary activities, etc.

[D] Special Cases

65 **Services PE.** As already mentioned above, China – as most other developing countries – follows the UN Model Treaty, which grants extended right of taxation to the state in which a service is provided, that is, extended taxation at source. The most relevant regulation in this regard is Article 5 section 3(b) of the UN Model Treaty, in which the so-called service PE is determined.

66 A recent development shows the Chinese tax authorities intending to assess secondment arrangements for their economic substance. Where economic substance is lacking, it may be assumed, that actually the secondee is performing services in China for the FE (i.e., Non-TRE) and thereby creating a PE for that Non-TRE in China. The concept of 'economic employer' seems to be starting to become relevant.

70. Art. 4 Circular GuoShuiFa [2010] No. 75 (DIN) and Page 29 of Action 7 report.
71. Art. 5s. 2 Circular GuoShuiFa [2010] No. 75 (DIN) and Page 16 of Action 7 report.
72. http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

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67 **Agents PE.** If a Non-TRE commissions a business agent to carry out production and business activities in the territory of China, including commissioning an enterprise or individual to regularly sign contracts, store and deliver goods etc., on its behalf, such a business agent shall be considered as the PE of the Non-TRE in China.[73]

68 In a published case (the San Rong case), an enterprise incorporated in Hong Kong was engaged in sales of equipment and provisions of technical services to customers in China.[74] The relevant contracts between this enterprise and the customers in China were generally signed by its subsidiary in China on behalf of this enterprise. The underlying technical services are actually provided by the subsidiary. The Hong Kong enterprise was deemed as having a PE in China and all the profits related to this PE were assessed to CIT.

69 **Server PE.** China has not issued so far any regulations or circulars which are defining whether and under which circumstances a computer server is triggering a PE.

70 **Affiliated companies as PE.** China does not have a clause in its CIT Law like Article 5(7) of the OECD MC; however, China does adopt this article in its DTCs. There have not been any cases where the Chinese tax authorities have classified affiliated companies as agency PEs simply because of that relationship.

71 **Building site PE.** Most DTCs concluded by China with other tax jurisdictions specify that only a building site, construction, assembly or installation project lasting for a period of more than six (or twelve) months is to be treated as a PE. In practice, the provisions shall be implemented in accordance with the following principles according to the DIN:

(1) Starting and ending dates of a site or project or related supervisory activities shall be determined, in accordance with the contract, from the date work begins (including preparatory activities) for a particular contract to the date of delivery (including trial operations). If the activities continue for more than six months (for those projects crossing over calendar year-end, the months shall be calculated continually), the foreign contractor shall be considered to have a PE in China and shall be subject to income tax.

(2) If a company of the other State continually undertakes two or more projects at the same site or for the same construction task in China, the period shall start from the commencement of the first project to the completion of the last project, rather than counting each project separately.

(3) Two or more projects at the same site or for the same construction task shall be considered as several project contracts belonging to the same commercial task. This pooling of several projects to one incident (commercial task) shall not apply, if a PE (Non-TRE) undertakes or has undertaken several projects which are not related to a particular site or a particular construction task.

(4) Special rules apply for temporary suspensions. In more detail, if one is computing the period during which activities are performed on a site respectively for a construction project including related supervisory activities, and if the operations are

73. See the CIT DIR 2007, Art. 5.
74. Circular GuoShuiHan [2006] No. 970.

temporarily suspended due to the shortage of equipment or materials, weather or other reasons, but the project has not been completed or abandoned and the workers and materials have not been withdrawn, the temporary suspension shall be included in the computation and the period shall still be computed continually.

(5) Where a company of the other State is subcontracting a project to other enterprises and the date of commencement on the contract with the sub-contractor is earlier, the computation of the period of the project shall begin from the date when the sub-contractor starts its activities; however, it shall not affect the sub-contractor which shall be allowed to count the project sub-contracted separately in ascertaining its liability to tax.[75]

72 **Other.** The new CIT Law, effective from 1 January 2008, introduces the concept of TRE. A PE with the place of effective management located in China could be regarded as a TRE and would hence be subject to China CIT on its worldwide income. The term 'place of effective management' is defined as the place where the overall management and control over production and business, personnel, accounting, properties and other assets and operations is, in substance, exercised.

73 The TRE concept goes beyond the PE concept which imposes CIT on PEs only in respect of their China sourced income and foreign sourced income effectively connected with the PE. As the concept is new in China, the Chinese tax authorities have so far only issued detailed guidance on how to determine Chinese-capital/controlled foreign companies as TREs.[76]

74 **Mobile phone masts, portable market stands and broadcasting trucks.** There are no regulations or court cases which specifically address whether mobile phone masts, portable market stands or broadcasting trucks may trigger a PE.

[E] Discrepancies between Local Law and Tax Treaties

75 The CIT Law has a provision which stipulates that 'where the provisions in tax treaties are different from the CIT Law, the provision in the tax treaties shall prevail'.[77]

[F] Practical Approach

76 DTC protection is available for a Non-TRE in determining whether it creates a PE in China. If the Non-TRE intends to avail itself to the treaty protection (i.e. not creating a PE thus not subject to China CIT), it needs to perform a self-assessment and file a prescribed form together with relevant supporting documents to claim the DTC protection. The in-charge tax officials are empowered to deny such DTC benefits over the post-examination process and require the non-TREs to make up for the taxes underpaid and impose late payment surcharge, interest and/or penalty.[78]

75. Art. 5.3 Circular Guoshuifa [2010] No. 75 (the DIN).
76. Circular GuoShuiFa [2009] No. 82.
77. See the CIT 2007, Art. 58.
78. SAT Public Notice 2015 No.60 and Tax Collection and Administration Law.

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77 If a Non-TRE constitutes a PE, it is subject to China CIT. More details on the tax treatment are set out in Section 4.04 below.

§4.04 PROFIT ALLOCATION

78 A PE is subject to CIT on its China sourced income as well as on foreign sourced income effectively connected with the PE.

79 Similarly, the DTCs concluded by China state that a Non-TRE may only be taxed in China, if it carries on a business in China through a PE, in respect of the relevant portion of the profit attributable to such PE.

80 Moreover, according to the DTCs, the arm's length principle shall be applied in determining the profits for the PE, that is, how much the PE would otherwise be paid by a 3rd party for the same services.

81 Generally, for computing the taxable income for Chinese CIT, a PE is required to maintain accurate and complete accounts to determine the actual profits. If a PE is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, there are three deemed profit methods to assess the taxable income of a PE, namely:

- Actual revenue deemed profit method.
- Cost-plus method.
- Expenditure-plus method.

82 These methods are illustrated in more detail below.

[A] Applicability of Allocation Method

83 In the past, the method most commonly adopted in China was the deemed profit method which was based on an estimation of the profit margin applicable on Chinese turnover. The deemed profit method has hence using some kind of direct allocation. Although the administrative measures for taxation of Non-TREs released in early 2010 tried to de-motivate Non-TREs from using the deemed profit methods and switch to the actual profit basis to compute the taxable income, in practice Non-TREs still tend to adopt deemed profit method as it is more convenient for filing purpose. Under this deemed profit approach, the Non-TREs shall obtain an official assessment form from their in-charge tax bureaus and need to fill it up for tax authorities' confirmation. The form includes the proposed deemed profit method, deemed profit rate, etc.[79]

84 The direct allocation is further used in combination with the cost-plus method or the actual profit method, which are the other two methods generally adopted to determine the profit attributable to a Chinese PE.

85 Indirect allocation of profit is only used in exceptional cases.

79. Guoshuifa [2010] No.19 and SAT Public Notice [2015] No.22.

[B] Mechanism of the Direct Allocation Method

86 For computing the CIT taxable income, a Non-TRE is required to maintain accurate and complete accounts of its PE in China to determine the actual profits arising from that PE which are commensurate with the functions and risks of that PE. If the Non-TRE is unable to correctly compute taxable income due to inaccurate or incomplete accounts or other reasons, the Chinese tax authorities shall assess the taxable income using one of the 'deemed profit methods', which are discussed in detail below.

87 *Actual revenue deemed profits method* – the actual revenue and deemed profit method would be applied to determine the taxable income generated by the PE of a Non-TRE in China where revenue of the PE can be ascertained but not costs and expenditures. The general formula for computing the CIT amounts are set out below:

CIT = Gross Revenue × Deemed Profit Rate × CIT Rate

88 *Cost-plus method* – the cost-plus method would be applied in cases where the income attributable to the PE is not easily measurable, but the costs can be determined accurately.

Gross Income = Cost /[1 – Deemed Profit Rate]
CIT = Gross Income × Deemed Profit Rate × CIT Rate

89 *Expenditure-plus method* – The expenditure-plus method would be applied in cases where the revenue and costs cannot be ascertained but expenditures can be.

90 The general formula for computing the CIT amounts are set out below:

Taxable Income = Expenditures / (1 – Deemed Profit Rate) * Deemed Profit Rate[80]
CIT = Taxable Income × CIT Rate

91 PEs adopting the cost-plus method and expenditure-plus method must accurately account for their costs/expenses in China. These accounts must be audited by a public accounting firm at year-end.

92 The range of deemed profit rates to be applied under the 'deemed profit methods' for different types of businesses are provided below:[81]

Industry	*Deemed Profit Rates*
Construction projects, designing and consulting services	15%–30%
Management services	30%–50%
Other operating and service income	No less than 15%

93 For ROs in particular, the 'Actual revenue deemed profits method' and 'Expenditure-plus method' discussed above may be adopted under deemed profit methods approach. The deemed profit rate for ROs cannot be less than 15%.[82]

80. Before 1 May 2016, the effective date of the B2V Pilot Program, the formula was 'Gross Income = Expenditures / (1 – Deemed Profit Rate – BT rate)'.
81. Circular Guoshuifa [2010] No. 19.
82. Circular Guoshuifa [2010] No. 18.

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94 **Determination of taxable income.** The determination of the taxable income under the direct method follows the main principle of profit allocation to PEs. Where provision of services for a certain project in China by a PE through its employees constitutes a PE, the profits derived from the services in China for the project shall be deemed profits of the PE and taxed as such.[83]

95 Specifically, PEs that conclude contracts for the sale of machinery and equipment and, at the same time, provide labour services such as equipment installation, assembly, technical training, guidance and supervision, etc., shall pay tax on income derived from such services. Where labour service charges are not expressly itemized in the sales contract, or the pricing is unreasonable, the Chinese tax authority shall, based on the circumstances of the case, assess the amount of income derived by the PE from its labour services and calculate and levy business tax and CIT on the principle that such income shall be assessed at no less than 10% of the total contract price.[84]

96 **Inbound versus outbound cases when applying the direct allocation method.** There is no differentiation in the application of the direct allocation method for inbound and outbound cases.

97 **Restrictions under DTCs.** Generally speaking, Chinese DTCs do not impose restrictions on the application of the direct allocation method.

[C] Mechanism of the Indirect Allocation Method

98 **Determination of taxable income.** In certain circumstances in the past, the Chinese tax authorities might adopt specific keys to apportion gross income to a PE. A typical example was the income apportionment mechanism introduced by Circular Guoshuifa [2000] No. 82 for FIEs and PEs engaging in conducting taxation, accounting, audit, legal and other consulting business in China. Such compulsory allocation ratio is no longer required under the administrative measures for taxation of Non-TREs discussed above. In January 2011, the SAT confirmed that Circular 82 has been abolished.

99 Under the administrative measures, if the services are rendered both inside and outside China, the PE shall allocate the onshore and offshore income respectively according to the locations of where the services are rendered, and the PE shall file and settle the CIT payments in respect of its onshore income. Where the Chinese tax authorities have doubts on the reasonableness and truthfulness of the onshore and offshore service income allocation, they can request the PE to provide evidence to substantiate the allocation. Where they think fit, they may re-allocate the onshore and offshore service income by reference to work volume, time, cost, and other relevant factors. In extreme cases where the PE is not able to provide the evidence, the entire service income may be deemed as onshore service income, and subject to CIT.

83. Circular Guoshuihan [2006] No. 694.
84. Circular Guoshuifa [2010] No. 19.

100 **Application of the indirect method to certain industries and businesses.** As mentioned above, the indirect method is only applied in special cases, that is, for PEs triggered by the provision of services in China.

[D] Details on the Transfer of Assets or Functions

101 **Transfer of assets.** Capital gains attributable to a transfer of assets would be subject to CIT levied at a rate of 25%. Such taxation is, however, only applicable if a PE is taxed based on the actual profit method. In case a PE is taxed based on the cost-plus method or expenditure-plus method, such a transfer of assets would generally not impact the PE's costs or operating expenses. Hence, there would be no additional CIT triggered by the asset transfer. However, if the PE is taxed based on the actual revenue and deemed profit method, such transfer would increase the actual revenue of the PE and result in higher taxation.

102 **Shift of functions.** The Chinese tax authorities have not provided any specific rules with regard to the shifting of functions so far.

103 **Restructuring.** The table below provides for a summary overview of the China tax implications triggered by a restructuring, which results in a transfer of PE assets (e.g., fixed assets of an RO) to a Chinese TRE.

	PEs Such as ROs[85] (Transferor)	*TRE (Transferee)*
Value Added Tax ('VAT')[86]	– For fixed assets for which the input VAT was not creditable at the time of purchase, VAT is imposed at the rate of 2% on the transfer price upon transfer; – For fixed assets for which the input VAT was creditable at the time of purchase, VAT is imposed at the applicable VAT rate (i.e., 17% in most cases) upon transfer.[87]	– Where VAT is imposed at the rate of 2% on the transfer price, such VAT is not creditable on the TRE side; – Where VAT is imposed at the applicable VAT rate, such VAT should be treated as input VAT and is creditable on the TRE side.
Corporate Income Tax ('CIT')	Generally no CIT, except in the situations where the PE is filing on an actual profit basis or under the actual revenue deemed profit method.	The transfer price of the assets should be booked as acquisition cost of the assets on the TRE side for CIT purpose.

85. Assuming ROs file their corporate tax under expenditure-plus method.
86. SAT Public Notice [2011] No. 13 clarifies that asset restructuring transactions such as merger, spin-off, sale or swap of assets, etc. involving the transfer of all or part of tangible assets of an enterprise to another enterprise together with their associated creditors' rights, liabilities and labour force shall not be subject to VAT.
87. Circular Caishui [2008] No. 170.

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[E] Details on Losses

104 Losses can occur only in case of the actual profits method. In this case, the general rules would apply, that is, a loss carry forward for five years would be available. For PEs under the deemed profit methods, tax losses may theoretically not occur.

[F] Practical Considerations

105 In China, strict foreign exchange controls exist for outward remittance. However, there is some relaxation[88] on service trade in recent years, including decentralized authorization, simplified verification procedures, cancellation of document verification for transactions with an amount under the prescribed threshold, etc. Although the procedural as well as the documentation requirements are simplified and the process of outward remittance becomes more straightforward, in some cases where the regulations are not very clear, it may still be subject to the interpretation of relevant in-charge authorities.

106 In order to effect a payment, it is required to provide the banks with a certification from the foreign exchange bureau, which in turn backed up by a tax clearance from the tax office. The tax clearance procedure used to be very time consuming, especially in cases of uncertain tax treatment, for example, whether a withholding tax is due or not. In 2013, China introduced a tax record filing system with an aim to simplify the clearance for most outward remittances. However, it does not mean that the Chinese tax authorities are relaxing its tax administration for outward remittances. Instead, the focus shifts from pre-remittance approvals to daily tax administration and post remittance examinations. As local-level tax authorities usually issue their own guidelines for implementation of the tax record-filing system locally, there may be slight variation in local practice in different regions.

§4.05 SUMMARY AND OUTLOOK

107 In the past, the taxation of PEs in China differed in various ways from the taxation in other countries. Firstly, the definition of PE was relatively broad, both from a domestic perspective (e.g., no time limitation compared to six months as stipulated in most DTCs) as well as from a DTC perspective (e.g., application of service PE). Furthermore, the taxation methods were unique and mostly not based on actual bookkeeping, but rather on deemed methods, leading to possible double taxation.

108 It is good to see that the Chinese tax authorities have issued a number of new regulations in recent years to strengthen the administration on taxation of Non-TREs. The new regulations provide detailed compliance requirements for Non-TREs in respect of tax registration and filing. The new regulations also encourage Non-TREs to maintain accurate and complete accounts to determine the actual profits arising from the PE in China which are commensurate with the functions and risks of the PE and file Chinese

88. Circular Huifa [2013] No. 30.

taxes on actual profit method rather than the rather arbitrary deemed profit methods. This is in line with the international practice. In addition, the new regulations have also removed the domestic tax exemption for RO and an RO has to rely on DTCs instead if it intends to apply for exemption from China income tax.

109 It may therefore be presumed that the Chinese tax authorities will in the future pay more attention on the PE issues. According to the SAT's contemplated work towards BEPS action plan of PE, more emphasis may be placed on the improvement of PE administrative rules and the strengthening of the administrative practice, by way of establishing a PE information sharing system. Apart from the administrative perspective, in practice there are still uncertainties in implementation of the regulation on Non-TREs. So far, it appears that the actual profit method in determining a PE's taxable income is not strictly enforced across the nation; and not many ROs have obtained tax exemption status under DTCs. As the issue of profit attribution has not been addressed specifically in the Action 7 report, Chinese tax authorities will look forward to further guidance from OECD on this subject.

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the PE concept applies to both branches and partnerships.[2] The latter are widely used in Germany, in particular in the middle market sector. Finally, the PE concept is also relevant for value-added tax (VAT) and wage tax purposes.

4 In terms of economic importance, PEs rank below subsidiaries of foreign corporations established in Germany. Foreign investors tend to prefer subsidiaries due to the clear organizational and economic borders between the affiliated companies and the ability to conclude loan and royalties contracts within a group.[3] For similar reasons, domestic corporations prefer to establish subsidiaries rather than PEs in foreign countries.

[B] Legal Principles and Resources

5 The German legal framework in relation to the income tax regime of PEs is laid down in the Income Tax Act (ITA) as well as the General Tax Code. However, Double Tax Conventions (DTCs) concluded by Germany prevail over these domestic law provisions unless they are explicitly overwritten by provisions under national law.

6 The interpretation of domestic law and DTC provisions by the tax authorities is included in administrative guidelines, decrees and rulings. These administrative positions are authoritative sources, although they are not legally binding.

7 Finally, there is abundant case law and legal doctrine that addresses various tax aspects of PE taxation in Germany.

8 Please see the Appendix for an overview of the relevant German resources.

[C] Key Features of Taxation

9 **How many tax treaties has Germany concluded?** Germany has concluded ninety-six tax treaties with respect to taxes on income, some of which are currently being revised, with fifteen additional treaties still being negotiated.[4] Nevertheless, treaties with several important trading partners are still outstanding. For instance, Germany has not signed treaties with Hong Kong or with Chile; Germany's treaty with Brazil has been terminated effective as of 1 January 2006.

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10 **Inbound cases.** *Tax types and rates* – If a non-resident corporation receives trade income from a PE in Germany, its profits are generally subject to corporate income tax, trade tax and solidarity surcharge[5] on the corporate income tax assessed. The PE's corporate tax base has to be determined in accordance with sections 4–7i of the ITA,[6] taking into

2. Please note that the following principles apply to partnerships in general, however, there are also specifics applying to partnerships which are not subject of this article.
3. M. Streck & J. Alvermann, 'Ausländer als Unternehmer im Inland', in *Körperschaftsteuergesetz Kommentar*, ed. M. Streck (München: Verlag C. H. Beck, 2014), 792.
4. As of 1 Jan. 2018. *Bundesministerium der Finanzen* (Federal Ministry of Finance - FMF), 17 Jan. 2018, IV B 2 - S 1301/07/10017-09, Federal Tax Gazette I 2018, 239.
5. In German: *Solidaritätszuschlag*.
6. In German: *Einkommensteuergesetz*.

account the modifications resulting from the German Corporate Income Tax Act (CITA).[7] The current corporate income tax rate is 15%[8] and the solidarity surcharge is 5.5% on the corporate income tax assessed.[9] The municipality multiplier,[10] which is a determinant of the trade tax rate, varies depending on the municipality where the PE is located. It currently averages 435% which results in an average trade tax rate of 15.225%.[11] The starting point for determining the trade tax base is the corporate income tax base.[12] However, sections 8 and 9 of the German Trade Tax Act[13] (TTA) modify the corporate income tax base to arrive at the trade tax base by, for instance, partially adding back interest, royalties and rental expenses.

11 The crucial difference between a PE and a subsidiary is that the PE is not itself a tax subject. Rather, the head office bears a non-resident tax liability on its income from the PE. Therefore, contracts between the head office and the PE are neither possible for civil law nor tax law purposes.[14] However, legislative amendments introduced the Authorised OECD Approach (AOA) with regard to PEs into German tax law with effect from 1 January 2013. According to this approach, PEs are deemed as independent entities and certain dealings are recognized for the purposes of determining the profit allocable to the PE (so-called functionally separate entity approach). Therefore, the implementation of the AOA constitutes a considerable change of the former practice of income allocation in Germany. Still, the rules do not fully reflect the AOA since they only apply to the disadvantage of the taxpayer. Only if the relevant treaty allows for 'dealings' for the purpose of profit attribution, the taxpayer can benefit from the application of the AOA. In cases where the relevant treaty does not allow for 'dealings' the taxpayer will have to demonstrate that the other state does not apply the AOA in order to avoid double taxation. Following a typical three-layer structuring process in Germany, an ordinance on income allocations of PEs was published on 13 October 2014.[15] This ordinance has legal status and mainly follows the AOA; however, there are many specific features that deviate from the general principles of the AOA. In particular, the regulations include German specifics regarding: (i) the preparation of the so-called auxiliary and supporting calculation, (ii) the definition of the people function, and (iii) the free capital to be allocated to the PE. By analogy to the functional and risk analysis and the transfer pricing analysis applicable to related enterprises, a two-step analysis is stipulated for purposes of the income allocation between head office and its PE. In addition, administrative principles on the income allocation of foreign taxpayers with

7. In German: *Körperschaftsteuergesetz*.
8. See the CITA, s. 23(1).
9. Section 4 of the Solidarity Surcharge Act.
10. In German: *Hebesatz*.
11. Deutscher Industrie- und Handelskammertag, http://www.dihk.de/ressourcen/downloads/dihk-hebesatzumfrage-2017-im-ueberblick.
12. See the TTA, s. 7.
13. In German: *Gewerbesteuergesetz*.
14. D. J. Piltz, 'Besteuerungsvergleich Tochtergesellschaft v. Betriebstätte', in *Internationale Betriebsstättenbesteuerung*, ed. D.J. Piltz & H. Schaumburg (Köln: Verlag Dr. Otto Schmidt, 2001), 16.
15. Ordinance, 13 Oct. 2014, Federal Law Gazette. I 2014, 1603 (*Betriebsstättengewinnaufteilungsverordnung*).

domestic PEs or domestic taxpayers with foreign PEs as a guideline from the German tax authorities have been released on 22 December 2016 in a 186-page degree.[16]

12 **Outbound cases.** *Tax types and rates* – Income received by a German tax resident via its foreign PE has to be calculated in accordance with German tax law.[17] In general, German tax residents are subject to domestic taxation on their worldwide income. However, trade income from a foreign PE is not subject to trade tax, whether or not the income is exempt under the relevant tax treaty.[18] Thus, foreign PE income of a German corporation will only be subject to corporate income tax and the solidarity surcharge unless the income is completely exempt under a tax treaty.

13 *Double tax avoidance* – As mentioned above, German tax residents are subject to taxation on the basis of their worldwide income. Since the state of the income source may also impose taxes on profits earned by non-residents, this can lead to double taxation (in particular where a tax treaty between Germany and the source state does not exist). To mitigate or eliminate such double taxation, the German domestic income tax law includes provisions that allow foreign taxes to be credited against German taxes.[19] Such tax credits can only be granted if the foreign tax was collected by the same state in which the income has its source.[20] Moreover, the tax credit, calculated separately for each source state, cannot exceed the German tax burden on the income from each particular source state ('per country limitation').[21] Any excess foreign tax credits cannot be carried forward into future years. Furthermore, under the provisions of section 50 of the ITA a tax credit can also be granted where a non-resident taxpayer receives a German PE income that has its source in a third country which is not the taxpayer's country of residence.[22]

14 At the request of the taxpayer, the foreign tax can be deducted from the PE income instead of being credited against the German tax on that income.[23] This option can be beneficial where the head office has incurred losses.[24]

15 In Germany's tax treaties, income received through a foreign PE can usually only be taxed in the source state and is therefore exempt from German tax. However, some treaties include so-called activity clauses, which make such an exemption dependent

16. FMF, 22 Dec. 2016, IV B 5 – S 1341/12/10001-03 (2016/1066571), Federal Tax Gazette I 2017, 182 (*Verwaltungsgrundsätze Betriebsstättengewinnaufteilung*).
17. *Bundesfinanzhof* (Federal Fiscal Court – FFC), 16 Feb. 1996, I R 43/95, Federal Tax Gazette II 1997, 129.
18. F. Roser, 'Kürzungen bei nicht im Inland belegener Betriebsstätte', in *Gewerbesteuergesetz Kommentar*, ed. E. Lenski & W. Steinberg (Köln: Verlag Dr. Otto Schmidt, 121th Supplement 11/2017), s. 9 no. 3 Annotation 2 TTA.
19. See the ITA, s. 34c.
20. V. Endert , 'Steuerermäßigung bei ausländischer Einkünften', in *Körperschaftsteuergesetz*, ed. Frotscher & Drüen (as of 2 February 2018), s. 26 no. 2.
21. W. Zenthöfer & D. Schulze zur Wiesche, *Einkommensteuer* (Stuttgart: Schäffer-Poeschel Verlag, 2007), 1084.
22. A. Ramackers, '§50', in *Das Einkommensteuerrecht*, ed. E. Littmann, H. Bitz & H. Pust (Stuttgart: Schäffer-Poeschel Verlag, 2008), s. 50 no. 81.
23. See the ITA, s. 34c (2) and (3).
24. W. Zenthöfer & D. Schulze zur Wiesche, *Einkommensteuer* (Stuttgart: Schäffer-Poeschel Verlag, 2007), 1084.

on the type of income received through the PE. Furthermore, several treaties include switch-over or subject-to-tax clauses, which cause a switch from the exemption to the credit system if the income is not subject to taxation in the source state.

16 **Legal and tax compliance in connection with a PE.** The complexity of legal compliance depends on the type of PE. Where the PE is entirely economically dependent on its head office, there is no obligation to register a PE in a commercial register. However, the activity of a PE needs to be registered at the appropriate trade office. The following documents are required for registration:

- power of attorney for the person applying for the registration;
- proof of identity of the person mentioned above;
- permits (if applicable);
- the German translation of the extract from the foreign commercial register;
- other documents (where necessary).[25]

17 On the other hand, if the PE meets the criteria for a branch office defined in section 13 of the German Commercial Code[26] (CC), registration in a commercial register would be necessary, in addition to registration at the trade office. Although a branch office does not possess its own legal personality,[27] it can be functionally independent from the head office. Registration in the commercial register entails additional costs since it requires a notarization. Furthermore, different types of activities may require additional permits. Moreover, every foreign employee would need a valid residence and work permit.

18 Furthermore, domestic PEs of foreign corporations need to be registered at the competent tax office. The non-resident taxpayers are obliged to file tax declarations for the taxable income received via the domestic PE.[28] Likewise, German tax residents must register their foreign PEs at the competent German tax office.[29]

19 Domestic PEs that qualify as branch offices in the terms of section 13 of the CC are obligated to maintain books and records and to file annual financial statements.[30] All other types of PEs are obligated to maintain books and records only if they meet one of the following criteria:

- annual revenues higher than EUR 600,000;
- utilized farming and forestry area worth more than EUR 25,000;
- annual trade income higher than EUR 60,000;
- annual income from farming and forestry higher than EUR 60,000.[31]

25. Industrie- und Handelskammer zu Köln, 'Selbständige Zweigniederlassung und unselbständige Betriebsstätte', <http://www.ihk-koeln.de/upload/ErrichtungEinerZweigniederlassung_2018_12304.pdf>, Januar 2018.
26. In German: *Handelsgesetzbuch*.
27. K.J. Hopt, '§13', in *Handelsgesetzbuch*, ed. A. Baumbach & K.J. Hopt (München: Verlag C. H. Beck, 38th Edition 2018), s. 13 no. 4.
28. See the GTC, s. 149, the ITA, s. 25, the CITA, s. 31 and the TTA, s. 14a.
29. See the GTC, s. 138(2) no. 1.
30. See the CC, s. 238(1) and 325a and the GTC, s. 140.
31. See GTC, s. 141(1) subs 1 no. 1-5.

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20 Since the German tax authorities lack jurisdictional competency to conduct investigations abroad, the cross-border transfer of assets and functions is accompanied by a duty to cooperate with the tax authorities.[32] This duty entails the obligation to clarify and explain any tax-relevant facts and circumstances and to provide any documentary evidence necessary for such clarification and explanation.[33] This duty of disclosure also applies to the income determination of domestic PEs.[34] The documentation to be provided includes:

- general information on shareholding relationships, the business itself and its organizational structure;
- business relationships with related parties;
- a function and risk analysis;
- an analysis of transfer prices;
- additional information (where necessary).[35]

21 Since a PE does not possess its own legal personality, it cannot enter into any contractual relationships with its head office. Therefore, no written agreements relating to contractual relationships between PE and the head office would exist to document the transfer prices used. Nevertheless, intra-company regulations and guidelines can serve to document the allocation of functions and assets between the head office and PE.[36] The recent legislative amendments mentioned earlier in this section might affect the disclosure obligations with regard to PEs in the future.

22 Should the taxpayer fail to fulfil their disclosure obligations, the tax authorities are allowed to estimate any figures that should have been, but were not, provided by the taxpayer.[37] Where the taxpayer fails to document the profit allocation between the domestic head office and a foreign PE or between a foreign head office and a domestic PE, the tax authority is permitted to estimate the taxable income at the most disadvantageous end of an arm's-length range.[38]

23 Failure to fulfil compliance obligations can also result in financial penalties. If the taxpayers do not file their annual tax return within the statutory time limit, a late filing penalty of up to of the income tax liability or the trade tax assessment base can be applied, but may not exceed EUR 25,000.[39]

24 The financial penalties resulting from non-compliance with the duty of disclosure in regard to the cross-border profit allocation between head office and PE can be significantly higher than the late filing penalty. If the taxpayer does not provide the appropriate

32. O. Busch, 'Amtsermittlungs- und Mitwirkungspflichten', in *Betriebsstätten Handbuch*, ed. F. Wassermeyer, U. Andresen & X. Ditz (Köln: Verlag Dr. Otto Schmidt, 2018), 929, no. 13.58.
33. See the GTC, s. 90(2).
34. See the GTC, s. 90(3) sentence 4.
35. Ordinance on the nature, content and extent of documentation required under s. 90 subs. 3 GTC, 12 Jul. 2017, Federal Law Gazette I 2017, 2367. (*Gewinnabgrenzungsaufzeichnungsverordnung*).
36. O. Busch, 'Amtsermittlungs- und Mitwirkungspflichten', in *Betriebsstätten Handbuch*, ed. F. Wassermeyer, U. Andresen & X. Ditz (Köln: Verlag Dr. Otto Schmidt, 2018), 971, no. 13.113.
37. See the GTC, s. 162(1).
38. See the GTC, s. 162(3).
39. See the GTC, s. 152(2).

documentation or the documents provided are in material aspects of no use, the penalty will amount to 5%–10% of the surplus amount resulting from the tax adjustment (but not less than EUR 5,000).[40] If the taxpayer provides usable documentation after the due date, the penalty will amount to up to EUR 1,000,000 (at least EUR 100 for each day after the due date).[41]

[D] Tax Rulings

25 The German General Tax Code[42] (GTC) allows taxpayers to apply for a binding ruling on specific legal questions relating, *inter alia*, to the existence of a PE for German tax purposes.[43] However, binding rulings can be costly. The amount of the fee depends on the value in question (*Gegenstandswert*), which is in turn calculated according to the potential fiscal effects of the fact situation posed by the taxpayer.[44] The fees for the advance ruling are currently capped at EUR 109,736. Where the value in question cannot be estimated by the tax authorities, the fees are calculated using a rate of EUR 50 for each thirty minutes spent by the tax authorities (minimum of EUR 100).[45] The advance ruling is binding for the tax authorities as long as the actual implementation of the proposed fact situation does not significantly differ from the fact situation proposed by the taxpayer during the binding ruling process. The binding ruling does not, however, bind the courts and will expire if any of the relevant legal provisions are modified.[46]

26 Moreover, bilateral and multilateral advance pricing agreements (APAs) based on the provisions of tax treaties are available for the issue of allocation of earnings and expenses between a foreign head office and a domestic PE as well as between a German head office and a foreign PE. Unilateral APAs are not available. Nevertheless, if a German tax resident enters into a unilateral APA with foreign tax authorities, it may be accepted by the German tax authorities, provided that the tax authority is able, without significant effort, to ascertain that accepting the unilateral APA would not harm domestic fiscal interests.[47]

27 The basic fee for entering into an APA is EUR 20,000, with amendments to the APA costing EUR 10,000, and extensions EUR 15,000.[48] As with advance rulings, APAs are binding on the tax authorities, but not on the courts.[49] The duration of an APA should be between three and five years.[50]

40. See the GTC, s. 162(4) sentence 1.
41. See the GTC, s. 162(4) sentence 3.
42. In German: *Abgabenordnung*.
43. See the GTC, s. 89(2).
44. H. Fittkau, 'Beratung, Auskunft', in *Abgabenordnung Kommentar*, ed. H. Pump & W. Leibner (Köln: Wolters Kluwer Deutschland, 2008), AO s. 89 no. 63.
45. See the GTC, s. 89(6).
46. Ordinance, 30 Nov. 2007, Federal Law Gazette I 2007, 2783 (*Steuer-Auskunfts-Verordnung*).
47. FMF, 5 Oct. 2006, IV B 4 – S1341 – 38/06, Federal Tax Gazette I 2006, 594, no. 1.2.
48. See the GTC, s. 178a(2).
49. G. Rosenbach, 'Rechtsschutzmöglichkeiten gegen Verständigungsvereinbarungen in der Praxis', *Praxis Internationale Steuerberatung* 6 (2004): 150.
50. FMF, 5 Oct. 2006, IV B 4 – S1341 – 38/06, Federal Tax Gazette I 2006, 594, no. 2.8.

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§8.03 DEFINITION OF 'PE'

[A] Definition of PE According to Domestic Law: General Definition

28 The term 'PE' is equivalent to the German word '*Betriebsstätte*'. Section 12 of the GTC defines a PE as a fixed place of business or a facility serving the business of an enterprise. Although it is not clear whether there is a minimum time period required for a PE to exist,[51] the prevailing opinion, influenced by relevant jurisprudence, sees a minimum time requirement of six months.[52] This six-month threshold is also mentioned in the relevant administrative guidelines.[53]

29 In addition, the term 'fixed' in the PE definition also indicates a requirement of geographic stability. According to relevant jurisprudence, a place of business or a facility is fixed if it has a permanent connection to the ground or is located for a certain period at a specific place.[54] A physical link to the ground is not necessary. In this sense, mobile facilities located for a certain time at a specific place can constitute a PE.[55]

30 Moreover, the place of business has to be (not merely temporarily) at the taxpayer's disposal. Nevertheless, this does not necessarily require the taxpayer to be the owner of the facility.[56] According to the jurisprudence, it is sufficient if the taxpayer enters a legal position which cannot be simply changed or cancelled without the taxpayer's cooperation.[57]

31 Additionally, the fixed place of business has to serve the activity of the enterprise. The term 'enterprise' refers not only to business enterprises but also to independent professional activities and farming and forestry.[58] The establishment is considered to serve the activity of the enterprise if it is used for the purpose of the enterprise.[59]

32 The domestic definition of a PE includes in particular the following non-exhaustive list of examples:

(1) the place of business management;
(2) branches and offices;
(3) factories or workshops;
(4) warehouses;
(5) purchasing offices or sales outlets;

51. A. Musil, '§12 Betriebsstätte', in *Kommentar zur Abgabenordnung und Finanzgerichtsordnung*, ed. W. Hübschmann, E. Hepp & A. Spitaler (Köln: Verlag Dr. Otto Schmidt, 246th Supplement), AO s. 12 no. 15.
52. *Finanzgericht* (Lower Financial Court) Münster, 6 Nov. 2000, 9 K 6931/98 K, Decisions of the Financial Courts 4 (2001), 234.
53. FMF, 24 Dec. 1999, IV B 4 – S 1300 – 111/99, Federal Tax Gazette I 1999, 1078, no. 1.1.1.1.
54. FFC, 30 Oct. 1996, II R 12/92, Federal Tax Gazette II 1997, 14.
55. FMF, 2 Jan. 2008, IV A 4 – S 0062/07/0001, Federal Tax Gazette I 2008, 26, §12 – Betriebsstätte no. 2.
56. A. Musil, '§12 Betriebsstätte', in *Kommentar zur Abgabenordnung und Finanzgerichtsordnung*, ed. W. Hübschmann, E. Hepp & A. Spitaler (Köln: Verlag Dr. Otto Schmidt, 246th Supplement), s. 12 AO no. 16.
57. FFC, 30 Oct. 1996, II R 12/92, Federal Tax Gazette II 1997, 14.
58. FMF, 2 Jan. 2008, IV A 4 – S-0062/07/0001, Federal Tax Gazette I 2008, 26, §12 – Betriebsstätte no. 1.
59. FFC, 30 Oct. 1996, II R 12/92, Federal Tax Gazette II 1997, 14.

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(6) mines, quarries or other stationary, moving or floating facilities for the exploration of natural resources;
(7) building sites or constructions or installation projects, including those moving or floating, where:
- an individual building site or construction or installation project; or
- one of several coexistent building sites or constructions or installation projects; or
- a number of immediately successive building sites or constructions or installation project

last(s) more than six months.[60]

33 It is worth mentioning that the minimum period of six months is only relevant for building and installation sites. Therefore, as noted earlier in this chapter, an ongoing analysis of relevant jurisprudence and administrative guidelines is useful in determining the minimum period required for a PE to exist.

34 Unlike in the OECD Model Tax Convention on Income and on Capital (OECD MTC), the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise has not been excluded from the scope of the domestic PE definition, since the latter includes a warehouse.[61] However, the maintenance of a stock of goods or merchandize belonging to the enterprise solely for the purpose of storage, display or delivery will not meet the criteria of a PE if the enterprise does not have a permanent facility which could be recognized as a warehouse at its disposal. Similarly, the maintenance of a stock of goods or merchandize belonging to the enterprise solely for the purpose of processing by another enterprise will not constitute a PE unless there is a facility which could be considered to be a warehouse of the enterprise.

35 The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandize or collecting information for the enterprise has not been excluded from the scope of the PE definition in the domestic German tax law. While purchasing offices or sales outlets are explicitly mentioned in the definition, it can be generally assumed that a fixed place of business for the purpose of collecting information also meets the criteria of a PE as long as the collection of information serves the business of the enterprise. It is irrelevant whether it is considered a major or an auxiliary activity.[62] Still, attention should be paid to the time and geographic stability requirements and whether the business is at the disposal of the taxpayer. Places of business which are a combination of the elements mentioned above can be treated as a PE, even if in such combination the activity of the fixed place of business is of a preparatory or auxiliary character. On the contrary, an Internet website, essentially a collection of electronic data, cannot be perceived as tangible property and therefore does not meet the fixed place of business criterion included in the domestic PE definition.[63]

60. See the GTC, s. 12.
61. M. Puls, *Die Betriebsstätte im Abgaben- und Abkommensrecht* (Köln: Carl Heymanns Verlag, 2005), 133.
62. *Bundesverwaltungsgericht* (Federal Administrative Court), 4 Aug. 1993, 11 C 36.9, Federal Tax Gazette II 1994, 139.
63. S. Bernütz, 'Ertragsbesteuerung grenzüberschreitender Internet-Transaktionen: Anknüpfung

36 To sum up, there are considerable differences between the domestic PE definition and the treaty definition. Although both definitions include time, geographic stability and power of disposal requirements and provide examples that are almost identical, Article 5(4) of the OECD MTC includes a list of fact situations that cannot be regarded as constituting a PE. In this sense, activities of an auxiliary character are excluded from the PE definition of the treaty, but can still be considered a PE under the provisions of German domestic tax law.[64] Unlike the domestic PE definition, Article 5(5) of the OECD MTC indicates that an agent can constitute a PE. According to the GTC, a permanent representative[65] is a separate trigger for non-resident tax liability, apart from the PE concept.[66]

[B] Double Tax Conventions

37 **General deviations of the DTCs from the OECD MTC.** Generally, the German treaty practice follows the Article 5 of the OECD MTC. In most cases, the deviations do not have any substantive relevance.[67]

38 A place of business can only be considered permanent if it is intended to serve the activity of the enterprise with a certain temporal consistency.[68] However, the term 'fixed' is not explicitly defined in the DTCs. Expressions that are not defined in the treaty have to be interpreted in accordance with the domestic tax law of the contracting state (Germany), unless 'the context otherwise requires'.[69] For this reason, the term 'fixed' would have the same meaning as it has under the domestic PE definition. However, the domestic concept of time requirements is influenced by the fact that the German PE definition includes the minimum duration of six months in case of building sites.[70] Consequently, the minimum duration of twelve months for building sites mentioned in Article 5(3) of the OECD MTC could serve as a basis for determining the time requirements for a PE under the DTCs.[71] Nevertheless, in the prevailing opinion, the twelve-month period refers only to the special case of building sites.[72] This means that a shorter period of time (for instance more than six months) could be sufficient to meet the time requirements. The crucial criterion (with the exception of building sites or constructions or installation projects) is the expected, not actual, duration of the establishment.[73]

39 As in the domestic PE definition, the term 'fixed' also indicates a requirement of geographic stability. Again, the expression needs to be interpreted according to the German tax law since it has not been explicitly defined in the DTCs. Therefore, an establishment is fixed if it has a permanent connection to the ground and is located for a certain period at a specific place.[74] A physical link to the ground is not necessary. In this sense, mobile facilities (such as market stands) located for a certain time at a specific place can also be considered a PE.[75]

40 Furthermore, the establishment must be at the disposal of the taxpayer.[76] This criterion has to be interpreted consistently with its interpretation under the domestic tax law provisions (see §8.03[A] above).

41 The domestic PE definition requires that the PE serves the business of the enterprise, while Article 5(1) of the OECD MTC demands that the business of the enterprise is wholly or partly carried on through the PE. In this regard, some authors interpret the activity threshold under tax treaty provisions to be higher than under domestic tax law.[77] Nevertheless, according to the tax authorities, the expressions should be interpreted in the same way.[78] The term 'enterprise' in the tax treaty provisions, however, should be understood differently than under the domestic PE definition. In this sense, the PE definition of the German tax treaties does not include independent professional activities as well as farming and forestry, since these categories of income are usually covered by separate treaty provisions. However, a few German tax treaties (for instance the treaty with the USA) do not include any separate articles regarding independent professional activities. In this case, the income from such activities qualifies as business profits for tax treaty purposes.[79] Also the concept of a deemed trade or business under German tax law should not fulfil the requirements of the term 'profits of an enterprise' in the tax treaty provisions.[80]

42 Similar to Article 5(2) of the OECD MTC, the PE definition in the German DTCs usually covers the following examples:

- a place of management;
- a branch;

an eine deutsche Betriebsstätte?', *Internationales Steuerrecht* 12 (1997): 355.

64. M. Puls, *Die Betriebsstätte im Abgaben- und Abkommensrecht* (Köln: Carl Heymanns Verlag, 2005), 133.
65. According to s. 13 GTC, a permanent representative shall mean any person who conducts the business of an enterprise in a sustained manner and, in so doing, is subject to its instructions. In particular, permanent representative shall mean any person who, in a sustained manner, on behalf of an enterprise: (1) concludes or brokers contracts or solicits orders, or (2) maintains a stock of goods or merchandise and makes deliveries from this stock.
66. See the GTC, s. 13.
67. A. Fresch & G. Strunk, 'Art. 5 OECD MTC', in *Außensteuergesetz Doppelbesteuerungsabkommen Kommentar*, ed. G. Strunk, B. Kaminski & S. Köhler (Bonn: Stollfuß Medien, 49th Supplement), Art. 5 OECD-MTC no. 81.
68. A. Fresch & G. Strunk, 'Art. 5 OECD MTC', in *Außensteuergesetz Doppelbesteuerungsabkommen Kommentar*, ed. G. Strunk, B. Kaminski & S. Köhler (Bonn: Stollfuß Medien, 49th Supplement), Art. 5 OECD-MTC no. 52.
69. See the OECD MTC, Art. 3(2).
70. FFC, 30 Oct. 1973, I R 50/71, Federal Tax Gazette II 1974, 109.
71. L. Rehfeld, 'Art. 5 OECD MTC', in *DBA-Kommentar*, ed. Gosch, Kroppen, Grotherr, Kraft (Berlin: Verlag Neue Wirtschafts-Briefe, 2017), Art. 5 OECD MTC no. 78.
72. M. Görl, 'Artikel 5. Betriebsstätte', in *Doppelbesteuerungsabkommen Kommentar*, ed. K. Vogel & M. Lehner (München: Verlag C.H. Beck, 2015), Art. 5 MTC no. 19.
73. F. Wassermeyer, 'Art. 5 MTC', in *Doppelbesteuerung*, ed. F. Wassermeyer (München: Verlag C.H. Beck, 72th Edition, 140th Supplement), Art. 5 MTC no. 37a.
74. Federal Administrative Court, 4 Aug. 1993, 11 C 36.93, Federal Tax Gazette II 1994, 139.
75. FFC, 8 Mar. 1988, VIII R 270/81, FFC Not Published (NP) 11 (1988), 736.
76. L. Rehfeld, 'Art. 5 OECD MTC', in *DBA-Kommentar*, ed. Gosch, Kroppen, Grotherr, Kraft (Berlin: Verlag Neue Wirtschafts-Briefe, 2017), Art. 5 OECD MTC no. 93.
77. A. Musil, '§12 Betriebsstätte', in *Kommentar zur Abgabenordnung und Finanzgerichtsordnung*, ed. W. Hübschmann, E. Hepp & A. Spitaler (Köln: Verlag Dr. Otto Schmidt, 246th Supplement), AO s. 12 no. 47a.
78. FMF, 24 Dec. 1999, IV B 4 – S 1300 – 111/99, Federal Tax Gazette I 1999, 1081, no. 1.2.1.1.
79. A. Hemmelrath, 'Artikel 14. Selbständige Arbeit', in *Doppelbesteuerungsabkommen Kommentar*, ed. K. Vogel & M. Lehner (München: Verlag C.H. Beck, 2015), Art. 14 no. 45.
80. FFC, 28 Apr. 2010, I R 81/09, FFC NP (2010), 1550; FFC, 19 May 2010, I R 191/09, Federal Tax Gazette II 2011, 156.

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- an office;
- a factory;
- a workshop; and
- a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

43 As mentioned above, German tax treaties do not contain minimum time requirements for the existence of a PE (apart from special cases like building sites).

44 German tax treaties also contain a list of examples that have been explicitly excluded from the scope of the PE definition (analogous to Article 5(4) of the OECD MTC):

- the use of facilities solely for the purpose of storage, display or delivery of goods or merchandize belonging to the enterprise;
- the maintenance of a stock of goods or merchandize belonging to the enterprise solely for the purpose of storage, display or delivery;
- the maintenance of a stock of goods or merchandize belonging to the enterprise solely for the purpose of processing by another enterprise;
- the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandize or of collecting information for the enterprise;
- the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- the maintenance of a fixed place of business solely for any combination of activities mentioned above, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

45 However, some of the German tax treaties contain deviations from the OECD MTC. For instance, a large number of German treaties do not specify that a combination of the activities mentioned above will not cause a PE to exist.[81]

46 Based on the explanations above, it is apparent that an internet web site as intangible property cannot be considered to be a fixed place of business for tax treaty purposes.[82] In the same manner, the courts have denied the existence of a PE in the following cases:

- a company split-up (*Betriebsaufspaltung*);[83]
- film production;[84]
- leasing of business (*Betriebsverpachtung*);[85]
- deep-freezer in supermarket provided by the food manufacturer;[86]
- ships.[87]

81. A. Fresch & G. Strunk, 'Art. 5 OECD MTC', in *Außensteuergesetz Doppelbesteuerungsabkommen Kommentar*, ed. G. Strunk, B. Kaminski & S. Köhler (Bonn: Stollfuß Medien, 49th Supplement), Art. 5 OECD MTC no. 162.
82. C. Watrin, 'Betriebsstättenbesteuerung im Electronic Commerce und die ökonomische Theorie der Firma', *Internationales Steuerrecht* 14 (2001): 425.
83. FFC, 10 Jun. 1966, VI B 31/63, Federal Tax Gazette III 1966, 599.
84. FFC, 30 Oct. 1973, I R 50/71, Federal Tax Gazette II 1974, 109.
85. FFC, 16 Aug. 1962, I B 223/61, Federal Tax Gazette III 1962, 478.
86. FFC, 17 Jan. 1968, I B 41/65, undisclosed; F. Wassermeyer, 'Art. 5 MA', in *Doppelbesteuerung*, ed. F. Wassermeyer (München: Verlag C.H. Beck, 72th Edition, 140th Supplement), Art. 5 MA no.

87. FFC, 26 Aug. 1987, I R 376/83, Federal Tax Gazette II 1988, 202.

[C] Implication of BEPS

47 At the end of January 2016, an EU Anti-Tax Avoidance Package was presented by the EU-Commission. Political agreement was reached in mid-June 2016 as regards the Anti-Tax Avoidance Directive (EU-ATAD), which is part of the 'package'. The EU-ATAD entered into force in August 2016. In May 2017, the EU's Council adopted a directive amending the EU-ATAD primarily with respect to hybrid mismatches which expands the scope of the rules to hybrid mismatches with respect to third countries and to cases involving PEs (ATAD II) The member states of the EU shall adopt and publish, by 31 December 2019, the laws, regulations and administrative provisions necessary to comply with ATAD II; with regard to Article 9a (reverse hybrid mismatches), the deadline shall be 31 December 2021. The EU member states shall apply those provisions from 1 January 2020 (with respect to Article 9a from 1 January 2022).

48 In the OECD-report various selected changes relating to Art. 5 of the MTC and the underlying commentaries are suggested. The OECD seems to tend to lower the preconditions under which a PE may be assumed in order to also cover: (i) activities lacking physical presence, (ii) structures falling under the exceptions listed in the OECD MTC, and (iii) commissionaire arrangements.

49 The German government supports the work to adjust the current definition of a PE and has in part already implemented the OECD-recommendations in its revised tax treaty with Australia (2015) which is applicable from 1 January 2017 onwards, but nevertheless further continues to ask for a 'minimum standard' for tax purposes.

50 The OECD released in July 2016 a 400-page discussion draft for public comments highlighting the importance of developing guidance that would be relevant for all countries, regardless of their approach to attributing profits to PEs. Since commentators identified a number of issues in the draft guidance which required further clarification, the OECD published a new discussion draft in June 2017. This new discussion draft sets out high-level general principles for the attribution of profits to PEs in the circumstances addressed by the OECD report on BEPS Action 7. Importantly, countries agree that these principles are relevant and applicable in attributing profits to PEs. Among others, the new discussion draft cover PEs arising from Article 5(5) of the OECD MTC, including examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. On 4 October 2017, the OECD published its comments received on public discussion draft. Half a year later, in March 2018, the OECD released its final report on "Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7". Besides the consideration of the content of and comments on the two mentioned public discussion drafts, the report includes additional guidance related to PEs created as a result of the changes to Article 5(4) of the OECD MTC, and provides an example on the attribution of profits to PEs arising from anti-fragmentation rule.

51 The OECD Inclusive Framework on BEPS (a group of 113 countries) issues its paper "Tax Challenges Arising from Digitalization – Interim Report 2018" on 16 March 2018, as individual countries recognized dissatisfying changes in their grow due to the allocation of taxing rights under the longstanding (and recently strengthened) international

tax framework in a digital world. The report shows comprehensive ideas related to the corporate taxation of a significant digital presence. The profit attribution guidelines are however considered unclear and thus additional work would be required at the international level to limit the instances of double taxation. One week later, on 22 March 2018, the European Commission issued two proposals for a directive on the corporate taxation of a significant digital presence and on a common system of a digital tax on income derived from certain digital services respectively. It remains to be seen if international agreement can be reached swiftly on new basis of taxation (and new attribution rules thereto).

[D] Special Cases

52 **Services PE.** The OECD Commentary on Article 5 of the OECD MTC introduces the concept of a 'service PE' which refers to the regular physical presence of a contractor (or the contractor's employees) in the client's premises even if such person does not have a fixed establishment at their disposal. According to German jurisprudence, a PE basically cannot be found by the usage of the facilities of the principal.[88] In contrast, the Ministry of Finance of Baden-Württemberg issued a decree in which it stated its position that usage of the client's office would provide sufficient basis for a PE.[89] This position is disputed by the prevailing view in the professional tax law literature which holds that the described circumstances do not meet the criteria of a fixed place of business under the domestic PE definition or under the treaty definition.[90] This view is supported by the fact, that the Federal Republic of Germany has officially rejected the interpretation contained in No. 17 of the OECD Commentary on Article 5 of the OECD MTC (so-called 'Painter Example').[91] The same tendency can be found in a statement by the Ministry of Finance of Karlsruhe[92] that service PEs are not to be recognized, neither for domestic nor for treaty purposes. Hence, said statement deliberately interprets the definition of a PE from a domestic and treaty perspective restrictively as more outbound than inbound cases tend to be recorded in Germany. Even though there is no formal agreement with the other German federal tax authorities, on informally shares the same view.

53 Nevertheless, the tax treaties with China, Philippines and Liberia contain the concept of a service PE.[93] Under provisions of these treaties a PE can also be assumed if the employees or other personnel of the enterprise provide services in the other contracting state and the duration of their activity for the individual (or related) project exceeds six months during a twelve-month period. In this case, a fixed place of business is not necessary to constitute a PE.[94]

88. FFC, 11 Oct. 1989, I R 77/88, Federal Tax Gazette I 1990, 166; FFC, 4 Jun. 2008, I R 30/07, Federal Tax Gazette II 2008, 922.
89. Ministry of Finance of Baden Württemberg, 14 Mar. 1983, S 1301 A – Schweiz – 5/71, Beck DBA-Textausgabe, DBA-Allgemein Nr. 5.1.
90. A dissenting opinion: F. Wassermeyer, 'Art. 5 MA', in *Doppelbesteuerung*, ed. F. Wassermeyer (München: Verlag C.H. Beck, 72th Edition, 140th Supplement), Art. 5 MA no. 42b.
91. See the OECD Commentary on Art. 5 of the OECD MTC 2017, no. 178.
92. Ministry of Finance of Karlsruhe, 16. Sep. 2014, S 130.1/316-St 222.
93. T. Hackemann & M. Pfaar, 'Art. 5 China', in *Doppelbesteuerung*, ed. F. Wassermeyer (München: Verlag C.H. Beck, 72th Edition, 140th Supplement), Art. 5 China no. 24.
94. M. Görl, 'Art. 5. Betriebsstätte', in *Doppelbesteuerungsabkommen Kommentar*, ed. K. Vogel & M. Lehner (München: Verlag C.H. Beck, 2015), Art. 5 no. 73.

54 **Agents PE.** According to the provisions of the OECD MTC, the activity of a dependent agent who has the authority to conclude contracts in the name of the enterprise and habitually exercises this authority can constitute a PE of the enterprise provided that the agent's activity is not limited to those listed in Article 5(4) of the OECD MTC.[95] On the contrary, an independent agent acting in the ordinary course of their business will not create a PE.[96] For this reason, it is very important to distinguish between a dependent and independent agent for tax treaty purposes.

55 The independence of the agent has to be examined in a legal and economic sense.[97] According to relevant jurisprudence, the decisive criterion is 'personal independence' as defined for the German trade tax law purposes.[98] Accordingly it is crucial to determine whether the agent bears their own entrepreneurial risk by, for example, being remunerated on a contingent fee basis instead of a fixed basis.[99] A group affiliation does not prevent an agent from being independent.[100] In the same sense, an agent that operates for only one principal is not necessarily a dependent agent, provided that they carry on their own economic activity.[101]

56 There can be cases where a person is both an independent and a dependent agent. Because an independent agent will not constitute a PE only when acting in the ordinary course of their business (Article 5(6) of the OECD MTC) it is crucial to determine the scope of the agent's business and occupational image according to trade practice[102] and to determine whether the agent has acted within the bounds of that scope. Consequently, where a commission agent closes additional contracts on behalf of a principal, a domestic PE might be assumed.[103]

57 Unlike under the provisions of the OECD MTC, neither a dependent nor an independent agent will constitute a PE under German domestic tax law. However, an agent can trigger non-resident tax liability in its own right, separate from the PE issue.[104] This distinction is particularly important for the purpose of trade tax liability because a non-resident taxpayer can be subject to trade tax by virtue of having a PE in Germany, but not by having a permanent agent in Germany.[105] The distinction between an independent and a dependent agent is largely irrelevant for purposes of the domestic agent definition.[106] However, where no tax treaty exists, the German tax authority would also

95. See the OECD MTC, Art. 5(5).
96. See the OECD MTC, Art. 5(6).
97. See the OECD Commentary on Art. 5 of the OECD MTC 2017, no. 104.
98. FFC, 23 Sep. 1983, III R 76/81, Federal Tax Gazette II 1984, 96.
99. L. Rehfeld, 'Art. 5 OECD MTC', in *DBA-Kommentar*, ed. H. Gosch, Kroppen, Grotherr, Kraft (Berlin: Verlag Neue Wirtschafts-Briefe, 2017), Art. 5 OECD MTC no. 233.
100. FFC, 14 Sep. 1994, I R 116/93, Federal Tax Gazette II 1995, 240.
101. FFC, 14 Sep. 1994, I R 116/93, Federal Tax Gazette II 1995, 240.
102. FFC, 14 Sep. 1994, I R 116/93, Federal Tax Gazette II 1995, 240.
103. D. Endres, 'Die Vertreterbetriebsstätte im Konzern', *Internationales Steuerrecht* 1 (1996): 4.
104. Section 13 of the GTC.
105. M. Frotscher, '§13 Ständiger Vertreter', in *Abgabenordnung Praxis Kommentar*, ed. B. Schwarz, A. Pahlke (Freiburg: Rudolf Haufe Verlag, 2016), s. 13 no. 4.
106. K.-D. Drüen, '§13 Ständiger Vertreter', in *Abgabenordnung Finanzgerichtsordnung Kommentar*, ed. K. Tipke & H.W. Kruse (Köln: Verlag Dr. Otto Schmidt, 151th Supplement 02/2018), s. 13 no. 5.

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apply the provisions of Article 5(6) of the OECD MTC.[107] Therefore, the activity of an independent agent acting in the ordinary course of their business will not establish non-resident tax liability.

58 **Server PE.** According to the prevailing opinion, the presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business as long as no personnel is in fact required. In this sense, automatic or mechanical facilities can constitute a PE.[108] This also applies to the PE definition in the tax treaties.[109]

59 Theoretically, these principles also apply to electronic commerce. The problem, however, is that such activities are carried on by electronic means, which makes it difficult to decide whether the time, geographic stability, power of disposal and functionality requirements necessary for the establishment of a PE, have been met.

60 In this sense, it has not yet been clarified under what circumstances a server can be perceived as a PE under the domestic and the tax treaty definitions.[110] In the prevailing opinion, an Internet server can be considered to be a fixed place of business if it meets the criteria mentioned in §8.03[A]. A server owned by an enterprise is indisputably at the disposal of the enterprise.[111] Under German tax law, the facility serves the business of the enterprise, whether its activity is of a major or merely an auxiliary character.[112]

61 On the other hand, an activity of a preparatory or auxiliary character is insufficient to establish a PE under the tax treaty provisions.[113] Therefore it is important to determine what kind of activity is carried out by the server. Many of the activities typically carried out by the server, like advertising, can be perceived as auxiliary.[114] Still, in the prevailing opinion a server can constitute a PE if it carries out the core functions of the enterprise.[115]

62 **Affiliated companies as PE.** Almost all German DTCs include a clause equivalent to Article 5(7) of the OECD MTC.[116] Domestic German tax law does not contain such a clause. Nevertheless, it is generally accepted that under domestic law and under the provisions of a tax treaty a subsidiary will not constitute a PE on behalf of its parent by the mere fact of its affiliation with the parent.[117]

107. Income Tax Regulations (*Einkommensteuer-Richtlinien*) 2012, R 49.1(1).
108. FFC, 30 Oct. 1996, II R 12/92, Federal Tax Gazette II 1997, 14.
109. A. Fresch & G. Strunk, 'Art. 5 OECD MTC', in *Außensteuergesetz Doppelbesteuerungsabkommen Kommentar*, ed. G. Strunk, B. Kaminski & S. Köhler (Bonn: Stollfuß Medien, 49th Supplement), Art. 5 OECD-MTC no. 48.
110. A. Musil, '§12 Betriebsstätte', in *Kommentar zur Abgabenordnung und Finanzgerichtsordnung*, ed. W. Hübschmann, E. Hepp & A. Spitaler (Köln: Verlag Dr. Otto Schmidt, 246th Supplement), s. 12 AO no. 43a.
111. A. Fröhlich, 'AO §12', in *Abgabenordnung Kommentar*, ed. H. Pump & W. Leibner (Köln: Wolters Kluwer Deutschland, 2008), AO s. 12 no. 48.
112. FFC, 8 Dec. 1971, I R 3/69, Federal Tax Gazette II 1972, 290.
113. Article 5(4) of the OECD MTC.
114. H. W. Arndt & T. Fetzer, 'Ein Internetserver im Ausland – ein Fall des §42 AO?', *Betriebs-Berater* 23 (2001): 1176.
115. C. Watrin, 'Betriebsstättenbesteuerung im Electronic Commerce und die ökonomische Theorie der Firma', *Internationales Steuerrecht* 14 (2001): 429.
116. A. Fresch & G. Strunk, 'Art. 5 OECD MTC', in *Außensteuergesetz Doppelbesteuerungsabkommen Kommentar*, ed. G. Strunk, B. Kaminski & S. Köhler (Bonn: Stollfuß Medien, 49th Supplement), Art. 5 OECD-MTC no. 167.
117. FFC, 29 Aug. 1984, I R 154/81, Federal Tax Gazette II 1985, 161.

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However, it is possible for a subsidiary to act as an agent of its parent company.[118] This is always the case if the subsidiary meets the criteria of section 13 of the GTC, for domestic tax law purposes, and Article 5(5) of the OECD MTC for tax treaty purposes. In this context, German courts have decided that a group affiliation does not necessarily lead to an assumption of dependence of an agent.[119] 63

An agent PE constitutes only a substitute taxable event in relation to a fixed place of business under tax treaty provisions. Therefore, if a taxpayer has a fixed place of business at their disposal, the activity of an agent carried on in that place will lead to a PE (as long as Article 5(4) of the OECD MTC is not applicable), whether or not the agent is independent or has the authority to conclude contracts in the name of that person.[120] Conversely, the parent company will not have a PE if the parent company simply receives an economic benefit from services provided by the subsidiary as a part of its own business carried on in premises that are not those of the parent company.[121] Such activities are only attributable to the subsidiary, unless it can be considered to be an agent within the meaning of Article 5(5) of the OECD MTC.[122] 64

Under domestic tax law, the requirements for a PE are fulfilled even if the taxpayer engages an independent subcontractor (for instance an affiliated company) who carries out an activity in the taxpayer's fixed establishment. However, the activity of the subcontractor can only serve the activity of the enterprise if the subcontractor is bound by instructions and is subject to inspection by the employees of the enterprise.[123] 65

Building site PE. Building sites or constructions or installation projects (*Bauausführungen oder Montagen*) are expressly included in the domestic PE definition as well as in the German tax treaties. According to the domestic law, the minimum period for building sites or constructions or installation projects is six months while under the majority of the German tax treaties the minimum period amounts to twelve months. Some treaties include a shorter period of six or nine months.[124] 66

Section 12 No. 8 of the GTC deals with the case where one taxpayer maintains two or more building sites in the same country consecutively and each building project alone does not exceed the minimum period of six months. Even with a gap of two weeks in between two separate projects a PE may exist if the second project had been planned by the time the first project ended.[125] Similarly, if two projects start simultaneously and one ends before the minimum period has expired, while the other one exceeds this period, 67

118. M. Puls, *Die Betriebsstätte im Abgaben- und Abkommensrecht* (Köln: Carl Heymanns Verlag, 2005), 151.
119. FFC, 14 Sep. 1994, I R 116/93, Federal Tax Gazette II 1995, 240.
120. L. Rehfeld, 'Art. 5 OECD MTC', in *DBA-Kommentar*, ed. Gosch, Kroppen, Grotherr, Kraft (Berlin: Verlag Neue Wirtschafts-Briefe, 2017), Art. 5 OECD-MTC no. 217.
121. See the OECD Commentary on Art. 5 of the OECD MTC, no. 105.
122. M. Görl, 'Artikel 5. Betriebsstätte', in *Doppelbesteuerungsabkommen Kommentar*, ed. K. Vogel & M. Lehner (München: Verlag C.H. Beck, 2015), Art. 5 no. 168.
123. FFC, 13 Nov. 1962, I B 224/61 U, Federal Tax Gazette III 1963, 71.
124. M. Görl, 'Artikel 5. Betriebsstätte', in *Doppelbesteuerungsabkommen Kommentar*, ed. K. Vogel & M. Lehner (München: Verlag C.H. Beck, 2015), Art. 5 no. 74.
125. FFC, 21 Apr. 1999, I R 99/97, Federal Tax Gazette II 1999, 697.

both projects together constitute one single PE.[126] An economic or organizational link between the two projects is not necessary.[127] The two projects can be added together even if the employees or the principal differ.[128]

68 Conversely, under the tax treaty provisions the minimum period applies to each individual building site or construction or installation project.[129] However, two economically and geographically interrelated projects can be considered to be a single unit.[130] According to the tax authorities, a geographical link exists if the straight-line distance between the two construction sites does not exceed 50 km.[131] An economic connection has to be looked for from a functional and organizational perspective.[132] In this regard, the tax authorities cite the example of the construction of a radio network.[133] There are different opinions on whether the identity of principal is necessary in order to have a link between two building sites. Nevertheless, it can generally be assumed that distinct customers (principals) indicate that the building sites should be considered as separate projects for purposes of the application of the tax treaties.[134]

69 **Other.** Based on the explanations above a mobile phone mast set up by a mobile telephone network provider can be considered a PE under domestic tax law since personnel is not required for the carrying out of the activity of the phone mast. Since the core business of the enterprise is carried on through the mobile phone mast, the activity is not merely of an auxiliary character within the meaning of Article 5(4) of the OECD MTC.[135] Therefore, a mobile phone mast constitutes a PE under both domestic law and tax treaties.

70 As mentioned in §8.03[A], the geographic stability of a PE does not necessarily mean the facility has to be physically connected to the ground. In this sense, a portable market stand established every morning at the same location can constitute a PE under tax treaties and domestic law as long as it meets the remaining criteria.[136] Similarly, a broadcasting truck could be considered to be a PE, provided that it is located at a specific place.[137] Nevertheless, it would have to meet the time requirements described in §8.03[A] and §8.03[B].

126. Section 12 no. 8b of the GTC.
127. U. Löwenstein, 'Bauausführungen und Montagen', in *Betriebsstättenbesteuerung*, ed. U. Löwenstein, C. Looks & O. Heinsen (München: Verlag C.H. Beck, 2011), 496, no. 1362.
128. K. Buciek, '§12 AO', in *Abgabenordnung Finanzgerichtsordnung Kommentar*, ed. D. Gosch (Bonn: Stollfuß Medien, 137th Supplement), s. 12 GTC no. 44.1.
129. L. Rehfeld, 'Art. 5 OECD-MTC', in *DBA-Kommentar*, ed. Gosch, Kroppen, Grotherr, Kraft (Verlag Neue Wirtschafts-Briefe, 2017), Art. 5 OECD-MTC no. 154.
130. F. Wassermeyer, 'Art. 5 MTC', in *Doppelbesteuerung*, ed. F. Wassermeyer (München: Verlag C. H. Beck, 72th Edition, 140th Supplement), Art. 5 MTC no. 99.
131. FMF, 24 Dec. 1999, IV B 4 – S 1300 – 111/99, Federal Tax Gazette I 1999, 1096, no. 4.3.5.
132. F. Wassermeyer, 'Art. 5 MTC', in *Doppelbesteuerung*, ed. F. Wassermeyer (München: Verlag C. H. Beck, 72th Edition, 140th Supplement), Art. 5 MTC no. 119.
133. FMF, 24 Dec. 1999, IV B 4 – S 1300 – 111/99, Federal Tax Gazette I 1999, 1096, no. 4.3.5.
134. M. Görl, 'Artikel 5. Betriebsstätte', in *Doppelbesteuerungsabkommen Kommentar*, ed. K. Vogel & M. Lehner (München: Verlag C.H. Beck, 20158), Art. 5 no. 66.
135. U. Löwenstein, 'Telekommunikation', in *Betriebsstättenbesteuerung*, ed. U. Löwenstein, C. Looks & O. Heinsen (München: Verlag C. H. Beck, 2011), 533, no. 1456.
136. K.-D. Drüen, 'Betriebsstätte', in *Abgabenordnung Finanzgerichtsordnung Kommentar*, ed. K. Tipke & H.W. Kruse (Köln: Verlag Dr. Otto Schmidt, 151th Supplement 02/2018), s. 12 GTC no. 9.
137. U. Löwenstein, 'Telekommunikation', in *Betriebsstättenbesteuerung*, ed. U. Löwenstein, C. Looks & O. Heinsen (München: Verlag H. C. Beck, 2011), 535, no. 1462.

[E] Discrepancies between Domestic Law and Tax Treaties

71 In outbound cases, profits received from PE activities are generally tax exempt under tax treaty provisions. However, German domestic tax legislation includes clauses that require the application of the credit method notwithstanding the treaty provisions. These so-called *treaty overrides* are aimed at avoiding low taxation or double non-taxation (so-called white income).

72 In this sense, section 20(2) of the Foreign Tax Act[138] (FTA) negates the tax exemption resulting from a tax treaty if the income received in the foreign PE is 'passive' and is subject to a low rate of taxation in the source state.[139] Section 50d(9) of the ITA also contains a switch-over clause for cases of income qualification conflicts under the applicable tax treaty or if the relevant sort of income is not subject to non-resident taxation under the domestic tax law of the source state.

73 The German Federal Tax Court submitted a request to the German Constitutional Court asking to verify whether a treaty override violates the German Constitution.[140] By decision of 15 December 2015, the Federal Constitutional Court has decided that a treaty override is constitutionally acceptable.[141]

[F] Practical Approach

74 As established by the foregoing PE discussion, it may sometimes be difficult to determine whether or not a PE exists. In particularly difficult cases an application for an advance ruling from the tax authorities is recommended.

§8.04 PROFIT ALLOCATION

[A] Introduction

75 As indicated in §8.02[C], the German legislator has introduced the Authorised OECD Approach (AOA) into German tax law. The German legislator has amended section 1 of the FTA by paragraphs 4 and 5 which now specify the income allocation between headquarter and PE based on the OECD's functional separate entity approach, i.e., the treatment of headquarter and PE as separate legal entities dealing under arm's length conditions. Additionally, section 1 of the FTA was adjusted by a provision in paragraph 6 authorizing the German Federal Ministry of Finance to issue an ordinance which illustrates the application of the AOA in Germany. This ordinance was issued on 13 October 2014.

138. In German: *Außensteuergesetz*.
139. F. Wassermeyer & J. Schönfeld, '§20', in *Außensteuerrecht Kommentar*, ed. H. Flick et al. (Köln: Verlag Dr. Otto Schmidt, 84th Supplement, 3/2018), s. 20 no. 119.
140. FFC, 10 Jan. 2012, I R 66/09, FFC NP 2012, 1056.
141. Federal Constitutional Court, 15 Dec. 2015, 2 BVL 1/12.

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