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Attribution of Profits Derived Before or After the Existence of a Permanent Establishment under Tax Treaty Law

Abstract

The attribution of profits to Permanent Establishments (PE) is one of the most discussed topics in international tax literature, the reason being that the attribution determines the amount of taxation in a PE state. Particular problems arise if such profits are derived before or after the existence of a PE. The article discusses the attribution of such profits under tax treaty law provided for by the OECD Model Tax Convention. In doing so, it is found that profits derived before or after the existence of a PE should be attributed to the PE because not only the wording but also the context and purpose of the OECD Model support this view. In further analysis, however, it is shown that slight changes in the attribution may be expected under the new "Authorized OECD Approach".

Keywords: OECD Model, Permanent Establishment, profit attribution, Authorized OECD Approach

Introduction

If an enterprise maintains a Permanent Establishment (PE) in another state, the allocation of taxing rights for the profits of the enterprise requires the attribution of profits to the PE[1]. This task regularly brings with it practical issues regarding the portion of the profits that is attributable to the PE. An issue of particular relevance is the attribution of such income derived before or after the existence of the PE. Whereas it is generally accepted that a taxpayer must be a resident at the time the treaty is to be applied, it remains unclear to what extent the factual requirements of the distributive rules (Art. 6 through 22 of the OECD Model) need to be fulfilled at that moment[2]. As for PEs, this question becomes relevant due to the fact that the possibility of income derived before or after the existence of a PE is beyond doubt. For example, start-up costs may arise from legal consulting or from planning of the functions of the PE, or even from travel expenses for visits in the future PE state[3]. On the other hand, income may be derived after the termination of the PE due to subsequent price adjustments of income with regard to existing receivables of the PE[4]. Even profit determination based on the accrual principle may lead to income derived before or after the existence of the PE[5]. Although the possibility is not questioned, the issue of attribution of such income under tax treaties is "largely unexplored"[6]. Even the OECD was not able to offer a solution to this issue in its 2010 Report on the Attribution of Profits to Permanent Establishments ("PE Report").

This article investigates the treatment of such income under the Tax Treaty Law as provided for by the OECD Model. In doing so, it will not only deal with attribution under the OECD Model in its original version (up to, and including, the 2010 Update), but also with potential implications through implementation of the Authorized OECD

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[1] See G. Frotscher, *Internationales Steuerrecht*, 4th ed., Verlag C.H. Beck, München 2015, p. 449 et seq.

[2] See F. Wassermeyer, in: F. Wassermeyer, *Doppelbesteuerung: DBA – Kommentar*, 133rd ed., Verlag C.H. Beck, München 2015, Art. 6–22 OECD–MC recital 16; D. Dürrschmidt, *Zeitliche Aspekte der Abkommensanwendung*, "Internationales Steuerrecht" 2015, p. 617 with further references.

[3] See U. Schmitz, in: U. Löwenstein, C. Looks, O. Heinsen, *Betriebsstättenbesteuerung*, 2nd ed., Verlag C.H. Beck, München 2011, recital 1000 et seq; X. Ditz, in: J. Schönfeld, X. Ditz, *Doppelbesteuerungsabkommen – Kommentar*, 1st ed., Verlag Otto Schmidt, Köln 2013, Art. 7 OECD–MC recital 184; F. Wassermeyer, in: F. Wassermeyer, U. Andresen, X. Ditz, *Betriebsstätten-Handbuch*, 1st ed., Verlag Otto Schmidt, Köln 2006, recital 5.2.

[4] See e.g. M. Schenk, S. Oesterhelt, *Timing Issues in the Application of Double Tax Treaties*, "Archiv für Schweizerisches Abgabenrecht" 2014, p. 907.

[5] See F. Wassermeyer, in: Wassermeyer, *Doppelbesteuerung…*, op.cit., Art. 14 OECD–MC recital 87.

[6] J. Wheeler, in: R. Vann et al., *Global Tax Treaty Commentaries*, International Bureau of Fiscal Documentation, Amsterdam 2015, sub 3.1.2.

Approach (AOA). Particular aspects of the influence of the European Union Law, however, will not be addressed in this article.

1. Purpose and Justification of the PE Principle in Art. 7 of the OECD Model

Tax treaties govern the allocation of taxing rights for business profits under Art. 7 of the OECD Model by means of the so-called PE concept[7]. According to this principle, a state may only tax the profits of an enterprise of the other state if the enterprise carries on its business through a PE situated in its territory and, under such conditions, only the portion of the profits that is attributable to the PE. Under this rule, as is the case for distributive rules in general, taxation is justified based on the benefit principle[8]. According to the benefit principle, taxation is justified by the fact that a state supports the generation of income by providing public goods as well as its infrastructure to the taxpayer[9]. In case of an enterprise carrying on its business through a PE in the other state, the enterprise is participating in the economic life of that state[10]. Due to this intense connection to the territory of the host state, all of the profits may be taxed there[11].

As for business activity in the host state, however, it must be considered that an enterprise can carry on its business in the other state without maintaining a PE there. According to the benefit principle, taxation may also be justified in this case because even then, the enterprise benefits from the public goods of that state[12]. Notwithstanding the latter, treaty practice regularly ties the taxing right for business profits to a PE being a *fixed* place of business. This fixed place of business aspect is based on two major considerations being certainty both for taxpayers and for tax officials on the one hand, and enforceability of tax liabilities on the other hand[13]. Insofar, the taxation based on the benefit principle becomes secondary to practicability aspects.

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[7] See e.g. E. Reimer, *Permanent Establishments*, 2nd ed., Kluwer Law International, Alphen aan den Rijn 2015, p. 10 et seq.

[8] See D. Dürrschmidt, op.cit., p. 619.

[9] See W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, "World Tax Journal" 2009, p. 75 et seq, A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle*, 1st ed., Kluwer Law International, Alphen aan den Rijn 1991, p. 24 et seq.

[10] See M. Kobetsky, *Article 7 of the OECD Model: Defining the Personality of Permanent Establishment*, "Bulletin of International Taxation", 2006, p. 411.

[11] See J. Schönfeld, N. Häck, in: J. Schönfeld, X. Ditz, op.cit., Systematik recital 11.

[12] See with regard to the "genuine link", W. Schön, op.cit., p. 100.

[13] See B. Arnold, in: B. Arnold, J. Sasseville, E. Zolt, *The Taxation of Business Profits under Tax Treaties*, 1st ed., ORT, Canadian Tax Foundation, 2003, p. 66; B. Arnold, in: R. Vann et al., op.cit., sub 1.1.2.1. with further references.

2. Treatment of Income Derived Before or After the Existence of a PE under the OECD Model

2.1. No Further Guidance from the 2010 PE Report

Because the OECD provided for detailed guidance on profit attribution to PEs, one may seek to find a solution to the issue at hand in the 2010 PE Report[14]. In fact, the problem of income derived before or after the existence of a PE was identified by the OECD, but without dealing with it by means of an in-depth analysis[15]. Instead, the Report acknowledges that further work would be needed to arrive at a comprehensive consensus on this issue. Even though no solution was provided by the PE Report – the same applies, as far as it can be seen, to the OECD Commentary[16] – the OECD finds it an appropriate approach to offset income with the expenses associated with generating such income[17]. Whereas this statement does not seem to be a binding principle for interpreting a treaty, it can be supported by one of the purposes of tax treaties, i.e., to fairly distribute taxing rights between both contracting states[18]. This purpose would hardly be fulfilled if one state taxed profits caused by a business activity while denying an offset of the expenses related to the activity.

2.2. The Present Tense of Art. 7(1) of the OECD Model

In German-language literature, one argument against the attribution of income derived before or after the existence of a PE is that a taxing right of a host state requires an existent PE there[19]. According to this view, start-up expenses can only be taxed in the state of residence since the conditions of Art. 7(1) of the OECD Model,

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[14] See OECD, *Attribution of Profits to Permanent Establishments*, OECD Publishing, 2010.

[15] Critical T. Hagemann, *Tax Treaty Treatment of Start-Up Expenses in Connection with the Establishment of a PE*, "Intertax" 2015, p. 454; see also O. Heinsen, J. Wendland, *Die steuerliche Behandlung von Gründungsaufwand im Zusammenhang mit der Etablierung einer ausländischen Betriebsstätte* (Zugleich Anmerkung zu BFH, U. v. 26.02.2014 – I R 56/12), GmbH-Rundschau, 2014, p. 1037.

[16] See J. Wheeler, in: R. Vann et al., op.cit., sub 3.3.2.2.2.; P. Plansky, *Die Gewinnzurechnung zu Betriebsstätten im Recht der Doppelbesteuerungsabkommen*, 1st Ed., Verlag Linde Ges. m.b.H, Wien 2010, p. 188: neither explicit nor implicit statements.

[17] See OECD, op.cit., Part I Tz. 221 et seq.

[18] See e.g. K. Vogel, R. Prokisch, *Gerenal Report*, "Cahiers de Droit Fiscal International", Vol. 78a, 1993, p. 72; J. Schönfeld, N. Häck, in: J. Schönfeld, X. Ditz, op.cit., Systematik recital 11.

[19] See e.g. F. Wassermeyer *Die BFH-Rechtsprechung zur Betriebsstättenbesteuerung vor dem Hintergrund des § 1 Abs. 5 AStG und der BsGaV*, "Internationales Steuerrecht" 2015b, p. 37 et seq; with further references; see also X. Ditz, in: J. Schönfeld, X. Ditz, op.cit., Art. 7 OECD–MC (2008) recital 185.

i.e., a PE in the other state, are not (yet) fulfilled[20]. In the same manner and for the same reasons, income derived after the termination of a PE shall only be taxed in the state of residence[21]. Consequently, the existence of a PE would cause a taxing right for the PE state only to the extent that the income is derived during the period of the existence of the PE[22].

In fact, starting with a literal interpretation, Art. 7(1) of the OECD Model might be understood to support this view because a source state taxing right is provided for if an enterprise "carries on" its business through a PE. This is not the case, however, if the enterprise "did carry on" or "will carry on" the business[23]. Nonetheless, it is doubtful whether the use of the present tense should exclude taxation in the PE state if the income is not derived while the PE exists[24], the reason being that Art. 7(1) of the OECD Model restricts the taxing right of the other state "unless" a PE exists, not "as long as" a PE is maintained[25]. Therefore, from a literal perspective, one may reasonably find that to "carry on" merely emphasizes the activity-based allocation of the taxing rights and, consequently, allocates to the PE state the taxing right for all the income derived therefrom[26]. In this case, it would be the activity aspect rather than the time aspect which determines the allocation of the taxing right[27]. Both interpretations could be supported by the purpose and justification of the PE principle. Limitation of the taxing right to those profits derived during the period of the existence of a PE would conform with the aspect that the PE threshold, i.e., the requirement of a fixed base, may allow the enforceability of tax liabilities. Such enforceability would be jeopardized if the PE was terminated in the meantime. On the other hand, the justification of an unrestricted taxing right of the PE state for business profits, i.e., the benefit principle, supports the view that taxation should not be limited with regard to timing aspects. If one agrees with the view that the purpose of the PE principle is the allocation of full taxing rights to the PE state if income is

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[20] See X. Ditz, in: J. Schönfeld, X. Ditz, op.cit., Art. 7 OECD–MC (2008) recital 185; F. Wassermeyer, in: Wassermeyer, *Doppelbesteuerung…*, op.cit., Art. 7 OECD–MC recital 295 et seq.

[21] See F. Wassermeyer, in: Wassermeyer, *Doppelbesteuerung…*, op.cit., Art. 7 OECD–MC recital 303.

[22] See also X. Ditz, in: J. Schönfeld, X. Ditz, op.cit., Art. 7 OECD–MC (2008) recital 188.

[23] See D. Gosch, in: Festgabe F. Wassermeyer, *Doppelbesteuerung*, 1st ed., Verlag C.H. Beck, München 2015, p. 213; see also K. Buciek, in: H. Flick, F. Wassermeyer, M. Kempermann, *DBA Deutschland – Schweiz – Kommentar*, 45. ed., Verlag Otto Schmidt, Köln 2015, Art. 7 recital 207.

[24] See also P. Plansky, op.cit., p. 195: strict wording.

[25] See Rheinland-Pfalz Fiscal Court judgment of 16.09.2014, case 5 K 1717/13, EFG 2015, p. 188.

[26] Similar J. Schuch, *Die Zeit im Recht der Doppelbesteuerungsabkommen*, 1st ed., Linde Verlag, Wien 2002, p. 161 et seq.

[27] See Ibidem, p. 171 et seq; J. Wheeler, in: R. Vann et al., op.cit., sub 3.2.3.3., see also D. Gosch, in: Festgabe F. Wassermeyer, op.cit., p. 214.

derived through a PE there[28], such an economic connection to the PE state should not be restricted by timing aspects. Instead, according to the benefit principle, the PE state should be allowed to tax all the income derived through the PE in its territory, even if it is derived after the termination of the PE. According to the latter view, the use of the present tense should only be interpreted in such a manner that a PE must be in existence when the relevant activity has been carried on. Consequently, the only restriction of the wording of Art. 7(1) of the OECD Model would be that a PE has to be existent eventually.

Since the literal interpretation seems to be open-ended, systematic and teleological aspects should be evaluated to resolve the issue.

2.3. Arguments from the Context of the Treaty

2.3.1. Comprehensive Taxing Right for a PE State

With regard to the taxing right for a potential PE state, the OECD Model not only provides for the right to tax the operating profits of a PE (Art. 7(1) of the OECD Model), but also for the taxing right with regard to gains from the disposition of movable property forming parts of the business property of the PE (Art. 13(2) of the OECD Model). This fact suggests that the OECD Model follows a comprehensive taxing right for a PE state[29]. Against the background of the benefit principle, this result would be consistent because the PE state would be allowed to tax all the income (incl. hidden reserves) to which it has contributed with its infrastructure. For this reason, however, it would remain questionable whether the operating profits would also include such profits which were derived before or after the period of the existence of the PE. Proving this would require evidence derived from the context of the treaty. By means of contextual interpretation, as stipulated by Art. 31 (1) of the Vienna Convention on the Law of Treaties, a cross-comparison of treaty provisions can help identify the meaning of one provision[30]. As for the question discussed here, those treaty provisions dealing with activity-related income may be relied on because

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[28] See in this direction Federal Fiscal Court judgement of 27.02.1991, case I R 15/89, BStBl. II 1991, p. 444, of 27.02.1991, case I R 96/89, BFH/NV 1992, p. 385; of 31.05.1995, case I R 74/93, BStBl. II 1995, p. 683.

[29] Similar T. Hagemann, *Freistellung für Gründungskosten einer festen Einrichtung?*, "Steuer und Wirtschaft International" 2014, p. 516.

[30] See H. Debatin, in: Festschrift für P. Scherpf, *Unternehmung und Steuer*, 1st ed., Verlag Gabler, Wiesbaden 1983, p. 307 et seq.

the same principles have to apply to them[31]. The group of activity-related treaty provisions consists, among others, of Art. 7, Art. 15, and Art. 17 of the OECD Model[32].

2.3.2. Coverage of Subsequent Income

Art. 15(1) of the OECD Model governs the taxing right for income from employment "subject to the provisions of Articles 16, 18 and 19". According to the prevailing view in literature, this statement expresses that Art. 18 or 19 of the OECD Model are to be given priority whenever the facts come under both provisions[33]. This reservation only makes sense if income covered by Art. 18 or Art. 19 of the OECD Model may also be covered by Art. 15 of the OECD Model. Put differently, income paid "in consideration of past employment" as referred to in Art. 18 of the OECD Model may at the same time be qualified as income derived "with respect of an employment" under Art. 15(1) of the OECD Model[34]. If this result holds true, then Art. 15 of the OECD Model without any doubt covers (subsequent) income derived after the (former) activity[35]. Like Art. 7 of the OECD Model, Art. 15 of the OECD Model is phrased in the present tense ("is exercised") regarding the allocation of taxing rights.

A comparison with Art. 17 of the OECD Model leads to similar findings. According to this provision, income derived by a person from activities as an entertainer or as a sportsperson "exercised" in one contracting state may be taxed there. Since the duration of the performance is usually short, neither the general allocation principles of Art. 7 nor those of Art. 15 of the OECD Model would grant the taxing right to the state where the activity is exercised[36]. Therefore, Art. 17 of the OECD Model implements a strict activity-based allocation. Assuming that the condition for obtaining the taxing right would need to exist at the time when the tax is levied under Art. 17

[31] So M. Lang, in: Festschrift für H. Flick, *Unternehmen Steuern*, 1st ed., Verlag Otto Schmidt, Köln 1997, p. 899; M. Lang, *Zeitliche Zurechnung bei der DBA-Anwendung*, "Steuer und Wirtschaft International" 1999, p. 285.

[32] See K. Vogel, A. Rust, in: E. Reimer, A. Rust, *Klaus Vogel on Double Taxation Conventions*, 4th ed., Kluwer Law International, Alphen aan den Rijn 2014, Introduction recital 65.

[33] See e.g. R. Ismer, in: K. Vogel, M. Lehner, *Doppelbesteuerungsabkommen: DBA*, 6th ed., Verlag C.H. Beck, München 2015, Art. 18 OECD Model recital 9.

[34] See R. Ismer, *Ruhegehälter nach Art. 18 OECD-MA: Grundlagen und Aktuelle Entwicklungen*, "Internationales Steuerrecht" 2011, p. 578, who states that pensions would be covered by Art. 15 OECD-MC in case of non-existence of Art. 18 OECD-MA.

[35] See also Art. 15 Tz. 2.2 OECD-Commentary 2014: „[...] regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee".

[36] See also M. Maßbaum, in: D. Gosch, H.-K. Kroppen, P. Grotherr, *DBA – Kommentar*, 29th ed., Neue Wirtschafts-Briefe, Herne 2016, Art. 17 OECD-MC recital 2.

of the OECD Model, the tax must have been levied during the performance of the activities. Consequently, Art. 17 of the OECD Model would regularly run idle[37].

2.3.3. Irrelevance of the Time of Income Derivation

The cross-comparison of treaty provisions seems to indicate that activity-related distributive rules allocate the taxing right regardless of when the tax is levied, if the activity has caused the respective income[38]. Further, it would not seem plausible that contracting states should agree to allocate profits derived during the operation of the activity as well as gains from the alienation of the hidden reserves generated by the activity, but not to allocate the taxing right if such income would be derived at a time when the PE was terminated. Instead, it seems preferable to refer to the activity as the only allocation criterion[39]. Consequently, the taxing right for all the income derived by an activity should be granted without time restrictions to the contracting state in which the activity is exercised under the required conditions (e.g., through a PE).

2.4. Teleological Aspects Regarding Preceding or Subsequent Income of a PE

According to Art. 31(1) VCLT, a treaty is also to be read in light of its objective and purpose. The main purpose of a tax treaty is the avoidance of double taxation[40]. From this – general – purpose, it does not appear at a first glance that much guidance can be derived for allocation of preceding or subsequent income. However, since the aim of a common interpretation of a treaty is derived from this purpose, which corresponds to an interpretation reflecting the common international understanding, one may attempt to find arguments in the legal practice of other states[41]. Support

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[37] See also J. Sasseville, in: Festschrift für J. Sasseville, *Temporal Aspects of Tax Treaties*, [in:] *Tax Polymath – A life in International Taxation. Essays in Honour of John F. Avery Jones*, P. Baker, C. Bobbett, (Eds..), International Bureau of Fiscal Documentation, Amsterdam 2011, p. 55; J. Wheeler, in: R. Vann et al., op.cit., sub 3.3.2.3.2.

[38] See K. Vogel, *Klaus Vogel on Double Taxation Conventions*, 3rd ed., Kluwer Law International, Alphen aan den Rijn 1997, Art. 7 OECD–MC recital 34; accordingly M. Lang, in: Festschrift für H. Flick, op.cit., p. 896.

[39] See also J. Schuch, op.cit., p. 162; M. Schenk, P. Oesterhelt, op.cit., p. 907, D. Dürrschmidt, op.cit., p. 619.

[40] See only J. Schönfeld, N. Häck, in: J. Schönfeld, X. Ditz, op.cit., Systematik recital 1.

[41] On the common interpretation see M. Zügler, *Arbitration under Tax Treaties*, International Bureau of Fiscal Documentation, Amsterdam 2001, p. 2; M. Kobetsky, op.cit., p. 413; A. Deitmer, I. Dörr, A. Rust, *Invitational Seminar on Tax Treaty Rules Applicable to Permanent Establishments*, "Bulletin of International Taxation" 2004, p. 186; see also W. Wijnen, *Some Thoughts on Convergence and Tax Treaty Interpretation*, "Bulletin of International Taxation" 2013, p. 576; A. Jiménez, *Transfer Pricing an EU Law Following ECJ*

for the possibility of allocating to a PE profits derived before or after the time of its existence can be found in legal practice in Germany, the Netherlands[42], Norway[43], Austria[44], and Switzerland[45]. Furthermore, a respective understanding is expressively embedded in the U.S. Model[46]. Insofar, the author presumes to find that in any case, the possibility to allocate subsequent income is not unknown in international tax treaty practice and, hence, might be cautiously supported by the aim for a common interpretation as a form of teleological interpretation. Although these references concern subsequent income of a PE, there seems to be a convincing case for not proceeding differently when allocating income derived before the existence of a PE[47].

Even from the abstract viewpoint of the goal of avoiding double taxation, the approach of not restricting allocation based on timing aspects seems superior. It seems quite possible that income is recorded for tax purposes at different times in the two contracting states, which would automatically invoke potential conflicts of qualifications if timing issues were to influence the allocation of taxing rights. Therefore, it seems most plausible that a PE state should be allowed to tax all the profits from a PE regardless of the time when the tax is levied[48].

Furthermore, it is considered another purpose of the treaty to fairly allocate the taxing rights between both contracting states[49]. Two arguments can be derived from this purpose. On the one hand, it is the justification of the taxing right of a PE state

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Judgment in SGI: Some Thoughts on Controversial Issues, "Bulletin of International Taxation" 2010, p. 278; see further K. Vogel, A. Rust, in: E. Reimer, A. Rust, op.cit., p. 89 et seq with further references.

[42] See E. Kemmeren, in: E. Kemmeren et al, *Tax Treaty Case Law Around the Globe*, International Bureau of Fiscal Documentation, Amsterdam 2014, p. 68 with further references; J. Wheeler, in: R. Vann et al., op.cit., sub 3.3.2.3.2.; D. Smit,, *Timing Issues under Double Tax Treaties: The Dutch Approach*, "Intertax" 2016, p. 34 et seq, with the remark to potentially deviating jurisprudence from South Africa.

[43] See A. Skaar, *Norway's Supreme Court Leaves Uncle John High and Dry: Miserly Allocation of Deductible Costs to Permanent Establishment*, "Tax Notes International", Vol. 9, 1994, p. 713 et seq.

[44] See Higher Administrative Court judgment of 06.03.1984, case 83/14/0107; of 22.03.2000, case 97/13/0093; cited by P. Plansky, op.cit., p. 195.

[45] See Federal Fiscal Court judgment of 12.10.1978, case I R 69/75, BStBl. II 1979, p. 64; see also K. Buciek, in: H. Flick, F. Wassermeyer, M. Kempermann, op.cit., Art. 7 recital 208. See. Recently simiar T. Hagemann, *DBA-Quellenstaatsregeln im Zusammenhang mit Ruhegehaltszahlungen*, "Internationales Wirtschafts- und Steuerrecht" 2016, p. 78.

[46] See Art. 7 section 5 US Model Income Tax Convention 2016: "In applying this Article, paragraph 8 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 5 of Article 12 (Royalties), paragraph 3 of Article 13 (Gains) and paragraph 3 of Article 21 (Other Income), any income, profit or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where such a permanent establishment is situated even if the payments are deferred until such a permanent establishment has ceased to exist".

[47] See also J. Schuch, op.cit., p. 173; G. Girlich, M. Philipp, *Nachträgliche Betriebsstätteneinfünfte im Outbound-Fall*, "Der Betrieb" 2015, p. 461.

[48] See K. Vogel, in: E. Reimer, A. Rust, op.cit., Art. 7 OECD–MC recital 34.

[49] See K. Vogel, R. Prokisch, op.cit., p. 72; J. Schönfeld, N. Häck, in: J. Schönfeld, X. Ditz, op.cit., Systematik recital 11.

based on the benefit principle. If income was derived through a PE in one state, i.e., by using the infrastructure and economy of this state, taxation is justified, whereas no other result can be found by simply considering the time of taxation[50]. On the other hand, income determination based on the accrual principle would establish tax planning opportunities by steering payments so that those payments might be derived before or after the existence of a PE. Furthermore, states might be inclined to steer the allocation of taxing rights by their domestic law, assuming that their taxing right is only restricted by the treaty if the income is derived during the period of the existence of a PE[51]. Such results would clearly defy the purpose of fairly allocating taxing rights between both states.

As for the benefit principle, however, one might oppose the idea that in the case of preceding income such as start-up expenses, an activity does not yet exist and, hence, in the absence of utilization of its infrastructure, a taxing right for the (future) PE state is not justified. However, only the PE state is allowed to tax the profits of a PE once it has been established[52]. Therefore, against the background of a fair allocation of taxing rights, it remains unclear why the state of residence shall grant deduction for those expenses incurred for the PE[53]. Instead, such deduction might lead to a unilateral burden for the state of residence[54]. Furthermore, the charging of costs corresponds to the arm's length principle[55], the reason being that an independent enterprise would also be unwilling to bear the costs of another enterprise[56]. Accordingly, the allocation of the start-up expenses to the PE (state) seems appropriate and even consistent with the explanations of the OECD, which suggest that income be offset with the expenses associated with generating it.

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[50] See also J. Schuch, op.cit., p. 189; another opinion: H.-K. Kroppen, in: D. Gosch, H. -K. Kroppen, P. Grotherr, op.cit., Art. 7 OECD–MC recital 197, who reasons for the consideration of the costs in the Head Office based on the arm's length principle.

[51] See also M. Lang, in: Festschrift für H. Flick, op.cit., p. 895 et seq.

[52] See M. Schenk, P. Oesterhelt, op.cit., p. 907.

[53] See also D. Gosch, in: Festgabe F. Wassermeyer, op.cit., p. 215.

[54] See M. Lang, in: R. Bertl, A. Egger, W. Gassner, M. Lang, *Verlustvorsorgen im Bilanz- und Steuerrecht*, 1st ed., Verlag Linde Ges. m.b.H, Wien 2000, p. 237(246); cited by J. Schuch, op.cit., p. 172.

[55] Siehe F. Wassermeyer, in: F. Wassermeyer, *Doppelbesteuerung…*, op.cit., Art. 7 OECD–MC recital 298; J. Schuch, op.cit., p. 172; H. -K. Kroppen, in: D. Gosch, H. -K. Kroppen, P. Grotherr, op.cit., Art. 7 OECD–MC recital 190; S. Bendlinger, *Die Betriebsstätte in der Praxis des Internationalen Steuerrechts*, 2nd ed., Verlag LexisNexis ARD ORAC, Wien 2012, p. 185; X. Ditz, in: J. Schönfeld, X. Ditz, op.cit., Art. 7 OECD–MC (2008) recital 211; T. Hagemann, *Freistellung für Gründungskosten…*, op.cit., p. 517.

[56] See auch K. Buciek, in: H. Flick, F. Wassermeyer, M. Kempermann, op.cit., Art. 7 recital 214; J. Schuch, op.cit., p. 178.

2.5. Interim Conclusion

Following the arguments outlined so far, PE profit allocation should not depend on the time when the income is derived. Instead, only the economic connection, expressed through a causal link between a PE and the income, should be determinative for allocation to a (future, present or former) PE. A significant criterion for the economic connection should be where the relevant activity is carried on[57]. Therefore, all income is allocated to a PE to the extent that it is caused by an activity carried on in this or through this PE at the time of its existence[58]. Consequently, this applies even in cases when income is derived before or after the existence of a PE. This approach corresponds to the benefit principle[59].

3. Generation of Preceding and Subsequent Income by a PE

The interim conclusion is that allocation of income to a PE depends on the required economic connection, which itself is expressed by causation. Since the causation principle is independent from time restrictions, the relevant question to ask must be whether income is caused by a PE, respectively the activity carried on therein. With regard to start-up costs, this approach may raise a different question: according to one view in literature, start-up costs for a PE are always caused by the Head Office[60]. Another view assumes that a causal link can only exist if a PE is actually maintained, and functions are performed therein[61]. Accordingly, causation of start-up expenses by the PE for which they were borne might be denied. Indeed, at a first glance, one might be inclined to apply a strict activity-based approach to determine the necessary causation link because Art. 7(1) of the OECD Model also allocates the taxing right based on activity[62]. The activity dealing with the establishment of a PE, however, will usually be executed in the Head Office, even though the cause of this activity is the

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[57] Im Ergebnis auch Dürrschmidt, in: K. Vogel, M. Lehner, op.cit., Art. 6–22 OECD–MC recital 8 et seq; for income from employment see also K. Vogel, *Tax Treaty News*, "Bulletin for International Taxation" 2008, p. 49.

[58] Similar M. Lang, in: Festschrift für H. Flick, op.cit., p. 897.

[59] See D. Smit, op.cit., p. 29(34).

[60] See F. Wassermeyer, *Der Zeitbezug bei der Anwendung von DBA*, "Internationales Steuerrecht" 1997, p. 395(396); F. Wassermeyer, in: F. Wassermeyer, *Doppelbesteuerung...*, op.cit., Art. 14 OECD–MC recital 5.3; Art. 7 OECD–MC recital 300.

[61] See J. Mössner, *Anmerkung zu FG Bremen, U. v. 14.06.2012–1 K 122/10(6) – (Vergebliche Auslandsaufwendungen)*, "Internationales Steuerrecht" 2013, p. 888.

[62] See also T. Hagemann, *DBA-Quellenstaatsregeln...*, op.cit., p. 78.

planned PE[63]. Hence, one has to ask whether Art. 7 of the OECD Model provides for a strict activity-related allocation or whether the relevant causation can be found either in the activity or in the existence of a PE. Up to, and including, the OECD Model 2008, Art. 7(3) provided for an approach that supports the latter view. According to this provision "in determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere." Even though this provision was eliminated, the obligation to allocate expenses to a PE is already mandated by Art. 7(2) of the OECD Model through the arm's length principle and the "functionally separate entity" approach[64]. Consequently, since a PE is the cause of the start-up expenses, the expenses should be regarded "incurred for the purposes" of the PE and should therefore be allocated to the PE.

The allocation of subsequent income is less complex. In general, subsequent income will be connected to the activity of a PE or, respectively, to assets arising from it, e.g., receivables. Consequently, such income would be considered to be caused by the PE's activity and, therefore, allocated to the PE.

4. Irrelevance of Causation in Case of Sunk Start-up Expenses

According to the preliminary findings, allocation should follow causation, while causation is to be affirmed in case of start-up expenses of a PE. Based on these conclusions, the German Federal Fiscal Court found that start-up expenses are to be allocated to the PE state even if the set-up of the PE fails[65]. Put differently, the Court allocated (negative) business income to the other state even though the PE was never maintained in that state. The author agrees with this decision insofar as the allocation to a PE should not depend on the existence of the PE at the time when the income is

[63] See also BMF of 24.12.1999, Tz. 2.9.1, BStBl. I 1999, p. 1076; Federal Fiscal Court judgement of 26.02.2014, case I R 56/12, BStBl. II 2014, p. 703; F. Wassermeyer, in: F. Wassermeyer, *Doppelbesteuerung…*, op.cit., Art. 14 OECD–MC recital 5.3; T. Hagemann, *Freistellung für Gründungskosten…*, op.cit., p. 513(517); affirmative towards causation see O. Jacobs, D. Endres, C. Spengel, in: O. Jacobs, *Internationale Unternehmensbesteuerung*, 8. neu bearbeitete und erweiterte Ed., Verlag C.H. Beck, München 2016, p. 720; G. Frotscher, op.cit., recital 492; see also O. Heinsen, J. Wendland, op.cit., p. 1033 et seq.

[64] Even though Art. 7 Abs. 3 OECD–MC 2008 was deleted, its content is mandated by Art. 7 Abs. 2 OECD–MC, see also M. Bennett, in: D. Weber, S. van Weeghel, *The 2010 OECD Updates*, Kluwer Law International, Alphen aan den Rijn 2011, p. 31.

[65] Federal Fiscal Court judgement of 26.02.2014, case I R 56/12, BStBl. 2014, p. 703.

derived (or the expense borne respectively) and to the extent that start-up expenses are caused by the planned PE. However, this does not automatically imply that causation itself is sufficient for the allocation of the taxing right to the other state. If an enterprise does business in the other state without maintaining a PE there, it would be beyond doubt that the other state is not allowed to tax the income. The same should apply to start-up expenses. If the set-up of the PE fails, the taxing right of the other state never exists. In that event, the expenses cannot be allocated to the PE there but must be allocated to the Head Office instead. This finding is not in conflict with allocating start-up expenses to a PE in case the PE is established later on because the OECD Commentary stipulates that if a PE is established, e.g., if the six-month period proves the required degree of permanency, the PE is assumed to exist from the moment the activity carried on in the PE begins[66]. Therefore, exceeding this time threshold retroactively triggers PE income for the time when it was not sure whether or not an activity would lead to the PE. The opposing view, i.e., the allocation of start-up expenses even in case of failure to establish a PE, overstrains the relevance of the attribution principle. This is so because the latter is part of the two-pronged PE principle consisting of the existence of a PE on the one hand, and the attribution of income to an *existent* PE on the other hand. This is clearly expressed by the wording of Art. 7(1) of the OECD Model requiring both the existence of a PE and the attribution of income. Overemphasizing the causation link would undermine the relevance of a PE. Indeed, since income can be earned in the other state without an existing PE, e.g., by means of a place of business which is not fixed in the meaning of Art. 5 of the OECD Model, the fixed place of business criterion obviously sets limits to the economic attribution principle for purposes of allocating taxing rights under Art. 7(1) of the OECD Model. Furthermore, if one considers that states will (likely) not perceive their taxing right until a PE exists, start-up expenses may neither be deductible in the state of residence nor in the other state. This situation would amount to a subset of double taxation and, hence, contradict the main purpose of the treaty[67]. Consequently, if no PE exists in the other state, the other state cannot tax any business income and therefore the taxing right is with the state of residence. This result is independent from the respective attribution approach.

[66] OECD Model Tax Convention on Income and on Capital (15 July 2014), Models IBFD, Commentary on Article 5 para. 6.3.

[67] A. Cloer, A. Conrath *Betriebsausgaben bei Gescheiterter Betriebsstättengründung im Drittland. Anmerkung zu FG Bremen, U. v. 14.06.2012–1 K 122/10*, "Internationale Wirtschafts-Briefe" 2013, p. 451.

5. Deviating Results under the Authorized OECD Approach?

5.1. Continued Validity of the Causation Principle

The 2010 update to the OECD Model fully implemented the AOA, which established both the so-called functionally separate entity approach and the allocation of risks, assets and, hence, profits based on significant people functions. The new concept has already been implemented in some states. Amongst others, the AOA is established in the treaty between Poland and the United States and in the new treaty between Poland and Germany. With regard to the allocation measure, it is assumed in literature that the AOA abandons the causation principle because allocation is now based on people functions[68].

The AOA is meant to implement an arm's length approach in PE profit allocation. At least from the viewpoint of German scholarly literature, it has been shown that the arm's length principle is closely connected to the causation principle[69]. For instance, if expenses are comprehensively caused by the business activity of one enterprise, charging the expenses to this enterprise would be at arm's length or, put differently, the arm's length principle would require that this enterprise bear the expenses[70]. Consequently, one should assume that income allocation based on the causation principle is mandated by the arm's length approach, whereas this allocation may, in the individual case, not be derived by referring to the people functions[71]. Therefore, the causation principle is not superseded through the implementation of the AOA.

5.2. Impacts of the AOA on Preceding Income

As mentioned above, major changes of the AOA include the functionally separate entity approach, which was introduced mainly to allow recognition of fictitious transactions (dealings), as well as the concept of people functions. If start-up expenses

[68] See P. Schnorberger, M. Dust., *Verluste als Profitable Dienstleistung? Steuerrechtliche Grundlagen des Fremdvergleichs*, "Betriebs-Berater" 2015, p. 608; O. Heinsen, J. Wendland, op.cit., p. 1037.

[69] Siehe F. Wassermeyer, in: Festschrift für K. Offerhaus, *Steuerrechtssprechung, Steuergesetz, Steuerreform*, Verlag Otto Schmidt, Köln 1999, p. 405 et seq.

[70] See only B. Kaminski, in: G. Strunk, B. Kaminski, P. Köhler, *Außensteuergesetz/Doppelbesteuerungsabkommen*, 42nd ed., Verlag Stollfuß, Bonn 2015, § 1 AStG recital 29.

[71] See also M. Bennett, in: D. Weber, S. van Weeghel, op.cit., p. 21(31): Art. 7(3) of the OECD Model war not considered to be needed any longer because the attribution of expenses to the PE stems from the separate entity approach and is already mandated by paragraph 2.

are borne in connection with the development or acquisition of assets that are transferred from the Head Office to a PE after its establishment, the transfer of assets can be regarded a dealing (see para. 70 of the Report) which would have to be charged at arm's length. Therefore, the recognition of the dealing would ensure that start-up expenses are borne by the PE. In many cases, however, start-up expenses will be made in connection with, e.g., legal consulting, costs of recruitment, or marketing. Hence, such expenses may not be booked and later transferred as an asset. With regard to such start-up expenses, one may suggest that people functions regarding the set-up of a PE will usually be executed in the Head Office and, hence, the (negative) income related to the activities is to be allocated to the Head Office as well[72]. Put differently, in the absence of people functions in the PE, no income should be allocable. However, besides the argument discussed above, i.e., that expenses incurred for purposes of a PE are allocable to it, this understanding does not necessarily follow from the AOA. The 2010 PE Report assumes that a server can constitute a PE to which, notwithstanding the absence of any people functions performed therein, income may be allocated[73]. This result proves that one has to distinguish between the allocation of people functions relevant for the allocation of risks and intangible assets and, subsequently, relevant for allocating substantial parts of the profits on the one hand, and other factors relevant for the allocation of income on the other hand. Therefore, the author pleads for charging start-up expenses to a PE because this is what the arm's length approach unambiguously requires. Nevertheless, the AOA could evoke changes: because the Head Office and a PE are to be regarded as separate entities, one could perceive that the Head Office renders start-up "services" to the PE and that therefore not only costs, but also a profit markup must be charged.

5.3. Effects of the AOA on Subsequent Income

In the author's view, comparable results can be inferred for subsequent income, i.e., income derived after the termination of a PE. Usually, such income will be connected to assets (e.g., receivables) or liabilities (e.g., provisions being reversed). If a PE is terminated, the transfer of such assets and liabilities to the Head Office would constitute a fictitious sale from the PE to the Head Office. Consequently, the assets and liabilities as well as relating risks and opportunities would also be transferred to the Head Office. Therefore, subsequent income should be allocable to the Head Office. Even though this result seems to be contrary to the allocation based on the causation

[72] See P. Schnorberger, M. Dust, op.cit., p. 608 et seq; see also G. Girlich, M. Philipp, op.cit., p. 461.
[73] See OECD, op.cit., Part I Tz. 128.

principle, as explained above, it is consistent with the OECD approach to recognize fictitious transactions between the different parts of one enterprise[74]. Furthermore, if one considers that the Head Office would recognize transferred risks (e.g., default on receivables) and opportunities (e.g., realization of hidden reserves) by calculating its price, this approach would even seem in accordance with the arm's length principle[75]. By means of this price calculation, one may expect the results not to deviate much from the strict causation-based approach. This result is also consistent with the approach to book start-up expenses as assets because after transferring those assets, the new "allocation pole" bears risks and opportunities relating to the assets.

4. Procedure of Allocating Preceding and Subsequent Income

To bring home the results established here, one has to distinguish: on the one hand, it seems to comply with the arm's length approach not to sever the economic connection by timing issues. On the other hand, allocation is not possible if a PE does not exist because it was never established.

As for start-up expenses, this would imply that allocation cannot occur until a PE is established. When the realization of establishment is still uncertain, start-up expenses are to be allocated to the Head Office. At the moment of establishment, the start-up expenses are to be charged to the PE. Instead, it is suggested that the Head Office be allowed to participate in the profits of the PE as compensation[76]. Even though both approaches may likely correspond[77], the latter view is not convincing for two reasons. First, the treaty solely provides for a legal basis for the attribution of the (negative) income to a PE, but not for the attribution of the (positive) PE income to the Head Office. Further, the participation in the profits of the PE would fail if the PE is never profitable[78]. In the author's view, it is preferable not to charge the start-up expenses until the moment of the establishment of a PE. Before a PE is established, typically only negative income is derived[79]. Therefore, the recognition

[74] See e.g. Ibidem, Part I Tz. 8.

[75] See H. -K. Kroppne, in: D. Gosch, H. -K. Kroppen, S. Grother, op.cit., Art. 7 OECD–MC recital 195.

[76] For this F. Wassermeyer, in: F. Wassermeyer, *Doppelbesteuerung…*, op.cit., Art. 14 OECD–MC recital 5.5.

[77] See also H. -K. Kroppen, in: D. Gosch, H. -K. Kroppen, S. Grother, op.cit., Art. 7 OECD–MC recital 190.

[78] See. U. Schmitz, in: U. Löwenstein, C. Looks, O. Heinsen, op.cit., recital 1008.

[79] See J. Schuch, op.cit., p. 166; similar also K. Buciek, in: H. Flick, F. Wassermeyer, M. Kempermann, op.cit., Art. 7 recital 213; U. Schmitz, in: U. Löwenstein, C. Looks, O. Heinsen, op.cit., recital 1004.

of the expenses in the PE state would not be possible before the establishment of the PE and, hence, may depend on domestic provisions regarding loss carry-forward[80]. It would be more convincing to avoid such situations since tax treaties are construed to allocate taxing rights to states so that the states take into account the income[81].

As for subsequent income, the findings above may require the allocation of the income to the PE state, even if the PE was terminated. In case of negative subsequent income, recognition in the PE state would depend on loss carry-back provisions in the respective state. Even though this may lead to awkward situations for taxpayers, distinctions in allocation do not seem possible[82]. Since each state quantifies its tax base autonomously[83], however, this result would not be in conflict with the treaty law, the reason being that non-recognition would then follow from domestic law.

Conclusion

According to the benefit principle, taxation in a PE state is justified by the fact that PE profits were earned by the utilization of the economy and the infrastructure of the PE state. Against this background, it is only consistent not to restrict the taxing right of the PE state if the PE does not yet, or no longer, exist at the time when the income is derived. Therefore, all the income connected to the PE should be taxable in the PE state without time restrictions. However, it is crucial that the PE exist at some point and that the income be caused by this existence or by the activities carried on in the PE during its existence. Hence, start-up expenses in connection with a failed PE are not to be allocated to the PE state, but to the Head Office instead. With regard to the AOA, these results may slightly change due to necessary profit mark-ups on charged costs as well as due to fictitious transactions which lead to a change in the allocation of assets and therefore, to the transfer of risks and opportunities relating to subsequent income.

[80] See also F. Wassermeyer, in: F. Wassermeyer, *Doppelbesteuerung…*, op.cit., recital 5.3; same opinion: M. Schwenke, in: Festschrift D. Gosch, *Nationale und Internationale Unternehmensbesteuerung*, 1st ed., Verlag C.H. Beck, 2016, p. 383.

[81] See B. Arnold, J. Sasseville, in: B. Arnold, J. Sasseville, E. Zolt, op.cit., p. 118.

[82] See also J. Schuch, op.cit., p. 173: equivalent treatment for income and expenses; same opinion: K. Buciek, in: H. Flick, F. Wassermeyer, M. Kempermann, op.cit., Art. 7 recital 210.1.

[83] See E. Reimer, in: E. Reimer, A. Rust, op.cit., Article 7 OECD MC recital 64.

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