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Profit allocation of cross-border pipeline operations

In two decisions, the Düsseldorf Tax Court commented on the profit allocation regarding the operation of a transnational pipeline network between Germany, Belgium and the Netherlands through so-called pipeline operating sites which are permanent establishments from a tax point of view.

Background

The two proceedings deal with the legal situation prior to the implementation of the Authorized OECD Approach (AOA) into national law (case: 3 K 1940/17 F - year in dispute 2011) and secondly, after its inclusion in Sec. 1 (5) of the Foreign Tax Act (case: 3 K 70/18 F - year in dispute 2015).

The plaintiff, as limited partnership, operates a network of pipelines for the transport of goods. The pipeline network runs through Germany, Belgium, and the Netherlands. The plaintiff's administrative headquarters were in Germany during the year in dispute. The operational control of the pipeline is carried out by an "operations center" located in the Netherlands.

It is beyond dispute between the plaintiff and the defendant (the tax office) that the pipeline network constitutes permanent establishments (PEs) and that the profit generated be allocated to Germany, Belgium, and the Netherlands.

Following a tax audit, the tax office determined the share of profit to be allocated to the Netherlands and Belgium on the (isolated) basis of the income which would have been earned if the pipeline had been used (leased) directly. In the further stage of the proceedings, the tax office argued that the allocation of income would have to be made while adhering to the direct method because of different functions between the head office and the other operating pipelines (the PEs).

In contrast, the plaintiff is of the opinion that an allocation of profits based on the indirect method (volume of sales – turnover key) was appropriate. For this purpose, the revenues from transit charges as well as **direct and overhead costs** were, among other things, allocated to single pipeline line sections.

Decision

The Düsseldorf Tax Court upheld the appeal on the following grounds.

If the operating units (PEs) had been running their respective pipeline networks as independent companies, they alone would have been entitled to the revenues for the transport of goods that took place in the Netherlands and Belgium. This was not taken into account by the tax office, which held that the total revenues from transit of goods through the pipelines be allocated the German head office.

The allocation of profits applied by the tax office does not comply with the provisions of the double tax treaties. In particular, the allocation of the total profit to the countries concerned would depend solely on the profit that the two foreign permanent establishments could have earned on a similar business volume - i.e., operating the parts of the pipelines running through Belgium and the Netherlands respectively - as an independent entity.

This had not been considered by the tax office. A reasonable allocation would be based on the share of turnover generated by each pipeline, i.e. the quantity of goods transported to each pipeline as well as the revenue attributable to it.

The decisions of the tax court are not final. Appeals launched by the tax office are pending at the Supreme

Tax Court (case: I R 37/23 and I R 38/23).

Source:

Tax Court of Düsseldorf, decisions of 12 May 2023 (3 K 1940/17 F and 3 K 70/18 F).

Conclusion and bottom line of the decisions:

The tax court confirms the view that for the purpose of profit allocation from permanent establishments (branches), the arm's length comparison and the underlying business model must always be the overriding yardstick. The mere fact that the company does not have own staff working in the PE should not justify a general adjustment of the permanent establishment's profit down to a negligible standard margin. Moreover, even in the case of unmanned business premises, the personnel functions in relation to the assets used by the PE should always be analyzed and evaluated.

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Schlagwörter

permanent establishment (PE), profit adjustment