By PwC Deutschland | 21. Oktober 2024

No tax exemption of foreign branch income in case of treaty switch-over clause

The Supreme Tax Court decided that the “switch-over" provision in the respective tax treaties with Russia and Romania, which changes the exemption method to the credit method, was to be applied by observing the activity requirements set in Section 8 (1) of the German Foreign Tax Act.

Legal background

According to Art. 23 (2) c of the double tax agreement (DTA) with Russia – and notwithstanding the provisions of letter a - income within the meaning of Art. 7 DTA Russia is only exempt from German tax if the person resident in Germany proves that the permanent establishment (PE) derived its gross income in the relevant financial year exclusively or almost exclusively from activities covered by **Section 8 (1(Nos. 1 to 6 Foreign Tax Act** (FTA). Article 23 (2) c of the DTA with Romania contains a comparable provision.

Section 20 FTA contains rules on the application of treaties for the avoidance of double taxation. According to **Section 20 (2) sentence 1** FTA, income which accrues to a foreign PE of a taxpayer with unlimited liability that, disregarding Sec. 8 (2), would have been taxable as intermediary income had the PE been a foreign company, double taxation is to be avoided to that extent, not by exemption, but by crediting the foreign taxes charged on that income. As an exception, **Sec. 20 (2) sentence 2** FTA states that this **does not apply** to income of the foreign PE that would have been taxable as so-called intermediary income underSec. 8 (1) no. 5 letter a FTA.

Case of dispute

The parties involved disagreed as to whether the exemption method or the tax credit method should be applied to income from foreign permanent establishments (PE) generated in 2004 (the year of dispute), considering the activity requirements under treaty law and Section 20 (2) FTA as applicable in the year of dispute.

Based on consulting contracts, the German X GmbH was operating in Russia and Romania, among other places. Business premises were made available there or rented by X GmbH for its own account and in which its own staff (including A) worked in an advisory capacity. X GmbH declared the income from its PEs to be tax- exempt in Germany in accordance with the applicable DTA. The tax office, on the other hand, took the view that the income from the projects in Russia and Romania was not subject to the exemption method but rather to be taken as income with a tax credit up to the amount of German income taxes on the specific foreign income.

Decision

In summary, the Supreme Tax Court held, that the income of the foreign branch income is generally exempt from German taxation under the respective DTA. However, due to the activity requirement contained in the respective DTA, the credit method must be applied. In particular, there were no (active) services of the kind mentioned in Section 8 (1) 1 No. 5 FTA, as X-GmbH had provided its services with the cooperation of A, which initially held a 70% and later a 95% interest in X. An exemption of the foreign branch income also did not arise from the exception in Section 20 (2) sentence 2 FTA (see further below).

If a "switch-over" clause under treaty law stipulates that the application of the exemption method for PE income is subject to an activity reservation and a **reference** is made to Section 8 (1) Nos. 1 to 6 FTA (here: No. 5), foreign PEs meet the definition of a "foreign company“ as defined therein. According to both DTAs, income is only exempt from German tax if the person resident in Germany can demonstrate that the PE derived its gross income exclusively or almost exclusively from economic (true) activities covered by Section 8 (1) Nos. 1 to 6 FTA in the financial year in which the profit was generated.

The above **reference** not only covers the truly active (basic) activities but also includes the restrictions contained in Section 8 (1) Nos. 1 to 6 FTO, specifically in Section 8 (1) No. 5 letter a FTA, where „the service of the foreign branch/company is provided with the assistance of a resident taxpayer with an interest in the (German) company, or with that of the related party of such a taxpayer (….).“

The **("reverse") exception** of Section 20 (2) sentence 2 FTA, which provides for the retention of the exemption method as a legal consequence, does not apply if a switch-over from the exemption method to the credit method does not only result from Section 20 (2) sentence 1 FTA, but already from the application of a "switch-over" clause under tax treaty.

Source:

Supreme Tax Court, decision of 3 July 2024 (I R 4/21) – published on 17 October 2024.

Schlagwörter

foreign tax credit, switch over provision