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By PwC Deutschland | 11. November 2024

Trade tax deduction of foreign branch income and profit allocation

The Supreme Tax Court had to decide on the profit allocation between Germany and the Netherlands in the case of construction sites. Among other things, the court held that the portion of the trading income which is attributable to the foreign permanent establishment (as not having been earned in Germany) must be eliminated from the trade tax basis according to Section 9 No. 3 Trade Tax Act even if Germany would not be prevented from taxing the entire trading income under the relevant double tax treaty.

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1. Legal background

In keeping with the legislative aim of taxing the trading income earned in Germany, the **trade tax adjustments** include the elimination of income from foreign branches as set out in Section 9 No. 3 Trade Tax Act (TTA). Up until now, it has been a matter of some debate whether this reduction also applies if Germany is allowed to tax the entire trade income under a double tax treaty (DTT).

Article 4 of the double tax treaty (DTT) between Germany and the Netherlands states that „if a person domiciled in one of the Contracting States derives income from immovable property (including accessories thereto) situated in the other State, such income shall be subject to taxation by the latter."

Article 5 (3) DTT provides that building sites, and construction and installation projects constitute a permanent establishment provided their duration exceeds 12 months.

2. Case of dispute

The plaintiff is a German GmbH & Co. KG (limited partnership with no natural person bearing unlimited liability) which is part of a Dutch group. In the years of dispute, the plaintiff was acting as a general contractor in residential construction in Germany. The general partner of the plaintiff is V GmbH, the limited partner is B GmbH; both partners have their registered offices in Germany.

The plaintiff carried out residential construction in Germany predominantly on its own properties which it resold after construction. To a much lesser extent third-party properties were used. In addition to the construction sites, it merely maintained a correspondence address ("letterbox") in Germany. The management of the plaintiff as well as the project planning with the necessary personnel were in the Netherlands.

Following a joint audit with the Dutch tax authorities, the tax office was of the opinion that a reduction of trading income pursuant to Section 9 No. 3 TTA was not possible. Instead, German and Dutch auditors agreed on a specific allocation of taxation rights as follows:

Profits from projects carried out on the company's own property were to be taxed in full in Germany, whereas a distinction was made for third-party property depending on the duration of the project. For construction periods of less than twelve months, capital gains from construction projects were to be taxed exclusively in the Netherlands, but for longer projects in a ratio of 80% for the Netherlands and 20% pro Germany.

The Düsseldorf Tax Court (lower tax court) rejected the trade tax reduction and instead ordered an additional deduction in accordance with Section 9 No. 3 TTA of one third of the profit from business operations.

3. Decision

The Supreme Tax Court set aside the judgment of the Düsseldorf Tax Court and referred the case back for

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further hearings and a final decision.

In summary, the Supreme Tax Court held that the findings reached by the German and Dutch tax authorities during the coordinated external audit do not have any binding effect for the courts and may not override the law. The lower tax court's estimate and the underlying profit allocation method are inadequate as no detailed functional and risk analysis of the activities of the permanent establishments was carried out. More precise findings on the allocation of profits between the German and Dutch permanent establishments are therefore yet to be made.

In more detail the Supreme Tax Court had the follow to say:

First, the DTT with the Netherlands (in reference to the OECD model treaty) does not apply to partnerships which cannot themselves invoke the agreement (here: with regard to trade tax) because they are treated as transparent vehicles for tax treaty purposes (as is the case under German domestic tax law) and, thus, in principle are not entitled to treaty benefits. Rather, it is the respective partner who is covered by the DTT and thus is able to claim treaty protection.

As co-entrepreneurs, the two partners of the plaintiff have maintained a business operation at the level of the GmbH & Co. KG. However, only part of the income generated by the plaintiff in the years of dispute is subject to trade tax. In accordance with the assumption of the lower tax court - and contrary to the opinion of the tax office - this also applies to the income generated from the sale of the domestic properties which were acquired, developed and then sold by the plaintiff.

The apportionment and allocation of the trading income to the German and Dutch permanent establishments carried out by the lower tax court does not withstand legal inspection. The lower court did not sufficiently deal with the underlying legal criteria for the apportionment and allocation of profits and did not adequately comply with its duty to clarify the facts which takes precedence over the power to estimate. According to the DTT, permanent establishments must be treated as independent companies to ensure a direct method of profit allocation.

It is without dispute for the Supreme Tax Court that the reduction of the part of the trading income which is attributable to a foreign permanent establishment (Sec. 9 No. 3 TTA) must also be applied if Germany would not be prevented from taxing the entire trading income under the relevant DTT even if the German and foreign tax authorities had agreed on full taxation by Germany as part of a coordinated external tax audit (joint audit).

However, the profits from the sale of the developed properties are not in full included in the trade tax assessment basis due to the restriction of the taxable object to only domestic permanent establishment income. Since the plaintiff's business was managed from the Dutch group headquarters, a permanent establishment within the meaning of Section 12 Sentence 2 No. 1 Fiscal Code (place of management) was maintained there from which the construction project planning and the commissioning of subcontractors for the plaintiff's construction projects were carried out. The portion of the trading income attributable to this

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foreign permanent establishment is not subject to trade tax.

Finally, the Supreme Tax Court states that the profit from the sale of a developed property by a commercial enterprise is fully subject to the general provision of Article 4 DTT Netherlands (income from immovable property) even if the construction work was carried out by the enterprise itself and the property was classified and allocated as current assets.

Source:

Supreme Tax Court, decision of 5 June 2024 (I R 32/20) - published on 31 October 2024.

Schlagwörter

Foreign branch, trade tax deduction