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By PwC Deutschland | 08. Mai 2025

# Adjustment of local branch profit according to Section 1 (5) Foreign Tax Act

**In a decision published today, the Supreme Tax Court held that Section 1 (5) Foreign Tax Act does not constitute an independent rule for determining permanent establishment profits. General allocation methods such as the cost-plus method require a clear legal basis - otherwise they are inadmissible.**

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**Transfer pricing and allocation of profit between units of the same business:**

**Section 1 (5) sentence 1 Foreign Tax Act** (FTA) provides that Section 1 paragraphs 1, 3, and 4 FTA on the adjustment of income are to be applied accordingly if the conditions for a business relationship with the permanent establishment, in particular the transfer prices on which the allocation of income between a domestic company and its foreign permanent establishment or the determination of the income of the domestic permanent establishment of a foreign company is based, do not comply with the arm's length principle and if (therefore) the domestic income of a limited taxpayer is reduced.

**Background**

The plaintiff, a Hungarian parent company with its registered office and management in Hungary (comparable by type to a limited liability company), operated a German permanent establishment in 2017, the year of dispute. It provided contract work in the form of installation and assembly services to local third parties. The tax office increased the profit of the permanent establishment for the assessment period 2017 on the grounds that this was a domestic routine permanent establishment for which the profit was to be calculated on a cost-plus method based on Section 32 of the ordinance on the allocation of profits of permanent establishments (Betriebsstättengewinnaufteilungverordnung - *BsGaV*).

The Nuremberg Tax Court decided that the provision of Sec. 1 (5) in conjunction with Sec. 1 (1) FTA regarding the arm's length principle for cross-border determination of the income of a permanent establishment is not relevant and, to this extent, Section 32 (1) sentence 2 *BsGaV* is also not applicable if there is no transfer pricing issue between a domestic permanent establishment and its foreign parent.

**Decision**

The Supreme Tax Court agreed with the court of first instance and rejected the appeal brought by the tax office. An adjustment of the branch profit is only possible if the terms of business do not meet the arm’s length test. To the Supreme Tax Court, it is already evident from the wording (see above) that Section 1 (5) sentence 1 FTA deals with the correction of income rather than being an independent provision for determining the profits of a permanent establishment.

Section 1 (5) in conjunction with Section 1 (1) FTA presupposes that the terms of the business relationship do not meet the third-party comparison test. Therefore, these provisions cannot be invoked and thus the *BsGaV* is not applicable as there are no indications in the case of dispute that the service relationship between the domestic permanent establishment and the foreign parent company is **not** arm's length.

Section 1 para. 5 sentence 1 FTA in conjunction with Section 32 para. 1 sentence 2 BsGaV (namely that “the transfer price for the service is generally determined using a

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cost-based transfer pricing method") are not a sufficient legal basis for completely rejecting the independent determination of profit by replacing it exclusively with a "profit determination" based on the cost-plus method as a cost-oriented transfer pricing method. There was also no sufficient legal basis to support fictitious (notional) mark-up rates between the domestic permanent establishment and its foreign parent.

Further, the Supreme Tax Court also confirmed the Nuremberg Tax Court on the following: To the extent that payments were made to the parent company, these were merely cost reimbursements (e.g., Hungarian social security fund) that were passed on without a markup.

**Source:**

Supreme Tax Court decision of 18 December 2024 I R 45/22- published on 8 May 2025.

**Schlagwörter**

German branch, income adjustment