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Treaty switch-over to tax credit method requires control of foreign company

The change in the method for avoiding double taxation of certain foreign profits (the „switch-over“ from exemption to the tax credit method) stated in Section 20 (2) of the Foreign Tax Act requires that the German taxpayer controls the foreign company that generates the profits. This most recent decision of the Supreme Tax Court is contrary to the opinion of the German Ministry of Finance in a circular from 2014.

Legal background

Section 20 (1) Foreign Tax Act (FTA) states that the provisions of Secs. 7 to 18 FTA (…) are not affected by the double tax treaties.

According to **Section 20 (2) sentence 1 FTA**, income which accrues to a foreign PE of a taxpayer with unlimited (German) tax 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 under Sec. 8 (1) no. 5 letter a FTA (i. e. services provided by the foreign company with the assistance of a related resident taxpayer…).

The addback in Section 20 (2) FTA is intended to prevent the absorption of the passive income from foreign intermediate companies by interposing permanent establishments in foreign low-tax regimes instead of corporations.

Case of dispute

The plaintiff is a German corporation that held a 30% interest in a US limited partnership. The partnership generated profits from the international granting of licenses. The profits were attributed to the plaintiff to the extent of its shareholding and subject to low taxation in the US. The double tax treaty (DTT) between the USA and Germany as applicable in the years of dispute 2007 to 2009 provided that profits from foreign permanent establishments in Germany were exempt from tax in Germany.

Due to the (partial) tax exemption of the income in the US, the German tax office assumed that the plaintiff's income was subject to low taxation within the meaning of Section 8 (3) FTA (as applicable at the time) and - despite the provision for exemption under treaty law - subject to German taxation pursuant to Section 20 (2) FTA with a credit of the US tax paid.

The lower tax court granted the claim of the plaintiff. The requirements of the unilateral switch-over clause were not met because the plaintiff did not hold a majority interest in the US partnership from a company-related perspective. The tax office instead argued that in the case of Section 20 (2) FTA a shareholder-related view should be taken. Each participation in a partnership with a foreign permanent establishment represented a separate participation for each participant. A majority requirement does cannot be inferred from Section 20 (2) FTA. This is also the opinion of the MoF in its circular of 26 September 2014.

Decision

The Supreme Tax Court agreed with the view of the lower tax court and rejected the tax office's appeal. Sec. 20 (2) FTA serves to prevent abuse. Domestic taxpayers should not

circumvent the regulations on CFC taxation for certain foreign income (passive income attribution from controlled companies, Secs. 7 et seq. FTA) by interposing a permanent establishment in a low-tax foreign country instead of a corporation controlled by them. An investment in a foreign partnership is also considered as permanent establishment.

Due to the equal treatment of permanent establishments (partnerships) and corporations, the Supreme Tax Court is of the opinion that the domestic company - unlike the plaintiff in the case of dispute - must legally or factually control the foreign partnership. Otherwise, even very small shareholdings would give rise to the application of Section 20 (2) FTA, although that would be excluded in the economically comparable case of an intermediary foreign corporation.

A glance at the wording of the law reveals the desired confirmation: Section 20 (1) FTA refers in its entirety to the provisions of Sections 7 through 18 FTA and thus also to the requirement for control as set out in Section 7 (1) and (2) FTA. The Supreme Tax Court went on to point out that, if the legislator had intended to limit the change from the exemption to the tax credit method only to cases where passive income and low foreign taxation existed, an exclusive and specific reference in Section 20 (2) FTA to Section 8 FTA would have been necessary.

Source:

Supreme Tax Court judgment IX R 32/23 of 8 April 2025 - published on 30 May 2025.

Schlagwörter

switch over provision