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By PwC Deutschland | 13 April 2011

Trade tax Organschaft with British parent up to 2001

The Supreme Tax Court has held that failure to recognise a British company as an Organschaft parent infringes the tax treaty prohibition on discrimination.

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Up to 2001 a trade tax group (*Organschaft*) depended on the classic three „integrations" by shareholding, by management and by business activity. The management and business activity integrations could be indirect as long as all three criteria were met at some stage the same ultimate entity within the group structure. A German GmbH borrowed from its German parent, a passive subsidiary of a British company. It claimed a trade tax *Organschaft* with its parent, with the elimination of intra-group interest in mind, its object being to avoid the partial disallowance of the expense to the borrower without a corresponding reduction of the income of the lender. The tax office did not accept this claim, as the parent was not an active business and could therefore not offer business activity integration.

The Supreme Tax Court has confirmed the tax office in its rejection of the intermediary parent company as an *Organschaft* parent, but has chosen to set aside a finance ministry decree prohibiting a trade tax grouping on a foreign parent. But for this prohibition, both German companies in the chain would be integrated with, and thus grouped on, their ultimate parent. The German taxable income of the group would be after elimination of intercompany interest and thus without the one-sided add-back. The two German companies were therefore worse off than they would have been within a German group, and this constituted discrimination by nationality prohibited under the German/British double tax treaty.

The tax office pointed out at the hearing that allowing a trade tax *Organschaft* on a foreign parent would mean allocating German taxable income to that parent, not, in most cases, subject to German taxation. Non-taxation of the income must inevitably result. The court accepted this as an argument, but not as a justification for breaching the non-discrimination provision of the treaty. The requirement was absolute and must be respected, even if loss of tax revenue was the consequence.

The court's finding appears at first sight as a fundamental blow to the trade tax system. However, its effects are mitigated by the adoption of the corporation tax definition of *Organschaft* for trade tax in 2002. Since this includes – in contrast to the definition it replaced – the condition of a five-year profit pooling agreement, only very few – if any – foreign companies may be expected to qualify as *Organschaft* parents from the on.

Supreme Tax Court judgment of February 9, 2011 on joined cases I R 54/10 and I R 55/10 published on April 13

Keywords

Organschaft, Organschaft parent, integration