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By PwC Deutschland | 09.07.2014

No deduction for preparatory costs of failed foreign PE

The Supreme Tax Court has held that a taxpayer cannot deduct costs incurred in preparing for a foreign permanent establishment even if, in the event, the establishment never came into existence.

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A medical partnership intended to open a branch in Dubai. To this end one of the partners incurred significant costs in flying to Dubai for consultations with government officials and future business partners. In the event, the formation efforts came to nought and the partnership claimed a deduction in Germany for the costs incurred in vain. The tax office refused on the grounds that the Dubai branch would have been a permanent establishment within the meaning of the double tax treaty with the UAE (United Arab Emirates).

The Supreme Tax Court has now agreed with the tax office. The costs were attributable to the Dubai permanent establishment and were therefore deductible in the UAE under the double tax treaty. That the PE was ultimately never formed did not make the costs deductible in Germany (note: this is not the case with costs incurred in vain on the formation of a PE elsewhere in the EU). The costs were not incurred in connection with a German business activity. Under the treaty, they were attributable to the future Dubai PE and to that entity only.

Supreme Tax Court judgment I R 56/12 of February 26, 2014 published on July 9

Keywords

Foreign Permanent Establishment (PE), branch, preparatory costs