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Blocking effect under treaty law for formal requirements of arm's-length comparison

In a decision on 24 June 2026 and published on 20 August 2026, the German Supreme Tax Court addressed the tension between domestic tax law rules on hidden profit distributions and international tax treaty protections under the Germany-Cyprus Double Taxation Agreement (DBA) 2011.

Background

Article 9 (1) of the Double Taxation Agreement with Cyprus (which is comparable to Article 9 (1) of the OECD Model Tax Convention) provides, among other things, for the following:

If an enterprise of one Contracting State participates, directly or indirectly, in the management, control, or capital of an enterprise of the other Contracting State, and the two enterprises are bound in their commercial or financial relations by terms that differ from those that independent enterprises would agree upon, the profits that either enterprise would have earned in the absence of such terms may be attributed to and taxed as profits of that enterprise.

Facts

The case involved a German GmbH (the plaintiff) whose shares were acquired by a Cyprus-based company, X-Ltd., which itself was controlled by another Cyprus company, Y-Ltd., in the year of dispute 2013. The German company purchased a property in Germany for €8.74 million, and Y-Ltd. invoiced € 87,333 for services related to this acquisition. The scope of services specified included the review and assessment of the sale and purchase agreement, the conduct and support of the price negotiations, technical due diligence, the review and confirmation of the rent roll relevant to the purchase price and other services. The plaintiff capitalized the amount invoiced by Y-Ltd. as acquisition costs for the purchase of the property and allocated it to the land and the building.

Following a tax audit, the German tax authorities, considered these invoiced payments as a hidden profit distribution because the payment of the invoice without legal basis can only be explained by the corporate relationship.

Judgment

According to German case law, a formal arm's length comparison requires that transactions with controlling parties be backed by clear, pre-agreed, and documented terms to avoid being classified as a hidden distribution. However, whilst the Supreme Tax Court adheres to its principles regarding the formal requirements, it clarified the need for a holistic approach.

The Court confirmed that in cases involving a hidden distribution of profits, Article 9(1) of the 2011 Cyprus Double Taxation Agreement may preclude the application of the formal requirements for the arm’s length test for controlling shareholders and persons closely associated.However, this does not mean that formal criteria are entirely irrelevant. Rather, they may – albeit only indirectly – provide guidance as to whether and to what extent the underlying terms and conditions are to be classified as arm’s length.

In any event, any blocking effect of Article 9(1) only applies if the relevant entities qualify as **“enterprises”** within the meaning of Article 3(1)(f) and (g) of the 2011 Cyprus Double Taxation Agreement. Pure asset management activities are not sufficient for this purpose. The national presumptions of commercial activity under Section 15(3)(2) of the Income Tax Act and Section 8(2) of the Corporation Tax Act do not apply.

Since the lower tax court failed to establish whether the company met the treaty's enterprise definition, the Supreme Tax Court set aside the previous judgment and sent the case back for further factual examination.

Source

Supreme Tax Court judgment I R 57/23 of 24 June 2026 published on 20 August 2026.

Keywords

arm's length, double tax treaty