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By PwC Deutschland | 10 November 2026

Implementation of mutual agreement pursuant to Arbitration Convention

Neither the Arbitration Agreement nor the resulting mutual agreement procedures provide an independent legal basis for a reduction of corporate income. According to the Supreme Tax Court in its recent decision, an agreed reduction in profits must be feasible to implement under national tax law. The specific subject matter in dispute was the non-deductibility of 5% of the tax-exempt income pursuant to Section 8b(5) of the Corporate Income Tax Act.

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Background

The *Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises* (commonly known as the **EU Arbitration Convention**, 90/436/EEC) is a European Union mechanism designed to resolve transfer pricing disputes between associated enterprises in different EU member states.

Section 175a General Tax Code (GTC) provides that a tax assessment notice shall be issued, cancelled or amended where this is required in order to implement a mutual agreement understanding or an arbitral award pursuant to an agreement (…). The period for assessment shall not end before the first year after the mutual agreement understanding or arbitral award has come into effect.

Case in dispute

The case in dispute concerned the question of whether Section 8b(5) CTA applies to profit adjustments based on mutual agreement procedures with other countries, pursuant to the EU Arbitration Convention, and which constitute hidden profit distributions received by the plaintiff, a domestic corporation. Section 8b(5) CTA , in general, provides that 5% of the tax-exempt income cannot be deducted as business expense.

In the case at issue, applying the mutual agreement solution to the year in dispute on the basis of the agreed profit margins and the attributable turnover resulted in a situation reversed compared that of previous years: the subsidiary's profit, calculated on the basis of the actually agreed transfer prices, was now too low, and, correspondingly, the plaintiff's profit was too high. Consequently, the agreement resulted in a reduction in the plaintiff's profit and a corresponding increase in profit for the (indirect) subsidiaries.

The plaintiff argued that the implementation of a mutual agreement procedure constitutes an adjustment of its own kind(sui generis adjustment) thereby excluding the possibility of meeting the factual requirements of Section 8b(5) CTA.

Decision

According to the relevant Article 14 which applies to proceedings under the EU Arbitration Convention, the double taxation of profits should be eliminated. Both the lower tax court (of first instance) and the Supreme Tax Court addressed the question of whether the application of Section 8b(5) CTA constitutes only an insufficient elimination of double taxation and concluded that a complete elimination must be assumed even if 5% of the adjustment amount is treated as non-deductible business expenses.

Thus, the reductions in profit **constitute tax-exempt investment income** within the meaning of Section 8b(1) Sentence 1 CTA from which 5 percent is considered a non-deductible business expense.

According to the established case law, the treaty provisions governing profit allocation are not self-executing. Any profit adjustment requires a domestic legal basis, such as a hidden distribution of profits.

The national regulations do not preclude the application of Section 8b(5) CTA. With regard to the resulting

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reduction in the plaintiff's profits, there is no sufficient legal basis for precluding the legal effects of that regulation - neither directly on the basis of the arbitration agreement or the mutual agreement, nor on the basis of Section 175a GTC.

Lastly, the Supreme Tax Court points out that, while the Arbitration Convention allows the taxation of higher profits, it does not provide a legal basis for implementing such taxation. Nor can the mutual agreement itself be considered as a basis for tax relief because it does not have the force of law. Similarly, Section 175a of the General Tax Code, which deals with the implementation of mutual agreement understandings, is a purely procedural provision and not a rule of substantive law that results in a tax benefit.

Source: Supreme Tax Court, judgment of 2 September 2026 (I R 39/23) published on 5 November 2026.

Keywords

income tax exemption, mutual agreement, non-deductible expenses