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BFH (I R 35/22): No Deduction of so-called Definitive Losses incurred by a Foreign Permanent Establishment

In its ruling I R 35/22 of 22 February 2023, the German Federal Tax Court (BFH) made an important decision for German companies operating internationally. According to this ruling, domestic companies may not offset losses from a branch located in another EU country against profits generated in Germany in order to reduce tax if, under the relevant double taxation treaty (DTT), there is no German right of taxation for the foreign income. This also applies if the losses abroad cannot be utilised under any circumstances for tax purposes and are thus "definitive" (so-called definitive losses). This does not violate European Union law.

In the case at hand, a German-based bank had opened a branch in the United Kingdom in 2004. However, after the branch had consistently only generated losses, it was closed again in 2007. Since the branch had never made profits, the bank could not use the losses incurred in the UK for tax purposes there.

The BFH stated that the losses could not be used in Germany either. This is because according to the relevant DTT, permanent establishment income from Great Britain is not subject to German taxation. The decisive factor here is the so-called symmetry theory, according to which the tax exemption of foreign income under treaty law includes both positive and negative income, i.e. losses. Comparable regulations are contained in many of the double taxation treaties concluded by Germany.

As the BFH further ruled after referring the matter to the Court of Justice of the European Union (CJEU), this exclusion of loss deduction does not violate EU law even with regard to definitive losses.

Originally, however, both the CJEU and the BFH assumed that, for reasons of freedom of establishment under EU law, a loss deduction is possible if and to the extent that the taxpayer proves that the losses are "definitive" in the foreign permanent establishment state. The CJEU ruling Timac Agro Germany (C-388/14) of 17 December 2015 was then understood by the BFH (ruling I R 2/15 of 22 February 2017) as an abandonment of this case law. However, after doubts had arisen due to further CJEU rulings, the BFH again called on the CJEU for clarification. In its ruling C-538/20 of 22 September 2022, the CJEU confirmed its ruling Timac Agro Germany - and thus, in effect, the abandonment of the previous case law.

Content

BFH (III R 22/20 und III R 5/22): Trade Tax Addition of Rental Expenses

The German Federal Tax Court (BFH) recently issued two judgements on the trade tax addition of rental expenses.

Corporations that maintain a permanent establishment in Germany are subject not only to corporate income tax but also to trade tax. Trade tax is calculated based on trade income. The trade income is the profit from business operations determined in accordance with the German Corporate Income Tax Act, which is increased or reduced by certain additions or deductions in accordance with the German Trade Tax Act (GewStG). For example, rental expenses for the use of movable and immovable fixed assets owned by another party are to be added to the trade income (Sec. 8 No. 1 Letters d and e GewStG).

However, a prerequisite for such an addition is that the rented assets belong to the fictitious fixed assets of the tenant. Fictitious because the rented assets cannot be allocated to the business assets of the tenant due to the lack of ownership. It must be determined whether the assets would be fixed assets of the tenant if he were their owner (so-called fictitious fixed assets). According to established case law, the business purpose of the company must be considered when determining whether fictitious fixed assets exist. It is to be asked whether the business purpose presupposes the permanent existence of such assets.

In the dispute III R 22/20, a limited liability company (event manager) rented movable assets (equipment) and immovable assets (in particular locations) for its customers. The question was whether fictitious fixed assets existed. According to the BFH, in the case in question, this depends on whether the event manager must hold the same assets for a longer period of time or repeatedly hold similar assets for a short period of time in order to be able to organize new events with these assets again and again (in this case, fictitious fixed assets). If, on the other hand, the assets in question are only expected to be used for a single event and are not interchangeable with other rented movable and immovable assets, this indicates that they are included in the product "single event" and would only be allocated to current assets (then no fictitious fixed assets). The use of the individual assets must now be determined by the lower court as the instance of fact.

In the dispute III R 5/22, the plaintiff (limited liability company) acted as the main sponsor of a sports club (essentially advertising on the jerseys and perimeter boards). According to the defendant tax office, the jersey and perimeter boards advertising is the rental of an advertising space (movable assets), which is subject to a trade tax addition. The BFH, however, denies a trade tax addition. A sponsoring contract is a mixed contract of its own kind. Although it also contains rental elements, these cannot be legally and economically separated from the other contract components. The performance of the sponsored party consists primarily in the provision of an advertising service (elements of a contract for work and services) for the sponsor, which gives the contract its character, and not in the provision of objects (jerseys and perimeter boards). The question of the existence of fictitious fixed assets was therefore no longer relevant here.

BMF Guidance on the Interpretation of Double Taxation Treaties

On 19 April 2023, the Federal Ministry of Finance (BMF) published a guidance on the significance of the OECD Model Commentary for the interpretation of the double taxation treaty (DTT) regulations corresponding to the OECD Model Convention.

The BMF guidance first deals with the legal character of the OECD Model Commentary, which - taking into account the observations of the OECD member states contained therein - is to be regarded as a rebuttable indication of the national practice of the OECD member states in interpreting the provisions of their DTTs that correspond to the OECD Model Convention. The indicative effect of the OECD commentary is refuted for domestic application if a different understanding of the treaty results from a BMF guidance or other administrative instruction. The binding effect of BMF guidances or other administrative instructions for the tax administration was therefore not affected by the OECD commentary.

Furthermore, the BMF comments on the question of the extent to which amendments to the OECD Model Commentary can be used for the interpretation of already existing DTTs. In its fundamental decision of 11 July 2018 (Ref.: I R 44/16), the German Federal Tax Court (BFH) stated that the mere amendment of the Model Commentary does not have any normative significance and must therefore not be taken into account by the courts. According to principles of international treaty law, it could only be taken into account in the interpretation if the model commentary was reflected in an amended treaty wording and a corresponding consent law.

In its current guidance, however, the BMF refers to the interpretation recommendations of the OECD Council of 1997, according to which the OECD Model Commentary should be followed in its current version at the time of application. The BMF does not see any contradiction in this so-called “dynamic” interpretation of DTTs with the requirements of international treaty law to be observed in Germany. An OECD member state that has not submitted a comment against a comment in the OECD commentary co-decided by its ambassador in the OECD Council shares this commentary.

It remains to be seen how the BFH will react to the new interpretation principles of the BMF, which are in contrast to its established case law. Depending on the specific content of the changes in the OECD Model Commentary, both the "static" interpretation of DTTs advocated by the BFH and the "dynamic" interpretation of DTTs advocated by the BMF may be advantageous for taxpayers on an individual basis.

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