

Lower tax court accepts PE profits allocation method based on actual use of pipeline networks

Personnel function at headquarters level is not seen as providing a significant contribution

In two decisions dated 12 May 2023 (and published in July 2023), Germany's lower tax court of Duesseldorf ruled that a profit allocation to a German permanent establishment (PE) must be based on provisions in the applicable double tax treaties (DTTs), and domestic rules for profit allocations to a PE that were issued after the applicable DTTs had entered into force generally do not apply. The court then determined that the allocation method chosen by the taxpayer, which was based on an arm's length allocation of revenue and expenses based on actual use of a pipeline network, was an acceptable allocation method, regardless of where the taxpayer's personnel functions were located.

Facts of the cases

The taxpayer, a German limited liability partnership (KG), operated a pipeline network in Germany, Belgium, and the Netherlands to transport goods. The administrative headquarters were based in Germany, while the operational headquarters for the pipeline activities (operated by a third party service provider) were based in the Netherlands. The taxpayer concluded standardized transportation agreements with its customers. The remuneration for the transportation was based on a fixed amount calculated based on the weight of the goods and a contingent amount calculated based on the distance over which the goods were transported.

It was not disputed that the pipeline network constituted a PE in the respective countries and the profits should be allocated among the countries involved. The question, however, was how to allocate the profits. The taxpayer determined the profit allocation based on the revenue percentage generated by the German/Belgian/Dutch part of the pipeline. The tax authorities took the view that the majority of the profits should be allocated to Germany, since the main functions and risks were based in Germany, whereas Belgium and the Netherlands should be remunerated on a cost-plus basis.

Both decisions of the court are based on the same fact pattern; however, the first decision covers the year 2011, whereas the second decision covers the year 2015.

Decisions of the lower tax court

In its first decision (year 2011), the court took the view that the general rule, according to which profits should be determined based on the functions, assets, and risks of the PE (i.e., the authorized OECD approach or AOA), should not be decisive in the case at hand, as the applicable German DTTs with Belgium and the Netherlands, which only contain a general arm's length standard, entered into force prior to the publication of the domestic rules based on the AOA. This implies that one of the core elements of the AOA, which is the determination of profits based on "significant people functions," also generally would not apply.

In its second decision (year 2015), the court further ruled that the tax authorities were not permitted to adjust the profits of the German PE based on section 1 (5) of the German Foreign Tax Act (which is the main transfer pricing adjustment norm under German tax law). The court explained that such an adjustment requires a transaction between related parties dealing with the PE for which the transfer price was set incorrectly. In the case at hand, there was no significant dealing in place, given that only minor overhead and management activities were performed by the German headquarters for the benefit of the Belgian and Dutch PEs.

The court concluded in the two cases that the method used by the tax authorities, which was based on where the taxpayer's personnel functions were located (i.e., the tax authorities' view as to where the main functions and risks were located in accordance with the AOA), could not be applied based on the specifics of the cases. The court agreed with the taxpayer that an allocation method based on revenue percentage, i.e., allocating

revenue and expenses based on actual use of the pipeline network, was an acceptable arm's length allocation method, even though not based on where the taxpayer's personnel functions were located.

Comments

The decisions of the lower tax court provide useful guidance regarding profit allocations to a PE and confirms that, for purposes of profit allocations between a head office and its PE, the arm's length method and the respective business model are of relevance. Even in the case of a PE without its own personnel (e.g., pipelines, windmills, solar panels), it must be analyzed whether personnel functions at the headquarters level provide a significant contribution to the overall profits of the operations. The tax court in the decided cases, however, denied a significant contribution by the personnel functions at the level of the head office.

The two cases are now pending before the federal tax court.

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