COMMENTARY

Introduction

The decision of the Federal Fiscal Court (*Bundesfinanzhof*) is likely to become one of the most disputed ones on international taxation in Germany. Although, at first glance, it relates to former rules on trade tax fiscal unity only, it may well cause amendments to the current rules on fiscal unity for both trade and corporate income tax (*gewerbesteuerliche* and *körperschaftsteuerliche Organschaft*). Moreover, the decision may have a major impact on the envisaged reform of the German fiscal unity regime which the government intends to start working on in autumn this year. Finally, it may have an impact on the OECD work regarding art 24 of the OECD Model.

Both parties of the proceedings are dissatisfied with the result. The tax authorities have lost from a formal point of view and, even worse, they are faced with the clear statement of the court that the income in question, which was derived in a domestic PE of a German company, will most likely be 'white income', as it cannot be taxed in Germany and will probably not be taxed in the state of residence of the UK parent company either. The taxpayer does not enjoy his formal success as his income in the year at stake was negative and the loss has gone to 'no man's land'.

For an easier understanding of the decision it seems helpful to note that there are three companies involved: (i) the German C-GmbH, (ii) its 96.5% parent, also a German GmbH (here referred to as 'Holding'), and (iii) C-plc, a resident of the UK, immediate parent of Holding and (to 100%) indirect parent of C-GmbH. In 1999, C-GmbH paid interest to Holding; the tax office treated the interest as partly non-deductible for trade tax purposes. C-GmbH sought to be treated as a member of a trade tax fiscal unity comprising Holding as well, which would—undoubtedly—lead to the interest being fully deductible. As C-GmbH had been merged into Holding in 2003, the current lawsuit was brought to court by Holding as the legal successor of C-GmbH; hence, Holding is the 'plaintiff'. For this reason, unfortunately, the decision is sometimes difficult to understand: when it talks about the 'plaintiff', it may mean either Holding, eg as the recipient of the interest or as the parent of the alleged trade tax fiscal unity, or C-GmbH, as now represented by its legal successor.

Summary of the decision: discrimination on the ground of foreign ownership

In the year in dispute (1999) a trade tax fiscal unity (*gewerbesteuerliche Organschaft*) only required a domestic corporate entity to be integrated financially, organizationally and in economic and operational terms into another domestic business enterprise. A profit and loss pooling agreement (*Gewinnabführungsvertrag*) was only necessary to form a fiscal unity for corporate income tax purposes. This requirement was extended to trade tax only in 2002.

The consequence of trade tax fiscal unity was that the subsidiary was a notional PE of the parent for trade tax purposes. This did not only mean that the trade tax profit (or loss) of the former company was imputed to the latter company. It also meant that interest paid between two members of the same trade tax fiscal unity was not subject to the rule under which 50% of the interest amount was not deductible for trade tax purposes at the level of the payor (so-called 'trade tax add-back', *gewerbesteuerliche Hinzurechnung*).

The court found that in the case at hand a trade tax fiscal unity did not exist between C-GmbH and the plaintiff (Holding), because integration in economic and operational terms could only be present if the parent pursued a business purpose of its own. Yet, the plaintiff was a mere passive holding company and could not serve as fiscal unity parent. Instead, the UK resident C-plc was running a sufficiently active business of its own and could be regarded as the fiscal unity parent since indirect integration of the subsidiary (C-GmbH) was also sufficient to form a trade tax fiscal unity according to the jurisprudence of the court.

The fact that only domestic enterprises could be a fiscal unity parent under the regime was seen as a violation of art XX(4) and (5) of the 1964/1970 double taxation treaty between Germany and the UK, which corresponds to art 24(5) and (6) of the OECD Model. C-GmbH was discriminated against because its indirect shareholder C-plc was a UK resident. The court decided that the discrimination was not only caused by the add-back of 50% interest paid by C-GmbH which could have been avoided in a trade tax fiscal unity, but also by the fact that C-GmbH was subject to trade tax at all. If C-plc had been a domestic company it would have been the fiscal unity parent company and C-GmbH would have been treated as its notional PE without personal liability to trade tax.

The court frankly admits that its interpretation of the treaty can lead to so-called 'white income' ('no-time taxation') since pursuant to art III(1) in conjunction with art II(1) letter l (vi) Germany-UK tax treaty the German tax authorities would only have the right to tax C-GmbH as a (notional) PE of C-plc if the treatment as PE was based on reasons other than the fact that C-GmbH is controlled by C-plc. According to the court, such other grounds did not exist in this case. The named articles correspond to arts 7(1) and 5(7) of the OECD Model and limit the taxing rights of the source state to the profits attributable to a PE on its territory whereas the mere shareholding in a domestic company does not 'of itself' constitute a PE.

No 77 of the 2008 Commentary on art 24 of the OECD Model could not lead to a different result in the court's view, as it prefers a static interpretation of tax treaties which takes only account of facts and circumstances that were present at the date of the conclusion of the treaty (see *Gosch*, BFH/PR 2011, p 268). Furthermore, neither the wording of the treaty nor its context require or allow to *a priori* exclude the fiscal unity regime from the scope of protection of art XX(4) Germany-UK tax treaty.

As a result, the tax assessments issued against C-GmbH were not just changed and the add-back of interest removed. In fact, the tax assessments were completely annulled because the court acknowledged a trade tax fiscal unity between C-GmbH and C-plc. Under the particular circumstances of the case this was disadvantageous for C-GmbH since it had suffered a loss in 1999 which had been assessed as a loss carry-forward as of end of 1999 and which seems to be forfeited due to the judgment (see also *Gosch*, BFH/PR 2011, p. 267).

Some technical background aspects of the plaintiff's claim

A reader who is neither familiar with details of the former trade tax fiscal unity regime nor with German procedural tax law may well wonder why the plaintiff filed his request in a way which allowed the court to annul the tax assessments under dispute, although they were beneficial insofar as they stated a loss carry-forward (which according to the plaintiff, however, should have stated a higher amount).

Originally, the plaintiff had filed two lawsuits with the Hesse Fiscal Court (8 K 3137/06 and 8 K 1160/10). With the former he applied for annulment of the tax assessment which stated his (negative) income for trade tax in fiscal year 1999. With the latter he sought to have the assessment annulled which stated the loss carry-forward as of 31 December 1999, and in an auxiliary capacity to have it amended by increasing the stated loss carry-forward assessed by the tax authorities.

Based on art XX(4) and (5) Germany-UK and on the EU fundamental freedoms he requested that a trade tax fiscal unity between C-GmbH and Holding should be accepted. If so, the interest paid by C-GmbH to Holding would have been fully deductible and, as a mere technical consequence, C-GmbH would no longer have been a taxpayer but its income for trade tax purposes would have been attributed to Holding and included in this company's tax assessments. Consequently, C-GmbH's tax assessments would have been annulled.

Should the court not accept a trade tax fiscal unity between C-GmbH and Holding (due to Holding's lack of own business), the plaintiff sought to be treated as if such fiscal unity had existed between C-GmbH and C-plc on the one hand and Holding and C-plc on the other hand, with the result of both German companies being regarded as members of the same (wider) fiscal unity (so-called *Organkreis*) and thus the interest paid being fully deductible (although a mere passive company was not able to act as the parent in an *Organschaft*, it could be the subsidiary in an *Organschaft*). With regard to this alternative line of arguments, it was, in an auxiliary capacity, requested to leave C-GmbH's trade tax assessments in place, but to increase the loss by 50% of the interest expense which the tax office had treated as non-deductible. The plaintiff expressly argued before the Hesse Fiscal Court in both proceedings that he did not at all require a 'full' cross-border trade tax fiscal unity of C-GmbH or Holding respectively to C-plc with the consequence of the former companies' profits and losses being shifted cross-border to C-plc (see decisions of the Hesse Fiscal Court of 18 May 2010, 8 K 3137/06, m.no. 16, and 8 K 1160/10, m.no. 11).

Is art 24(5) of the OECD Model applicable with regard to fiscal unity?
First reactions in German professional literature basically agree with the Federal Fiscal Court that the denial of *all* aspects of trade tax fiscal unity in the case at hand does indeed violate the prohibition to discriminate against a German enterprise because its (indirect) parent is a foreign resident (see *Mössner*, Internationales Steuerrecht 2011, 349; *Rödder/Schönfeld*, Deutsches Steuerrecht 2011, 886; *Frotscher*, Internationales Steuerrecht 2011, (in preparation); dissenting *Mitschke,* Internationales Steuerrecht 2011, 537). It is not convincing when No 77 of the 2008 Commentary on art 24 of the OECD Model states *a priori* that art 24(5) of the OECD Model 'cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises' (for criticism see also John Avery Jones et al, *World Tax Journal* 2011, p 179 et seq.). The examples given in the Commentary (eg consolidation or transfer of losses) suggest that the statement is mainly driven by the fear to allow for a cross-border shift of profits through the back-door. As explained above, to achieve such result was obviously not at all the plaintiff's intent.

Professional literature, however, expresses much surprise but only little sympathy with the court's conclusion that the discrimination should be removed by accepting a *full* cross-border trade tax fiscal unity, although this is admittedly apt to result in 'white income'. The court's reasoning may well be stringent from a logical point of view as the wording of art 24(5) of the OECD Model may not offer much room for interpretation with regard to the legal consequences once a violation has been found (the court refers to the 'absolute effectiveness' of the non-discrimination clause). Here one may note two interesting differences to the EU fundamental freedoms. First, the EU freedoms require removing the disadvantage and then leave it with the legal system of the member state concerned how to do so. In Germany, for example, it is the Federal Fiscal Court's jurisprudence to 'read down' the discriminating rule at stake. In the case at hand, it is quite probable that the application of the EU freedom of establishment principle would have resulted only in the 'trade tax add-back' not being applied. Second, an infringement may be justified if, for example, it serves the purpose to protect a balanced allocation of the power to impose taxes between the different member states concerned (see in particular the Court of Justice of the European Union decision *Proceedings brought by Oy AA* (Case C-231/05) [2008] STC 991, [2007] ECR I-6373, para 56).

Does art 24(5) of the OECD Model require or allow shifting the tax liability to the foreign parent?

It is obviously correct when the Federal Fiscal Court assumes that the parent of the fiscal unity (C-plc) will not be taxed by its state of residence with regard to the income earned by C-GmbH and attributed to C-plc according to the German *Organschaft* rules. It is also correct when the court states that this is solely due to the national laws of the other contracting state. Why should other states' tax laws reflect the income attribution under the German *Organschaft* system and its potential application under a non-discrimination clause? In addition to that: most other states do not levy a trade tax at all.

Yet, it is quite surprising that the court denies the right for Germany under art 7(1) in conjunction with art 5(7) of the OECD Model to tax the income in question in the hands of the UK parent. It is well debatable whether or not the German taxation of the income attributed to the UK parent does indeed require this company to have an own PE in Germany. The court seemingly believes so.

The court concludes from art II (1) letter 1 (vi) Germany-UK tax treaty 1964/1970 (similar to art 5(7) of the OECD Model) that C-GmbH cannot be treated as a PE of C-plc just because the former company is controlled by the latter company. However, one has to stress that the control must not be taken as the decisive criterion 'of itself'. No 40 of the Commentary on art 5 of the OECD Model refers to a situation where 'the trade or business carried on by the subsidiary is managed by the parent company' which does not qualify the subsidiary a PE of the parent. The court does not deal with this issue in more detail. It would have been interesting to learn whether, in the court's view, 'control' as explained in the Commentary does indeed comprise the requirement of organizational integration. Under this requirement it was not sufficient for the establishment of a trade tax *Organschaft* in 1999 to control the subsidiary's trade or business as a shareholder; rather, at least one of the members of the parent's board of directors (or a similar body) had to act simultaneously as a member of the subsidiary's board of directors or a management subordination agreement had to be concluded. Furthermore, the subsidiary had to be integrated in economic and operational terms into the trade or business of the parent. (As exactly the latter requirement was not fulfilled between C-GmbH and Holding, *Organschaft* between these companies was denied.) Against this background it is not convincing to simply exclude the possibility of the C-GmbH being regarded as a PE of C-plc based on the only argument that control 'of itself' is not sufficient.

It would have been more convincing to deal with the question as to whether or not, irrespective of art 5(7) of the OECD Model, C-GmbH should be treated for treaty purposes as a PE of C-plc, as it is the case for domestic trade tax purposes by way of fiction. In the author's opinion, however, even this question does not need to be answered as it is not decisive for Germany's right to tax C-plc. The reason for Germany to tax the foreign parent of an *Organschaft* would not be the fact that this parent derives own income which might indeed require an own domestic PE. The reason to tax the parent can rather be found in the fact that the German *Organschaft* leads to an attribution of the subsidiary's income to the parent (similar to consolidation systems but different from group contribution systems). There is no doubt that Germany could tax the German source income in question in the hands of the subsidiary if there were no *Organschaft* in place. If such income is attributed to another taxpayer (the foreign parent), the income still has the attribute to originate from a domestic PE. In other words, the income of subsidiary is, together with its tax attributes (here: to stem from a domestic PE), attributed to the foreign parent. Furthermore, one may well question of whether or not arts 6 through 21 of the OECD Model prevent the source state to tax such income which is attributed under grouping provisions as the state of residence will not regard it as income of the parent; hence, there is no potential double taxation to be avoided.

Yet, such income attribution renders the foreign parent a German taxpayer. One may well wonder whether this is a decent result of the application of a treaty non-discrimination clause on the ground of foreign ownership for the benefit of a different company, i e the subsidiary. At least as long as the foreign parent does not expressly apply for and consent to being treated as the taxpayer it is hard to see any legal basis for such taxation. Under domestic law, a foreign enterprise which has neither its place of effective management in Germany nor an own branch to which the subsidiary belongs is not suited to be the parent of an *Organschaft*. Article 24(5) of the OECD Model is certainly not apt to change that.

Against this background the court's deliberation of whether or not the tax treaty Germany-UK 1964/1970 allowed for the taxation of the foreign parent appears to be rather irrelevant for the decision of the case at hand.

As a general conclusion of the foregoing, it seems to be the better view that said non-discrimination clause does not require a cross-border group taxation with, and in particular a cross-border transfer of profits or losses to, a foreign parent that otherwise would not be taxable in the subsidiary's state of residence (for a more general and detailed reasoning see John

Avery Jones et al, *World Tax Journal* 2011, p 179 et seq).

How can the discrimination under art 24(5) of the OECD Model be removed?

Under the assumption that art 24(5) of the OECD Model does not require or allow to shift subsidiary's income to its foreign parent resulting in the latter becoming the taxpayer it seems as if the discrimination would not have any legal consequence.

However, the impact for C-GmbH of the fact that no *Organschaft* is assumed is two-fold. First, this company is liable to trade tax on its income which has to be accepted under the above-mentioned basic assumption. Second, the income for trade tax purposes is increased by the add-back of the interest paid to Holding. This add-back clearly leads to a taxation which is 'more burdensome' than the taxation of the same income if *Organschaft* between the foreign parent and C-GmbH on the one hand and Holding on the other hand respectively had been in place. It is difficult to see why there should be no obligation under art 24(5) of the OECD Model to remove this very disadvantage. To do so does not involve any shifting of profits or losses cross-border, nor does it require to treat the foreign parent as the actual taxpayer. It only requires examining of whether or not all prerequisites for *Organschaft* are fulfilled save for the domestic residence of the parent. If this is the case, the element of C-GmbH's taxation which is more burdensome but does not require for its removal to actually involve the taxation of the foreign parent, must be removed.

Examples of a more burdensome taxation of members of a group of companies which are, however, not subject to grouping provisions, can be found in many states. One prominent example are interest capping rules which are not applied to interest payments between domestic members of a group taxation system (for more details and other examples see John Avery Jones et al, *World Tax Journal* 2011, p 209 et seq).

To restrict the legal consequences of the application of art 24(5) of the OECD Model to these domestic effects would also avoid the questionable result of the court's judgment, i e the annulment of both the trade tax assessment for 1999 and the assessment which stated the trade tax loss carry-forward as a means to remove discrimination.

Does the decision offer planning opportunities?

Leaving aside all critical remarks on the decision as expressed above it is of utmost interest for foreign-owned German companies to evaluate the significance of the judgment for today's regimes of trade tax and corporate income tax fiscal unity. Different from the year at stake in the decision (1999) fiscal unity for trade tax purposes has required since 2002 that a profit and loss pooling agreement (*Gewinnabführungsvertrag*) is in place, as has always been the case for corporate income tax fiscal unity. A profit and loss pooling agreement is provided for and regulated under German company law. Under such agreement a corporation is obliged to transfer all of its income to the other party (normally being the immediate or an indirect parent). On the other hand the other party undertakes to make good any current loss of the corporation.

There is some debate in the German professional literature whether or not it is legally possible to conclude such profit and loss pooling agreement with a foreign party. However, whereas this question is not easy to answer if a foreign subsidiary promises to transfer all of its profit to a German parent, the question seems to be much easier to answer if a German corporation concludes such an agreement with a foreign parent. German tax law has accepted since decades *Organschaft* between a domestic branch of a foreign enterprise and a German subsidiary; hence, there is, in general, no doubt as to the legal validity of a *Gewinnabführungsvertrag* between a German corporation and a foreign parent.

Against this background it is quite likely that the—additional—requirement of a profit and loss pooling agreement as such does not hinder to apply the decision on the current fiscal unity regimes (this issue was obviously known to the court but no decision was made, as annotations by two of its members show; see *Buciek*, Finanzrundschau 2011, p 588, and *Gosch*, BFH/PR 2011, p. 268).

The above consideration may induce businesses to test the potential for 'white income' in accordance with the judgment, although the result seems to be inappropriate. Therefore, tax administration and legislation will most likely try to reduce the potential for such tax planning. It is, however, difficult to conceive that the legislator attempts to introduce a general treaty override provision with regard to art 24(5) of the OECD Model which is enshrined in almost all German tax treaties. It is even more difficult to conceive that the fiscal unity system in total would be abolished.

One solution might be to expressly deny any cross-border profit and loss attribution to a foreign parent (except for cases where the parent owns the subsidiary through a domestic branch by which the profit and loss pooling agreement has been concluded; these cases have been covered by the existing fiscal unity regime since decades). As long as the Federal Fiscal Court sticks with its jurisprudence (or has, in the absence of another suitable case, not got the opportunity to decently amend it) the legislator may wish to ascertain that no 'white income' can be created by introducing a respective provision. Such provision, however, should be restricted to that very point. In particular, the legislator should accept that effects like add-back of intra-group interest payments under trade tax law or the application of interest capping rules on intra-group payments in the absence of a fiscal unity do indeed discriminate against domestic companies if the only reason for their inability to create a fiscal unity is the foreign residence of the parent. All these purely domestic effects do neither have any impact on the foreign parent's tax position nor do they require treating him as the taxpayer.

Another solution might be to tax the foreign parent on the basis of the income attributed to him under the fiscal unity rules. Although, contrary to the opinion expressed by the Federal Fiscal Court, art 5(7) in conjunction with art 7(1) of the OECD Model should not be an obstacle (see above). Any tax liability of the foreign parent clearly lacks the legal basis in the German Corporate Tax Act and Trade Tax Act respectively. Such legal basis would need to be introduced.

The effect of the latter solution compared to the former one would be further-reaching. Whereas the former solution would likely not allow for an off-setting of profits and losses of the German group companies, the latter solution would inevitably lead to a consolidation in the hand of the foreign parent. It is unclear whether or not art 24(5) of the OECD Model does indeed require such consolidation as it seemingly involves the tax position of the foreign parent. However, one should note that the requirements of the EU freedom of establishment might be stricter anyway.

With regard to the potential replacement of the *Organschaft* regime by a so-called modern group taxation system which has been announced by the government as one of the major tax reform projects for the near future, the same considerations apply. It is obviously not at all in the interest of the German tax administration if the discussion continues of whether or not it is possible to shift domestic income to 'no man's land'. Consequently, any modern group taxation system should be designed in a way that such discussion cannot seriously be initiated. On the other hand, the mere possibility of such attempts should not block up the political process to pursue the reform at all and, in particular, the necessary political discussion of the question as to whether or not the requirement of the internationally uncommon and out-moded requirement of the conclusion of a *Gewinnabführungsvertrag* should be given up.

Juergen Luedicke