

Taxation of Permanent Establishments

A foreign enterprise can do business in Germany, choosing from various forms of organisation:

1. It can set up a subsidiary with a legal structure of its own.
2. It can set up a permanent establishment
 - a) as an independent branch, or
 - b) as a dependent permanent establishment.

This information sheet answers questions about setting up a dependent permanent establishment in Germany.

The information is based on the OECD's Model Tax Convention on Income and on Capital for avoiding double taxation, which may differ from the double taxation convention actually applying in any specific case.

What is a permanent establishment?

A permanent establishment is a legally dependent part of an enterprise.

A permanent establishment is defined as a fixed place of business where an enterprise conducts all or some of its operations.

Examples: place of management
branch
office
factory
workshop
mineral extraction plant

A fixed place of business exists if it is designed to serve the entrepreneur with a certain degree of permanence. This is always deemed the case if the fixed place of business exists for more than six months.

Fixed places of business run solely for the purpose of performing preparatory or auxiliary tasks for the enterprise, do not count as permanent establishments (e.g. warehouses, procurement centres, information desks, representative offices).

However, the operations done there may not make up for a significant or major part of the operations done by the enterprise as a whole.

Doing construction or assembly work generally only counts as a permanent establishment if it lasts for a period of more than 12 months.

Exception: agencies

The activities of a business representative or agent sent abroad may also be classified as a permanent establishment. This requires the agent's dependency on the enterprise, on top of which the agent must be authorised to do transactions on the enterprise's behalf and actually exercise this authority in the foreign country.

May Germany levy tax on the profits of a permanent establishment in this country?

As a matter of principle, a company's profits are taxed in the country where the entrepreneur is resident. If the company does operations in another country through a permanent establishment located there, then the country where the permanent establishment is located has the right to levy tax on the profits which the company earns there.

Germany therefore has the right to tax profits earned by a foreign company's permanent establishment in this country.

How are profits divided between the head company and the permanent establishment?

The assets are allocated to the permanent establishment applying the principle of beneficial ownership, whilst the revenues and expenditures incurred by these assets are allocated applying the principle of causation.

The dealing-at-arm's-length rule has to be observed. This means that the permanent establishment is attributed those profits which it could have earned, if it had performed the same or similar operations under the same or similar conditions whilst acting as an independent business, or if it had acted entirely independently in its business dealings with the enterprise of which it is a permanent establishment.

The overall result has to be divided between the head company and its permanent establishment. This is done by applying the direct or indirect method of profit allocation.

Direct method:

In the direct method, the profit earned by the permanent establishment is worked out separately from the accounts, applying German regulations on determining taxable income. The direct method has to be used in particular if the head company and the permanent establishment perform different functions.

Indirect method:

In the indirect method, an appropriate allocation base is used for distributing the company's total profits between the head company and the permanent establishment. If they both perform the same function and have the same internal structure, then the figures which may be used as an allocation base include e.g. turnover (trade and service sector), premiums (insurance), shares in operating capital (banking), or wage and/or material costs (industry).

How are the profits of a permanent establishment in Germany taxed?

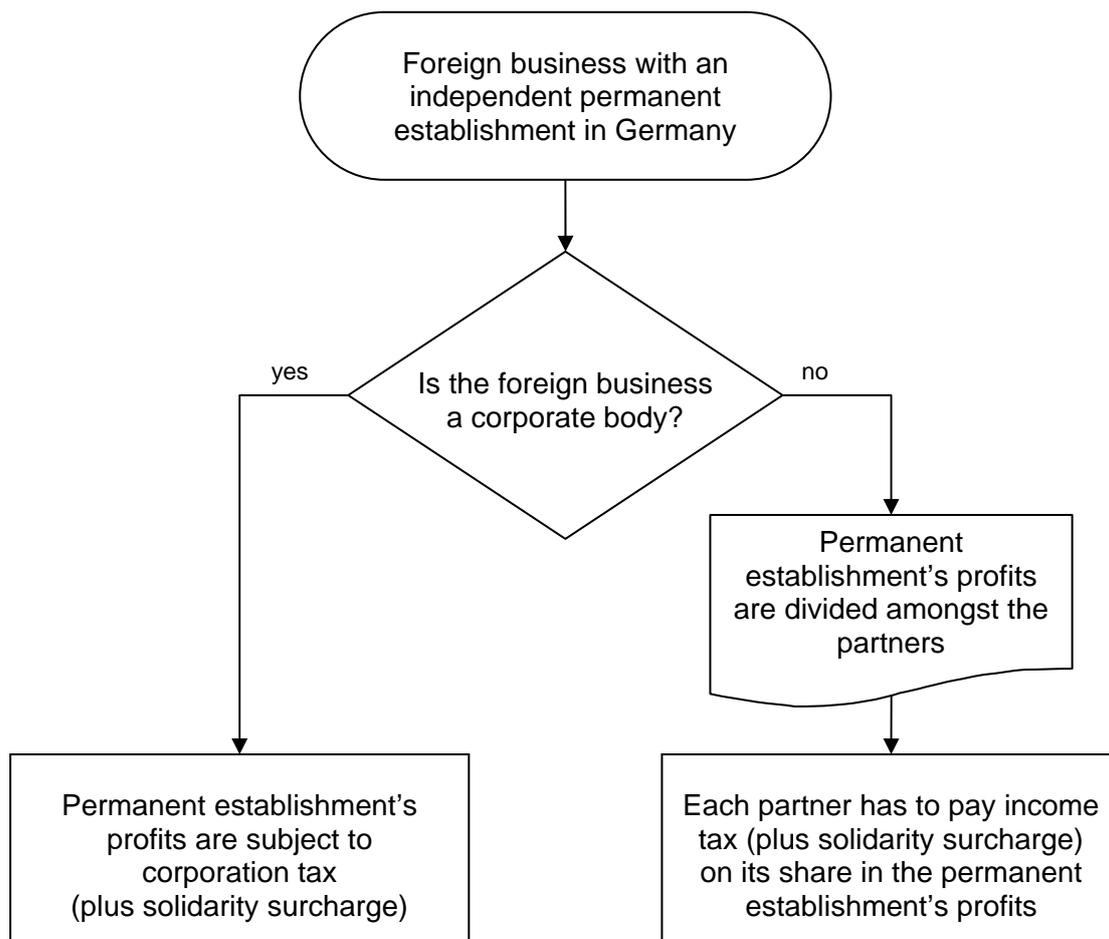
If a foreign enterprise earns revenues in Germany from business operations for which it runs a permanent establishment or has appointed a permanent representative here, then these revenues are subject to limited income or corporation tax.

The taxes levied depend on the legal structure of the foreign enterprise.

Corporation tax has to be paid on profits earned at a permanent establishment by a corporate body.

Any business which is not a corporate body is not itself liable to pay either income tax or corporation tax. The profits are attributed pro rata to the partners. The partners then each have to pay income tax on their respective shares in profits.

In addition to corporation and income tax, a solidarity surcharge is also levied.



The profits earned by a foreign company's permanent establishment are also subject to trade tax. This tax is incurred merely by the existence of the permanent establishment. Trade tax is not incurred if there is only a permanent representative present in this country.

Goods and services provided by the business are subject to German turnover tax (VAT) if the place of performance is in this country.

How is double taxation avoided?

The profits of a permanent establishment in this country are taxed in Germany. In the other country, the permanent establishment's profits are either exempted from tax (subject to the progression rule where applicable), or the amount of tax paid in Germany is counted towards that charged in the other country.