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Client Alert

September 2023

Germany: Is the German Federal Fiscal Court lowering the threshold for a permanent establishment arising from the performance of services?

In brief

In its recent ruling dated 7 June 2023, the German Federal Fiscal Court (**Bundesfinanzhof** (BFH)) had the opportunity to comment on the conditions under which the provision of services by a nonresident service provider on the premises of a German service recipient leads to a fixed place of business (FPoB) permanent establishment (PE) of the service provider arising from the performance of its services (such PE is sometimes referred to as "pseudo service PE" or unechte **Dienstleistungsbetriebstätte**).

The court's decision is interpreted by some observers as lowering the thresholds for a FPoB PE in such circumstances. We do not necessarily agree with such observations. The BFH's reasoning may be ambiguous in parts, but in our view, there is more to suggest that the court has not departed from its previous case law. Rather, the BFH's decision seems to be owed to the particular circumstances of the individual case. The court is following the well-trodden paths of previous established case law. However, this only becomes clear at second glance.

In our view, the provision of services within the principal's business premises should, therefore, also in the future not typically constitute a FPoB PE of the service provider at the principal's business premises, if certain precautionary measures are taken and actually implemented. However, in view of the BFH's ambiguous reasoning, it is to be expected that the German tax authorities could in future increasingly take up cases involving the (not only temporary) provision of services on third-party business premises for asserting a PE. As a result, the precautionary measures listed under point 4. below should become (even) more important in the future.

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1. Relevant facts

The taxpayer — an individual trained as an aircraft mechanic and/or aircraft engineer ("**Mechanic**") — had a residence (dwelling) in Germany and in the UK. For the purposes of the Germany-UK Double Tax Treaty (DTA), the Mechanic was a tax resident of the UK only, where he also had the center of his vital interests.

The Mechanic was the sole shareholder and (without a written contract of employment) director of X Ltd., which had its (registered) office in the UK. The business address of X Ltd. was in a building where an accounting firm and more than 130 other companies were also registered. X Ltd. did not have its own website or telephone number. Its annual accounts showed salary payments to the Mechanic in his capacity as director.

From 2008 to 2014, the Mechanic acted as a subcontractor to Y Ltd. under a so-called freelance arrangement ("... between Y Ltd., on the one hand, and the Mechanic (in bold) and X Ltd., on the other hand"), in which the Mechanic as "freelancer" undertook to provide aircraft-related maintenance services as a subcontractor of Y Ltd. The Mechanic signed the contract with his name (without adding that he was acting in his role as director of X Ltd.).

Y Ltd. — the Mechanic's principal under the "freelancer" agreement — in turn was party to so-called line maintenance agreements with A GmbH, a company based in Germany that acted as an operator and charterer of aircraft, under which Y Ltd. undertook to provide A GmbH with licensed aircraft maintenance personnel and their tools.

The Mechanic carried out his aircraft maintenance work on the airport premises of A GmbH. He brought his tools with him at the beginning of each work shift and took them away again at the end of the shift. The tools were not kept on the airport premises during his absence.

To facilitate the work on site, Y Ltd. had rented changing rooms as well as administrative and common rooms in the premises from A GmbH, which Y Ltd.'s personnel and its contractors (including the Mechanic) could use.

The work carried out by Y Ltd.'s personnel and its contractors on the aircraft was documented in a computer-equipped room of Y Ltd. next to the hangar. In this room, Y Ltd.'s personnel and its contractors had a dedicated locker labelled with their name and the name of Y Ltd. in which they could store personal items such as mobile phones, keys, money, etc.

Before entering the premises of A GmbH, Y Ltd.'s personnel and its contractors (including the Mechanic) had to undergo a security check. For this purpose, the Mechanic received an airport security pass. Access was technically possible irrespective of the shift schedule organized for duty.

Y Ltd.'s personnel and its contractors logged in and out of the time recording system of A GmbH at the beginning and end of their shift. Y Ltd. prepared its invoices to A GmbH based on the working hours that A GmbH had communicated to it.

2. Decision of the BFH

The Mechanic's case was taken up by the German tax authorities, which concluded that the Mechanic had a PE in Germany under the Germany-UK DTA to which part of his income from self-employment was attributable. Consequently, the Mechanic filed court action. The local tax court (i.e., the court of first instance) ruled in favor of the Mechanic, concluding that the Mechanic's activities did not constitute a PE, and provided the following reasoning:

- An important consideration of the local tax court was that the Mechanic did not have a power of disposal over facilities/equipment required for the performance of the contractually owned services. The fact that the Mechanic was entitled to use a dedicated locker was not considered relevant as the locker could not be used to store the Mechanic's tools but only to store his personal belongings.
- In the local tax court's view, for there to be a FPoB PE, it is ultimately decisive that a certain business activity is carried on through the place of business. The court held that the mere possibility of storing private belongings in a locker in a theft-proof manner during work shifts did not meet that requirement (i.e., "through which the business is wholly or partly caried on").

To the taxpayer's regret, the decision of the local tax court was later overturned by the BFH. According to the BFH, the Mechanic maintained a PE in Germany within the meaning of the Germany-UK DTA. The BFH's reasoning can be summarized as follows:

- The BFH initially noted that, according to settled case law, the existence of a FPoB PE under German domestic tax law and Germany's DTAs generally requires a place of business with a fixed location on the surface of the earth, which is of a certain duration, which serves the business activities of the foreign enterprise and over which the foreign enterprise has a power of disposal that is not merely temporary.
- The court stressed that for there to be a sufficient power of disposal under settled case law, the nonresident taxpayer must have a legal position that cannot easily be withdrawn without his consent ("independent right of use"). Such power of disposal will not exist where the nonresident taxpayer, without an independent right to use, is merely co-using the premises, is merely authorized to use the premises in the interest of someone else or only enjoys a mere possibility of use.
- The court also emphasized that the place of business must directly serve the nonresident taxpayer's business. In this respect, the BFH required that an independent entrepreneurial activity with a fixed local connection must be carried out there and a certain "rootedness" of the nonresident taxpayer's enterprise with the place where the entrepreneurial activity is carried out must be expressed in that connection.

Based on the specific facts of the case, the BFH concluded that the Mechanic had a sufficient power of disposal over those premises of A GmbH, which the Mechanic had to enter to perform his aircraft maintenance services for Y Ltd. (i.e., the hangar, the computer room, the changing rooms, etc.):

- The fact that such power of disposal was only indirectly derived from the service contract between A GmbH and Y Ltd. and the freelance contract between Y Ltd. and the Mechanic was not considered to be problematic for the Mechanic's power of disposal.
- Nor did the BFH consider the fact that the respective contracts between A GmbH and Y Ltd. or Y Ltd. and the Mechanic could have been terminated within the applicable notice periods, thus eliminating the Mechanic's power of disposal thereunder, to be an obstacle to the Mechanic's power of disposal during the term of the contracts.

The BFH furthermore held that the entrepreneurial activity of the Mechanic also had a certain "rootedness" through the specific facilities that were made available to the Mechanic for his exclusive use (i.e., the locker), as follows:

- The fact that the Mechanic used the locker solely for storing personal items such as clothing, mobile phone, keys and money but not store his tools did not preclude the "rootedness."
- Contrary to the local tax court, the BFH considered it to be sufficient that the locker was suitable and intended to store the Mechanic's private belongings during the work shift and the Mechanic's work clothes after the work shift.

Interestingly, the BFH did not cite OECD commentary at all.

Finally, although the scope of the FPoB PE resulting from the BFH decision is not entirely clear, it is likely to include more than just the Mechanic's locker, which, however, according to the BFH, is crucial in the present case to establish the "rootedness" of the Mechanic's self-employed business within the premises of A GmbH and thus to make the argument that the Mechanic's activity is actually carried on within such premises.

In our view, the BFH intended the scope of the FPoB PE to encompass all premises over which the Mechanic (in the view of the court) had a power of disposal indirectly derived from the contract between A GmbH and Y Ltd and which were used by him to provide his contractually owed aircraft maintenance services. Otherwise, the BFH's ruling would indeed be nonsensical, as a relevant profit could hardly be attributed under the Authorized OECD Approach to a locker used exclusively for the storage of private belongings during work shifts and for the storage of work clothing after work shifts.

3. Technical discussion

Since the BFH's landmark ruling of 4 June 2008, both the German tax jurisprudence and the German tax authorities have uniformly held that a service provider in general has no power of disposal (in the sense of an independent right of use) over the business premises of his principal:

- The background to this case law is that although the service provider must offer his contractually owed services, the principal is not obliged under (German) civil law to accept the service. Rather, the principal may refuse to receive the service at any time and thus can also refuse the service provider access to its business premises.
- If the principal does so, he must nevertheless pay the service provider his service fee, because in this case the impossibility of providing the service is the principal's own fault. However, the service provider has no enforceable right to provide the service at his principal's business premises. In other words, the service provider cannot enforce his access.

Exceptions to the aforementioned rule can apply in the exceptional circumstance that the agreements between the service provider and its principal indicate that the service provider has an independent right of use.

This case may be given, for example, if the service provider has a right of use expressly granted to him in the service contract or if the service provider has, for example, the (implied) right to use a desk in the principal's premises also for work not related to that principal.

In contrast, an actual joint use or the mere authorization of use in the interest of another were generally not considered sufficient by settled case law since the BFH's landmark ruling in 2008, even if the services were to be provided over a longer period (e.g., more than six months).

Consequently, in comparison to many other countries that follow the so-called painter example in paragraph 17 of the OECD's commentary on Article 5 of the OECD Model Tax Convention, the threshold for a FPoB PE through the provision of services has so far been comparably high in Germany because even long-term activities at the principal's site did not necessarily trigger a FPoB PE. For completeness, it should also be noted that Germany also made a reservation on the "painter example" in paragraph 17 of the OECD's commentary.

Deviation from previous case law?

Some observers seem to interpret the recent BFH ruling of 7 June 2023 as suggesting that the German tax jurisprudence may have embarked on a path to lower the threshold for a FPoB PE through the provision of services (so-called pseudo service PE). As mentioned, we do not necessarily agree with such observations, for the following reasons:

- The BFH has based its recent ruling on precedent case law principles, citing in particular the landmark ruling on pseudo service PE dated 4 June 2008. In other words, the court is following the well-trodden paths of previously established case law.
- If the BFH had intended to deviate from its previous case law, it can be assumed that the court's reasoning would have made this deviation clear.

- Moreover, the court could also have cited its 2004 decision (which confirmed a FPoB PE through the provision of services under similar conditions) instead of its 2008 decision (which overturned the 2004 decision) in order to indicate a change in case law.

Against this background, we believe that there is more to suggest that the BFH did not intend to deviate from its previous case law with its present ruling. Rather, the BFH's decision appears to be owed to the particular circumstances of the individual case, which — from the BFH's point of view — apparently were sufficiently different from the facts and circumstances that formed the basis of its 2008 landmark ruling. This notwithstanding, the concerns expressed by some observers are understandable given the ambiguous reasoning of the BFH in its recent ruling, which indeed raises a number of questions:

Did the BFH modify the concept of power of disposal?

At first glance, the ruling may well be understood to mean that, contrary to previous case law, a sufficient power of disposal can exist even if it can be withdrawn from the nonresident taxpayer without the nonresident taxpayer's consent due to circumstances beyond his control.

However, if one reads the court's reasoning more closely, it becomes clear that the court actually wanted to make a different point. The court states that where the power of disposal of the nonresident taxpayer depends on a contract, the mere possibility to terminate that contract has no influence on the existence of the taxpayer's power of disposal during the term of the contract.

Accordingly, the court's reasoning does not contradict its previous case law. On the contrary, the court still requires a power of disposal that cannot easily be withdrawn without the taxpayer's consent. The only clarification is that the possibility to terminate the contract does not exclude such power of disposal and that the power of disposal exists until the contract termination becomes effective.

Otherwise, i.e., if the possibility to terminate an agreement were in fact to be used as a yardstick for the power of disposal, PEs of any kind (not only those arising through a provision of services) could simply be excluded in the future by way of concluding rental agreements that have particularly short notice periods.

Will the indispensability of use become a new key criterion for the "power of disposal" test?

However, it is somewhat disturbing to see that in its recent ruling the BFH seems to be very quick to assume that the taxpayer has joint power of disposal over all premises where the services were provided, and that the court did not further substantiate its conclusion in this respect. This is particularly worrying because neither the facts of the local tax court ruling nor the facts of the BFH ruling indicate that there could be specific wording in the freelance arrangement that would suggest that the parties intended the Mechanic to have an independent right to use all premises of A GmbH. Rather, the BFH's reasoning suggests that the court assumed a power of disposal of the Mechanic over the premises of A GmbH simply because the use of the premises of A GmbH was an indispensable prerequisite for the provision of the services by the Mechanic.

However, it is doubtful that the BFH in fact intended to make the indispensability of use of the principal's premises the sole criterion for the power of disposal. Otherwise, i.e., if the indispensability of use of the principal's premises was in fact seen as the sole relevant criterion for the power of disposal, practically every form of rendering services on third-party premises not only temporarily would in principle have to lead to a FPoB PE in the future. That the BFH intended this consequence, seems unlikely.

In our view, it is more likely that the BFH came to its conclusion in the context of an overall assessment of the individual case, considering not only certain facts that might indicate a certain power of disposal of the Mechanic (e.g., the fact that Y Ltd. had rented certain rooms in the business premises of A GmbH, that the Mechanic could at least co-use these rooms, that the Mechanic had a dedicated locker at his disposal to store his personal belongings and that the use of the business premises was indispensable for the provision of the service) but also certain facts that might indicate an attempt by the Mechanic to optimize his income tax burden in a possibly abusive manner. The latter point is discussed more comprehensively in the local tax court ruling.

4. Final remarks

In summary, the present case illustrates very clearly that in practice it is essential to ensure that the relevant agreements are clear and unambiguous. In situations where rights of use are not needed by the service provider and where the agreements can, therefore, clearly and unambiguously provide that no such rights of use are granted to the service provider, there should, in our view, still be good arguments to hold that the not just temporary provision of services at the premises of the principal should not lead to a FPoB PE.

Accordingly, companies that typically provide their services in their clients' business premises may want to consider in particular the following measures to mitigate their FPoB PE risk in Germany (always assuming that these measures correspond to the actual business need and are "actually lived"):

- The service contract should be clearly identified as a service contract in terms of Section 611 of the German Civil Code and, unless there is a compelling business need, a right of the service provider to use the principal's premises should be expressly excluded.
- In the event of a refusal of its services by the principal, the service provider's sole remedy under the service contract should be the payment of its contractually agreed service fee.
- The service provider must not have the (implied) right to use specific facilities or equipment (such as a desk or a computer) within the principal's premises.
- Permitting the service provider to use the premises of the principal or specific facilities or equipment therein also for work unrelated to the principal or for the service provider's private matters is not allowed.
- Entry to the principal's premises should be authorized on a case-by-case basis only by the principal's staff exclusively for the provision of the agreed services.
- The service provider should not have an explicit right to use common or administrative rooms. However, it should not be harmful if the service provider's personnel merely have the factual possibility of co-using common facilities such as the kitchen.
- The service provider should not be allocated any dedicated facilities (lockers, rooms, individual workstations or shelves) within the principal's premises. There should be no labelling of such facilities.
- The service provider's staff should be instructed to appear in working clothes. Work materials, tools and work clothes should not be stored on site. Personal belongings should be stored in generally accessible lockers fitted with, for example, coin deposit locks.

As a final remark, the present case is also a good example of how important it can be in practice to clearly present the facts to the local tax court as the court of first instance, and to make sure that the facts are correctly stated in the statement of facts of the local tax court's ruling. If the statement of facts in the local tax court's ruling had clearly stated that the Mechanic did not have a power of disposal over A GmbH's premises based on the relevant terms of the agreements, it would have been more difficult for the BFH to overturn the decision of the first instance court.

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