Series on International Tax Law
Michael Lang (Ed.)

Tax Treaty Case Law around the Globe – 2011

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Greece: The Calculation of the Profits that are Attributable to a PE

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I. Introduction

In its decision No. 917/2010 the Greek Supreme Administrative Court dealt with the interpretation of the provisions of Article 3 of the Greece-Germany DTC[1] and the compatibility of taxation by deduction at source of a Greek PE of a German company with the provisions of the applicable DTC. The Greece-Germany DTC is one of the oldest that Greece has signed, as it was negotiated and signed in the mid-1960s and it therefore presents some differences compared to the current OECD MC. The particular provision, however, that was the subject of the examination of the Greek Court closely follows the wording of Article 7(3), as it stood up until, and including, the 2008 version of the OECD MC.

International bilateral treaties, such as DTCs, enjoy a higher rank in the norm hierarchy within the Greek legal order. According to Article 28(1) of the Greek Constitution, they supersede domestic legislation and they may only be set aside if their provisions are found to be contrary to the Greek Constitution.[2] This high ranking provides increased security regarding the interpretation and application of the provisions of the DTC by the Greek public administration and the Greek courts.

II. Facts of the Case

In 1995 a company having its seat in Germany was awarded a contract with the Public Electricity Company for a construction project in Greece. The total value of the contract was EUR 3,472,105 (at that time GRD 1,183,119,650). For the taxable period from 28 June 1996 until 31 December 2007 the German company kept accounting books in Greece. For the period in question the German company suffered a loss of about EUR 205,430 (at that time around GRD 70 million). The loss was calculated on the basis of the books and records that the German company was required to maintain in Greece, according to the Greek accounting rules and the Greek Code of Books and Records (*Κώδικας Βιβλίων και Στοιχείων*) (Presidential Decree 186/1992); the books and records of the company were accurate.

During the fiscal years in question, Article 13(7) of the Greek Income Tax Code (*Κώδικας Φορολογίας Εισοδήματος*) (Law 2238/1994) provided that foreign companies and organizations that undertook the construction of private or public technical projects in Greece were subject to tax in Greece for the net income that they derived from these works. The tax due was calculated, for the specific category

1 Ratified by Law 52/1967, published in the Official Journal of the Hellenic Government 226 A'/ 20-12-1967; it entered into force as from 23 December 1967.

2 On the issue of the status of double taxation conventions in the Greek legal order and their position in the norm hierarchy see, of the many, K. Perrou, 'Tax Treaty Interpretation in Greece' in *Tax Treaty Interpretation*, ed. M. Lang (Vienna: Kluwer Law International, 2001), 153 et seq.

of the construction works undertaken by the German company in Greece, at 4% on the total gross value of the contract with the Public Electricity Company. The tax so imposed was furthermore withheld by the Greek public authority or organization that had awarded the contract and that was making the payments to the contractor. The 4% tax withheld was paid by the Greek public authority or organization to the Greek tax authorities. It was a final tax and the foreign contractor had no further income tax obligations for the income it derived from the contract in question.

No issue of discrimination was raised. At the same time the net profits of Greek companies undertaking the construction of public works were determined by the application of a 10% rate on the gross income (i.e. the gross value of the public contract). Taking into account that the general corporate income tax rate for the years 1996-1997 was 40%,[3] a foreign PE taxed at 4% on the gross value of the contract is treated in the same way as a Greek company taxed with 40% on the 10% of the gross value of the contract.

During the execution of the project and the payments that took place from the Public Electricity Company to the German company, the 4% tax was being withheld from each payment and it was subsequently paid by the Greek Electricity Company to the tax authorities. When the project ended, the German company complained to the Greek tax authorities that although it had suffered a loss according to the data of its fiscal books and records and based on calculations following the accounting method, at the same time it had been burdened with total income tax amounting to around EUR 138,884 due to the 4% withholding tax on the gross value of the contract. The German company claimed that the tax so withheld was illegal as its tax liability should have been determined following the accounting method according to the provisions of Article 3(3) of the Greece-Germany DTC and not by applying a flat tax rate on the gross income the company derived in Greece.

The company filed a claim for the reimbursement of the tax withheld (EUR 138,884) with the tax authorities, but the claim was rejected. The company then filed a suit before the Administrative Court of First Instance. Both the Administrative Court of First Instance and the Administrative Court of Appeals

3 The 40% corporate income tax rate applied for Greek *societes anonymes* with bearer shares that were not traded in the stock market; a lower rate of 35% applied for *societes anonymes* that had registered shares or for those that their shares were traded in the stock market. No information is provided regarding the category of the shares that the German company had or regarding the fact of whether its shares were traded in a stock market or not. For the purposes of this analysis it is assumed that it is in the same category as the Greek companies that were taxed at 40%. For a discussion of the possible consequences in case the German company fulfilled the requirements for the application of the 35% corporate tax rate, see below in *IV. Observations by the Author*. The different corporate income tax rates were held to be contrary to EU law by the ECJ; see Case C-311/97, ECJ 29 April 1999, *Royal Bank of Scotland plc v. Elliniko Dimosio,* [1999] ECR I-2651.

ruled against the taxpayer. They held that the method used for the determination of the tax liability of the German company in Greece was not contrary to the provisions of the double taxation convention between Greece and Germany.

The case was brought before the Supreme Administrative Court (Conseil d'Etat, Συμβούλιο της Επικρατείας), which was asked to declare the domestic legislation providing for the determination of the tax due by applying a flat tax rate on the gross income of the German company as being contrary to the Greece-Germany DTC, which requires that the taxable income of a German company in Greece must be calculated following the accounting method.

III. Reasoning of the Court

Article 3 of the Greece-Germany DTC provides for the taxation of business profits and it contains provisions similar to those of Article 7 of the OECD MC before the adoption of the 2010 amendments. The particular provision that the taxpayer relied on is Article 3(3) of the Convention with Germany providing that '*In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred.*'

The taxpayer argued that this provision implies that the taxable profits of the permanent establishment in Greece must be calculated following the accounting method, that is: by taking into account the expenses incurred by the permanent establishment. The DTC therefore did not allow the application of a flat tax rate on the gross income attributed to the PE in Greece, as this method did not take into account the expenses incurred by the PE.

The Supreme Administrative Court dismissed the arguments put forward by the taxpayer. Firstly, it held that the method provided by the Greek legislation for the determination of the tax due by the foreign PE does take into account the expenses incurred by the PE. The application of a 4% tax rate on the gross income implies in any case, according to the Court, the recognition of deductible expenses from the gross income of the taxpayer. The Court went on to point out that the true meaning of Article 3 (3) of the Greece-Germany DTC is that in case the taxable profits of the PE in Greece are determined according to the accounting method, then the portion of administrative expenses that are attributed to the PE must be deducted. It does not go as far as to oblige the contracting states to apply in all the cases the accounting method.

Indeed, the Court went on, the choice of the method for the calculation of the profits that are attributable to the PE and consequently taxable in the host state belongs to the host state. To support this argument the Court relied on Article 2(2) of the applicable DTC that contains provisions similar to Article 3(2) of the OECD MC, it provides that: *'As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of the State* *for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under the other laws of that State'.*

This provision of the DTC, taken together with the provisions of Article 3 of the Convention, led the Court to conclude, following on this point its earlier case law, that the accounting method is not the only acceptable method under a DTC for the determination of the taxable profits of a foreign PE in Greece. On the contrary, the contracting states enjoy certain discretionary power as to the choice of the methods they apply for the determination of the taxable profits of the PE.

IV. Observations by the Author

The judgment of the Supreme Administrative Court discussed here confirms the Court's previous case law on the subject. The Court had the opportunity to deal with the same issue in the past again in the context of the DTC between Greece and Germany.[4] In both cases the Court reached the same conclusion: the provisions for the deduction of the administrative expenses incurred by the PE do not have the specific purpose of determining the exact method that a contracting state has to use for the determination of the taxable profits of the PE. The provisions on the deductibility of administrative expenses contained in the DTC aim at clarifying that in case the accounting method is used, then the portion of the general administrative expenses that are attributed to the PE must be deducted in order to determine the taxable profits of the PE.[5]

This conclusion is also supported by the wording of the Commentary on Article 7(3) of the 2008 version of the OECD MTC, which is rather explicit on this point. According to the Commentary (emphasis added):[6] *'Also, paragraph 3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment.* ***It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law****, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3 and 4 of that Article).'*

Interestingly enough, the decision of the Greek Supreme Administrative Court does not make any reference, not even implicitly, to the Commentary on

4 See the judgment of the Supreme Administrative Court No. 1956/1986 and the comments by A. Karakitis, *The taxation of international enterprises in Germany and Greece under the light of the greek-german [sic] agreement for the avoidance of double taxation* (Athens-Komotini: Ant. N. Sakkoulas Publishers, 1996), 213.

5 It is worth mentioning that the corresponding provision in the OECD MC is not present in the current form of Article 7 OECD MC, after the 2010 amendments.

6 See para. 30 of the Commentary on Article 7 of the 2008 version of the OECD Commentary.

Article 7 of the OECD MC, although the provision it interprets is substantially the same.

The facts of the case are similar to the facts that gave rise to the ECJ's *Gerritse* case,[7] which dealt, among other issues, with the compatibility of the taxation by deduction at source with EU law. The judgment of the Greek Supreme Administrative Court in Case 917/2010 is correct from an EU law perspective. Indeed, in the *Gerritse* case the German system of deduction at source for the taxation of non-residents in Germany was considered to be compatible with EU law, under the condition that it applies in the same way for residents and non-residents and it does not result in non-residents being subject to more burdensome taxation in Germany.

In order to find out whether discrimination exists or not, the tax on the Greek PE of the German company must be calculated according to the provisions that applied at that time for Greek companies engaged in the same kind of activities. According to those rules, the tax of the PE would be:

Gross income: EUR 3,472,105
Net profit rate: 10%
Notional net profit: EUR 347,210.50
Corporate income tax rate: (i) 40% or (ii) 35%
Tax due: (i) EUR 138,884 or (ii) EUR 121,523.675
Tax paid by the PE in Greece: EUR 138,884

It appears from these calculations that Judgment 917/2010 of the Greek Supreme Administrative Court is in line with the *Gerritse* judgment, although it does not make any mention to the latter, assuming that the German company would fall under the 40% corporate income tax rate. In the other case, however, if for whatever reason it should qualify for the 35% corporate income tax rate, then the deduction at source of 4% tax would prove to be heavier and in the end discriminatory taxation compared to the taxation imposed on Greek companies in a comparable situation. The Court did not discuss any EU law issues.

[7] Case C-234/01, ECJ 12 June 2003, *Arnoud Gerritse v. Finanzamt Neukölln-Nord*, [2003] ECR I-5933.