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German Tax Traps for Foreign Companies

Permanent Establishments, Transfer Pricing and Director Liability

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Who Should Read This Guide?

Foreign companies operating in Germany or with employees, agents, or business activities here; their directors and executives; in-house counsel; and foreign law firms advising clients on German market entry or expansion.

Key situations covered

- Assessing whether a permanent establishment exists in Germany
- Remote work arrangements and the tax exposure they create
- Transfer pricing compliance for German subsidiaries and branches
- Withholding tax on outbound payments from Germany
- Personal liability of managing directors for German tax obligations

Introduction

Germany's tax system is thorough, well-enforced, and largely unforgiving of errors made through ignorance of how it works. For foreign companies operating in Germany - or with employees, agents, or business activities here - the tax risks are real and can accumulate silently over years before they become visible. A permanent establishment created without any deliberate decision to establish one, a transfer pricing policy that cannot withstand scrutiny by the German tax authorities, or a managing director unaware of their personal tax liability can each have consequences far more serious than the underlying business issue that gave rise to them.

This article identifies the principal German tax traps that foreign companies encounter and explains what foreign counsel and their clients need to understand before they arise.

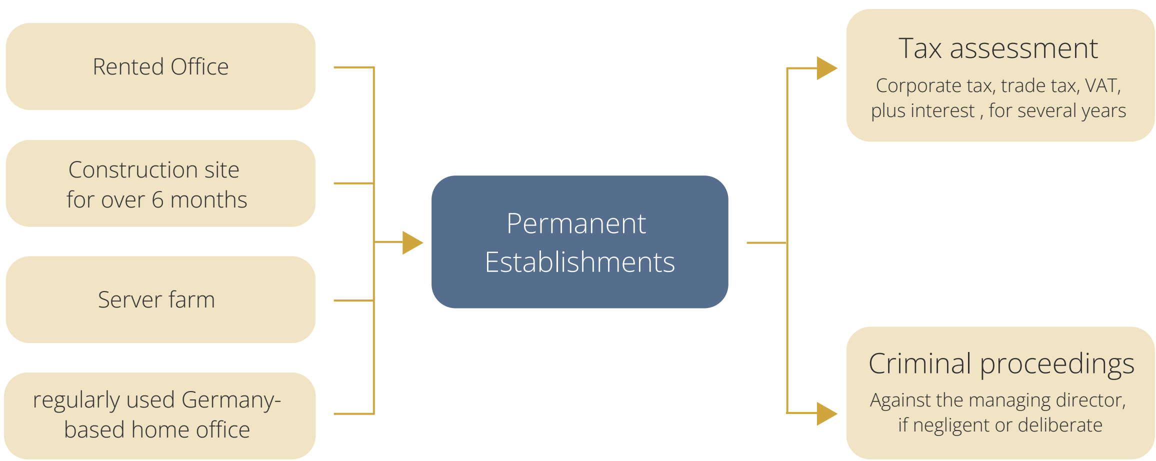
1. Permanent Establishments - The Hidden Tax Trigger

The permanent establishment (Betriebsstätte) is the foundational concept of German international tax law and the source of the most common and most costly tax surprise for foreign companies operating in Germany.

Under Section 12 of the German Fiscal Code (Abgabenordnung - AO), a permanent establishment exists wherever a foreign company has a fixed place of business through which its business is carried on in Germany. The definition is deliberately broad. A single rented office, a construction site that runs for more than six months, a server farm, or even a home office regularly used by a German-based employee can constitute a permanent establishment. Once a permanent establishment exists, Germany has the right to tax the profits attributable to it - regardless of whether the foreign company has any formal legal presence in the country.

Most double taxation agreements (DTAs) to which Germany is a party follow the OECD Model Convention in their definitions of permanent establishment, but the thresholds for the creation and attribution of profits can differ significantly between individual treaties. The DTA between Germany and the United States, for example, contains specific carve-outs for preparatory and auxiliary activities - but these are narrowly construed by German courts and tax authorities. Companies that rely on treaty carve-outs without obtaining specific legal advice on the facts of their situation are taking a significant risk.

The consequences of an undisclosed permanent establishment are severe. The German tax authorities can assess corporate income tax, trade tax (Gewerbesteuer), and VAT for several years, with interest accruing at statutory rates. Where the non-disclosure is found to have been negligent or deliberate, criminal tax proceedings against the responsible managing director may follow in parallel.



2. Remote Work and the Permanent Establishment Risk

The expansion of remote working arrangements has created a new and poorly understood permanent establishment risk for foreign companies with employees based in Germany.

Where a foreign company employs a person who works from home in Germany - even without any German office or branch - that home office may constitute a permanent establishment of the foreign employer under German tax law. The decisive question is whether the home office is at the disposal of the foreign company in a way that enables it to carry on business there. German tax authorities have taken an increasingly active approach to this question, and the position has tightened significantly since 2020.

A single remote employee working from a home office in Germany for a foreign employer, performing substantive business activities rather than merely preparatory or auxiliary functions, is a genuine permanent establishment risk. Foreign companies that have allowed employees to relocate to Germany without assessing the tax consequences - or that have structured remote work arrangements without legal and tax advice - may already have an undisclosed German tax exposure running from the date the employee established their German residence.

IMPORTANT NOTE

Obtaining a lawful immigration status for a remote worker in Germany does not resolve the employer's tax position. The immigration authorization and the permanent establishment question must be addressed separately and simultaneously.

3. Dependent Agents

A permanent establishment can be created not only through a fixed place of business but also through a dependent agent - a person in Germany who habitually exercises authority to conclude contracts on behalf of the foreign company.

The dependent agent permanent establishment is the most commonly overlooked variant of the concept. It does not require an office, a server, or any physical infrastructure. A sales representative based in Germany who regularly visits clients and concludes or negotiates contracts on behalf of a foreign principal may be sufficient. Whether the agent is an employee or an independent contractor is relevant but not determinative - what matters is whether they are economically dependent on the foreign company and whether they habitually act on its behalf in a way that binds it commercially.

Foreign companies that use German-based sales representatives, account managers, or commercial agents - whether employed or self-employed - should obtain a specific legal assessment of whether a dependent agent permanent establishment exists. The assessment must be made against both the German domestic definition and the applicable DTA, and the two do not always produce the same result.

4. Transfer Pricing

Transfer pricing is the area of German tax law that most frequently affects foreign companies that have already established a German subsidiary or branch. It governs the prices charged between related entities within the same corporate group - and Germany's transfer pricing regime is one of the most strictly enforced in Europe.

Under Section 1 of the Foreign Tax Act (Außensteuergesetz - AStG) and the OECD Transfer Pricing Guidelines as incorporated into German practice, all transactions between a German entity and related foreign entities must be priced on arm's length terms - that is, on the same terms that would have been agreed between independent parties in comparable circumstances. This applies to intercompany loans, royalty payments, management fees, the supply of goods, and the provision of services.

Where the German tax authorities determine that intercompany pricing has not been at arm's length, they will adjust the taxable income of the German entity upward, assessing additional corporate income tax and trade tax on the difference. Interest and penalties apply to the resulting shortfall. In serious cases, criminal tax proceedings may follow.

German law requires taxpayers to maintain contemporaneous transfer pricing documentation under Section 90(3) AO and the Transfer Pricing Documentation Regulation (Gewinnabgrenzungsaufzeichnungsverordnung - GAufzV). Where documentation is not available on request during a tax audit, the burden of proof effectively reverses - the tax authority may make its own estimate of arm's length prices, and the company bears the burden of demonstrating that the estimate is wrong. Companies with German subsidiaries that are receiving management charges, royalties, or intercompany loans from foreign parents must ensure that transfer pricing documentation is prepared and maintained on an ongoing basis - not assembled retrospectively when an audit begins.

Country-by-country reporting obligations under German law, which implement the OECD BEPS framework, apply to multinational groups with consolidated revenues exceeding applicable thresholds. Smaller groups are not subject to CbCR but remain fully subject to the arm's length standard and documentation requirements.

	Documentation maintained	**Documentation missing**
Burden of proof	Stays with the tax office	Reverses to the company
Tax authority action	Must justify any proposed adjustment	Makes its own estimate of arm’s length prices
Financial consequence	None, if pricing was genuinely at arm’s length	Extra corporate and trade tax, plus interest and penalties

5. Withholding Tax

Germany imposes withholding tax on certain categories of outbound payments from German entities to foreign recipients. The most significant categories for foreign companies are:

DIVIDENDS: Dividends paid by a German GmbH or AG to a foreign parent company are subject to withholding tax at the standard statutory rate. The rate is reduced under applicable DTAs and may be reduced to zero under the EU Parent-Subsidiary Directive, where the recipient is an EU-resident company holding at least 10 percent of the paying company's shares. The relief must be applied for in advance through the Federal Central Tax Office (Bundeszentralamt für Steuern - BZSt).

ROYALTIES: Royalties paid by a German entity to a foreign licensor are subject to withholding tax at the applicable statutory rate. DTA rates vary and may reduce this significantly. EU-resident recipients may benefit from the Interest and Royalties Directive.

INTEREST: Interest payments on certain instruments are subject to withholding tax in Germany, though the scope is narrower than for dividends and royalties.

CONSTRUCTION AND CERTAIN SERVICES: Withholding tax obligations also arise in respect of payments to foreign companies providing certain construction services and related activities in Germany under Section 48 of the Income Tax Act (EStG), even where no permanent establishment exists. This is a frequently overlooked obligation for German companies engaging foreign contractors.

Foreign companies that receive payments from German entities without ensuring that applicable DTA or EU Directive relief has been properly claimed and documented may find that withholding tax has been deducted that could have been avoided or recovered. The refund procedure through the BZSt is available but entails time and administrative effort that proactive planning can avoid.

6. VAT

Germany's VAT system (Umsatzsteuer) is broadly aligned with the EU VAT Directive but includes several features that regularly create compliance challenges for foreign companies.

REGISTRATION OBLIGATIONS: A foreign company that makes taxable supplies in Germany - including the supply of goods from German stock, intra-EU distance selling above the applicable threshold, or certain electronically supplied services - may be required to register for VAT in Germany regardless of whether it has any physical presence or permanent establishment there. The VAT registration obligation arises independently of the permanent establishment question and is assessed under different criteria.

INPUT VAT RECOVERY: Foreign companies that are not registered for German VAT but incur German VAT on purchases may be entitled to recover it through the EU VAT refund procedure (for EU-based businesses) or the 13th Directive refund procedure (for non-EU businesses). Both procedures are subject to strict deadlines - the EU procedure must be filed by September 30 following the relevant calendar year - and are frequently missed by foreign companies that are not aware of the entitlement.

IMPORTANT NOTE

The September 30 deadline for EU VAT refund claims is a hard deadline. Missing it results in the permanent loss of the refund entitlement for the relevant period. Non-EU businesses face equivalent deadlines under the 13th Directive procedure.

CHAIN TRANSACTION AND TRIANGULATION RULES: Cross-border supply chains involving German entities or German-located goods raise complex VAT questions regarding the allocation of intra-EU supplies and the applicable place-of-supply rules. Errors in this area result in VAT arrears, interest, and potential penalties.

7. Payroll Taxes and Social Security

Foreign companies that employ staff in Germany - or that have employees working in Germany under any arrangement - face payroll tax and social security obligations from the date employment activities commence in Germany.

Where a foreign company qualifies as a domestic employer under Section 38 of the Income Tax Act (EStG) - which includes having a registered seat, management, a permanent establishment, or a permanent representative in Germany - it must register with the German tax office, operate a payroll, withhold income tax (Lohnsteuer), and remit it monthly to the Finanzamt. Social security contributions - covering pension, health, unemployment, and long-term care insurance, with a substantial employer contribution calculated as a percentage of gross salary - must be registered and remitted to the relevant social security authorities.

Where a foreign company does not meet the domestic employer threshold but has employees working in Germany, the obligations are more complex, but do not disappear. The employee may be required to self-assess German income tax on German-source earnings, and social security obligations continue to apply, subject to any applicable bilateral agreement. The determination of the domestic employer status and the applicable social security framework requires a fact-specific legal analysis.

Failure to register, withhold, and remit wage tax and social security contributions is not merely an administrative issue in Germany. The managing director of a German entity - or the person effectively responsible for the company's affairs in Germany - faces personal civil liability for shortfalls in wage tax and social security contributions, and potential criminal liability under Section 266a of the German Criminal Code (StGB) for intentional non-remittance of social security contributions.

	Domestic employer	Not a domestic employer
Income tax	Company registers, runs payroll, withholds Lohnsteuer, remits monthly to the Finanzamt	Employee self-assesses German income tax on German-source earnings
Social security	Company registers and remits pension, health, unemployment, and long-term care contributions	Obligations continue, subject to any applicable bilateral agreement
If unmet	Managing director faces personal civil liability and criminal liability for intentional non-remittance	Requires fact-specific legal analysis to confirm status

8. Tax Audits in Germany

German tax audits (Betriebsprüfungen) are systematic and thorough. Large companies are audited on a continuous or near-continuous basis. Medium-sized companies are audited at regular intervals. The audit typically covers all taxes - corporate income tax, trade tax, VAT, wage tax, and withholding tax - over a three-year period, though the period can be extended where there is suspicion of tax evasion.

When tax investigators (Steuerfahndung) conduct a search of business premises rather than a standard audit, different rules apply. Investigators arrive without advance notice, hold a search warrant, and can seize documents and digital data on the spot. The right to remain silent applies in full - no information should be provided to investigators before legal counsel has been consulted. Once a formal tax investigation has been opened, it is no longer possible to file a voluntary self-disclosure (Selbstanzeige) to extinguish criminal liability - this option is only available before the investigation commences.

For foreign companies subject to a German tax audit, early engagement of German tax counsel is essential. The audit process involves a detailed examination of financial records, intercompany transactions, and the company's legal and economic relationships. Where transfer pricing documentation is absent or inadequate, or where the audit reveals an undisclosed permanent establishment, the resulting assessments can be substantial.

9. Personal Liability of Managing Directors

The personal liability of the managing director (Geschäftsführer) of a German GmbH for the company's tax obligations is one of the most significant and most frequently overlooked tax risks for foreign companies operating in Germany through a subsidiary.

Under Sections 34, 35, and 69 of the German Fiscal Code (AO), managing directors are personally responsible for ensuring that the GmbH meets all its tax obligations. Where the company's tax debts cannot be recovered from the company itself, the German tax authorities may issue a formal liability notice (Haftungsbescheid) against the managing director personally, reaching their private assets.

Personal liability arises where three conditions are met: a breach of tax duty, fault in the form of intent or gross negligence, and a causal link between the breach and the tax shortfall. The most common liability scenarios are:

WAGE TAX (LOHNSTEUER): Managing directors are required to ensure that wage tax withheld from employees' salaries is remitted to the tax office in full. Where the company's liquidity is insufficient, wages must be reduced proportionally rather than paid in full at the expense of the tax remittance. A managing director who allows full wages to be paid while wage tax goes unremitted faces personal liability for the shortfall.

VAT: Failure to file accurate and timely VAT returns, or to remit VAT due, can give rise to personal managing director liability on the same basis.

PRO-RATA SETTLEMENT PRINCIPLE: Where the company has limited liquidity and multiple creditors, the managing director must treat the tax authorities on the same basis as other creditors. Preferential payment of other creditors at the expense of the tax office can result in personal liability for the resulting tax shortfall.

INSOLVENCY FILING DELAY: A managing director who fails to file for insolvency within the statutory period once the company is insolvent or over-indebted faces personal liability for payments made during the delay and criminal liability under Section 15a of the German Insolvency Code (InsO). The offense of Insolvenzverschleppung - wrongful delay in filing - carries up to three years' imprisonment and can be committed through negligence.

IMPORTANT NOTE

Personal liability does not end when the managing director leaves the position. Foreign nationals appointed as managing directors of German GmbHs are as fully exposed to these risks as German nationals - and are often unaware of the obligations the role entails until it is too late.

10. Common Mistakes Made by Foreign Companies

01 **Assuming no German tax nexus without taking advice.**

Foreign companies often conclude that, because they have no German subsidiary or office, they have no German tax exposure. The permanent establishment rules, the dependent agent rules, and the remote work question each demonstrate that this assumption is frequently wrong.

02 **Failing to prepare transfer pricing documentation before an audit.**

Transfer pricing documentation must be contemporaneous - prepared at the time transactions are entered into, not when the audit begins. Companies that assemble documentation retrospectively under audit pressure face a reversed burden of proof and a significantly weaker legal position.

03 **Missing VAT and withholding tax refund deadlines.**

The September 30 deadline for EU VAT refund claims and the equivalent deadlines for withholding tax refund applications are hard deadlines. Missing them results in the permanent loss of the refund entitlement for the relevant period.

04 **Appointing a managing director without briefing them on their personal obligations.**

The personal liability of the Geschäftsführer for wage tax, VAT, social security contributions, and insolvency filing is real, extensive, and applies to foreign nationals in the role. Foreign companies that appoint a local hire or an expatriate as managing director without ensuring they understand these obligations are creating a risk for both the individual and the company.

05 **Treating a tax investigation as a routine audit.**

When the Steuerfahndung arrives at business premises, the situation is fundamentally different from a standard audit. Making spontaneous statements or volunteering documents without legal counsel present can cause irreversible damage to the company's legal position.

11. Key Takeaways

- A permanent establishment in Germany can be created through a fixed place of business, a construction site, or a dependent agent - and creates German tax liability on attributable profits from the date of its establishment.

- Remote work arrangements create a genuine permanent establishment risk for foreign employers with employees based in Germany. Immigration authorization and tax establishment are separate questions that must both be addressed.

- Transfer pricing between German entities and related foreign entities must be at arm's length and supported by contemporaneous documentation. The absence of documentation shifts the burden of proof in a tax audit.

- Withholding tax applies to dividends, royalties, and certain other outbound payments from Germany. DTA and EU Directive relief must be applied for proactively.

- VAT registration obligations in Germany arise independently of permanent establishment status and are frequently overlooked by foreign companies making taxable supplies here.

- Wage tax and social security contributions must be withheld and remitted from the date German employment activities begin. Failure to do so exposes the managing director to personal civil and criminal liability.

- German tax audits are systematic and thorough. When the Steuerfahndung conducts a premises search, legal counsel must be contacted immediately, and no information must be volunteered without advice.

- The managing director of a German GmbH bears personal liability for the company's tax obligations under Sections 34, 35, and 69 AO. This applies to foreign nationals in the role and survives their departure from the position.

- Voluntary self-disclosure to extinguish criminal tax liability is only available before a formal tax investigation is opened. Once investigators arrive, that option is gone.

- German tax counsel should be engaged before establishing any business presence in Germany, before deploying employees, and before entering into intercompany transactions with a German entity.

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