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## The BMF-letter regarding the application of Double Tax Treaties on partnerships

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On 16 April 2010 the Federal Ministry of Finance (“BMF”) published a long awaited letter (IV B 2 – S 130/09/10003, BStBl. 2010 part 1, page 354 -the “Letter”) regarding the application of Double Tax Treaties (“DTT”) on partnerships. A draft letter was made public already in 2007 with the request for comments. The official publication of the letter, however, had been postponed several times because of numerous pending cases before the Federal Tax Court (“BFH”). Still, conclusions from these decisions which have been published to a great part in the meantime are not reflected in the Letter what actually results to some extent in a ‘non-application decree’.

With the Letter, the BMF tries to comprehensively clarify questions which arise in this context and also comments on so-called “special remunerations” (*Sondervergütungen* – for instance, interest paid on partner loans) and the newly introduced Sec. 50d (10) of the Income Tax Act (“EStG”). Some of the most important statements and consequences of the Letter as well as the remaining open questions are described herein.

### 1. General Principles

Germany treats partnerships as **fiscally transparent**. Therefore, a partnership as such is not subject to income taxes. Rather, its income ‘flows through’ to the partners who are taxed on their distributive shares of partnership taxable income. Only for trade tax purposes a partnership is regarded as a taxable entity.

German tax law furthermore distinguishes between (“investment”) **partnerships managing assets** and (“trading”) **partnerships conducting a trade or business**. Trading partnerships are called “co-entrepreneurships” (Sec. 15 (1) no. 2 EStG). Pursu-

ant to Sec. 15 (3) nos. 1 and 2 EStG, furthermore, so-called trade-characterized (*gewerblich geprägt*) and trade-infected (*gewerblich infiziert*) partnerships are **deemed trading partnerships** by operation of law.

Whether a **foreign legal entity** is classified as a partnership or a corporate entity has to be determined for purposes of the German taxation under German tax law. For this purpose a comparison of the civil law characteristics of a foreign entity with the German types of legal entities has to be conducted (comparison of types), whereby the classification under foreign civil or tax law is irrelevant. In this regard reference is made to the BMF-letter concerning the classification of US-LLCs (dated 19 March 2004, BStBl. 2004 I, page 411).

Because partnerships are not subject to income taxes, they generally do not qualify as a resident person within the meaning of a DTT and are thus not entitled to treaty benefits. Treaty benefits can only be claimed by the partners of the partnership under the DTT applicable to the relevant partner.

With respect to German withholding taxes the Letter grants an exception: a reduction of German withholding tax under the applicable DTT (concluded with the state of residence of the partnership) shall be granted, in case the partnership is a taxpayer and its income is subject to income tax in the state of residence. The different view so far taken in the BMF-letter regarding US-LLCs thereby has been given up. Further questions (e.g., reduction of withholding tax rates as in the case of a corporation?) are, however, not commented on. Related special provisions in certain DTTs are described in an enclosure to the Letter.

## 2. Business Profits (Art. 7 OECD-Model Convention – “OECD-MC”)

The Letter focuses on the question under which circumstances a partnership generates business profits within the meaning of Art. 7 OECD-MC. This question is of significant relevance as business profits under DTTs can be taxed in the state in which the enterprise carries on its business through a permanent establishment (“PE”). Germany, as the state of residence of the partner, in general, exempts the share in profits generated in a foreign PE allocable to the partner from German taxation (however, taking into account such income for purposes of the progressive tax rate of individuals).

It is undisputed that the participation in a partnership which conducts a trade or business qualifies as a business of the partner. The question is, however, whether Art. 7 OECD-MC also applies to mere deemed trading partnerships (which actually do not carry on a trade or business).

**The BMF takes the view that the terms “profits of an enterprise” and “business profits” within the meaning of Art. 7 OECD-MC do not only comprise actual trading partnerships but also deemed trading partnerships under domestic law. This shall also apply to special remunerations.**

Despite of the (indeed relatively vague) definition of an enterprise in Art. 3 (1) (c) OECD-MC, the BMF refers to Art. 3 (2) OECD-MC which applies to terms which are *not defined* in a DTT, and thus shall be construed in accordance with the laws of the contracting state applying the DTT.

This argumentation is not convincing. It is also not shared by tax courts so far dealing with this question and indeed the BFH in recently published decisions explicitly argued against this domestic interpretation under the Letter in two cases concerning the DTT USA and the DTT Spain, respectively.

Therefore, mere asset management should not qualify as a business for DTT purposes, even in the case the partnership is a deemed trading partnership from a German standpoint.

The above question has gained even more relevance since the BFH decided that also foreign partnerships (with foreign corporate partners) can qualify as deemed trading partnerships for German tax pur-

poses, which consequently on the basis of the Letter offers tax planning opportunities to the tax payer.

Finally, the Letter clarifies that also profits received from an “atypical silent partnership” qualifies as business profits.

## 3. PE of a partnership

Business profits of an enterprise of a contracting state shall be taxable in the other contracting state but only so much of them as is attributable to the PE situated in the other contracting state (Art. 7 (1) OECD-MC).

Here, the BMF clarifies that a PE of a non-trading partnership that is not classified as a deemed trading partnership is not within the scope of Art. 7 OECD-MC.

Furthermore, the existence of a business partnership does not automatically lead to a PE of that partnership. This question has to be determined under general PE rules (Art. 5 OECD-MC). However, in this regard it should be noted that according to the BFH any entrepreneur at least has one PE at its place of management to which, in case of doubt, all income of the enterprise has to be attributed. This means that “floating income”, i.e., income not attributable to a PE, does not exist. It is not entirely clear whether the BMF intends to deviate from this case law.

## 4. Germany as the state of source (inbound cases)

Under domestic law Germany can tax the share in profits of a partner resident abroad in a (domestic or foreign) partnership only in case the (deemed) trading partnership has a PE or a permanent representative in Germany (Sec. 49 (1) no. 2 (a) EStG). This leads to domestic income taxable in Germany. Under Germany’s DTTs such right to tax follows from Art. 7 OECD-MC.

However, the German tax liability of a foreign partner does not extend to such income of the partnership which cannot be attributed to the German PE (e.g., income generated in a third-state PE). Such income is not subject to tax in Germany (see item 1.1.5.5 of the Permanent Establishment-Degree – *Betriebsstätten-Erlass*).

In accordance with Art. 13 OECD-MC, the tax liability of a foreign partner also extends to profits resulting from

- the disposition of movable or immovable property of a PE,
- the disposal or discontinuation of a PE as such, and
- the disposal of an interest in a partnership to the extent it is attributable to the domestic PE. This disposal of an interest in a partnership is deemed as a sale of the (allocable) assets of the partnership – however, pursuant to Sec. 16 EStG only one single comprehensive gain is to be determined.

A taxable discontinuation of a PE is also found, in case the partnership discontinues its trade or business or no longer qualifies as a deemed trading partnership.

Profits of a foreign (deemed) trading partnership are only subject to German trade tax (with the partnership as the taxpayer) if the partnership maintains a PE in Germany to which such income can be allocated. A permanent representative does not lead to a trade tax liability of the partnership.

The Letter furthermore refers to specific provisions of Sec. 49 (1) no. 2 (f) EStG, which deems rental income (*inter alia*) from real estate and related capital gains as domestic trade income even in case no PE or permanent representative exists. Germany has a right to tax those profits under Art. 6 (4) or Art. 13 (1) OECD-MC.

## 5. Germany as the state of residence (out-bound cases)

In case a German tax resident holds an interest in a (domestic or foreign) partnership, which maintains a PE abroad, a foreign PE of the German resident partner is found. The foreign state has a right to tax the profits attributable to such PE pursuant to Art. 7 OECD-MC and Germany exempts those profits from German taxation (but takes those profits into account for calculating the tax rate of an individual partner).

However, this exemption is – as laid down in detail in the Letter – subject to the following strict requirements:

### a) *Assets to be effectively connected to the PE*

The assets which generate the income (participations, receivables, rights or other assets) actually have to be effectively connected to the PE through which the enterprise conducts its business in the foreign state. Under case law of the BFH such connection requires that the respective asset has a functional link to the activities conducted in the PE. The taxpayer's allocation of an asset to the PE may be an indication for such connection, however, the decisive criteria are that the asset is actually used in the PE and contributes to the profits generated in the PE.

In particular, the allocation of a shareholding to a PE is subject to strict requirements. Such allocation cannot only be based by a transfer of legal title (i.e., a transfer of legal title from the German tax resident to the foreign partnership which, for German tax purposes, qualifies as a PE of the German tax resident). Moreover, according to the Letter it is necessary that the participation has "actual functional relevance" or leads to "other positive effects" for the partnership. It is unclear how this test shall be met in practice, especially as management functions of the partnership with respect to the participation held shall not suffice. Furthermore, this view appears to be in contradiction to the view taken by the BFH.

### b) *Activity test*

An exemption of business profits can be excluded, in case the applicable DTT (e.g., the DTT with Switzerland) requires the conduct of certain activities in the foreign PE which generates to the income for which an exemption is claimed. In case the activity test is not met, an exemption can not successfully be claimed. Rather, Germany only credits foreign taxes.

### c) *Sec. 20 (2) Foreign Relations Tax Act ("AStG")*

Pursuant to Sec. 20 (2) AStG a "passive" PE can be subject to Germany's CFC-rules which stipulate a switch-over from the exemption to the foreign tax credit method. For these rules to apply no minimum participation is necessary. Foreign taxes can be credited against German taxes or deducted in calculating the taxable income.

### d) *Subject-to-tax clauses*

Certain of Germany's DTTs contain subject-to-tax clauses which require that the income to be ex-

empted is **actually taxed** in the contracting state. Pursuant to the BMF the following DTTs contain such clauses: Italy, USA, Denmark, New Zealand, Norway and Sweden.

As the BFH's view on the interpretation of these clauses changed in the past, uncertainties exist and the BMF announces the publication of a specific letter addressing these questions.

Currently, it is unclear whether a number of former decrees published by the administration dealing with the interpretation of subject-to-tax clauses can still be relied upon.

#### e) *Domestic subject-to-tax clause*

Sec. 50d (9) sentence 1 no. 2 EStG provides that in case a source state does not tax income because the recipient is not a tax resident of the source state, the exemption under a DTT cannot be claimed. In an example provided in the Letter the BMF – contrary to case law – takes the view that also a partial non-taxation shall suffice (the example deals with royalty income generated in a foreign PE). However, in case the income in general is not taxable (i.e., also in case the taxpayer was a tax resident) or in case the source state in general does not levy income taxes, such provision shall not be applicable. As this provision clearly qualifies as a treaty override and dishonors the autonomous decision of the contracting state to not fully tax its source income (in contradiction to no. 43 of the OECD-commentary to Art. 23) serious constitutional doubts against its validity have been raised.

#### f) *Conflict of income qualification*

An exemption under a DTT may also not be claimed in case this source state does not tax the income and such non-taxation is based on a conflict of income qualification. The Letter explains the position of the tax authorities in this regard.

Conflicts of income qualification can lead to a double taxation (positive conflict of income qualification) or a double exemption (negative qualification income – *white income*). They result from a different application of DTT provisions. This may have different reasons:

- Domestic and foreign tax authorities base their decisions on different facts.

- Domestic and foreign tax authorities apply different provisions of the DTT as they interpret its provisions differently.
- Foreign and domestic tax authorities apply different provisions of the DTT because they interpret such provisions in accordance with Art. 3 (2) OECD-MC in accordance with domestic law.

The BMF differentiates between DTTs where a switch-over clause is provided for (i.e., the exemption method is replaced by the credit method) and DTTs which do not provide specific switch-over rules.

In case applicable DTT provisions provide for a switch-over clause, a double taxation remaining subsequent to a mutual agreement procedure, in general is dealt with by providing a tax credit for foreign taxes. In case of double non-taxation Germany switches from the exemption method to the credit method. The Letter does not clarify whether in case the pre-conditions laid down in a DTT for a switch-over clause to apply are not met, the general switch-over provision of domestic law (Sec. 50d (9) sentence 1 no. 1 EStG) nevertheless can be applied.

In case of a DTT without switch-over clause a double taxation remaining after a mutual agreement procedure shall be dealt with by abating a portion of the German tax liability.

In case of a double non-taxation the Letter refers to Sec. 50d (9) sentence 1 no. 1 EStG, which excludes an exemption. This newly introduced provision applies to all cases where tax assessments have not been made or still can be amended.

## 6. **Different classification of a foreign partnership**

### a) *Treatment as a corporation in the other state*

In case a foreign legal entity which, under German tax law, qualifies as a partnership is treated as a corporation in the other state this has no impact on the taxation of this entity in Germany.

However, the other state taxes the “partnership” as a corporation and also foreign withholding tax on distributions may be applicable. To the extent the domestic “partner” cannot claim an exemption under the DTT, Germany will provide a tax credit for the corporate tax paid.

A credit or deduction of foreign withholding tax is not possible, as from Germany's view no dividend income exists and distributions from a partnership are non-taxable.

b) *Treatment as a corporation in Germany*

In the case where a foreign legal entity which qualifies as a corporation for German tax purposes is treated as a transparent partnership in the other state, such state will generally tax the domestic "shareholders" on its share in profit allocable to the foreign PE.

Under German tax law the shareholders in a corporation in general (exemption: taxation under Germany's CFC-rules) are only taxed on dividends received (i.e., distributions from the partnership in the view of the other state). Such income does qualify as income within the meaning of Art. 21 (1) OECD-MC (other income) that can be taxed in Germany, as the legal entity in the other contracting state does not qualify as a resident (Art. 4 (1), 10 (1) OECD-MC). However, the domestic tax exemptions available for dividends (40% exemption or flat taxation for individuals; 95% exemption in case of corporations) shall apply.

In case of dividends foreign withholding tax should not apply as the other contracting state qualifies the legal entity as a fiscally transparent entity.

## 7. Special remunerations

The treatment of special remunerations (e.g., interest on loans granted by a partner to the partnership or income from an employment relationship between the partner and the partnership) has been a topic of controversial discussion in the area of international tax law for years.

In the past, case law allocated these payments to business profits within the meaning of Art. 7 OECD-MC. This allocation was based on the argument that absent a specific provision in the DTT the interpretation under domestic rules shall be decisive. However, the BFH changed its view in 2007 and now prefers an autonomous interpretation of the DTT law without reference to domestic law. Special remunerations shall, therefore, be covered by the specific provisions of the DTT, except for those cases where the DTT provides for a specific allocation to a PE and the underlying assets are actually allocable to such permanent establishment.

As a counter-reaction the BMF initiated an amendment to the law and a new Sec. 50d (10) EStG aims to overrule this case law as it deems those special remunerations to be business income for purposes of a DTT. This new provision is to be applied in all open cases. Whether or not this goal of the government was successfully achieved is subject to an ongoing discussion and the BFH will finally have to decide. The Letter – which is no surprise – states that pursuant to Sec. 50d (10) EStG special remunerations in inbound as well as in outbound cases have to be treated as business income under Art. 7 OECD-MC.

In case Germany is the state of the residence, these special remunerations are to be exempt from German taxation provided, however, the other contracting state actually levies taxes thereon. Otherwise an exemption in Germany is excluded, either by means of a switch-over clause in a DTT or pursuant to Sec. 50d (9) sentence 1 no. 1 EStG (see 5.f. above).

In the inbound case this special remunerations do qualify as business profits taxable in Germany. In case also the other contracting state taxes these remunerations (e.g., interest on loans) the BMF takes the view that it is the obligation of the other contracting state to eliminate the double taxation.