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Decision of German Federal Fiscal Court on Taxation of Interest Payments of a Partnership to a Partner

I'm going to present a case of the German Federal Fiscal Court, the *Bundesfinanzhof*, which illustrates that not everything which looks like a conflict with a Double Tax Treaty Partner, turns out to be one.

On the 17th of October 2007[1] the *Bundesfinanzhof* decided that interest paid by a German partnership to its partners resident in the United States may not be taxed in Germany pursuant to Article 11 paragraph 1 of the U.S.-German Double Tax Treaty of 1989.

The case concerns a German limited partnership, which had one general partner, a German corporate entity, and nine limited partners. Two of the limited partners, A and B, were residents of the United States. The partnership kept interest bearing loan accounts for A and B.

The German tax authorities assumed that the interest, which had accrued on the loan accounts, was subject to German income tax pursuant to the German Income Tax Act and to Article 7 paragraph 1 of the U.S.-German Treaty.

I would like to outline briefly to you how Germany taxes interest received by a partner from his partnership under national tax law, because this concept is the basis for the authorities' interpretation of the U.S.-German treaty.

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[1] I R 5/06.

Although taxed as transparent entities, partnerships are not disregarded by German civil and tax law. In fact, our *civil* law acknowledges that a partner can have a debt claim against his partnership and vice versa. Our *tax* law adopts this approach and provides that the debt claim of the partner does constitute a liability in the balance sheet of the partnership.

However, a partnership does not only draw up a balance sheet for itself, but also a so-called "special balance sheet" for each partner. The debt claim of a partner against the partnership constitutes an asset in the special balance sheet of the partner in question. The total of the income computed in both balance sheets is qualified as "business income from the partnership".

Even if the income, which is computed in the special balance sheet, also qualifies as a different category of income, for example "interest", national tax law explicitly provides that the categorisation as "business income from the partnership" prevails over such different category. Furthermore, all such income is attributed to the German PE of the partnership. Similar concepts of partnership taxation can be found in other countries like Austria or the Czech Republic.

The German tax authorities wanted to transfer this concept of national tax law to the treaty level. They argued that the U.S.-German treaty did not include a definition for the term "business profits" in the sense of Article 7. One would thus have to define the term according to German law pursuant to Article 3 paragraph 2 stating that any term not defined in the treaty shall have the meaning that it has under the laws of the applicant state, unless the context otherwise requires or it is otherwise agreed in a mutual agreement procedure.

This would mean for Germany that interest, which is qualified as business profits attributable to the German PE under national tax law, would have to be regarded as business profits and be attributed to the German PE under the treaty, as well.

The German tax authorities, however, lost the case, as the *Bundesfinanzhof* did not follow this reasoning.

It decided that Germany had to exempt the interest from taxation, because the treaty provides in Article 11 paragraph 1 that interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State, which in the case at hand was the U.S.

I would like to give you a summary of the three step treaty construction operated by the court, which I consider to be convincing.

First, the *Bundesfinanzhof* concluded that the interest received by the U.S. partners constituted interest pursuant to the definition in the treaty, which is similar to Article 11 paragraph 3 of the OECD Model Treaty: "interest" means income from debt claims of every kind.

The *Bundesfinanzhof* relied on the fact that the term "debt claim" is not defined in the treaty, which leads to the application of Article 3 paragraph 2. Since German national tax law does, as I mentioned, in fact acknowledge the existence of the debt claim, the *Bundesfinanzhof* concluded that it must not be denied for treaty purposes.

The court also explicitly rejected the argument that a debt claim in the sense of the treaty could only exist between a creditor and a debtor who are "persons" under the treaty. This does indeed not follow from the wording.

Secondly, the application of Article 11 is not excluded by the fact that interest may also be considered to constitute business income under Article 7, because it follows from Article 7 paragraph 6 of the treaty, which is identical to Article 7 paragraph 7 of the OECD Model, that the other articles on the qualification of income prevail over Article 7.

Thirdly, Germany cannot claim a right to tax pursuant to Article 11 paragraph 3, either. This treaty clause, which is similar to Article 11 paragraph 4 of the OECD Model, provides that Article 7 shall apply if the debt claim, in respect of which the interest is paid, forms part of the business property of a permanent establishment, through which the beneficial owner of the interest carries on business in the other contracting state.

The *Bundesfinanzhof* held that this provision mirrors the arm's length principle, which is referred to expressly in Article 7 paragraph 2.

A debt claim can therefore not form part of a permanent establishment's business property, if a separate legal entity would have to show a liability in its books with respect to the debt claim in an equivalent situation. This is clearly the case for a loan granted by a shareholder under both German commercial and tax law.

The court refused to construe the words "forms part of the business property of the permanent establishment" according to the principles of German national tax law. Since Article 11 paragraph 3 expresses the arm's length principle, the *Bundesfinanzhof* was convinced that the "context requires otherwise" but to apply the national law of the applicant state.

Last but not least, the German authorities could not successfully allege that there had been a subsequent practice in the sense of the Vienna Convention between Germany and the U.S., according to which Germany would tax the interest and the U.S. would grant their residents a credit for the tax paid in Germany. The *Bundesfinanzhof* rather held, that such subsequent practice could only impact the treaty construction if it established the agreement of the treaty parties as to the interpretation. Such agreement did definitely not exist between the U.S. and Germany.

As a result, Germany must exempt the interest from taxation, because the treaty leaves no right to tax to the Source State of interest.

You may be wondering why I have not mentioned the OECD Partnership Report yet. It is because the court did not do so, either.

As you will all know, the report contained solutions for problems resulting from different tax law concepts concerning partnerships in the Contracting States.

The Partnership Report states in its examples 13 through 15, that a conflict of qualification between the Source State and the State of Residence can arise, if in the absence of a treaty definition for a treaty term both States apply their differing domestic law to construe the term.

Example 15 of the Partnership Report is at first glance similar to the case before the *Bundesfinanzhof*.

It reads as follows:

"Partner A makes a loan to Partnership P, which has been established in State P where it carries on a business through a permanent establishment. P pays interest to A. State R recognizes loans between partners and partnerships ***but State P does not****.* [I will come back to this phrase.]

Both States treat partnerships as transparent entities and apply Article 7 to the income of P, but State R considers that Article 11 should apply to the payment made to partner A."

According to the Partnership Report State R will be obliged either to exempt what it considers to be interest or to give a credit for the full amount of tax levied by State P on that item of income pursuant to Article 23 A or 23 B, because the taxation in State P was *in accordance with the Provisions of Article 7*. Since State P does not recognize loans between a partner and his partnership in its national law, it is legally justified to apply Article 7 and not Article 11.

German authorities deduced from example 15 that the OECD accepted that interest received by a partner from his German partnership can be treated as business income by Germany.

Yet, they completely misinterpreted the Partnership Report. In fact, the report does not contain a statement as to how States can or even should categorise income when applying the articles on the qualification of income. Examples 13 through 15 in fact presuppose the existence of a so-called conflict of qualification and then suggest a solution for it.

The *Bundesfinanzhof* made very clear that it was not dealing with a conflict of qualification in the case, because the arm's length principle prevents Germany from applying its domestic tax law concept. And indeed, it is inappropriate to cite example 15 to support the German authorities' position, if one analyzes the wording carefully. The example explicitly requires that State P as the Source State ***does not recognize loans*** between partners and partnerships. That is not true for Germany as I already mentioned at the beginning of my speech.

Let me draw a conclusion.

We can without exaggeration say that the decision of the *Bundesfinanzhof* is of very high importance:

First, for international tax practitioners and scholars who are interested in the meaning of OECD Reports and Commentaries on actual cases.

Secondly, for international investors who own an interest in a German partnership or intend to acquire one. They have the possibility to grant their partnership an interest bearing loan and receive the interest free of German tax, provided that the Double Tax Treaty in question reserves an exclusive taxation right to their State of Residence.

Yet, uncertainty remains, because the German authorities have not yet decided whether they are going to accept the judgment.

In my view, at least three different scenarios seem possible at present:

First, the tax authorities can, of course, accept the judgment. If they do so, which I would highly appreciate, the German treaty negotiators should refrain from trying to stipulate explicit clauses in new or revised treaties designed to re-establish their traditional position.

Secondly, it would not be surprising if we were going to see a bill for a treaty overriding new law soon. This would certainly show a great deal of disrespect for our treaty partners and should therefore not be a serious option.

Thirdly, those of you, who are familiar with German tax law, will know that new interest capping rules have been in force since the beginning of this year. Even if the German authorities accept the judgment and refrain from taxing interest paid to a foreign partner, the deduction of interest costs at the level of the partnership might be restricted by the application of those somewhat unclear rules.

So the story is always the same in international tax law: Once we have reached clarity with respect to one issue, we are faced with numerous new problems that will keep us busy in future congresses.