BMF issues decree on treatment of partnerships under tax treaties

The German Ministry of Finance (BMF) has published guidance on the German tax treatment of income derived by domestic and foreign partnerships in tax treaty situations. Although parts of the guidance merely reiterate standard approaches to tax treaty situations and make reference to the OECD model convention, the BMF also issued its final view on some issues that have been and probably will remain controversial.

The most relevant aspects of the guidance are as follows:

- **Transparency:** The BMF confirms that partnerships will be treated as transparent for tax treaty purposes (as is the case under German domestic tax law) and, thus, in principle are not entitled to treaty benefits. The partners, however, may be entitled to treaty benefits if they are resident in a country that has concluded a treaty with Germany.

- **Deemed trading partnerships:** Based on German domestic tax law, trading partnerships include those actually operating a trade or business, as well as partnerships that are only deemed to be trading due to their corporate partner and management structure. The guidance confirms that a deemed trading partnership also may be presumed if a German partnership only has nonresident corporations as its managers. Moreover, contrary to the prevailing view in professional literature, the guidance states that such partnerships will be deemed to earn business profits under the relevant treaty (rather than, for example, income from asset management). Income from these partnerships should be taxable in Germany only if the partnership's activities give rise to a permanent establishment (PE) in Germany.

- **Non-trading partnerships:** The partners of a non-trading partnership should be deemed to earn income directly, so that the income should be treated as e.g. dividends, interest, income from immovable property, etc. Moreover, the guidance takes the position that, for example, interest income in connection with rental activities should not lead to income from immovable property but rather should be taxed as interest income under the applicable treaty. This view is also controversial and a case addressing this question is pending before the Federal Tax Court (BFH).

- **Classification of foreign partnerships:** The classification of a non-domestic partnership for German tax purposes as a partnership or corporation is exclusively governed by German tax law and is based on a comparison of the main features of the foreign entity with the features of a comparable German entity (similar to the guidance regarding the German tax treatment of U.S. LLCs).

- **Determination of PE income:** Repeating previous guidance, the BMF emphasizes that the determination of PE income requires that the assets generating the income be attributed to the PE due to their functional link, especially with regard to shares in subsidiaries. The tax authorities make it clear that assets can only be allocated to the PE in case they are used in the PE. The statements of the BMF suggest that it will remain difficult to allocate shares to a PE (even in cases where the partnership/PE performs certain management holding activities).

- **Withholding tax relief for nonresident partnerships:** Only a partner of a partnership generally should be entitled to file for withholding tax relief if a nonresident partnership is treated as transparent under both foreign and domestic tax law and earns (e.g. dividend) income from German sources. If the partnership is treated as transparent abroad, but qualifies as a corporation for German tax purposes, the German tax authorities will grant withholding tax relief only if the income is taxed in
the hands of the partners who are tax resident in the same country as the partnership.

- Payments by the partnership to its partners for services ("special purpose income and expenses"): As a result of previous conflicting court decisions, the German legislator introduced specific language into the Income Tax Code governing the allocation of taxing rights for special purpose income in a cross-border context. Under this rule, such income and expenses – which could result from interest income/expenses or rental income/expenses – are included in the determination of a partnership's business income and should be subject to German tax in inbound situations. The same approach applies in tax treaty cases and, therefore, may result in a treaty override.

- Conflict of qualification: The guidance states that cases of double non-taxation resulting from different interpretation of the rules should be remedied by applying either the relevant anti-abuse rules in a treaty (e.g. switch-over clauses, subject-to-tax clauses) or the German anti-avoidance rules in domestic law.

Because of the controversial positions of the BMF on certain issues (e.g. qualification of business income and special purpose income and expenses), further discussions and possibly court proceedings in cross-border cases involving partnerships are expected.

If you have any questions, please contact the authors of this article at gtl@deloitte.de or your regular Deloitte contact.

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