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German Tax and Legal News

Federal Fiscal Court confirms residence country taxation of interest income from rental profits in cross-border situations

In a decision published 28 April 2010, the Federal Fiscal Court confirmed the view of several lower courts that interest income of a deemed trading partnership that rented out real property in the U.S must be allocated to its partners and is subject to tax in the country where the partners are resident, which in the case was Germany (case reference I R 81/09). The cash surplus resulting from the leasing activities was invested and generated interest income. Applying the interest article in the Germany-U.S. tax treaty, the court held that, from a treaty perspective, the interest income does not fall within the scope of the business profits article due to the fictitious “deemed trading” nature of the KG, or under the real estate article. The income is based on the use of capital, not on the use of real property. The Federal Fiscal Court’s conclusions are supported in the tax literature.

The court also held that in the case of double taxation, a credit for any foreign tax paid is possible only if there is a binding decision of the tax authorities that the mutual agreement procedure would not resolve the issue.

Although the case involved an outbound situation, the decision should apply equally to inbound situations. In typical situations where foreign investors hold German real estate for rental purposes through a foreign entity (e.g. Netherlands B.V. or Luxembourg Sarl) or through a partnership deemed to be trading by virtue of law, interest income earned in connection with the real estate should, in principle, be subject to tax outside Germany (at the level of the foreign entity or at the level of the partners in the partnership, respectively).

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