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German Tax and Legal News

Federal Tax Court rules on classification of partnership income in German-Hungarian cross-border situation

In a decision dated 25 May 2011, the Federal Tax Court (BFH) ruled on classification conflicts in connection with rental proceeds in a German-Hungarian cross-border situation (case reference: I R 95/10).

The case involved a German resident limited partner that held almost the entire partnership interest in a Hungarian partnership (T-BT). The sole general partner of T-BT was a Hungarian corporation. T-BT generated rental income from the letting of immovable property situated in Hungary and the equipment located thereon. The lessee of the movable and immovable property was another Hungarian partnership (E-BT) in which the German resident had a majority interest. T-BT was treated as a taxable entity in Hungary and thus paid Hungarian corporate income and trade tax on the rental income.

The BFH first addressed the classification of T-BT and whether Germany should qualify it as a transparent or taxable entity for treaty purposes. Under German domestic income tax law, T-BT, as a partnership, is considered a transparent entity. The OECD partnership report, as well as the minority view taken in German tax literature, however, support the position that Germany should follow the classification of the partnership's residence country (i.e. in this case, the Hungarian classification as a taxable entity). The BFH, however, rejected this view, referring to article 3(2) of the Germany-Hungary tax treaty (i.e. terms that are not defined shall have the meaning they have under the law of the state to which the treaty applies). As a result, the income was not automatically taxable in Hungary from a German treaty perspective.

The second issue before the BFH was the classification of the partnership's Hungarian (rental) income. Under German domestic law, the income would qualify as deemed business income – either because T-BT would be seen as a deemed trading partnership or because the rental activity carried out by T-BT would be seen as being artificially separated from the commercial activity undertaken by E-BT. According to the BFH, these fictions under domestic law do not apply for treaty purposes. In addition, the court stated that the letting of immovable property as such does not constitute a permanent establishment in Hungary. As a result, the income was not classified as business income within the meaning of the treaty.

Instead, the BFH concluded that the income from the letting of the immovable property should be classified as income within the meaning of article 6 of the treaty (right to tax in Hungary, tax-exempt income in Germany), whereas the income from the letting of movable property should fall within the scope of article 21 and, therefore, should be taxed in Germany. With regard to a potential tax credit for the tax paid in Hungary, the case was referred back to the lower tax court.

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