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German Tax and Legal News

Lower tax court clarifies application of subject-to-tax rule in Germany-US double tax treaty

Partial non-taxation is not sufficient to apply switch-over from exemption to credit method

In a decision dated 18 April 2023 and published on 15 May 2023, the lower tax court of Duesseldorf, Germany, clarified the conditions for applying the subject-to-tax clause in article 23 (4) of the Germany-US double tax treaty (DTT). The court ruled that a partial non-taxation of income generated by a trading US partnership and allocated to a German partner is not sufficient to apply the switch-over clause of article 23 (4) lit. b 3. alternative of the DTT, which as a consequence would grant a tax credit instead of exempting the income from German tax. In addition, the lower tax court opined that the German CFC rules are not applicable because, in the case of a foreign partnership that generates low-taxed passive income, the German partner must control the partnership, i.e., it must hold at least a 50% interest in the foreign partnership. In this regard, the court rejected the view of the tax authorities as provided in a 2014 decree, which stated that, in case of an interest in a foreign partnership, the ownership percentage is irrelevant to determine whether the German CFC rules apply.

Relevant fact pattern
In the case at hand, a German GmbH that was part of a multinational group held a 30% ownership interest as a limited partner in a trading US limited partnership (LP). The LP generated income from marketing the group's brand and licensing it to related and unrelated parties. The LP had substantive business operations, office space, and personnel in the US. As the LP qualified as a transparent entity for US federal income tax purposes, its partners were subject to US taxation at the federal level, as well as in various states and cities. However, based on US Internal Revenue Code section 864(c)(4)(D)(i), royalty income derived from related parties was not taxed by the US as this portion of the royalty income qualified as income that is not effectively connected with a US trade or business (not "effectively connected income" or ECI). On the other hand, royalty income derived from unrelated parties was taxed in the US at the partner level as such income qualified as ECI.

The German tax authorities did not grant a tax exemption for the income generated by the US LP as requested by the German partner based on articles 7 (1) and 23 (3) lit. a of the DTT. The tax authorities argued that, due to the partial non-taxation of the income in the US, the subject-to-tax clause of article 23 (4) lit. b of the DTT, provided for the application of the tax credit method instead of the exemption method and taxed the income allocated to the German partner. The taxpayer was then granted a credit for the tax paid in the US on this income. In addition, the tax authorities argued that, even without relying on the subject-to-tax clause in the Germany-US DTT, the application of the German CFC rules would have provided for the same result based on the switch-over clause in section 20 (2) of the German Foreign Tax Act. The income generated by the US LP qualified as low-taxed passive income under the German CFC rules and, therefore, the switch from the exemption method to the credit method applicable to income derived through a foreign permanent establishment (PE) had to be applied.

Decision of the tax court
The lower tax court in its decision came to the conclusion that the subject-to-tax clause in the Germany-US DTT was not applicable and sided with the argument of the German taxpayer that it should not be possible to divide the income of the US LP into separate components. The tax court carefully analyzed the wording of the Germany-US DTT and also compared it with the wording in other treaties concluded by Germany. The court's analysis referred to the use of the general term "income" in the switch-over clause of article 23 (4) lit. b, 3. alternative of the Germany-US DTT and the fact that this provision does not include a limitation to separate "items of income" as provided in other parts of the treaty (such as, e.g., in article 23 (3) lit. a and lit. b of the Germany-US DTT or as provided in other German treaties). The lower tax court also referred to a similar decision issued by the lower tax court of Munich in 2020.

Finally, the tax court also denied the application of the switch-over clause as provided in section 20 (2) of the German Foreign Tax Act. Even though the income generated by the US LP qualified as low-taxed passive income under the German CFC rules, the tax court found that the German partner lacked the requisite control over the partnership as its interest in the partnership was less than 50%. The tax court rejected the interpretation of the tax authorities as provided in a 2014 decree, which deemed the ownership percentage irrelevant to determine whether the German CFC rules apply. Instead, the court confirmed that, in the case of a foreign partnership that constitutes the foreign PE of a German taxpayer, the control requirement of the German CFC rules has to be met based on the total partnership interest percentage. This requirement was not met in the case as the German taxpayer only held a 30% interest in the US LP. The lower tax court confirmed this interpretation of the German CFC rules in a separate decision also published on 15 May 2023 (same fact pattern but different years involved).

The tax authorities have appealed the lower tax court decision to the federal tax court.

Comments

The decision of the lower tax court of Duesseldorf is a welcome clarification of the interpretation of the subject-to-tax clause in the Germany-US DTT and provides some relief for affected taxpayers. The area of application of the switch-over mechanism in the treaty is narrowed down to cases where the entire income of a US business is exempt from US taxation and should not apply in cases where only a portion of the income is exempt. The comment of the lower tax court regarding the partnership/PE control requirement to apply the switch-over clause of section 20 (2) of the German CFC rules should still be relevant even if the German CFC rules were substantially modified in the past couple of years.