

Lower tax court clarifies criteria for classification of a US limited liability company for German tax purposes

Lack of an obligation to contribute equity does not count in favor of classifying an LLC as transparent.

The lower tax court of Munich, in two separate decisions dated 10 November 2020 and published on 28 January 2021, provided clarification on the application of the criteria for determining whether a US limited liability company (LLC) should be classified as a corporation or as a flow-through for German tax purposes. Even though the lower tax court's decisions have been provided only as part of an interim legal protection procedure and are being appealed to the federal tax court, the decisions provide some interesting insights into how the lower tax court analyzes the characteristics of a US LLC.

Whether a US LLC is classified as a corporation or a flow-through for German tax purposes may have significant tax consequences, given that eligibility for certain tax benefits under German domestic tax law and the Germany-US tax treaty depends on whether an entity has the status of a corporation or of a partnership or branch. In particular, this may be relevant for purposes of the application of the German participation exemption rules (for German outbound investments) or the determination of the applicable dividend withholding tax rate (for German inbound investments).

Back in 2004, the German Ministry of Finance (MOF) issued a decree to provide guidance on how to analyze the characteristics of an LLC and what criteria must be taken into account. According to the MOF guidance, a US LLC can be classified either as a corporation, a partnership, or a branch (permanent establishment) of a single owner for German tax purposes. German law is authoritative for purposes of determining the appropriate classification in Germany, and the principles developed by the federal tax court regarding the classification of an entity established under foreign law must be followed. Based on these principles, a foreign entity is classified as a corporation if a comparison of the essential characteristics of a corporation under German law with (i) the rules governing the entity under the laws of the jurisdiction in which it is established, and (ii) the provisions of the entity's operating agreement demonstrate that the foreign entity legally and economically resembles a German corporation. The MOF guidance states that the following criteria must be taken into account in classifying a US LLC:

- Whether the LLC has centralized management and representation;
- Whether the shareholders have limited liability;
- Whether the interests in the LLC are freely transferable;
- The mechanism for the attribution of profits;
- The rules governing capital contributions and capital preservation;
- Whether the LLC has limited or unlimited life;
- The mechanism for the distribution of profits;
- The relevant registration and formation provisions; and
- Other relevant criteria.

In a case where an LLC has some characteristics of a flow-through and other characteristics of a corporate entity, the MOF guidance provides that the individual characteristics will be "weighted," thus giving the German tax authorities a degree of discretionary power. However, none of the criteria listed above will be determinative, nor will any criterion override the other criteria.

In its 10 November 2020 decisions, the lower tax court of Munich considered the criteria mentioned above and analyzed how they apply based on the provisions in the LLC's operating agreement and the applicable LLC law (the LLC law of the US state of Colorado was applicable in both cases). The court stated that the fact that there was no obligation in the LLC's operating agreement for the shareholder of the LLC to contribute equity into the company and that the applicable LLC law also did not provide for such an obligation generally would be an indication that the LLC has the character of a flow-through. However,

the court went on to clarify that the existence of an obligation to make capital contributions should not be relevant in the analysis of the LLC for German tax purposes because it also is possible under the current German law to set up a corporate entity with only minimal capital. This refers to the possibility to set up an “entrepreneurial” or “small business company” under section 5a of the limited liability company act with a stated share capital of only EUR 1, which was introduced into German law with effect as from 1 January 2008. At the time the MOF decree was published, the legal form of such a company was not available and a minimum stated share capital of EUR 25,000 was required to set up a corporate entity under German law.

The decisions of the lower tax court provide some valuable insights into how the criteria for classifying LLCs that are described in the 2004 MOF decree must be applied, taking into account that the corporate law has developed since the publication of the 2004 decree. The tax court decisions also highlight that an individual analysis, based on the features of the operating agreement and the applicable LLC law, is required in each case to determine the appropriate classification of the LLC for German tax purposes.

As noted above, an appeal against the lower tax court’s decisions currently is pending at the federal tax court.

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