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German Tax and Legal News

Germany's Federal Fiscal Court rules its first case regarding Guaranteed Payments

The application of subject-to-tax clauses was not decisive but the allocation of taxation rights under article 14 of the former Double Tax Treaty between the US and Germany based upon individual partner's services performance

Opposite to the commonly applied PE principle based taxation of self-employment income deriving from international professional service firms Germany's Federal Tax Court (BFH) now held a different treatment in relation to the US. The BFH published its decision from 25 November 2015 on 27 April 2016 (I R 50/14) that concerns the taxation of German partners of a law firm established as a limited liability partnership (LLP) in the US. The BFH held that the decisive factor to allocate a taxation right to the other contracting state where the taxpayer is not resident for income from professional services under article 14 of the DTT between the US and Germany as of 29 August 1989 is the place where the partner's individual services are performed in case there is a fixed base available to the partner.

Background and facts of the case
The claimant in the case was a law firm organized as a US-LLP with a number of German resident partners. A certain amount of the partners' compensation received in 2004 was set as fixed guaranteed payments. The German partners requested a ruling from the German tax authorities to confirm that the PE principle laid down in the business profits article (article 7) applies accordingly to profits generated by self-employed lawyers of an US-LLP. Reason for that was a ruling by the IRS issued in 2004 stating that the performance of services of partners in the US is not required in order to be able to allocate profits to a fixed base. The German tax authorities issued a binding ruling stating that the partnership profits of the US-LLP would be taxable in Germany only to the extent they were attributable to a PE of the US-LLP in Germany; however, the ruling also included a "reservation" by the German tax authorities that it would apply only if the US tax authorities adopted the same position.

Decision of the BFH
The BFH held that, due to the language in article 14(1), the basis for the allocation of the right of a source country to tax professional services income of a resident of the other treaty county should be considered to be "person-related", i.e. a partner who is not resident in the source country must personally perform the services in the source country and a fixed base must be regularly available to the partner in that country. If those conditions are fulfilled, the remuneration received by the partner for such services that is attributable to the fixed base may be taxed in the source country.

The BFH held that all income received by the individuals as partners of the US-LLP should be treated as self-employment income arising from their participation in the LLP. German individuals generally are subject to tax in Germany on their worldwide income. Taxing rights are allocated to the US under the 1989 treaty only to the extent the individual actually performs personal services in the US and can be attributed to a fixed base that is regularly available to the individual in the US for the purpose of performing the services.

In discussing the independent personal services article in the old Germany-US tax treaty, the BFH noted that there are conflicting interpretations of the article in the tax literature. The court adopted a "static" rather than an "ambulatory" interpretation of the treaty and ruled that the wording of article 14(1) is decisive. According to the BFH, it is necessary to look at each partner individually; each partner receives his share of the partnership profits individually as a result of the performance of his professional service in the source country.

The BFH also ruled that the PE principle, under which the profits of an enterprise of a contracting state are taxable only in that state unless the enterprise carries on business in the other contracting state through a PE in that other state, did not apply. The court concluded that article 14(1) of the 1989 treaty does not foresee a "mutual attribution of profits" (other than article 14(1) OECD Model Tax Convention 1995). A mutual attribution of profits leads to the consequence that, for example, each partner participates in the German

sourced income, the US sourced income etc. with its profit share.

The German tax authorities were not bound by the ruling because of the reservation; taxation of the partners not resident in the US who received a fixed guaranteed payment is actually not made according to the PE principle; the performance of work in the US is decisive. A deviating result would also not be given based on the fact that others partners were taxed based on the PE principle.

Comments

A protocol amending the Double Tax Treaty between the US and Germany was signed in 2006 and article 14(1) was deleted. Under the 2006 amendment, income received by German residents for personal services as independent contractors or self-employed individuals is subject to the business profits article 7 of the treaty. Article 7 exempts business profits of an enterprise of one contracting state from taxation in the other contracting state unless the enterprise has a PE in that state, in which case the enterprise is taxed in the latter state on the profits attributable to the PE. The amendment became effective for years from 2008 onwards. The former article 14 is therefore only applicable before 2008 regarding the allocation of taxation right between the US and Germany.

The BFH decision is not limited to US partnerships that grant guaranteed payments to their partners. Any US law firms organized as LLPs and operating in Germany should ascertain whether there any tax assessment notices are open for assessment periods before 2008. As mentioned above, article 14(1) does not appear in the current tax treaty between Germany and the US. LLPs that granted guaranteed payments to its partners in the years from 2008 should consider the position taken for these periods. Moreover it is necessary to check if a treaty does apply which has a wording that corresponds to the wording of article 14(1) of the 1989 Germany-US tax treaty (e.g. Germany-France tax treaty).

The BFH referred the case back to the local tax court of Munich. The local tax court of Munich now has to check if the German resident partners performed work in the US and the income is attributable to a fixed base in the US.

For US resident partners German taxes might be reduced if a performance based taxation right provides for lower income to be taxed in Germany if respective tax assessments for years before 2008 are open for re-assessment.

If you have any questions or would like to discuss further, please send an email to lawfirmadvisorysvcs@deloitte.com.

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