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by Wolfgang Kessler and Rolf Eicke

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FEATURED PERSPECTIVES

Germany's Statutory Treatment of Special Payments

by Wolfgang Kessler and Rolf Eicke

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Foreign partners in German partnerships should take note of the new statutory treatment of special payments (*Sondervergütungen*) now codified in section 50d paragraph 10 of the Income Tax Act (Einkommensteuergesetz, or EStG). The question is whether these special payments qualify as business profits according to article 7 of the OECD model treaty or as interest according to article 11 of the OECD model.

The concept of checks and balances and the system of separation of powers can only partly explain the keenness of the legislature to draft so-called nonapplication laws against individual decisions of the German Supreme Tax Court (Bundesfinanzhof, or BFH). This occurs rather frequently in tax law, particularly because of the government's interest in preserving the fisc. To safeguard the budget, the legislature passed rules that mostly conform to EC law and international public law, especially the rules that govern double taxation conventions. Lately, section 50d EStG has been modified (paragraph 3)[1] or amended (paragraphs 9 and 10) in this manner.

The last amendment was sparked by the legislature's concern that payments between German partnerships and foreign partners could circumvent the new and tightened German thin cap rule (*Zinsschranke*).[2] Interest from partner loans is not considered interest in the sense of the thin cap rule since the loans do not affect the overall profit of the partnership because of the interest's nature as special payments. However, because of the BFH decision of October 17, 2007, these special payments are tax free if they are paid to a foreign partner. This problem was resolved with the creation of a new rule in section 50d paragraph 10 EStG.

The new rule in section 50d paragraph 10 EStG[3] has been effective since January 1, 2009, and applies to all income tax and corporate income tax cases that are not definitive. Thus, the rule has broad effect as it is enforceable retroactively.

The special payments are qualified as business profits. However, there is no automatic attribution to a German permanent establishment of the foreign investor or partner. According to the BFH, the attribution of the loan receivables of the partner are determined functionally and autonomously according to the applicable

[1] *See* Wolfgang Kessler and Rolf Eicke, "Germany: Treaty Shop Until You Drop," *Tax Notes Int'l*, Apr. 23, 2007, p. 377, *Doc 2007-8765*, or *2007 WTD 83-10*.

[2] *See* Kessler and Eicke, "New German Thin Cap Rules — Too Thin the Cap," *Tax Notes Int'l*, July 16, 2007, p. 263, *Doc 2007-15373*, or *2007 WTD 141-9*.

[3] The wording of section 50d paragraph 10 EStG reads:

> If payments in the sense of section 15 paragraph 1 sent. 1 no. 2 sent. 1 and no. 3 [EStG] are subject to a double taxation convention, and if the double taxation convention does not contain an explicit rule, these payments are deemed as business profits. Paragraph 9 no. 1 is applicable.

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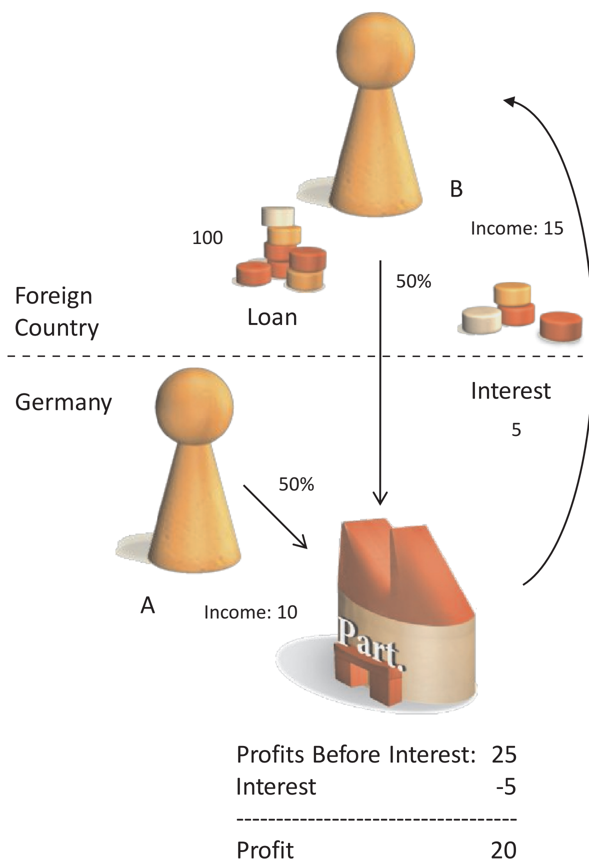
Figure 1. Concept of Coentrepreneurship



Limited Taxation of a Foreign Coentrepreneur (*Mitunternehmer*)

(1) Share of Profit

Profit Before Interest	25
Interest (Business Expense)	-5
Profit	20
Share of Profit (= 50%)	**10**

+

(2) Special Payment (*Sondervergütung*)

Interest	**5**
= Partner B Income	**15**

convention. An attribution to a German PE requires that the receivables are an asset of the German PE. In practice, this is rare, and thus, the BFH would not likely attribute the receivables to a German PE in most cases.

The understanding of this wording requires some knowledge about the little-known concept of *Mitunternehmerschaft* (coentrepreneurship), which is applied only in Germany and Austria. In brief, German partnerships are not subject to profit taxation, except for trade tax purposes. Each partner is taxed on both his share of the profit and on the special payments he receives from the partnership (for instance, as interest for a loan granted to the partnership). Historically, the special payments were developed first in the context of the trade tax. Today, they are also relevant for purposes of the individual income tax.

From a national point of view, these special payments are treated as income from commercial business (*Einkünfte aus Gewerbebetrieb*) according to section 15 EStG, which is not the same as the term ''business profits'' in article 7 of the OECD model. Foreign coentrepreneurs are subject to limited taxation according to section 49(1)(2)(a) EStG in connection with section 15(1)(1)(2) EStG. Figure 1 shows the mechanism by which the share of the profit and the special payments of a foreign coentrepreneur are taxed. The interest payment is deducted from the partnership's balance as business expense, and thus reduces the taxable share of the profit of all partners. Simultaneously, the payment is added to the individual balance of the coentrepreneur as a special payment. The addition of both balances constitutes the taxable income of commercial business (section 15 EStG) that is calculated separately for each coentrepreneur.

Section 50d paragraph 10 EStG refers to these special payments and determines that they are treated as business profits for purposes of income tax treaties. However, the term ''business profits'' (*Unternehmensgewinne*) does not exist in German national tax law and

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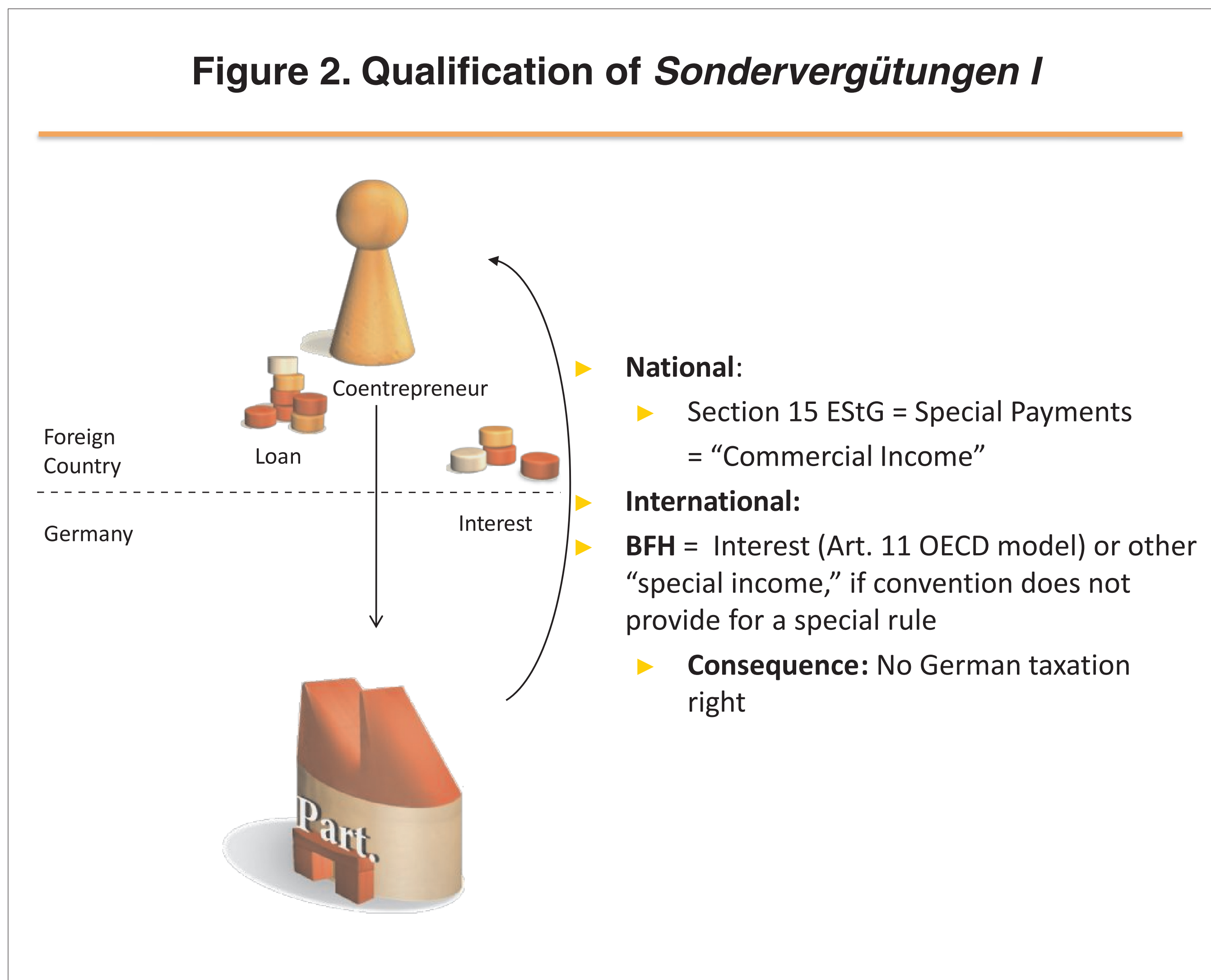
Figure 2. Qualification of *Sondervergütungen I*



is therefore not defined. To copy a treaty term into national law that is not congruent with the national definition of income from commercial business gives leeway for interpretation.

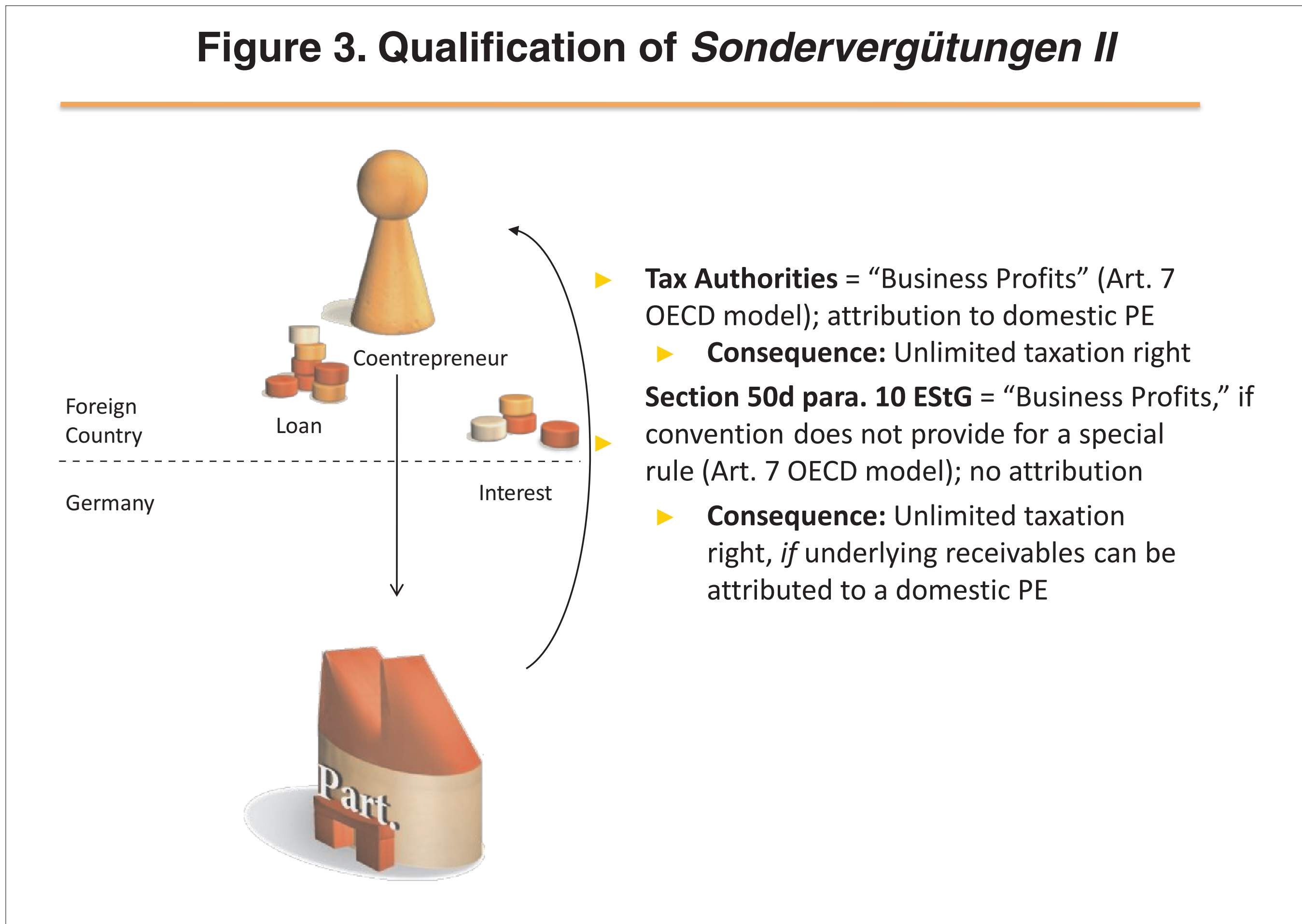
The new rule does not apply if an income tax treaty explicitly deals with the qualification of special payments. Yet this rarely occurs — for example, in Germany's treaties with Switzerland, Austria, Singapore, the United Kingdom, France, and the Czech Republic. All of these treaties qualify special payments as business profits, mostly in article 7 paragraph 7 of each treaty.

Effectively, the new rule is the codification of the approach of the tax authorities that have been qualifying special payments as business profits since the December 24, 1999, letter of the Federal Ministry of Finance. The opinion of the tax authority goes even farther and attributes receivables underlying the special payments (for instance from a loan) to the German partnership, which is treated as a PE for purposes of the treaty.

Some might wonder why the tax authority and the legislature are so keen to qualify special payments as business profits. The answer has to do with a recent Supreme Tax Court decision.

Supreme Tax Court Jurisdiction

In its October 17, 2007, decision, the BFH upheld its jurisdiction and declared the special payments to a U.S. partner-coentrepreneur to be interest according to article 11(1) of the Germany-U.S. treaty. Moreover, the court found that the payment is not subject to the PE exception in article 11(4) of the Germany-U.S. treaty because the underlying receivable could not be functionally attributed to the German PE of the U.S. partner. Regarding the attribution of the special payment to a PE, the court referred to the arm's-length standard in



article 7(2) of the OECD model and did not refer to the national German standards. (See figures 2 and 3.)

To Whom They Might Be Attributed

The decisive question is whether there will be an attribution to the German branch of the foreign investor and thus a taxation right for Germany. Some authorities argue that there is no automatic attribution in section 50d paragraph 10 EStG and claim that BFH case law will not lead to such an attribution.

However, prominent authorities like Sören Goebel[4] and Gerrit Frotscher[5] rebut this view and claim that BFH case law that is based on article 11(4) of the OECD model cannot be applied in this situation. The argument is that there is a fundamental difference between the attribution based on facts and circumstances in article 11(4) of the OECD model and the attribution based on legal grounds in article 7(1) and (2) of the OECD model. Frotscher also posits that article 11(4) of the OECD model covers only receivables of a partnership, whereas article 7(1) and (2) covers receivables and liabilities of a partnership with special payments qualified as liabilities. Instead, Frotscher applies a three-step test:

- The attribution must be conducted autonomously according to article 7 of the OECD model. However, the provision deals only with the legal consequences and not with the attribution.
- Therefore, article 3(2) of the OECD model applies, giving Germany the right to deal with the issue under its national law, which attributes special payments to the partnership.
- Finally, this result must be tested by the content and the purpose of section 50d paragraph 10 EStG, which is perfectly in line with this result.

[4]Sören Goebel, Tino Boller, and Markus Ungemach, "Die Zuordnung von Beteiligungen zum. Betriebsvermgen im nationalen und internationalen Kontext," *Internationales Steuerrecht* 2008, Beck, Munich, p. 643.

[5]Gerrit Frotscher, "Treaty Override und 50d Abs. 10. EStG," *Internationales Steuerrecht* 2009, Beck, Munich, p. 593.

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Apart from the dispute in German literature, another crucial question will be whether the modifications in article 7 of the commentary to the model treaty will change the result.

Coentrepreneur PE?

The problem of attribution to a German PE could be solved if the concept of a coentrepreneur PE prevails. This concept, advanced by Franz Wassermeyer, a former BFH judge, states that a coentrepreneur establishes an original PE if he manages, for instance, his loans from a fixed place of business. By contrast to the approach followed by the tax authorities, this coentrepreneur PE is not induced through the partnership as such. If, for instance, a U.S. partner of a German partnership manages his loans from his home in Texas, Germany would lose its taxation right. However, this view has not yet been adopted by the legislature.

Floating Income

Another problem arises because of the denial of the concept of a coentrepreneur PE — how to deal with ''floating'' income (income that cannot be attributed to any PE). Under treaty law, article 5 of the OECD model does not prohibit the existence of floating income. However, under German law, there is no floating income because this type of income is attributed to the PE at the place of management. This divergence between treaty law and domestic German law leads to different results when attributing income to a PE.

Other Cases of Special Payments

Interest is not the only type of payment that constitutes *Sondervergütungen*. Others types include fees for the performance of operations or services, or fees for the surrender of goods, rights, or licenses.

Other Implications

The enactment of the new rule also led to an amendment of the trade tax law rules in section 7 sentence 6 of the Trade Tax Act (Gewerbesteuergesetz). It provides that section 50d paragraph 10 EStG is applicable when calculating the trade earnings.

Outbound Cases

Outbound cases are also covered by the new rule. In the opposite situation with a German partner making a loan to a foreign partnership, the interest is also qualified as business profits, which does not constitute a change regarding the previous legal situation. However, two problems must be kept in mind for outbound cases.

First, foreign countries often apply the special income articles in treaties so that there is no or only limited taxation abroad. Secondly, that leads to the possibility that the German authorities might apply section 50d paragraph 9 EStG. It is a switchover rule applying the credit instead of the exemption method for the taxation of foreign partnership profits in case of no or limited taxation abroad.

Effects

The new unilateral rule in section 50d paragraph 10 EStG qualifies special payments as business profits for treaty purposes. Moreover, because of the qualification as business profits, Germany waives the right to tax special payments with at least a limited tax rate. Therefore, the overall effect for the German budget might be negative.

Some authorities suggest that there could be little effect, since the rule does not automatically attribute the special payments to a (taxable) German PE. Yet, this view might be shortsighted and does not sufficiently solve the crucial question of attribution. In fact, other authorities claim that in most cases there will be an effective attribution to the German branch. More thinking and new ideas are needed to solve this legal uncertainty.

The debate will go on over whether the new rule constitutes a treaty override that infringes on international public law. One milestone in this dispute had been set by the Finance Court of Munich on July 30, 2009. It found that there is no infringement on international public law nor on national constitutional law regarding the retroactive application of the provision. ◆

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