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COMMENTARY

The Bundesfinanzhof decided that interest paid by a German partnership d
to its partners resident in the United States may not be taxed in Germany pursuant to art 11 of the US-German Double Taxation Convention (DTC) 1989. The decision is at the same time convincing and surprising because it is apparent from the highest German fiscal court's reasoning that the
case in fact does not involve a so-called 'conflict of qualification' between e
German and US tax law concerning the tax treatment of partnership income.

Under German civil law and tax law, the existence of contracts between a partnership and its partners and of debt claims deriving from them is
acknowledged, although partnerships are treated as transparent for tax f
purposes. However, German tax law attributes interest received by a partner from the partnership to his/her partnership income (so-called separate partner remuneration). It was therefore doubtful whether
Germany had to apply either the provision on business income in the g
US-German DTC 1989 (art 7) or the interest provision (art 11).

In its 1999 report 'The Application of the OECD Model Tax Convention to Partnerships' (so-called partnership report) the OECD developed solutions for problems resulting from different tax law concepts
concerning partnerships in the member states. The solutions presented by h
the OECD were based on the speech on the interpretation of DTCs given by Déry and Ward at the 1993 IFA Congress in Florence, Italy. Their concept of solving qualification conflicts was explained in detail in an article by the International Tax Group of John Avery Jones et alii, which
was published in [1996] European Taxation 118. i

The partnership report states in its example 15, which is at first glance similar to the case at hand, that a conflict of qualification can arise if the source state qualifies income received by a partner as business income under art 7 of the OECD model convention, whereas the partner's state of residence treats the same income as interest under art 11 (see para 120 of the partnership report). To solve the conflict, the partnership report proposes that the state of residence exempts what it considers to be interest or gives a credit for the full amount of tax levied in the source state pursuant to art 23A, para 1 or art 23B, para 1 of the model convention. This proposition is based on the assumption that the source state was justified to treat the income as business income, because art 3, para 2 allows the source state to apply national law in order to make the qualification. Since the source state's taxation is 'in accordance with the provisions of the Convention' in the meaning of art 23A, para 1 and art 23B, para 1, one of these provisions must be applied by the state of residence.

Nonetheless, the BFH made its decision not even mentioning the partnership report but simply construing the US-German DTC 1989.

First, the court concluded that the interest received by the US partners constituted interest under art 11, para 2 US-German DTC 1989, because the partners' claim against the partnership was a debt claim in the sense of art 11, para 2. The court did not follow the argument promoted by some scholars in German literature that a debt claim in the sense of the DTC required a creditor and a debtor who are 'persons' under the DTC (see for example *Prokisch* in: Klaus Vogel on *Double Taxation Conventions* (3rd edn), art 1, marginal number 43). Since a German partnership is not a person under the US-German DTC 1989, this would have excluded the recognition of 'interest' pursuant to art 11, para 2.

The Bundesfinanzhof rather relied on the fact that the term 'debt claim' is not defined in the DTC, which leads to art 3, para 2 making reference to the national law of the state applyling the DTC (so-called lex fori clause). Since German law (as well as US law) acknowledges the existence of a debt claim between a partner and his/her partnership, which constitutes an asset for the former and a liability of the same amount for the latter, the debt claim must not be denied for treaty purposes.

The application of the interest provision is not excluded by the fact that interest may also be considered to be business income under art 7, since para 6 of that article clearly provides for the prevalence of the interest provision.

Germany cannot claim a right to tax pursuant to art 11, para 3 US-German DTC 1989 either, because the partners' debt claim did not form part of the business property of the partnership's permanent establishment (PE) located in Germany, which is attributed to the partners for tax treaty purposes. Although the US-German DTC 1989—unlike the OECD model convention in its art 11, para 4—does not use the wording '… if … the debt-claim … is effectively connected with such permanent establishment' but rather uses '… if … the debt-claim …

forms part of the business property of such permanent establishment', the deviation cannot lead to a different tax treatment. In the Bundesfinanzhof's view, both phrases result from the arm's length principle, which states that a permanent establishment has to be attributed those profits that a comparable separate legal entity would have made under the same or similar conditions (art 7, para 2 US-German DTC 1989). A debt claim can therefore not form part of a PE's business property, if a separate legal entity would have to show a liability with respect to the debt claim in an equivalent situation. Since this is the case under German commercial and tax law, the partners' debt claims could not be attributed to the German PE.

Finally, Germany had to grant a tax exemption for the interest, because the US-German DTC 1989 leaves no right to tax to the source state of interest. The Bundesfinanzhof did not have to make reference to the solution presented in example 15 of the OECD partnership report, because the solution only applies if a qualification conflict between the source state and the partners' state of residence really exists. Yet, if German national tax law and the US-German DTC 1989 are construed correctly, such conflict does not occur.

JL