There is a full commentary on this case by Prof. Juergen Luedicke.

COMMENTARY

I. Introduction and case facts

Although the case under review was decided by the German Federal Fiscal Court in 2011 already, it has been chosen for publication in this issue of ITLR as it deals with some aspects of hybrid entities (in the case at hand a Hungarian partnership having a German partner) and may therefore contribute to the current BEPS discussion. The fact pattern is quite similar to the one in example 18 of the Partnership Report.

The plaintiff was a resident of Germany. He was a limited liability partner of a Hungarian limited partnership (betéti társaság). The partnership's head office was located in Hungary. The only general partner was a Hungarian corporation having its head office in Hungary. Only the corporation as the general partner was, according to the articles of association, authorised to manage the partnership.

The partnership's income was exclusively derived from renting out a property located in Hungary as well as machines situated there.

Under Hungarian tax law, the partnership was treated as fiscally intransparent and subject to Hungarian corporate taxation.

Under German tax law, the Hungarian partnership was treated identically to a comparable German partnership (so-called *Typenvergleich*, see *Rust* in *Klaus Vogel on Double Taxation Conventions*, 4th edn, 2015, art 1 m.no. 16). Consequently, the Hungarian partnership's income was attributed to the plaintiff on a pro rata basis. Although the income, by its nature, was merely leasing income, it was, for the purpose of applying German domestic tax law, recharacterised as business income due to the fact that the partnership was exclusively managed by the general partner and that this partner was a corporation (so-called *gewerbliche Prägung*, sec. 15 para. 3 no. 2 German Income Tax Act – GITA).

The plaintiff sought to have his income share from the partnership exempt under art 23 para 1 lit. a and c of the Germany-Hungary tax treaty (1977). The provision reads as follows:

> '**Article 23**
>
> *Elimination of double taxation*
>
> 1. With respect to individuals resident in the Federal Republic of Germany the tax shall be determined as follows:
>
> (a) In so far as subparagraph (b) is not applicable, income and capital which may, pursuant to this Convention, be taxed in the Hungarian People's Republic shall be excluded from the tax base for purposes of taxes levied in the Federal Republic of Germany. The

> Federal Republic of Germany shall, however, take into account the income and capital so excluded in determining the rate of tax applicable to the remaining income or remaining capital. […]
>
> (b) The tax which is paid pursuant to the laws of the Hungarian People's Republic in accordance with this Convention on:
>
> (1) dividends not covered by subparagraph (a);
>
> (2) income within the meaning of Article 16;
>
> (3) income within the meaning of Article 17
>
> shall be set off against the tax which is levied on such income in the Federal Republic of Germany, due consideration being given to the provisions of the taxation laws of the Federal Republic of Germany regarding the imputation of foreign taxes.
>
> (c) Subparagraph (a) shall only apply to profits which can be attributed to a permanent establishment situated in the Hungarian People's Republic, to profits from the alienation of property forming part of the business assets of such a permanent establishment and to dividends paid by a company resident in the Hungarian People's Republic as well as to elements of capital situated in the Hungarian People's Republic from which such income is derived where the permanent establishment or the company in which there is a participation derives its income exclusively or almost exclusively from the following kinds of activities carried out within the Hungarian People's Republic: the manufacture or sale of goods or merchandise, the rendering of services, the carrying out of banking or insurance transactions. Where these requirements are not fulfilled, subparagraph (b) shall apply accordingly. […]'

In the proceedings of the first instance at the local tax court the plaintiff had, by way of a subsidiary claim, also requested that the Hungarian corporate tax be credited on a pro rata basis against his income tax on his profit share from the partnership if this income was not exempt.

II. Profits of an Enterprise of a Contracting State

The case is of particular interest as it is the first German decision which deals with the question of whether the profits derived by the partnership are, for the purpose of applying the tax treaty, profits of the partnership or profits of the German partner. The former leads to exclusive taxation in Hungary according to art 7 para 1 sentence 1 Germany-Hungary (1977), as the partnership is a resident of Hungary and as such entitled to benefit from the treaty. If the latter is the case, Germany has to exempt the profits under the prerequisites of art 23 para 1 lit. a and c Germany-Hungary (1977), ie if the profits qualified as active business profits from a PE in

Hungary or leasing income from real estate situated in Hungary. Otherwise, Germany could tax them and give an ordinary credit for the Hungarian tax on such profits.

After quoting the different opinions advocated in the German professional literature, the Federal Fiscal Court follows the view that the provisions of tax treaties do not deal with the attribution of income to particular persons (see m.no. 16 et seq. of the decision). Hence, this attribution follows the rules of Germany's domestic tax law when Germany applies the treaty (reference is made to art 3 para 2 of the Germany-Hungary tax treaty (1977)). The Federal Fiscal Court did not find any provision in the treaty according to which Germany is bound by the qualification of the partnership as a taxable entity and thus as a resident under Hungarian tax law. In particular, the Federal Fiscal Court denies that art 23 para 1 lit. a Germany-Hungary (1977), which is similar to art 23A para 1 OECD Model, requires Germany to follow the Hungarian partnership's qualification and thereby income attribution. Although Germany has to exempt income which, in accordance with this treaty, may be taxed by Hungary, this is to be interpreted as an 'objective finding' and does not prejudice the question which of the two tax laws is relevant. Consequently, Germany has to refer to art 3 para 2 of the treaty and thereby to German tax law in order to determine whether the partnership is the taxable subject. The Federal Fiscal Court disagrees with the argument put forward in literature that one may infer the type of income (eg dividends derived by the partner from his partnership) from the treaty entitlement of a partnership (see for example *Klaus Vogel on Double Taxation Conventions*, 3rd edn, 1997, art 1 m.no. 27b). To the contrary, the Federal Fiscal Court argues that treating a partnership, for treaty purposes, as intransparent would lead to a somewhat inconsistent result (see m.no. 20 of the decision). The transfer of the respective profits by the partnership to the German partner could not be taxed as a dividend (as foreseen by the tax treaty) because such transfer would not represent any taxable event under German tax law.

The Federal Fiscal Court specifically mentions the OECD Partnership Report and the new interpretation of art 23A in para 32.3 et seq. of the OECD Commentary (see m.no 19 of the decision). However, the Federal Fiscal Court reiterates its jurisprudence according to which the Commentary is not binding for German courts and may at most be regarded as one source for interpreting tax treaties which were agreed upon after the publication of the particular part of the Commentary in question. Consequently, the changes made to the Commentary by the Partnership Report are of no specific meaning for the Germany-Hungary tax treaty (1977).

The reference made to para 32.3 et seq. of the Commentary on art 23A is worth being discussed in more detail. Looking at para 32.3 et seq. in isolation, one might come to the conclusion that the fact pattern in the case at hand is indeed an example for a conflict of qualification due to differences in the domestic law between the State of source and the State of residence. If so, the State of residence might be required to give relief from double taxation as the State of source is taxing the income, from its domestic law point of view, in accordance with the treaty. Yet, it is obviously not the view taken by the OECD in the Partnership Report that the State of residence of a partner in a partnership has to respect the fact that the partnership state (State of source) treats the partnership as opaque and attributes the income to the partnership with the consequence that the State of residence must refrain from attributing said income to the partner. Example 18 of the Partnership Report is based on the assumption that the current income of such a hybrid partnership can be attributed to the partner by its State of residence which then has in turn to apply the treaty on the income so attributed.

In the author's opinion there is no contradiction between para 32.3 et seq. of the Commentary and example 18 of the Partnership Report. Paragraph 32.3 et seq. solely deal with cases where both contracting states attribute the income to the same person (ie the partner, see example in para 32.4). The conflict of qualification only relates to how both states tax such income in the hands of the partner under their domestic law and therefore when applying the treaty, too. If one agrees to this interpretation, the reference made by the Federal Fiscal Court to para 32.3 et seq. is slightly misleading. The reference suggests that the Federal Fiscal Court deviates from the Commentary by denying an obligation for Germany to follow Hungary as the State of source with regard to the income attribution. To the contrary, with regard to the income attribution for the purpose of applying the treaty, the jurisprudence of the Federal Fiscal Court seems to be in full agreement with the OECD.

In a court ruling of 13 November 2013 (doc no I R 67/12) the Federal Fiscal Court extended its decision to a situation where the relevant tax treaty expressly stipulates that a German partnership with its place of effective management in Germany be treated as a resident of Germany.

Such clauses can be found in various German tax treaties (for older examples see *Klaus Vogel on Double Taxation Conventions*, 3rd edn, 1997, art 4 m.no. 47). However, no uniform wording exists. Interestingly, in the late nineties Germany tried to convince the Working Group, which had been formed by the Committee on Taxation to study the application of the Model Tax Convention to partnerships to introduce such a clause in the Model Tax Convention. After the Working Group had declined to do so, Germany put a respective reservation for German treaties in the Commentary (see para 32 on art 4 of the Model, introduced by the 2000

Update to the Model Tax Convention and deleted by the 2014 Update). The purpose of such clauses was to ease the application of the treaties in the source State in cases where income flows to a partnership that is not a resident of the State where it is managed. The source State should grant treaty relief to all income derived by the partnership without having to distinguish between income shares attributed to partners who are residents in the partnership state and other partners who are residents of third states (see the explanation given by the Working Group representative for Germany, *Krabbe*, Internationales Steuerrecht 2000, p 196 (198)).

The plaintiff in the case I R 67/12 was an individual and resident of Belgium who disposed of his participation in a German partnership. The partnership operated a ship in international traffic. Under domestic German tax law, the partnership's profits fall under the tonnage tax. Therefore, the disposal of the partner's participation in the partnership triggered the taxation of a specific amount to be added back to the profits (so-called *Unterschiedsbetrag*). The plaintiff argued that the amount in question was part of his capital gain from the alienation of his partnership interest. He claimed that the capital gain could only be taxed by Belgium according to art 13 para 3 of the Belgium-Germany tax treaty (1967) as the partnership had to be treated as opaque under the treaty and the capital gain stemmed from the alienation of any other property. Article 13 para 3 of the Belgium-Germany tax treaty (1967) equals art 13 para 5 of the OECD Model Treaty. The Federal Fiscal Court did not follow this line of argument. The Federal Fiscal Court rather stressed that one has to distinguish between the treaty entitlement of the partnership and the entitlement of its partners. If income is attributed to a partner under domestic law (here the plaintiff's share in the *Unterschiedsbetrag*), this will not be changed for the application of the treaty. The residence and thereby the treaty entitlement of the partnership has no implication on this result. In particular, for the Belgium-Germany tax treaty (1967) the Federal Fiscal Court found further evidence for its reasoning in para 12 no. 2 lit. a of the Protocol to the treaty. The provision stipulates that benefits of the treaty will be granted to the partners if a German partnership must be treated as a resident of Germany.

The court ruling is further proof for the clear tendency of the Federal Fiscal Court to give preference to an interpretation of a treaty oriented to the applying state's viewpoint rather than a treaty-oriented viewpoint.

It is interesting to see whether this tendency will be confirmed in a pending case (doc no I R 49/14) which concerns a (yet differently drafted) special rule for income derived via a partnership in art 4 para 4 of the former Germany-Spain tax treaty (1966).

III. Profits of an enterprise?

The German partner's profit share was exempt according to art 23 para 1 lit. a and c of the Germany-Hungary tax treaty (1977) if the profits derived by the partnership qualified as profits of an enterprise and if they were attributable to an active PE in Hungary. The treaty did not provide for a definition of the term 'enterprise' as it is enshrined since 2000 in art 3 para 1 lit. c of the OECD Model Treaty. According to the factual findings of the lower tax court of first instance, by which the Federal Fiscal Court was bound, the partnership did not carry on a sort of a business in whatever form, but rather derived passive leasing income from the real estate and the machines. Hence, the income did not, by its nature, qualify as income of an enterprise (see m.no. 22 of the decision).

This holds true, although the income indeed qualified as 'business' income under domestic German tax law for two reasons. Firstly, according to s 15 para 3 no. 2 GITA (*gewerbliche Prägung*, see above) the partnership's income was recharacterised as business income as the general partner was a corporation and the only manager of the partnership. Secondly, the partnership's income was recharacterised as business income as the real estate and the machines were rented out to a second Hungarian partnership, in which the plaintiff held the majority of the partners' shares, too (so-called *mitunternehmerische Betriebsaufspaltung*). The Federal Fiscal Court confirmed its steady jurisprudence according to which the effect of a *gewerbliche Prägung* is restricted to the application of Germany's domestic tax law. The *gewerbliche Prägung* is not apt to qualify passive income as profits of an enterprise within the meaning of art 7 of the OECD Model Treaty. The same is true for the effects of a *mitunternehmerische Betriebsaufspaltung*. Consequently, there is no fixed place of business (in the sense of art 5 of the OECD Model Treaty) in Hungary to which any profit of an enterprise could be attributed.

Meanwhile, the German tax authorities have accepted the above-mentioned jurisprudence. They no longer claim that a partnership, which derives passive income by its nature, may generate profits of an enterprise for its partners. Nowadays, the German interpretation of art 7 of the OECD Model Treaty seems to be better aligned with international treaty practice.

For international readers it may be interesting to mention that there are some difficult issues to be solved in inbound cases as the tax authorities had a different view and practice for decades. They held that current income and capital gains from the disposal of assets and, in particular, of shares in a corporation which a foreign treaty resident person held via a German partnership which derived 'business' income by virtue of a *gewerbliche Prägung*, could be taxed by Germany in accordance with art 7 para 1, 2nd sentence, art 13 para 2, art 5 of the OECD Model Treaty.

Now, in the absence of profits of an enterprise, the German taxation turned out to be restricted in most cases by a provision like art 13 para 5 of the OECD Model Treaty in case of capital gains or art 10 para 2 of the OECD Model Treaty in case of dividends. In order to cope with this situation, the legislator introduced a new provision (s 50i GITA) in 2013 and extended it by way of a legislative amendment in 2014. The provision is heavily debated among German tax practitioners and academics as both versions of the provision are poorly drafted and generate a lot of collateral damage in a variety of cases which are not related to the described jurisprudence of the Federal Fiscal Court.

IV. Leasing income

After denying the existence of profits of an enterprise the income actually derived had to be split up. On the one hand the income from the real estate situated in Hungary can be taxed in Hungary according to art 6 of the treaty and is to be exempted by Germany according to art 23 para 1 lit. a of the treaty. On the other hand the income from renting out machines qualifies as other income (art 21 of the treaty) which can only be taxed in Germany. The Federal Fiscal Court expressly stated that the income had to be split up irrespective of the ratio between the income from renting out the real estate and the machinery.

The case was referred back as the lower tax court had not ascertained the respective amounts of income from renting out the real estate and the machinery.

V. Foreign tax credit

The Federal Fiscal Court expressly mentions the lower tax court's obligation to decide on the plaintiff's subsidiary claim. At the lower tax court the plaintiff had applied for the Hungarian corporate tax levied on the partnership's income to be credited on a pro rata basis against the German income tax on his profit share which is not exempt.

The subsequent decision of the lower tax court seems not to be published. However, there is no doubt that such tax credit had to be granted with regard to the income from renting out the machinery. It is general practice in Germany to give an ordinary foreign tax credit for corporation profits tax levied on a hybrid foreign partnership insofar as the profit share is taxed by Germany in the hand of a partner. This holds true irrespective (i) of whether the partner is an individual who is subject to personal income tax rather than corporation profits tax and (ii) of whether or not there is a tax treaty in place between Germany and the state of the hybrid partnership (see Bundesministerium für Finanzen (Federal Ministry of Finance), decree of 26 September 2014, m.no. 4.1.4.1 for treaty cases).

Juergen Luedicke

25 May 2011. The following judgment was delivered.

JUDGMENT

LEITSÄTZE

[1] Die Besteuerung des in Deutschland ansässigen Gesellschafters einer ungarischen, nach dortigem im Gegensatz zum deutschen Recht steuerlich als intransparent behandelten Personengesellschaft ist nach Maßgabe des DBA-Ungarn auf der Grundlage des deutschen und nicht des ungarischen Steuerrechts vorzunehmen.

[2] Bei Einkünften aus der Vermietung unbeweglicher und beweglicher Wirtschaftsgüter, die von einer i.S. von § 15 Abs. 3 Nr. 2 EStG 1990 gewerblich geprägten, aber vermögensverwaltend tätigen ungarischen Personengesellschaft erzielt werden, an der in Deutschland unbeschränkt steuerpflichtige Personen beteiligt sind, handelt es sich nicht um Gewinne eines Unternehmens i.S. von Art. 7 Abs. 1 DBA-Ungarn. Gleichermaßen verhält es sich, wenn die vermögensverwaltend tätige Personengesellschaft als Besitzgesellschaft im Rahmen einer mitunternehmerischen Betriebsaufspaltung zu einer anderen ungarischen Personengesellschaft als Betriebsgesellschaft fungiert. Das Besteuerungsrecht für solche Vermietungseinkünfte ist den jeweiligen Vertragsstaaten deswegen nach Maßgabe entweder von Art. 6 Abs. 1 oder von Art. 21 DBA-Ungarn zuzuweisen (Anschluss an die ständige Spruchpraxis des Senats).

TATBESTAND

1. Der in Deutschland wohnhafte Kläger und Revisionskläger (Kläger) war im Streitjahr 1996 mit einem Gesellschaftsanteil in Höhe von 96,62 v.H. beschränkt haftender Mitgesellschafter einer Personengesellschaft ungarischen Rechts in der Rechtsform der betéti társaság (BT), der T-BT, mit Sitz in Ungarn. Weitere Gesellschaftsanteile in einem Umfang von 2,03 v.H. hielt der ebenfalls in Deutschland wohnende Beigeladene. Gesellschafterin mit den übrigen Geschäftsanteilen und (einzige) Komplementärin war eine ungarische Kapitalgesellschaft in der Rechtsform der korlátolt felelösségü társaság (KFT), die T-KFT, mit Sitz in Ungarn, an der der Kläger ebenfalls mehrheitlich beteiligt war (90 v.H. der Gesellschaftsanteile). Zur Geschäftsführung in der T-BT war nach dem Gesellschaftsvertrag nur die Komplementärin befugt, die im Streitjahr in Ungarn ein eigenes Büro unterhielt.

2. Die T-BT erzielte Einkünfte aus der Vermietung eines in Ungarn belegenen Grundstücks und der darauf befindlichen Maschinen an eine weitere ungarische Personengesellschaft, die E-BT, mit Sitz ebenfalls in