discriminatory treatment between a US LLC with a permanent establishment in Germany, when compared with a German company in the same position as a limited partner in the Claimant.

Further points relating to the case are discussed in the commentary below.

COMMENTARY

This case is one of the rare examples in which a German court has applied the PE non-discrimination clause of a tax treaty. It relates to the former German thin cap rule which was designated to prevent disproportionate debt financing of a German corporate entity (limited liability company—GmbH—, stock corporation—AG—or company limited by shares—KGaA—) by its shareholder or a legal entity affiliated with the shareholder. The law was introduced in 1993 with a limited scope as it was only aimed at foreign lenders at the time. On 12 December 2002 the Court of Justice of the European Union ruled in the Lankhorst-Hohorst case (C-324/00) that the law discriminated against foreign lenders and therefore infringed the freedom of establishment guaranteed by art 43 of the Treaty establishing the European Community. As a consequence, the rule was revised in 2003 and extended to purely domestic cases. As of 1 January 2008 the legislator replaced the rule with a completely new system, the so-called interest capping rule (Zinsschranke).

The decision of the Fiscal Court of Düsseldorf concerns the tax year 2005 in which the 2003 version of said law was in force (§ 8a of the German Corporate Income Tax Act – Körperschaftsteuergesetz, abbr. KStG).

According to § 8a para 1 sentence 1 no 2 KStG as amended by the law of 27 December 2003, consideration paid to a shareholder with a substantial holding of at least 25% of the nominal capital at some time of the fiscal year for debt by a type of corporate entity (inter alia by a limited liability company) was deemed a hidden profit distribution under the following circumstances:

The consideration was assessed at a fixed interest rate.

The company's debt, at some time during the fiscal year, exceeded the safe haven cap of 150% of the so-called pro rata equity capital of the respective shareholder.

The qualification as hidden profit distribution entailed that the payment was not deductible for tax purposes at the level of the payor and subject to withholding tax for the account of the payee. The hidden profit distribution could be avoided if the company proved that it could have equally received said debt, all else being equal, from an independent third party.

For the purpose of this provision, the pro rata equity was generally calculated by multiplying the shareholder’s share of the subscribed capital by the company’s overall equity as defined in § 8a para 2 sentence 2 KStG. According to § 8a para 2 sentence 5 KStG, this general method of determining the relevant pro rata equity did not, however, apply to corporate entities which were not required to keep accounts according to the German Commercial Code (Handelsgesetzbuch—HGB). Instead, the pro rata equity in these cases was determined by multiplying the shareholder’s share of the subscribed capital by the value of the assets that were economically linked to the company’s domestic German income.

As all corporate entities founded under German corporate law, by their form of organization, are legally required to keep accounts in accordance with the HGB, the provision of § 8a para 2 sentence 5 KStG did in fact only apply to foreign corporate entities. While German corporate entities could therefore include the overall equity as defined in § 8a para 2 sentence 2 KStG—which included assets from both domestic and even exempt (!) foreign permanent establishments—in the calculation of the relevant pro rata equity, foreign corporate entities were limited to including the assets from permanent establishments within Germany. All else being equal, it was possible that the safe haven cap for German corporate entities was much higher than for foreign corporate entities, thereby allowing German companies a comparably higher degree of shareholder debt financing without fearing requalification of the respective consideration as hidden profit distribution.

In its decision dated 21 May 2015, the Fiscal Court of Düsseldorf held § 8a para 2 sentence 5 KStG to be inapplicable because it violated the non-discrimination clause of art 24(2) of the double taxation treaty between Germany and the United States of 1989 (‘DBA-USA’) which is identical to art 24(3) of the OECD Model Convention.

Beforehand, it is noteworthy that the court—prior to focusing on the violation of the non-discrimination clause—addressed and confirmed the treaty entitlement of the A-LLC according to art 4(1)(b) DBA-USA, thereby following the precedent set by the German Federal Fiscal Court (Bundesfinanzhof—BFH, decision of 20 August 2008, case I R 39/07) as well as the corresponding view of the Federal Ministry of Finance as expressed in the circular of 19.3.2004, IV B 4 – S 1301 USA – 22/04.

The court emphasised that it was one of the core principles of the non-discrimination clause that business expenses attributable to a domestic permanent establishment were equally deductible for the foreign corporate entity as they would be for a domestic corporate entity. Since under German domestic law the interest paid by A-LLC to B-Inc. was attributable to A-LLC’s German PE being its partnership interest in the claimant, a German limited partnership (Kommanditgesellschaft—KG) the tax deductibility needed to depend on the same conditions as it would for a German limited liability company. The court thereby followed the prevailing legal notion among German scholars that the non-discrimination clause is not open for any justifications.

While it is arguable among German legal scholars and German jurisprudence whether art 24 of the OECD Model Convention requires a direct form of discrimination (ie a provision under national law which expressively links the exception to the criteria listed in art 24 or an equivalent criterion with the same effect, cf. Rust in Klaus Vogel on Double Taxation Conventions, 4th ed, Vol 2, art 24 no 5) to be applicable or whether an indirect form of discrimination will suffice (cf. BFH, decision of 8 September 2010, case I R 6/09, cf. 13 ITLR (2011) p 646 et seq.), the court could leave this question open as the particular case at hand concerned a form of direct discrimination. As no corporate entity that is a resident of the USA is required to keep accounts in accordance with HGB, § 8a para 2 sentence 5 KStG always applied to US corporate entities that were subject to limited tax liability in Germany because of their domestic permanent establishments. Therefore, the fiscal treatment of US corporate entities under § 8a para 2 sentence 5 KStG constituted a form of direct discrimination when compared to the respective treatment of domestic corporate entities which are in any case obliged to keep accounts under HGB.

The court furthermore established that it was—contrary to the arguments presented by the Tax Office—irrelevant to the decision that, in light of the non-discrimination clause, § 8a para 2 sentence 5 KStG was left with a very small scope of application, because nearly all German tax treaties include a non-discrimination clause equivalent to art 24 para 3 of the OECD Model Convention.

In the second part of its grounds of judgment the Fiscal Court of Düsseldorf made clear that contrary to another argument of the Tax Office which followed the opinion expressed by a prominent member of the German tax administration in journals, the provision of § 50d para 10 of the German Income Tax Act (EStG) could also not be invoked to limit or exclude the tax deductibility of the interest paid by the US limited liability company. Given the fact that nobody outside the tax administration has ever shared this opinion, the debate is of little interest for international readers, though.

The tax office withdrew its appeal a few weeks after filing it so the BFH only ruled on costs, not on the merits of the case.

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