Germany – Federal Tax Court Clarifies Taxation of Partners in International Law Firms

In its decision of 5 December 2023, published 2 May 2024, Germany's highest tax court, the Bundesfinanzhof (BFH), ruled that certain guaranteed payments from a U.S. law firm to its German partners are exempt from German income tax under the U.S.-Germany income tax treaty (hereinafter, "Treaty") to the extent they are attributable to a U.S. permanent establishment.[1] The basis of the BFH's decision was that the conditions prescribed by the Treaty for a reversion of the right of taxation from the United States to Germany were not met, notwithstanding that the income in question was exempt from U.S. federal income tax.

WHY THIS MATTERS

The BFH's ruling clarifies the tax treatment of partners in international law firms, specifically regarding the taxation of profit share distributions under the Treaty. It contradicts the official views of the German tax authorities both as to the application of the specific Treaty article at issue and as to the general approach to treaty interpretation (static vs. dynamic), as explained in detail below.

Background

The taxpayers in this case were seven German equity partners of a U.S. law firm. The law firm generated the majority of its profits in the United States but also maintained several permanent establishments outside the United States, including one in Germany. The taxpayers worked predominantly in this German permanent establishment, but also had a number of working days in the United States. As compensation for their U.S. work-days in 2008 (the tax year in issue), they received a combined total of approximately €1.7 million in guaranteed payments, carved out from their combined total of approximately €3.6 million of U.S.-source income.

The remittances of the guaranteed payments were not subject to U.S. federal income tax pursuant to section 707(c) of the U.S. Internal Revenue Code. Following an audit of the taxpayers' German tax returns in 2011, the local tax office (*Finanzamt*) assessed German income tax on those payments on the basis that the right to tax such income reverted to Germany pursuant to paragraph 3(a) of Article 23 of the Treaty (the "Relief from Double Taxation" Article).

The taxpayers appealed the tax authority's determination to the lower tax court in Munich (*Finanzgericht (FG) München*), which ruled in favor of the taxpayers. The tax authority appealed this decision to the BFH.

BFH's Ruling

The BFH upheld the decision of the lower court in favor of the taxpayers (while not accepting all aspects of the lower court's reasoning).

The BFH ruled that the profit shares earned by the partners (including the guaranteed payments) are tax-exempt in Germany under the Treaty to the extent that they are attributable to a U.S. permanent establishment. The conditions for a reversion of the right of taxation to Germany due to non-taxation in the United States are not fulfilled.

From a German perspective, the partners' profit shares, including the guaranteed payments, are part of the business profits of the partnership subject to tax in accordance with Article 7 of the Treaty ("Business Profits"). In the case of partners resident in Germany, the profits attributable to the U.S. permanent establishment are exempt from domestic taxation pursuant to paragraph 3(a) of Article 23 of the Treaty. Further, the guaranteed payments were not covered by the "switch-over" clause of paragraph 4(b) of Article 23 of the Treaty. According to this provision, the crediting method and not the exemption method ("switch-over") applies:

> *to income or capital where the United States applies the provisions of the Convention to exempt such income or capital from tax ... or may under the provisions of the Convention tax such income or capital but is prevented from doing so under its laws*.

In the case in dispute, neither of these requirements were met. Specifically, the (partial) non-taxation of the guaranteed payments to the German partners was not based on a different understanding of the Treaty or the underlying facts, but was by reason of the application of U.S. domestic tax law. Further, the application of the switch-over clause failed because the non-taxation by the United States did not affect the entire profit share of the German partners, but only the portion that represented the guaranteed payments.

Reference to the Commentary on the OECD Model

The BFH also rejected an argument advanced by the German tax authority based on the commentary to the Model Tax Convention of the Organisation for Economic Co-operation and Development (OECD), ruling that a version of the OECD commentary that did not exist before the Treaty came into force cannot be relied on. The Treaty should therefore be interpreted according to the law and other guidance in place at the time it entered into force and not in light of subsequent developments, thus applying the "static" as opposed to "dynamic" rule of interpretation. The BFH noted that the relevant provision of the OECD Model is worded differently from the provision of the Treaty under review.

KPMG INSIGHTS

It should be noted that a provision in German national tax law (Sec. 50d (9) Income Tax Act/EStG § 50d Abs 9 S 1) applicable to the switch-over rule came into effect on 1 January 2017. This provision is designed as a treaty override on the issue of whether the switch-over rule applies to an entire category of income or to individual items of income. In the case in dispute, the new regulation was not yet applicable (the tax year in issue was 2008). The outcome could therefore be different for similar cases from 2017 onwards. However, the BFH has not yet had to decide this.

FOOTNOTE:

1 *Urteil vom 05. Dezember 2023, I R 42/20*. The BFH decision (in German) is available at: https://www.bundesfinanzhof.de/de/entscheidung/entscheidungen-online/detail/STRE202410067/.

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