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Foreign limited partnership does not shield non-trading income from German taxation

The Supreme Tax Court has held that rental income earned through a Hungarian partnership is not automatically exempt as the income from a foreign permanent establishment, merely because the partnership was taxed locally as a corporation, or because the income would have been treated as trading income had it been earned through a German partnership.

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The taxpayer held most of the capital in a Hungarian limited partnership (Bt. equivalent to a German KG) as a limited partner. The only general partner had its own limited liability as a Kft., the equivalent of a German GmbH. Had the partnership been registered in Germany, if would thus have been a GmbH & Co. KG and its entire income would automatically have been recast as trading income, as though it had been earned through a corporation. In Hungary, all partnerships are taxed as corporations, with partners' drawings against profits being treated as dividends. The partnership's sole business activity lay in letting a fully equipped factory to a related party. The taxpayer maintained that the net profits of the partnership should be exempt in Germany as the trading income from a foreign permanent establishment. He based this claim on the alternative contentions that (a) the partnership was taxed as a corporation and therefore as a trading entity in Hungary, or (b) the partnership's income was trading income by German legal definition. The Supreme Tax Court has now rejected both contentions.

The court took the view that the Hungarian taxation of the Hungarian entity was a matter for Hungarian law. The Hungarian tax status of an entity was not decisive for the German taxation of its partners. This depended on the nature of their income as defined by the double tax treaty. That income was taxable, or exempt, in Germany following the provisions of the treaty. Similarly, the court refrained from applying the German domestic rule redefining partnership income as trading income if earned through a partnership with no ultimate unlimited liability, where this was in conflict with the treaty allocation of taxing rights.

The ultimate conclusion was thus to split the income into its component parts. That earned from letting the Hungarian property was taxable in Hungary and exempt in Germany under the treaty. That earned from the hire of plant and equipment (from moveable assets) was taxable in Germany in the hands of a German resident partner.

Supreme Tax Court judgment I R 95/10 of May 25, 2011 published on August 10

Keywords

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