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LLP partners to be taxed where they practise

The Supreme Tax Court has held that the German partners in a US LLP law firm should tax their partnership earnings in the country where they carried out their practice.

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An international law firm constituted as a US LLP maintained two offices in Germany with a total of four partners. Partners' remuneration was fixed centrally, based on the profits of the partnership. The German resident partners considered their partnership profit shares to be taxable in the USA under the US-German double tax treaty and obtained a binding ruling to that effect from the local German tax office. Unfortunately, they overlooked the reservation made in the ruling that it was subject to the US authorities' taking the same view. Rather, they argued before the IRS that their partnership profit shares were remuneration for professional services carried out in Germany and should not therefore be taxed in the USA. Effectively, their partnership profits became "white income", that is, income not taxed in either state as a result of clash of concept, or, in this case, presentation.

Later, however, the German tax office changed its mind about its ruling and assessed the German partners to income tax on their full profit shares on the assumption that they had operated solely from Germany. The partners protested that these profits were drawn from a US trade or business and pointed to the binding ruling. The tax office drew their attention to the reservation of the IRS' taking the same approach and the case went to court.

The Supreme Tax Court has now decided – effectively – in favour of the tax office. Partnerships were transparent vehicles from the point of view of income determination, but not from that of where it was earned. Rather, the earnings as partnership profits from professional services rendered were taxable in the hands of each individual partner where he or she carried out the work from a fixed place of business permanently at his or her disposal. Accordingly, the profits were only taxable in the USA, to the extent each partner had actually worked there from his or her own office. As regards the validity of the ruling, the court explained that the reservation made could only mean that it was conditional on actual taxation in the USA of the relevant income.

Supreme Tax Court judgment I R 50/14 of November 25, 2015 published on March 27, 2016

Keywords

LLP, law firm, partnership income