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Double Taxation of Profits from a Hybrid U.S. LLC

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In a recently published decision, the German Federal Supreme Tax Court (*Bundesfinanzhof*, "BFH") ruled that Germany has the right to tax income received by a German member from an LLC treated as a corporation for German tax purposes, even if the LLC is classified as a partnership from a U.S. tax perspective and the pro rata share of income of the German member is taxable in the U.S. The BFH decision confirmed the view of the German tax authorities and overruled a decision of a lower German tax court. This court decision has been given wide attention by German tax practitioners and has led to legal uncertainty in cross-border tax planning.

Background of the LLC Classification

The German tax authorities published a ruling on March 19, 2004 (the "LLC Ruling") on whether an LLC is classified as either a partnership or a corporation for German tax purposes. The classification approach of the German tax authorities is similar to the U.S. entity classification rules before December 1996, and employs an eight-factor test. The German ruling stipulates in general that the characteristics of an LLC are drawn from the LLC agreement, its operating agreement, or from any other relevant document that is considered an organizational document of the LLC, as well as applicable state law. The U.S. tax classification of an LLC under the check-the-box rules has no bearing on the German entity classification.

The German tax authorities use the following criteria to determine whether to treat a particular LLC as a corporation or a partnership for German tax purposes: (1)

centralization of management in a representative capacity, (2) limited liability, (3) free transferability of interests, (4) discretion to access profits, (5) equity contributions, (6) continuity of life, (7) profit allocation and (8) formation requirements.

The classification is to be made on a case-by-case basis and rests on an overall assessment of whether the above-described characteristics of the given LLC more closely resemble those of a typical German corporation or those of a partnership. Each of the criteria listed above must be reviewed on its particular relevance and no single criterion is controlling. If such judgment on the basis of all the facts and circumstances does not readily yield a conclusion, then the LLC is classified as a corporation if the majority of the criteria under clauses (1) to (5) above indicate corporate characteristics.

Tax Consequences of Qualification as a Hybrid Entity

In practice, the classification of an LLC becomes particularly relevant if the classifications from a German and a U.S. perspective are different.

LLC as a Corporation for U.S. Tax Purposes

In the event that an LLC is treated as a partnership for German, but not for U.S. tax purposes, the income of the German members qualifies as business income under Article 7 of the German/U.S. treaty. To the extent the business income can be allocated to the U.S. permanent establishment of the LLC, Germany does not have the right to tax it (Article 23, para. 3(a) of the German/U.S. treaty). There is no tax credit for any withholding taxes imposed on LLC distributions.

LLC as a Partnership for U.S. Tax Purposes

The LLC Ruling stipulates that if an LLC is classified as a partnership from a U.S. tax perspective, but as a corporation from a German tax perspective, Germany treats the LLC distribution as "other income" subject to German taxation pursuant to Article 21, para. 1 of the German/U.S. treaty. This results in German taxation of the

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LLC distributions according to the German rules concerning the taxation of dividend income.

On March 17, 2008, the tax court of Baden-Wuerttemberg rejected the view of the German tax authorities and held that income of a German individual member derived from an LLC that was classified as a partnership for U.S. tax purposes was not taxable in Germany, even if that LLC would be treated as a corporation from a German tax perspective. In fact, the LLC's classification as a corporation or a partnership from a German tax perspective would be moot. Consequently, the LLC's business operations were attributable pro rata to its German member and treated as its pro rata permanent establishment. However, because the right to tax business profits was assigned to the U.S. under Article 7, para. 1, sent. 2 of the German/U.S. treaty when those profits were attributable to the U.S. permanent establishment, the court held that the business income was exempt from German taxation. The court further denied the applicability of Article 10 of the German/U.S. treaty, as the LLC itself is not taxed in the U.S. and, therefore, not a tax resident in the U.S. Finally, the court held that the classification of that income as business profits pursuant to Article 7 of the German/U.S. treaty precluded its taxation in Germany as other income under Article 21, para. 1 of the German/U.S. treaty.

On August 20, 2008 the BFH overruled the aforementioned decision of the tax court of Baden-Wuerttemberg, confirming the view of the German tax authorities that LLC distributions are subject to the German rules concerning the taxation of dividend income if the LLC is classified as a partnership from a U.S. perspective, but as a corporation from a German tax perspective. The binding effect of the August 20 decision should now in many cases result in legal certainty. However, for German

individual members, the August 20 decision of the BFH has a serious consequence: in essence, double taxation of LLC earnings without credit for U.S. taxes paid. The U.S. tax is not considered a tax on dividend distributions, which would be creditable. For German individual members, half of the dividend income is subject to German income tax at a maximum rate of 45%; beginning January 1, 2009 there will be a flat tax of 25% on dividend income of German individual members. German corporate members benefit from a domestic tax exemption on dividend income of 95% and do not have to rely on a credit for U.S. taxes paid.

Outlook

In principle, the risk of double taxation due to the qualification of an LLC as a hybrid entity is mitigated by Article 23, para. 4(a) of the German/U.S. treaty introduced by the new protocol dated June 1, 2006, amending the German/U.S. treaty signed on August 29, 1989. Article 23, para. 4(a) of the German/U.S. treaty states that double taxation can be avoided through a credit, if income or capital is subject to double taxation due to such income or capital falling under different provisions of the treaty; this conflict cannot be settled by a mutual agreement procedure. But as the mutual agreement procedure is time-consuming, it may be an ineffective measure to avoid double taxation for German individual members of a hybrid LLC. □

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