LIBER AMICORUM

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Redactiecomité
Koen Morbée, Koen Van Duyse

Verantwoordelijke uitgever
KnopsPublishing in samenwerking met Tiberghien Advocaten

Ontwerp cover
Oeyen en Winters

Sint-Antoniusstraat 22
2200 Herentals
www.knopspublishing.com

THE MANY FLAVORS OF CARRY GERMAN TAXATION OF CROSS-BORDER CARRIED INTEREST

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A. Carried Interest: Global Perspective

Although already roughly 30 years ago, I still remember very well when Albert Rädler, my first boss, introduced me, Thomas, to Tiberghien, at that time already the most reputable tax law firm in Belgium. Bernard PEETERS just joined the firm. Starting from then, I have known Bernard for so many years and met him and his lovely wife privately, but it is only three years ago that we worked together for the first time on a complex case involving four jurisdictions and centring, among other things, on the taxation, and the nature, of carried interest. The cooperation was intensive, encouraging and highly fruitful. This work inspired me and my colleague, Michael BLANK, to this contribution on cross-border carried interest to honour and pay tribute to Bernard PEETERS and his extraordinary and impressive career.

I. Political and Historical Aspects

1. Carried Interest Taxation: Controversial since Decades

Anyone involved in private equity and venture capital cannot avoid a discussion on the taxation of carried interest. However, opinions on how carried interest should be taxed differ wildly. But is that true? You may not believe this, but even Hillary Clinton and Donald Trump have something in common. It is the concern about whether carried interest is taxed fairly. But what is fair? And more importantly, what is carried interest really?

In the supposed "home" of private equity, the USA, a reform of carried interest taxation has been and is again being discussed. During the 2016 presidential election, such a reform was on the agenda across party lines. Indeed, reforming the tax treatment of carried interest was one of the few issues on which then-candidates Hillary Clinton and Donald Trump agreed. However, the "tightening" that was later implemented was limited to extending the average holding period for the shares held by a fund required to qualify for the reduced taxation as long-term capital gains. On both sides of the Atlantic, people are eager to see whether President Biden will be able to push through his plans for a more far-reaching reform (general taxation of carried interest as fully taxable ordinary income) in view of the narrow Democratic majorities in Congress.[1]

1. Only a few months ago, on 5 August 2021, Senate Finance Committee Chairman Ron Wyden introduced a Bill, called "Ending the Carried Interest Loophole Act", which would subject holders of carried interest to ordinary income treatment on an annual basis on the "*Foregone Interest*" on a Deemed Loan. But since then – and once again – nothing happened.

The appropriate taxation of carried interest has been the subject of political debate for decades. However, no real progress has been made. On the one hand, it seems to cause discomfort when wealthy fund managers with annual incomes in the triple-digit millions pay only half the tax and not the full tax. On the other hand, France, for example, used the "favourable", it appears, taxation of carried interest only a few years ago, in the course of the Brexit, to lure fund managers from the UK to Paris.

Terms such as carried interest or simply carry, two and twenty, waterfall, hurdle, catch-up and clawback as well as carry calculations on a deal-by-deal or whole-of-fund basis stand for typical contractual agreements between the (active) fund initiators entitled to carry and the (passive) capital investors. They are decisive for the disbursement modalities of proceeds and/or profits of private equity and venture capital funds and are of elementary importance both in economic terms and for tax consequences. However, these English terms are not mentioned in the relevant German tax laws. The identification of suitable solutions is not facilitated using terms unknown to German tax law and regularly also to the tax laws of other jurisdictions.

2. Carried Interest: What is it? Where does it come from?

The general view in the market is that carried interest amounts to 20% of the capital gains. But where does this "rule" come from? From the bible or from the bottom of the ocean?

It is always worth starting with the bible, where – surprisingly (?) – one finds the earliest reference to Joseph's plan to promote grain production in ancient Egypt. "*And at the harvests you shall give a fifth to Pharaoh, and four fifths shall be your own, as seed for the field and as food for yourselves and your households, and as food for your little ones.*"[2]

Others say the concept of "carried interest" can be traced back almost – and only – 500 years, to a time when a ship's captain was given 20% of whatever he or she physically "carried" back to the private investors. In the 16th and 17th centuries, when European merchants travelled to the New World and the Far East, voyages were financed by private investors, each of whom took a share of the risk and a share of the profits in proportion to his or her investment. It was customary for the captain of the ship to receive 20% of the cargo. The captain

2. Genesis 47:23-24.

was compensated for putting his or her life on the line in a dangerous environment. And it was the extremely risky nature of these voyages that led private investors to give the captains a massive (borderline outrageous) incentive to do whatever it took to get the ship's cargo back to the private investors. In fact, this incentive was so great that some believe it was partly responsible for captains "going down with the ship". After all, if you personally owned 20% of the ship's cargo, you might also do everything in your power to get the ship to safety ... even if it cost you your life.[3]

While fund managers may not put their life on the line, this rule still applies. Private equity firms typically take a carried interest equal to 20% of the capital gains made by the funds they manage.

II. Capital Gain, Remuneration, Other Income or Anything Else: What Kind of Income Is It?

Carried interest is the capital-disproportionate share in the profit of a private equity fund, regularly organized as a partnership. While one group of partners, the capital investors, is ultimately passive and "only" provides the fund with capital, the other group of partners is active and responsible for ensuring that the capital of the capital investors is invested profitably. The profit earned by the fund in this way is divided between the two groups of partners, in short: 80:20. Such agreements also exist in other areas, often also in family partnerships, in which some members are actively involved in the management, while others are only passive with the capital provided. Such agreements, especially between third parties, are also "fair". This is because one group of shareholders cannot get along without the other. The capital investors need the managers. And the managers need the "outside" capital. Seen in this light, the distribution of profits is disproportionate in terms of capital, but it is proportional from an economic perspective.

The general admissibility of such a capital-disproportionate allocation of profits can be found in the German Civil Code ("**BGB**"), in the provisions on private partnerships and the rights and duties of partners (sections 705 to 740c BGB). While section 706(1) BGB stipulates that the partners must in principle make equal contributions, section 706(3) BGB allows that such contributions do not necessarily have to be made in cash but may also consist

3. *Ashby Monk*, in: https://www.institutionalinvestor.com/article/b14zbb8qz70mtn/dont-get-carried-awUnternehmesgewinn ay.

of services. These provisions are the basis for allocating to the partners, within the framework of the so-called profit distribution waterfall, a share in those profits which the partnership as such generates. In tax-transparent private equity fund structures, these are regularly capital income, namely interest, dividends and – typically, making up the vast majority – share capital gains.

Therefore, the capital-disproportionate share in the profits of such a private equity fund should also be taxed in accordance with the provisions of the law for the taxation of capital income. From this point of view, it is surprising that not only in Germany, but in many other jurisdictions as well, an oftentimes misguided and overly simplified discussion has been going on for decades about the tax qualification of the capital disproportionate profit shares allocated to the initiators and fund managers.

The range of possible income qualifications is broad. Using the terms of the OECD Model Tax Convention on Income and on Capital ("**OECD MC**") nearly every qualification appears possible. While some believe carried interest should be fully taxed as employment income other say it should be fully taxed as income from independent personal services, director fees, business profits or "other income". Some jurisdictions have quite creatively, but also tendentiously, created entirely new income categories such as "lucrative interest" in the Netherlands.[4]

III. Profit Share, Remuneration, Salary and/or Bonus? What a Difference the Facts Make

In view of the corporate nature of the carried interest agreements between legally unrelated parties, such a creative allocation of capital income (interest, dividends, capital gains) to completely different income categories is astonishing.

Insofar as the remuneration for services rendered to a client or employer and the associated rights and obligations are agreed between different parties under the law of obligations and/or employment law, this will be income of the type mentioned above, not capital income.

However, if third parties join in a partnership or a company because they pursue a common goal, but one of them cannot do so without the other, the

4. See *PÖTGENS, Frank P.G.*, Tax Treaty Classification of Netherlands-Source Income from Lucrative Interests (Carried Interest), in: European Taxation, 2011, 465.

starting position is completely different. In such a constellation, the partners, who are still faced with each other as third parties, are free to decide how the profit that is generated through this joint operation by pooling their resources – here capital, there entrepreneurial experience – should be split and allocated among the partners. The details of this allocation do not change the tax character of the capital income contained in the profit of the company. This ultimately banal insight may explain why governments, in their repeated attempts to change the taxation of carried interest, have found it so difficult to move away from taxing it as capital income and toward taxing it as labour income, corporate profit or other income.

B. Cross-Border Carried Interest: German Perspective

I. Trading *vs.* Asset-Managing Funds: A German Peculiarity

The taxation of German private equity funds (limited partnerships), their managers and investors largely depends on whether the fund, almost without fail set up as a German limited partnership (*GmbH & Co. KG*), qualifies as a trading (*gewerblich*) or an asset-managing (*vermögensverwaltend*) partnership. The delimitation is far from straightforward and subject to considerable uncertainty. In practice, taxpayers largely rely on guidance issued by the German Federal Ministry of Finance dated 16 January 2003 (the so-called "private equity decree"), which – without any clear legal basis/out of thin air – puts forth several criteria seen to indicate a trading activity of a fund. The German courts (including the highest German tax court, the *Bundesfinanzhof*) have – in obiter dicta – cast doubt on the relevance of these criteria put forth by the tax authorities, arguably taking an even stricter approach, with the somewhat unusual result that German private equity funds aiming to qualify as an asset-managing fund typically apply to obtain a corresponding (binding) ruling from the competent tax office, knowing full well that any recourse to the courts on this question is unlikely to be found to have merit.

Traditionally, German private equity funds have, wherever possible, been structured to comply with the criteria for an asset-managing fund set forth by the tax authorities.

A deliberate qualification as a trading partnership has been avoided (or where that was seen not to be feasible, the fund managers often attempted – more or less successfully/robust – to move the fund structure out of Germany entirely, for example, to Luxembourg). The main reason for this is that (foreign) investors who invest in a German trading partnership are – merely by reason of their investment in the fund – considered to carry on a trade business through

a German permanent establishment, triggering corresponding tax payment as well as tax filing obligations for all foreign investors (and that, for the avoidance of doubt, with respect to the worldwide income of the fund). Although the effective taxes due are insignificant, provided that the fund generates its returns exclusively in the form of capital gains (due to the German 95% participation exemption for corporate investors), in practice, the tax filing and payment obligations are often considered a "no-go" by institutional investors. The issue is made significantly worse by the fact that certain institutional investors ineligible for the German participation exemption (*e.g.*, certain pensions funds) may risk being subject to an effective tax burden of ca. 30% when investing directly in a German fund. It is also not helped by the oddity of the German trade tax (*Gewerbesteuer*), which – despite the partnership's general transparency for German corporate and personal income tax purposes – is levied directly on the level of the trading fund, further alienating international – and especially tax-exempt institutional – investors.

In contrast, an asset-managing partnership is fully tax transparent for the purposes of German taxation (not only for German corporate and personal income tax but also for trade tax purposes). The investors will not be held to carry on a German permanent establishment solely by reason of their investment in the fund. Rather, the investors are considered to directly hold their fractional *pro rata* share of each asset of the fund (*Bruchtsteilsbetrachtung* – fractional ownership assessment). Capital gains derived by standard corporate investors are not subject to tax in German (without having to rely on the protection of an applicable double tax treaty), a position that has been confirmed by the German *Bundesfinanzhof* as recently as 2017.[5] In general, foreign investors in an asset-managing fund will only be subject to tax in Germany with their domestic income, *id est*, with their German-sourced income as defined in section 49 of the German Income Tax Act ("**EStG**"), which in standard private equity structures usually will be limited to dividend distributions from German-resident portfolio companies respectively holding companies, a type of income that is typically avoided in standard private equity acquisition structures.

Curiously, under German law, the tax treatment of the carried interest, *id est*, the capital-disproportionate share in the fund's profits allocated and derived by the fund's initiators, also depends on whether the fund qualifies as an asset-managing or a trading fund. In its seminal decision of 11 December 2018

5. BFH of 31 May 2017 – I R 37/15, BFHE 258, 484, BStBl. II 2018, 144.

the *Bundesfinanzhof* confirmed the position of the taxpayer, and the prevailing opinion among German practitioners, that, in a trading structure, the carried interest allocated to the initiators is exactly that: a share in the profits of the fund[6]; it is not a fee paid from investors to the management (to be taxed as ordinary income), but a share in the capital gains (and other income, if any) generated by the fund. In contrast, in an asset-managing structure (which, again, is the rule rather than the exception for German-based funds), the qualification of carried interest is – at least on a conceptual level – far less clear, which is particularly baffling given that German tax law includes a special provision for carried interest derived from asset-managing private equity funds.[7]

II. Carried Interest as Income from Self-Employment– An Enigma?

In 2004, following some back-and-forth during the legislative process on the nature of carried interest (fee or share in the profits), the German legislator introduced a special provision on carried interest: section 18(1) no. 4 EStG. According to the compromise solution of section 18(1) no. 4 EStG, carried interest is to be taxed as income from self-employment, rather than – as was the position at least of the taxpayers – as capital gains, which at that time generally were still subject to exemption if the shares were not held for less than one year. This was the declared aim when section 18(1) no. 4 EStG was introduced: ensuring that individuals with unlimited tax liability would be taxed by Germany.[8] Still, while the carried interest was deemed to be income from self-employment, it was not taxed as such ordinary income. In a compromise solution reached during the legislative process, a special 40% partial tax exemption was introduced for income falling within the new rule. This compromise means that carried interest from asset-managing funds was effectively taxed the same as capital gains (or dividends) derived by individuals from trading partnerships (sog. *Teileinkünfteverfahren*).

6. BFH of 11 December 2018 – VIII R 11/16, BFH/NV 2019, 746.
7. It is hoped that an appeal that is currently in front of the *Bundesfinanzhof* will bring more clarity, cfr. BFH no. VIII R 3/21 as well as the first instance ruling of the FG München of 17 November 2020 – 12 K 2334/18, DStRE 2021, 587.
8. BT-Drucks. 15/3336, 7.

The wording of this compromise provision has remained unchanged since 2004:

> *Income from self-employment is (...) no. 4 income derived by a partner in an asset-managing entity or association, the purpose of which is to acquire, hold and dispose of shares in corporations, as remuneration for services rendered in furtherance of the entity's or association's purpose, provided that the entitlement to the remuneration has been granted on the condition that the partners or members have received their paid-in capital back in full; section 15(3) does not apply.*

Curiously, the provision's express limitation to asset-managing funds as well as the inconsistent and confusing choice of words (oscillating between a remuneration for services and a partner's profit share for its contributions towards furthering the fund's purpose) prompted some German tax offices to assert that carried interest from trading funds therefore was to be seen as a remuneration falling outside the scope of the new special rule and therefore to be taxed as ordinary business income – a position that – after more than a decade of prohibitive uncertainty – was finally struck down by the *Bundesfinanzhof*'s seminal decision of 11 December 2018.

However, even in the case of asset-managing structures, the application of section 18(1) no. 4 EStG is still subject to considerable uncertainties in practice.[9] One of these unresolved points of contention is the treatment of carried interest derived by non-resident initiators, which shall be the focus of the further chapters of this contribution. While it is occasionally alleged that, by reason of its qualification as income from self-employment, carried interest derived from German asset-managing funds is to be considered income from German sources subject to a limited German tax liability, in our opinion, such interpretation misses the mark and is based on a fundamentally flawed understanding of section 18(1) no. 4 EStG. Such understanding could lead to conflicts of qualification in cross-border contexts.[10] This is because carried interest is regularly taxed abroad (at least when considering typical fund and fund manager residences) as what it is, namely as capital income and not as income from self-employment.

9. See, *e.g.*, TÖBEN/SCHREPP, DStR 2019, 526 and DStR 2019, 573.
10. See, *e.g.*, Schnittker/Steinbiß, IStR 2015, 760 (767).

III. Inbound Case: Carried Interest Paid to Non-Resident Initiators

The uncertainties regarding the conceptual characterisation of carried interest pursuant to section 18(1) no. 4 EStG are particularly relevant for the inbound case, *id est*, for non-resident initiators who receive carried interest from a German fund qualifying as an asset-managing partnership. In the inbound case to be analysed in the remainder of the contribution, it is assumed that initiator A, tax resident solely in state X, as carried interest beneficiary is entitled to a disproportionate share of the results of a German asset-managing private equity partnership (hereinafter the "**Fund KG**"), which generates returns primarily in the form of capital gains from the sale of shares in German and foreign portfolio companies (as well as negligible amounts of dividends and interest.

In practice, the initiator will typically hold his carried interest entitlement indirectly as partner of a (tax transparent) pooling partnership (hereinafter the "**Initiator KG**"). This Initiator KG will be the direct limited partner of the Fund KG (often referred to as the "special limited partner" or "carry vehicle" of the Fund KG). Its (sole) purpose is to pool the team members (and potentially otherwise associated carried interest beneficiaries), *inter alia* allowing that the internal (economic) arrangements of the team can be set and adjusted independently of the Fund KG documentation (and the investors). However, these carried interest pooling vehicles do not engage in any "entrepreneurial" activity independent of the fund.

A has his domicile (section 8 of the German Fiscal Code ("**AO**")) and habitual residence (section 9 AO) exclusively in state X. A is part of the initiator team of a globally operating German private equity fund in the legal form of a GmbH & Co KG. The Fund KG invests worldwide, including in X. In the base case, it is assumed that A stays in X (and carries out any activity with respect to the Fund KG outside of Germany, potentially receiving an ongoing compensation as an advisor to the Fund KG's German management company). In the next step, it is assumed that A will occasionally be physically present in Germany (however, without such presence amounting to a habitual abode in Germany). It is assumed that Germany has concluded a double taxation treaty ("**DTT**") with X mirroring the OECD MC.

IV. Deeming Provision Should Not Give Rise to a German Limited Tax Liability

In our opinion, the carried interest allocated to A should not give rise to a limited tax liability of A in Germany already by reason of Germany's national tax law.[11]

Pursuant to German tax law, non-residents will only be subject to (limited) taxation in Germany to the extent that they derive income from German sources as (exhaustively) defined in section 49 EStG. Income from self-employment is considered to be from German sources only (section 49(1) no. 3 EStG) if the activity considered to be self-employment is exercised in Germany, is or has been exploited in Germany or is carried on through a fixed base or a permanent establishment in Germany. In our opinion, none of these connecting factors is present in the assumed circumstances of a non-resident initiator (solely) deriving carried interest from an asset-managing German fund.

Although the carried interest is reclassified as income from self-employment pursuant to section 18(1) no. 4 EStG, it is entirely unclear what is to constitute such "self-employment activity" (if any) entitling the initiator to his disproportionate share in the profits. Commercially, the investors are willing to grant the initiators a disproportionate share in the profits, to create incentives for the initiators to utilize their time, unique skills, expertise, experience and network to the benefit of the fund, *id est*, to make an intangible – but arguably critical – contribution towards the fund partnership.

But even if it were assumed that some sort of tangible "self-employment activity" was identified, in the assumed base case such activity will not be exercised in Germany.

Such assumed "self-employment activity" will also not be exploited in Germany neither for the Initiator KG nor for the Fund KG. According to the

11. A limited tax liability may at attach under the so-called isolated approach pursuant to section 49(2) EStG with respect to (German-sourced) profits not in the form of capital gains. However, there is no general non-resident taxation of interest under German law (cfr. section 49(1) no. 5 EStG). Hence, in practice, a limited tax liability may only to dividends from shares in domestic corporations (section 49(1) no. 5(a) EStG). Of course, in practice, he distribution of dividends subject to German withholding tax is usually avoided in private equity fund structures (for a variety of reasons separate from the taxation of carried interest). That said, in our opinion, there is a strong argument that the so-called isolated approach of section 49(2) EStG is not applicable to the present situation anyway. For the avoidance of doubt, dividends and gains from the sale of shares in *foreign* corporations are not subject to German limited tax liability even if a foreign shareholder receives this income indirectly from his shareholding in a German fund partnership, which in the present case is merely an asset managing fund partnership and these shares are attributed to the fund partnership's total assets.

general opinion, this would require exploitation by A himself;[12] only the person who has himself performed the exploited service, and not a third party, who in turn has acquired the result of a self-employed activity, can exploit the work as defined by section 49(1) no. 3 EStG.[13] This means that the (German-resident) partners of the Fund KG or of the Initiator KG are excluded as potential "exploiters" of any such activity to be assumed on the part of A. There is also no "self-employment activity" or work performed by A abroad that is (simultaneously or subsequently) exploited in Germany by anyone. It seems doubtful that a mere intangible contribution can be exploited (beyond the mere receipt of such contribution), domestically or elsewhere, by anyone.

Additionally, A does not maintain or carry on any assumed "self-employment activity" through a fixed base or a permanent establishment located in Germany. Under the assumed facts, A does not himself have any (fixed) place of business in Germany. Further, there also exists no fixed base or permanent establishment constituted by others that could somehow be attributed to A as or like a fixed base or permanent establishment of his own. In an asset-managing structure, under German law, due to the lack of any business, there is also no place of business.

Being an asset-managing partnership, the Fund KG does not constitute a permanent establishment (or fixed base) for anybody, neither the investors nor the initiators. Similarly, such permanent establishment (or fixed base) also cannot be said to be established by the Initiator KG. The Initiator KG has no offices or other fixed place of business of its own. Being a mere pooling vehicle without any activity of its own, even if it were to be considered to pass through income from self-employment – which is still unsettled –, the Initiator KG cannot be said to carry out any "self-employment activity" through a fixed place of its own. Any other conclusion would be downright absurd, as the existence of a German permanent establishment, and thus the existence of a limited German tax liability, would depend on whether the carry beneficiaries are pooled in an upper-level partnership (or receive their disproportionate profit share directly from the Fund KG without any such pooling vehicle). Such conclusion would also be inconsistent with the wording of section 18(1) no. 4, last sentence EStG and contradict the legislative intention behind the

12. Cfr. BFH of 12 November 1986 – I R 38/83, BStBl 1987 II, 377, m.no. 16; on the parallel provision of section 49(1) no. 4 EStG; cfr. also Loschelder in Schmidt, EStG, 40. ed. 2021, § 49 m.no. 74; Reimer in Blümich, EStG/KStG/GewStG, § 49 EStG m.no. 205.
13. Loschelder in Schmidt, EStG, 40. ed. 2021, § 49 m.no. 74.

provision.[14] The Initiator KG is in no way comparable to a partnership of freelance professionals, whose partners actively appear on the market, often in relation to authorities and courts, and provide paid consulting services to third parties. The Initiator KG is a shell without any "activity" of its own that merely serves to pool the initiators in a common legal structure.[15]

As an even more general point, it is also not apparent that, or according to which criteria, the intangible contribution of a partner set forth as an obligation under the Fund KG's governing documents could be attributed to a presumed – but factually non-existent – permanent establishment of the Initiator KG or the Fund KG (much less constitute such permanent establishment itself as if out of thin air).

V. Non-Resident Carried Interest Beneficiaries Should be Able to Rely on DTT Protection

In any case, any limited tax liability of such cross-border carried interest allocations assumed to arise by operation of the – unclear – German national law provisions should, in our opinion, be precluded by an applicable DTT. Any artificial or fictitious finding of a permanent establishment (or fixed base) of an assumed "self-employment activity" under German national law should be irrelevant for the purposes of a DTT. This should also be the case in the variant of the base case where A may be found to trigger a limited German tax liability due to his physical presence (and exercising his intangible "self-employment activity") in Germany.[16]

As a resident of X, A is entitled to benefit from the DTT pursuant to articles 1, 4(1), sentence 1 OECD MC. Evidently, there is no explicit allocation rule for carried interest in the OECD MC. Legal commentary on the appropriate treatment of carried interest under DTTs is sparse at best (and often riddled with considerations based on any special provisions to be found in national law). That said, in our opinion, in the absence of any relevant provisions in the DTT in question, the allocation rule(s) for carried interest should be the

14. Cfr. BT-Drucks. 15/3336, 7.
15. Mardini in Pöllath/Rodin/Wewel, Private Equity und Venture Capital Fonds [Private Equity and Venture Capital Funds], 2018, § 11 m.no. 55.
16. The temporary stays of A in Germany, which are assumed in the variant of the base case, give rise to a limited tax liability in a strict interpretation of the German law, insofar as an activity performed in Germany is also identifiable for an intangible contribution. However, a limited tax liability due to a self-employed activity being exercised in Germany for only a short period of time, even for only a few hours, is one of those phenomena in German international tax law, which all parties involved in practice prefer to ignore by referring to the overriding treaty law.

same as for such carried interest's constituent parts, *id est*, as for any other capital income.

In a standard private equity fund, the fund's profits – and thus the carried interest – will typically be generated (predominantly) in the form of capital gains from the sale of shares in the fund's portfolio companies (as well as usually minor amounts of dividends and interest). Accordingly, pursuant to articles 13(5) and 21(1) OECD MC, A's residence state X should generally have the exclusive right to tax any carried interest allocated to A, while any taxation in the source state, regardless of whether such concept would solely refer to the residence state of the relevant portfolio company or also to Germany as the fund's domicile, would generally be excluded under the OECD MC (except that portion of the carried interest derived from dividends or interest, which may be subject to withholding tax in the company's residence state, cfr. articles 10(2)(b) and 11(2) OECD MC).

1. Reclassification under German National Law Without Effect on DTT

In our opinion, an assumed reclassification of such capital income (into income from self-employment pursuant to section 18(1) no. 4 EStG) under German national law should be irrelevant for the application of the OECD MC.

The reclassification of the disproportionate profit share of the initiators (pooled in the transparent Initiator KG) as income from self-employment, as provided for in section 18(1) no. 4 EStG, does not have any effect on treaty law. In our opinion, for the purposes of the DTT, these continue to be capital gains, dividends or interest to which the relevant allocation rules apply (articles 10, 11, 13 and 21 OECD MC).[17] Section 18(1) no. 4 EStG was introduced to secure a taxation of carried interest seen as "fair" (or some sort of lose-lose-compromise), focusing solely on residents – not as some sort of legal magic trick to reverse the allocation of taxing rights under DTTs. The provision does not change the original character of the disproportionate share in the fund's profits (capital income as consideration for an intangible contribution by a partner as defined in section 706 of the German Civil Code).[18]

17. Cfr. also the similar position of the Austrian Federal Minitry of Finance: öBMF, decree of 6 January 2006 - BMF-010221/0053-IV/4/2006.
18. FG München of 17 November 2020 – 12 K 2334/18, DStRE 2021, 587; TÖBEN/SCHREPP, DStR 2019, 526 (530 *et seq.*); Weber-Grellet, DStR 2018, 992.

Under treaty law, the application of article 7 OECD MC (business profits) requires an actual entrepreneurial *activity* to be carried out. According to the definition of article 3(1)(c) OECD MC, the term "enterprise" refers to the "*carrying on of any business*". The term business also "*includes the performance of professional services and of other activities of an independent character*" (article 3(1)(h) OECD MC). Hence, even if the concept of an enterprise — at least according to the (disputed) opinion of the tax authorities[19] — is to be determined primarily according to the domestic laws of the contracting states, a mere attribution to a specific category of income under one state's domestic law cannot be sufficient in and of itself.

To that end, the reclassification pursuant to section 18(1) no. 4 EStG should not be treated differently for treaty purposes than the fiction of business income pursuant to section 15(3) no. 2 EStG, for which it is the settled case-law of the *Bundesfinanzhof* that the mere fiction of a partnership as a trading partnership under German national law is irrelevant for treaty purposes. Both the *Bundesfinanzhof* as well as the tax authorities require an actual entrepreneurial activity for there to be an "enterprise" within the meaning of an applicable DTT.[20] While it is true that section 18(1) no. 4 EStG is not expressly framed as a fiction[21], in our opinion, this cannot make any difference for treaty purposes, since it should be enough that the income in question in the case of section 18(1) no. 4 EStG, just as in the case of section 15(3) no. 2 EStG, does not derive from any actual "entrepreneurial activity".[22] The mere promise of an intangible contribution (entitling the partner to a share in the profits) is not an "entrepreneurial activity".

2. The General Subsidiarity of Business Profits under the OECD MC

Moreover, even if – contrary to our view – it is assumed that carried interest could be regarded as business profits within the meaning of article 7 OECD MC solely on the basis of a reclassification under the national tax law, the more

19. BMF, decree of 26 September 2014, BStBl 2014 I, 1258, m.no. 2.2.1.
20. See, *e.g.*, BFH of 28 April 2010 – I R 81/09, BStBl 2014 II, 754, m.no. 23; BFH of 24 August 2011 – I R 46/10, BStBl 2014 II, 764, m.no. 16; BMF, decree of 26 September 2014, BStBl 2014 I, 1258, m.no. 2.3.3.
21. Cfr. BT-Drucks. 15/3336, 7; Wacker in Schmidt, EStG, 41. ed. 2021, § 18 m.no. 285; cfr. also BFH of 11 December 2018 – VIII R 11/16, BFH/NV 2019, 746, m.no. 41.
22. Cfr. even the German tax authorities BMF, decree of 26 September 2014, BStBl 2014 I, 1258, m.no. 2.2.1, according to which only a freelance activity within the meaning of section 18(1) no. 1 is stated as falling within such treaty rule (without referring to the capital income reclassified as income from self-employment pursuant to section 18(1) no. 4 EStG.

specific allocation rules for capital gains, dividends and interest (articles 10, 11, 13 and 21 OECD MC) would take precedence over article 7 OECD MC.

While the underlying permanent establishment principle is one of the pillars of the international tax order, article 7 is generally subsidiary to any other applicable allocation rule (cfr. article 7(4) OECD MC). In other words, the relationship between business profits and other types of income under treaty law is almost exactly reverse as under German tax law: under the OECD MC, items of income are primarily allocated according to the article dealing with the relevant item of income, even if such item is derived in the course of a business activity (which, again, in our opinion, is not the case anyway).[23]

3. *Permanent Establishment Proviso of the other Allocation Rules Inapplicable*

The so-called permanent establishment proviso contained in these specific allocation rules for capital income should also not be applicable in the present case, *id est*, there is no reference to article 7(1) OECD MC granting Germany a right of taxation.

The permanent establishment provisos in articles 10(4), 11(4), 13(2) and 21(2) OECD MC provide that the allocation of the taxing rights under these rules for capital income (granting the exclusive or primary right to tax to the recipient's residence state) is effectively superseded by the permanent establishment principle of article 7 OECD MC, if the capital income in question is effectively connected to a permanent establishment situated in the state of source. In other words, if the permanent establishment proviso were to apply, the (primary) right of taxation would be with the state of the permanent establishment (of course, provided that its domestic law allows such a right of taxation).

However, the requirements laid down in the permanent establishment proviso are, in our opinion, evidently not met in the present case. For even if it were assumed that the carried interest originates from a "*business*" within the meaning of the OECD MC, there is no permanent establishment of A in Germany. Article 5(1) OECD MC defines permanent establishment as *"a fixed place of business through which the business of an enterprise is wholly or partly carried on."* A evidently does not have any place of business at all, not even

23. Cfr. on the permanent establishment provisos within the special allocation rules: TÖBEN in Festschrift für Georg Crezelius, 2018, 779; TÖBEN, FR 2016, 543.

an office, in Germany and therefore does not maintain a German permanent establishment himself. Furthermore, neither the Initiator KG nor the Fund KG – both being mere asset-managing partnerships – can be considered to give rise to a permanent establishment through which a presumed business activity of A would be performed. As already argued above, the Initiator KG is a mere pooling vehicle, which does not itself carry on any entrepreneurial activity (much less maintain a place of business for such purpose). Moreover, even more so than under national law, it would be completely absurd to argue that the pooling of entitlements in a tax transparent partnership (a mere "pass through" vehicle) could change the allocation of taxation rights under the DTT. Finally, as a mere asset-managing partnership, the Fund KG cannot constitute a permanent establishment for its partners under national or treaty law[24] – this applies to the initiators as well as to the investors.

For the avoidance of doubt, the place of business of the management company also cannot simply be attributed to the initiator, who participates in the Fund KG via the Initiator KG. This applies regardless of whether the management company provides its services on the basis of a contractual fund management agreement or as the managing limited partner of the Fund KG. This is because the management company provides its management services exclusively to the (asset managing) Fund KG; they are both legally and functionally separate from the intangible contributions of the initiators made through the Initiator KG.[25]

Finally, also under treaty law, it is not apparent how an intangible contribution by a partner, which is by its very nature linked to the special expertise, experiences, or ingenuity of a person, could be provided "*through*" an assumed fixed place that is completely independent from A's physical presence in Germany.

C. Our All Perspective/Conclusion

The multi-layered and often highly complex structures of international private equity funds are regularly met with particular suspicion and scrutiny from the tax authorities. This is especially true for the disproportionate profit participation usually granted to the initiators of such funds, the carried in-

24. Cfr. Hruschka in Schönfeld/Ditz, DBA, 2. ed. 2019, Art. 5 OECD-MA m.no. 76; Wassermeyer/Kaeser in Wassermeyer, DBA, Art. 5 OECD-MA m.no. 34.
25. Please note that this question is separate and distinct from the question whether the management company of a trading fund can constitute a permanent establishment for its partners, cfr. BFH of 24 August 2011 – I R 46/10, IStR 2011, 925 (931).

terest. All over the globe, the oftentimes low taxation of such carried interest (compared to ordinary income) is the source of ongoing political reform debates as well as of challenges by the tax authorities. In our view, however, there is no compelling conceptional reason why disproportionate profit shares (granted for valid economic reasons) should be treated any different than the profits as such. Just as the principle of neutrality should, in our opinion, be the guiding principle for the taxation of the fund level, the same should apply with respect to the carried interest of the initiators.

The initiators are entitled to a share of the profits – there is no reason why profits allocated to the initiators should be treated differently from profits allocated to the investors. If the level of taxation of such carried interest is seen to be unfairly low, the fault lies in the taxation of capital income in general (and is not limited to carried interest). Transferring the above considerations to the language of international tax law, in our opinion, there is thus a strong case for treating carried interest as what it is: capital income in the form of capitals gains, dividends and/or interest.

The collegial, engaging and highly fruitful cooperation with Bernard PEETERS a few years ago gave us the opportunity to learn more about the many aspects associated with cross-border carried interest structures. We would like to thank Bernard not only for this, but also for the now many years of friendship. We wish him continued success and, above all, good health.