U.S.-German Tax Treaty Developments

United States and Germany Sign New Protocol to Income Tax Treaty

SUMMARY

On June 1, 2006, the United States and Germany signed a protocol (the “Protocol”) to the income tax treaty between the two countries as amended by a prior protocol (the “Existing Treaty”).

Most importantly for German investors in the United States, the Protocol would eliminate the withholding tax on payments of dividends or dividend equivalent amounts by a U.S. subsidiary or branch to its German parent, would generally exempt from withholding tax dividend payments by a U.S. corporation to a German pension fund and would extend the reduced 15% withholding tax on payments of dividends by a real estate investment trust to additional classes of German investors. U.S. branches of a German bank would be allowed to determine branch equity using risk weighting. The Protocol would also significantly expand the limitation on benefits clause to address treaty shopping, would re-source as German-source income otherwise U.S.-sourced income that is subject to German tax under the Treaty and would introduce mandatory binding arbitration in certain cases where the competent authorities of the two countries cannot come to an agreement.

While this memorandum focuses primarily on the effect of the Protocol for German investment in the United States, the provisions of the Protocol are, in general, reciprocal.

It is likely that hearings will be held on this and the pending protocols to U.S. income tax treaties with Denmark, Sweden and Finland this fall and, if the Senate consents, that the Protocol will be ratified before the end of 2006. If that is the case, the U.S.-German tax treaty as modified by the new Protocol (the “Treaty”) generally will be effective for withholding tax on payments made after December 31, 2006 and for income taxes for taxable years beginning after December 31, 2006.

PROVISIONS RELATING TO WITHHOLDING TAX

LIMITATIONS ON U.S. WITHHOLDING TAX ON DIVIDENDS

In general. The Protocol would exempt from U.S. withholding tax any dividends paid by a U.S. corporation to:
• a "pension fund" that is a German resident (except where the dividends are derived in carrying on a business); or
• a German resident parent corporation—that is, a corporation that has owned directly shares representing 80% or more of the voting power of the U.S. corporation paying the dividend for the 12 month period ending on the date the entitlement to the dividend is determined.

The parent corporation would in addition have to meet one of the following conditions imposed by the limitation on benefits provision, which is described in more detail below: the publicly-traded corporation test, the international headquarters test, the ownership test, both the indirect ownership and the active business tests, the derivative benefits test or receive a competent authority determination of eligibility.1

A “pension fund” is an entity established and maintained primarily to administer or provide pensions or other similar remuneration and is a plan to which contributions are eligible for preferential income tax treatment.

The Protocol would continue the existing general limitation of withholding tax on dividends paid by a U.S. corporation to 15% if paid to a German resident and to 5% if paid to a German corporation that owns 10% or more of the voting stock of the U.S. corporation paying the dividend.

The provisions of the Protocol that eliminate U.S. withholding tax on certain dividends follow similar provisions in recent U.S. income tax treaties with the United Kingdom, Japan,2 Mexico, Australia and the Netherlands3 and the pending protocols with Denmark, Sweden and Finland.

Dividends Paid by regulated investment companies (RICs) and real estate investment trusts (REITs). The Protocol would continue to limit the withholding tax on dividends paid by a U.S. RIC to 15%. The reduced 5% withholding tax rate would not be available for RICs, but the exemption from withholding tax on dividends described above would be available for dividends paid to a pension fund (unless the fund derives the dividends from carrying on a business).

The protocol would also provide for a reduced 15% withholding tax on dividends paid by a REIT to a German shareholder that

• owns 10% or less of the REIT and is an individual, as under the Existing Treaty;
• owns 5% or less of any class of stock of the REIT, and the dividends are paid on a class of stock that is publicly traded; or
• owns 10% or less of the stock of the REIT, and the REIT is “diversified.”4

1 The derivative benefits would currently operate for dividend payments by a person eligible for the benefits under the income tax treaties of the United States with the United Kingdom and the Netherlands and, if the relevant protocol is ratified, Denmark, Finland and Sweden.
Any other dividends paid by a REIT would not be covered by the Protocol and would therefore generally be subject to a 30% withholding tax. The provisions with respect to dividends paid by a REIT are similar to those included in other recent U.S. income tax treaties and protocols and consistent with amendments made to the Internal Revenue Code in 2004 and 2005.

**BRANCH PROFITS TAX**

The Protocol would also eliminate the branch profits tax otherwise imposed on the “dividend equivalent amount” of a U.S. branch or other permanent establishment of a German bank or other corporation—that is, the amount considered under the branch profits tax to be repatriated to Germany. This exemption would apply only if the German corporation satisfies one of the tests under the limitations on benefits clause that must be met for the zero withholding tax to apply to dividends paid by a U.S. subsidiary to its German parent corporation.

**EFFECTIVE DATE OF WITHHOLDING PROVISIONS**

The provisions on withholding tax will take effect for payments or credits made after December 31 of the year following the date the Protocol enters into force and so, if the Protocol is ratified this year, will apply to payments or credits made after December 31, 2006.

**PROFITS OF BRANCHES AND PERMANENT ESTABLISHMENTS**

The Protocol amends the rules for determining the income and expense of a U.S. branch or other permanent establishment in the United States and provides that the principles of the OECD Transfer Pricing Guidelines may be used for purposes of determining the profits attributable to a branch or other permanent establishment.

In particular, capital would be attributed to a permanent establishment in the amount that it would need as a separate entity. In the case of a bank or other financial institution (but not an insurance company) the United States may use a risk-weighting of assets to determine the equity of a U.S. branch, and the financial institution may use this approach if it uses such risk-weighting in the ordinary course of its business.

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(footnote continued)

4 A REIT is diversified if no single interest in real property (excluding foreclosure property) held by the REIT is more than 10% of the REIT’s total interests in real property. A REIT that holds an interest in a partnership is treated as owning its proportionate share of the partnership’s real property.

5 Unlike the treaty with Japan, however, pension funds are not exempt from withholding tax on dividends by a REIT.

6 Section 1.882-5(a)(2) of the Treasury regulations does not allow a risk-weighting approach to the attribution of equity to branches, but the income tax treaties with the United Kingdom and with Japan
Effective Date. These provisions will be effective for taxable years beginning after December 31 of the year following the date the Protocol enters into effect and so, if the Protocol is ratified this year, will take effect in the case of a calendar year taxpayer for 2007.

LIMITATIONS ON TREATY BENEFITS

New Limitation on Benefits Provision. The Protocol would substantially modify the limitation on benefits article of the Existing Treaty—that is, the article intended to reduce treaty shopping by limiting the extent to which a resident of the United States or of Germany is entitled to the benefits of the Treaty.

In addition to individuals resident in the United States or Germany and qualified government entities, the benefits of the Treaty would also be available for charitable and similar organizations, although tax-exempt in their country of residency, and to pension funds that are, in each case, organized under U.S. or German law (hereafter, “noncorporate qualified persons”). In the case of pension funds, however, more than 50% of the fund’s beneficiaries or participants must be individuals resident in the fund’s country of organization, or the organization that sponsors the fund must be eligible for the benefits of the Treaty.

A German corporation would be eligible for the benefits of the Treaty if either

- its principal class of shares is regularly traded on a “recognized stock exchange” and primarily traded on such an exchange in Germany (the “publicly-traded corporation test”); unlike several other treaties or protocols in effect, there is currently no agreement to include the customary third-country stock exchanges in certain member states of the European Union, Switzerland, Canada and Australia in the definition of a recognized stock exchange;
- its principal class of shares is regularly traded on a recognized stock exchange and the corporation’s primary place of management and control is in Germany (the “international headquarters test”);
- it meets the “ownership test”—that is, shares representing at least 50% of the corporation (by vote and value) and at least 50% of any “disproportionate” class of shares are owned, either directly or indirectly through a chain of U.S. resident or German resident owners, by no more than five corporations that satisfy the publicly-traded test or the headquarters test above; or
- it meets the “derivative benefit test”—that is, (i) shares representing at least 95% of the corporation (by vote and by value) and at least 50% of any disproportionate class of shares are

(footnote continued)

have superseded this rule, as the Internal Revenue Service has acknowledged in Notice 2005-53, I.R.B. 2005-32.

7 The NASDAQ system, any stock exchange registered with the SEC and any German stock exchange on which registered dealings in shares take place a “recognized stock exchanges” for this purpose, and so would be any other stock exchanges recognized by the competent authorities.

8 A class of shares of a company resident in Germany is “disproportionate” if it entitles the shareholder to disproportionately higher participation in the earnings in the United States by particular assets or activities of the company, and vice versa.
owned by no more than seven person who are “equivalent beneficiaries”\(^9\) and (ii) less than 50% of the corporation’s gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries (the “\textit{base erosion test}”).

A German resident (other than an individual) would also be entitled to the benefits of the Treaty on income derived from the United States if:

- it meets the “\textit{indirect ownership test}”—that is, (i) on at least half of the days of the taxable year, at least 50% of each class of shares (or other interests) in the German resident is owned, either directly or indirectly through a chain of U.S. resident or German resident owners, by German residents who are either noncorporate qualified persons or meet the publicly-traded corporation test and (ii) the German resident satisfies the base erosion test; or

- where the Treaty otherwise specifically applies to an item of income, the German resident meets the “\textit{active business test}”—that is, the German resident is, directly or with “connected persons”,\(^{10}\) engaged in a trade or business in Germany,\(^{11}\) and the income is derived in connection with, or incidental to, the trade or business.

German Investment Funds and German \textit{Investmentaktiengesellschaften} would be entitled to the benefits of the Treaty only if at least 90% of the shares or interests are owned, directly or indirectly, by German residents that are noncorporate qualified persons or that meet the publicly-traded corporation test.

In addition, a resident that is not otherwise entitled may nonetheless be able to qualify for the benefits of the Treaty if the competent authority of the payor country so determines, taking into account whether the person was established, acquired or maintained, or its operations were conducted, with one of its principal purposes to obtain Treaty benefits.

**Branches in Third Countries.** A special rules would apply to a German resident that derives the income through a permanent establishment in a third jurisdiction. Treaty benefits would in that case be available only if the combined tax imposed by Germany and the third jurisdiction were at least 60% of the tax that would have been payable by the German resident in Germany if the income had not been derived through a permanent establishment outside Germany. This limitation would not apply, however, to royalty income for the use of, or the right to use, intangible property produced or developed by the permanent

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\(^9\) An “equivalent beneficiary” is any person who is a resident of a member state of the European Union or the European Economic Area or a party to NAFTA and either (i) is entitled to the benefits of an applicable income tax treaty (or would be so entitled under mostly analogous provisions to the Treaty if that treaty lacks a limitation on benefits provisions) and is not subject to higher withholding rates under that treaty or (ii) is a resident of the United States or Germany and either meets the publicly-traded test or is a simple qualified person.

\(^{10}\) Two persons are “connected persons” if (i) based on all facts and circumstances, one is controlled by or under common control with the other, (ii) one owns at least 50% of the other, or (iii) a third person owns at least 50% of each of the two persons.

\(^{11}\) Such a trade or business includes the making or managing of investments for the resident’s own account only if done in connection with banking, insurance or securities dealing of a resident that is a bank, an insurance company or a registered securities dealer.
establishment or to income with respect to which the permanent establishment meets the active business test.

**Fiscally Transparent Entities.** The Protocol adopts the rules for payments to a partnership or other fiscally transparent entity that apply under the Internal Revenue Code.\(^\text{12}\) If a U.S. payor makes a payment to a fiscally transparent entity in Germany or in a third country, the income would be treated as derived by a German person only to the extent that the income is treated as income of a German resident for purposes of German tax laws. Thus, if a U.S. payor distributed a dividend to a check-the-box entity in a third country that is wholly owned by a German individual, and the item was not subject to German income tax as income of the individual or of the check-the-box entity, the Treaty would not apply to the dividend and (unless another treaty applied) the regular 30% U.S. withholding tax would be imposed on the dividend.

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**OTHER MODIFICATIONS**

**ADDITIONAL RELIEF FROM DOUBLE TAXATION**

The Protocol provides that items of income that may be taxed by Germany under the Treaty will be income from sources in Germany for U.S. federal income tax purposes and thus taken into account in calculating a U.S. taxpayer’s foreign tax credit limitation. U.S. taxpayers will be entitled to a foreign tax credit, subject to applicable limitations under the Code, in respect of German income tax, corporation tax and trade tax (*Gewerbesteuer*), but not in respect of capital tax (*Vermögenssteuer*).\(^\text{13}\)

**BINDING ARBITRATION PROCEDURE FOR SOME COMPETENT AUTHORITY DISAGREEMENTS**

The Protocol adopts for the first time in a Treaty a detailed binding arbitration procedure that may apply if the competent authorities of Germany and the United States cannot reach an agreement on the application of the Treaty. Mandatory binding arbitration would be limited to questions regarding the residence of an individual, the permanent establishment article, the business profits article, the associated enterprises article or the royalties article, unless the competent authorities agree that the case was not suitable for arbitration, and in any other case if the competent authorities agreed to submit the issue to binding arbitration. In particular, the procedure would generally require a final resolution within two years from commencement of arbitration.

Any person affected by the arbitration would have to agree not to disclose any information received in connection with the arbitration to any other person. While a determination by the arbitration board would be binding on the competent authorities, it would have no precedential value. The arbitration board would

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\(^{12}\) See Section 894(c); Treas. Reg. § 1.894-1(d)(1).

\(^{13}\) Under the Existing Treaty, capital tax is also not a creditable foreign tax, and only the portion of trade tax that is determined based on profits is creditable against a taxpayer’s U.S. tax liability.
resolve the matter by adopting the proposal of either the U.S. or the German competent authority, but would not explain the reasons therefor.

**Effective Date.** This provision will be effective as of the date the Protocol enters into force, including for cases then under consideration by the competent authorities.

**SPECIAL TRANSITION RULE FOR EFFECTIVE DATE**

A person that would enjoy greater benefits under the Existing Treaty than under the Treaty, as modified by the Protocol, would be able to elect the benefits of the Existing Treaty after the Protocol enters into force for one additional year from the otherwise applicable effective date.

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U.S. - German Income Tax Treaty

Effective Date of Protocol to U.S. - German Income Tax Treaty:
Withholding Rate Provisions May Apply to Entire Calendar Year 2006

As described in our memorandum dated June 15, 2006, the United States and Germany recently signed a protocol (the “Protocol”) to the income tax treaty between the two countries.

It is possible that the Protocol will be ratified this year and that instruments of ratification will be exchanged before January 1, 2007. If that occurs, the Protocol provisions relating to withholding taxes will apply for all of 2006. Persons eligible for a reduced rate of, or exemption from, U.S. withholding tax on dividends paid by a U.S. corporation during 2006 would in that case be entitled to refunds to the extent that the U.S. withholding tax withheld in accordance with the U.S.-German income tax treaty, as currently in effect, exceeded the rates under the Protocol.
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