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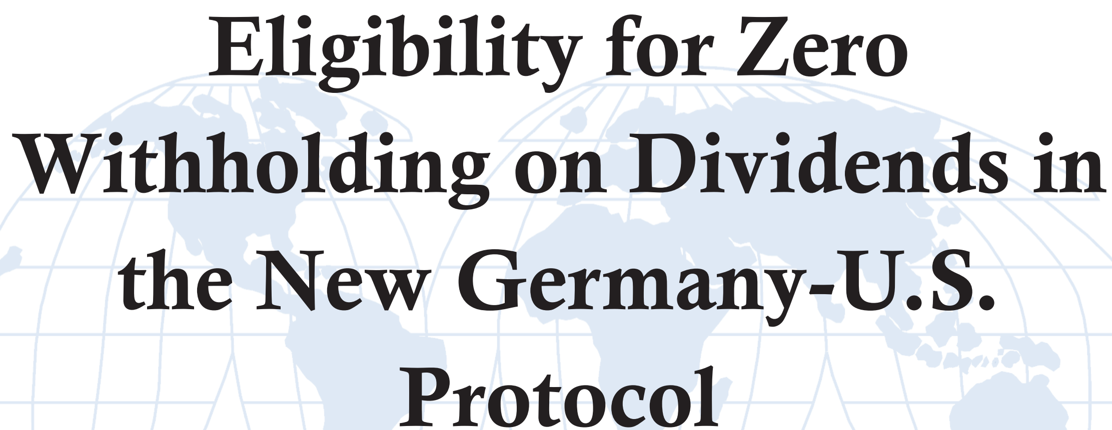

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by John Venuti and Alexey Manasuev

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SPECIAL REPORTS

Eligibility for Zero Withholding on Dividends in the New Germany-U.S. Protocol

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On June 1, 2006, the United States and Germany signed a protocol to the 1989 income tax treaty that introduced a comprehensive limitation on benefits provision and a 0 percent withholding tax rate on some dividends.[1] Recently, the 2006 protocol was approved by the Senate. The two countries exchanged instruments of ratification, and the protocol entered into force.[2] This article includes flowcharts to assist taxpayers in navigating some withholding tax aspects and LOB provisions of the protocol.

This article is the first in a series of articles that will provide similar flowcharts to assist companies in determining eligibility for a 0 percent withholding tax rate on dividend payments under other U.S. treaties that provide for a zero rate on dividends, and/or in determining the eligibility for tax treaty benefits under the LOB provisions of the respective income tax treaty.

The flowcharts in this article focus on the U.S. taxation of dividend payments from the United States to Germany. This article, however, does not address the eligibility for treaty benefits of partnerships or other transparent entities. Also, the flowcharts do not address ''triangular cases'' under article 28.5 of the Germany-U.S. income tax treaty (as amended by the 2006 protocol). This article is based on the provisions of the 2006 protocol, the U.S. Treasury technical explanation to the 2006 protocol, as well as applicable Treasury regulations.

Pursuant to Article XVII(2) of the 2006 protocol, generally, the protocol enters into force upon the exchange of instruments of ratification. The instruments of ratification were exchanged on December 28, 2007, which is also the protocol's entry into force date. However, the 2006 protocol has different effective dates for some of its provisions.

As relevant for the purposes of this article, the 2006 protocol is effective with respect to withholding taxes (such as dividends) for amounts paid or credited on or after January 1, 2007 (retroactively). According to the U.S. Treasury technical explanation, if a withholding agent withholds at a higher rate than that provided by the 2006 protocol (for example, for payments made during 2007), a beneficial owner of the income that is

[1]Protocol Amending the Convention Between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital and to Certain Other Taxes, signed on August 29, 1989. For the text of the 2006 protocol, see ''Protocol to the 1989 Germany-U.S. Income Tax Convention, Signed June 1, 2006,'' *Doc 2006-10666*, *2006 WTD 107-9*.

[2]The instruments of ratification were exchanged on December 28, 2007. *See* U.S. Treasury Department release hp-753 (Jan. 2, 2008), *Doc 2008-22*, *2008 WTD 3-16*.

a German resident may make a claim for refund pursuant to Section 1464 of the Internal Revenue Code of 1986, as amended.

Article XVII(5) of the 2006 protocol provides an exception. If the Germany-U.S. income tax treaty, as unmodified by the 2006 protocol, would have afforded any person that was entitled to benefits under the unmodified treaty greater relief from tax than under the treaty as modified by the 2006 protocol, the unmodified treaty will, at the election of such person, continue to have effect in its entirety for a 12-month period from the date on which the provisions of the 2006 protocol would have otherwise had effect with respect to such person. However, if the grace period is elected, all of the provisions of the unmodified treaty must be applied for that additional year. This rule is designed to prevent taxpayers from cherry-picking between more favorable provisions under the unmodified treaty and the treaty as modified by the 2006 protocol.

The 2006 protocol allows some companies to qualify for a 0 percent withholding tax rate on dividend payments.[3] This article contains eight flowcharts for determining the eligibility of a German company to obtain a 0 percent withholding tax rate on dividends paid by a U.S. subsidiary under the 2006 protocol.

The flowcharts may serve as a useful practice tool for practitioners and taxpayers. Although the flowcharts provide for a comprehensive review of applicable provisions contained in the 2006 protocol, taxpayers and their tax advisers should carefully evaluate each individual case and determine whether requirements of the 2006 protocol are met based on all facts and circumstances. ◆

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[3] *See* article 10 (Dividends) and article 28 (Limitation on Benefits) of the protocol.

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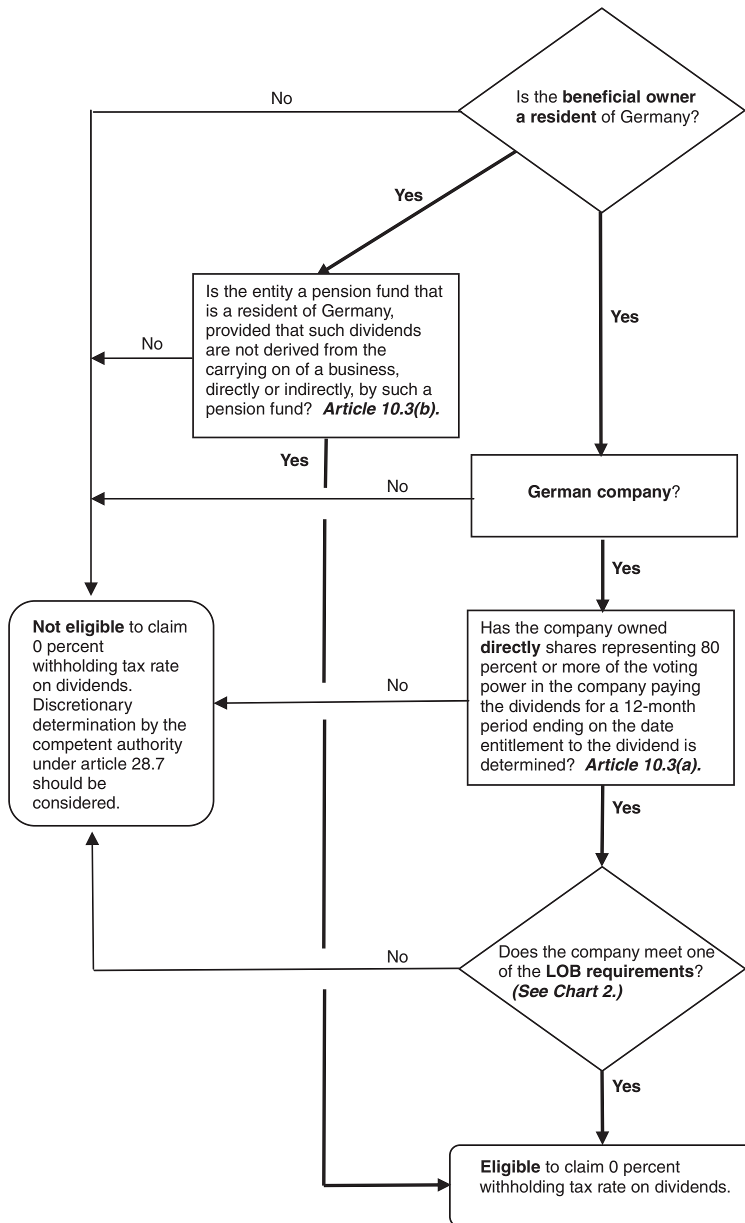
Chart 1. Eligibility for 0 Percent Withholding Tax Rate on Dividend Under Article 10.3*



"Resident" means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature, and also includes that state and any political subdivision or local authority thereof. *The term, however, does not include any person who is liable to tax in that state in respect only of income from sources in that state or of profits attributable to a permanent establishment in that state or capital situated therein.* ***Article 4.1.*****

"Dividends" means income from shares, "jouissance" shares or "jouissance" rights, founders' shares, or other rights (not being debt-claims) participating in profits, as well as other income from other rights that is subjected to the same taxation treatment as income from shares by the laws of the contracting state of which the company making the distribution is a resident. This term also includes in Germany income under a sleeping partnership (*Stille Gesellschaft*), a participating loan (*Partiarisches Darlehen*), or "*Gewinnobligation*," as well as distributions on certificates of a German *Investmentvermoegen*. ***Article 10.5.***

"Beneficial Owner" is the person to which the dividend income is attributable under the laws of the source state. Thus, if a dividend paid by a corporation that is a resident of one of the states is received by a nominee or agent that is a resident of the other state on behalf of a person that is not a resident of that other state, the dividend is not entitled to the benefits of this article. *However, a dividend received by a nominee on behalf of a resident of that other state would be entitled to benefits.* ***U.S. Treasury Technical Explanation to the 2006 Protocol.***

"Pension fund" means any person that: (a) is established under the laws of the United States or Germany; (b) is established and maintained in the United States or Germany primarily to administer or provide pensions or other similar remuneration, including social security payments, disability pensions, and widow's pensions or to earn income for the benefit of one or more of such persons; and (c) is either: (i) in the case of the United States, exempt from tax in the United States with respect to the activities described in subparagraph b) of this paragraph, or (ii) in the case of Germany, a plan the contributions to which are eligible for preferential treatment under the Income Tax Act. ***Article 10.11.***

*The flowchart takes into consideration the amendments to the Germany-U.S. income tax treaty (currently in force) contained in the protocol signed on June 1, 2006.
**Article references are to the articles of the Germany-U.S. income tax treaty (as amended by the 2006 protocol).

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Chart 2. Eligibility for Treaty Benefits (for the Purposes of Article 10.3) Under Article 28 (LOB)

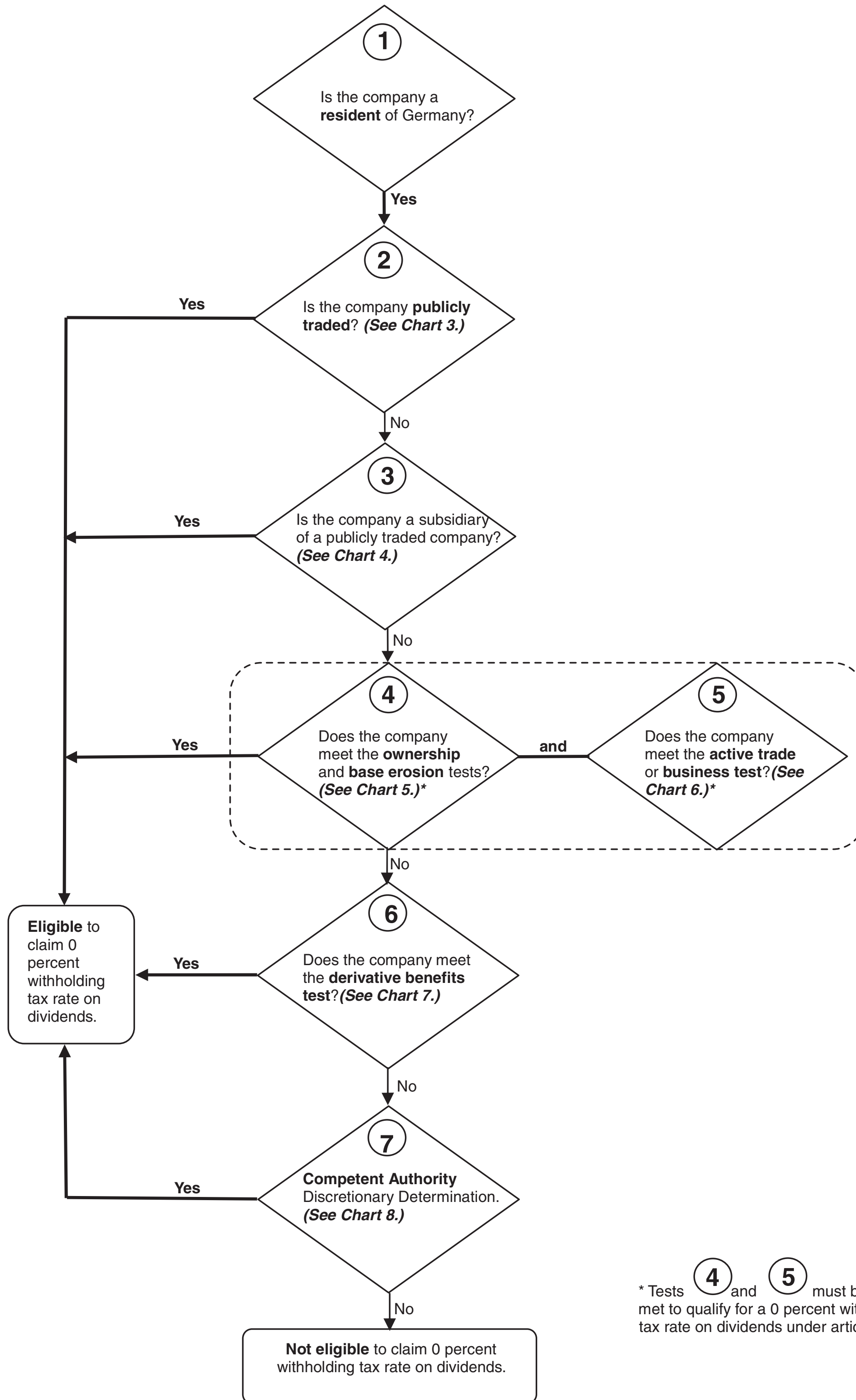

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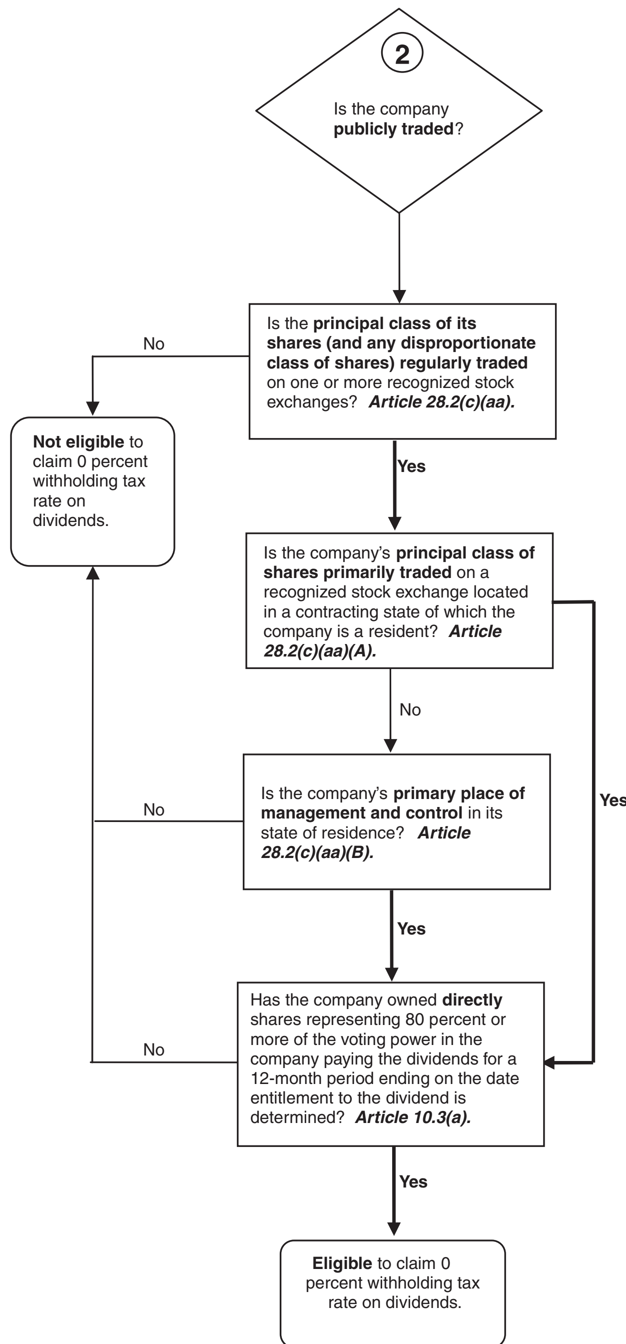
Chart 3. Publicly Traded Company Test Under Article 28.2(c)(aa) (LOB)



"Shares" include depository receipts for shares or trust certificates for shares. ***Article 28.8(b)(bb).***

"Principal class of shares" means the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. ***Article 28.8(b)(aa).***

"Disproportionate class of shares" — A company has a disproportionate class of shares if it has outstanding a class of shares that is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income, profit, or gain in the other contracting state than that to which the holder would be entitled in the absence of such terms or arrangements. ***Article 28.8(c).***

"Recognized stock exchange" includes: **(a)** the NASDAQ System and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; **(b)** any German stock exchange on which registered dealings in shares takes place; and **(c)** any other stock exchange agreed upon by the competent authorities of the United States and Germany. ***Article 28.8(a).***

"Regularly traded" — In the case of the United States, a class of shares is considered to be "regularly traded" if two requirements are met: **(a)** trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year; and **(b)** the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. ***U.S. Treasury Technical Explanation to the 2006 Protocol: Treas. reg. section 1.884-5(d)(4)(i)(B).***

"Primarily traded" — Stock of a corporation is "primarily traded" on a recognized stock exchange located in the state of residence if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the state of residence exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country. ***U.S. Treasury Technical Explanation to the 2006 Protocol; Treas. reg. section 1.884-5(d)(3).***

"Primary place of management and control" test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. The company's primary place of management and control will be located in the state in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that state than in the other state or any third state, and the staff that support the management in making those decisions are also based in that state. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the headquarters of the company (that is, the place at which the CEO and other top executives normally are based) be located in the contracting state of which the company is a resident. ***U.S. Treasury Technical Explanation to the 2006 Protocol; Article 28.8(d).***

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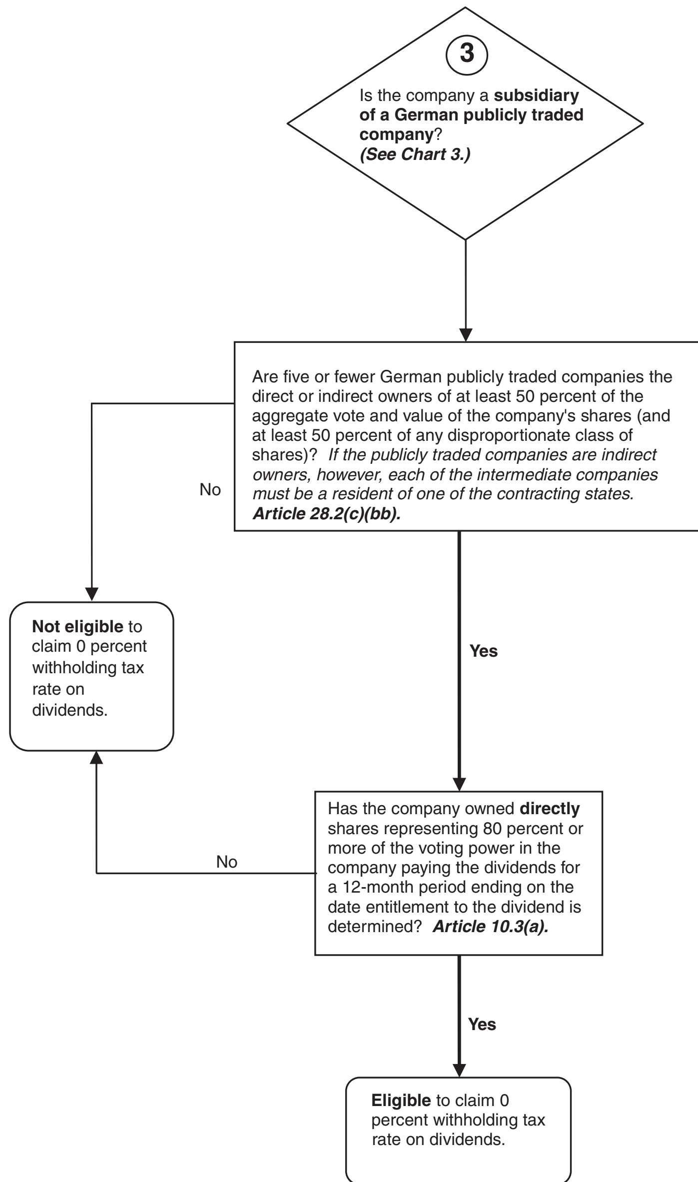
Chart 4. Subsidiary of a Publicly Traded Company Test Under Article 28 (LOB)



Example. A German company, all the shares of which are owned by another German company, would qualify for benefits under the Convention if the principal class of shares (and any disproportionate classes of shares) of the German parent company are regularly and primarily traded on the London stock exchange and primary place of management and control is in Germany. However, a German subsidiary would not qualify if the publicly traded parent company were a resident of Ireland, for example, and not a resident of the United States or Germany. Furthermore, if a German parent company indirectly owned a German company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or Germany for the German subsidiary to meet this test. ***U.S. Treasury Technical Explanation to the 2006 Protocol.***

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Chart 5. Ownership and Base Erosion Test Under Article 28.2(f) (LOB)

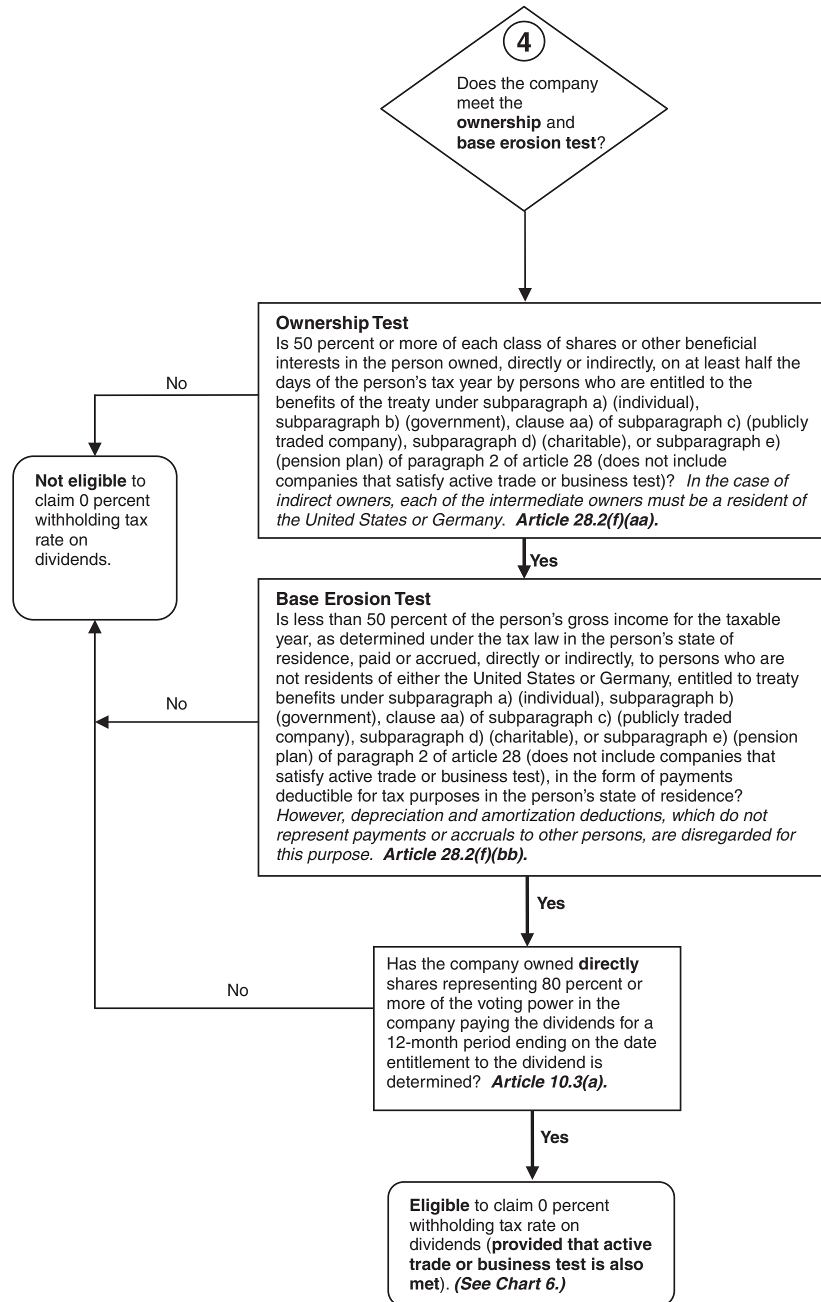

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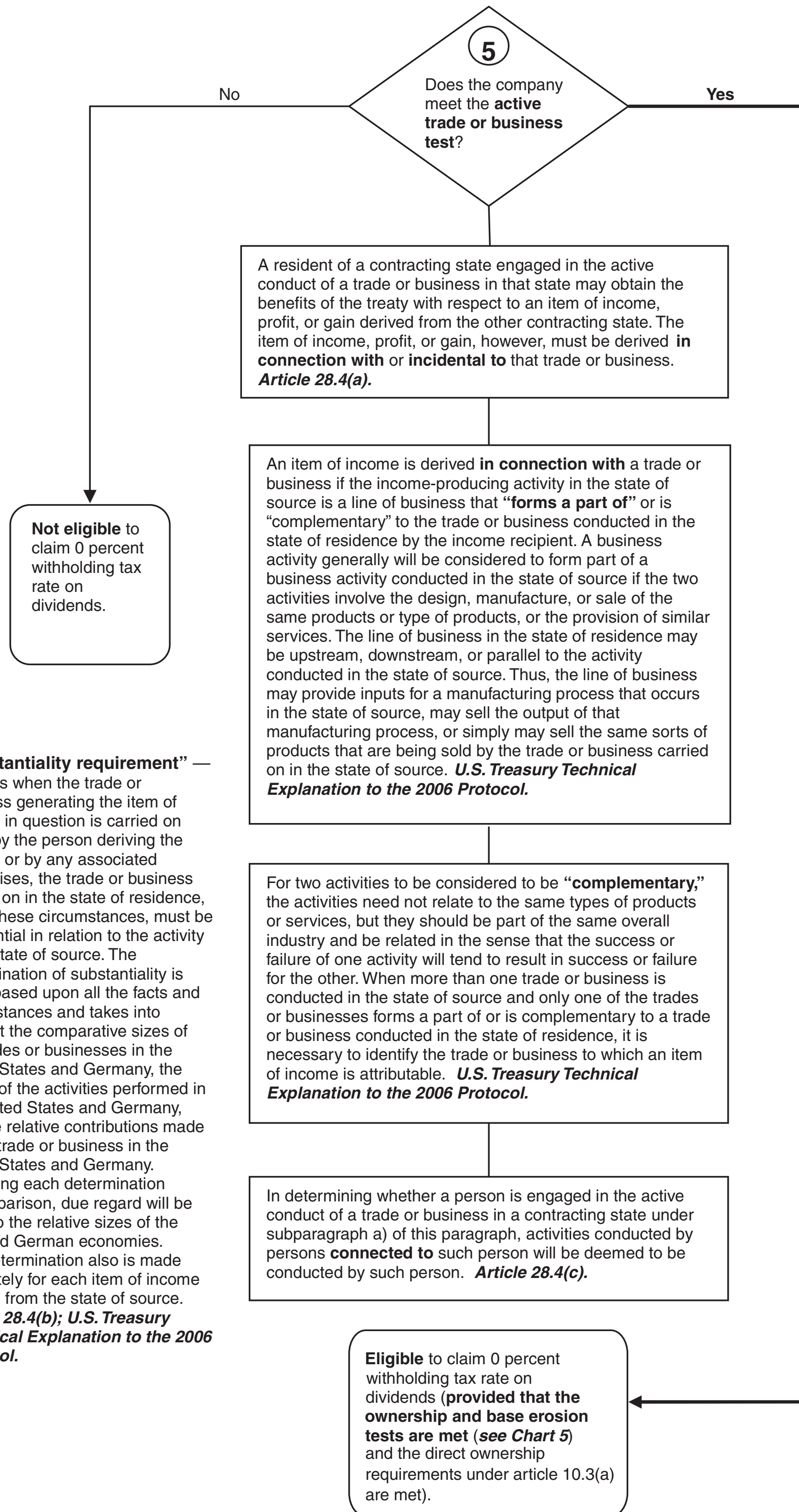
Chart 6. Active Trade or Business Test Under Article 28.4 (LOB)



"Substantiality requirement" — In cases when the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises, the trade or business carried on in the state of residence, under these circumstances, must be substantial in relation to the activity in the state of source. The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in the United States and Germany, the nature of the activities performed in the United States and Germany, and the relative contributions made to that trade or business in the United States and Germany.
In making each determination or comparison, due regard will be given to the relative sizes of the U.S. and German economies.
This determination also is made separately for each item of income derived from the state of source. ***Article 28.4(b); U.S. Treasury Technical Explanation to the 2006 Protocol.***

"Trade or business" — In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities. *For example, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business.*
The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking, insurance, or securities activities conducted by a bank, an insurance company, or a registered securities dealer. Such activities conducted by a person other than a bank, insurance company, or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company, or registered securities dealer but not as part of the company's banking, insurance, or dealer business. ***U.S. Treasury Technical Explanation to the 2006 Protocol; U.S. Treas. reg. section. 1.367(a)-2T(b)(2).***

"Incidental to" — An item of income derived from the state of source is "incidental to" the trade or business carried on in the state of residence if production of the item facilitates the conduct of the trade or business in the state of residence. An example of incidental income is the temporary investment of working capital of a person in the state of residence in securities issued by persons in the state of source. ***U.S. Treasury Technical Explanation to the 2006 Protocol.***

"Connected to" — A person will be connected to another if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, shares representing at least 50 percent of the aggregate voting power and value of the company or of the beneficial equity interest in the company) or another person possesses, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, shares representing at least 50 percent of the aggregate voting power and value of the company or of the beneficial equity interest in the company) in each person. In any case, a person shall be considered to be connected to another if, on the basis of all the facts and circumstances, one has control of the other or both are under the control of the same person or persons. ***Article 28.4(c).***

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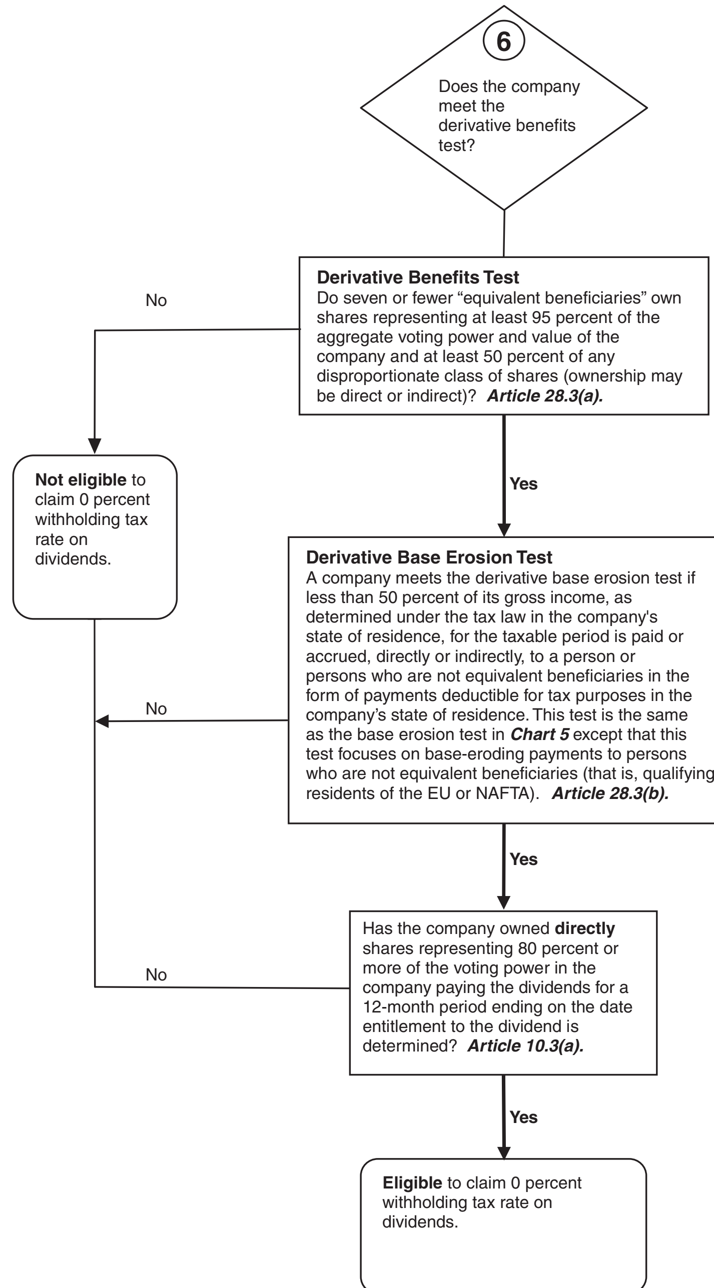
Chart 7. Derivative Benefits Test Under Article 28.3 (LOB)



"Equivalent beneficiary" means a resident of a member state of the European Union or of a European Economic Area state or of a party to the North American Free Trade Agreement but only if that resident:

aa) A) would be entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between any member state of the European Union or a European Economic Area state or any party to the North American Free Trade Agreement and the state from which the benefits of this convention are claimed under provisions analogous to subparagraph a), subparagraph b), clause aa) of subparagraph c), subparagraph d), or subparagraph e) of paragraph 2 of this article provided that if such convention does not contain a comprehensive limitation on benefits article, the person would be a qualified person under subparagraph a), subparagraph b), clause aa) of subparagraph c), subparagraph d), or subparagraph e) of paragraph 2 of this article if such person were a resident of one of the states under article 4 (Resident) of this convention; and

B) with respect to insurance premiums and to income referred to in article 10 (Dividends), 11 (Interest), or 12 (Royalties) of this convention, would be entitled under such convention to a rate of tax with respect to the particular class of income for which benefits are being claimed under this convention that is at least as low as the rate applicable under this convention; **or**

bb) is a resident of the United States or Germany that is a qualified person by reason of subparagraph a) (individual), subparagraph b) (government), clause aa) of subparagraph c) (publicly traded company), subparagraph d) (charitable), or subparagraph e) (pension plan) of paragraph 2 of article 28.

Thus, a German company that owns all of the stock of a U.S. corporation may qualify for the elimination of withholding tax if it is wholly owned, for example by a **U.K., Dutch, Mexican, Swedish, Belgian, Danish, or Finnish** publicly traded company and the other requirements of the derivative benefits test are met.

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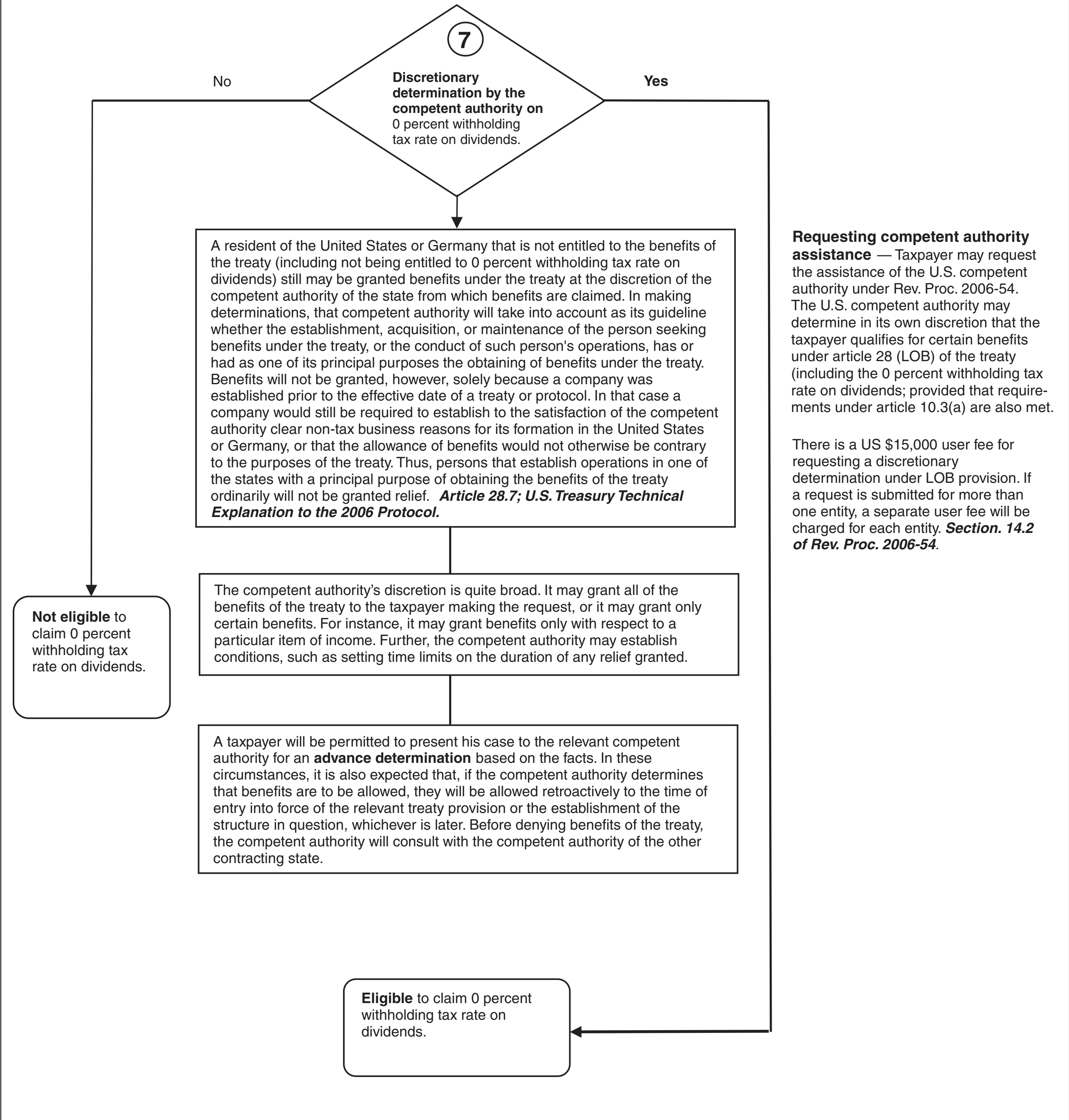

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