

A Practical Overview of the Current U.S. and German Income Tax Treatment of Dividends, Interest and Royalties Paid from Germany to the United States

By Adam R. Konrad*

Adam Konrad examines the current U.S. and German income tax treatment of dividends, interest and royalties paid from a German company to a U.S. recipient.

Introduction

The tax treatment of dividends, interest and royalties paid from a German company to a U.S. recipient will depend in part on the choice of entity, the eligibility of the payor and payee for benefits under 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, as amended by the Protocol signed on June 1, 2006 (the "Treaty"; prior to the execution of such Protocol, the "1989 Treaty"), and the internal tax laws of the United States and Germany.¹

Section 2 of this article provides an overview of some of the more frequently encountered types of German business entities, as well as their basic tax treatment for U.S. and German purposes. Section 3 summarizes the key changes made by the Protocol amending the 1989 Treaty, which took effect on December 28, 2007. Sections 4, 5 and 6 take a closer look at payments of dividends, interest and royalties from a German company to a U.S. recipient.

*Adam R. Konrad, J.D., LL.M., is an attorney at Reinhart Boerner Van Deuren s.c., in Milwaukee, Wisconsin.

2. Choice of Entity

The taxation of cross-border payments, particularly dividends, depends in large part upon the legal form of the payor and the payee. This section describes the more frequently encountered types of entities available in Germany, as well as their basic tax treatment for U.S. and German purposes.

2.1 Aktiengesellschaft

The *Aktiengesellschaft* (AG) is the German analogue to the corporation in the United States.² Generally, an AG may be formed with 50,000 € start-up capital by one or more legal or natural persons and provides limited liability to all of its shareholders.³ For both German and U.S. tax purposes, AGs are separately taxable entities/*Kapitalgesellschaften*.⁴ The 2009 German income tax rate is 15 percent.⁵ Like corporations, AGs may reduce their taxable income by deducting certain business expenses, such as interest and royalties.⁶ Dividends paid by AGs, however, are generally not deductible.⁷

2.2 Gesellschaft mit beschränkter Haftung

The *Gesellschaft mit beschränkter Haftung* (GmbH) may be formed with 25,000 € start-up capital by one or more legal or natural persons and provides limited li-

ability to all of its members.⁸ For German tax purposes, GmbHs are separately taxable entities/*Kapitalgesellschaften*, with essentially the same German corporate income tax rates and deduction opportunities as AGs.⁹ For U.S. tax purposes, a GmbH will be treated as a foreign corporation, although it may elect to be treated as a disregarded entity (if it has one member) or as a partnership (if it has multiple members).¹⁰ Like AGs, GmbHs may reduce their taxable income by deducting certain business expenses, such as interest and royalties.¹¹ Dividends paid by GmbHs, however, are generally not deductible.¹²

2.3 *Kommanditgesellschaft* (including GmbH & Co. KG, AG & Co. KG, Limited & Co. KG)

The *Kommanditgesellschaft* (KG) is the German analogue to the limited partnership in the United States.¹³ Generally, a KG may be formed with nominal capital by two or more legal or natural persons.¹⁴ KGs must have at least one general partner/*Komplementär* with unlimited liability and any number of limited partners/*Kommanditisten* with limited liability.¹⁵ For German tax purposes, a KG is treated like a fiscally transparent entity/*Personengesellschaft*.¹⁶ For U.S. tax purposes, a KG will be treated as a foreign partnership, although it may elect to be treated as a corporation (or, depending on its ownership structure, a disregarded entity).¹⁷ Like AGs and GmbHs, KGs may reduce their taxable income by deducting certain business expenses, such as interest and royalties.¹⁸

The general partner/*Komplementär* of a KG may itself be a legal person with limited liability,¹⁹ like a GmbH, AG or other EU entity²⁰ (e.g., a U.K. limited company²¹). In such cases, the KG's name must reflect the limited liability of the general partner/*Komplementär* (e.g., GmbH & Co. KG, AG & Co. KG, Limited & Co. KG).²² In such structures, the KG will be treated as a fiscally transparent entity/*Personengesellschaft* and the general partner/*Komplementär* (e.g., the GmbH, AG or Limited) will be treated as a separately taxable entity/*Kapitalgesellschaft*.²³

3. Overview of Key Changes Effected by the Protocol

On June 1, 2006, the United States and Germany concluded a Protocol to the 1989 Treaty containing significant changes with respect to the residence of fiscally transparent entities, the limitations on treaty

benefits, withholding rates on dividends and mutual agreement procedures. The Protocol became effective on December 28, 2007.

3.1 Residence of Fiscally Transparent Entities

The Protocol significantly revised the definition of "resident" in Article 4 of the 1989 Treaty, as well as inserted a new Article 1.7 that specifically addresses the residence of fiscally transparent entities.

Under the Treaty, a person is a resident of a contracting state if he, she or it is liable to tax therein.²⁴ Natural persons liable to tax in both contracting states are to have their residence determined through tie-breaker rules based on the individual's permanent home, center of vital interests, habitual abode or nationality.²⁵ Legal persons liable to tax in both contracting states are to have their residence determined through consultation by the U.S. and German competent authorities.²⁶

Article 1.7 provides that income received by entities that are fiscally transparent under the laws of either contracting state will be treated as received by a resident of a state to the extent the laws of that state treat such income as the income of a resident of that state.²⁷

The following corollaries about residence and entitlement to treaty benefits can be inferred from this rule:

- Article 1.7 does not confer residence on the fiscally transparent entity, but rather treats income received by such an entity as received by a resident.²⁸ For example, income received by a German resident from an LLC that is treated as a fiscally transparent entity/*Personengesellschaft* for German tax purposes is to be treated as received by a German resident (although not necessarily that particular German resident), and the LLC remains a nonresident with respect to that income for treaty purposes. Conversely, income received by a U.S. resident from a GmbH that is treated as a disregarded entity for U.S. tax purposes is to be treated as received by a U.S. resident (although not necessarily that particular U.S. resident), and the GmbH remains a nonresident with respect to that income for treaty purposes.
- As implied by the examples above, this analysis does not change when the fiscally transparent entity has been formed in the same state as the source state (e.g., a German individual owning an LLC that in turn owns a U.S. corporation,

which pays dividends to the LLC). If the LLC is treated for German purposes as a fiscally transparent entity/*Personengesellschaft*, Article 1.7 provides that dividends should be treated as having been received by a resident of Germany, as under German law, such dividends would be attributable to the German individual upon receipt by the LLC, even if not remitted from the LLC to the individual. The timing of U.S. withholding tax will depend on how the United States treats the LLC: If the LLC is a disregarded entity for U.S. purposes, the dividends to the LLC should trigger U.S. withholding tax; if the LLC is a corporation for U.S. purposes, the dividends should not trigger withholding tax until paid by the LLC to the individual.²⁹

- Residence with respect to a particular item of income is determined independently of a specific payee's entitlement to treaty benefits (e.g., reduced withholding), which is determined by reference to the laws of the source state.³⁰

3.2 Limitation on Treaty Benefits

The Protocol also completely replaced the 1989 Treaty's limitation on benefits article with a new article designed to further prevent treaty shopping. In addition to individuals,³¹ government³² and charitable³³ entities and certain types of entities organized to provide pension or similar benefits,³⁴ the following types of taxpayers can generally claim treaty benefits:

- Companies traded on U.S. or German stock exchanges, provided they are primarily traded on an exchange or managed and controlled in the state in which they are resident, as well as certain of their subsidiaries³⁵
- Legal persons owned 50 percent or more by other treaty beneficiaries of the same contracting state (e.g., privately held U.S. companies owned by U.S. residents, etc.), provided that less than 50 percent of their income is paid as a deductible expense (e.g., interest or royalty payments) to parties not entitled to treaty benefits³⁶
- Legal persons owned 95 percent or more by "equivalent beneficiaries" (i.e., residents of EU, EEA or NAFTA countries entitled to all the benefits of a comprehensive tax treaty between their state and the contracting state from which treaty benefits are being sought), provided that less than 50 percent of their income is paid as a deductible expense (e.g., compensation,

interest, royalties, etc.) to parties not entitled to treaty benefits. Subject to the EU rules on parent-subsidiary dividends,³⁷ additional rules also apply to limit the benefits available to equivalent beneficiaries to what they might be entitled to under their country's treaty with the contracting state ostensibly to avoid gaming of different withholding rates among treaties.³⁸

- Persons resident in and engaged in an active trade or business in one contracting state with activities in the other contracting state, provided, however, that the trade or business activity in the person's state of residence must be "substantial" in relation to its activities in the other contracting state³⁹

Persons not entitled to treaty benefits may, upon application to the competent authority from which benefits are sought, be granted benefits in special cases.⁴⁰

3.3 Withholding Rates on Dividends

In connection with the changes to the limitation on benefits article, the Protocol also introduced a new zero-withholding rate for certain types of dividends. As such, the Treaty provides for three rates of withholding on dividends, depending on the type of shareholder (company or noncompany) and the extent of the shareholder's ownership in the company paying the dividends. Specifically:

- Dividends paid to companies that have held at least 80 percent of the voting stock of the payor company for at least 12 months and satisfy certain tests of the limitation on benefits article are free from withholding.⁴¹
- Dividends paid to companies owning at least 10 percent, but less than 80 percent, of the voting stock of the payor company are subject to withholding at a rate of five percent.⁴²
- All other dividends (i.e., dividends paid to non-company recipients or to companies holding less than 10 percent of the voting stock of the payor company) are subject to withholding at a rate of 15 percent.⁴³

The German nontreaty withholding rate on dividends is generally 25 percent.⁴⁴

3.4 Mutual Agreement Procedures

The Protocol also revised Article 25 of the Treaty to provide for mandatory arbitration of certain cases in the mutual agreement procedure. Tax treaty disputes between parties in EU countries are generally subject to the arbitration rules of the EU Arbitration

Convention.⁴⁵ By contrast, prior U.S. treaties did not provide for mandatory arbitration.⁴⁶ The unfamiliarity of the United States with mandatory arbitration was said to be the reason why more than 18 months were required to ratify the protocol, and the ratified text reflects a compromise by stating general principles and deadlines, while leaving specific procedural rules to be determined. Since ratification, the competent authorities of the United States and Germany have developed a Memorandum of Understanding and Arbitration Guidelines to address procedural aspects of the mandatory arbitration.⁴⁷

4. Dividends

4.1 Treaty Provisions

Article 10 of the Treaty generally provides that cross-border dividends may be taxed by the state in which the recipient of such payments resides, as well as subject to a rate of withholding tax ranging from zero percent to 15 percent, depending on the type of shareholder (company or noncompany) and the extent of the shareholder's ownership in the company paying the dividends. The German nontreaty withholding rate on dividends is generally 25 percent.⁴⁸ "Dividends" are broadly defined to include income from shares, jouissance shares or jouissance rights, founders' shares, income under a silent partnership/*Stille Gesellschaft*, participating loan/*partiarisches Darlehen* or other right to participate in profits that is not a debt claim.⁴⁹

4.2 Treatment of the Payor

Dividends are generally not deductible.⁵⁰

4.3 Treatment of the Payee

(a) *Applicable Withholding Rates*

As described in section 3.3 above, dividends are subject to varying withholding rates, depending on the type of shareholder (company or noncompany) and the extent of the shareholder's ownership in the company paying the dividends.

(b) *Ownership Through Fiscally Transparent Entities*

Article 10 of the Treaty conditions the zero-percent and five-percent withholding rates on "direct" ownership of the voting stock of the company paying dividends. Despite this language, the Technical Explanation (*i.e.*, the U.S. position) provides that companies holding shares through fiscally transparent entities are consid-

ered to hold their proportionate interest in the shares held by the intermediate entity.⁵¹ Although the German tax authority has not provided clear guidance on this point with respect to the Treaty, they adopted a position similar to that of the Technical Explanation in the 2002 protocol to the Germany-Switzerland tax treaty.⁵²

(c) *U.S. Tax Imposed*

Dividends received from German companies by non-corporate taxpayers are currently taxable as "qualified dividend income" at capital gains rates (currently at a rate of up to 15 percent).⁵³ Dividends received by corporate taxpayers are currently taxable as ordinary income at applicable rates.

(d) *Availability of Dividends-Received Deduction*

Generally, no U.S. dividends-received deduction is available with respect to dividends from German companies.⁵⁴

(e) *Availability of Foreign Tax Credit*

U.S. shareholders may generally claim a direct foreign tax credit with respect to withholding taxes imposed on dividends paid by German companies.⁵⁵ Additionally, a "deemed paid" foreign tax credit is available to corporate shareholders that directly or indirectly own 10 percent or more of a German company.⁵⁶ The credit essentially treats the U.S. shareholder as if it had received the pre-tax share of the German company's earnings and profits to which the dividend relates and then paid the German company's foreign tax obligations. The purpose of the credit is to make investors indifferent to conducting their foreign operations through a branch or a separately taxable subsidiary.

(f) *Reducing Withholding Tax Imposed on Dividends to Non-"Company" Investors*

S corporation. In August 2008, the *Bundesfinanzhof* (Germany's highest court for tax matters) effectively held that dividends paid to an S corporation are paid to a company for purposes of Article 10 of the Treaty.⁵⁷ Accordingly, U.S. individuals that would otherwise hold stock in German companies directly (and therefore be subject to withholding tax on dividends at a rate of 15 percent) may be able to achieve significant withholding tax savings (*i.e.*, a reduction in the withholding rate to five percent or zero percent) by structuring their investment through an S corporation.⁵⁸

LLCs and the Factor-Based Analysis/*Rechtstypenvergleich*. Similarly, U.S. investors can realize

withholding tax savings by holding stock in German companies through an LLC that is treated for U.S. purposes as fiscally transparent but for German tax purposes as a separately taxable entity/*Kapitalgesellschaft*. Whether Germany will treat an LLC as a separately taxable entity/*Kapitalgesellschaft* or a fiscally transparent entity/*Personengesellschaft* will depend on a factor-based analysis/*Rechtstypenvergleich* somewhat similar to U.S. law prior to the check-the-box rules.⁵⁹ An LLC will be more likely to be treated as a separately taxable entity/*Kapitalgesellschaft* if:

- the LLC is managed by a group of managers that does not include all of the LLC's members and may include nonmembers;⁶⁰
- the members of the LLC are protected from the liabilities of the LLC;⁶¹
- transfers of membership units of the LLC (*i.e.*, not just assignments of economic rights, but also of management and control rights) do not require the consent of other members;⁶²
- distributions of the LLC's profits require action by the LLC's management;⁶³
- members are required to contribute capital (other than services) to the LLC on formation;⁶⁴
- the LLC is of perpetual duration (*i.e.*, it will not automatically go into dissolution upon the death or dissociation of a member);⁶⁵
- profit distributions are made according to ownership percentages, rather than prior capital contributions;⁶⁶ and
- the formation of the LLC occurs through the action of a public body (e.g., filing and approval by a Secretary of State of organization documents), rather than unilateral action by the members.⁶⁷

The determination is to be made on a case-by-case basis, taking into account the specific provisions in a given LLC's governing documents.⁶⁸

Investment Through a Branch. Investors may also avoid withholding tax by holding their investments in a German branch rather than a subsidiary, as Germany does not currently impose a branch profits tax.⁶⁹

5. Interest

5.1 Treaty Provisions

Article 11 of the Treaty generally provides that cross-border interest payments may only be taxed by the state in which the recipient of such payments resides (*i.e.*, generally no withholding tax). The German nontreaty withholding rate is generally 25 percent.⁷⁰

"Interest" is broadly defined to include all income from debt claims of any kind, whether or not secured, and including in particular income from government securities, bonds or debentures and all other income from the lending of money.⁷¹

5.3 Treatment of the Payor

Germany generally permits taxpayers to deduct business-related interest expenses for income tax purposes.⁷² This deduction, however, is subject to certain limitations, the most significant of which being the *Zinsschranke*, which replaced Germany's prior thin capitalization regime in 2007.⁷³ The *Zinsschranke* generally limits the deductibility of interest payments to 30 percent of the payor's EBITDA and applies to *all* interest, not just related party interest.⁷⁴

The operation of the *Zinsschranke* is relatively complicated and depends on several factors, including (a) whether the payor's annual net interest expense is greater than or equal to 3 million € (if below 3 million €, all of the interest is fully deductible; if above 3 million €, all of the interest is subject to the *Zinsschranke*), (b) whether the funding was provided by 25-percent shareholders (or related parties thereto), (c) whether the payor is (or deemed to be) part of a consolidated group and (d) if part of a consolidated group, whether the payor's equity-to-assets ratio is equal to (or no more than one percent below) the equity-to-assets ratio of the group.

Although nondeductible amounts may be carried forward indefinitely, when there is no substantial year-to-year change in the earnings of the company or the interest burden of the debtor, it is unlikely that the carryforwards will have any economic significance.⁷⁵ Additionally, changes in control of the debtor entity can result in the loss of such carryforwards. For example, carryforwards are completely lost upon the assignment/*Aufgabe* or conveyance/*Übertragung* of the debtor company's business.⁷⁶ A shareholder's withdrawal from the debtor company also results in a loss of carryforwards in proportion to the exiting shareholder's former holdings.⁷⁷ Finally, if the debtor company has corporate shareholders, the rules generally applicable to the elimination of loss carryforwards upon changes of control apply.⁷⁸

5.3 Treatment of the Payee

Interest received by U.S. taxpayers is treated as income, and subject to tax at the rate applicable to the recipient.⁷⁹

6. Royalties

6.1 Treaty Provisions

Article 12 of the Treaty generally provides that cross-border royalty payments may only be taxed by the state in which the recipient of such payments resides (*i.e.*, no withholding tax). The German nontreaty withholding rate on royalties is generally 25 percent.⁸⁰ “Royalties” are broadly defined to include all consideration for use of copyrights of literary, artistic or scientific works (but specifically excluding films or other media suitable for use in broadcasting), patents, trademarks, designs, *etc.* and for contingent consideration for the sale of such items.⁸¹

6.2 Treatment of the Payor

Germany generally permits taxpayers to deduct business-related royalty expenses for income tax purposes.⁸² Unlike the special *Zinsschranke* rules applicable to interest payments, the deductibility of royalties is primarily limited by the rules relating to transactions between related parties (*i.e.*, royalties must be within an “arm’s-length” range/comparable to what might be agreed to by unrelated third parties).⁸³ Payments of royalties to related parties often require additional justification, which may

involve a detailed economic analysis of comparable transactions and companies.

6.3 Treatment of the Payee

Royalties received by U.S. taxpayers are treated as income, and subject to tax at the rate applicable to the recipient.⁸⁴

7. Conclusion

Despite the fact that nearly two years have passed since the Protocol entered into force, many unresolved questions remain. For example, the 2008 court decision addressing the German tax treatment of S corporations⁸⁵ deviates from the factor-based analytical framework normally used to characterize entities. While the decision is currently the law, there is no guarantee that the German tax authority will acquiesce.⁸⁶ Similarly, the *Zinsschranke* rules⁸⁷ can create issues for U.S. taxpayers unfamiliar with such a broad-based thin capitalization regime. Finally, although significant progress has been made with respect to the development of the mandatory arbitration procedures,⁸⁸ they remain largely untested and are certain to present questions in the future.

ENDNOTES

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¹ The scope of this article is limited to the U.S. federal income tax and German income tax provisions in effect as of the date of publication; issues relating to trade tax/*Gewerbesteuer* and VAT/*Umsatzsteuer* have not been reviewed. Additionally, it is emphasized that this article is limited to an overview of the matters discussed and does not constitute tax advice; persons seeking tax advice should consult with qualified legal and/or tax advisors.

² Code Sec. 11; Reg. §301.7701-2(b)(8)(i); *BMF Schreiben vom 24.12.1999 IV B 4-S 1300-111/99* (BStBl. I S. 1076), Tabelle 1.

³ §§1, 2, 7 AktG.

⁴ §1 Abs. 1 Nr. 1 KStG; Reg. §301.7701-2(b)(8).

⁵ §23 Abs. 1 KStG. Additionally, a solidarity surcharge/*Solidaritätszuschlag* of 5.5 percent of the corporate rate (*i.e.*, effectively increasing the corporate rate to 15.825 percent) and

an additional amount of seven percent–17.5 percent trade tax/*Gewerbesteuer* (depending on where in Germany the company's headquarters is located) are also imposed.

⁶ §9 Abs. 1 Nr. 1 EStG (specifically permitting deduction of business expenses); §9 Abs. 1 Satz 1-2 EStG (generally permitting business expense deductions, which ostensibly include royalties); *see also Schmidt/Drenseck EStG*, 27. Auflage 2008 §9 Rz 185.

⁷ §8 Abs. 3 KStG.

⁸ §§1, 5 Abs. 1, 13 Abs. 2 GmbHG. While it is possible to operate a GmbH without having paid in the entire 25,000 € as an *Unternehmergeellschaft* (*haftungsbeschränkt*), certain restrictions on dividends, *etc.* apply until the full amount is paid in. *See* §5a GmbHG.

⁹ §1 Abs. 1 Nr. 1 KStG.

¹⁰ Reg. §301.7701-3(b)(2)(i)(B)–(C).

¹¹ §9 Abs. 1 Nr. 1 EStG (specifically permitting deduction of business expenses); §9 Abs. 1 Satz 1-2 EStG (generally permitting business expense deductions, which ostensibly include royalties); *see also Schmidt/Drenseck EStG*, 27. Auflage 2008 §9 Rz 185.

¹² §8 Abs. 3 KStG.

¹³ *BMF Schreiben vom 24.12.1999 IV B 4-S 1300-111/99* (BStBl. I S. 1076), Tabelle 1.

¹⁴ German commentators have taken the position that a single person may not simultaneously act in the dual capacities of general partner/*Komplementär* and limited partner/*Kommanditist*. *Baumbach/Hopt*, HGB, 33. Auflage 2008 §124 Rz 16. Rather, when a person holds both general partner/*Komplementär* and limited partner/*Kommanditist* interests, the limited liability of the *Kommanditist* interest is effectively eliminated by the general liability of the *Komplementär* interest. *Schmidt/Grünwald*, Münchner Kommentar zum HGB, 2. Auflage 2007 §161 Rz 4.

¹⁵ §161 Abs. 1 HGB.

¹⁶ *Schmidt/Heinicke EStG*, 27. Auflage 2008 §1 Rz 13. Note, however, that although *Personengesellschaften* are not themselves subject to income tax/*Einkommensteuer*, they are subject to trade tax/*Gewerbesteuer* and VAT/*Umsatzsteuer*.

¹⁷ Reg. §301.7701-3(b)(2)(i)(A); as to the treatment of partnerships as disregarded entities, *see* Rev. Rul. 2004-77, IRB 2004-31, 119.

¹⁸ §9 Abs. 1 Nr. 1 EStG (specifically permitting deduction of business expenses); §9 Abs. 1 Satz 1-2 EStG (generally permitting business expense deductions, which ostensibly include royalties); *see also*

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- Schmidt/Drenseck* EstG, 27. Auflage 2008 §9 Rz 185.
- ¹⁹ *Schmidt/Grunewald*, Münchner Kommentar zum HGB, 2. Auflage 2007 §161 Rz 45-46; *Baumbach/Hopt*, HGB, 33. Auflage 2008 §161 Rz 3.
- ²⁰ EuGH, Urteil vom 5. 11. 2002 - Rs. C-208/00 (Überseering BV/Nordic Construction Company Baumanagement GmbH [NCC]); BGH, Urteil vom 13. 3. 2003-VII ZR 370/98 (Überseering BV/Nordic Construction Company Baumanagement GmbH [NCC]).
- ²¹ LG Bielefeld, Beschluß vom 11. 8. 2005-24 T 19/05.
- ²² §19 Abs. 2 HGB.
- ²³ The partnership agreement may provide, however, that the general partner/*Komplementär* will have no interest in the partnership's income or property on liquidation. *Sudhoff/Ihrig*, GmbH & Co. KG, 6. Auflage 2005 §19 Rz 8-9. A similar concept is provided for in Delaware Code, Title 6 §17-404.
- ²⁴ Treaty Art. 4.1.
- ²⁵ Treaty Art. 4.2(a)–(c). Failing resolution, the competent authorities are to determine a natural person's residence through mutual agreement.
- ²⁶ Treaty Art. 4.3. If the competent authorities cannot determine a legal person's residence, such person shall not be considered to be a resident of either contracting state.
- ²⁷ Treaty Art. 1.7. See also Wolff/Eimermann: *Neuerungen im DBA-USA: Änderungsprotokoll vom 1. Juni 2006 zum DBA-USA 1989 und dem Protokoll dazu* in *IStR* 2006 Heft 24, 838; Schönfeld: *Der neue Artikel 1 DBA-USA—Hinzurechnungsbesteuerung und abkommensrechtliche Behandlung von Einkünften steuerlich transparenter Rechtsträger* in *IStR* 2007 Heft 8, 274.
- ²⁸ Treaty Art. 1.7.
- ²⁹ *Id.*; see also Technical Explanation to the Treaty ("Technical Explanation"), at 7–8; Wolf/Eimermann at 838; Schönfeld at 275.
- ³⁰ See Treaty Art. 3.2 (*i.e.*, withholding taxes relate to the source state); Technical Explanation, at 14, 43. See also Schönfeld, at 280.
- ³¹ Treaty Art. 28.2(a).
- ³² Treaty Art. 28.2(b).
- ³³ Treaty Art. 28.2(d).
- ³⁴ Treaty Art. 28.2(e).
- ³⁵ Treaty Art. 28.2(c).
- ³⁶ Treaty Art. 28.2(f).
- ³⁷ The Parent-Subsidiary Directive generally eliminates withholding taxes on dividends to 10 percent or greater company shareholders within the EU. See Directive 90/435/EEC, as amended.
- ³⁸ Treaty Art. 28.3. Furthermore, the United States has taken the position that the phrase "all the benefits" in the definition of equivalent beneficiaries prevents parties entitled to derivative or partial third-country treaty benefits (*e.g.*, as equivalent beneficiaries or under an active trade or business provision) from becoming equivalent beneficiaries. Technical Explanation, at 49.
- ³⁹ Treaty Art. 28.4.
- ⁴⁰ Treaty Art. 28.7.
- ⁴¹ Treaty Art. 10.3.
- ⁴² Treaty Art. 10.2(a).
- ⁴³ Treaty Art. 10.2(b).
- ⁴⁴ See §43a Abs. 1 Satz 1 EstG; §43 Abs. 1 Satz 1 Nr. 1 EstG; §20 Abs. 1 Nr. 1 EstG.
- ⁴⁵ See *Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises*, July 23, 1990, 90/436/EEC, O.J. L 225, CELEX 41990A0436.
- ⁴⁶ Similar arbitration language in the U.S. treaty with Belgium took effect at the same time as the Protocol; additionally, the fifth protocol to the U.S. treaty with Canada (ratified by the United States on September 23, 2008) also provides for mandatory arbitration.
- ⁴⁷ See Announcement 2008-125, IRB 2008-52, 1363 (Dec. 29, 2008); IRS Announcement 2008-124, 2008-52 IRB 1359 (Dec. 29, 2008).
- ⁴⁸ See §43a Abs. 1 Satz 1 EstG; §43 Abs. 1 Satz 1 Nr. 1 EstG; §20 Abs. 1 Nr. 1 EstG.
- ⁴⁹ Treaty Art. 10.5.
- ⁵⁰ §8 Abs. 3 KStG.
- ⁵¹ Technical Explanation, at 15.
- ⁵² Protokoll zum Abkommen vom 11. August 1971 zwischen der Bundesrepublik Deutschland und der Schweizerischen Eidgenossenschaft zur Vermeidung der Doppelbesteuerung auf dem Gebiete der Steuern vom Einkommen und vom Vermögen in der Fassung des Protokolls vom 21. Dezember 1992, added to the treaty as part of Revisionsprotokoll v. 12. 3. 2002 (BGBl. 2003 II S. 68); see also *Tischbirek* in *Vogel/Lehner DBA*, 5. Auflage 2008, Art 10. Rz 64, 73, 74.
- ⁵³ Code Sec. 1(h)(11).
- ⁵⁴ Code Sec. 243(a). As a general rule, corporations may not claim a U.S. dividends-received deduction for dividends from foreign corporations, as the receipt of the dividend is normally the U.S. Treasury's first opportunity to tax the foreign earnings. By contrast, such a deduction is available with respect to dividends from U.S. corporations because the underlying earnings have already been subject to tax.
- ⁵⁵ Code Sec. 901(b).
- ⁵⁶ Code Sec. 902(a), 902(c)(7). Members of an affiliated group may not aggregate their ownership interests for purposes of satisfying the 10-percent ownership requirement. *First Chicago NBD Corp.*, CA-7, 98-1 *ustc* ¶ 50,169, 135 F3d 457 (1998). *Aff'g*, 96 TC 421, Dec. 47,218. Rev. Rul. 85-3, 1985-1 CB 222.
- ⁵⁷ BFH Urteil vom 20.8.2008-I R 39/07 (FG Köln, Urteil vom 20.4.2007-2 K 4034/05). Unfortunately, this decision does not provide a detailed explanation as to why an S corporation is to be treated as a separately taxable entity/*Kapitalgesellschaft* or why it, and not its shareholders, are to be treated as the beneficial owners of dividends received. (See section 4.3(f)(ii) for more detail on the *factor-based analysis* generally applicable to LLCs.) Furthermore, the decision relates to payments made pursuant to the 1989 Treaty, which one commentator has argued raises the question as to whether the decision can be applied to payments made since the Protocol. See Eimermann, *Schachtelprivileg auf Ausschüttungen an eine S-Corporation oder einen anderen hybriden Rechtsträger nach dem DBA-USA 2006?—Eine Erwiderung auf die Anmerkungen von Anger/Sewtz in IStR 2008, 852* in *IStR* 2009 Heft 2, 58. Others, however, have suggested that the rule of the decision remains valid following the Protocol. See Anger/Sewtz, *Zum Schachtelprivileg auf Ausschüttungen an eine S-Corporation nach dem DBA-USA 2006—Duplik zu Eimermann (IStR 2009, 58/59)* in *IStR* 2009 Heft 8, 273; Anger/Sewtz in *IStR* 2008 Heft 23, 852; Behrens/Wagner, *Auch hybride U.S.-Gesellschaften können die Kapitalertragsteuer-Reduktion auf 5 percent oder gar 0 percent beanspruchen* in *BB* 4.2009, 147.
- ⁵⁸ Note, however, that the use of S corporations may impose additional compliance burdens. For example, Code Sec. 1375 imposes an "excessive net passive income" tax on S corporations with prior Subchapter C earnings and profits.
- ⁵⁹ BFH Urteil vom 20.08.2008 I R 34/08 (FG Baden-Württemberg, Urteil vom 17.03.2008 4 K 59/06); BMF Schreiben vom 19.3.2004 IV B 4-S 1301 U.S.A-22/04 (BStBl. I S. 411).
- ⁶⁰ BMF Schreiben vom 19.3.2004, at IV. 1.
- ⁶¹ BMF Schreiben vom 19.3.2004, at IV. 2.
- ⁶² BMF Schreiben vom 19.3.2004, at IV. 3. It is unclear whether this criterion applies only to direct transfer restrictions or also to more indirect restrictions (*e.g.*, rights of first refusal, tag/drag rights, *etc.*).
- ⁶³ BMF Schreiben vom 19.3.2004, at IV. 4.
- ⁶⁴ BMF Schreiben vom 19.3.2004, at IV. 5. It is unclear, however, whether any particular minimum amount of capital would be required.
- ⁶⁵ BMF Schreiben vom 19.3.2004, at IV. 6.

ENDNOTES

⁶⁶ BMF Schreiben vom 19.3.2004, at IV. 7.
⁶⁷ BMF Schreiben vom 19.3.2004, at IV. 8. The BMF Schreiben speaks in terms of a public body confirming the validity of the LLC's Gesellschaftsvertrag, which appears to suggest that an LLC's entire operating agreement would need to be filed (and therefore made a matter of public record), as opposed to the more typical U.S. practice of filing a short-form Certificate of Formation/Articles of Organization.
⁶⁸ BMF Schreiben vom 19.3.2004, at V.
⁶⁹ See Frotscher: *Die Branch profits tax und das DBA-USA* in IStR 2009 Heft 2, 51; Pohl, 962-3rd T.M., Business Operations in Germany at VI.D.1. Investing through a branch as opposed to a subsidiary carries with it additional considerations. For example, it may be more difficult to justify certain deductions (e.g., interest or royalties) incurred by a branch to its home office. Pohl, at VI.D.2. Additionally, loss-making branches that are subsequently incorporated may also be subject to the branch loss recapture rules of Code Sec. 367(a)(3)(C). Nontax considerations with respect to branches also include the availability of business licenses or permits for as well as

the willingness of customers and suppliers to do business with a branch (as opposed to a domestic entity). Pohl, at VI.D.4.
⁷⁰ See §43a Abs. 1 Satz 1 EStG; §43 Abs. 1 Satz 1 Nr. 7 EStG; §20 Abs. 1 Nr. 7 EStG.
⁷¹ Treaty Art. 11.2. Penalty charges for late payments (e.g., "default interest") are not treated as interest under the Treaty.
⁷² §9 Abs. 1 Satz 1 Nr. 1 EStG.
⁷³ §4h EStG; §8a KStG; note also that financing arrangements between related parties may also be subject to adjustment pursuant to §1 AStG, a rough analogue to Code Sec. 482.
⁷⁴ Köhler: *Erste Gedanken zur Zinsschranke nach der Unternehmensteuerreform* in DStR 597, 597.
⁷⁵ *Id.* at 603.
⁷⁶ §4h Abs. 5 Satz 1 EStG.
⁷⁷ §4h Abs. 5 Satz 2 EStG.
⁷⁸ §4h Abs. 5 Satz 3 EStG. These rules generally provide that a more-than-25-percent change in ownership within a five-year period results in a loss of carryforwards in proportion to the change in ownership, and that more-than-50-percent change in ownership within a five-year period results in a total loss of carryforwards. See §8c EStG.

⁷⁹ Code Sec. 61(a)(4).
⁸⁰ See §43a Abs. 1 Satz 1 EStG; §43 Abs. 1 Satz 2 EStG; §20 Abs. 3 EStG.
⁸¹ Treaty Art. 12.2. Note, that the specific exclusion of broadcast materials from the definition of royalties in the Treaty differs from the approach taken in EU and German law. See Directive 2003/49/EC, Art. 2(b). Under the Treaty, the excluded items are subject to tax in accordance with Article 7 (Business Profits), which should result in taxation similar to as if those items were not excluded from Article 12. See Pöllath/Lohbeck in Vogel Lehner DBA, 5. Auflage, Art. 12 Rz. 90.
⁸² §9 Abs. 1 Satz 1-2 EStG (generally permitting business expense deductions, which ostensibly include royalties); see also Schmidt/Drenseck EStG, 27. Auflage 2008 §9 Rz 185.
⁸³ §1 AStG.
⁸⁴ Code Sec. 61(a)(6).
⁸⁵ See note 57, *supra*.
⁸⁶ For example, §42 AO might be employed to attack S corporation-based structures as purely tax-motivated abuses of form.
⁸⁷ See section 5.2.
⁸⁸ See section 3.4.

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