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Bundesfinanzhof Clarifies Treaty Withholding Rate Applicable to Certain Dividends Received by S Corporations from German Companies

Like many countries, Germany imposes a withholding tax on dividends paid to foreign investors. In the absence of a tax treaty, this tax is imposed at a rate of 25%.[1] A recent ruling[2] of Germany's highest tax court, the Bundesfinanzhof, addresses the longstanding question of whether certain dividends paid to an S corporation may qualify for the favorable 5% "company" withholding rate provided for in Article 10(2) of the U.S.-Germany tax treaty (the "Treaty"). Ruling in favor of the taxpayer, the court held that such dividends do indeed qualify for this reduced rate, although the court did not address whether such dividends might also qualify for the even more favorable 0% withholding rate provided for in Article 10(3) of the Treaty.

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Background

Article 10 of the Treaty reduces the rate of withholding tax on dividends paid to treaty residents to 15% generally, with more favorable treaty rates of 5% and 0% available when the beneficial owner of the dividends is a company that meets certain ownership thresholds (at least 10% voting ownership for the 5% rate; at least 80% voting ownership for the 0% rate), and in the case of the 0% rate, certain holding period and other requirements. Compared with the default rate of 25%, the Treaty provides for a significant reduction.

Summary of the Ruling

- The underlying facts of the case are as follows: an S corporation holding a 50% interest in a German GmbH received a dividend in 2008 against which withholding tax of 21.1% was initially withheld.[3] The tax authority agreed to a partial refund of the withholding tax, such that the total amount withheld would amount to 15% of the dividend.[4] Following a lower court ruling in favor of the tax authority,[5] the taxpayer appealed to the Bundesfinanzhof, arguing for a further refund, such that the total amount withheld would amount to only 5% of the dividend.[6]
- Under the old Treaty (*i.e.*, prior to the effective date of the 2006 protocol amending the Treaty), a "resident" of a country was any person who was liable

for tax in that country by reason of its domicile, residence, place of management, etc. Additionally, the Treaty deemed partnerships, estates and trusts to be residents of a country to the extent that income derived by such entities was subject to tax as the income of a resident of that country. In a ruling addressing years governed by the old Treaty, the Bundesfinanzhof extended this concept to apply to S corporations.[7] In addition to generating significant controversy among commentators, this ruling created an incentive for U.S. investors to hold their investments in Germany through S corporations where possible.

- While the current Treaty continues to treat persons liable for tax in a country as residents of that country, it does not deem fiscally transparent entities (such as S corporations) to be residents.[8] Rather, it provides that income derived by or through such entities will be considered to be derived by a resident of a country to the extent that country treats such income as the income of a resident.[9] Put another way, the dividends received by an S corporation are treated as if they had been received by a U.S. resident if they are taxable to its shareholders.
- In applying this principle, the court noted that the Treaty does not specify what type of resident should be treated as having received the dividends—*e.g.*, a "company" (which would be eligible for the 5% withholding rate) or another type of payee (which would be eligible for the 15% withholding rate).[10] The court's analysis further suggests that such a determination is not necessary, as it separates the question of whether a dividend is received (or considered received) by a resident (a determination to be made by applying Treaty Article 1(7)) from the question of the identity of the beneficial owner of such dividend (a determination to be made under German law).[11] In addressing the latter question, the court held that for German tax purposes, an S corporation will be deemed to be the beneficial owner of dividends it receives, notwithstanding its fiscal transparency in the United States[12]
- The court noted, however, that its holding was subject to recent changes in Germany's income tax law.[13] For payments made after June 30, 2013, standing for treaty-based refund claims for withholding in situations where a payee is not the party with respect to which such payment is taxed (either under the German tax law or the law of the other treaty party) is limited to the party with respect to which such payment is taxed.[14] Put another way, S corporations will not be able to bring such refund claims—rather, these claims must be brought by S corporation shareholders.
- The court also made reference to, but did not rule upon, taxpayer arguments that the withholding was incompatible with EU law.[15]

Practical Implications of the Ruling

- Although not treaty residents, S corporations may be eligible for the 5% withholding rate on certain dividends. Moreover, the court's analysis could be extended to other types of fiscally transparent entities, such as LLCs, to the extent such dividends are treated as received by a resident pursuant to Treaty Article 1(7).
- The ruling does not address whether S corporations may also avail themselves of the 0% withholding rate on dividends provided for in Treaty Article 10(3), which expressly requires that the beneficial owner of the dividends be "a company that is a resident." The German tax authority might attempt to disallow the 0% withholding rate based on this language, which differs from the 5% withholding rate language.
- S corporation shareholders may want to review returns and consider filing claims for refunds for potential overwithholding, as well as examine how the new ruling may impact their ability to take advantage of the U.S. foreign tax credit on the amounts withheld by Germany.
- The full impact of the recent changes to the German income tax law purporting to override the Treaty remains to be seen.

If you have questions about the ruling, please contact Adam Konrad, any member of the Reinhart Tax Team or your Reinhart attorney.

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[1] See § 43a Abs. 1 Satz 1 EStG; § 43 Abs. 1 Satz 1 Nr. 1 EStG; § 20 Abs. 1 Nr. 1 EStG. This is also subject to the solidarity surcharge and church tax, where applicable.

[2] BFH Urteil vom 26.6.2013 I R 48/12.

[3] BFH Urteil vom 26.6.2013, ¶ 2.

[4] BFH Urteil vom 26.6.2013, ¶ 3.

[5] FG Köln Urteil vom 24.4.2012, 2 K 3928/09.

[6] BFH Urteil vom 26.6.2013, ¶ 5.

[7] BFH Urteil vom 20.8.2008-I R 39/07.

[8] BFH Urteil vom 26.6.2013, ¶ 16. The court also noted that while an abstract obligation to pay taxes may be sufficient for residency claims in some situations, it must apply to the facts at hand, which was apparently not the case here. The ruling suggests that the taxpayer had argued that social security contributions ("Sozialabgaben") constituted taxes for which the S corporation itself has liability; this was not sufficient. The ruling did not address potential arguments that S corporations are liable for tax (and therefore residents) by virtue of the potential

liability for tax under the built-in gain provisions of IRC § 1374.
[9] Treaty Art. 1(7).
[10] BFH Urteil vom 26.6.2013, ¶ 20.
[11] See BFH Urteil vom 26.6.2013, ¶¶ 21, 24. Insight into another possible rationale for the court's analysis can be found at the end of paragraph 20, where the court notes that the treatment of S corporations under the current Treaty does not differ from that of the old Treaty.
[12] BFH Urteil vom 26.6.2013, ¶ 22.
[13] BFH Urteil vom 26.6.2013, ¶ 26.
[14] See § 50d Abs. 1 Satz 11 EStG.
[15] BFH Urteil vom 26.6.2013, ¶ 27.