

AN ALERT FROM BDO'S US/GERMANY TAX DESK

BDO KNOWS:

INTERNATIONAL TAXATION

► SUBJECT

GERMANY RULES ON S CORP TREATY BENEFITS

Germany's highest tax court has held that the 5% withholding tax rate available under the 2006 United States - Germany Income Tax Treaty (the "Treaty") will apply to dividends issued by German corporations to United States S corporations. This decision may have a significant impact on a number of structures involving hybrid entities under the Treaty.

► INTRODUCTION

On June 26, 2013, the Bundesfinanzhof, the highest tax court in Germany ("BFH"), reversed a lower tax court's decision and held that a United States S corporation was entitled to the 5% dividend withholding tax rate under Article 10(2)(a) of the Treaty (BFH Judgment of June 26, 2013, IR 48/12) as far as the income of the United States S corporation is taxed in the United States at the level of its United States resident shareholders. During 2012, lower-tier tax court in Cologne, Germany, had held that a United States S corporation was not entitled to the 5% dividend withholding tax rate but rather the individual withholding tax rate of 15% applied.

In reversing that decision, the BFH concluded that a United States S corporation is the beneficial owner of dividends paid by a German GmbH because from a German perspective, the S corporation, rather than its shareholders, is considered the recipient of the dividend payments. As such, the BFH held, that the United States S corporation is a deemed tax resident of the United States pursuant to Art. 1(7) of the Treaty.

► DISCUSSION

Background

In general, under domestic German law, dividend payments from a German GmbH to a shareholder are subject to a withholding tax of 26.375%. In certain circumstances however, that rate may be reduced under the Treaty. Pursuant to Art. 10(2)(a) of the Treaty, dividends paid by a German subsidiary to its United States shareholder are subject to a 5% withholding rate if the corporate shareholder directly owns at least 10% of the voting stock of the dividend-paying company. Until recently, however, the issue of whether an S corporation that



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receives a dividend payment from a German corporation was entitled to the privileged 5% withholding rate or the general 15% withholding rate under the Treaty had been unresolved. The lower court in Cologne held that an S corporation is not a resident of the United States under Art. 4(1) because it is a transparent entity and not subject to United States federal income tax. The lower court also concluded that the S corporation cannot claim residency under Art. 1(7), because Art. 1(7) does not stipulate the residency of transparent entities but instead stipulates those cases in which income and profits enjoy advantages of the Treaty.

The BFH Decision

On appeal, the BFH reversed the lower tax court. The BFH confirmed that the general residency rules under Art. 4(1) do not apply but then gave three arguments as to why a United States S corporation should be considered a tax resident under Art. 1(7) of the Treaty (*i.e.*, rules relating to hybrid entities):

First, the BFH emphasized that the meaning of Art. 1(7) is not limited to determining the beneficial ownership of income or profits.

Second, in contrast to the lower court, the BFH clarified that tax residency is not a prerequisite for the application of Art. 1(7).

Third, the BFH explained that the United States person to whom the profits or income is being attributed under United States domestic law (*i.e.*, the S corporation's shareholders) does not have to be identical with the person (*i.e.*, the S corporation) who is considered a resident of a State who derived such income for purposes of Art. 1(7). The BFH states that an item of income shall be considered derived by "a" resident to the extent that such item is treated as income or profits of "a" resident of such State. Nothing in the language of Art. 1(7) indicates that the person to whom the income is attributed must be identical to the person who is subject to taxation on such income items in the State of residence.

The BFH goes on to determine, by reference to Art. 10(2)(b), that the beneficial owner of the dividends is the S corporation. Irrespective of its flow-through character for United States income tax purposes, the S corporation is a corporate entity from a German tax perspective and the recipient of the dividends. The BFH held that the beneficial owner must be determined in accordance with the laws of the source State, here Germany (referencing a prior BFH decision under the 1989/1991 Treaty).

The BFH decision is not only significant for entities classified as United States S corporations but should also be applicable to a United States limited liability company if it is also treated as a corporation from a German tax perspective.

Notably, this decision may provide some guidance on the interpretation of other United States income tax treaties, as the concept of whether the lower withholding rate of 5% should apply to dividends received by United States S corporations is being debated in a number of countries. For example, Canada and Israel have held that a United States S corporation receiving a local dividend is entitled to the 5% withholding rate, while France and Switzerland and others apply the 15% withholding rate.

Consideration should be given to the filing of a claim for refunds on the over-withheld German tax. Such claims must generally be filed within four years after the end of the year payment was made.

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