



New Protocol to German / U.S. Tax Treaty Signed

On June 1, 2006 representatives of Germany and the United States signed a new Protocol to amend the existing income tax treaty between the two countries (the "Treaty"). Highlights of the Protocol include zero percent withholding on certain dividends and a more comprehensive limitation on benefits (LOB) article.

Set forth below is a summary of some of the most significant changes affecting corporations.

1. Acceptance of German CFC Rules (Treaty, Art. 1)

The Protocol establishes that the Treaty shall not be construed to prevent the application of the German CFC rules set forth in the "Außensteuergesetz" (AStG). Any double taxation resulting from the German CFC rules shall be eliminated by means of a Mutual Agreement Procedure.

This explicit acceptance of the German CFC rules was prompted by recent discussions questioning whether the German CFC rules override the Treaty (or are potentially incompatible with EU law).

2. Zero Percent Dividend Withholding (Treaty, Art. 10)

The Protocol provides a full exemption from dividend withholding tax on certain inter-company dividends. To qualify, the corporate recipient must have owned directly for 12 months shares representing at least 80 percent of the paying company's voting power. In addition, the recipient of the dividend must satisfy at least one of the following LOB tests (see also 4. below):

- (1) the publicly traded company (or subsidiary thereof) test;
- (2) the ownership/base erosion test coupled with the active-trade-or-business test;
- (3) the derivative benefits test; or
- (4) competent authority relief is granted.

The full exemption is also afforded to pensions funds. Moreover, special provisions limit the availability of zero percent withholding in the case of dividends from US Regulated Investment Companies (RIC), US Real Estate Investment Trusts (REIT) or German "Investmentvermögen" (Investment Fund or Investment Corporation).

3. Clarification Regarding US Profit Participating Debt Arrangements (Art. 10)

Income from an arrangement carrying the right to participate in profits and that is deductible to the payor may be fully taxed in the source country (i.e., does not qualify for reduced withholding as dividends or interest). The current Treaty provides examples of such profit participating arrangements under German law (e.g., partiarisches Darlehen, Gewinnobligationen).

The new Protocol now indicates that this provision also applies, in the United States, to contingent interest of the type that would not qualify for the portfolio interest excep-



tion. US corporations that have issued (or will issue) a hybrid debt instrument, or contingent debt instrument, to a German holder should carefully consider whether payments on the instrument would qualify for Treaty benefits under this standard.

4. New LOB Provision (Treaty, Art. 28)

The Protocol replaces the LOB article with one that resembles those found in other recently revised US tax treaties. A German or US resident company may qualify for benefits if:

- it is publicly traded on a recognized stock exchange and either its principal trading or seat of management is located in its country of residence;
- at least 50% of its voting shares are held by five or fewer qualifying publicly-traded companies;
- for at least half of the year, at least 50% of each class of shares is held by certain qualifying residents, and a base erosion test is satisfied;
- the company meets a derivative benefits test (i.e., at least 95 percent owned by seven or fewer "equivalent beneficiaries" (EU, EEA and NAFTA residents) and a base erosion test is met;
- the company maintains an active trade or business in its country of residence; or
- the company is granted discretionary benefits by the competent tax authority.

Again special provisions apply to pension and investment funds.

5. Triangular Branch Arrangements (Treaty, Art. 28)

The LOB article also includes a relatively strict "triangular branch" provision. It applies where a German or US resident derives income from the other contracting state through a permanent establishment located in a third country, where the combined tax paid with respect to such income is less than 60 percent of the tax that would have been paid if the income were earned directly in the resident country. In such case, Treaty benefits may be denied or, in the case of dividends, interest or royalties, a 15 percent withholding tax may be imposed by the source country.

6. Calculation of Branch Profits (Protocol, para. 4)

The Protocol to the Treaty provides that the principles of the OECD Transfer Pricing Guidelines will apply for purposes of determining the profits attributable to a permanent establishment, taking into account the different economic and legal circumstances of the single entity.

7. Mandatory Arbitration (Treaty, Art. 25)

The Protocol provides for mandatory arbitration (under certain conditions) where the competent authorities have attempted but have failed to reach agreement regarding the application of the Treaty. This is the first instance of such a provision appearing in a US or German treaty.



8. Entry into Force

The Protocol must now go through the ratification procedures in Germany and the United States. Once the Protocol enters into force, its provisions will generally be effective:

- with respect to withholding tax - for amounts paid or credited on or after the first day of January of the year in which the Protocol enters into force (i.e., it is retroactive);
- with respect to capital and other taxes on income - for tax years beginning on or after the first day of the next January after date the Protocol enters into force.

Therefore, if the ratification procedures are finalized in 2006, the new provisions will be effective as of 1 January 2006 for withholding taxes and as of 1 January 2007 for capital and other taxes on income.

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