The New US-Germany Tax Treaty

On January 1, 2008 the new US-Germany Income Tax treaty took effect. The most important changes are the limitation-on-benefits provision, the "zero-rate" dividends provision, and the mandatory and binding arbitration provision. The main point of the tax treaty is to eliminate double taxation on income earned by residents of the U.S. or Germany when conducting business in the other country. In addition, the treaty is used to prevent avoidance or evasion of taxes. The treaty promotes economic cooperation between the United States and Germany regarding cross-border transactions.

Limitation-on-Benefits Provision

The limitation-on-benefits provision changes are designed to prevent an individual from a third country from taking advantage of the US-German treaty to avoid paying taxes. The purpose of a bilateral treaty is to determine which country taxes the income from cross-border investments. As a result some third parties can engage in "treaty shopping" where they organize in one country to take advantage of the tax treatment that the US-German treaty provides.

The new provisions enact two tests to determine if the entity qualifies as a US or German entity for purposes of the treaty. The first test is the "public trading test." This test is satisfied only if the principal class of a company's shares is primarily traded on a recognized stock exchange located in the company's country of residence. The second test is a derivative benefits test. This test is satisfied if the resident's owners would have been entitled to the benefits if the income would have flowed to them. This rule is designed to eliminate triangular arrangements (arrangements where income is lightly taxed because it is derived from a third-country permanent resident).

Zero-Rate Dividend Provisions

The dividend provisions of the treaty provide a maximum 15% tax rate with a reduced 5% tax rate for dividends received if the company owns at least 10% of the dividend-paying company. There is a zero-rate withholding tax on dividends received by a parent company if the subsidiary is at least 80% owned by the parent. This would be contingent on a limitation-on-benefits provision that is even more stringent than the one included in the treaty. The zero rate is also generally available for dividends received by a pension fund. There are also special rules for dividends received from U.S. regulated investment companies and real estate investment trusts.

Mandatory and Binding Arbitration Provisions

The new treaty also makes arbitration mandatory and binding. The new procedures are designed to resolve tax disputes effectively and efficiently. These procedures are similar to mandatory and binding arbitration provisions used by the European Union and the Organisation for Economic Co-operation and Development (OECD). The arbitration utilizes a "last best offer" procedure where each side gives their last best offer and then the arbitrator chooses the best one. This encourages both parties to moderate their positions. An arbitration procedure is a new development for the United States as it updates its treaties. Time will tell if the procedure works.

The new US-German Tax Treaty is great news for the US-German cross-border business community. Please feel free to contact our partners Florian Hauswiesner or Peter King with any questions on the new tax proposal and what it means for you and your business.