Legal Insight

K&L GATES

www.klgates.com

October 10, 2012

Practice Group(s):

Tax

New double taxation agreement between Germany and Taiwan

By Rainer Schmitt and Valentina Farle

Introduction

The "Agreement between the German Institute in Taipei and the Taipei Representative Office in the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital" and the respective protocol (together hereafter the "DTA"), as signed end of 2011 by representatives or both parties, have now been transformed into German national tax law. Negotiations for the DTA started in 2002. It will enter into force upon exchange of notifications. If both notifications take place this year, the DTA will become effective as of 1 January 2013.

Unlike typical double taxation conventions, the DTA does not qualify as a treaty for international law purposes. Nevertheless, pursuant to the German legislator in the DTA implementation act, the provisions of the DTA shall be treated in Germany as if the DTA were an international treaty. However, it remains to be seen whether the status as a double taxation convention will be fully recognized by the German tax courts.

The DTA is largely based on the 2005 OECD Model Convention. Please find below selected high-level descriptions of applicable provisions:

Business Income and Permanent Establishments, Art. 5, 7, 9, Protocol

As a general rule, the profits of a business can only be taxed in the state where the enterprise is situated. However, if there is a permanent establishment (hereafter a "PE") maintained for the business in another state, the PE state may also tax the business profits allocable to such a PE. With regard to such business income, the DTA contains a few small but nevertheless interesting modifications to previous double taxation conventions concluded by Germany.

A PE can be established, inter alia, by having a centre of management, an office facility, a production site etc. Regarding the definition of a PE, however, the new DTA already explicitly contains a clause stipulating that even the mere rendering of services may constitute a PE. This even applies to advisory services where the activity for the same or even only connected projects is carried out in the respective state for a period or aggregated periods of more than six months within a 12 months period. This is a true change from previous German double taxation conventions. Traditionally, Germany is in favor of a narrow PE definition. The DTA now incorporates changes resulting from discussions in recent years at OECD level concerning the extension of the PE definition. Such broader definition, however, is expected to trigger more uncertainty for businesses and more cases of double taxation. Under German domestic tax law such service PE would not constitute a PE and it remains to be seen whether German domestic tax law will be adapted to this new PE concept. As the PE concept under German domestic tax law differs from the approach taken by double taxation conventions, differences need to be determined and analyzed in each particular case.

New double taxation agreement between Germany and Taiwan

In cases where a business maintains a PE pursuant to the DTA in another country, in a second step the business profits (or losses) need to be allocated to such a PE state and the home state. In this respect, the DTA implements the new OECD model approach which allocates the profits to the PE as if it were a functionally separate entity comprising the activities of the PE. This approach is also about to be introduced into German domestic tax law by a new bill currently discussed in Parliament. Therefore, it is to be expected that such new approach will trigger cases of double taxation and also increase the uncertainty as to the attribution of profits to PEs until tax authorities and tax payers have established a reliable practice for this new approach.

Immovable Property, Art. 6

In accordance with the OECD Model Convention, current income derived from immovable property (for example from the leasing of real estate) and from agriculture and forestry may be taxed in the state in which the property or land is located as well as in the state of tax residence.

Dividends, Interest, Royalties, Art. 10, 11, 12, Prot

Of particular importance to foreign investors is the allocation of taxing rights for dividends, interest and royalties. In general, dividends distributed by a company as well as interests or royalties paid by a company or an individual resident in one state to a company or individual resident in the other state may be taxed in both territories. The DTA stipulates that the source state's right to tax those payments is restricted to 10% of the gross amount. Exceptions apply to (1) dividends distributed and interest paid by REITs based in Germany or Taiwan where the taxing rights of the source state are capped at 15% and furthermore to (2) profit-related payments, for example returns from silent partnerships or from loans with a profit-linked interest rate, where the debtor enjoys respective tax deductibility. Finally, the dividend article also contains a most-favored-nation clause stipulating that if Taiwan enters into a double taxation agreement with another OECD country providing for a lower source state taxing right than 10% of the gross amount of the dividend, then Taiwan has to apply such lower rate also to dividends covered by the agreement with Germany. In such a case, Germany will also be likely to grant the reduced rate for German source dividends.

Shipping and Air Transport, Art. 8

Since Germany and Taiwan both play an important role in international shipping and air transportation, the DTA also contains a clause dealing with profits derived from the operation of ships and aircraft in international traffic. Like previous double taxation conventions, it is stipulated that income generated from the operation of sea ships or aircraft in international traffic may only be taxed in the business's resident state. However, it has to be noted that income derived from ships or aircraft on the basis of bare-boat/aircraft-charter is only covered by this article of the DTA if it only occurs occasionally and is linked to the operation of sea ships or aircraft in international traffic. The use or rental of containers linked to the operation of ships or aircraft in international traffic is subject to this article, too. The same applies to income from pools, joint businesses and internationally operating agencies but limited to the participant's proportional share in the joint operation. Therefore, such specific restrictions have to be noted.

New double taxation agreement between Germany and Taiwan

Capital Gains, Art. 13

In general, the right to tax capital gains is attributed to the state in which the seller is deemed to be resident under the double taxation convention provisions on residence. Exceptions usually apply to the sale of immovable property, movable property allocable to a PE or ships and aircraft in international traffic. In the latter cases, the right to tax capital gains is also allocated to the state where the immovable property, the PE or the aircraft or shipping business is located. The DTA between Germany and Taiwan follows this principle, too. In accordance with a new German approach recently introduced into German double taxation policies, the DTA stipulates that selling the shares in entities holding predominantly, directly or indirectly, real estate located in one state may be taxed in such state. With respect to German real estate, Germany will exercise this taxing right conferred under the DTA if the shareholder held at least 1% at one point in time within the last five years in a German resident company. With respect to foreign resident companies, it remains to be seen whether Germany will establish a new taxability for such capital gains under its German national tax law in order to use the taxing right conferred to it under the recent treaties.

Others, Art. 14 et seqq.

In addition to the aforementioned provisions, every double taxation convention contains a number of particular provisions regarding the taxation of certain income items such as income from employment, director’s fees, certain activities of artists and sports persons, pensions as well as income of visiting professors, teachers and students, etc. In this respect, the DTA is no exception. It contains a number of particular provisions regarding such special income items and such articles are generally in accordance with the current treaty policies of Germany. Due to the number of specific provisions and the purpose of this alert to give only a first overview in this respect, this alert does not address such items in detail.

Avoidance of Double Taxation, Art. 22

Wherever a double taxation convention confers the taxing right for a particular income item not only to one but to both treaty states, double taxation is typically avoided or mitigated by the state of residence by way of applying either of the two standard methods: the tax credit method or the tax exemption method. According to the tax credit method, broadly speaking, tax paid in the source state can be credited against tax assessed in the residence state. Where the tax exemption method applies, income taxed in the source state is exempt from tax in the residence state. It has to be noted that the tax credit method is usually further defined and restricted in the national tax laws of the residence state, resulting in potential double taxation due to non-creditable tax amounts.

The DTA follows a mixed approach: Taiwan, as a resident state, generally avoids or mitigates double taxation by applying the tax credit method. Germany as a resident state, generally applies the tax exemption method; however, it does apply the tax credit method for income such as dividends not complying with the participation exemption requirements (the dividend receiving shareholder is a company directly holding at least 25% of the shares in the dividend distributing company and the dividend distributing company has not enjoyed tax deductibility of the payments; the latter requirement is a recent introduction to German double taxation agreement policies aimed at hybrid instruments), interest, royalties and certain other income. Furthermore, with respect to business and dividend income, an activity clause is to be observed. Finally, the DTA also contains a so-called switch-over clause.

New double taxation agreement between Germany and Taiwan

Conclusion

It is fortunate that the long-lasting period of time without any double taxation agreement between Germany and Taiwan is about to come to an end.

The DTA should facilitate cross-border tax-planning, although – as with all double taxation conventions – a number of issues are left open for interpretation and discussion. It remains to be seen how such issues will be solved by tax authorities and courts in both territories.

Authors:

Rainer Schmitt
rainer.schmitt@klgates.com
+49.69.945.196.290

Valentina Farle
valentina.farle@klgates.com
+49.69.945.196.295