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TAX INFO

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Recent Developments in German Business Taxation

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New judgment on tax treaty between Germany and the US

Hybrid US S-Corporation eligible for participation exemption. Refund practice of taxes withheld remains to be seen.

In a recent judgment (file no. I R 48/12), the German Federal Fiscal Court has commented on Art. 1 para. 7 of the new tax treaty between Germany and the US dated 2008. The central issue of the judgment is the different tax treatment of US S-Corporations (i.e. corporations which have opted for a pass-through taxation for US federal tax purposes) under US and German tax law. The S-Corporation itself is not subject to federal corporate income taxes in the US, but the corporation's income is taxed at shareholder level (so-called transparent/pass-through taxation). However, German tax law does not recognize a transparent taxation of corporations. This difference in the tax treatment of S-Corporations raises the question how to apply provisions in the tax treaty that require the residence of the S-Corporation in one of the contracting states. According to the definition of "residence" in the tax treaty, a person needs to be liable to tax in one of the contracting states in order to be resident in that state.

The Federal Fiscal Court now had to decide, whether the residence of an S-Corporation can be established by means of Art. 1 para. 7 of the tax treaty. Art. 1 para. 7 of the treaty provides that, in case of income derived by or through a person that is fiscally transparent under the laws of one of the contracting states, such income shall nevertheless be considered to be derived by a resident of one of the contracting states to the extent the income is treated as income of a resident under the law of such state.

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Should further analysis or explanation of the subject matter be required, please contact a member of our Tax team or the lawyer with whom you normally consult.

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In the case at hand, an S-Corporation held 50% of the shares in a German limited liability company (GmbH) resident in Germany and received dividend payments from the German entity. The question arose to what extent these dividends were subject to German withholding taxes. The tax treaty provides that withholding taxation of dividends shall not exceed 5% under certain conditions (Art. 10 para. 2, so-called participation exemption). Part of these conditions is, however, that the S-Corporation can be deemed resident in the US. The court of first instance (Fiscal Court of Cologne, file no. 2 K 3928/09) held that, within the meaning of the tax treaty, the S-Corporation was not resident in the US because the corporation itself was not liable to taxes in the US.

The Federal Fiscal Court rejected the decision. According to the Court, the S-Corporation can be deemed resident in the US. Although such residence is not covered by the general definition of residence, the residence of the S-Corporation could be established under Art. 1 para. 7 of the tax treaty. Unlike the court of first instance, the Federal Fiscal Court held that the effect of Art. 1 para. 7 is not limited to the protection of the shareholders of the S-Corporation under the tax treaty, but also covers the qualification of the S-Corporation as resident in the US.

The Federal Fiscal Court came to the conclusion that all requirements of the participation exemption were met. Therefore it had to decide upon the details of the refund of the taxes withheld in Germany. In the case at hand, the Federal Fiscal Court was bound to a legal provision (Sec. 50d German Income Tax Act) which has been amended in the meanwhile. According to this provision, the S-Corporation itself was entitled to the refund. Although the Court mentioned the amendment of the law with effect as of 30 June 2013, it did not comment on the numerous legal problems arising from the new law. According to the new provision it might be the shareholders (and not the S-Corporation itself) who are entitled to the tax refund. Nevertheless, it remains to be seen how the new refund regulations will be applied by the Federal Central Tax Office (*Bundeszentralamt für Steuern*).

The new judgment provides legal certainty in a crucial aspect: It has now been clarified by the Federal Fiscal Court that S-Corporations can, in general, be covered by regulations under the tax treaty and benefit from the participation exemption provided in the German/US tax treaty. Furthermore, the judgment and the eligibility for the participation exemption under the tax treaty could be applied to other types of hybrid companies, such as US Limited Liability Companies. It seems that the Federal Ministry of Finance is willing to adopt the judgment: While a current circular letter explicitly denies that S-Corporations are covered by the tax treaty (circular letter concerning the application of Germany's tax treaties on partnerships, Sec. 2.1.2), such statement is no longer contained in a recently published discussion draft for an updated version of such circular letter. However, the decision by the Federal Fiscal Court does not contribute to legal certainty with regard to the future tax refund practice. It is therefore advisable to carefully assess the assertion of claims to the refund in each individual case.

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