EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND GERMANY

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States and Germany (the "proposed protocol").[2] The proposed protocol was signed on June 1, 2006. The Senate Committee on Foreign Relations (the "Committee") has scheduled a public hearing on the proposed protocol for July 17, 2007.[3]

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of German tax laws. Part IV provides a discussion of investment and trade flows between the United States and Germany. Part V contains an article-by-article explanation of the proposed protocol. Part VI contains a discussion of issues relating to the proposed protocol.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended.

[2] The proposed protocol is accompanied by official understandings implemented by an exchange of diplomatic notes (the "notes," collectively).

[3] For a copy of the proposed protocol, *see* Senate Treaty Doc. 109-20.

I. SUMMARY

The principal purposes of the existing treaty between the United States and Germany are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

The proposed protocol modifies several provisions in the existing treaty (signed in 1989). The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the United States Model Income Tax Convention of November 15, 2006,[4] and the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development, ("OECD Model treaty"). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed protocol in Part V of this pamphlet.

The proposed protocol expands the "saving clause" provision in Article 1 (General Scope) of the existing treaty to allow the United States to tax certain former citizens and long-term residents regardless of whether the termination of citizenship or residency had as one of its principal purposes the avoidance of tax. This provision generally allows the United States to apply special tax rules under section 877 of the Code as amended in 1996 and 2004. The proposed protocol also updates the existing treaty to include the rules in the U.S. Model treaty related to fiscally transparent entities.

The proposed protocol amends Article 4 (Residence) of the existing treaty to clarify which persons are residents of a treaty country. The proposed protocol specifically addresses the residence of the two treaty countries (and subdivisions and local authorities thereof), U.S. citizens and aliens lawfully admitted for permanent residence in the United States, and certain investment funds.

The proposed protocol modifies Article 7 (Business Profits) in two important respects. First, the protocol modifies Article 7 to provide that income derived from independent personal services (i.e., income from the performance of professional services and of other activities of an

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[4] The United States Model Income Tax Convention of September 20, 1996 was amended on November 15, 2006. Because the United States Model Income Tax Convention of November 15, 2006 had been under development for some time, and was issued only a few months following the signing of the proposed protocol, this pamphlet generally compares the provisions of the proposed protocol with the provisions of the more recent United States Model Income Tax Convention of November 15, 2006 ("U.S. Model treaty").

For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

independent character) is included within the meaning of the term "business profits." Accordingly, the treatment of such income is governed by Article 7 rather than by present treaty Article 14 (Independent Personal Services), which the proposed protocol deletes. In addition, Paragraph 4 of Article XVI provides that the OECD Transfer Pricing Guidelines apply by analogy in determining the profits attributable to a permanent establishment under Article 7. These new rules are similar to provisions included in other recent U.S. treaties and protocols, including the U.S Model treaty.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, however, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally applies to dividends received by a pension fund. The proposed protocol also includes special rules for dividends received from U.S. regulated investment companies and real estate investment trusts (and from similar German entities). These special rules are similar to provisions included in other recent U.S. treaties and protocols.

The proposed protocol adds to the present treaty Article 11 (Interest) two new exceptions to the general prohibition on source-country taxation of interest income, one for contingent interest and the other for interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit.

The proposed protocol adds to the present treaty Article 18A (Pension Plans). Article 18A includes new rules related to cross-border pension contributions and benefit accruals. These rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions and the taxation of a pension plan's earnings and accretions in value. These new rules are similar to provisions included in other recent U.S. treaties and protocols, including the U.S Model treaty.

The proposed protocol replaces Article 19 (Government Service) of the existing treaty with a new article that more closely reflects the government service provisions included in the U.S. Model treaty and recent U.S. income tax treaties.

The proposed protocol modifies Article 20 (Visiting Professors and Teachers; Students and Trainees) of the existing treaty to provide that professors or teachers who visit the other treaty country for a period that exceeds two years do not retroactively lose their exemption from host country income tax. The proposed protocol increases the amount of the exemption from host country tax for students and trainees who receive certain types of payments.

The proposed protocol replaces Article 23 (Relief From Double Taxation) of the present treaty with a new article providing updated rules for the relief of double taxation. Among other changes, the new Article 23 provides special rules for the tax treatment in both treaty counties of certain types of income derived from U.S. sources by U.S. citizens who are resident in the Federal Republic of Germany.

The proposed protocol changes the voluntary arbitration procedure of Article 25 (Mutual Agreement Procedure) of the treaty to a mandatory arbitration procedure that is sometimes referred to as “last best offer” arbitration, in which each of the competent authorities proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. Under the proposed protocol, unless a taxpayer or other “concerned person” (in general, a person whose tax liability is affected by the arbitration determination) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case. The mandatory and binding arbitration procedure is new to the U.S. treaty network.

The proposed protocol replaces Article 28 (Limitation on Benefits) of the existing treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits solely by reason of residence in Germany or the United States.

The proposed protocol updates Article 17 (Artistes and Athletes) and Article 20 (Visiting Professors and Teachers; Students and Trainees) of the existing treaty to reflect Germany’s use of the euro.

The proposed protocol replaces paragraphs 1 through 28 of the Protocol signed at Bonn on August 29, 1989. In many instances, the paragraphs are not substantively changed.

Article XVII of the proposed protocol provides for the entry into force of the proposed protocol. The provisions of the proposed protocol are generally effective on a prospective basis. However, the provisions of the proposed protocol with respect to withholding taxes are effective for amounts paid or credited on or after the first day of January of the year in which the proposed protocol enters into force.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, special limitations apply to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other country will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS") and the treaty partner's tax authorities can request specific tax information from a treaty partner. This information can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two countries.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF TAXATION IN GERMANY[5]

A. National Income Taxes

Overview

Germany imposes a national income tax on individuals and companies. In addition, German municipalities impose a business tax on the income of local commercial establishments. The German tax year is the calendar year, although businesses may adopt another year with the permission of the tax authorities. Taxpayers conducting a business are required to maintain their records using the accrual method of accounting. German tax law has a strong anti-avoidance provision that allows tax authorities to disregard for tax purposes any legal construct they view as inappropriate toward achieving the desired economic result sought by the taxpayer.

Individuals

Individuals resident in Germany are subject to tax on their worldwide income. Gross income is divided into several categories, including employment income, self-employment income, business income, and investment income. In computing gross income, resident taxpayers aggregate their income from the various categories. Losses incurred in one category generally may be used to reduce income in other categories; however, some losses, such as those from tax-advantageous investments, may be offset only against income within the same category. Losses arising from foreign operations may be offset only against income within the same country. The marginal tax rates on gross income increase gradually, ranging from 15 percent for single taxpayers with incomes above €7,664 ($10,119) to 45 percent for income levels in excess of €250,000 ($330,068) (€500,000 ($660,135) for married couples filing jointly).[6] A basic allowance of €7,664 ($10,119) (€15,329 ($20,238) for married couples filing jointly) is tax free. For all taxpayers, except for low income earners, a solidarity surcharge of 5.5 percent of the actual tax liability is imposed to defray the cost of German unification.

Individual taxpayers are entitled to allowances for old age and to defray the cost of child-rearing. Spouses filing jointly are entitled to the more favorable benefit of either a tax-free allowance of €5,808 ($7,668) per year per dependent child or a monthly cash payment of €154 ($203) for each of the first three children and of €179 ($236) for each additional child. Single

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[5] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part Juergen Killius, *Business Operations in Germany*, Tax Management Portfolio No. 962-2nd; IBFD European Taxation Analysis, Germany, available at http://checkpoint.riag.com. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

[6] The quoted tax rates and threshold amounts apply in 2007. U.S. dollar equivalents were calculated using the currency rate for January 1, 2007 according to OANDA's FX Converter, available at http://www.oanda.com.

parents obtain either the full child benefit or a portion of it, depending on their circumstances. They may also qualify for an additional hardship allowance.

For business enterprises subject to individual income taxation (non-incorporated businesses), all business expenses generally are deductible from gross income. However, a tax reform that is expected to become effective January 1, 2008 will reduce the deductibility of interest that exceeds received interest income by one million euros or more. The deduction of such interest will be disallowed to the extent that it exceeds an amount equal to 30 percent of the taxable income of the business before interest, taxes, depreciation, and amortization. Some exceptions will exist for enterprises owned by a group. The rules are essentially the same as those described below for corporate taxpayers. The same tax reform also will allow substantial investors in partnerships and individual owners of businesses to elect a preferential income tax rate of 28.25 percent (plus surcharge) for earnings that remain in the business.[7]

Dividends, interest, and royalties are subject to regular income tax. A 20-percent withholding tax is levied on payments of dividends, and a 30-percent withholding tax is levied on payments of interest. The withholding tax is increased by the 5.5 percent solidarity surcharge; the aggregate rates are, therefore, 21.1 percent for dividends and 31.65 percent for interest. For resident taxpayers, these withheld taxes may be credited against the final income tax liability. Only 50 percent of gross dividends are taxable for purposes of computing the final income tax liability. Consequently, residents can generally recoup the over-withholding of dividend income.

Capital gains arising in the course of a business are generally treated as income, and thereby are fully taxable. Rollover rules for replacement assets may mitigate this tax burden. Capital gains derived from private transactions are generally tax free. However, capital gains from shares held as private assets are included in taxable income if the shares have been held for less than 12 months or if they amount to a substantial participation, which is defined as the ownership of at least one percent of the share interest in that corporation during the five-year period preceding the sale; generally, only 50 percent of the gain from shares is subject to tax. Gains from the disposal of private-asset real estate held less than 10 years are includible as ordinary income unless the property was used exclusively by the taxpayer in the year of sale and for the two preceding years.

Under changes expected to be effective January 1, 2009, the income of private individuals derived from capital investments will be taxed at a flat rate of 25 percent, plus a 5.5 percent solidarity charge.[8] The new flat tax will replace the current personal tax regime applicable to capital income, and it will apply to both current income and income earned on the disposition of capital investments by private individuals. Unlike under the current tax regime, capital gains will be taxable regardless of the holding period. Domestic banking institutions will

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[7] Thomas Eckhardt, “German Lower House Passes Business Tax Package,” 46 Tax Notes Int’l 985 (June 4, 2007).

[8] Urs Bernd Brandtner & Jochen Busch, “German Tax Reform Revises Taxation of Private Capital Investments,” 2007 Worldwide Tax Daily 132-1 (July 10, 2007).

withhold the 25-percent flat tax on behalf of the beneficial investor when crediting the capital income to his account. The existing 50-percent tax exemption for dividends and share capital gains will be abolished for private individuals. Expenses related to the dividends and capital gains will no longer be tax deductible. Private investors will be allowed to offset losses from capital investments only with positive income from capital investments of the same or future years. In addition, the deduction of capital losses from shares will be limited to the amount of share capital gains of the current calendar year; any excess losses will be carried forward.

Also effective January 1, 2009, dividends and share capital gains derived from capital investments that constitute business assets will qualify for a 40-percent tax exemption, instead of the current 50 percent.

Corporations

The corporate income tax is applied to stock corporations, limited liability companies, and various incorporated associations and foundations. However, the provisions for the individual income tax are also of significance for corporate entities because their income is determined according to the rules for the business income of individuals. Thus, taxable income of corporations generally is gross income less business expenses, including organizational expenses, interest, royalties, and amortization of fixed assets.

Germany overhauled its corporate tax system in 2001, replacing its imputation system with a classical system. Corporate entities resident in Germany are generally subject to tax on their worldwide income at a flat rate of 25 percent. The additional solidarity surcharge of 5.5 percent also applies to corporate income tax, thus raising the tax rate to 26.38 percent. Under corporate tax law changes generally expected to take effect January 1, 2008, the main corporate tax rate will drop to 15 percent; after the change, the solidarity surcharge of 5.5 percent will result in a total tax rate of 15.8 percent.[9] A corporate entity is considered to be a resident of Germany if it has its statutory seat or principal place of management in Germany. Corporate shareholders receive a 95-percent deduction for dividends received, regardless of the holding period, the extent of the share interest in the distributing company, or whether the interest is in the shares of a domestic or foreign corporation. A similar 95-percent deduction generally is available for a corporation's capital gain from the sale of shares in another corporation. Resident corporations may claim a foreign tax credit for foreign withholding taxes with respect to dividends, interest, and royalties received from abroad.

Under the corporate tax law changes expected to take effect January 1, 2008, there will be an annual cap on all interest deductions incurred by a German business, regardless of whether interest is paid to related or unrelated parties. The changes provide for the disallowance of excess net interest expense, which is defined as the sum of interest income and expenses that exceeds an amount equal to 30 percent of the taxable income before interest income and

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[9] Currently, German corporations are generally subject to a total tax burden of 38.65 percent, which is the highest in the EU. The changes would result in a combined average effective rate for corporations of 29.83 percent. The 2008 tax reform also makes a number of changes to Germany's transfer pricing rules. *See* Eckhardt, supra note 7.

expenses and tax depreciation ("taxable EBITDA"). For purposes of the excess net interest expense, depreciation also includes deductions for low-cost investment items (such as equipment with an acquisition cost of €1,000 or less).[10]

Recent REIT legislation

Germany recently enacted the German Real Estate Investment Trust ("REIT") Act, which has retroactive effect beginning January 1, 2007 and introduces a German REIT regime. The legislation generally exempts from company-level taxation income of a REIT that satisfies certain distribution, asset, and revenue requirements. A REIT is required to distribute at least 90 percent of its profits to its shareholders. At least 75 percent of a REIT's total assets must consist of domestic or foreign real estate other than real estate located in Germany that is predominately used for residential purposes and was built before January 1, 2007. At least 75 percent of a REIT's gross revenue must be derived from renting, leasing, or disposing of real estate. The REIT legislation also provides favorable tax rules for certain sales of real estate to REITs.[11]

[10] For a more thorough explanation of the 2008 business tax reform package, and in particular the general interest limitation and its escape clause, see *id*.

[11] Joachim Kramer, "An Analysis of Germany's New REIT Regime," 2007 Worldwide Tax Daily 65-2 (April 4, 2007).

B. International Aspects of Taxation in Germany

Individuals

Individuals who are residents of Germany are generally taxed on their worldwide income. An individual is considered a resident if Germany is his or her "customary place of abode." An individual who has stayed in Germany for longer than six months is presumed to maintain residence in Germany. Nonresidents are subject to tax only on certain German-source income, including commercial profits derived from a permanent establishment in Germany, income derived from employment and independent personal services performed in Germany, and income from the use of real and intangible property within Germany. There is currently a 20-percent withholding tax applicable to dividends paid by a domestic corporation to a nonresident individual; and that withholding tax is the final payment of German tax on the dividend. Beginning January 1, 2009, that withholding tax rate will increase to 25 percent plus the 5.5 percent solidarity surcharge. In the absence of a treaty, employment income received by German residents working abroad is generally subject to German income taxation. However, remuneration for services rendered abroad for a German distributor or manufacturer may be exempt from income tax if the assignment lasts at least three months.

Corporations

Companies resident in Germany are generally taxed on their worldwide income. Nonresident corporations are generally subject to tax only upon certain items of German-source income. All taxable German-source income is currently taxed at a rate of 25 percent plus the 5.5 percent solidarity surcharge. Under corporate tax law changes generally expected to take effect January 1, 2008, the main corporate tax rate will drop to 15 percent plus the solidarity surcharge of 5.5 percent. Business profits are considered to be derived from German sources if they are attributable to a German permanent establishment or the activities of a permanent representative stationed in Germany. Dividends paid by resident corporations to nonresident corporations are subject to a 20-percent withholding tax (plus the 5.5 percent solidarity surcharge), except if the payee is a resident of a member state of the European Union ("EU"). The withholding tax is generally deductible or creditable against a German final income tax liability if the payee corporation holds the shares through a German permanent establishment; otherwise, the withholding tax is the final payment of tax. Beginning January 1, 2009, the withholding rate on dividends will generally be increased to 25 percent plus the 5.5 percent solidarity surcharge. However, companies subject to German tax as nonresidents are entitled to a refund of 40 percent of the withholding tax. A German resident taxpayer that holds shares in a controlled foreign corporation ("CFC") is required to pay tax on certain items of income realized by that CFC if such CFC is subject to foreign tax at rates below 25 percent. A foreign corporation is deemed to be a CFC if more than 50 percent of its shares or total voting power is controlled by resident shareholders, regardless of the size of each shareholder's ownership.

Relief from double taxation

In the absence of a treaty, Germany generally provides double tax relief by way of a credit for foreign taxes paid against German tax. The 95-percent deduction generally available to corporations for dividends and for capital gains from the sale of shares effectively exempts foreign-source dividends and gains from German tax.

C. Other Taxes

Municipal business tax

A municipal business tax (trade tax) is collected by municipalities on all commercial establishments. The tax is imposed on the profits (income) of the establishment and the basic tax rate is five percent, although municipalities often apply a multiplier to this rate. Under business tax changes generally expected to go into effect January 1, 2008, this rate is lowered from five percent to 3.5 percent, and the trade tax will no longer be deductible as a business expense. Foreign business enterprises are subject to this tax on their permanent establishments in Germany. For purposes of the U.S.-Germany tax treaty, the municipal business tax is treated like an income tax.

Inheritance, gift, and wealth taxes

Germany imposes a tax upon the transfer of property by inheritance or by gift. The rate of tax is graduated and varies with the nature of the relationship between the transferor and the transferee. For transfers to a spouse or child, the rates range up to 30 percent, while if there is no family relationship, the rates range up to 50 percent.

Social security

Social security taxes are used to finance social insurance programs. Compulsory contributions towards old-age pension, long-term care, and unemployment insurance are levied at a rate of 26 percent on employment income up to €63,000 ($83,177) a year. One half of the contributions must be paid by the employer. Health insurance contributions are mandatory for those who earn less than €42,750 ($56,442). The average rate of such contributions is 14.8 percent, half of which must be paid by the employer.

Indirect taxes

Germany imposes a value added tax (“VAT”) on the consumption of goods and services. Although the VAT is levied at each stage of the economic chain, it is ultimately borne by the final customer. The VAT due on any sale is a percentage of the sale price less all the tax paid at the preceding stages. The generally applicable rate is 19 percent, but a reduced rate of seven percent is imposed upon basic foodstuffs, medical care, books, newspapers, some public transportation, and various other goods and services. Goods and services exported outside the EU are wholly exempt from the VAT.

There is a tax on the transfer of real property imposed jointly on both parties to the transaction at a rate of 3.5 percent of the consideration (4.5 percent in Berlin, since January 1, 2007).

IV. THE UNITED STATES AND GERMANY: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and direct investment. Therefore, in reviewing the proposed protocol it may be beneficial to examine the cross-border trade and investment between the United States and Germany.

When measuring by trade in goods or services or when measuring by direct and non-direct cross-border investment, the United States and Germany are important components of each country's current and financial accounts. In 2006, aggregate cross-border direct investment between the United States and Germany exceeded $24 billion. Substantial cross-border investment by persons in both countries over the years has resulted in cross-border income flows in excess of $15 billion (real 2006 dollars) annually since 1988. The income from cross-border trade and investment generally is subject to net-basis income tax in either the United States or Germany and in many cases also is subject to gross basis withholding taxes in the source country.

B. Overview of International Transactions Between the United States and Germany

The value of trade between the United States and Germany is large. In 2006, the United States exported $34.2 billion of goods to Germany and imported $84.8 billion in goods from Germany.[12] These figures made Germany the United States' sixth largest goods export destination and the fifth largest source of imported goods. These figures also represent 3.8 percent of all goods exports from the United States and 5.1 percent of all imports into the United States. Similarly, the value of cross-border investment, U.S. investments in Germany, and German investments in the United States is large. In 2006, U.S. investments in Germany decreased by $33.9 billion and German investments in the United States increased by $21.9 billion.[13] The increase in German-owned U.S. assets represents approximately one percent of the increase in all foreign-owned assets in the United States in 2006. Table 1, below, summarizes the international transactions between the United States and Germany in 2006.

Table 1 presents the balance of payments accounts between the United States and Germany. Two primary components comprise the balance of payments account: the current account and the financial account.[14] The current account measures flows of receipts from the current trade in goods and services between the United States and Germany and the flow of income receipts from investments by U.S. persons and by German persons in the United States. The financial account measures the change in U.S. investment in Germany and the change in German investment in the United States.

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[12] Bureau of Economic Analysis, U.S. Department of Commerce, "U.S. International Trade in Goods and Services, Annual Revision for 2005," June 9, 2006.

[13] Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," www.bea.gov/international, May 2007. Preliminary data.

[14] Prior to 1999, the U.S. Department of Commerce, Bureau of Economic Analysis reported and described international transactions by reference to the "current account" and the "capital account." Beginning in June 1999, the Bureau of Economic Analysis adopted a three-group classification to make U.S. data reporting more closely aligned with international guidelines. The three groups are labeled, as in Table 1: current account; capital account; and financial account. Under this regrouping, the "financial account" encompasses all transactions that used to fall into the old "capital account," so that the financial account measures U.S. investment abroad and foreign investment in the United States. The new (post-1999) system redefines the "current account" by removing a small part of the old measure of unilateral transfers and including it in the newly defined "capital account." The newly-defined capital account consists of capital transfers and the acquisition and disposal of non-produced, non-financial assets. For example, the newly defined capital account includes such transactions as forgiveness of foreign debt, migrants' transfers of goods and financial assets when entering or leaving the country, transfers to title to fixed assets, and the acquisition and disposal of non-produced assets such as natural resource rights, patents, copyrights, and leases. In practice, the Bureau of Economic Analysis believes the newly-defined "capital account" transactions will be small in comparison to the current account and financial account.

Table 1.–International Transactions Between the United States and Germany, 2006
($ billions, nominal)

Current Account Balance	**-66.3**
Exports of Goods and Services from the United States and income receipts from Germany	81.0
Merchandise	40.7
Services	20.7
Income receipts from U.S. assets in Germany	19.6
Imports of goods and services from Germany and income payments to Germany	143.8
Merchandise	89.1
Services	28.0
Payments on German-owned U.S. assets	26.7
Unilateral Transfers	-3.5
Financial Account Balance	**-55.8**
German Investment in the United States	21.9
Direct Investment	18.0
Private non-direct investment	n.a.[2]
Official	n.a.[2]
U.S. Investment in Germany[1]	-33.9
Direct Investment	6.5
Private non-direct investment[1]	-40.4
Increase in government assets	0.0
Capital Account Transactions, net	**0.0**
Statistical Discrepancy	**10.5**

Notes:

[1] A negative number represents net dispositions of such assets.

[2] Foreign private holding and foreign official holdings of assets are combined in the data to avoid disclosure of holdings by foreign official agencies. The Bureau of Economic Analysis combines official asset holdings with other non-direct investment.

Source: Bureau of Economic Analysis, U.S. Department of Commerce, May 2007. Preliminary data.

C. Trends in Current Account Income Flows Between the United States and Germany

Payments of Royalties

As Table 1 displays, the current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. Numerous disparate activities constitute trade in services. Among the sources of receipts from exported services are transportation of goods; travel by persons and passenger fares; professional services such as management consulting, architecture, engineering, and legal services; financial services; insurance services; computer and information services, and film and television tape rentals. Also included in receipts for services are the returns from investments in intangible assets in the form of royalties and license fees. In 2006, U.S. persons received approximately $3.5 billion in royalties and license fees from Germany.[15] In 2005, German persons' payments of royalties and license fees constituted 6.0 percent of all such payments to the United States. Germany ranked as the fifth largest payor of royalties and license fees among all U.S. trading partners.[16] In 2006, German persons received $2.6 billion in royalties and license fees from the United States.[17] In 2005, U.S. payments of royalties and license fees constituted 10.1 percent of all such payments made by U.S. persons. Germany ranked as the third largest recipient of royalties and license fees among all U.S. trading partners.[18] Figure 1 documents the cross-border payments of royalties and license fees between the United States and Germany measured in constant dollars.[19] Even with virtually no real growth in such receipts to the United States over the past decade, the aggregate amount of such cross-border flows has grown from less than $1.5 billion in 1986 (measured in real 2006 dollars) to more than $3.0 billion in 2006.

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[15] Bureau of Economic Analysis, U.S. Department of Commerce, May 2007. Preliminary data.

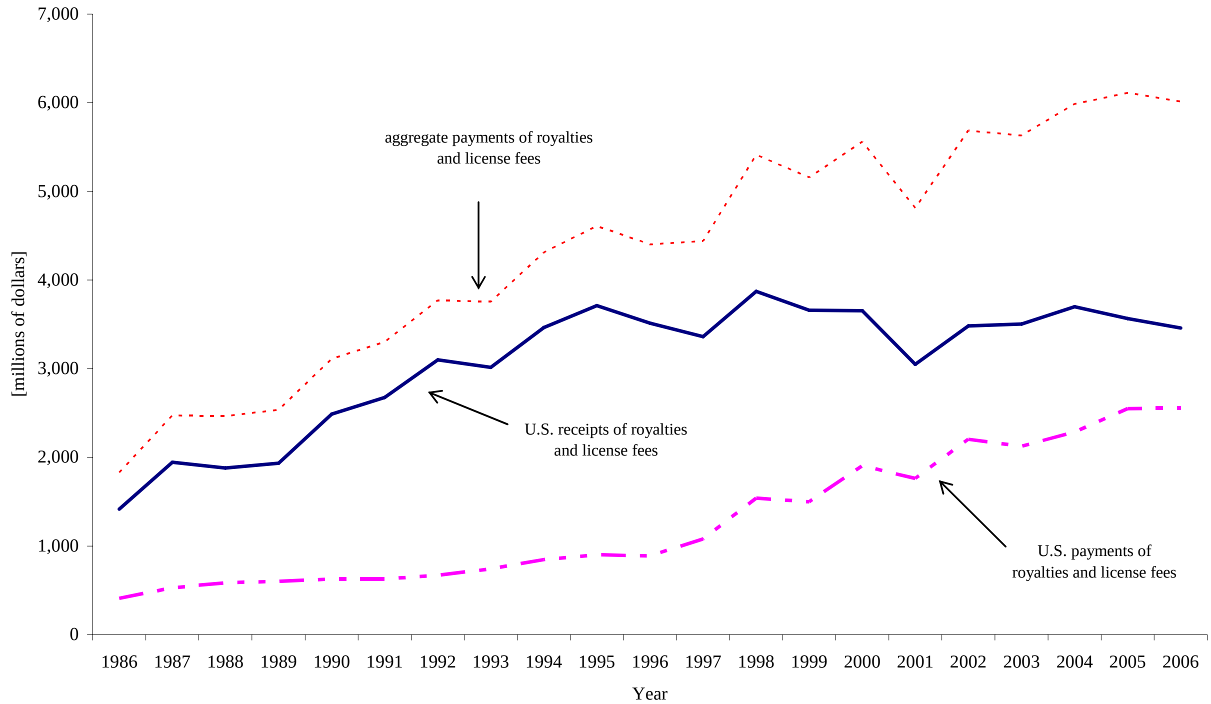
[16] Jennifer Koncz, Michael Mann, and Erin Nephew, "U.S. International Services, Cross-Border Trade in 2005 and Sales Through Affiliates in 2004," *Survey of Current Business*, Vol. 86, October 2006, p.53. The four countries providing larger total payments of royalties and license fees in 2005 were Japan, the United Kingdom, Canada, and Switzerland.

[17] Bureau of Economic Analysis, U.S. Department of Commerce, May 2007. Preliminary data.

[18] Koncz, Mann and Nephew, "U.S. International Services," p.54. Japan and Switzerland received more total payments of royalties and license fees from the United States in 2005.

[19] In Figure 1 through Figure 4 a solid line represents payments to the United States from Germany and a heavy broken line represents payments from the United States to Germany. Figure 1 and Figure 2 also have a lighter broken line representing the sum of payments from Germany and from the United States.

Figure 1.–U.S. and Germany Payments of Royalties and License Fees, 1986-2006
[Millions of Real 2006 Dollars]

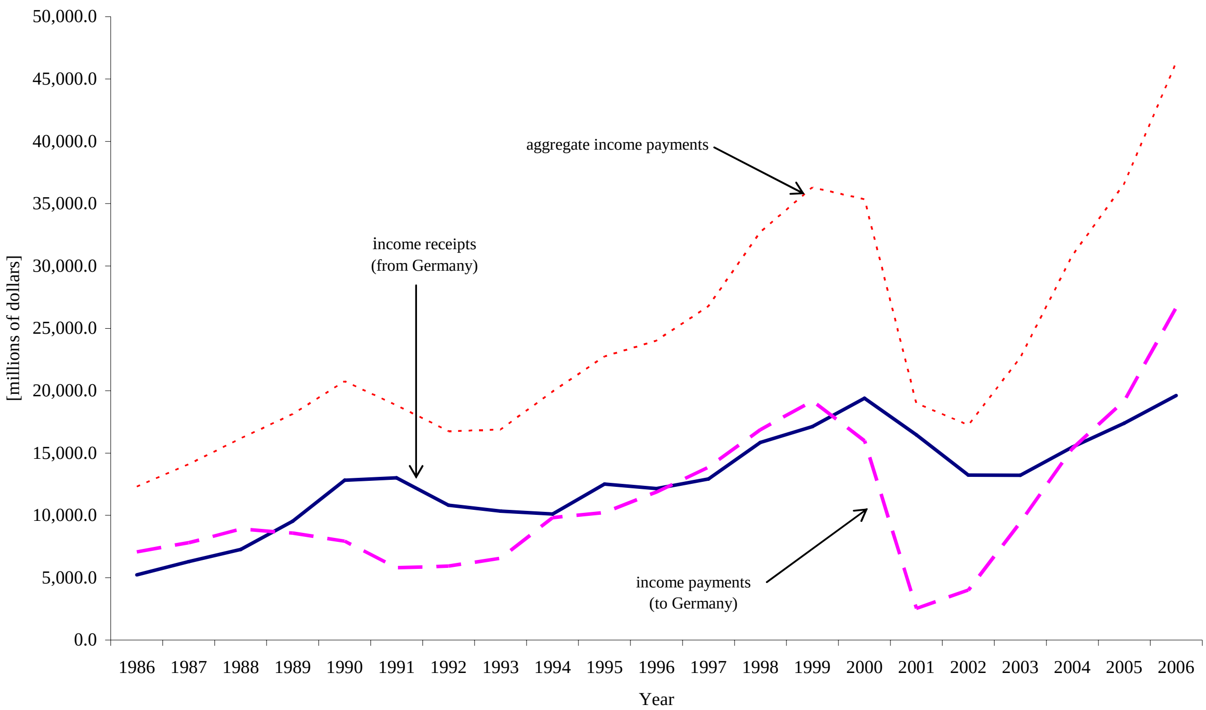


Income receipts from investments

Overview

Figure 2 shows the growth in cross-border receipts between the United States and Germany that has occurred in cross-border payments of income from German assets owned by U.S. persons and from U.S. assets owned by German persons. Measured in real dollars, income received by U.S. persons from the ownership of assets in Germany has grown just under fourfold since 1986. Over the same period, income received by German persons from the ownership of assets in United States has also grown just under fourfold.

Figure 2.–U.S. and Germany Receipts of Income from Investments, 1986-2006
[Millions of Real 2006 Dollars]

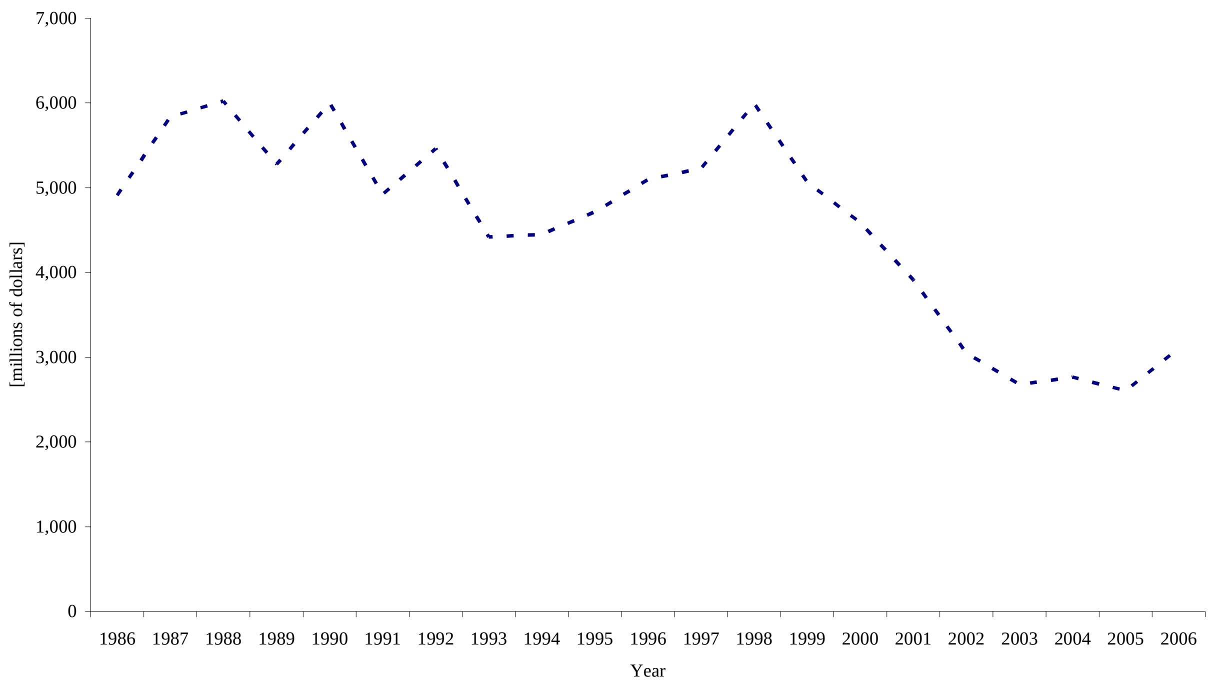


Income from direct investment and income from non-direct investment

Income from foreign assets is categorized as income from "direct investments" and income from "non-direct investments." Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments, the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as "portfolio investments," and bank deposits and loans. Hence, the income from non-direct investments generally is interest, dividends, or gains. German persons have substantial holdings of U.S. government bonds. Figure 3 shows the payments by the U.S. government to German persons, largely interest on holdings of U.S. government bonds. Holdings of U.S. government bonds by German persons have varied since 1986 and, as holdings have varied, interest received by German persons has varied. Such payments totaled over $3.1 billion in 2006.[20]

Figure 3.–Real U.S. Government Payments to German Persons, 1986-2006

[Millions of Real 2006 Dollars]



While the flow of income to Germany from German holdings of U.S. government bonds is significant, German persons earn greater income both from direct investments in the United States and from private, portfolio (non-governmental) and other non-direct investments in the United States.

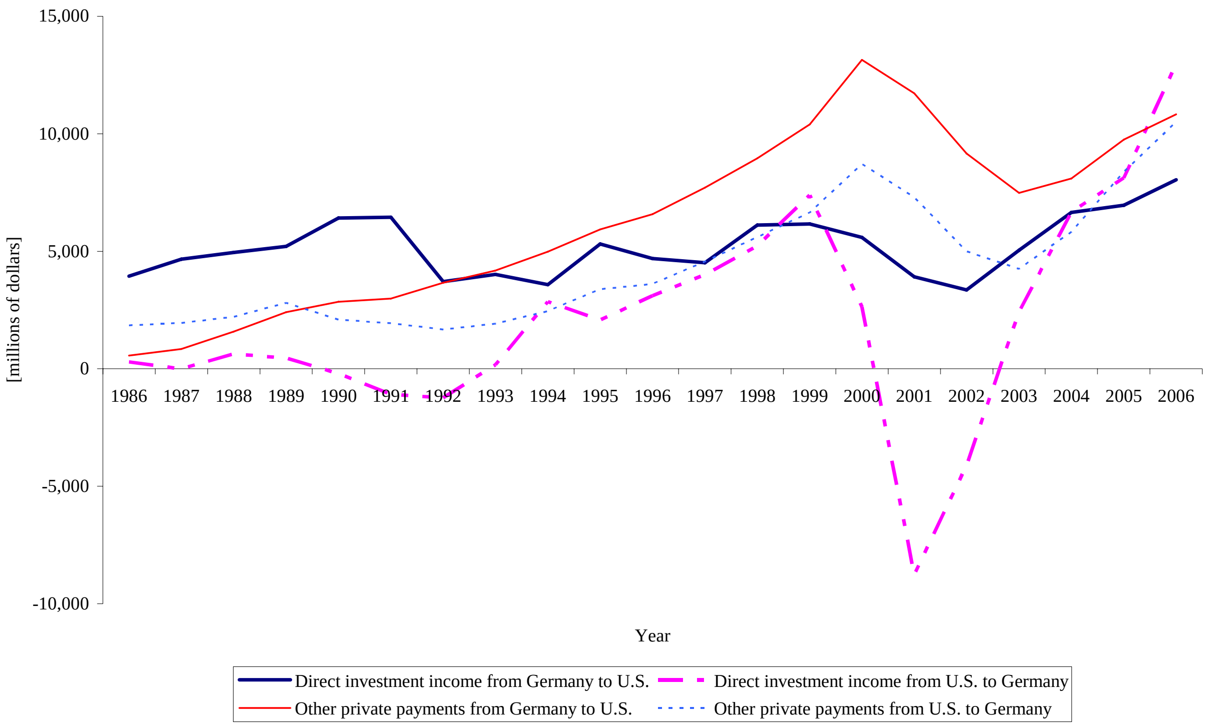
In 2006, the income received by German persons from direct investments in the United States totaled nearly $13.0 billion and the income received by German persons from portfolio (non-governmental) and other non-direct investments in the United States totaled $10.5 billion.

In 2006, the income of German persons from direct investments in the United States was roughly 60 percent greater than the income received by U.S. persons on their direct investments in Germany ($13.0 billion compared to $8.0 billion). The income received by U.S. persons on their portfolio and other non-direct investments in Germany ($10.8 billion in 2006), was

[20] Comparable data are not available for holdings of governmental bonds of Germany by U.S. persons.

modestly greater than the income received by German persons from portfolio (non-governmental) and other non-direct investments in the United States ($10.5 billion in 2006). Figure 4 records the cross-border income flows from direct and portfolio and other non-direct investments between the United States and Germany.

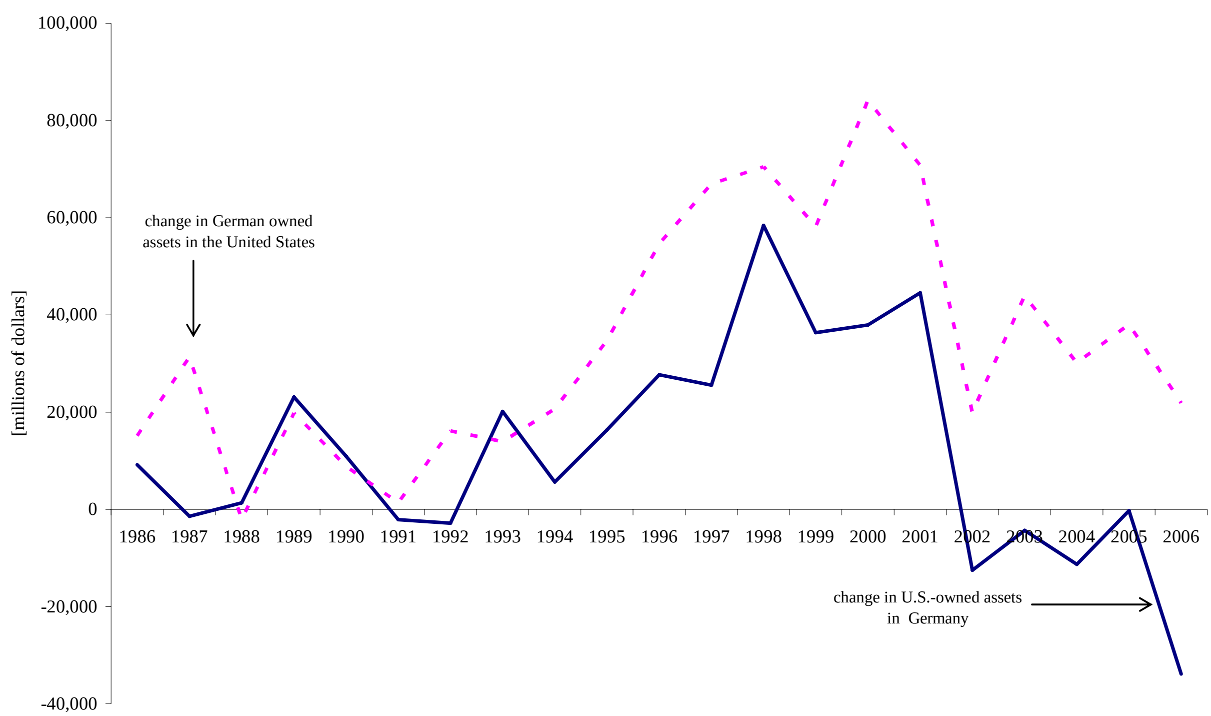
Figure 4.–U.S. and Germany Income from Direct and Non-Direct Investments, 1986-2006
[Millions of Real 2006 Dollars]



D. Trends in the Financial Account Between the United States and Germany

As discussed above, the current account of international transactions between the United States and Germany records the current-year flow of receipts from current export of goods and services and the income flows arising from past investments. The financial account of international transactions between the United States and Germany (the bottom portion of Table 1) measures the change in U.S ownership of German assets and the change in German ownership of U.S. assets. The importance of the financial account, as documented in preceding discussion, is that ownership of assets abroad generates future receipts of income. In 2006, aggregate cross-border investment between the United States and Germany totaled $13.2 billion. As Table 1 documented, in 2006 the United States' financial account balance with Germany was a negative $55.8 billion, as U.S. persons reduced asset holding in Germany by $33.9 billion while German persons increased their ownership of U.S. assets by $21.9 billion. U.S. persons have made net dispositions of German assets since 2002. Figure 5, below, shows the annual change in U.S.-owned German assets and the annual change in German-owned U.S. assets.[21]

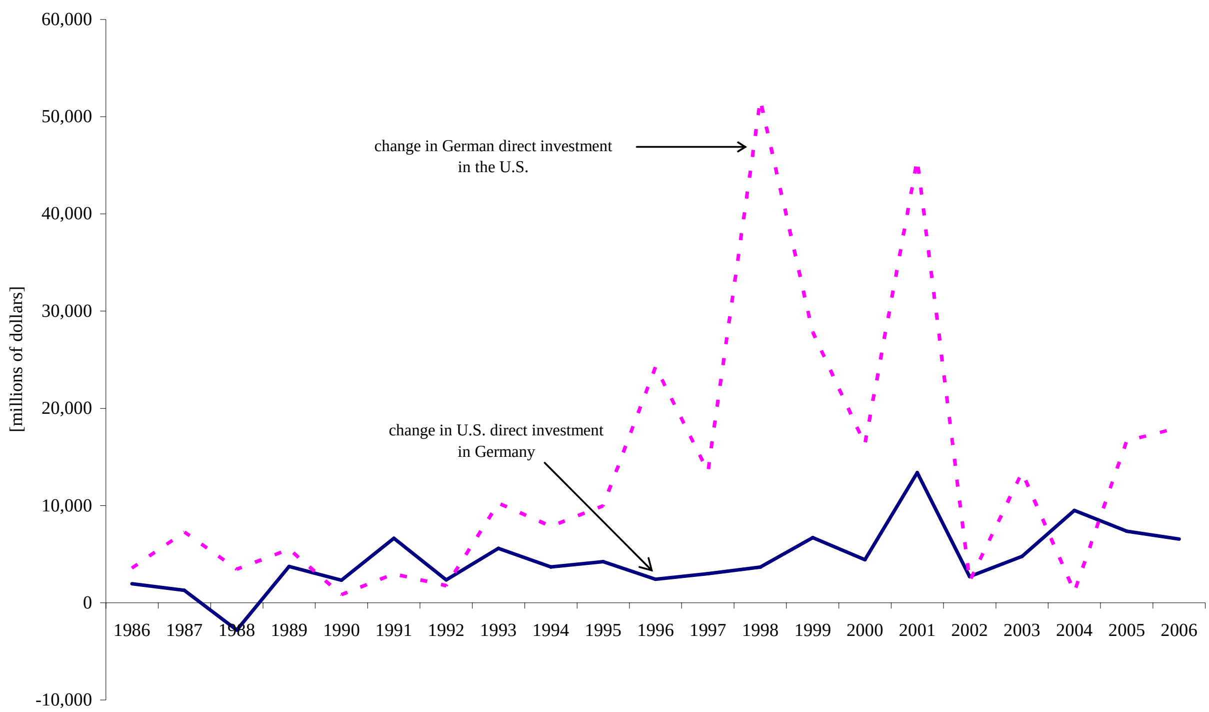
Figure 5.–U.S. and Germany Financial Account Annual Change in Assets Owned, 1986-2006
[Millions of Real 2006 Dollars]



[21] In Figure 5 through Figure 9 a solid line indicates the net acquisition (purchase of assets, purchase of securities, bank deposit, or extension of credit) by U.S. persons of assets in Germany, and a broken line indicates the net acquisition by German persons of U.S. assets. If any line reports a negative number, there was a net disposition of such assets.

Figure 6, Figure 7, Figure 8, and Figure 9 decompose these annual changes in asset ownership into direct investment and components of non-direct investment. Figure 6 reports the annual change in U.S. direct investment in Germany and the annual change in German direct investment in the United States since 1986. Almost all years since 1986 have showed an increase in the amount of direct investment in assets of the one country by investors in the other country. The changes measured in direct investment occur because of increases or decreases in equity investment, changes in intra-company debt, the reinvestment of earnings, and currency valuation adjustments.

Figure 6.–Change in U.S. and Germany Direct Investment, 1986-2006
[Millions of Real 2006 Dollars]



Total direct investment by U.S. persons in Germany is large. Measured on an historical cost basis,[22] the value of U.S. direct investment in Germany as of the end of 2005 was $86.3 billion. This comprised 4.2 percent of total U.S. direct investment overseas and represented the fifth largest U.S. direct investment position in 2005 after the United Kingdom, Canada, the Netherlands, and Australia.[23] The value of German direct investment in the United States at the

[22] The Bureau of Economic Analysis prepares detailed estimates of direct investment by country and industry on an historical cost basis only. Thus, the estimates reported reflect price levels of earlier periods. For estimates of aggregate direct investment the Bureau of Economic Analysis also produces current-cost and market value estimates.

[23] Jennifer L. Koncz and Daniel R. Yorgason, "Direct Investment Positions for 2005: Country and Industry Detail," vol. 86, *Survey of Current Business*, July 2006.

end of 2005 was $184 billion. This comprised 11.3 percent of total foreign direct investment in the United States and represented the third largest foreign direct investment position in the United States after the United Kingdom and Japan.[24]

Non-direct investment generally may be thought of as consisting of two components, portfolio investment, that is, the purchase of securities, and lending activities. Figure 7 reports the annual change in the holdings of German securities (stocks and bonds) by U.S. persons and the annual change in the holdings of U.S. securities (other than Treasury securities) by German persons. In 2005, U.S. holdings of German stocks and bonds had a year-end estimated value of $203.4 billion.[25] Of this total, German stocks account for $140.4 billion and German bonds account for $63.0 billion.[26] Among U.S. holdings of foreign stocks, the value of German stock held is sixth after holdings of U.K. equities, Japanese equities, French equities, Bermudan equities, and Dutch equities by U.S. persons.[27] German holdings of U.S. securities (other than Treasury securities) totaled $83.7 billion of U.S. corporate stocks and $67.8 billion of U.S. corporate bonds and the bonds of certain Federal agencies (other than general obligation Treasury bonds) at the end of 2005. In the case of equities, these holdings comprised 4.0 percent of total foreign holdings of U.S. equities. In the case of bonds, these holdings comprised 3.0 percent of total foreign holdings of such bonds.[28]

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24 *Ibid*.

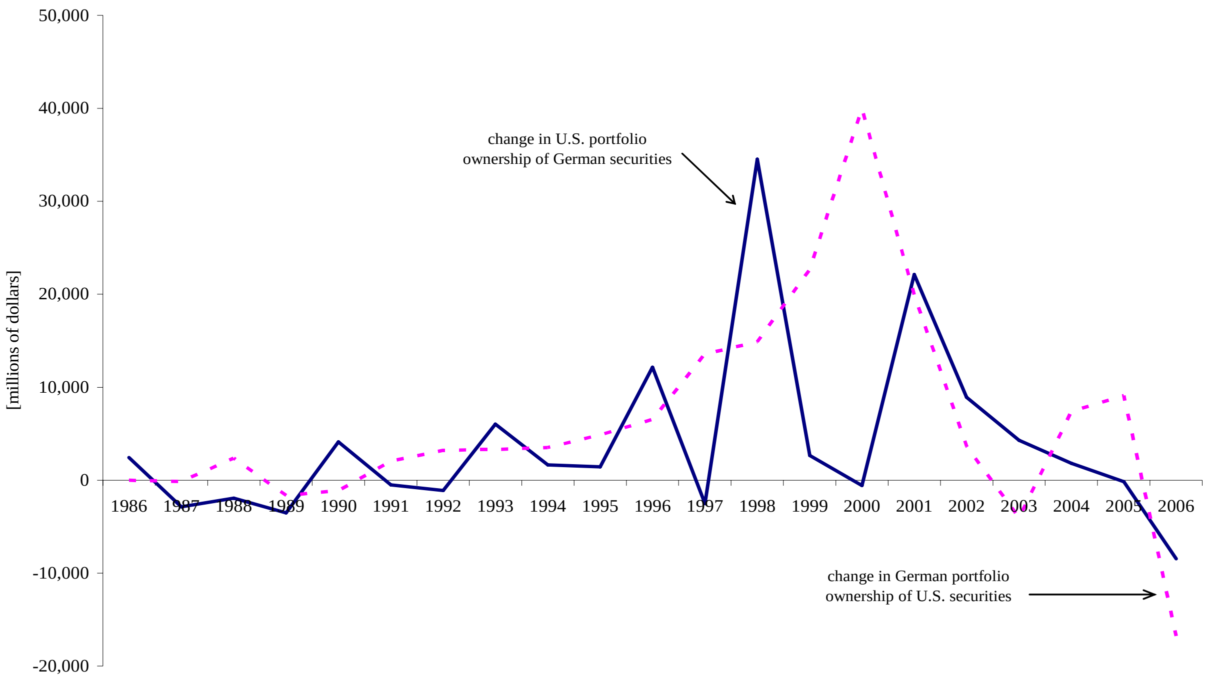
25 Elena L. Nguyen, "The International Investment Position of the United States at Year end 2005," *Survey of Current Business*, vol. 86, July 2006.

26 *Ibid*.

27 *Ibid*. Among U.S. holdings of foreign bonds, U.S. holdings of bonds issued by German persons is fourth in size after holdings of bonds issued by British, Canadian, and Cayman Islands persons.

28 *Ibid*.

Figure 7.–Change in U.S. and Germany Ownership of Portfolio Securities, 1986-2006
[Millions of Real 2006 Dollars]



Lending activities, aside from the sale of debt securities, constitute the remaining source of non-direct cross-border investment. When a U.S. bank makes a loan to a foreign person abroad (including a foreign subsidiary), the U.S. bank is making a foreign investment. Non-bank U.S. persons also make foreign investments through lending activities. When a non-bank U.S. person makes a deposit in a foreign bank, the non-bank U.S. person is making a foreign investment. Likewise if a U.S. business draws on a line of credit from a bank in Germany, the German bank is making an investment in the United States. Such deposit and borrowing activity can be quite variable and changes in exchange rates and business activity abroad may lead to substantial variability in the annual level of such activity. Figure 8 reports the changes in lending by non-banking U.S. persons to German persons and borrowing by non-banking U.S. persons from German persons since 1986.

Figure 8.–Change in U.S. and Germany Non-Direct Investment by Persons Other Than Banks, 1986-2006
[Millions of Real 2006 Dollars]

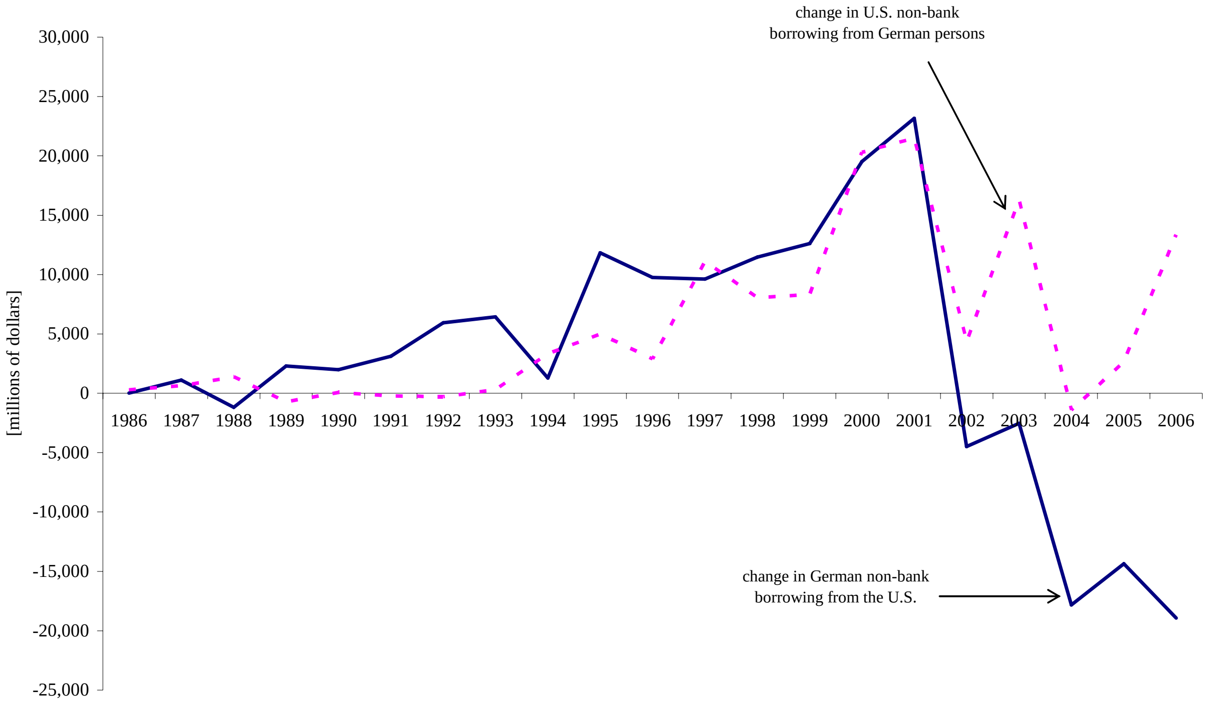
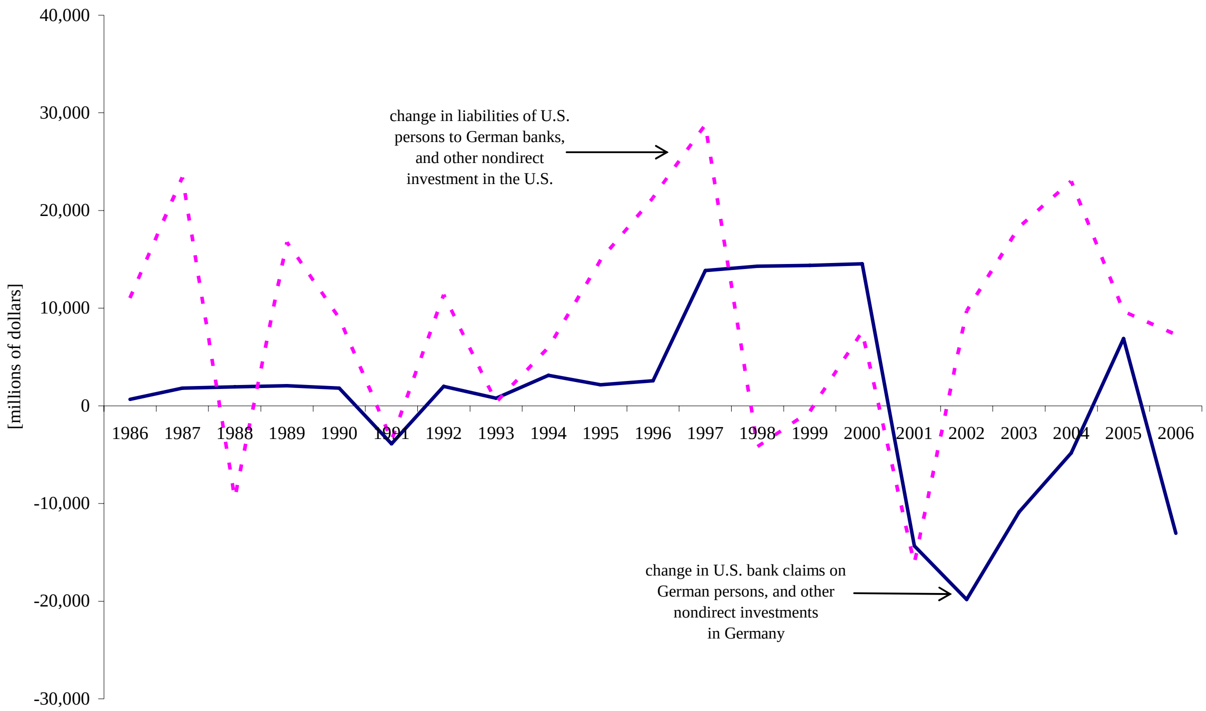


Figure 9 reports cross-border investment activity between the United States and Germany by U.S. banks, including intra-affiliate loans. The solid line in Figure 9 displays lending by U.S. banks to Germany and deposits made in German banks by U.S. persons. The broken line in Figure 9 includes data on U.S. borrowing from German banks and bank deposits accepted from German persons. However, in Figure 9, the broken line also includes annual changes in German holdings of U.S. Treasury securities.

Figure 9.–Change in U.S. and Germany Non-Direct Investment by Banks, 1986-2006
[Millions of Real 2006 Dollars]



E. Income Taxes and Withholding Taxes on Cross-Border Income Flows

The data presented above report the amount of direct investment in Germany by U.S. persons and the amount of direct investment in the United States by German persons. Data from tax returns reflect the magnitudes of cross-border investment and trade and income flows reported above. In 2003, U.S. corporations with German parent companies had $4.0 billion of income subject to tax and paid $1.2 billion in U.S. Federal income taxes.[29] U.S. corporations, including U.S. parent companies of German controlled foreign corporations, reported the receipt of $2.2 billion of dividends from German corporations in 2002.[30] Of the $2.2 billion in dividends reported, approximately $0.7 billion reflected the grossed up value of net dividends to account for deemed taxes paid to Germany. U.S. corporations recognized about $4.1 billion in taxable income originating in Germany, including the dividend amounts just cited. This income was subject to an average German corporate income tax rate of approximately 28.6 percent (after allowing for apportionment and allocation of certain expenses incurred in the United States).

Data for withholding taxes from 2000 show that Germany and the United States collected approximately the same amounts of receipts, with each country withholding roughly $100 million annually, by withholding tax on respective payments to each other.[31] Data on withholding taxes may not be an accurate indicator of cross-border investment and income flows, because a taxpayer can often control the amount and timing of dividend payments to the home country and pays withholding tax only when these payments are made.

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[29] James R. Hobbs, "Foreign Controlled Domestic Corporations, 2003," *Statistics of Income Bulletin*, Summer 2006, pp. 67-112.

[30] Data Release, "Corporate Foreign Tax Credit, 2002," *Statistics of Income Bulletin*, Fall 2006, pp. 285-318.

[31] Data Release, "Foreign Recipients of U.S. Income, 2000," *Statistics of Income Bulletin*, Summer 2003, pp. 177-186.

F. Analyzing the Economic Effects of Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and German income tax liabilities.

Generally, a treaty-based reduction in withholding rates will directly reduce U.S. tax collections in the near term on payments from the United States to foreign persons, but will increase U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this dampening of collections on payments to foreign persons and related decrease in foreign tax credits will begin to reverse. The present protocol's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Germany. Over the longer term, the withholding tax rate changes coupled with other changes in the protocol are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED PROTOCOL

<u>Article I. General Scope</u>

<u>In general</u>

The proposed protocol replaces Article 1 of the present treaty with a new Article 1. The general scope article describes the persons who may claim the benefits of the proposed protocol. It also includes a "saving clause" provision similar to provisions found in most U.S. income tax treaties.

The proposed protocol generally applies to residents of the United States and to residents of Germany. The determination of whether a person is a resident of the United States or Germany is made under the provisions of Article 4 of the treaty (Residence).

The proposed protocol provides that it does not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by internal law, by any other agreement between the United States and Germany, or by any multilateral agreement to which the United States and Germany are parties. Thus, the proposed protocol will not apply to increase the tax burden of a resident of either the United States or Germany.

According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), the fact that the proposed protocol applies only to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Germany has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Code, but do not constitute permanent establishments as determined under the proposed protocol; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed protocol. The Technical Explanation makes clear that the taxpayer may not invoke the proposed protocol to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[32]

The Technical Explanation states that the proposed protocol does not serve to deny any benefit in any other agreement between the United States and Germany, and provides an example, stating that benefits provided under a Status of Forces Agreement for military personnel or military contractors are available to residents of the United States or Germany regardless of provisions to the contrary (or silence) in the proposed protocol.

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[32] *See* Rev. Rul. 84-17, 1984-1 C.B. 308.

The proposed protocol provides that the dispute resolution procedures under its mutual agreement article (Article 25) take precedence over the corresponding provisions of any other agreement to which the United States and Germany are parties in the event of a question as to the interpretation or application of the proposed protocol, and particularly in determining whether a taxation measure is within the scope of the proposed protocol. The Technical Explanation points out that dispute resolution procedures under trade, investment, or other agreements to which the United States and Germany are parties do not apply in determining the interpretation, application, or scope of the proposed protocol. This provision is broader that the comparable provision in the U.S. Model treaty, which provides only that the model treaty provision takes precedence over the corresponding provisions of the General Agreement on Trade in Services ("GATS").

The proposed protocol also provides that no other agreement to which the United States and Germany are parties applies to any taxation measure, unless the competent authorities agree that the measure is not within the scope of the nondiscrimination provisions (Article 24) of the treaty. This provision is broader than the comparable provision in the U.S. Model treaty. This provision, unlike the U.S. Model treaty, does not specifically provide for the non-application of only the GATS to taxation measures that are also within the scope of the nondiscrimination article. The Technical Explanation points out that under the proposed protocol, no national treatment or most favored nation ("MFN") obligations of the United States or Germany in any other agreement apply to a taxation measure if the nondiscrimination provisions of Article 24 of the treaty apply to that measure.

For purposes of this provision, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

Saving clause

Like all U.S. income tax treaties and the U.S. Model treaty, the proposed protocol includes a "saving clause." Under this clause, with specific exceptions described below, the proposed protocol does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed protocol, the United States may continue to tax its citizens who are residents of Germany as if the treaty were not in force. For purposes of the proposed protocol (and, thus, for purposes of the saving clause), the term "residents," which is defined in Article 4 (Residence), includes corporations and other entities as well as individuals.

The proposed protocol contains a provision under which a former citizen or long-term resident of the United States may be taxed under United States law for the period of 10 years following the loss of citizenship or long-term resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of 10 years following the loss of citizenship or long-term resident status.

Under U.S. domestic law, an individual is considered a "long-term resident" of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country. Article XVI of the proposed protocol makes clear that this rule applies for purposes of applying Paragraph 4(b) of Article 1 in determining whether a person is a long-term resident of the United States.

Exceptions to the saving clause are provided for the following benefits conferred by the United States: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2), treatment of gains of former residents (Article 13, paragraph 6), provisions for taxation of alimony and child support payments in only one of the treaty countries and taxation of social security benefits only in the country of the recipient's residence (Article 18, paragraphs 3, 4, and 5), deferral of income earned on pension plans established in the other country and deductibility of contributions (and excludability of benefits) under a German pension plan of an German employer (Article 18A, Paragraphs 1 and 5), exemption from tax in the other country for government pensions, annuities, or other amounts for injury or damage due to hostilities or political persecution (Article 19, paragraph 3), relief from double taxation through the provision of a foreign tax credit (Article 23), protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 24), and benefits under the mutual agreement procedures of the treaty (Article 25).

In addition, the saving clause does not apply to certain benefits conferred by the United States upon individuals who neither are citizens nor have immigrant status. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Germany who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are the allowance of a host-country deduction for contributions and host-country deferral of taxation of accrued benefits under pension plans established in the source country (Article 18A, paragraph 2), and exemptions from host-country tax for certain compensation paid by German federal, "*Länder,*" or municipal governments (Article 19, subparagraph (b)(1)), certain income received by visiting professors and teachers, students, and trainees (Article 20), and certain income received by members of diplomatic missions and consular posts (Article 30).

The proposed protocol provides a rule, analogous to the saving clause, that the proposed protocol does not prevent Germany from imposing tax on amounts included in the income of a resident under part 4, 5, and 7 of the German "*Aussensteuergesetz*." If the imposition of this tax gives rise to double taxation, the competent authorities are to seek to eliminate it in accordance with the mutual agreement procedure of Article 25, paragraph 3, which provides that they may consult together to eliminate double taxation.

<u>Fiscally transparent entities</u>

The proposed protocol contains special rules for fiscally transparent entities that are identical to those in the U.S. Model treaty. Under these rules, as explained in the Technical Explanation, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a German company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (i.e., in the United States, Germany, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for German tax purposes as a corporation and is owned by a German shareholder who is a German resident for German tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the proposed protocol, the income is treated as derived by the U.S. entity.

The Technical Explanation generally defines fiscally transparent entities as entities in which income derived by such entities is taxed at the beneficiary, member, or participant level, under the law of either the United States or Germany. Entities are not considered fiscally transparent if the entity tax may be relieved under an integrated system. For example, in the United States, a partnership, common investment trust under Code section 584, or grantor trust, or a limited liability company ("LLC") that is treated for tax purposes as a partnership or disregarded entity, is considered a fiscally transparent entity.

The Technical Explanation also states that the treatment of fiscally transparent entities is not an exception to the saving clause. Therefore, such treatment does not preclude a treaty country from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with German members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Germany views the LLC as fiscally transparent.

Article II. Residence

The proposed protocol replaces the definition of the term "resident of a Contracting State" that appears in paragraph 1 of Article 4 (Residence) of the present treaty. Under paragraph 1, as modified by the proposed protocol, "resident of a Contracting State" means any person who, under the laws of that country, is subject to tax therein by reason of the person's domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The proposed protocol also makes explicit the generally understood practice of including in the definition of "resident of a Contracting State" the two treaty countries and any political subdivisions, statutory bodies, or local authorities of those countries. However, the term "resident of a Contracting State" does not include persons who are subject to tax in a treaty country only on income from sources in that country or on profits attributable to a permanent establishment in that country or capital situated therein.

In addition to the changes made by Article II of the proposed protocol, paragraph 2 of Article XVI of the proposed protocol clarifies whether certain persons are residents of one of the treaty countries. Specifically, paragraph 2(a) of Article XVI of the proposed protocol includes an exception to the general rule described above that residence under internal tax law also determines residence under the treaty. The exception applies to a U.S. citizen or an alien lawfully admitted for permanent residence in the United States (i.e., a "green card" holder). The exception requires that such a person must also have a substantial presence, permanent home, or habitual abode in the United States to be considered a resident of the United States under the treaty and thereby qualify for treaty benefits.

Paragraph 2(b) of Article XVI of the proposed protocol states that a German Investment Fund and a German *Investmentaktiengesellschaft* (collectively referred to as *Investmentvermögen*) to which the provisions of the Investment Act (*Investmentgesetz*) apply are residents of the Federal Republic of Germany. Paragraph 2(b) similarly provides that a U.S. Regulated Investment Company ("RIC") and a U.S. Real Estate Investment Trust ("REIT") are residents of the United States.

The proposed protocol does not change the other provisions of Article 4 of the present treaty.

<u>Article III. Business Profits</u>

Consistent with the U.S. Model treaty, the OECD Model treaty and recent U.S. treaty practice, the proposed protocol deletes language from the present treaty specifically enumerating certain categories of expenses that will (if incurred for the purposes of a permanent establishment) be allowed as deductions in determining the business profits of such permanent establishment. In particular, the present treaty provides for the deduction of expenses incurred for the purposes of the permanent establishment, including research and development expenses, interest, and other similar expenses and a reasonable amount of executive and general administrative expenses. The proposed protocol deletes explicit references to research and development expenses, interest and other similar expenses; instead, it simply refers to expenses incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred.

Paragraph 4 of Article XVI (which replaces paragraphs 1 through 28 of the protocol to the present treaty signed at Bonn on August 29, 1989) provides, consistent with language in the U.S. Model treaty, that the OECD Transfer Pricing Guidelines apply by analogy in determining the profits attributable to a permanent establishment. Accordingly, any of the methods described in the Guidelines may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines.

For purposes of determining the amount of profits that are attributable to a permanent establishment, Paragraph 4 of Article XVI states that a permanent establishment is treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. This means, for example, that a permanent establishment cannot be funded entirely with debt. Paragraph 4 of Article XVI states that a treaty country may determine the amount of capital to be attributed to a permanent establishment that is a financial institution (other than an insurance company) by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. However, a financial institution may determine the amount of capital attributed to its permanent establishment using its risk weighted assets only if it risk weights its assets in the ordinary course of its business.

In addition, the proposed protocol adds language providing that income derived from independent personal services (i.e., income from the performance of professional services and of other activities of an independent character) is included within the meaning of the term "business profits" and is thus governed by Article 7. Under the present treaty, such income is not regarded as business profits, but is instead governed separately by Article 14 (Independent Personal Services). The change is consistent with the deletion of Article 14 by the proposed protocol.

Article IV. Dividends

Overview

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable maximum rate of withholding at source of 15 percent and the reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. Like several other recent treaties and protocols, however, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally applies to dividends received by a pension fund.

The proposed protocol also includes special rules for dividends received from RICs and REITs (and from similar German entities). These special rules are similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In that case, the foreign recipient is subject to U.S. tax on the dividends on a net basis at graduated rates in the same manner in which a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the

United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a U.S. domestic corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[33] This distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[34]

A REIT generally is organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as both a corporation and as an entity not subject to corporate tax to the extent it distributes substantially all of its income. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2008, net short-term capital gains by designating a dividend it

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[33] Because a REIT generally does not pay corporate level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

[34] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[35]

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[36] generally may designate a dividend it pays before January 1, 2008 as derived from that interest income, to the extent of that income. Nonresident aliens and foreign corporations are not subject to tax on interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Germany

Dividends paid by a German company to a nonresident individual or a nonresident company generally are subject to withholding tax at a rate of 20 percent (plus the 5.5 percent solidarity surcharge). Dividends paid to EU resident corporations generally are exempt from this withholding tax.

Proposed protocol limitations on internal law

In general

Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the payor company is resident, but the rate of tax is limited. Under the proposed protocol, source-country taxation of dividends (that is, taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends derived and beneficially owned by residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a

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[35] The exception described in the immediately preceding footnote also applies for distributions by RICs.

[36] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

company that owns directly at least 10 percent of the voting stock of the dividend-paying company.

The term "beneficial owner" is not defined in the current treaty or in the proposed protocol and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country.

According to the Technical Explanation, companies holding shares through fiscally transparent entities, such as partnerships, are considered to hold their proportionate interests in those shares. As a result of this rule, the Technical Explanation states, if a company that is the beneficial owner of a dividend owns at least 10 percent of the voting stock of the dividend-paying company through a fiscally-transparent entity, that beneficial owner may be eligible for the reduced five-percent withholding rate available for 10-percent owners. The Technical Explanation notes that when shares are owned through fiscally transparent entities, it may be difficult to determine whether the 10-percent ownership threshold is satisfied; analysis of the applicable partnership or trust agreement may be required.

The proposed protocol provides a zero rate of withholding tax for certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends") and for certain dividends beneficially owned by a pension fund.

Zero rate for direct dividends

Under the proposed protocol, when a company that is a resident of one treaty country receives and beneficially owns dividends paid by a company that is a resident of the other treaty country, the source-country withholding tax rate is reduced to zero if the company receiving the dividends has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the current treaty, these dividends may be taxed at a five-percent rate. The determination whether the 80-percent ownership requirement is satisfied is made by taking into account only stock owned directly. Taking into account only direct stock ownership contrasts with the rule in the proposed protocols with Denmark and Finland. Under those protocols, the 80-percent ownership requirement may be satisfied by direct or indirect ownership (through one or more residents of either treaty country).

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than the requirements that normally apply under the proposed protocol. Specifically, in order to qualify for the zero rate, the dividend-receiving company must (1) satisfy the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

The Technical Explanation states that these additional restrictions are intended to prevent companies from reorganizing to become eligible for the zero rate. As an example, the Technical Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned German subsidiary to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. In that case, the Technical Explanation explains that treaty shopping could occur notwithstanding the German company's satisfaction of the active trade or business test with respect to the dividend. For this reason, the proposed protocol does not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

The Technical Explanation notes that, in the case of a German company that receives dividends from a U.S. subsidiary, the derivative benefits test might be satisfied if the German company is wholly owned, for example, by a publicly traded company resident in a European Union ("EU"), European Economic Area ("EEA"), or North American Free Trade Agreement ("NAFTA") country with which the United States has a zero-rate treaty provision.[37] In the case of a U.S. company receiving dividends from a German subsidiary, the derivative benefits test could be satisfied if the U.S. company is wholly owned by a company resident in the EU, because the EU Parent-Subsidiary Directive would exempt from withholding tax a dividend paid directly by the German company to an EU parent company.

The proposed protocol also modifies the application of the derivative benefits test under the zero-rate provision to ensure that certain joint ventures may qualify for the zero rate. Specifically, in determining whether a shareholder of a dividend-receiving company is an equivalent beneficiary, each such shareholder is treated as owning shares in the dividend-paying company with the same percentage voting power as the shares held by the dividend-receiving company for purposes of determining entitlement to the zero rate. Thus, as the Technical Explanation describes, a German company owned 49 percent by another German company and 51 percent by a company resident in another EU country that has an identical zero-rate provision with the United States may qualify under the derivative benefits test for the zero rate on a dividend received from a wholly-owned U.S. company even though neither shareholder of the dividend-receiving company would meet the 80-percent ownership test individually.

A zero rate of withholding tax also applies for dividends paid by a resident of one treaty country and beneficially owned by a pension fund that is a resident of the other treaty country, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the fund. Paragraph 8(b) of Article XVI of the proposed protocol provides that for dividends received by a German pension fund, this rule applies to the person treated under German law as owning the assets of the pension fund, provided the dividends may be used only for providing retirement benefits through the fund. The Technical Explanation states that this rule makes clear that the zero rate of withholding tax for dividends paid to pension funds is available when a German employer has not set up a pension fund but commits to pay a certain

[37] These countries currently are Mexico, the Netherlands, Sweden, and the United Kingdom.

level of retirement income to its employees and satisfies certain related requirements of German internal law.

Dividends paid by U.S. RICs and REITs and similar German entities

The proposed protocol generally denies the five-percent and zero rates of withholding tax to dividends paid by U.S. RICs and REITs or by a German Investment Fund or a German *Investmentaktiengesellschaft* (together referred to as *Investmentvermögen*).

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC or an *Investmentvermögen.* The zero source-country withholding rate generally available for dividends beneficially owned by a pension fund is available when the dividends are paid by a RIC or an *Investmentvermögen.*

The 15-percent rate of withholding and the zero rate for dividends beneficially owned by pension funds are allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Germany could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. Absent the additional RIC restrictions, there is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or five percent).

Similarly, the Technical Explanation provides an example of a resident of Germany that directly holds U.S. real property and is required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate rental income into dividend income, taxable at the lower rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Paragraph 8(a) of Article XVI of the proposed protocol provides that if Germany introduces tax rules that exempt REIT-like entities from tax, the zero rate of withholding tax for dividends paid by a REIT and beneficially owned by a pension funds will not be available for dividends paid by German REIT-like entities.

Definitions and special rules and limitations

The proposed protocol generally defines dividends as income from shares or other corporate participation rights that are not treated as debt under the laws of the source country, as well as other amounts that are subjected to the same tax treatment by the source country as income from shares (for example, constructive dividends). In Germany the term dividends also includes income under a sleeping partnership *(Stille Gesellschaft),* a participating loan *(partiarisches Darlehen),* or *"Gewinnobligation,"* and also distributions on certificates of a German *Investmentvermögen.*

The proposed protocol permits a source country to tax according to its internal law income from arrangements that carry the right to participate in profits and that are deductible in determining the profits of the payor. In Germany this income includes income under a sleeping partnership *(Stille Gesellschaft),* a participating loan *(partiarisches Darlehen),* or *"Gewinnobligation"* or *"jouissance"* shares or *"jouissance"* rights. In the United States, this income includes contingent interest of a type that would not qualify as portfolio interest.

The proposed protocol's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country and the holding in respect of which the dividends are paid is part of the business property of that permanent establishment. In this case, the dividends are taxed as business profits (Article 7).

The proposed protocol prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country, unless the dividends are paid to a resident of the first country or the holding in respect of which the dividends are paid is part of the business property of a permanent establishment in that country.

The proposed protocol allows each treaty country to impose a branch profits tax on a company that has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the tax may be imposed only on the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (Code section 884). Paragraph 9 of Article XVI of the proposed protocol clarifies that the "dividend equivalent amount" approximates that portion of the income source-country income described immediately above that is comparable to the amount that would be distributed as a dividend if the income were earned by a locally incorporated subsidiary.

In the case of Germany, which currently does not impose a branch profits tax under its internal law, the tax may be imposed only on the portion of a German permanent establishment's income that is comparable to the amount that would be distributed as a dividend by a locally incorporated subsidiary.

The rate of branch profits tax is generally limited to five percent, but a zero rate applies where limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied.

The proposed protocol defines a pension fund as a person that is established under the laws of Germany or the United States; is established and maintained in that country primarily to administer or provide pensions or other similar remuneration, including social security payments, disability pensions, and widow's pensions, or to earn income for the benefit of one or more such persons; and is either, in the case of Germany, a plan the contributions to which are eligible for preferential treatment under the Income Tax Act, or, in the case of the United States, is exempt from tax in the United States with respect to its pension activities.

Relation to other Articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the treaty (General Scope) permits the United States to tax dividends received by its residents and citizens as if the proposed protocol had not come into effect (subject to special foreign tax credit rules in paragraph 4 of Article 23 (Relief from Double Taxation) of the treaty).

The benefits of the dividends article are also subject to the provisions of Article 28 of the treaty (Limitation on Benefits).

Article V. Interest

The proposed protocol adds a new paragraph, providing that interest that is an excess inclusion with respect to a residual interest in a U.S. real estate mortgage investment conduit may be taxed by the United States in accordance with its domestic law. This change is consistent with the U.S. Model treaty.

The proposed protocol also makes a technical conforming change to a cross-reference to Article 10 (Dividends).

Article VI. Gains

The proposed protocol replaces paragraph 6 of Article 13 (Gains) of the current treaty with a new paragraph.

Article 13 (Gains) of the current treaty provides rules for the taxation of gains from the sale of property by a resident of a treaty country. The article permits the source country to tax gains derived by a resident of one treaty country from (1) the alienation of immovable property situated in the other country and (2) the sale of movable property forming part of the business property of a permanent establishment in the other country. Article 13 also includes rules for, among other things, gains from the sale of ships, aircraft, or containers operated in international traffic.

Existing paragraph 6 of Article 13 and the new paragraph 6 included in the proposed protocol both address the treatment by the treaty countries of an individual who gives up residence in one treaty country, becomes a resident of the other treaty country, and derives (or is treated by the former residence country as deriving) gain from the sale of property.

Paragraph 6 in the proposed protocol provides a special basis rule when an individual ceases to be a resident of one treaty country and is treated under that country's tax laws as having sold property and is thus taxed by that country on the deemed sale. The proposed protocol provides that in this circumstance, the individual may elect to be treated for tax purposes in the other treaty country (the new residence country) as if the individual had, immediately before ceasing to be a resident of the first treaty country, sold and reacquired the property for an amount equal to its fair market value at that time. This election in the new residence country has the effect in that country of giving the individual a basis in the property equal to its fair market value at the time the individual gave up his residence in the first treaty country. The result of this deemed sale-and-reacquisition election is that if the individual subsequently sells the property, the new residence country will be permitted to impose tax only on gain that accrues after the individual ceased to be a resident of the first treaty country.

The Technical Explanation notes that notwithstanding the rule of new paragraph 6, the saving clause of paragraph 4(a) of Article 1 (General Scope) of the treaty, as amended by the proposed protocol, permits the United States to tax its citizens and residents as if the treaty had not come into effect. The exception in treaty Article 1, paragraph 5(a), from the saving clause, however, ensures that the saving clause does not affect the benefits conferred by new paragraph 6.

Paragraphs 12 and 13 of Article XVI of the proposed protocol clarify two rules in the current treaty. First, for immovable property situated in the United States, immovable property includes a U.S. real property interest. Second, when a resident of one treaty country disposes of an interest in a partnership, trust, or estate that has a permanent establishment in the other treaty country, nothing in Article 13 prevents the gain from being treated as gain from the alienation of movable property forming part of the business property of that permanent establishment. Thus, the gain may be taxed in that other treaty country.

Article VII. Independent Personal Services

The proposed protocol deletes Article 14 (Independent Personal Services) from the present treaty, consistent with the U.S. Model treaty and the OECD Model treaty. Under the proposed protocol, income derived from independent personal services is considered to be business profits under Article 7.

The proposed protocol makes numerous technical conforming changes to reflect the deletion of Article 14.

Article VIII. Pensions, Annuities, Alimony, Child Support, and Social Security

Article 18 of the present treaty generally governs the treatment of pension benefits, annuities, alimony, and child support paid to a resident of a treaty country; these rules are unchanged by the proposed protocol. Article 19 of the present treaty governs government service and social security and other public pension benefits paid by a treaty country to a resident of the other treaty country. Paragraph 2 of Article 19 provides that social security benefits paid under the social security legislation of a treaty country and other public pensions (which the Technical Explanation states is intended to refer to U.S. Tier 1 Railroad Retirement benefits) paid by a treaty country to a resident of the other treaty country shall be taxable only in the other treaty country. The treaty country of residence must treat the benefit or pension as though it were a social security benefit paid under the social security legislation of the treaty country of residence. These rules apply to social security beneficiaries whether they have contributed to the system as private-sector or governmental employees.

Article VIII of the proposed protocol incorporates as paragraph 5 of Article 18 the rule of paragraph 2 of Article 19. Article X makes a conforming change to Article 19. In addition, the proposed protocol modifies the titles of Articles 18 and 19 to reflect those changes.

The treatment of social security benefits in the treaty and the proposed protocol differ from that in the U.S. Model treaty, which provides for exclusive source country taxation of social security benefits. On June 1, 2006, the United States and Germany signed a Joint Declaration with regard to Article 18 of the treaty as amended by the proposed protocol. The Joint Declaration recognizes that, effective January 1, 2005, and subject to a long phase-in period, Germany changed its taxation rules relating to retirement income and pension plan contributions. The changes, when fully implemented, will combine full taxation of retirement income with extended tax exemption of pension plan contributions. Accordingly, the United States and Germany state in the Joint Declaration their intentions to enter into consultations at the appropriate time, but not before January 1, 2013, to amend the proposed protocol to allow for the source country taxation of retirement income. Such source country taxation is to be based on the following principles: (1) social security benefits may also be taxed by the source country, in an amount not to exceed 15 percent of the gross payment, and (2) pensions and other similar remuneration paid in consideration of past employment may also be taxed in the country in which the employment had been exercised for a substantial period of time, in an amount not to exceed 15 percent of the gross payments. Germany declared its intention that such modifications should not enter into force before January 1, 2015.

<u>Article IX. Pension Plans</u>

Article IX of the proposed protocol adds to the treaty Article 18A (Pension Plans), relating to cross-border pension contributions and benefit accruals. The proposed rules are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions and the taxation of a pension plan's earnings and accretions in value. These rules are similar to new rules that were recently added to the corresponding articles of the Netherlands and United Kingdom treaties, and are also similar to the rules of new Article 18 of the U.S. Model treaty.

The proposed protocol provides (Article 18A, paragraph 1) that neither country may tax a resident on pension income earned through a pension plan that is a resident of the other country until such income is distributed. When a resident receives a distribution from a pension plan, such distribution is subject to taxation in accordance with the provisions of Article 18. For example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Germany, Germany is prevented from taxing currently the plan’s earnings and accretions with respect to that individual. For purposes of this provision, rollovers to another pension plan in the same country are not treated as distributions.

Under the proposed protocol (Article 18A, paragraph 2), if an individual who is a beneficiary of, or participant in, a pension plan established under the laws of one treaty country performs personal services in the other country, whether or not the individual is resident in that other country, contributions made by or on behalf of the individual to the plan during the period he or she performs such personal services are deductible in computing his or her taxable income in the other country. Similarly, contributions made to the plan by or on behalf of his or her employer during such period, and benefits accrued under the plan, are not treated as part of his or her taxable income, and such contributions are allowed as a deduction in computing the employer's profits in the other country. For example, if a participant in a U.S. qualified plan goes to work in Germany for a period of time, contributions made by the participant and his or her employer during that period are not included in the participant's income in Germany, and the employer may deduct its contributions from its business profits in Germany. The relief provided under paragraph 2 of Article 18A by the other country will not exceed the relief that would be allowed by that country to its residents for contributions to, or benefits accrued under, a pension plan established in that country. The proposed protocol provides that the competent authorities shall determine the relief available under paragraph 2.

Under the proposed protocol (Article 18A, paragraph 3), the rules of the immediately preceding paragraph apply only if: (a) contributions were made by or on behalf of the individual, or by or on behalf of the individual's employer, to the pension plan (or, according to the Technical Explanation, to a similar pension plan for which the pension plan has been substituted) before he or she began to exercise employment or self-employment in the other country; and (b) the competent authority of the other country accepts the pension plan as "generally corresponding" to a pension plan recognized for tax purposes by that country (i.e., eligible for benefits under paragraph 2).

The proposed protocol (Article 18A, paragraph 4) defines "pension plan" for purposes of Article 18A as an arrangement established in a treaty country that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. The definition differs from that in the Netherlands and United Kingdom treaties, and the U.S. Model treaty, in that it is not required that the pension plan be exempt from income tax in the country of its residence.

Paragraph 16(a) of Article XVI of the proposed protocol provides that, for the purposes of paragraph 4 of Article 18A, the term pension plan includes the following plans, and any identical or substantially similar plans established pursuant to legislation enacted after June 1, 2006, the date the proposed protocol was signed. In the case of the United States, pension plans include qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts, individual retirement annuities, section 408(p) accounts, and Roth IRAs under section 408A), section 403(a) qualified annuity plans, section 403(b) plans, and section 457(b) governmental plans. In the case of Germany, pension plans include arrangements under section 1 of the German law on employment-related pensions.

Paragraph 16(b) of Article XVI of the proposed protocol provides that, for purposes of paragraph 3(b) of Article 18A, Germany recognizes qualified plans listed in paragraph 16(a) of Article XVI of the proposed protocol, with the exception of Roth IRAs, as corresponding to German pension plans. Likewise, the United States recognizes arrangements under section 1 of the German law on employment-related pensions as corresponding to U.S. pension plans.

The proposed protocol also provides (Article 18A, paragraph 5) special rules applicable to certain U.S. citizens who are resident in Germany. Under these rules, a U.S. citizen who is resident in Germany may exclude or deduct for U.S. tax purposes contributions to a pension plan established in Germany, provided such contributions are made during the period (or are attributable to the period) the U.S. citizen exercises taxable employment in Germany and are attributable to such employment, and expenses related to such employment are borne by a German employer or German permanent establishment. Similarly, employer contributions to, or benefits accrued under, a German pension plan are not treated as part of the employee's taxable income in the United States.

The benefits under the rules of paragraph 5 of Article 18A do not apply unless the U.S. competent authority has agreed that the pension plan generally corresponds to a pension plan established in the United States. For these purposes, the relevant German plans that correspond to employer plans in the United States are retirement benefit plans under section 1 of the German law on employment-related pensions. The U.S. tax benefits under the rules of the immediately preceding paragraph are limited to the lesser of: (1) the amount of relief allowed for the contributions or benefits in Germany, and (2) the amount of relief that would be allowed by the United States for contributions to, and benefits accrued under, a generally corresponding pension plan established in the United States. Further, to the extent relief is available to the individual under this provision, the contributions made to (and benefits accrued under) a German pension plan are counted when determining the individual's eligibility for benefits and contribution limits under a generally corresponding pension plan established in the United States. Paragraphs 1 and 5 of Article 18A are not subject to the saving clause of paragraph 4 of Article 1 (General Scope) by reason of the exception in subparagraph 5(a) of Article 1. Thus, the benefits of these paragraphs are preserved in the case of U.S. citizens or residents with German pension plans. Paragraph 2 of Article 18A is not subject to the saving clause by reason of subparagraph 5(b) of Article 1. Thus, a person who is a beneficiary of a German pension plan and who is employed in the United States may deduct contributions to the pension plan for U.S. tax purposes only if such person is not a citizen or permanent resident of the United States.

Article X. Government Service

The proposed protocol replaces Article 19 (Government Service) of the present treaty. Pursuant to paragraph 3(b) of Article XVII of the proposed protocol, the amendments made by Article X will not have effect with respect to individuals who, at the time of the signing of the proposed protocol, were employed by the United States or a political subdivision or local authority thereof.

Under paragraph 1 of proposed Article 19, salaries, wages, and other remuneration, other than a pension, paid by a treaty country (or a political subdivision, local authority, or an instrumentality thereof) to an individual for services rendered to that country (or subdivision, authority, or instrumentality) generally is taxable only by that country.[38] However, such

[38] The term "instrumentality" is defined for purposes of proposed Article 19 to mean any agent or entity created or organized by a treaty country, one of its states, or a political subdivision or local

remuneration is taxable only by the other (host) country if the services are rendered in that other country by an individual who is a resident of that country and who: (1) is also a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. The Technical Explanation states that the rules of proposed paragraph 1 apply to remuneration paid only to government employees and not to independent contractors engaged by governments to perform services for them. This treatment of payments to independent contractors is consistent with the OECD Model treaty and some recent U.S. treaties, but is inconsistent with the U.S. Model treaty.

Proposed paragraph 2 provides that any pension and similar remuneration paid by, or out of funds to which contributions are made by, a treaty country (or a political subdivision, local authority, or an instrumentality thereof) to an individual for services rendered to that country (or subdivision, authority, or instrumentality) generally is taxable only by that country. However, such a pension is taxable only by the other country if the individual is a national and resident of that other country or if the pension is not subject to tax in the treaty country for which the services were performed because the services were performed entirely in the other treaty country. Social security benefits with respect to government service are covered by Article 18 (Pensions, Annuities, Alimony, Child Support, and Social Security) and not by the provisions of proposed Article 19.

Proposed paragraph 3 provides that pension, annuities, and other amounts paid by one treaty country (or by a juridical person organized under the public laws of that country) that are compensation for an injury or damage sustained as a result of hostilities or political persecution are exempt from tax in the other treaty country. The Technical Explanation states that this provision, although drafted reciprocally, is intended to provide an exemption from U.S. tax for German war reparation payments. This provision is an exception to the saving clause (paragraph 4 of Article 1 (General Scope)) pursuant to paragraph 5(a) of Article 1. Thus, a U.S. citizen or resident who receives German reparations payments would not be subject to any U.S. tax on that payment, regardless of whether he would be taxable under the Code.

Proposed paragraph 4 provides that if a treaty country (or a political subdivision, local authority, or an instrumentality thereof) is carrying on a business, the provisions of Articles 15 (Dependent Personal Services), 16 (Directors' Fees), 17 (Artistes and Athletes), and 18 (Pensions, Annuities, Alimony, Child Support, and Social Security), and not the provisions of proposed Article 19, will apply to remuneration and pensions for services rendered in connection with that business.

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to the benefits conferred by paragraph 1 of proposed Article 19 by the United States to a resident of the United States who is neither a citizen nor a permanent resident (i.e., a "green card" holder) of the United States. However, the saving clause will apply to benefits conferred by the United States to U.S. citizens and permanent residents. Thus, for example, a resident of the Federal Republic

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authority thereof to carry out functions of a governmental nature that is specified and agreed to in letters exchanged between the competent authorities of the treaty countries.

of Germany who, in the course of rendering services to the government of the Federal Republic of Germany, becomes a resident of the United States (but not a permanent resident) would be entitled to the exemption from taxation by the United States. However, an individual who receives a pension paid by the government of the Federal Republic of Germany in respect of services rendered to that government is taxable on that pension only in the Federal Republic of Germany unless the individual is a U.S. citizen or acquires a U.S. green card.

Article XI. Visiting Professors and Teachers; Students and Trainees

Visiting professors and teachers

The treatment provided to professors and teachers under the proposed protocol corresponds to the treatment provided under the present treaty, with certain modifications. Such a provision is not part of either the U.S. Model treaty or the OECD Model treaty.

Under both the present treaty and the proposed protocol, a professor or teacher who visits the other treaty country (the host country) for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution of a similar nature, and who immediately before that visit is, or was, a resident of the other treaty country, generally is exempt from host country tax on any remuneration received for teaching or research.

The proposed protocol modifies the present treaty by allowing the professor or teacher an exemption from host country taxation for the two-year period beginning on the date the professor or teacher first visits the host nation, even if he or she continues to remain in the host country after two years. Under the present treaty, the visiting professor or teacher generally would retroactively lose his or her exemption if the professor or teacher remained in the host country for longer than two years. Although the proposed protocol still retains the requirement that the professor's or teacher's stay be a temporary one, the professor or teacher will not retroactively lose the exemption should his or her stay last longer than two years.

Students and trainees

The treatment provided to students and business apprentices under the proposed protocol generally corresponds to the treatment provided under the present treaty, with certain modifications. The provision in the proposed protocol corresponds to the provision in the U.S. Model treaty.

The present treaty provides that certain payments received by a visiting full-time student or business apprentice for purposes of maintenance, education, or training are exempt from tax in the host country, provided that such payments are from sources outside the host country.

The present treaty provides a $5,000 (or its Deutsch Mark equivalent) exemption from host country tax for dependent personal service income earned by a full-time student or business apprentice within the host country. This exemption applies only to persons present in the other country for a period of four years or less. The proposed protocol increases the exemption amount from $5,000 to $9,000. This amount is meant to serve as a proxy for the combined amount of the standard deduction and personal exemption for U.S. resident taxpayers.

Article XII. Relief from Double Taxation

Article XII of the proposed protocol replaces Article 23 (Relief From Double Taxation) of the present treaty with a new Article providing updated rules for the relief of double taxation.

Paragraph 1 provides that the United States will allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to the Federal Republic of Germany. For this purpose, the taxes covered by subparagraph (b) of paragraph 1 and by paragraph 2 of Article 2 (Taxes Covered), other than the capital tax (*Vermögensteuer*) are income taxes. This marks an expansion of taxes eligible for credit when compared to the present treaty, which in addition to excluding the capital tax (*Vermögensteuer*) also excludes that portion of the trade tax (*Gewerbesteuer*) computed on a basis other than profits. According the Technical Explanation, the granting of a foreign tax credit with respect to German taxes is based on the Treasury Department's review of the laws of the Federal Republic of Germany.

Paragraph 2 provides a re-sourcing rule for gross income covered by paragraph 1, intended to ensure that a U.S. resident can obtain a U.S. foreign tax credit for German taxes paid when the Convention assigns to the Federal Republic of Germany primary taxing rights over an item of gross income. This is consistent with the U.S. Model treaty.

Paragraphs 3 and 4 provide that the Federal Republic of Germany will relieve double taxation on German residents through a dual method of exemption and credit. In general, the Federal Republic of Germany will provide an exemption from the German tax base for income or capital that may be taxed in the United States under the Convention or that is exempt from U.S. tax under the proposed zero-rate provision of Article 10(3) (except in cases where a foreign tax credit is provided for under subparagraph (b) of paragraph 3). The Federal Republic of Germany, however, retains the right to take the excluded income and assets into account for purposes of determining the rate of tax on other items of income and capital (i.e., the Federal Republic of Germany may provide for exemption with progression).

In the case of dividends, the proposed protocol provides that the Federal Republic of Germany will only exempt distributions of profits on corporate rights subject to corporate income tax under U.S. law. In addition, the exemption shall not apply to dividends from a RIC or REIT and distributions that are deductible for U.S. income tax purposes by the distributing company. With respect to German capital taxes, the Federal Republic of Germany will exclude any shareholding the dividends on which would be exempt from German income tax under subparagraph (a) of paragraph 3.

Certain other items of income which have been taxed in the United States in accordance with the provisions of U.S. law and the treaty will remain subject to taxation by the Federal Republic of Germany, but will be eligible for a foreign tax credit. These are: (i) income from dividends which do not qualify for the zero-rate of withholding; (ii) gains from the alienation of immovable property to which Article 13 (Gains) apply provided such gains are taxable in the United States by reason only of paragraph 2(b) of Article 13 (Gains) (i.e., gains from the sale of a U.S. real property holding company); (iii) income to which Article 16 (Directors' Fees) applies received by German residents in respect of their services rendered in the United States as directors of U.S. corporations; (iv) income to which Article 17 (Artistes and Athletes) applies;

and (v) income which would be exempt from U.S. tax under the Convention (e.g., interest), but which is denied the benefits of the Convention and is subject to tax by virtue of Article 28 (Limitation on Benefits). According to the Technical Explanation, income described in (v) of the preceding sentence would be fully taxable in the Federal Republic of Germany with no credit for U.S. tax absent a special provision; the provision provides for a German foreign tax credit in cases where the United States taxes solely by virtue of the Limitation on Benefits provisions.

The foreign tax credit granted by the Federal Republic of Germany under the proposed protocol is subject to the provisions of German law regarding credits for foreign taxes. Income that may be taxed in the United States in accordance with the proposed protocol is deemed, for purposes of the German foreign tax credit and exemption rules, to be from U.S. sources.

The Federal Republic of Germany will provide a foreign tax credit (as opposed to exemption) in three additional instances: (i) if income or capital would be subject to double taxation as a result of the placement of such income under different provisions of the Convention and this conflict cannot be resolved pursuant to Article 25 (Mutual Agreement Procedure); (ii) if the United States applies the provisions of the Convention to exempt such income or capital from tax, or applies paragraph 2 or 3 of Article 10 (Dividends) to such income or capital or may under the provisions of the Convention tax such income or capital but is prevented from doing so under its domestic law; and (iii) to the extent consistent with internal German law and, after due consultation with the United States and notification of the United States through diplomatic channels (but in such a case the foreign tax credit treatment will apply only for taxable years following the year of such notification). According to the Technical Explanation, the change from the exemption method to credit method provided in these circumstances is designed to prevent unintended instances either of double taxation or of double non-taxation or inappropriately low taxation.

According to the Technical Explanation, the so-called “switchover clause” described in clause (iii) above is intended to deal with cases of double exemption of income (e.g., through the granting of a dividends paid deduction to the U.S. payor of a dividend and a correlative exemption of such dividend in Germany) or arrangements for improper use of the treaty, and it was not intended to apply to cases where the profits out of which a distribution is made have been subject to the general U.S. corporate-level tax regime. Thus, the Technical Explanation provides, the fact that a U.S. corporation pays a reduced level of U.S. corporate-level tax because of the nature or source of its income (e.g., because it is entitled to a dividends received deduction, a net operating loss carry forward, or a foreign tax credit) will not entitle Germany to switch from the exemption to the credit regime.

Finally, Paragraph 5 provides special rules for the tax treatment in both treaty counties of certain types of income derived from U.S. sources by U.S. citizens who are resident in the Federal Republic of Germany. These rules are designed to address the fact that the United States taxes its citizens on a worldwide basis even when such citizens are not resident in the United States, and therefore the U.S. tax on the U.S. source income of a U.S. citizen resident in the Federal Republic of Germany may exceed the U.S. tax that may be imposed under the treaty and the proposed protocol on an item of U.S. source income derived by a resident of the Federal Republic of Germany who is not a U.S. citizen. According to the Technical Explanation, these provisions ensure that the Federal Republic of Germany does not bear the cost of U.S. taxation of its citizens who are German residents.

Article XIII. Arbitration

Article XIII of the proposed protocol deletes paragraph 5 of Article 25 (Mutual Agreement Procedure) of the treaty, which provides for a voluntary arbitration procedure, and replaces it with new paragraphs 5 and 6, which introduce a mandatory arbitration procedure that is sometimes referred to as "last best offer" or "final offer" arbitration.[39] Under the proposed protocol, unless a taxpayer or other "concerned person" (in general, a person whose tax liability is affected by the arbitration determination) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case. Under the current treaty, the competent authorities may agree to submit disagreements to arbitration, with procedures to be established by the exchange of diplomatic notes. The Protocol dated August 29, 1989 and the diplomatic notes exchanged on that date set forth the detailed rules for the current-law arbitration procedure, which at that time was not found in other U.S. tax treaties. The 1989 Protocol is replaced by Article XVI of the proposed protocol. Paragraph 22 of Article XVI of the proposed protocol provides the detailed rules regarding the new arbitration procedures.[40]

The proposed arbitration procedures raise a number of issues, which are discussed in Part VI of this pamphlet.

Under the current treaty, the competent authorities may agree to invoke binding arbitration in a particular case only after fully exhausting other procedures and only if the taxpayer agrees in advance to be bound by the arbitration. Taxpayers are given the opportunity to present their views to the arbitration board (the "board"). The board is required to decide each case on the basis of the treaty, with due consideration to the domestic laws of the treaty countries and the principles of international law. The board is also required to provide to the competent authorities an explanation of its decision. The diplomatic notes provide that while the decision of the board does not have precedential effect, it is expected that such decisions will ordinarily be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue, and substantially similar facts, and may also be taken into account in other cases where appropriate.

New paragraph 5 of Article 25 sets forth the basic rule of the mandatory arbitration that requires the competent authorities to invoke the arbitration procedures if they have endeavored, but are unable, to reach a complete agreement in the case, and if three conditions are met. The

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[39] The new arbitration procedure is also informally called "baseball arbitration" because it is similar to the procedure used to resolve major league baseball salary disputes. In this type of arbitration, each of the parties proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award.

[40] A similar arbitration procedure is introduced in the proposed U.S.-Belgium income tax treaty. The few differences between the proposed Belgium and Germany treaty provisions are footnoted in the discussion below.

first condition is that tax returns have been filed with at least one of the treaty countries with respect to the taxable years at issue in the case. The second condition is that the case (i) involves the application of one or more articles that the treaty countries have agreed shall be the subject of arbitration and is not a particular case that the competent authorities agree, before the date on which arbitration proceedings ("proceedings") would otherwise have begun, is not suitable for determination by arbitration; or (ii) is a particular case that the competent authorities agree is suitable for determination by arbitration. The third condition is that the taxpayer and all "concerned persons" agree to certain nondisclosure conditions, as discussed below.

New paragraph 6 of Article 25 and paragraph 22 of Article XVI of the proposed protocol provide detail regarding these general conditions and fill in the detailed rules regarding the arbitration procedures. Regarding the second condition, paragraph 22 of Article XVI of the proposed protocol enumerates the articles for which arbitration is generally required if the requirements of paragraphs 5 and 6 of Article 25 are otherwise satisfied (unless the competent authorities agree that the particular case is not suitable for determination by arbitration): Article 4 (Residence), insofar as it relates to the residence of a natural person; Article 5 (Permanent Establishment); Article 7 (Business Profits); Article 9 (Associated Enterprises); and Article 12 (Royalties).[41]

The third condition is met when both competent authorities have received from each concerned person a statement agreeing that the concerned person and each person acting on the concerned person's behalf (i.e., their authorized representatives or agents) will not disclose to any other person any information received during the course of the proceedings from either treaty country or the board, other than the determination of the board (the "nondisclosure agreement"). A concerned person that has the legal authority to bind any other concerned person on this matter may do so in a comprehensive statement. A concerned person is defined as the presenter of a case to a competent authority for consideration under Article 25 (i.e., the taxpayer) and any other persons whose tax liability to either treaty country may be directly affected by a mutual agreement arising from that consideration. For example, in the case of a U.S. corporation that brings a transfer pricing case for resolution to the U.S. competent authority with respect to a transaction with its German subsidiary, both the U.S. corporation and its German subsidiary (that may have a correlative adjustment as a result of the resolution of the case) are concerned parties.

Meeting the third condition may trigger the beginning of arbitration proceedings. As amended by Article XIII of the proposed protocol, paragraph 6(c) of Article 25 provides that the proceedings begin on the later of (i) two years after the "commencement date" of the case, unless the competent authorities have previously agreed to a different date, and (ii) the earliest date upon which both competent authorities have received the nondisclosure agreement. Paragraph 6(b) provides that the commencement date of a case is the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities.

[41] Under the proposed U.S.-Belgium treaty, issues arising under any article of that treaty are generally eligible for arbitration.

Section 22(p) of Article XVI of the proposed protocol requires that each competent authority shall confirm in writing to the other competent authority and to the concerned person or persons the date of its receipt of the information necessary to undertake substantive consideration for a mutual agreement. With respect to the United States, that information is the information required to be submitted to the U.S. competent authority under Revenue Procedure 2002-52, section 4.05, (or any applicable successor provisions), and for cases initially submitted as a request for an Advance Pricing Agreement, the information required to be submitted to the Internal Revenue Service under Revenue Procedure 2006-9, section 4 (or any applicable successor provisions). With respect to Germany, that information is the information required to be submitted to the German competent authority under the circular of July 1, 1997, - IV C 5 - S 1300 - 189/96-, published by the Ministry of Finance (or any applicable successor circular). In any event, the information is not considered received until both competent authorities have received copies of all materials submitted to either treaty country by every concerned person in connection with the mutual agreement procedure. Thus, the competent authorities must have exchanged copies of all of the submitted materials before the commencement date of the case is deemed to arrive, triggering the two-year period.

Paragraph 22 of Article XVI of the proposed protocol provides for several procedural rules once arbitration proceedings have begun, but paragraph 22(q) provides that the competent authorities may modify or supplement any of the rules or procedures of paragraph 22 as necessary to more effectively implement the intent of paragraph 5 of Article 25 to eliminate double taxation. In addition, paragraph 22(f) of Article XVI provides that the board may adopt any procedures necessary for the conduct of its business provided that such procedures are not inconsistent with any provision of Article 25 or Article XVI of the proposed protocol.

Paragraph 22(e) of Article XVI of the proposed protocol provides that within 60 days from the date on which the proceeding begins, each treaty county is required to send a written communication to the other appointing one member of the board. Within 60 days from the date that the second such communication is sent, the two appointed board members are required to appoint a third member to serve as Chair of the board. If either treaty country fails to appoint a board member, or if the appointed members fail to appoint a third member, the remaining member or members are to be appointed by the highest ranking member of the Secretariat at the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development ("OECD")[42] who is not a citizen of either treaty country, by written notice to both treaty countries within 60 days of the date of such failure. The competent authorities are required to develop a list of individuals with familiarity in international tax matters who may potentially serve as Chair of a board. However, the Chair may not be a citizen of either treaty country.

Paragraph 22(g) of Article XVI of the proposed protocol prescribes the submission procedures in detail. Each of the treaty countries is permitted to submit to the board a proposed resolution describing its proposed disposition of the specific amounts of income, expense, or taxation at issue in the case, and a supporting position paper. These submissions are due within

[42] That position is currently occupied by Jeffrey Owens.

90 days of the appointment of the Chair of the board.[43] The board is required to provide copies of these submissions to the other treaty country on the date on which the later of the two submissions are received by the board. If only one treaty country submits a timely proposed resolution, that proposed resolution is deemed to be the determination of the board in that case and the arbitration proceeding is terminated. Each of the treaty countries may submit a reply submission to the board, within 180 days of the appointment of the Chair,[44] to address any points raised by the other country's proposed resolution or position paper. Additional information may be submitted to the board only at its request, and copies of any such request and the treaty country's response is to be provided to the other treaty country on the date on which the request or response is submitted. Except for certain logistical matters, all communications between the treaty countries and the board is required to be in writing between the designated competent authorities and the Chair of the board.

Any meetings of the board are required to be held in facilities provided by the treaty country whose competent authority initiated the mutual agreement proceeding in the case. Fees and expenses of the arbitration, including language translation fees, are generally to be borne equally by the treaty countries. The fees of members of the board are, in general, fixed at $2,000 per day (or the equivalent amount in euros), subject to modification by the competent authorities. The expenses of the board members are set, in general, in accordance with the International Centre for Settlement of Investment Disputes Schedule of Fees for arbitrators, as in effect on the date on which the proceedings begin, subject to modification by the competent authorities. Meeting facilities, related resources, financial management, other logistical support, and general administrative coordination of the arbitration proceeding are to be provided, at its own cost, by the treaty country whose competent authority initiated the mutual agreement proceedings in the case. Any other costs are to be borne by the treaty country that incurs the costs.

New paragraph 6(f) of Article 25 provides that the members of the board and their staffs are considered persons or authorities to whom information may be disclosed under Article 26 (Exchange of Information and Administrative Assistance). Paragraph 22(n) of Article XVI provides that all members of the board and their staffs must submit statements to each of the treaty countries in confirmation of their appointment to the board in which they agree to abide by and be subject to the confidentiality and nondisclosure provisions of Article 26 (Exchange of Information and Administrative Assistance) and the applicable domestic laws of the treaty countries. In the event these provisions conflict, the most restrictive condition applies. All materials prepared in the course of the proceeding, or relating to the proceeding, are considered to be information exchanged between the treaty countries under Article 26. In addition, no information relating to the arbitration proceeding, including the board's determination, may be disclosed by the members of the board or their staffs or by either competent authority, except as otherwise permitted by the treaty and the domestic laws of the treaty countries.

[43] The proposed U.S.-Belgium treaty allows 60 days.

[44] The proposed U.S.-Belgium treaty allows 120 days.

Paragraph 22(h) of Article XVI of the proposed protocol provides that the board will deliver its determination in writing to the treaty countries within nine months of the appointment of the Chair.[45] The board is required to adopt as its determination one of the proposed resolutions submitted by the treaty countries. In making its determination, the board is required to apply the following authorities, in the following order of priority: (a) the provisions of the treaty; (b) any agreed commentaries or explanations of the treaty countries concerning the treaty; (c) the laws of the treaty countries to the extent not inconsistent with each other; and (d) any OECD commentary, guidelines, or reports regarding relevant analogous portions of the OECD Model treaty.

New paragraph 6(e) of Article 25 provides that unless any concerned person does not accept the determination of the board, the determination shall constitute a resolution by mutual agreement under Article 25 and is binding on both treaty countries in the case. Paragraph 22(j) of Article XVI of the proposed protocol also provides that the determination of the board is binding upon the treaty countries, but adds that the determination will not state a rationale and will have no precedential value. Paragraph 22(b) provides that the determination by the board in a proceeding is limited to a determination regarding the amount of income, expense, or tax reportable to the relevant treaty country. Paragraph 22(m) provides that the treatment of any associated interest or penalties will be determined by applicable domestic law of the treaty country concerned.

Paragraph 22(k) of Article XVI of the proposed protocol provides that, within 30 days of receiving the determination of the board from the competent authority to which the case was first presented, each concerned person must advise that competent authority whether that concerned person accepts the determination of the board.[46] If any concerned person fails to so advise the relevant competent authority within that time frame, the determination of the board will be considered not to have been accepted in that case. If the board's determination is not accepted, the case may not subsequently be the subject of an arbitration proceeding.

Paragraph 22(c) of Article XVI of the proposed protocol provides that, notwithstanding the initiation of an arbitration proceeding, the competent authorities may reach a mutual agreement to resolve a case and terminate the proceeding, but only before a decision of the board has been accepted by all concerned persons. In addition, any concerned person may withdraw a request for the competent authorities to engage in the mutual agreement procedure under Article

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[45] The proposed protocol as initially executed provided for a determination within six months of the appointment of the Chair. The six-month time frame was corrected to nine months by an exchange of diplomatic notes dated August 17, 2006. The proposed U.S.-Belgium treaty allows six months.

[46] Under the proposed U.S.-Belgium treaty, if the case is in litigation, each concerned person who is a party to the litigation must also advise, within the same time frame, the relevant court of its acceptance of the determination of the board as the resolution by mutual agreement and withdraw from the consideration of the court the issues resolved through the arbitration proceeding. If any concerned person fails to so advise both the relevant competent authority and any relevant court within that time frame, the determination of the board will be considered not to have been accepted in that case.

25, thereby terminating the arbitration proceeding (as well as the mutual agreement procedure generally).

Article XIV. Limitation on Benefits

In general

The proposed protocol replaces the rules of Article 28 (Limitation on Benefits) of the present treaty with rules that are similar to the limitation-on-benefits provisions included in recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Germany or the United States.

The proposed protocol is intended to limit double taxation caused by the interaction of the tax systems of the United States and Germany as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to the benefits accorded by the proposed protocol if the resident is a "qualified person" and satisfies any other specified conditions for obtaining benefits. A treaty country resident is a qualified person if the resident is (1) an individual; (2) one of the two countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) an entity that is maintained in its country of organization solely for a religious, charitable, educational, scientific, or other similar purpose; (5) an entity that is established and maintained in its country of organization to provide pensions or other similar benefits under a plan and that satisfies a beneficiary or sponsor test; or (6) an entity that satisfies an ownership test and a base erosion test.

A resident that is not a qualified person under the rules described above may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test. These tests and the qualified person definition are described in detail below.

Special anti-abuse rules govern certain items of income derived from a treaty country in so-called "triangular cases."

The proposed protocol also includes special rules applicable to German *Investmentvermögen.*

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Qualified person

Individual

Under the proposed protocol, an individual resident of the United States or Germany is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed protocol provides that the United States and Germany, and any political subdivision or local authority of the two countries, are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of Germany or the United States is entitled to all treaty benefits if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, a company resident in Germany meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The term "shares" includes depository receipts for shares and trust certificates for shares.

The term "regularly traded" is not defined in the proposed protocol. The term is therefore defined by reference to the domestic tax laws of the treaty country from which treaty benefits are sought, generally the source country. In the case of the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(4)(i)(B). Under these regulations, a class of shares is regularly traded if trades in the shares are made in more than de minimis quantities on at least 60 days during the taxable year and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation states that the regular trading requirement can be satisfied by trading on any recognized exchange or exchanges and that trading on more than one recognized exchange may be aggregated for purposes of the requirement.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; any German stock exchange of which registered dealings in shares take place; and any other stock exchange that the competent authorities agree to recognize for purposes of the limitation-on-benefits rules.

The term "primarily traded" also is not defined in the proposed protocol and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares (and any disproportionate class of shares) of which is regularly traded on a recognized stock exchange but which does not satisfy the primary trading test (that is, the requirement that a company's principal class of shares be primarily traded on a recognized stock exchange in its country of residence) may claim treaty benefits if it satisfies the management and control test -- that is, if the company's primary place of management and control is in the treaty country of which it is a resident. According to the Technical Explanation, a company's primary place of management is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed protocol, by contrast, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not itself satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) is entitled to treaty benefits if it is a resident of the United States or Germany and shares representing at least 50 percent of its aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or Germany. This rule allows certain subsidiaries of publicly-traded companies to be eligible for all benefits under the treaty.

Tax-exempt organizations

An organization that is resident in a treaty country is entitled to treaty benefits if it is organized under the laws of the United States or Germany and established and maintained in that country exclusively for a religious, charitable, educational, scientific, or other similar purpose. There is no requirement that a specified percentage of the beneficiaries or members of such an organization be resident in the United States or Germany.

Pension funds

An entity organized under the laws of a treaty country and established and maintained in that country to provide, under a plan, pensions or similar benefits to employed and self-employed persons, is entitled to all the benefits of the treaty if more than 50 percent of the entity's beneficiaries, members, or participants are individuals resident in either the United States or Germany, or if the organization sponsoring the pension fund is entitled to the benefits of the treaty. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year at least 50 percent of each class of the entity's shares or other beneficial interests is owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds, provided that in the case of indirect ownership, each intermediate owner also is a resident of that treaty country.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, tax-exempt organizations, or pension funds.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Residence) and they otherwise satisfy the ownership and base erosion tests.

Derivative benefits rule

The proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement and satisfies any other specified conditions for the obtaining of treaty benefits for that income item.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. The term "disproportionate class of shares" has the same definition as the definition previously described.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is the same as the base erosion test described previously (that is, the test that is included in the rules for determining whether a treaty country resident is a qualified person), except that, for the derivative benefits rule, deductible payments made to equivalent beneficiaries, not just to residents of a treaty country entitled to treaty benefits, are excluded from the payments that count toward the 50-percent limitation.

An equivalent beneficiary must be a resident of a European Union member state, a European Economic Area state, or a North American Free Trade Agreement party (together, "qualifying countries") and must satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the U.S.-Germany treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed protocol's rules, described above, for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would be considered a qualified person under the proposed protocol's tests previously described for individuals, governments, publicly-traded companies, tax-exempt organizations, and pension funds. Second, for income from insurance premiums, dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the U.S.-Germany treaty, as modified by the proposed protocol (the "tax rate test").

The Technical Explanation gives the following example to illustrate the operation of the tax rate test. A U.S. company is wholly owned by a German company that in turn is wholly owned by an Italian company. Assume the German company otherwise satisfies the requirements of the zero-rate dividend provision, and assume that if the Italian company received a dividend directly from the U.S. company, the applicable dividend withholding tax rate under the U.S.-Italy treaty would be five percent. Under these facts, the Italian company would not be an equivalent beneficiary under the rules described above because it would not be entitled to a withholding tax rate at least as low as the applicable rate (zero) under the U.S.-Germany tax treaty as modified by the proposed protocol.

For dividend, interest, or royalty payments arising in Germany and beneficially owned by a resident of the United States, the proposed protocol includes a special rule for determining whether a company that is a resident of an EU member state satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member state resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Germany and paid directly to that EU member state resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Germany and that EU member state would permit imposition of a higher withholding tax rate on that payment than is permitted by the U.S.-Germany tax treaty, as amended by the proposed protocol. The Technical Explanation states that this special rule takes account of the fact that withholding taxes on many inter-company dividend, interest, and royalty payments are exempt within the EU under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not renegotiated their tax treaties to reflect the EU directives' elimination of withholding tax.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a German or a U.S. resident that is a qualified person by reason of the limitation-on-benefits rules described previously for individuals, governments, publicly-traded companies, tax-exempt organizations, or pension funds. Under this rule, according to the Technical Explanation, a German individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or German company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a German company is owned by five companies that are residents of EU member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the German company is owned by a U.S. or a German individual, the German company still can satisfy the requirements of the ownership test of the derivative benefits rules.

Active business test

Under the proposed protocol, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country and (2) the income from the other country is derived in connection with or is incidental to that trade or business (and the resident satisfies any other specified conditions for the obtaining of benefits). The proposed protocol provides that the activities of making or managing investments for the resident's own account do not constitute an active trade or business unless these activities are banking, insurance, or securities dealing carried on by a bank, an insurance company, or a registered securities dealer.

The term “trade or business” is not defined in the current treaty or in the proposed protocol. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the current treaty, when determining whether a resident of Germany is entitled to the benefits of the treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term “trade or business.” In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived “in connection with” or be “incidental to” the resident’s trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that “forms a part of” or is “complementary to” the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the country of source if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be “complementary,” the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first out of earnings and profits of the treaty-benefited trade or business and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed protocol provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. According to the Technical Explanation, in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and German economies.

The proposed protocol provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons "connected" to that first person are deemed to be conducted by that first person. A person is "connected" to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The triangular case

The proposed protocol provides a special anti-abuse rule that, according to the Technical Explanation, addresses a German resident's use of the following structure to earn interest income from the United States. The German resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The German resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the German resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Germany and the third country, Germany does not tax the income earned by the permanent establishment. Consequently, the income is not taxed in Germany or the United States, and is only lightly taxed in the third country.

Under the proposed protocol, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in Germany and in the third country is less than 60 percent of the tax that would have been payable to Germany if the income were earned in Germany and were not attributable to the permanent establishment in the third country.

By its terms, this triangular provision also applies if a U.S. resident derives income from Germany, the income is attributable to a permanent establishment in a third country, and the combined tax actually paid on the income in the United States and the third country is less than 60 percent of the tax that would have been payable to the United States if the income were earned in the United States and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision is not limited to interest income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies may be subject to tax under the domestic law of the treaty country in which the income arises.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. For any other income, the provision does not apply if the income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or simply holding investments for the person's own account, unless these activities are banking or securities activities carried on by a bank or a registered securities dealer).

German *Investmentvermögen*

The proposed protocol provides that notwithstanding the limitation-on-benefits rules described above, a German Investment Fund or German *Investmentaktiengesellschaft* (collectively referred to as *Investmentvermögen)* may be granted treaty benefits only if at least 90 percent of the shares or other beneficial interests in the *Investmentvermögen* are owned directly or indirectly by residents of Germany that are entitled to treaty benefits under the limitation-on-benefits rules for individuals, governments, publicly-traded companies, tax-exempt organizations, or pension funds or by persons that are equivalent beneficiaries with respect to the income derived by the *Investmentvermögen* for which benefits are being claimed. Special rules are provided for determining whether the 90-percent ownership requirement is satisfied. Paragraph 24 of Article XVI of the proposed protocol provides that the competent authorities of the treaty countries will establish procedures for determining indirect ownership in calculating whether the 90-percent ownership requirement is satisfied. It is anticipated these procedures may include the use of statistically valid sampling techniques.

Grant of treaty benefits by the competent authority

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the treaty country in which the income arises so determines. The proposed protocol provides that in making a determination, the competent authority will consider whether the establishment, acquisition, or maintenance of the resident and the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under the treaty. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted.

Article XV. German Currency References

The proposed protocol updates the present treaty to reflect the current currency of Germany. The proposed protocol modifies paragraph 1 of Article 17 (Artistes and Athletes) and paragraphs 4 and 5 of Article 20 (Visiting Professors and Teachers; Students and Trainees) of the present treaty by replacing the words "Deutsche Mark" with the word "Euro" each time that they appear.

Article XVI. August 29, 1989 Protocol

The proposed protocol replaces paragraphs 1 through 28 of the Protocol signed at Bonn on August 29, 1989. The following description of Article XVI of the proposed protocol discusses only the aspects of Article XVI that were not originally included in the Protocol signed at Bonn on August 29, 1989, and that are not described elsewhere in this pamphlet. Consequently, only paragraphs 21 and 23 of proposed Article XVI are described below.

Proposed paragraph 21 clarifies that paragraph 4 of Article 24 (Nondiscrimination) of the present treaty shall not be construed as requiring a treaty country to allow foreign corporations to join in filing a consolidated return with a domestic corporation or to allow similar benefits between domestic and foreign enterprises.

Proposed paragraph 23 clarifies that Article 26 (Exchange of Information and Administrative Assistance) of the present treaty provides the competent authority of each treaty country the power to obtain and exchange information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity, and information relating to the ownership of legal persons. The Technical Explanation states that such information must be provided to the requesting treaty country notwithstanding the fact that the other treaty country's laws or practices might otherwise preclude the obtaining of the information.

Article XVII. Entry into Force

The proposed protocol provides that the protocol is subject to ratification in accordance with the applicable procedures of each country, and that instruments of ratification will be exchanged as soon as possible. The proposed protocol will enter into force upon the exchange of instruments of ratification.

With respect to withholding taxes, the provisions of the proposed protocol will have effect for amounts paid or credited on or after the first day of January of the year in which the proposed protocol enters into force. With respect to most other taxes, the provisions of the proposed protocol will have effect for taxable periods beginning on or after the first day of January next following the date of entry into force of the proposed protocol. With respect to taxes on capital, the proposed protocol will have effect for taxes levied on items of capital owned on or after the first day of January next following the entry into force of the proposed protocol.

The proposed protocol also contains several special effective dates. First, the provisions of Article 1 (General Scope) shall have effect after the proposed protocol enters into force and shall apply in respect of any tax claim irrespective of whether such claim pre-dates the entry into force of the proposed protocol (or the effective date of any of its provisions). Second, the proposed amendments to Article 9 (Government Services) shall not have effect with respect to individuals who at the time of the signing of the treaty (on August 29, 1989) were employed by the United States or any political subdivision or local authority thereof.

For purposes of the binding arbitration provisions of Article 25 (Mutual Agreement Procedure), the proposed protocol is effective with respect to: (1) cases that are under consideration by the competent authorities as of the date the proposed protocol enters into force and (2) cases that come under consideration after that time. For cases that are under consideration as of the date the proposed protocol enters into force, the commencement date for such cases shall be the date the proposed protocol enters into force.

Moreover, notwithstanding the date which the proposed protocol enters into force, taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed protocol takes effect if they would have been entitled to greater benefits under the present treaty. For such a taxpayer, the present treaty would continue to have effect in its entirety for a 12-month period from the date on which the provisions of the proposed protocol would otherwise take effect.

Finally, the proposed protocol provides that the following notes exchanged with respect to the present treaty shall cease to have effect when the provisions of the proposed protocol enter into effect: (1) notes exchanged on August 29, 1989 referring to paragraph five of Article 25 (Mutual Agreement Procedure) and Article 28 (Limitation on Benefits) and (2) the German note of November 3, 1989 referring to paragraph 21 of the protocol to the treaty.

VI. ISSUES

A. Arbitration

<u>In general</u>

Article XIII of the proposed protocol deletes paragraph 5 of Article 25 (Mutual Agreement Procedure) of the treaty, which provides for a voluntary arbitration procedure, and replaces it with new paragraphs 5 and 6, which introduce a mandatory arbitration procedure under which each of the competent authorities proposes one (and only one) figure for settlement and the arbitrator must select one of those figures as the award. Under the proposed protocol, unless a taxpayer (or other concerned person) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case.

Under the procedures currently in force, the competent authorities may agree to invoke binding arbitration in a particular case after fully exhausting other procedures, if the taxpayer agrees in advance to be bound by the arbitration.[47] Taxpayers are given the opportunity to present their views to the arbitration board (the "board"). The board must consist of at least three members, with each of the competent authorities appointing the same number of members, and those members agreeing on the appointment of the other members. The board is required to decide each case on the basis of the treaty, giving due consideration to the domestic laws of the treaty countries and the principles of international law. The board is also required to provide to the competent authorities an explanation of its decision. The diplomatic notes provide that while the decision of the board does not have precedential effect, it is expected that such decisions will ordinarily be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue, and substantially similar facts, and may also be taken into account in other cases where appropriate. Under the current treaty, many of the procedural rules governing the arbitration proceedings are subject to agreement by the competent authorities or are established by the board.

New paragraph 5 of Article 25 requires the competent authorities to invoke the binding arbitration procedures if they have endeavored, but are unable, to reach a complete agreement in the case, and if three conditions are met. The first condition is that tax returns have been filed with at least one of the treaty countries with respect to the taxable years at issue in the case. The second condition is that the case (i) involves the application of one or more articles that the treaty countries have agreed shall be the subject of arbitration, and is not a particular case that the competent authorities agree, before the date on which arbitration proceedings ("proceedings") would otherwise have begun, is not suitable for determination by arbitration; or (ii) is a particular case that the competent authorities agree is suitable for determination by arbitration. The third

[47] Under paragraph 5 of the current treaty, the competent authorities may agree to submit disagreements to arbitration, with procedures to be established by the exchange of diplomatic notes. The Protocol dated August 29, 1989 and the exchange of diplomatic notes on that same date set forth the detailed rules for the current-law arbitration procedures. The 1989 Protocol is replaced by Article XVI of the proposed protocol. Paragraph 22 of Article XVI of the proposed protocol provides detailed rules regarding the new arbitration procedures.

condition is that the taxpayer and all "concerned persons" agree to certain nondisclosure conditions.

Regarding the second condition, paragraph 22 of Article XVI of the proposed protocol enumerates the articles for which arbitration is generally required if the requirements of paragraphs 5 and 6 of Article 25 are otherwise satisfied (unless the competent authorities agree that the particular case is not suitable for determination by arbitration): Article 4 (Residence), insofar as it relates to the residence of a natural person; Article 5 (Permanent Establishment); Article 7 (Business Profits); Article 9 (Associated Enterprises);[48] and Article 12 (Royalties).[49]

The proposed protocol provides detailed procedural rules governing the arbitration proceedings, including strict time limits for submissions and the final determination of the board.

Overview of issues

In general, it is beneficial to resolve tax disputes effectively and efficiently. The new arbitration procedures are intended to ensure that the mutual agreement procedures proceed according to a schedule and that all cases will be resolved within a time period not exceeding approximately 38 months. However, the proposed mandatory and binding arbitration procedures are new to the United States' treaty network. It will take time to ascertain if these procedures are effective in meeting these objectives or if unexpected problems arise. Meanwhile, the Treasury Department may seek to negotiate treaty provisions with current or future treaty partners that are similar, in whole or in part, to the arbitration procedures of the proposed protocol. It is appropriate, therefore, to address issues or potential issues that may arise under the procedures, while considering the place of arbitration within the framework of the mutual agreement procedures of the U.S. treaty system.

Other mandatory arbitration proposals and conventions

There have been other recent developments in the area of arbitration. On January 30, 2007, the OECD adopted proposed changes to its Model treaty and commentary, incorporating a mandatory and binding arbitration procedure (the "OECD mandatory arbitration procedure"), some elements of which are generally similar to those of the proposed protocol.[50] The OECD mandatory arbitration procedure allows a taxpayer whose case has any issues that remain unresolved after the case has been in a mutual agreement procedure for two years to require the

[48] Article 9 relates to transfer pricing.

[49] A similar arbitration procedure is introduced in the proposed U.S.-Belgium income tax treaty. Under the proposed U.S.-Belgium treaty (Article 24, paragraph 7), issues arising under any article of the treaty are generally eligible for arbitration.

[50] OECD Centre for Tax Policy and Administration (Report adopted by the Committee on Fiscal Affairs), *Improving the Resolution of Tax Treaty Disputes* (Jan. 30, 2007). Paragraph 7 of this report states that the changes will be included in the next update to the OECD Model treaty, which will be published in 2008.

issues to be submitted to arbitration. However, the details of the OECD mandatory arbitration procedure are not to be specified in the OECD Model treaty, but are, instead, left to an agreement, governing all arbitration cases, between the competent authorities. A proposed Annex to the proposed Commentary contains a Sample Mutual Agreement on Arbitration ("Sample Agreement") that may be varied by the treaty countries (the Annex discusses a number of possible variations in a separate commentary on the issues raised by the Sample Agreement (the "Sample Agreement Commentary")).

The European Union has adopted certain mandatory and binding arbitration procedures that are applicable to transfer pricing disputes between the "EU-15" countries (the "EU mandatory arbitration procedure").[51] Under these procedures, two years after the case is submitted to one of the relevant competent authorities, the relevant competent authorities must set up an "advisory commission" charged with delivering an opinion within six months on the elimination of double taxation in the case under the arm's-length principle. The competent authorities must either reach an agreement to eliminate double taxation within six months of the advisory commission's opinion, or must accept and implement that opinion.

Due to the implementation procedures employed by the EU, there was an interim period from January 1, 2000 through October 2004 in which the EU mandatory arbitration procedure was not in effect. Beginning November 1, 2004, the EU mandatory arbitration procedure was extended retroactively back to January 1, 2000. Due in part to these timing issues and in part to other reasons, a number of cases are currently awaiting arbitration under the EU mandatory arbitration procedure. The European Commission recently expressed its concern with the procedure:

> The Commission considers that the number of long outstanding transfer pricing double tax cases means that, for reasons that need to be further explored, the Arbitration Convention is not eliminating transfer pricing related double taxation in the EU as well as it is supposed to. The proper functioning of the single market is therefore impaired. The Commission intends to consider how this failing can be addressed. It might well be that an instrument that ensures a more timely and effective elimination of double taxation, is necessary from the perspective of the single market.[52]

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[51] *See* Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC), 1990 O.J. (L 225) 10 (extended by Protocol amending the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 1999 O.J. (C 202) 1). The EU-15 countries are: Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, Finland, Sweden, and the United Kingdom. A process is under way to extend those arbitration rules to newer members of the EU.

[52] Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreements within the EU, COM(2007) 71 final, at para. 28 (Feb. 26, 2007).

Mandatory arbitration and issues covered

Mandatory arbitration

The current treaty rules allow a particular case to be submitted to arbitration only if the competent authorities agree to its submission. The proposed protocol generally requires arbitration of qualifying cases that are unresolved two years after submission to both competent authorities, unless both competent authorities agree that the case in not suitable for arbitration. One objective of the new procedures is the more efficient resolution of these cases by the competent authorities prior to the running of the two-year deadline triggering referral to arbitration. Another objective is the resolution of cases by arbitration within a guaranteed time period, notwithstanding the difficulty of one or both of the treaty countries in reaching agreement through the general mutual agreement process.

However, if one competent authority is able to slow down the mutual agreement process in a number of cases with the expectation that the arbitrators will resolve difficult issues, the proposed arbitration procedures may not yield the expected favorable results for the mutual agreement process. The Committee may wish to inquire how the Treasury Department and the U.S. competent authority will monitor the competent authority function to determine the overall effects of the new arbitration procedures on the mutual agreement process.

Issues covered

Another set of questions relates to the circumstances, treaty partners, and types of issues for which the mandatory resolution of cases would benefit the United States. The Committee may wish to inquire whether mandatory and binding arbitration will generally favor the United States or its treaty partner, whether particular types of issues would be more likely than others to be resolved adversely to the position of the United States, and whether it would be more appropriate for arbitration to cover all, rather than just some, of the issues arising under this treaty (and future treaties). For example, the Committee may wish to consider the potential effects of including a mandatory and binding arbitration provision in U.S. tax treaties with developing countries as well as the appropriateness of including such a provision in the U.S. Model treaty.

Taxpayer participation in arbitration proceedings and consent to initiation and decision

Taxpayer participation

Taxpayers have an important role to play under the mutual agreement procedure of most U.S. tax treaties, including the U.S.-Germany treaty. Under the existing treaty, as well as the proposed protocol and most other treaties, the taxpayer initiates the mutual agreement procedure and presents its case to the competent authorities. Similarly, under the current arbitration process of the treaty, taxpayers must be afforded the opportunity to present their views to the board.[53]

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[53] Diplomatic note on arbitration, paragraph 4, August 19, 1989. The EU mandatory arbitration procedure also permits each of the associated enterprises, at its request, to appear before the advisory commission. EU mandatory arbitration procedure, Article 11, paragraph 2. *See also* Sample Agreement,

Once initiated, however, the general framework for mutual agreement proceedings is that they are a government-to-government activity.[54] The arbitration procedures of the proposed protocol do not provide for direct taxpayer input to, or appearance before, the board (although such participation is not precluded).

Some believe that the proposed arbitration procedures do not give due regard to the effect of the arbitration process upon taxpayers, and assert that the board might benefit from a direct understanding of taxpayers' positions. Others fear that too much taxpayer involvement in the arbitration process could result in a more lengthy, expensive, and complicated set of procedures than those currently proposed. These persons believe that taxpayers' primary concern in the competent authority process is that their cases are resolved expeditiously. It is also important to note that a taxpayer need not accept the board's determination (as more fully discussed below). The Committee may wish to consider whether the proposed arbitration procedures strike the appropriate balance between efficiency of the deliberative process and taxpayer involvement.[55]

Taxpayer consent to initiation and decision

Under the current treaty, the competent authorities may not invoke arbitration unless the taxpayer both consents in advance to the arbitration and agrees in advance to be bound by the arbitration decision. Under the proposed protocol, although the taxpayer does not have the formal right to consent to the arbitration process, the third required condition for arbitration is not met until both competent authorities have received from each concerned person (generally, taxpayers and related parties affected by the case) a statement agreeing that the concerned person and each person acting on the concerned person's behalf (i.e., their authorized representatives or agents) will not disclose to any other person any information received during the course of the proceedings from either treaty country or the board, other than the determination of the board (the "nondisclosure agreement"). Accordingly, a taxpayer can prevent the initiation of arbitration proceedings by failing to enter into a nondisclosure agreement. Thus, the nondisclosure agreement has the effect of a consent and triggers the process initiating arbitration. In addition, a taxpayer or other concerned person can reject the determination of the board (including simply by failing to accept it within 30 days of receiving it from the competent authority). In that event, the case may not be the subject of further arbitration.

Under the OECD mandatory arbitration procedure, the taxpayer must request arbitration, but has the option not to accept the mutual agreement between the competent authorities

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paragraph 11, which allows the taxpayer to present its position to the arbitrators in writing to the same extent as would be allowed during mutual agreement procedures generally, and which also allows for oral presentation by the taxpayer with the permission of the arbitrators.

[54] *See, e.g.,* Rev. Proc. 2006-54, sec. 12.02(4), 2006-49 I.R.B. 1035.

[55] A number of alternative means could be devised to balance efficiency and greater taxpayer involvement, if desired. For example, a taxpayer could be permitted to submit one brief to the board at its request, limited to five or 10 pages, if such taxpayer agrees to be bound by the board's determination.

implementing the arbitration decision.[56] In contrast, under the EU mandatory arbitration procedure, the taxpayer has no right to request or refuse arbitration in advance, or to accept or reject an arbitration decision.

The Committee may wish to consider whether providing the taxpayer with the option to reject the arbitration decision is a necessary attribute of the type of arbitration adopted by the proposed protocol. In addition, the Committee may wish to inquire whether rejecting an arbitration determination could render uncreditable foreign taxes that would otherwise be creditable, due to the taxpayer's failure to exhaust its remedies.[57]

"Last best offer" vs. "independent opinion" arbitration

In general

Under the arbitration rules of the current treaty, the board is not limited to a choice between the two competent authorities' positions and is required to provide an explanation of its decision with respect to the case. The current treaty rules provide that while the decision of the board does not have precedential effect, it is expected that such decisions will ordinarily be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue, and substantially similar facts, and may also be taken into account in other cases where appropriate. Under the EU mandatory arbitration procedure, the advisory commission must base its opinion on the arm's-length principle. The competent authorities' decision must also be based on that principle, and they may agree to publish their decision, if the taxpayer consents.

Under paragraph 22(g) of Article XVI of the proposed protocol, each of the treaty countries submits to the board a proposed resolution describing its proposed disposition of the specific amounts of income, expense, or taxation at issue in the case, and a supporting position paper. The board is required to adopt as its determination one of the proposed resolutions submitted by the treaty countries, limited to a determination regarding the amount of income, expense, or tax reportable to the relevant treaty country. This method may be referred to as the "last best offer" or "final offer" approach.[58] Paragraph 22(j) of Article XVI of the proposed protocol provides that the determination of the board is binding upon the treaty countries, but adds that the determination will not state a rationale and will have no precedential value.

The OECD Sample Agreement Commentary describes the various options open to treaty partners in structuring the arbitral process. One method is the "independent opinion" approach, under which the arbitrators are presented with the facts and arguments of the parties based on

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[56] Proposed paragraph 5 of Article 25 of the OECD Model treaty.

[57] The exhaustion of remedies rule requires the exhaustion of "all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties." Treas. Reg. sec. 1.901-2(e)(5)(i).

[58] The method is also informally called "baseball arbitration" because it is similar to the arbitration method used to resolve major league baseball salary disputes.

applicable law, and then reach their own independent decision based upon a written, reasoned analysis of the facts involved and applicable legal sources. The Sample Agreement Commentary explains that there are a number of variations between the independent opinion and the last best offer approaches. For example, the arbitrators could reach an independent decision but would not be required to submit a written decision, but simply their conclusions. The Sample Agreement Commentary states that "to some extent, the appropriate method depends on the type of issue to be decided." Although the Sample Agreement takes as its starting point the independent opinion approach, the Sample Agreement Commentary suggests that the last best offer approach may be better suited to factual questions rather than questions of law and, alternatively, that competent authorities may agree to use this more "streamlined" process on a case-by-case basis.[59]

The use of the last best offer approach for decision making is intended to cause the negotiators to moderate their positions, on the theory that the arbitrators are more likely to accept a position that they view as reasonable or moderate. Consequently, the potential use in a particular case of the last best offer approach may induce the competent authorities to reach a voluntary agreement at some point in the mutual agreement process, prior to the issuance of the final arbitration decision or even before the case advances to arbitration.

Precedent, feedback, or neither

Under the current treaty, the board provides to the competent authorities an explanation of its decision. Under the proposed protocol, the board provides only a determination regarding the amount of income, expense, or tax reportable to the relevant treaty country. The OECD mandatory arbitration procedure does not take a position on this issue, but the Sample Agreement provides that, unless otherwise provided in the terms of reference to the arbitrators, the decision of the arbitrators is required to indicate the sources of law relied upon and the reasoning that led to its result.[60] The Sample Agreement Commentary states that "showing the method through which the decision was reached is important in assuring acceptance of the decision by all relevant participants."[61] It is far less important, and perhaps undesirable, to disclose such reasoning if it only represents a position of one of the competent authorities which must be chosen by the board, as in the proposed protocol.

Under last best offer arbitration, it is possible that interpretations of similar law (e.g., the arm's-length principle) might vary widely across different arbitration proceedings. Moreover, no one would know that fact because the board's rationale would never be disclosed. However, the question of whether the arbitration determination should be a reasoned opinion, and, if so, should be published, involves several considerations. A "judicial" model of published precedent, as

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[59] Sample Agreement Commentary, paragraphs 2-4.

[60] Sample Agreement, paragraph 15. Article 11 of the EU mandatory arbitration procedure requires the board to issue an "opinion," which could be published with the consent of the enterprises concerned, implying that the board's reasoning is stated in the opinion.

[61] Sample Agreement Commentary, paragraph 36.

some have recommended, might require the submission of more formalized legal briefs to the board and, therefore, more board resources, perhaps including staff, to interpret those briefs and devise a written opinion. The resulting body of bilateral international tax treaty law might, or might not, extend to other tax treaties in the U.S. tax treaty network. Overall, this might result in a much more expensive and time-consuming arbitration process than that proposed. Moreover, many competent authority cases are based on disputes that are factual in nature, or at least on disputes perceived as factual in nature by one of the competent authorities; the creation of precedent might be of limited usefulness in resolving factual disputes. On the other hand, it might be useful to the competent authorities and the taxpayers to understand the rationale for the board's determination. Under a last best offer arbitration procedure, no such feedback is available.

Given these considerations, the Committee may generally wish to inquire regarding the rationale for selecting the last best offer approach instead of the independent opinion approach or a more hybrid approach. More specifically, the Committee may wish to consider whether the lack of feedback from the board to the competent authorities of the rationale for the board's determination is an essential and desirable feature of the mandatory and binding last best offer arbitration procedure.[62]

Sources of authority for decision of the board

Under the current treaty, the board is required to decide each case on the basis of the treaty, giving due consideration to the domestic laws of the treaty countries and the principles of international law.

Under the proposed protocol, the board is required to apply the following authorities in making its determination, in the following order of priority: (a) the provisions of the treaty; (b) any agreed commentaries or explanations of the treaty countries concerning the treaty; (c) the laws of the treaty countries to the extent not inconsistent with each other; and (d) any OECD commentary, guidelines, or reports regarding relevant analogous portions of the OECD Model treaty.

With regard to (b) above, the Committee may wish to inquire regarding precisely what is meant by "any agreed commentaries or explanations of the treaty countries concerning the treaty," and whether the Treasury Department has a process in place for obtaining agreement from treaty partners with respect to the technical explanations of the Treasury Department.

The IRS has stated that the U.S. competent authority is to be guided in part by certain OECD pronouncements, as well as U.S. law:

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[62] There could be a number of ways to obtain such feedback without materially altering the proposed arbitration procedure. For example, the competent authorities could meet with the arbitration board after the board's determination has been accepted (or not accepted) by the taxpayer to learn the board's rationale for its determination. Such a "back-end" procedure might be of assistance in measuring the effectiveness of the arbitration procedure.

> With respect to requests for competent authority assistance involving the allocation of income and deductions between a U.S. taxpayer and a related person, the U.S. competent authority and its counterpart in the treaty country will be bound by the arm's length standard provided by the applicable provisions of the relevant treaty. The U.S. competent authority will also be guided by the arm's length standard consistent with the regulations under section 482 of the Code and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as published from time to time by the Organisation for Economic Co-operation and Development.[63]

Although the OECD mandatory arbitration procedure does not take a firm position on the authorities to be used, the Sample Agreement and Sample Agreement Commentary provide that the arbitrators must decide the issues in accordance with the applicable provisions of the treaty and, subject to those provisions, of the domestic laws of the treaty countries.[64] Beyond that, the Sample Agreement and Sample Agreement Commentary allow for a certain degree of flexibility with respect to interpretation. They invoke Articles 31 to 34 of the Vienna Convention on the Law of Treaties, "having regard to the Commentaries of the OECD Model Tax Convention."[65] The Sample Agreement also states that "issues related to the application of the arm's length

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[63] Rev. Proc. 2006-54, sec. 3.03, 2006-49 I.R.B. 1035.

[64] Sample Agreement, paragraph 14, and Sample Agreement Commentary, paragraphs 33-35.

[65] The Vienna Convention on the Law of Treaties ("Vienna Convention") permits a wide access to supplementary means of interpretation. Article 31 of the Vienna Convention states that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context, and in the light of its object and purpose." The "context" comprises, in addition to the text of the treaty (including its preamble and annexes), agreements made between all the parties in connection with the conclusion of the treaty and instruments made by one party in connection with the conclusion of the treaty and accepted by the other party as an instrument related to the treaty. There shall be taken into account, together with the context, any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions, any subsequent practice in the application of the treaty that establishes the agreement of the parties regarding its interpretation, and any relevant rules of international law applicable in the relations between the parties. Article 32 of the Vienna Convention states that under certain circumstances recourse may also be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion. The Committee may wish to inquire whether the nonprecedential nature of the arbitration methodology adopted by the proposed protocol will restrict the future interpretation of the treaty by the competent authorities, with regard to the broad interpretive means adopted in the Vienna Convention.

Although the Vienna Convention has not been ratified by the United States, it has been "generally recognized as the authoritative guide to current treaty law and practice." Message from the President of the United States Transmitting the Vienna Convention on the Law of Treaties Signed for the United States on April 24, 1970 (quoting from Letter of Submittal of Secretary of State to the President), S. Exec. Doc. L, 92nd Cong., 1st Sess. 1 (1971).

principle should similarly be decided having regard to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations."[66]

In the case of a difference in opinion as to the appropriate interpretation of applicable law, that is, where the authorities listed above as priorities (a), (b), and (c) are inconsistent or not agreed by the treaty countries, it is possible that the OECD authorities referenced in (d) above could rise in importance, even with respect to issues or articles that the United States has reserved its rights to treat in a different manner. On the other hand, it may be useful to specify the hierarchy of authorities to foreign-trained arbitrators. The Committee may wish to inquire whether the listing and priority of authorities to be invoked by the arbitrators, when coupled with the requirement that the arbitrators decide the case, could result in giving excessive deference in certain circumstances to OECD commentaries, guidelines, and reports.

[66] Sample Agreement, paragraph 14. The arbitration board under the EU mandatory arbitration procedure must base its opinion on the arm's length method. EU mandatory arbitration procedure, Article 11, paragraph 1.

B. Treaty Shopping

In general

The proposed protocol includes limitation on benefits rules that are similar to the limitation on benefits rules in other recent U.S. income tax treaties; in the proposed protocols with Denmark and Finland and the proposed treaty with Belgium; and in the U.S. Model treaty. These rules are intended to prevent the indirect use of the U.S.-Germany income tax treaty by persons who are not entitled to its benefits by reason of residence in Germany or the United States.

When a resident of one country derives income from another country, the internal tax rules of the two countries may cause that income to be taxed in both countries. One purpose of a bilateral income tax treaty is to allocate taxing rights for cross-border income and thereby to prevent double taxation of residents of the treaty countries. Although a bilateral income tax treaty is intended to apply only to residents of the two treaty countries, residents of third countries may attempt to benefit from a treaty by engaging in treaty shopping. This treaty shopping may involve organizing in a treaty country a corporation that is entitled to the benefits of the treaty or engaging in income-stripping transactions with a treaty-country resident. Limitation on benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping.

Although the limitation on benefits rules in the proposed protocol are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, they are not identical, and the Committee may wish to inquire about certain differences. In particular, the Committee may wish to examine the rules for derivative benefits, certain triangular arrangements, and a German Investment Fund and *Investmentaktiengesellschaft* (collectively referred to as *Investmentvermögen*).

Derivative benefits

Like the proposed protocols with Denmark and Finland and the proposed treaty with Belgium, and like other recent treaties, the proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners (referred to in the proposed protocol as equivalent beneficiaries) would have been entitled to the same benefits for the income had those owners derived the income directly.

The derivative benefits rules may grant treaty benefits to a treaty country resident company in circumstances in which the company would not qualify for treaty benefits under any of the other limitation on benefits provisions. The U.S. Model treaty does not include derivative benefits rules. The Committee may wish to inquire about the circumstances that justify inclusion of these rules in new treaties notwithstanding their absence from the U.S. Model treaty.

Triangular arrangements

The proposed protocol includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a German resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Germany. Similar anti-abuse rules are included in other recent treaties and in the proposed protocols with Denmark and Finland and the proposed treaty with Belgium. The U.S. Model treaty, however, does not include rules addressing triangular arrangements. The Committee may wish to ask the Treasury Department about the circumstances that justify inclusion of the anti-abuse rules notwithstanding their absence from the U.S. Model treaty. In particular, the Committee may wish to inquire whether the Treasury Department will insist on inclusion of anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty partner resident.

The triangular arrangement rules in the proposed protocol potentially apply not just when a German company derives U.S.-source income that is attributable to a third country permanent establishment, but also when a U.S. company derives German-source income that is attributable to a third country permanent establishment. By contrast, the triangular arrangement rules in the proposed protocols with Denmark and Finland and in the proposed treaty with Belgium apply only to U.S.-source income derived by residents of the other treaty countries. The Technical Explanations to the proposed protocols with Denmark and Finland state that the triangular arrangement rules apply only to U.S.-source income (and not to Danish- or Finnish-source income) because U.S. internal tax rules do not exempt from tax the income of a third-country permanent establishment of a U.S. resident. The Committee may wish to inquire why, given the lack of such an exemption in internal U.S. tax rules, the proposed protocol's triangular rules potentially apply to German-source income of a U.S. company's third-country permanent establishment.

German *Investmentvermögen*

The proposed protocol includes rules restricting eligibility for treaty benefits for German *Investmentvermögen*. Under these rules, a German *Investmentvermögen* is eligible for treaty benefits only if at least 90 percent of the shares or other beneficial interests in the *Investmentvermögen* are owned directly or indirectly by residents of Germany that are entitled to treaty benefits under the limitation on benefits rules for individuals, governments, publicly-traded companies, tax-exempt organizations, or pension funds or by persons that are equivalent beneficiaries with respect to the income derived by the *Investmentvermögen* for which benefits are being claimed. The Committee may wish to ask the Treasury Department why these special rules are necessary.

C. Zero Rate of Withholding Tax on Dividends from 80-Percent-Owned Subsidiaries

In general

When certain conditions are met, the proposed protocol eliminates withholding tax on dividends paid by a company that is resident in one treaty country to a company that is a resident of the other treaty country and that owns at least 80 percent of the stock of the dividend-paying company (often referred to as "direct dividends"). The elimination of withholding tax on direct dividends is intended to reduce the tax barriers to direct investment between the two treaty countries.

Under the present treaty, direct dividends may be taxed by the source country at a maximum rate of five percent. Both Germany and the United States impose withholding tax on direct dividends under their internal tax laws. The principal effects of the zero-rate provision on U.S. taxpayers and the U.S. tax base would be (1) to relieve U.S. companies of the burden of German withholding tax on dividends qualifying for the zero rate; (2) to increase the U.S. tax base by eliminating foreign tax credits for German withholding tax that would be imposed in the absence of the zero-rate provision; and (3) to decrease the U.S. tax base by eliminating the U.S. withholding tax on dividends paid by U.S. companies to German companies eligible for the zero rate.

Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the U.S. and OECD models do not provide an exemption. By contrast, many bilateral income tax treaties of other countries eliminate withholding taxes on direct dividends between treaty countries, and the EU Parent-Subsidiary Directive repeals withholding taxes on intra-EU direct dividends. Recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom include zero-rate provisions. The Senate ratified those treaties in 2003 (Australia, Mexico, United Kingdom), 2004 (Japan, Netherlands), and 2006 (Sweden). The zero-rate provisions in those treaties are similar to the provision in the proposed protocol.[67]

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends paid by a treaty country resident company and beneficially owned by a company that is a resident of the other treaty country and that has directly owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined.

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally apply under the proposed protocol. To qualify

[67] The treaty with Japan provides a zero-percent rate at a lower ownership threshold than the threshold in the proposed protocol and the other treaties (more than 50 percent as opposed to at least 80 percent).

for the zero rate, the dividend-receiving company must: (1) satisfy the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority.

The proposed protocol provides that the zero-rate provision will have effect for amounts paid or credited on or after the first day of January of the year in which the proposed protocol enters into force.[68]

Issues

In general

The proposed protocols with Denmark, Finland, and Germany and the proposed treaty with Belgium would bring to ten the number of U.S. income tax treaties that provide a zero rate for direct dividends. Because zero-rate provisions are a relatively recent but now prominent development in U.S. income tax treaty practice, the Committee may wish to consider the costs and benefits of zero-rate provisions; the Treasury Department's criteria for determining when a zero-rate provision is appropriate; and certain specific features of zero-rate provisions such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements.

Costs and benefits of adopting a zero rate with Germany

Tax treaties mitigate double taxation by resolving potentially conflicting source and residence country claims of taxing rights for a particular item of income. Under most income tax treaties, source countries wholly or partly yield to residence countries the right to tax most dividends (other than dividends attributable to a permanent establishment that a company has in the source country). Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a low rate (five percent, for example) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow the possibility of double taxation. If the residence country allows a foreign tax credit for source-country withholding tax, double taxation may be mitigated or eliminated, but the effect of a credit is to violate the residence country's primary right to tax dividend income. If a residence country imposes limitations on its foreign tax credit (as the United States does with its overall and basket limitations), withholding taxes may not be fully creditable, and some double taxation may remain. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. Removing a barrier to cross-border investment is a principal argument for the proposed protocol's zero-rate provision.

[68] The January 1 effective date applies to all taxes withheld at the source. This would include, for example, withholding on interest and royalties, as well as dividends.

Direct dividends may present an appropriate circumstance for eliminating withholding tax. A company deriving business income in the United States or Germany generally is subject to net-basis income tax in that country on the business income, and when it pays a dividend out of the income to a company in the other country, the dividend income generally is taxed in that other country (subject to allowable foreign tax credits). If the dividend-paying company is at least 80-percent owned by the dividend-receiving company, the dividend-receiving company may be viewed as a direct investor (and taxpayer) in the source country rather than as a portfolio investor. A portfolio investor would be less likely to be subject to net-basis taxation in the source country; a source-country withholding tax on dividends paid to a portfolio investor therefore might be viewed as more appropriate than a withholding tax on direct dividends.

Under domestic laws, both the United States and Germany generally impose withholding tax on cross-border dividends. The zero-rate provision, therefore, would benefit direct investment in Germany by U.S. companies and direct investment in the United States by German companies. Stated differently, the zero-rate provision would provide benefits both when the United States is exporting capital and when it is importing capital. The revenue effect of the zero-rate provision is unclear: the revenue loss to the United States from the elimination of withholding tax on U.S.-source dividends might be offset in whole or part by reduced foreign tax credit claims related to German-source dividend payments.

Many countries have included zero-rate dividend provisions in their income tax treaties for longer than the United States has done. These countries include OECD members Austria, Denmark, France, Germany, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, and non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. The EU Parent-Subsidiary Directive also eliminates withholding tax on direct dividends between EU companies. Many countries have eliminated withholding taxes on dividends as a matter of internal law. Thus, although the zero-rate provision in the proposed protocol is part of a relatively recent development in U.S. income tax treaties, there is substantial international precedent. This international precedent may be a reason in itself why the zero-rate provision in the proposed protocol is appropriate: by eliminating withholding tax on direct dividends between the United States and Germany, the proposed protocol joins many existing income tax treaties and domestic and international tax rules in reducing tax barriers to foreign direct investment.

General direction of U.S. tax treaty policy

Because zero-rate provisions are common in U.S. income tax treaties that have entered into force since 2003, the Committee may wish to examine the Treasury Department's criteria for determining the circumstances under which a zero-rate provision may be appropriate. Although zero-rate provisions are common in recent U.S. treaties, recent treaties with Bangladesh, France, and Sri Lanka do not include zero-rate rules. The U.S. Model also does not provide a zero dividend withholding tax rate. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only based on an evaluation of the overall balance of benefits under the treaty. The Committee may wish to ask what overall balance considerations might prompt the Treasury Department not to seek a zero-rate provision in a treaty that has limitation-on-benefits and information-exchange provisions meeting the highest standards.

Specific design features

The Committee also may wish to examine certain specific design features of zero-rate provisions, features such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements. The Committee may wish to ask the Treasury Department what factors support a minimum ownership requirement of 80 percent and what factors may argue for a lower ownership threshold. The Committee also may wish to ask the Treasury Department why a 12-month holding period strikes a proper balance between the competing considerations of, on the one hand, preventing short-term shifting of ownership to claim the zero rate and, on the other hand, of allowing the zero rate in connection with ordinary, non-abusive structures.

The Committee may wish to inquire about the proposed protocol's rule that the 80-percent ownership requirement may be satisfied by taking into account only stock owned directly. Other recent treaties and protocols have provided that the 80-percent ownership requirement may be satisfied both by direct stock ownership and by stock owned indirectly through one or more treaty-country residents. The Committee may wish to ask what considerations determine whether zero-rate treaty provisions should permit indirect ownership to be taken into account in testing whether ownership rules are satisfied.

The Committee may wish to ask whether the proposed protocol's special limitation-on-benefits conditions for qualification for the zero rate – for example, the active trade or business and ownership and base erosion tests – are likely to be included in future treaties, and how these special provisions might change as zero-rate provisions become more widespread in the U.S. income tax treaty network.

Because the zero-rate provision is effective for amounts paid or credited on or after the first day of January of the year in which the proposed protocol enters into force, the provision may have retroactive effect. By contrast, the U.S. Model treaty effective date for taxes withheld at source (and for other taxes) is prospective. The Committee may wish to ask Treasury Department about the rationale for applying the zero-rate provision retroactively; whether this retroactive application may cause administrative problems; and whether retroactive effective dates for dividend withholding rules may be included in future treaties.[69]

[69] As stated above, the retroactive effective date applies to all taxes withheld at the source, not just the withholding tax on dividends. Thus, similar issues may arise with respect to other payments subject to retroactive application.

D. Visiting Professors and Teachers; Students and Trainees

Treatment under proposed protocol

The proposed protocol would slightly modify the application of income taxes to certain individuals who visit the United States or Germany as students, teachers, or academic researchers. The present treaty (Article 20) provides that a professor or teacher who visits the United States from Germany or Germany from the United States for a period of two years or less for the purpose of carrying out advanced study or research or for teaching at an accredited university, college, school, or other educational institution, or a public research institution or other institution engaged in research for the public benefit, is exempt from tax on any remuneration received for such teaching or research. In addition, the present treaty provides that certain payments received by a visiting full-time student or business apprentice for purposes of support and maintenance are exempt from tax in the host country, provided that such payments are from sources outside the host country. The present treaty provides a $5,000 (or its Deutsch Mark equivalent) exemption from host country tax for personal service income earned by a full-time student or business apprentice within the host country. This exemption applies only for a period of four years or less.

Under Article 20 as amended by the proposed protocol, the tax treatment of professors or researchers is much the same as the present treaty. Article 20 as amended provides that the primary purpose of the professor or teacher must be the carrying out of advanced study or research or teaching at an accredited university or other recognized educational institution, or an institution engaged in research for the public benefit. The proposed protocol allows for an exemption from host country taxation for the two-year period beginning on the date the professor or researcher first visits the host nation, even if he or she continues to remain in the host country after two years. The present treaty retroactively denies any exemption to a professor or researcher who remains in the host country longer than two years. Under the proposed protocol, although the exemption will apply only if the taxpayer's stay is a temporary one, that taxpayer will not retroactively lose his or her exemption if the temporary stay lasts in excess of two years. Additionally, the proposed protocol, in conformity with the U.S. Model treaty, increases the exemption amount for personal service income earned by a full-time student or business apprentice from $5,000 to $9,000.[70] This exemption amount is meant to serve as a proxy for the combined amount of the U.S. personal exemption and standard deduction.

Issues

Teachers and professors

Unlike the U.S. Model treaty, but like the present treaty, the proposed protocol would provide an exemption from the host country income tax for income an individual receives from teaching or research in the host country for a period not exceeding two years. Under the terms of both the present treaty and proposed protocol, a U.S. person who is serving temporarily in

[70] The equivalent amount of the exemption provided for in the proposed protocol is calculated in euros.

Germany as a professor or researcher at a university can receive a significant exemption from income tax for any income earned for these services. Under Code section 911, a U.S. citizen or resident who is present in a foreign country for at least 330 full days in any 12-month consecutive period, or a U.S. citizen who is a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year, is entitled to exclude $85,700 of non-U.S. source earned income attributable to personal services performed by that individual during that period.[71] Additionally, such an individual is allowed either an exclusion or a deduction from gross income for certain foreign housing costs paid or incurred on behalf of the individual. Thus, the combined effect of Code section 911 and the treaty provision is to allow a professor or researcher to receive remuneration of $85,700 without being subject to either U.S. or German tax. Likewise, both the present treaty and proposed protocol provide an exemption from U.S. tax for a German person who is visiting the United States as a professor or researcher. The proposed protocol continues to afford this tax-exempt treatment to professors and researchers, but unlike the present treaty, the proposed protocol would not cause the professor or researcher to lose his tax-exempt status retroactively if his temporary stay in the host country were to last longer than two years.

The proposed protocol has the effect of continuing to make cross-border visits by professors and researchers financially attractive. Ignoring relocation expenses, a U.S. citizen or permanent resident may receive more net, after-tax remuneration from teaching or research from visiting Germany than if he or she had remained in the United States. German professors or researchers who are visiting the United States are similarly advantaged over their domestic counterparts.

While the proposed treaty retains the benefit of tax exemption only for those professors and researchers who are teaching abroad on a temporary basis, it ceases to penalize those recipients of this benefit who stay longer than two years. On the one hand, this provision could be seen as eliminating a harsh consequence to those academics that, whether through unforeseen circumstances or poor tax advice, stayed in their host country only a few days over the two year limit and were retroactively denied their exemption as a result. On the other hand, the proposed protocol provides no guidance towards determining when a teacher or researcher has in fact ceased to become a temporary visitor. Under the proposed protocol, it is not clear when, if ever, a teacher who relocates to a foreign country and decides to remain in that country will retroactively lose the benefit of the exemption.

The Committee may wish to satisfy itself that it would not be appropriate to give more substance to the meaning of a professor or teacher who is "temporarily present." Alternatively, the Committee may wish to satisfy itself that the inclusion of a grace period that extends beyond the two-year exemption period, but that nonetheless has a firm termination date, would not be an effective means of alleviating a tax burden on those academics who needed to extend their temporary stay slightly, while providing a firm rule for tax administrators who need to make a determination if a stay is in fact temporary.

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[71] The $85,700 exemption amount for 2007 is indexed for inflation. Sec. 911(b)(2)(D).

Full-time students and business apprentices

The proposed protocol, like the present treaty, has the effect of exempting from host country tax any payments received for the maintenance, education, and training of full-time students and business apprentices as visitors from the United States to Germany or as visitors from Germany to the United States. This provision would have the effect of reducing the cost of such education and training received by visitors.

Under the proposed protocol, a visiting student or business apprentice is exempt from host country taxation on up to $9,000 of personal service income earned to support himself while abroad. This exemption amount has been raised from $5,000 in the present treaty. The $9,000 level falls in between the current U.S. zero-tax rate amount and the German zero-tax rate amount.

The Committee may wish to satisfy itself that it would not be more appropriate to link the exemption rate to either the host country or resident country rates, so as to create equity between the student and similarly situated taxpayers.

E. Treatment of Social Security Benefits and Pensions

Article 18 of the present treaty generally governs the treatment of pension benefits, annuities, alimony, and child support paid to a resident of a treaty country; these rules are unchanged by the proposed protocol. Article 18 provides with respect to pensions that, subject to Article 19, pensions and other similar remuneration derived and beneficially owned by a resident of a treaty country in consideration of past employment are taxable only in the recipient's country of residence. Article 19 of the present treaty governs government service and social security and other public pension benefits paid by a treaty country to a resident of the other treaty country. Paragraph 2 of Article 19 provides that social security benefits paid under the social security legislation of a treaty country and other public pensions (which the Technical Explanation states is intended to refer to U.S. Tier 1 Railroad Retirement benefits) paid by a treaty country to a resident of the other treaty country shall be taxable only in the other treaty country. The treaty country of residence must treat the benefit or public pension as though it were a social security benefit paid under the social security legislation of the treaty country of residence. These rules apply to social security beneficiaries whether they have contributed to the system as private-sector or governmental employees.

Article VIII of the proposed protocol incorporates as paragraph 5 of Article 18 the rule of paragraph 2 of Article 19. Article X makes a conforming change to Article 19. In addition, the proposed protocol modifies the titles of Articles 18 and 19 to reflect those changes.

On June 1, 2006, the United States and Germany signed a Joint Declaration with regard to Article 18 of the treaty as amended by the proposed protocol. The Joint Declaration recognizes that, effective January 1, 2005, and subject to a long phase-in period, Germany changed its taxation rules relating to retirement income and pension plan contributions. The changes, when fully implemented, will combine full taxation of retirement income with extended tax exemption of pension plan contributions. Accordingly, the United States and Germany state in the Joint Declaration their intentions to enter into consultations at the appropriate time, but not before January 1, 2013, to amend the proposed protocol to allow for the source country taxation of retirement income. Such source country taxation is to be based on the following principles: (1) social security benefits may also be taxed by the source country, in an amount not to exceed 15 percent of the gross payment, and (2) pensions and other similar remuneration paid in consideration of past employment may also be taxed in the country in which the employment had been exercised for a substantial period of time, in an amount not to exceed 15 percent of the gross payments. Germany declared its intention that such modifications should not enter into force before January 1, 2015.

The treatment of social security benefits in both the current treaty and the proposed protocol differ from that in the U.S. Model treaty, which provides for exclusive source country taxation of social security benefits. Permitting source country taxation of both pension and social security benefits pursuant to the Joint Declaration in addition to residence country taxation would represent a further deviation from the U.S. Model treaty position. The Committee may wish to consider whether such a deviation from the U.S. Model treaty pursuant to the Joint Declaration would be justified under the circumstances in which the applicable rules under German domestic tax law are moving closer to those of the United States.