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International Tax Advisory

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Insights Into Recent Regulatory, Judicial and Legislative Developments

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United States and Germany Agree to Amend Income Tax Treaty

Protocol Amending the United States-Germany Income Tax Treaty (June 1, 2006)

Overview

The Protocol amends the United States-Germany income tax treaty (the "Treaty") that took effect on August 21, 1991. Highlights include elimination of withholding tax on dividends paid by an 80% owned subsidiary to its parent company, a new limitation on benefits provision ("LOB") consistent with recent treaty practice and, in a ground breaking move, "mandatory" arbitration of competent authority disputes in certain situations.

Withholding Tax on Dividends

The Protocol eliminates withholding tax on dividends paid by a subsidiary corporation to its parent company if the parent owns at least 80% of the voting power in the dividend paying company for the 12-month period ending on the day on which entitlement to dividends is determined. The zero withholding tax benefit also applies to certain pension funds that are resident in the non-source country.

A parent company must also satisfy one of the following conditions under the LOB provision to qualify for the withholding tax exemption. It must be: (i) publicly traded on a stock exchange in Germany or the U.S. (including the NASDAQ system) and either its principal class of shares is primarily traded on an exchange located in the company's home country, or it is managed and controlled in its home country; (ii) at least 50% owned (considering voting power and value) by publicly traded companies described in the preceding clause; (iii) engaged in a trade or business to which the dividend is attributable and at least 50% owned (considering all classes of stock) by persons entitled to Treaty benefits and in compliance with base erosion restrictions; (iv) at least 95% owned (considering voting power and value of its shares) by "equivalent beneficiaries" (European or North American persons that are eligible for comparable treaty benefits from the source country) and in compliance with base erosion restrictions; or (v) the recipient of a ruling from the source country to the effect that it was not organized and operated for the principal purpose of obtaining benefits under the Treaty.

Branch Profits Tax

The Protocol provides that the branch profits tax may apply to a German corporation, but the rate is limited to the rate that would apply if the branch were incorporated and it paid a dividend to the German corporation. If the German corporation owns 100% of the U.S. branch, the branch profits tax does not apply because the corporation would not be subject to withholding tax on dividends if the branch were a wholly-owned subsidiary. There is no holding period requirement for the exemption from branch profits tax.

Binding Arbitration

The Protocol requires binding arbitration if the competent authorities of the U.S. and Germany are unable reach agreement under the mutual agreement provisions of the Treaty in disputes involving the following issues: (i) residence of a natural person; (ii) existence of a permanent establishment in either the U.S. or Germany; (iii) determination of business profits; (iv) associated enterprises; and (v) royalties. The competent authorities may also agree to submit any other matter governed by the mutual agreement provision to binding arbitration. The presenter of the case (the taxpayer) and any other persons whose tax liability to either state may be directly affected by resolution of the dispute ("concerned persons") must agree not to disclose information received during the arbitration.

The Protocol contains procedural rules and principles governing the arbitration proceeding. Each country appoints one member of the arbitration board and within 60 days of the appointment the two members

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Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202-756-3300
Fax: 202-756-3333

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must appoint a third member as chair of the arbitration board. The chair cannot be a citizen of either the U.S. or Germany. If the two members of the panel are unable to agree on a third member, the third member will be appointed by the highest ranking member of the secretariat at the centre for tax policy and administration of the Organization for Economic Cooperation and Development ("OECD") who is not a citizen of either the U.S. or Germany.

Each party must submit a proposed resolution to the arbitration panel within 90 days of the appointment of the chair and each party may also submit a reply submission. Within six months of the appointment of the chair, the panel will select one of the proposed resolutions which is binding if the parties accept the determination within 30 days. The panel will offer no rationale or explanation for the decision and the determination will have no precedential value. Finally, it should be noted that all rules and procedures relating to binding arbitration may be modified by the competent authorities as necessary to implement the intent of the binding arbitration provision.

Other Provisions

The Protocol modifies the definition of "resident" in line with the U.S. treatment of fiscally transparent entities under code section 894(c). The new rule provides that an item of income derived by a person that is fiscally transparent under the laws of Germany or the U.S. is considered to be derived by a resident of either country to the extent the item is treated as income of a resident under the law of either country. The new LOB provision is generally consistent with LOB provisions in the new U.K. treaty and the amended Dutch treaty (as well as other recently proposed modifications of treaties with European countries). Among other things, the provision extends Treaty benefits to companies owned by "equivalent beneficiaries" (generally speaking, North American or European companies eligible for comparable benefits contained in a treaty between the source country and a third country).

The Protocol also provides that OECD transfer pricing guidelines will apply to determine business profits to be attributed to a permanent establishment ("PE"). Profits to be attributed to the PE include only profits derived from assets used, risks assumed and activites performed by the PE. Any method described in the OECD guidelines as acceptable for determining an arm's-length result may be used to determine the income of a PE. This linkage to OECD guidelines is consistent with provisions in the new U.S. income tax treaties with the U.K. and Japan. The PE is treated as having the amount of capital it would need if it were a separate and distinct enterprise engaged in the same or similar activites. The capital attributed to the PE of a financial institution other than an insurance company is determined by allocating total equity among offices on the basis of risk-weighted assets attributable to each office (as long as the financial institution risk weights its assets in the ordinary course of its business).

Effective Date

The Protocol will generally enter into force on the day on which instruments of ratification are exchanged. The Protocol is effective in respect of withholding taxes for amounts paid on or after January 1 of the year in which the exchange of instruments of ratification occurs and in respect of other taxes on income for any taxable year beginning on or after the first day of January next following the general effective date. The binding arbitration provisions in the Protocol are effective with respect to cases that are under consideration by the competent authorities on the general effective date and cases that come under consideration after that date.

Planning Considerations

Since it is likely that the Protocol will be finalized in due course, U.S. taxpayers with operations in Germany and German taxpayers with operations in the U.S. should consider the Protocol in structuring their operations in each country.

For additional information contact Kevin Rowe (212-210-9505) or Edward Tanenbaum (212-210-9425).

International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404-881-7481

Edward Tanenbaum
Co-Chair
212-210-9425

Pinney L. Allen
404-881-7485

Gideon T. J. Alpert
212-210-9403

J. Bradford Anwyll
202-756-3432

Saba Ashraf
404-881-7648

John F. Baron
704-444-1434

Henry J. Birnkrant
202-756-3319

Robert T. Cole
202-756-3306

Philip C. Cook
404-881-7491

James E. Croker, Jr.
202-756-3309

Jasper L. Cummings, Jr.
202-756-3386

Eva Farkas-DiNardo
212-210-9592

Jennifer L. Dowell
404-881-4491

Tim L. Fallaw
404-881-7836

Terence J. Greene
404-881-7493

Michelle M. Henkel
404-881-7633

L. Andrew Immerman
404-881-7532

Andrea Lane
202-756-3354

Brian E. Lebowitz
202-756-3394

Clay Littlefield
704-444-1440

Edgar D. McClellan
202-756-3462

Nicki N. Nelson
404-881-4288

Timothy J. Peaden
404-881-7475

Kevin M. Rowe
212-210-9505

Gerald V. Thomas II
404-881-4716

Charles W. Wheeler
202-756-3308