

Lower tax court rules that dividends paid to US S-Corporation qualify for a reduced 5% or 0% WHT under the Germany-US DTT

Lower tax court decision confirms 2013 federal tax court decision and rejects tax authorities' view that law change has changed the treatment of S-Corporations.

On 10 March 2023, the lower tax court of Cologne published a long-awaited decision dated 16 November 2022 and ruled that a US "S corporation," which is a transparent entity for US federal income tax purposes, was entitled to a 0% withholding tax (WHT) rate pursuant to article 10 (3) (a) (bb) of the Germany-US double tax treaty (DTT). The lower tax court also ruled that, pursuant to section 50d (1) sentence 11 of the German income tax code (ITC), the shareholders of the S corporation were required to file for the dividend WHT refund and not the S corporation itself, and that such provision is merely procedural and does not govern whether a particular treaty provision applies in determining the dividend WHT rate.

Case background

In the case at hand, a German GmbH paid a dividend to its 100% shareholder, a US resident corporation that elected to be treated as a transparent entity for US federal income tax purposes under subchapter S of the US Internal Revenue Code ("S corporation"). The income of the S corporation was taxed for US federal income tax purposes only at the level of the shareholders. The shareholders were US tax resident individuals and US trusts with US tax resident individuals as beneficiaries.

The German GmbH withheld tax at a rate of 26.375% on the dividend payment to the S corporation. The S corporation applied to the German tax authorities for a 0% WHT rate based on article 10 (3) (a) (bb) of the DTT (for certain companies holding at least an 80% interest in the company paying the dividends) and requested a refund of the tax withheld. The tax authorities denied the request but granted a rate reduction to 15% pursuant to article 10 (2) (b) of the DTT, which was based on the individual shareholders of the S corporation receiving the dividends. The tax authorities argued that section 50d (1) sentence 11 ITC (which states that only the person to whom the tax law of its country of residence allocates the income is entitled to claim a refund of WHT) overrides the DTT and requires the tax authorities to determine treaty eligibility for a transparent entity at the level of the shareholders that are ultimately subject to tax for local country tax purposes.

After an unsuccessful appeal to the federal tax office and certain procedural discussions, the case was brought to the lower tax court of Cologne.

Decision of the lower tax court of Cologne

The lower tax court of Cologne ruled that the dividends paid to the S corporation by the German GmbH were subject to WHT at a 0% rate based on articles 1(7) and 10 (3) (a) (bb) of the DTT. The lower tax court's ruling followed and confirmed a 2013 federal tax court decision that the WHT provisions of the DTT applied to a US S corporation even though it was transparent for US federal income tax purposes.

The lower tax court rejected the argument that section 50d (1) sentence 11 ITC overrides the provisions in the DTT. The lower tax court provided a detailed analysis and came to the conclusion that section 50d (1) sentence 11 ITC must be seen as a mere procedural provision not having an impact on the treaty analysis. In providing its opinion, the lower tax court took into consideration the rationale of the law introducing the provision in 2013, as well as the original legislative materials. The lower tax court concluded that the wording of the provision, the original intent of the legislator, and the position of the provision in the ITC indicate a mere procedural character of section 50d (1) sentence 11 ITC. The tax court also confirmed that the repositioning of the provision within the ITC in 2021 did not change the character of the provision as a mere procedural provision.

The tax court further concluded that pursuant to section 50d (1) sentence 11 ITC, the WHT

refund claim must be filed by the shareholders of the S corporation rather than the S corporation itself. This result, however, was expected, and the refund claim already had been filed by the S corporation, as well as its shareholders.

Comments

The decision of the lower tax court has been eagerly awaited by taxpayers and comes almost 10 years after the 2013 S-Corporation decision of the federal tax court. The tax authorities have been arguing that the 2013 federal tax court decision no longer applied, because section 50d (1) sentence 11 ITC became effective after such decision. As such, this issue had to be brought to court again.

It is highly welcome that the lower tax court confirmed that the repositioning in 2021 of section 50d (1) sentence 11 ITC to section 50d (1 1a) ITC does not affect the character of the provision as a mere procedural provision. This confirmation is important in regard to US investments into Germany and has led to much frustration over the last couple of years for US taxpayers and advisors. WHT refund applications within internal appeals in this regard were not processed by the federal tax office for several years, and there are countless refund applications still pending at the federal tax office waiting for a decision.

It is widely expected that the tax authorities will appeal the decision of the lower tax court and the case ultimately will be decided by the federal tax court. Affected taxpayers and US investors with pending WHT refund applications likely must wait for another few years until a final decision of the federal tax court is available.

The case decided by the lower tax court should not only be of relevance for US S corporations receiving dividends from its German subsidiaries but also for US limited liability companies that are treated as either partnerships or disregarded entities for US federal income tax purposes and that receive dividends from their German subsidiaries.

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