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AICGS POLICY REPORT

BREAKING DOWN BARRIERS TO TRADE AND INVESTMENT: THE U.S.-GERMANY INCOME TAX TREATY REVISITED

Mayer, Brown, Rowe & Maw, LLP

AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES THE JOHNS HOPKINS UNIVERSITY

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ISBN 0-941441-87-3

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FOREWORD

This Policy Report is the third in a series of studies that examine the challenges facing an increasingly interdependent transatlantic market place. The growing cross-border trade and investment between Germany and the United States in particular has been of central importance to economic growth on both sides of the Atlantic.

One of the main problems for those engaged in foreign direct investment, mergers, and trade of all sorts is the obstacle created by competing taxation systems, which can impede the flow of economic activities. A clash of jurisdictions and regulations can generate double taxation penalties. With an enormous stake in the amount of German and American economic interests in both countries, policymakers need to continuously review how regulations can encourage, not impede, that flow of interests. This can be of importance to individuals and large corporations alike.

This study proposes changes in the taxation regimes in Germany and the United States and recommends a revised treaty to accommodate the rapidly changing environment of transatlantic trade and travel. The study offers considerations for policymakers in Washington and Berlin and addresses the needs and concerns of those engaged in the German-American economic partnership. It draws on lessons from other bilateral tax treaties and serves as an illustration of the larger set of challenges to a global marketplace.

We are grateful to Rafic H. Barrage (Washington, D.C.), Werner J. Hein (Washington, D.C.), Dr. Ingo Kleutgens (Frankfurt), Dr. Patrick Sinewe (Frankfurt), and Charles S. Triplett (Washington, D.C.) for their efforts to shed light on a complicated issue of great importance to government and corporate leadership. We are also grateful to the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft for its generous support of this publication.

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INTRODUCTION

The current income tax treaty between the United States and the Federal Republic of Germany (which was signed on August 29, 1989, and entered into force on August 21, 1991) should be renegotiated to reflect the close economic ties between the two countries and to modernize the treaty in light of more recent model income tax treaties as well as recent income tax treaties that the United States has concluded with its other major trading partners.[1]

Chapter 1 of this paper explains the role of government and taxpayers, from the German and U.S. perspectives, in negotiating income tax treaties. Chapter 2 provides a summary of proposals for a renegotiated treaty, and Chapter 3 explains why the current treaty should be renegotiated. Chapter 4 then analyzes the provisions of the current U.S.-Germany Income Tax Treaty and makes specific proposals for a renegotiated treaty.

01 CHAPTER ONE

NEGOTIATING BILATERAL INCOME TAX TREATIES: THE ROLE OF THE GOVERNMENT[2]

Overview of Bilateral Income Tax Treaties

Most nations tax their residents (individuals and entities) on their worldwide income and tax non-residents on their income from domestic sources. As a result of increasing economic interdependence among nations and cross-border trade and investment, this system of taxation gives rise to the potential for double taxation of income (i.e., both the country from which the income is derived (the source country) and the country of residence may tax the same item of income).

Such double taxation may impede the free flow of international trade and investment, causing economic inefficiencies. As discussed more fully below, a significant purpose of income tax treaties is to reduce or eliminate double taxation, thereby allowing for the free flow of international trade and investment.[3] Income tax treaties achieve this objective by: (1) allocating taxing jurisdiction so as to avoid double taxation; (2) reducing source state taxation; (3) prohibiting discrimination based on alienage, foreign organization, or foreign ownership; and (4) promoting resolution of situations in which the income taxable by one contracting state as opposed to the other contracting state is in question.[4]

Germany

Most of the tax treaties signed by Germany are structured in accordance with the Organisation for Economic Co-operation and Development's (OECD) model treaty.[5] Hereby the conclusion of double tax treaties as international agreements must be conducted in a multiphase procedure where different legal bodies are involved. In particular, the conduct of negotiations and its legal virtue requires a parliamentary proceeding. The following steps have to be distinguished:

NEGOTIATIONS

The conclusion of a tax treaty is preceded by negotiations. In Germany, the Federal Ministry of Finance (*Bundesfinanzministerium*), represented by a chief negotiator, is responsible for conducting treaty negotiations. Deviating from the usual legislation procedure, the executive authorities are exclusively entitled to prepare any subsequent conclusion. The Ministry of Finance is also responsible, at the conclusion of the negotiations, for authenticating two copies of the treaty by initialing each page. This authentication results in the binding effect of the wording of the treaty and constitutes (only) the obligation to submit the treaty to the parliament, as discussed below. At this stage, the treaty itself does not become effective vis-à-vis the contracting states.

RATIFICATION AND ENTRY INTO FORCE

Once the government has finalized the negotiations over the treaty it has to obtain the consent of the legislature in the form of a federal act in accordance with the Constitutional Act (*Grundgesetz*). These legal bodies are, as a rule, the Lower House of German Parliament (*Bundestag*) and the Federal Council (*Bundesrat*). Double tax treaties must be adopted by both houses.

The *Bundesrat* and the *Bundestag* make their decisions on the basis of the draft of the treaty, which they receive from the government together with the notes the government has exchanged with the contracting state and the protocols over the negotiations.

The final ratification is enacted by the Federal President (*Bundespräsident*) by means of signing the ratification deed. The signature of the Federal President is a formal requirement. The Federal President can refuse to sign only in the case that the treaty violates fundamental principles of constitutional law. By the signature of the Federal President, Germany declares that it accepts the treaty as a legally binding agreement for purposes of public international law. Upon the exchange of both ratification deeds by the German ambassador or a representative of the government, the treaty becomes effective vis-à-vis the contracting states.

The United States

The tax treaty-making process in the United States is comprised of the following steps: negotiations, signing, advice and consent, ratification, and entry into force.[6] The U.S. Constitution provides that "[the President] shall have the power, by and with the advice and consent of the Senate to make treaties, provided two thirds of the Senators concur."[7] Therefore, unlike domestic tax legislation, treaties are negotiated exclusively by the executive branch of the government.[8]

NEGOTIATIONS

Treaty negotiations are undertaken by the Assistant Secretary for Tax Policy (currently, Mr. Gregory Jenner (acting)) and the International Tax Counsel of the U.S. Department of the Treasury ("Treasury") (currently, Ms. Barbara Angus). The negotiations are usually commenced by forwarding to the treaty partner a copy of the current U.S. model income tax treaty, described in greater detail below, which serves as a first offer of the U.S. negotiating position. After several rounds of negotiating the specific terms of the treaty, the parties initial the treaty. The treaty is subsequently signed by the President or his delegate on behalf of the United States. At this point, the treaty is officially made available to the public. The Department of State and Treasury then prepare a report to the President recommending that he transmit the treaty to the Senate for ratification. The President then forwards this report together with the treaty and a transmittal letter to the Senate.

ADVICE AND CONSENT

Jurisdiction over income tax treaties lies with the Senate Foreign Relations Committee, which schedules hearings regarding the treaty.[9] A representative from Treasury usually testifies in support of the treaty at this hearing. Both Treasury and the Joint Committee on Taxation advise the Foreign Relations Committee on the treaty by preparing separate reports explaining in detail each of the treaty's provisions.[10] The Foreign Relations Committee also prepares its own report with respect to the treaty. However, these reports tend to be released very close to the date set for the hearing. As a result, taxpayers are afforded very little or no opportunity to comment on particular issues presented by the pending treaty.[11]

Following committee action, the treaty is reported to the full Senate, which must vote in favor of ratifying the treaty by a vote of two thirds of the members present. The Senate may offer amendments, reservations, or understandings with respect to the treaty, which must be approved by a majority vote. The other country may accept such amendments, reservations, or understandings, usually through a protocol to the treaty. If, however, the other country does not accept such amendments, reservations, or understandings, the treaty must be renegotiated or it may effectively die.

RATIFICATION AND ENTRY INTO FORCE

If the Senate gives its advice and consent, the executive branch then prepares instruments of ratification. The President then signs the treaty and the Statement of Ratification. If the parallel process has been completed in the other country, the treaty then enters into force upon an exchange of the instruments of ratification or, depending on the terms of the partic-

ular treaty, when each country has notified the other that its constitutional and statutory requirements for the treaty's entry into force have been completed.

As alluded to above, taxpayers are afforded almost no opportunity to influence the tax treaty-making process. Prior to the official release of the proposed tax treaty, which occurs after the treaty has been negotiated and signed by the parties, taxpayers are informed only of the fact that negotiations are underway and interested parties are invited to submit comments.[12] Accordingly, taxpayers are generally unable to discern the important issues for negotiation and cannot effectively comment on the proposed treaty. Treasury has justified the secrecy surrounding the tax treaty-making process by citing the need for confidentiality in sensitive, quasi-diplomatic negotiations.[13] In a 1993 issues paper that was generally critical of the secrecy shrouding the tax treaty-making process, the American Bar Association made several recommendations on how Treasury could improve the process.[14] The recommendations included the following:

- Prior to the initiation of negotiations, Treasury should announce to the public what issues are of particular concern in negotiating or renegotiating the treaty or protocol in question;

- Treasury should publish its technical explanation of any proposed treaty well in advance of any hearings before the Senate Foreign Relations Committee. The Senate Foreign Relations Committee similarly should publish its report in good time. The hearings should not take place until at least six weeks after the reports have been made public.[15]

Treasury has not implemented any of the above recommendations.

02 CHAPTER TWO

SUMMARY OF PROPOSALS FOR A RENEGOTIATED INCOME TAX TREATY WITH GERMANY

A renegotiated income tax treaty between the United States and Germany should accomplish the following:

- Eliminate the withholding tax with respect to certain dividends and provide for reduced withholding with respect to dividends paid by U.S. Real Estate Investment Trusts (REITs) and U.S. Regulated Investment Companies (RICs);
- Maintain the exemption from withholding tax with respect to most interest and royalties;
- Provide for anti-conduit rules with respect to dividends, interest, royalties, the other income article, and the exemption from the U.S. excise tax on insurance premiums issued by foreign insurers;
- Maintain the categories of gain that are subject only to resident state taxation;
- Clarify the scope of income subject only to resident state taxation under the shipping and air transport article;
- Clarify the non-application of the U.S. excise tax on insurance policies issued by foreign insurers and reinsurers;
- Include specific provisions addressing fiscally transparent, hybrid, and reverse hybrid entities;
- Eliminate the U.S. branch profits tax and maintain the exemption from the U.S. branch level interest tax;
- Exempt from source state taxation securities loans fees, guarantee fees, and commitment fees;
- Provide rules benefiting employees and employers with respect to contributions to qualified pension schemes;
- Clarify the treatment of income, gains, or other benefits received by an employee with respect to an employee share or stock option plan;
- Amend the active trade or business test and the derivative benefits test of the limitation on benefits article;
- Explicitly adopt the OECD Transfer Pricing Guidelines with respect to transactions between associated enterprises and for purposes of attributing profits to a permanent establishment; and
- Strengthen the binding arbitration provision in the mutual agreement procedure article.

03 CHAPTER THREE

WHY THE CURRENT U.S.-GERMANY INCOME TAX TREATY SHOULD BE RENEGOTIATED

Significant Trade and Investment Between the United States and Germany

The traditional objectives of U.S. income tax treaties are the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. income tax treaties is the removal of 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.[16] Given the substantial trade and investment between the United States and Germany, the current treaty should be renegotiated to further reduce the barriers to trade and capital flows that result from the potential for double taxation.

Recognizing the importance of eliminating tax barriers to trade with its major trading partners, the United States has recently signed a new income tax treaty with Japan[17] and the United Kingdom.[18] The United States has also amended, by protocol, its existing income tax treaties with Australia, the Netherlands, and Mexico[19] and is currently negotiating a new protocol to its existing income tax treaty with Canada.[20] Among the most significant provisions of such treaties and protocols is an exemption from withholding tax with respect to certain dividends.[21] A U.S. Treasury Department official has recently encouraged the United States' other trading partners to negotiate new income tax treaties with the United States.[22]

With regard to the trading partners of the United States, in 2002 Germany ranked fifth after Canada, Mexico, Japan, and China, with imports from Germany of almost $61 billion and exports to Germany of almost $25 billion.[23] In terms of Germany's trading partners, in 2001 the United States ranked third after only France and the Netherlands.[24] Therefore, besides Germany and China, the United States has renegotiated its income tax treaties with its top five trading partners.[25] Renegotiating the current treaty would not only benefit the economies of both countries through increased cross-border investment, but would also put Germany on an equal footing with the United States' other major trading partners.

Outdated Income Tax Treaty

The 1989 U.S.-Germany Income Tax Treaty is outdated because the starting point for negotiating the treaty was the 1981 U.S. Model Treaty, the 1977 OECD Model Treaty, and an unpublished German model treaty.[26] Since 1989, the United States Treasury Department released a new model treaty in 1996 (the "U.S. Model Treaty"),[27] and the OECD updated its model treaty in 2003 (the "OECD Model Treaty").[28] These new model treaties, as well as other recent income tax treaties to which the United States

is a party, depart in many significant respects from the U.S.-Germany Income Tax Treaty, such as in the areas of the exchange of information and mutual assistance and dispute resolution, as more fully discussed in the following chapters. As the U.S. Joint Committee on Taxation has noted, treaties that were signed and entered into force more than ten years ago, including the U.S.-Germany Income Tax Treaty, should be updated because such treaties "may contain outdated provisions or may not reflect current U.S. treaty policy or other tax law developments," resulting in greater "complexity for taxpayers and tax administrators."[29] Given the substantial amount of trade and investment between the two countries, it is even more imperative that the U.S.-Germany Income Tax Treaty be renegotiated in the near future.

04 CHAPTER FOUR

SPECIFIC RECOMMENDATIONS FOR A NEW U.S.-GERMANY INCOME TAX TREATY

Elimination of Withholding Tax on Certain Dividends

CURRENT U.S.-GERMANY INCOME TAX TREATY

The United States generally imposes a 30 percent withholding tax on U.S. source dividends derived by foreign corporations and nonresident aliens not engaged in a U.S. trade or business.[30] Germany generally imposes a 20 percent withholding tax on dividends (plus 5.5 percent solidarity surcharge thereon, i.e. 21.1 percent in total) derived by non-resident companies and individuals with no German permanent establishment (PE).[31]

The U.S.-Germany Income Tax Treaty reduces the withholding tax on dividends to 5 percent of the gross amount of the dividends provided that the beneficial owner is a company that holds at least 10 percent of the voting shares of the payor company directly.[32] In all other cases, the withholding tax is generally reduced to 15 percent.[33]

PROPOSAL FOR RENEGOTIATED TREATY

Consistent with recent U.S. income tax treaties, a renegotiated treaty with Germany should exempt certain dividends from withholding tax. As previously noted, the recent income tax treaties and protocols with the United Kingdom, Japan, Australia, the Netherlands, and Mexico exempt certain dividends from withholding tax. Under those treaties, the exemption from withholding tax applies provided that the beneficial owner of the dividends directly owns more than 80 percent (or more than 50 percent in the case of the treaty with Japan) of the payor company for the 12-month period ending on the date the dividend is declared.[34] The U.S.-U.K Income Tax Treaty was the first income tax treaty to which the United States is a party that contained a provision exempting certain dividends from withholding tax.[35]

It is not clear whether the recently concluded treaties signal a broader shift in U.S. tax treaty policy, or under what circumstances the United States will seek to include a similar provision in other treaties.[36] Indeed, Senator Paul Sarbanes of the Senate Foreign Relations Committee and Ms. Barbara Angus, Treasury International Tax Counsel, have separately stated that the recent treaties should not be viewed as establishing a change in U.S. tax treaty policy.[37] Rather, future treaty negotiations seeking the exemption from withholding tax will be considered on a case-by-case basis,[38] and to demonstrate its willingness to accept similar zero-rate provisions in future treaty negotiations, the Senate Foreign Relations Committee has specifically directed the Treasury Department to “develop criteria for determining the circumstances under which the elimination of withholding tax on intercompany dividends would be appropriate in the future negotiations with other countries.”[39] Indeed, in her very recent testimony before Senate Foreign Relations Committee regarding the income tax treaty with Japan, Ms. Angus reiterated that “the elimination of source-country taxation of dividends is something that is to be considered only on a case-by-case basis. It is not the U.S. model position because we do not believe that it is appropriate to agree to such an exemption in every treaty.”[40] Ms. Angus also set forth the following factors in determining whether a particular treaty should eliminate source-country taxation of dividends: (1) The treaty must contain anti-treaty shopping rules that meet the highest standards; (2) The information exchange provision of the treaty is sufficient to allow the U.S. government to confirm that the requirements for entitlement to this benefit are satisfied; and (3) The “overall balance of the treaty will be considered.”[41]

Nevertheless, there are several reasons why a renegotiated treaty with Germany should include such a provision. First, eliminating withholding taxes with respect to certain dividends removes a significant barrier to trade by reducing double taxation.[42] This is because treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist (i.e., because of limitations under the provisions of the domestic foreign tax credit that fail to fully mitigate double taxation).[43] Second, in many cases (including the case of Germany and the United States), both the payor company and the payee company are fully subject to net-basis income taxation in their respective countries of incorporation.[44] Third, where the dividend paying company is at least 80 percent owned by the dividend-receiving company, it is appropriate to regard the dividend-receiving company as a direct investor and taxpayer in the source country.[45] Fourth, it is possible that eliminating the withholding tax with respect to certain dividends will increase the tax base (and consequently, the revenues for the fisc) of both countries, as capital investment in both countries will be made more attractive.[46] Fifth, eliminating the withholding tax with respect to certain dividends provides predictability to investors, facilitating long-term business planning. Finally, although the United States has only recently adopted an exemption from withholding tax with respect to certain dividends in certain treaties, "many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its 'Parent-Subsidiary Directive.'"[47] As the Joint Committee on Taxation noted in the context of the U.S.-U.K. Income Tax Treaty:

> In light of the fact that the United States would stand to benefit more comprehensively from zero-rate provisions in treaties with countries that currently impose withholding taxes in the relevant dividends, the general implications of this first zero-rate provision are likely to be of greater interest in the United States than the particular implications with respect to the United Kingdom [which currently does not impose withholding taxes on dividends].[48]

Moreover, although the zero-rate provisions are a departure from the U.S. Model Treaty and, therefore, should arguably be adopted only in rare circumstances, the U.S. Model Treaty is outdated and may not reflect recent treaty developments that have occurred since 1996.[49] To be sure, the Joint Committee on Taxation has recommended that the Treasury Department annually update the U.S. Model Treaty.[50]

Consistent with the U.S.-U.K. Income Tax Treaty and the U.S.-Japan Income Tax Treaty, a renegotiated treaty should also provide for reduced source state taxation (10 percent in the case of the treaty with Japan, and 15 percent in the case of the treaty with the United Kingdom) with respect to dividends paid by either a U.S. Real Estate Investment Trust ("REIT") or a U.S. Regulated Investment Company ("RIC").[51] In addition, a renegotiated treaty should exempt pension funds from withholding taxes on dividends paid by REITs and RICs.[52]

In addition, the renegotiated treaty should adopt the language contained in the U.S.-U.K. Income Tax Treaty regarding dividends that are "attributable to" a PE.[53] Such language is preferable to the language used in the U.S.-Japan Income Tax Treaty, pursuant to which dividends are taxed under Article 7 (Business Profits) if they are "effectively connected" to a PE.[54] Under U.S. law, "effectively connected" is arguably broader in scope and could subject certain items of income to tax that would not be subject to tax under the "attributable to" language.[55]

The negotiators may also consider whether to include a general "anti-conduit" provision similar to that found in the U.S.-U.K. Income Tax Treaty and the U.S.-Japan Income Tax Treaty.[56] The U.S.-U.K. Income Tax Treaty was the first U.S. income tax treaty to include such a provision. In general, an anti-conduit provision is intended to prevent residents of third countries from improperly obtaining the reduced rates of tax provided under a treaty with respect to dividends, interest, royalties, the other income article, and the insurance excise tax provision by channeling payments to a third-country resident through a treaty country resident.[57] To the extent that German law already contains anti-conduit provisions, such a provision in

the renegotiated treaty may be unnecessary, as U.S. domestic law already provides detailed and broader rules governing arrangements to reduce U.S. tax through the use of conduits.[58] If such a provision were to be adopted, it should use the language contained in the U.S.-U.K. Income Tax Treaty, which requires the conduit arrangement to have "as its main purpose, or one of its main purposes," obtaining treaty benefits.[59] The approach taken in the U.S.-Japan Income Tax Treaty should not be adopted, as it does not require a showing of a "main purpose" of obtaining treaty benefits.[60]

Continue the Exemption from Withholding Tax With Respect to Most Interest

CURRENT U.S.-GERMANY INCOME TAX TREATY

The United States generally imposes a 30 percent withholding tax on U.S. source interest derived by foreign corporations and nonresident aliens not engaged in a U.S. trade or business.[61] Germany generally imposes a 20 percent withholding tax on interest.[62]

The U.S.-Germany Income Tax Treaty exempts from source state withholding tax interest derived and beneficially owned by a resident of a Contracting State.

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should continue to exempt from source state withholding tax most interest beneficially owned by a resident of the other contracting state. Similar to the U.S.-U.K. Income Tax Treaty and to the U.S.-Japan Income Tax Treaty, the negotiators may wish to include certain anti-abuse exceptions to the exemption from withholding. For example, recent treaties provide exceptions for certain contingent interest, as well as for interest with respect to ownership interests in a vehicle used for the securitization of real estate mortgages or other assets to the extent that the amount of interest exceeds the return on comparable debt instruments as specified by domestic law.[63]

The negotiators may also consider whether to include a general "anti-conduit" provision, as discussed above with respect to dividends.[64] If such a provision were to be adopted, it should use the language contained in the U.S.-U.K. Income Tax Treaty, which requires the conduit arrangement to have "as its main purpose, or one of its main purposes," obtaining treaty benefits.[65] The approach taken in the U.S.-Japan Income Tax Treaty should not be adopted, as it does not require a showing of a "main purpose" of obtaining treaty benefits.[66]

In addition, so-called "excess interest" (interest that exceeds the amount that would have been paid to the beneficial owner of the interest, but for the controlled relationship, the arm's length amount) should be taxed at a 5 percent rate, as is the case under the U.S.-Japan Income Tax Treaty.[67]

Finally, the renegotiated treaty should adopt the language contained in the U.S.-U.K. Income Tax Treaty regarding interest that is "attributable to" a PE.[68] Such language is preferable to the language used in the U.S.-Japan Income Tax Treaty, pursuant to which interest is taxed under Article 7 (Business Profits) if it is "effectively connected" to a PE.[69] Under U.S. law, "effectively connected" is arguably broader in scope and could subject certain items of income to tax that would not be subject to tax under the "attributable to" language.[70]

Continue the Exemption from Withholding Tax With Respect to Most Royalties

CURRENT U.S.-GERMANY INCOME TAX TREATY

The United States generally imposes a 30 percent withholding tax on U.S. source royalties derived by foreign corporations and nonresident aliens not engaged in a U.S. trade or business.[71] Germany generally imposes a 20 percent withholding tax on royalties.[72]

The U.S.-Germany Income Tax Treaty generally exempts from source state withholding tax royalties derived and beneficially owned by a resident of a contracting state.[73]

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should continue to exempt from source state withholding tax most royalties beneficially owned by a resident of the other contracting state. The negotiators may consider whether to include an "anti-conduit" provision, as discussed above with respect to dividends.[74] If such a provision were to be adopted, it should use the language contained in the U.S.-U.K. Income Tax Treaty, which requires the conduit arrangement to have "as its main purpose, or one of its main purposes," obtaining treaty benefits.[75] The approach taken in the U.S.-Japan Income Tax Treaty should not be adopted, as it does not require a showing of a "main purpose" of obtaining treaty benefits.[76]

So-called "excess royalties" (royalties that exceed the amount that would have been paid to the beneficial owner of the royalties, but for the controlled relationship, the arm's length amount) should be taxed at a 5 percent rate, as is the case under the U.S.-Japan Income Tax Treaty.[77]

In addition, the renegotiated treaty should adopt the language contained in the U.S.-U.K. Income Tax Treaty regarding royalties that are "attributable to" a PE.[78] Such language is preferable to the language used in the U.S.-Japan Income Tax Treaty, pursuant to which royalties are taxed under Article 7 (Business Profits) if they are "effectively connected" to a PE.[79] Under U.S. law, "effectively connected" is arguably broader in scope and could subject certain items of income to tax that would not be subject to tax under the "attributable to" language.[80]

Maintain the Categories of Gain Subject to Resident State Taxation

CURRENT U.S.-GERMANY INCOME TAX TREATY

Most U.S. source gains, other than gains attributable to certain U.S. real property interests, derived by nonresident aliens and foreign corporations not engaged in a U.S. trade or business are exempt from U.S. taxation.[81] Germany, however, taxes many gains derived by a non-resident company or individual from German sources in cases where no income tax treaty attributes the right to tax this income to the state of residence (e.g., 50 percent of gains from the disposal of any shares in a resident company in which a non-resident company or natural person owns at least a 1 percent interest[19]; gains from the sale of real property, ships, or aircraft registered in a German aircraft or ship register[83]).

The U.S. Germany Income Tax Treaty generally provides that the source state may tax gains attributable to immovable property located in that contracting state, as well as gains attributable to the alienation of movable property used in a permanent establishment.[84] Gains from the alienation of ships, aircraft, or containers operated in international traffic or movable property pertaining to such property are taxable only by the resident state.[85] Gains from the alienation of any other property, including gains from the alienation of shares in a company of the other contracting state, are also taxable only by the resident state.[86]

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty generally should preserve the benefits available under the U.S.-Germany Income Tax Treaty with respect to gains.

Clarify the Scope of Income Subject Only to Resident State Taxation Under the Shipping and Air Transport Article

CURRENT U.S.-GERMANY INCOME TAX TREATY

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States.[87] However, income derived by a foreign corporation from the international operation of ships is generally excluded from gross income and exempt from U.S. federal income taxation, provided that the jurisdiction in which the foreign corporation is organized provides a reciprocal exemption for corporations organized in the United States.[88] A similar unilateral tax relief for foreign shipping companies exists under German

income tax law. Income derived from the operation of an owned or chartered ship is subject to income tax or corporate income tax respectively if the operation comprises the transportation of goods and persons between domestic havens and between domestic and foreign havens including other domestic transportation connected with the shipping.[89] The income from the operation is tax exempt if the taxpayer is domiciled in a country which itself grants a German shipping company a tax exemption for income from the operation of ships.[90] Germany also taxes capital gains from the alienation of a ship registered in a German ship register.[91]

Under the U.S.-Germany Income Tax Treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft will be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country.[92] The Treasury Department's Technical Explanation of the treaty provides that the article covers only income from the rental of ships or aircraft on a full basis (i.e., with a crew), but does not cover income from bareboat rentals, which are taxed as business profits under Article 7.[93] Profits from the use or rental of containers and related equipment used in international traffic are also subject only to resident state taxation.[94]

PROPOSAL FOR RENEGOTIATED TREATY

Consistent with the U.S. Model Treaty, as well as recent income tax treaties, a renegotiated treaty should broaden the categories of income currently covered by Article 8(1) of the treaty.[95] Specifically, Article 8 should explicitly cover income from the rental of ships or aircraft on a bareboat basis if such rental income is incidental to profits from the operation of ships or aircraft in international traffic, or if the lessee operates such ships or aircraft in international traffic.[96] A renegotiated treaty should also cover profits derived by an enterprise from the inland transportation of property or passengers within a contracting state provided that such transportation is undertaken as part of international traffic conducted by such enterprise.[97] Finally, the negotiators may wish to clarify that Article 8 also applies to income from lighterage undertaken as part of the international transport of goods.[98]

Clarify Nonapplication of the Excise Tax on Insurance Premiums

CURRENT U.S.-GERMANY INCOME TAX TREATY

Article 7(1) of the U.S.-Germany Income Tax Treaty provides that the business profits of an enterprise of a contracting state are taxable only in that state unless the enterprise maintains a permanent establishment in the other contracting state to which such profits are attributable.

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should clarify what is already implicit under a combination of U.S. domestic law and Article 7(1) of the existing treaty: the United States may not impose its excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a German enterprise, regardless of whether such enterprise carries on business through a U.S. permanent establishment ("PE").[99] Such provision may also incorporate an anti-conduit rule (as discussed more fully above with respect to dividends), which, similar to the anti-conduit rule found in the U.S.-U.K. Income Tax Treaty, would apply only if the conduit arrangement has as its "main purpose," or one of its main purposes, obtaining benefits under the treaty.[100]

Inclusion of Specific Provisions for Fiscally Transparent, Hybrid, and Reverse Hybrid Entities

CURRENT U.S.-GERMANY INCOME TAX TREATY

Certain entities are treated as fiscally transparent for most U.S. federal tax purposes, including partnerships and domestic limited liability companies.[101] Accordingly, the income of such fiscally transparent entities is generally taxable currently to its owner or owners.

Article 4(1)(b) of the treaty provides that a partnership, estate, or trust is treated as a resident of a contracting state to the extent that the income derived by such person is subject to tax in that state as the income of a resident, either in the hands of the person deriving the income or in the hands of its partners or beneficiaries. For U.S. tax purposes, the question of whether income received by a partnership is received by a resident is determined by the residence of its partners rather than by the residence of the partnership itself.

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should specifically address the issue of fiscally transparent, hybrid, and reverse hybrid entities. Article 4(1)(d) of the U.S. Model Treaty provides that income derived by an entity that is fiscally transparent under the laws of either contracting state shall be considered derived by a resident of a state, to the extent that the income is treated for purposes of the taxation law of such contracting state as the income of a resident.

The U.S.-Japan Income Tax Treaty goes even further than the U.S. Model Treaty by addressing hybrid and reverse hybrid entities.[102] Under that treaty, a hybrid entity is entitled to treaty benefits if the entity is a treaty resident and the entity (and not the beneficiary) is treated as the beneficial owner of the payments under the rules of its home country, regardless of whether the source country treats the entity (or the beneficiary) as the beneficial owner.[103]

Elimination of Branch Profits Tax and Maintenance of the Exemption From the Branch Level Interest Tax

CURRENT U.S.-GERMANY INCOME TAX TREATY

Under Article 10(8) and (9) of the current treaty, the United States may impose a 5 percent branch profits tax[104] on a German company that has a U.S. PE. The branch profits tax is imposed on the "dividend equivalent amount" (generally, the dividend amount a U.S. branch office would have paid up to its parent for the year if it had been operated as a separate U.S. subsidiary).

Interest paid by a U.S. PE of a German company to a resident of Germany is not subject to U.S. tax.[105] Paragraph 11 of the Protocol provides that the excess of interest deductible by a German company over the interest actually paid by such PE is treated as interest derived and beneficially owned by a resident of Germany. Accordingly, such interest is exempt from the U.S. branch level interest tax.[106]

PROPOSAL FOR RENEGOTIATED TREATY

Consistent with recent U.S. income tax treaties, a renegotiated treaty with Germany should eliminate the branch profits tax in those cases where the zero-rate would apply, as discussed above with respect to dividends, if the U.S. branch business had been conducted by a German company through a separate U.S. subsidiary.[107]. In those cases where the German company would not qualify for the zero-rate with respect to dividends, the branch profits tax should continue to be imposed at the 5 percent rate. A renegotiated treaty should also continue to exempt excess interest from the branch level interest tax.

Exemption from Source State Taxation of Securities Loans Fees and Similar Fees

CURRENT U.S.-GERMANY INCOME TAX TREATY

The existing treaty does not contain any rules regarding whether the source state may tax securities loans fees. Accordingly, such fees may be subject to source state taxation in accordance with the domestic laws of each state.

PROPOSAL FOR RENEGOTIATED TREATY

The treaty should exempt from source state taxation fees received in connection with a loan of securities, guarantee fees, and commitment fees paid by a resident of the source country and beneficially owned by a resident of the other treaty country, unless such fees are attributable to a PE in that other country.[108]

Pension Schemes

CURRENT U.S.-GERMANY INCOME TAX TREATY

Pensions and similar remuneration derived and beneficially owned by a resident of a contracting state in consideration of past employment are taxable only in the resident state.[109]

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should adopt a provision similar to those found in the U.S. income tax treaties with the United Kingdom and France.[110] Under those provisions, if an individual who is a member of a pension plan established and recognized under the law of one country performs personal services in the other country, contributions made by the individual to the plan during the period are deductible in computing the individual's income in the other country within the limits that would apply if the contributions were made to a pension plan established and recognized under the laws of the other country.[111] Similarly, payments made to the plan by or on behalf of the individual's employer during such time are not treated as part of the individual's taxable income and are allowed as a deduction in computing the employer's profits in the other country.[112] However, such provisions do not apply unless the competent authority of the other country has agreed that the plan generally corresponds to a pension plan recognized for tax purposes by that country.[113]

A renegotiated treaty should also specify that neither country may tax residents on pension income earned through a pension scheme in the other country until such income is distributed.[114] The above proposed provisions are intended to remove barriers to the flow of personal services between the two countries that could otherwise result from the discontinuities under the laws of each country regarding the deductibility of pension contributions.[115]

Clarification Regarding Stock Option Plans

CURRENT U.S.-GERMANY INCOME TAX TREATY

Article 15(1) provides that, in general, salaries, wages, and "other similar remuneration" derived by a resident of a contracting state with respect to employment exercised in the other contracting state may be taxed by that other state. However, under Article 15(2) only the state of residence may tax the income from such employment exercised in the other state if (1) the employee is present in the other state for periods not exceeding 183 days in the calendar year, (2) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other state, and (3) the remuneration is not borne by a PE that the employer has in the other state.

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should clarify that any benefits, income, or gains received by an employee, pursuant to an employee share or stock options plan, constitute "other similar remuneration." Each country should be able to tax only that portion of the gain on an option that relates to the period or periods between the grant of the option and the exercise of the option during which the employee has exercised employment in the treaty country. More specifically, the recent U.S. treaties with the United Kingdom and Japan require the allocation of taxing jurisdiction between the treaty countries over such plans if an employee: (1) has been granted a share or stock option in the course of employment in one of the treaty countries; (2) has exercised that employment in both treaty countries during the period between the grant and exercise of the option; (3) remains in that employment at the date of the exercise; and (4) under the respective domestic laws of the treaty countries, would be taxable by both countries with respect to the gain on the option.[116] The portion of the gain attributable to a treaty country may be determined by multiplying the gain by a fraction, the numerator of which is the number of days during which the employee exercised employment in

that country and the denominator of which is the total number of days between the grant and the exercise of the option.[117] The competent authorities should resolve by mutual agreement any difficulties arising from the application of this provision.[118]

Amendment to the Limitation on Benefits Article Regarding the Active Trade or Business Test and the Ownership Test of the Derivative Benefits Test

CURRENT U.S.-GERMANY INCOME TAX TREATY

Article 28(1)(c) sets forth a general active trade or business test pursuant to which a resident of a contracting state that derives income from the other contracting state is entitled to treaty benefits if the person is engaged in an active trade or business in his state of residence, and the item of income in question is derived in connection with, or is incidental to, that trade or business. Income that is derived in connection with, or is incidental to, the business of making or managing investments does not qualify for benefits, unless the business is a bank or insurance company engaged in banking or insurance activities.

Article 28(1)(e) sets forth a "derivative benefits test" that entitles a resident of a contracting state to treaty benefits if its owner would have been entitled to the same benefits had the income in question flowed directly to that owner. To qualify under this test, the company must meet an ownership test and a base erosion test. The ownership test provides that more than 50 percent of the beneficial interest in the person or corporation must be owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of Article 28(1) (other than the active trade or business test), or by U.S. citizens.

PROPOSAL FOR A RENEGOTIATED TREATY

Active Trade or Business Test

As has been the practice in several recent U.S. income tax treaties[119] as well as in the U.S. Model Treaty,[120] a renegotiated treaty should explicitly[121] provide that the active trade or business test may only be satisfied if, in addition to meeting requirements under the current U.S.-Germany Income Tax Treaty, the trade or business carried on by the company in the resident state is substantial in relation to the activity in the other state generating the income.[122] This additional condition should apply in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any "associated enterprises."[123] It may be preferable to use the arguably narrower language found in the U.S.-Ireland Treaty (i.e., where the resident "has an ownership interest" in the trade or business activity in the other state), or in the U.S.-Japan Treaty (i.e., where the resident company derives income from a person in the other contracting state that the resident effectively manages or controls). The substantiality requirement is intended to prevent 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.[124] The application of the substantiality test only to income derived by the income recipient or from related parties focuses on these potential abuses without hampering certain other kinds of non-abusive activities involving unrelated parties, including those where the activities of the income recipient in the treaty country may be very small in relation to the entity generating the income in the other contracting state.[125]

Substantiality should generally be determined based on all the facts and circumstances, taking into account the comparative sizes of the trades or businesses in each country (measured in reference to asset values, income and payroll expenses), the nature of the activities performed in each country, and the contributions made to that trade or business in each country.[126] The negotiators might also specify that due regard may be given to the relative sizes of the U.S. and German economies.[127] In addition to this subjective facts-and-circumstances test, an objective safe harbor test should also be provided under which the trade or business of the income recipient may be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the other state.[128] The three ratios compare: (1) the value of the assets in the recipient's state to the assets used in the other state; (2) the gross income derived in the recipient's state

to the gross income derived in the other state; and (3) the payroll expense in the recipient's state to the payroll expense in the other state. The average of the three ratios with respect to the preceding taxable year must exceed 10 percent, and each individual ratio must exceed 7.5 percent. If any individual ratio does not exceed 7.5 percent for the preceding taxable year, the average of the three preceding taxable years may be used instead.[129] Although the recent treaties with the United Kingdom and Japan do not contain such a safe harbor provision, a renegotiated treaty with Germany should contain the safe harbor rule to provide certainty to taxpayers.

Ownership Test of the Derivative Benefits Test

The ownership test of the derivative benefits provision should also be amended by including an "equivalent beneficiaries" provision similar to that found in other U.S. treaties with European countries, such as the United Kingdom, Ireland, and France. For example, under the U.S.-U.K. Income Tax Treaty, the ownership test is satisfied if seven or fewer "equivalent beneficiaries" own, directly or indirectly, shares representing at least 95 percent of the vote and value of the income recipient.[130] The definition of "equivalent beneficiary" may be met in two ways.[131] Under the first alternative, a person may be an equivalent beneficiary if they are entitled to equivalent benefits under a treaty between the source country and the country in which the person is a resident.[132] The first alternative imposes two requirements. The first requirement is that the person must be a resident of a Member State of the European Community, a European Economic Area state, or a party to the North America Free Trade Agreement ("qualifying states").[133] The second requirement is that the person must be entitled to all the benefits of a comprehensive income tax treaty (generally, a treaty with a comprehensive limitation on benefits article, except if the person is a resident of a contracting state, where being an individual, a qualified governmental entity, a company, another entity that meets the publicly-traded test, or a tax-exempt organization, qualifies them).[134] To meet the second requirement necessary to qualify as an equivalent beneficiary under the first alternative, in the case of dividends, interest, and royalties, the person must be entitled to a rate of withholding tax that is at least as low as the withholding tax rate that would apply, under the treaty, to such income.[135] Under the second alternative, a person may be an equivalent beneficiary only if they are a resident of one of the contracting states.[136]

Explicit Adoption of OECD Transfer Pricing Guidelines With Respect to Transactions Between Associated Enterprises and for Purposes of Attributing Profits to a Permanent Establishment

CURRENT U.S.-GERMANY INCOME TAX TREATY

Article 9 of the current treaty generally provides that when related persons engage in transactions that are not at arm's length, the contracting states may make appropriate adjustments to the taxable income and tax liability of such related persons to reflect what the income or tax of these persons with respect to such transactions would have been had there been an arm's length relationship between them.[137] The Internal Revenue Service may audit taxpayers in the United States, including German companies, retroactively for an unlimited number of years.[138] Japan, on the other hand, limits the retroactive examination period to seven years.[139]

Article 7(2) provides that the contracting states will attribute to a PE the profits that it would have earned had it been an independent entity engaged in the same or similar activities under the same or similar circumstances. In determining the business profits attributable to the PE, Article 7(3) provides that deductions may be made for expenses incurred for the purposes of the PE regardless of where such expenses are incurred.

PROPOSAL FOR RENEGOTIATED TREATY

Consistent with the U.S.-Japan Income Tax Treaty,[140] the contracting states should be required to apply the principles set forth in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Transfer Pricing Guidelines") when conducting transfer pricing exam-

inations of enterprises and in evaluating applications for advance pricing arrangements.[141] Such guidelines "reflect the international consensus with respect to these issues."[142] Moreover, the domestic transfer pricing rules of the contracting states should not apply to the extent that they are inconsistent with the OECD Transfer Pricing Guidelines.[143] Such a provision could facilitate settlement of double taxation cases (under the Mutual Agreement Procedure article) because it could be interpreted as giving both competent authorities the ability to abandon domestic law and accept the other side's position on the grounds that their own country's law is inconsistent with the OECD Transfer Pricing Guidelines.[144] The negotiators may also wish to explicitly list factors affecting comparability in applying the arm's length principle of Article 9, such as the characteristics of the property or services transferred and the functions of the enterprise and the associated enterprise, taking into account the assets used and the risks assumed by them.[145]

A renegotiated treaty should also include a provision similar to that found in the U.S.-Japan Income Tax Treaty pursuant to which an adjustment under Article 9 may not be made by either contracting state unless an examination of the enterprise is initiated within seven years from the end of the taxable year in which the profits that would be subject to the adjustment would have accrued to that enterprise, except in cases involving fraud.[146]

The OECD Transfer Pricing Guidelines should also apply for purposes of determining the profits attributable to a PE, as in the case of the U.S.-U.K. Income Tax Treaty and the U.S.-Japan Income Tax Treaty.[147] In particular, in determining the amount of attributable profits, the PE should be 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. With respect to financial institutions other than insurance companies, a contracting state should be permitted to determine the amount of capital to be attributed to the PE 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.[148]

Strengthen the Arbitration Provision in the Mutual Agreement Procedure Article

CURRENT U.S.-GERMANY INCOME TAX TREATY

Article 25(5) provides that if a disagreement between the contracting states regarding the interpretation or application of the treaty cannot be settled by the competent authorities, the matter may be submitted for binding arbitration, if both competent authorities agree to such submission. The exchange of notes to the treaty specify a set of procedures to be used in the implementation of Article 25(5).[149] Paragraph 3 of the exchange of notes provides that the competent authorities may agree on and instruct the arbitration board regarding specific rules of procedure, such as appointment of a chairman, procedures for reaching a decision, and the establishment of time limits, etc. The exchange of notes also provides that the competent authorities will not generally accede to arbitration with respect to matters concerning either the tax policy or the domestic tax law of either treaty country.

PROPOSAL FOR RENEGOTIATED TREATY

A renegotiated treaty should strengthen the arbitration procedure provision in Article 25(5) (as elaborated in the exchange of notes) along the lines of the EU Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (the "EU Arbitration Convention").[150] The U.S.-Germany Income Tax Treaty was the first U.S. income tax treaty to contain such a provision.[151] Similar provisions have since been adopted in U.S. income tax treaties with France, the Netherlands, Mexico, and Canada, although none of these provisions have entered into force. Moreover, the recent treaties with the United Kingdom and Japan have not included an arbitration provision.[152] As far as we know, no disagreement between the United States and Germany arising under the U.S.-Germany Income Tax Treaty has been referred to arbitration.

One purpose of the arbitration provision was to introduce a mechanism whereby essentially factual disputes may be resolved in a manner advantageous to both sides.[153] Another stated purpose of the provision was to avoid the delays involved in resolving disputes through the domestic courts or in the tax examinations process.[154] The same purposes would be served by strengthening the arbitration provision in a renegotiated treaty along the lines of the EU Arbitration Convention. For example, the EU Arbitration Convention requires the competent authorities concerned to refer a case to an arbitration panel (referred to as an "advisory commission") for resolution if the competent authorities have failed to reach an agreement regarding the case within two years of the date on which the case was first submitted to one of the competent authorities.[155] There are certain provisions in the EU Arbitration Convention, however, that should not be adopted in a renegotiated treaty, such as the provision that gives the competent authorities discretion to deviate from a decision of an advisory commission;[156] rather, as is the case under the existing U.S.-Germany Income Tax Treaty, a decision of the arbitration panel should be binding.

The treaty should also provide that while the competent authorities of both states are attempting to resolve a case, neither contracting state will seek to collect the tax that is in dispute until the mutual agreement procedure has been completed.[157] However, any tax that might be payable following the conclusion of the mutual agreement procedure would be subject to interest charges and, if appropriate, surcharges and penalties, as long as it remains unpaid.[158]

05 CHAPTER FIVE

CONCLUSION

The suggestions in this report to modernize the U.S.-Germany Income Tax Treaty should, if adopted, further effectuate the substantial cross-border trade and investment between the two countries that has played a vital role in both economies over the last several decades. As this report has demonstrated, the current U.S.-Germany Income Tax Treaty should be renegotiated for several important reasons. A primary reason is that the existing treaty is outdated, as evidenced by the fact that the U.S. Treasury Department and the OECD have each updated their model treaties and the United States has entered into new income tax treaties with other major trading partners, suggesting a shift in U.S. income tax treaty policy.

Indeed, many provisions in the U.S.-Germany Income Tax Treaty are now unfavorable when compared with analogous provisions contained in more recent income tax treaties. As a result, the U.S.-Germany Income Tax Treaty is not able to as effectively achieve many of the primary objectives of income tax treaties, including reducing the potential for double taxation and preventing tax barriers to direct cross-border investment and trade between the United States and Germany.

Of great importance in achieving these objectives is the elimination of source country taxation with respect to certain dividends. As discussed at length above, the recent treaties with Australia, Japan, Mexico, the Netherlands, and the United Kingdom now exempt source state taxation with respect to certain dividends. In addition, although the United States has only recently agreed to such a provision under certain bilateral income tax treaties, many OECD members and nonmembers have already included such a provision in one or more of their bilateral tax treaties and/or pursuant to their domestic law. The decision to eliminate source state taxation with respect to certain dividends is an acknowledgment that both parties to the treaty stand to benefit from such a provision in terms of increased direct investment. This is because both Germany and the United States generally impose, pursuant to their domestic laws, a withholding tax on dividends paid to nonresidents. Accordingly, the elimination of source state taxation with respect to certain dividends would benefit both direct investment in the United States by German companies and direct investment in Germany by U.S. companies. In other words, both countries would benefit as both importers and exporters of capital. One potentially positive long-term effect of such increased and more attractive cross-border investment is that the domestic tax bases of both countries may also increase.

Aside from a provision that would eliminate source state taxation with respect to certain dividends, many other provisions of the U.S.-Germany Income Tax Treaty should also be updated. These include provisions to strengthen the binding arbitration provision in the mutual agreement procedure article, which is critical in enabling taxpayers to resolve disputes with the tax authorities that might otherwise result in double taxation, and the adoption of the OECD Transfer Pricing Guidelines for purposes of attributing profits to a PE, whose adoption is currently subject to ongoing discussions among OECD members.

NOTES

1 Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, August 29, 1989 [hereinafter U.S.-Germany Income Tax Treaty]. Simultaneously with the signing of the U.S.-Germany Income Tax Treaty, the two countries signed a protocol (the "Protocol"). Unless otherwise stated, references to the U.S.-Germany Income Tax Treaty include references to the Protocol.

2 Most nations rely on bilateral income tax treaties (or conventions) as the primary means by which to remove barriers to trade. There are, however, multilateral efforts, such as through the Organisation for Economic Co-operation and Development (OECD), regarding the development of income tax treaties.

3 For a general discussion of the function of income tax treaties, see Vogel, Shannon & Doernberg, *United States Income Tax Treaties* 1.1 - 1.2 (Kluwer).

4 Richard E. Anderson, *Analysis of United States Income Tax Treaties* 1.01[1] (1999). The resolution of disputes arising under income tax treaties is specifically addressed by the Mutual Agreement Procedure article of income tax treaties. The competent authorities of each contracting state is charged with resolving such disputes. The U.S. competent authority is the Internal Revenue Service (Director, International). See Rev. Proc. 2002-52, 2002-31 I.R.B. 242 (August 5, 2002). In Germany, the competent authority is the Federal Ministry of Finance.

5 See infra footnote 28 and accompanying text. Both Germany and the United States are members of the OECD.

6 See generally Anderson, supra note 4, at 1.04.

7 U.S. Const. art. II, § 2, cl. 2.

8 Statutory domestic tax legislation must originate in the U.S. House of Representatives. U.S. Constitution art. I, § 7.

9 The Senate Finance Committee has jurisdiction over statutory domestic tax legislation.

10 Five members each from the House Ways and Means Committee and the Senate Finance Committee sit on the separate Joint Committee on Taxation ("JCT"). The JCT is charged with investigating the operation and effects of the tax system, its administration, and means of simplifying it.

11 See American Bar Association Section of Taxation, Committee on U.S. Activities of Foreigners and Tax Treaties, *Issues Paper on the Tax Treaty Making Process*, 46 Tax Law. 477, 478-81 (1993) [hereinafter ABA Issues Paper].

12 See, e.g., Treasury Department News Release LS-1137 (Jan. 19, 2001).

13 See ABA Issues Paper, supra note 10, at 479.

14 Id.

15 Id. at 482.

16 Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code 1986* (JCS-3-01), April 2001, at 448.

17 Convention Between the Government of the United States of America and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Nov. 6, 2003 [hereinafter U.S.-Japan Income Tax Treaty]. The United States and Japan exchanged instruments of ratification of the U.S.-Japan Treaty on March 30, 2004; accordingly, the treaty's new withholding tax rates will take effect on July 1, 2004.

18 Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, July 24, 2001 [hereinafter U.S.-U.K. Income Tax Treaty]. The U.S.-U.K. Income Tax Treaty generally entered into force on January 1, 2004.

19 The exemption from withholding tax on certain dividends in the protocol amending the income tax treaty between Mexico and the United States was the result of a most-favored nation provision in the first protocol to the treaty pursuant to which the United States agreed to promptly amend the treaty if it adopted a rate on dividends lower than 5 percent in a treaty with another country. Protocol to the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, art. 8(b) (Sept. 18, 1992). Both protocols generally entered into force on January 1, 2004.

20 See Cordia Scott, *New U.S., Canadian Treaties Include Key Changes, Officials Say*, 2003 TNT 111-5 (June 10, 2003) (explaining that government officials would like to conclude negotiations for a new protocol in the near future).

21 It is not yet known whether, if ratified by both countries, the new protocol with Canada would also provide for an exemption from withholding tax with respect to certain dividends.

22 Alison Bennett, *Angus Says Governments Can Cooperate, Foster Competitiveness Simultaneously*, BNA Daily Tax Report, at G-7 (Dec. 10, 2003).

23 *U.S. Trade Balance, by Partner Country 2002 in Descending Order of Trade Turnover* (Imports Plus Exports), United States International Trade Commission, available at http://www.usitc.gov. The current trade deficit in trade with Germany (as of September 2003) is $27.9 billion.

24 *Economic Indicators* (March 12, 2003), available at http://www.germany-info.org/relaunch/index.html (under "Business & Technology," "Economic Trends").

25 However, the previous treaty with the United Kingdom was signed in 1975, and the former treaty with Japan was signed in 1971, making those treaties even more outdated than the current U.S.-Germany Income Tax Treaty.

26 U.S. Treasury Department, Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes (Aug. 29, 1989) [hereinafter Treasury Department Technical Explanation to U.S.-Germany Income Tax Treaty].

27 Convention Between the United States of America and ***** for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Sept. 20, 1996) [hereinafter the U.S. Model Treaty]. In recent testimony before the Senate Foreign Relations Committee, Ms. Barbara Angus has implied that the recent treaty with Japan more accurately reflects the U.S. negotiating position: "The existing treaty [with Japan] also is inconsistent in many respects with U.S. tax treaty policy. The proposed new treaty brings the treaty relationship into much closer conformity with U.S. tax policy and generally modernizes the agreement in a manner consistent with other recent treaties. . . . The new treaty substantially lowers . . . maximum withholding tax rates, bringing the limits in line with U.S. preferred tax treaty provisions." Testimony of Barbara M. Angus, International Tax Counsel, United States Department of the Treasury before the Senate Foreign Relations Committee on Foreign Relations on Pending Income Tax Agreements (Feb. 25, 2004), JS-1191.

28 Model Tax Convention on Income and on Capital (Jan. 28, 2003) [hereinafter the OECD Model Treaty].

29 Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code 1986* (JCS-3-01), April 2001, at 448-50.

30 I.R.C. §§ 871(a)(1), 882(a), 1441(a), 1442(a). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

31 Juergen Kilius, 962-2nd T.M., *Business Operations in Germany* (2002), at A-53.

32 U.S.-Germany Income Tax Treaty, art. 10(2)(a).

33 Id. at art. 10(2)(b).

34 See, e.g., U.S.-U.K. Income Tax Treaty, art. 10(3)(a). The exemption from withholding tax also applies to dividends received by tax-exempt pension funds. Id. at art. 10(3)(b).

35 Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 2, 71.

36 See generally Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 72-75.

37 Kevin A. Bell, U.S. Senate Panel Approves Treaties, Protocols, 2003 TNT 49-5 (March 12, 2003) (the Senate is not "accepting what has been done as now setting a new custom"); Cordia Scott, *New U.S., Canadian Treaties Include Key Changes, Officials Say*, 2003 TNT 111-5 (June 10, 2003) ("It is not a blanket change from policy").

38 Id.

39 *Report of the Senate Foreign Relations Committee on the Convention Between the Government of the United Kingdom and the United States Signed on July 24, 2001, Together With an Exchange of Notes, as Amended by the Protocol Signed on July 19, 2002*, S. Exec. Doc. No. 108-2 (March 13, 2003).

40 Testimony of Barbara M. Angus, International Tax Counsel, United States Department of the Treasury before the Senate Foreign Relations Comm. on Foreign Relations on Pending Income Tax Agreements (Feb. 25, 2004), JS-1191.

41 Id.

42 See Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 72-73.

43 Id.

44 Id. at 73.

45 Id.

46 Id. More specifically, although eliminating the U.S. withholding tax would decrease revenues for the U.S. fisc, there would be an offsetting revenue gain to the United States in the form of decreased foreign tax credit claims with respect to German withholding taxes. Basically the same principles apply under German income tax and corporate income tax law as the recipient of dividends is entitled for a tax credit for foreign withholding tax (cf. Sec. 34c German Income Tax Act and Sec. 26 German Corporate Income Tax Act). The taxpayer can offset the foreign dividend withholding tax against his German income tax burden but limited to that portion of German income tax which equals the relation of the foreign dividend income to the whole income generated in the respective fiscal year including the foreign dividend income.

47 Id. at 74. As previously explained, the exemption from withholding tax provided for in the U.S.-Mexico Income Tax Treaty was due to a most-favored nation article in a previous protocol to that treaty. See supra note 5. The EU Parent-Subsidiary Directive generally exempts dividends from withholding tax where the payee company holds at least 25 percent of the capital of the payor company. Council Directive 90/435/EEC, 1990 O.J. (L 225) 6, art. 5(1) [hereinafter the EU Parent-Subsidiary Directive].

48 Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 74-75.

49 Staff of the Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code 1986* (JCS-3-01), April 2001, at 445-47.

50 Id. at 447.

51 U.S.-U.K. Income Tax Treaty, art. 10(4); U.S.-Japan Income Tax Treaty, art. 10(4).

52 Id.

53 U.S.-U.K. Income Tax Treaty, art. 10(5).

54 U.S.-Japan Income Tax Treaty, art. 10(7).

55 See Zion Levi, *Are All Things Royal in Royalties*, 32 Tax Notes Int'l 1015 (Dec. 15, 2003) (quoting from Revenue Ruling 81-78, 1981-1 C.B. 604, in which the IRS explained as follows: "The concept of taxing profits attributable to a permanent establishment in the United States in the context of a tax treaty . . . is analogous to the concept of taxing income effectively connected with conduct of a trade or business embodied in section 864(c) of the Code. [However,] [al]though there are many areas in which the "attributable to" and "effectively connected" principles overlap, these principles are only analogous. They are not synonymous. The "attributable to" principle is limited in its scope, which does not encompass the residual "force of attraction" principle present in [the effectively connected with language of] section 864(c)(3) of the Code." Emphasis added.)

56 See, e.g., U.S.-U.K. Income Tax Treaty, art. 10(9); U.S.-Japan Income Tax Treaty, art. 10(11).

57 Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 76-78.

58 I.R.C. § 7701(l).

59 U.S.-U.K. Income Tax Treaty, arts. 10(9) & 3(1)(n)(ii).

60 U.S.-Japan Income Tax Treaty, art. 10(11).

61 I.R.C. §§ 871(a)(1), 882(a), 1441(a), 1442(a). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

62 Jürgen Kilius, 962-2nd T.M., *Business Operations in Germany* (2002), at A-53.

63 See, e.g., U.S.-U.K. Income Tax Treaty, arts. 11(5), (6); U.S.-Japan Treaty, art. 11(9).

64 See, e.g., U.S.-U.K. Income Tax Treaty, art. 11(7); U.S.-Japan Income Tax Treaty, art. 11(7).

65 U.S.-U.K. Income Tax Treaty, arts. 11(7) & 3(1)(n)(ii).

66 U.S.-Japan Income Tax Treaty, art. 11(11).

67 U.S.-Japan Income Tax Treaty, art. 11(8). Compare U.S.-U.K. Income Tax Treaty, art. 11(4) (excess interest "shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."). Under the U.S.-U.K. Income Tax Treaty the rate of tax to which such excess interest would be subject is not clear.

68 U.S.-U.K. Income Tax Treaty, art. 11(3).

69 U.S.-Japan Income Tax Treaty, art. 11(6).

70 See supra note 39.

71 I.R.C. §§ 871(a)(1), 882(a), 1441(a), 1442(a). Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

72 Christiane Hagen, International Bureau of Fiscal Documentation, *Taxation of Companies in Europe - Germany 167* (2003).

73 U.S.-Germany Income Tax Treaty, art. 12(1).

74 See, e.g., U.S.-U.K. Income Tax Treaty, art. 12(5); U.S.-Japan Income Tax Treaty, art. 12(5).

75 U.S.-U.K. Income Tax Treaty, arts. 12(5) & 3(1)(n)(ii).

76 U.S.-Japan Income Tax Treaty, art. 12(5).

77 U.S.-Japan Income Tax Treaty, art. 12(4). Compare U.S.-U.K. Income Tax Treaty, art. 12(4) (excess royalties "shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention."). Under the U.S.-U.K. Income Tax Treaty the rate of tax to which such excess royalties would be subject is not clear, as royalties are subject to tax rates of between 0 and 15 percent.

78 U.S.-U.K. Income Tax Treaty, art. 12(3).

79 U.S.-Japan Income Tax Treaty, art. 12(3).

80 See supra note 39.

81 See I.R.C. § 897.

82 Sec. 49 paragraph 1 No. 2 e) Income Tax Act. However a tax exemption of 95 percent applies for capital gains from the alienation of shares derived by non-resident corporations (Sec. 8b paragraph 2, 3 Corporate Income Tax Act). In cases where a natural person is shareholder of a domestic corporation only 50 percent of the capital gains are subject to taxation (so-called "Half-Income-Procedure").

83 Sec. 49 paragraph 1 No. 2f and No. 8 Corporate Income Tax Act.

84 U.S.-Germany Income Tax Treaty, art. 13(1)-(3).

85 Id. at art. 13(4).

86 Id. at art. 13(5).

87 I.R.C. §§ 887; 882; 871(b).

88 I.R.C. § 883.

89 Sec. 49 paragraph 1 No. 2 b) Income Tax Act.

90 Sec. 49 paragraph 4 German Income Tax Act.

91Sec. 49 paragraph 1 No. 2 f) Income Tax Act

92 U.S.-Germany Income Tax Treaty, art. 8(1).

93 Treasury Department Technical Explanation to U.S.-Germany Income Tax Treaty, at 17.

94 U.S.-Germany Income Tax Treaty, art. 8(2).

95 For the last three years, the OECD has been discussing various aspects of Article 8 (Shipping, Inland Waterways Transport and Air Transportation) of the OECD Model Treaty, including the scope of income covered by the article. When the results of such discussions become final, it may be necessary to change the proposals made in this paper.

96 See, e.g., U.S.-U.K. Income Tax Treaty, art. 8(2); U.S.-Japan Income Tax Treaty, art. 8(2); U.S. Model Treaty, art. 8(2).

97 Id.

98 See, e.g., Exchange of Notes to U.S.-U.K. Income Tax Treaty.

99 Section 4373 provides that the excise tax on insurance premiums issued by foreign insurers may not be imposed on any amount that is effectively connected with a U.S. trade or business. Any amount attributable to a U.S. PE will also be effectively connected with a U.S. trade or business. Therefore, the tax may not be imposed on any income of a U.K. enterprise that is attributable to a U.S. PE. See U.S. Treasury Department, Technical Explanation of the U.S.-U.K. Income Tax Treaty, at 28-29.

100 U.S.-U.K. Income Tax Treaty, arts. 7(5) and 3(1)(n)(ii). See also Protocol to U.S.-Japan Income Tax Treaty, art. 1(a).

101 I.R.C. § 701; Treas. Reg. § 301.7701-3.

102 Hybrid and reverse hybrid entities are entities that are treated as fiscally transparent in one country and as taxable entities in the other country.

103 See U.S.-Japan Income Tax Treaty, art. 4(6). See generally Letter from Mary C. Bennett and Edwin T. Whatley, Baker & McKenzie, to Barbara M. Angus, International Tax Counsel, Department of Treasury (Feb. 24, 2003) (available at Tax Analysts, document number 2003-6538) (regarding treatment of U.S. limited liability companies under the former income tax treaty between the United States and Japan).

104 I.R.C. § 884(a).

105 U.S.-Germany Income Tax Treaty, art. 11(1).

106 I.R.C. § 884(f).

107 See, e.g., U.S.-U.K. Income Tax Treaty, art. 10(7); U.S.-Japan Income Tax Treaty, art. 10(9).

108 See, e.g., Protocol to U.S.-Japan Income Tax Treaty, art. 8.

109 U.S.-Germany Income Tax Treaty, art. 18(1).

110 See, e.g., U.S.-U.K. Income Tax Treaty, art. 18(2)-(3).

111 Id. at art. 18(2)(a).

112 Id. at art. 18(2)(b).

113 Id. at art. 18(3)(b).

114 Id. at art. 18(1).

115 Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 43.

116 Exchange of Notes to U.S.-U.K. Income Tax Treaty; Protocol to U.S.-Japan Income Tax Treaty, art. 10.

117 Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003, at 40.

118 Exchange of Notes to U.S.-U.K. Income Tax Treaty; Protocol to U.S.-Japan Income Tax Treaty, art. 10(b).

119 See, e.g., U.S.-U.K. Income Tax Treaty, art. 23(4); U.S.-Japan Income Tax Treaty, art. 22(2).

120 U.S. Model Treaty, art. 22(3).

121 A memorandum accompanying the U.S.-Germany Income Treaty arguably imposes a substantiality requirement. The first example in the memorandum states that the active trade or business test is met under the facts of the example in part because the active German business is substantial in relation to the business of the U.S. subsidiary.

122 See, e.g., id. at art. 22(3)(a)(iii).

123 See, e.g., U.S.-U.K. Income Tax Treaty, art. 23(4)(b); Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (July 28, 1997), art. 23(3)(ii) [hereinafter U.S.-Ireland Income Tax Treaty]. The U.S. Model Treaty does not explicitly limit the application of the substantiality test to cases involving associated enterprises and should not be followed to that extent. U.S. Model Treaty, art. 22(3)(a)(iii).

124 Treasury Department Technical Explanation to U.S.-U.K. Income Tax Treaty, at 92.

125 Id.

126 See, e.g., Treasury Department Technical Explanation to U.S.-U.K. Income Tax Treaty, at 91.

127 Id.

128 See, e.g., U.S. Model Treaty, art. 22(3)(c); U.S.-Ireland Treaty, art. 23(3)(b)(ii).

129 Id.

130 U.S.-U.K. Income Tax Treaty, art. 23(3)(a).

131 Protocol to U.S.-U.K. Income Tax Treaty, art. IV (which amends Article 23(7) of the U.S.-U.K. Treaty, as signed in 2001, before the protocol was signed). This paper will refer to Article 23(7) as amended by Article IV of the protocol.

132 U.S.-U.K. Income Tax Treaty, art. 23(7)(d)(i).

133 Id. at art. 23(7)(d)(i)(A).

134 Id.

135 Id. at art. 23(7)(i)(B). At present, the United Kingdom and Mexico are the only "qualify states" (as defined in the text) the residents of which qualify for the zero rate withholding tax with respect to certain dividends.

136 Id. at art. 23(7)(ii). This provision is included to clarify that ownership by certain residents of a contracting state would not disqualify a company of a contracting state under this provision. See Treasury Department Technical Explanation to U.S.-U.K. Income Tax Treaty, at 87.

137 See also I.R.C. § 482.

138 Toshio Aritake, *U.S.-Japanese Convention to Limit Competent Authority Examination Period*, BNA Daily Tax Report, at G-4 (Nov. 5, 2003).

139 Id.

140 Exchange of Notes to U.S.-Japan Income Tax Treaty, at 3.

141 The U.S. IRS may be “guided” by the arm’s length standard of the regulations under section 482 and the OECD Transfer Pricing Guidelines in its competent authority procedures. Rev. Proc. 2002-52, § 3.03, 2002-31 I.R.B. 242, 244. Section 482 is the U.S. Code section that authorizes the IRS to allocate gross income, deductions, credits and other allowances among two or more organizations, trades, or businesses under common ownership or control whenever it determines that this action is “necessary in order to prevent evasion of taxes or clearly reflect the income of any such organizations, trades, or businesses.” I.R.C. § 482.

142 Id.

143 Id.

144 Mitchell J. Tropin, *Unique Language in U.S.-Japan Treaty May Give More Flexibility on Settlements*, BNA Daily Tax Report (November 28, 2003), at G-2.

145 Protocol to U.S.-Japan Income Tax Treaty, art. 5.

146 U.S.-Japan Income Tax Treaty, art. 9(3).

147 Exchange of Notes to U.S.-U.K. Income Tax Treaty; Exchange of Notes to U.S.-Japan Income Tax Treaty, at 2.

148 Id.

149 Exchange of Notes to U.S.-Germany Income Tax Treaty (Aug. 29, 1989).

150 90/436/EEC, 1990 O.J. (L 225) 10. The EU Arbitration Convention is not currently in effect, although a protocol extending the convention was signed in 1999 and must be ratified by all EU Member States before it will enter into force. All EU Member States have ratified the protocol except Greece, Ireland, Italy, Portugal, and Sweden. If ratified by all EU Member States, the protocol will enter into force retroactively as of January 1, 2000. 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.

151 Treasury Department Technical Explanation to U.S.-Germany Income Tax Treaty.

152 The entry into force of the arbitration provisions in the treaties with Canada, France, Mexico, and the Netherlands was made subject to a subsequent exchange of notes in order to permit the evaluation of the arbitration provision under the U.S.-Germany Income Tax Treaty. There has been no subsequent exchange of notes.

153 See *Hearing on the Pending Bilateral Tax Treaties and OECD Tax Convention: Treaty Doc. 101-10, Federal Republic of Germany Before the Senate Comm. on Foreign Relations*, 101st Cong. (1990) (statement of Kenneth W. Gideon, Asset. Sec. for Tax Policy, U.S. Depth. of the Treasury).

154 Id. (statement of Harrison J. Cohen, Legislation Counsel, Joint Committee on Taxation).

155 EU Arbitration Convention, art. 7(1).

156 Id. at art. 12(1).

157 See, e.g., Exchange of Notes to U.S.-U.K. Income Tax Treaty.

158 Id.

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