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Dividends to US “S corporation” rank for full treaty relief

The Supreme Tax Court has held that a dividend paid to a US S corporation on a holding of at least 10% is subject to a 5% withholding tax insofar as its shareholders are tax-resident in the USA.

A US corporation may opt for “S” status if it has no more than 100 shareholders, all of whom must be resident individuals. An S corporation – the most common corporation in the USA today – is exempt from corporate income tax in its own name, but passes its income, allowances and credits direct to its shareholders. In other words, it is a fully transparent vehicle.

The Supreme Tax Court has now held – for a second time – that an S corporation basically qualifies for double tax treaty relief as a corporation on the basis of its corporate form – akin to a GmbH. However its rights in this respect are restricted by the condition that the income be chargeable to US tax, albeit in the hands of a shareholder or other party. Normally, the condition will be fully met, but exceptions are possible, such as when a minority shareholder moves abroad without telling the company.

The Supreme Tax Court thus reduced the withholding tax to be charged on a dividend to an S corporation with a 50% shareholding to 5% as opposed to the Central Tax Office demand for 15% as “another” dividend within the meaning of the US double tax treaty. The Central Tax Office had argued that the S corporation was not taxed as a corporation in the USA and thus could not be treated as one for withholding tax. However the Supreme Tax Court took the view that the legal form of the entity was a question of company law, and not of tax status. The corporate form was clearly closer to a German company than a partnership, and the condition restricting treaty relief to the degree to which the beneficial owners (the shareholders) taxed their income followed from an explicit treaty provision.

Supreme Tax Court judgment I R 48/12 of June 28, 2013 published on October 30

Keywords

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