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# *US Tax Treaty Newsalert*

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*US-German Competent Authority  
Agreement addresses characterization  
of foreign pension funds*

## *Overview*

On April 12, 2012, the Internal Revenue Service (the "IRS") announced that the Competent Authorities of the United States and Germany had reached an agreement not to tax dividends from investments made by certain US or German pension funds specifically listed in the Competent Authority Agreement pursuant to the exemption from tax provided in paragraph 3(b) of Article 10 (Dividends). As discussed in detail below, the Agreement clarifies that the term "pension fund", as defined in Article 10(11) of the 1989 United States-Germany Tax Treaty, as amended by the 2006 Protocol (the "Treaty"), includes a German contractual trust arrangement ("CTA"), special German investment funds, group trusts as described in certain IRS guidance, and a common trust fund as defined in section 584 of the Internal Revenue Code of 1986, as amended. The Competent Authority Agreement also provides that dividends derived by these specifically identified entities are eligible for an exemption from tax withheld at source under Article 10(3)(b) of the Treaty *as if the entity is the beneficial owner of the dividends*. The Competent Authority Agreement, signed on March 19, 2012, applies to all open tax years to which the Treaty applies.

## *Application of Article 10(3)(b) of the treaty to dividends received by pension funds*

Pursuant to Article 10(3)(b) of the Treaty, dividends are not taxed by the source State if the beneficial owner of the dividends is a pension fund that is a resident of the



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other Contracting State and the dividends are not derived from a business directly or indirectly carried on by the pension fund. For this purpose, the term "pension fund" is defined in Article 10(11) to mean any person organized under the laws of the United States or Germany that is established and maintained to primarily administer or provide pensions or other similar payments. Additionally, in the case of the United States, the pension fund must be exempt from tax and, in the case of Germany, it must be a type of plan the contributions to which are eligible for preferential treatment under the German Income Tax Act.

The Treasury Department Technical Explanation to the Treaty explains that the exemption from source-based taxation in Article 10(3)(b) is necessary to prevent pension funds from suffering unrelieved double taxation. In the absence of the Article 10(3)(b) exemption, pension funds may suffer unrelieved double taxation because they generally are exempt from income tax and as a result typically are ineligible to claim a foreign tax credit with respect to source state tax withheld on dividends. Furthermore, because distributions from pension funds generally do not maintain the character of the underlying income received by the pension fund (in this case, dividend income), beneficiaries of pension funds often are not able to claim foreign tax credits for tax withheld when payments from the fund are finally received, which may be years after tax was imposed by the source state.

Article 16(8)(b) of the 2006 Protocol provides that Article 10(3)(b) applies to persons treated as owning the assets of the pension fund under section 39 of the German Fiscal Code. The Technical Explanation also explains that Article 16(8)(b) of the Protocol makes clear that in the case of Germany, the Article 10(3)(b) exemption from source State tax for dividends paid to pension funds is available to an employer that has not organized a pension fund, but commits to pay the level of retirement income to its employees as set forth in section 6a of the German Income Tax Act. The employer, however, must have established a CTA that satisfies the requirements of section 39 of the German Fiscal Code which provides that for German tax purposes, the assets of the pension fund are attributable to the employer that established the CTA.

**Observation:** The Protocol language and the accompanying Technical Explanation could be read to suggest that a contractual arrangement, such as a CTA, is not a person. That is consistent with the analysis contained in Treas. Reg. §1.894-1(d)(5), Example 7. Note, however, that a contractual arrangement is treated as an entity for US tax purposes (*see* Treas. Reg. §301.7701-1(a)(2); *see also* PLR 200024024 to the same effect). Note also that Article 3(1)(d) provides that a person "includes but is not limited to an individual and a company" (unless the context requires otherwise). Since US tax law treats a contractual arrangement as an entity, does that mean it should be treated as a "person" under the Treaty? A further question is whether a contractual arrangement would be treated as fiscally transparent for purposes of the Treaty. These questions are not unique to this treaty.

## *Characteristics of German CTAs*

Historically, German pension funds have been internally funded by employers, meaning that the pension liabilities have been recognized on an employer company's balance sheet and that a company's pension assets and business assets were integrated, not segregated. The CTA, which is one of many diverse pension funding vehicles that exist under German law, became popular in the 1990s as an off-balance sheet vehicle for pension liabilities. Under German law, a CTA is treated as a contractual arrangement that permits a company to dedicate or restrict company assets for the purpose of funding pension benefits by effectively ring-fencing them. The CTA often is referred to as a "trust" for German purposes; however, it should be

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noted that foreign legal standards that may apply in classifying a CTA as a trust may not be consistent with the rules and principles that apply to classify an entity as a trust for US federal tax purposes. In certain cases, a special purpose vehicle may be organized to manage the assets held in the CTA. While German tax law recognizes the assets segregated in the CTA as the company's assets, accounting standards treat the assets held in the CTA as pension plan assets.

## *Competent Authority Agreement and treaty eligibility with respect to CTAs*

The Competent Authority Agreement is intended to provide certainty for taxpayers by clarifying the treatment of a German CTA that is established to fund the employer's simple employer sponsored pension plan ("SESP"). The Agreement states that if an SESP satisfies all the requirements of section 6a of the German Income Tax Act, and the assets of the CTA are treated as being owned by the employer under section 39 of the German Fiscal Code, then dividends derived by the CTA are eligible for exemption from withholding under Article 10(3)(b) of the Treaty (provided other requirements of the Treaty, such as the Limitation on Benefits article, are satisfied). The Competent Authority Agreement specifically provides that in such cases, "it is the employer that established the CTA that makes the claim for benefits under Article 10(3)(b) of the Treaty rather than the CTA." This language seems to conflict, however, with the explanation in the Agreement that the term "pension fund" of Article 10(11) of the Treaty is clarified to include a fund that holds the assets of a CTA that satisfies the above German law requirements, and that dividends derived by such entities are eligible for the benefits of Article 10(3)(b) "as if the entity is the beneficial owner of the dividends."

**Observation:** The Competent Authority Agreement highlights the challenges faced in characterizing foreign pension funding vehicles that do not neatly fit into traditional US tax entity classifications. The Agreement highlights that a CTA is an example of the diversity in forms of foreign retirement systems, and that even within a single country, there may be many types of funding or plan vehicles. In this regard, the interpretation and application of the Competent Authority Agreement raises a number of additional questions for US federal income tax purposes. For example, is the CTA, which is described as a contractual arrangement, an entity for US tax purposes (Treas. Reg. §301.7701-1(a)(2) seems to say it is) and, if it is, what type of entity should a CTA be classified as for US federal tax purposes - a business entity treated as a partnership or a corporation, or alternatively, perhaps a trust? To the extent it is properly classified as a trust for US federal tax purposes, what kind of trust is it - an employee trust, an investment trust, a grantor trust or a complex trust? Further, what are the US consequences if the CTA is not treated as an entity? To date, the IRS has issued little guidance on the classification of a foreign pension fund for US federal tax purposes. The classification of a CTA for US federal tax purposes is relevant not only with regard to determining whether it, or the employer that established it, is entitled to the benefits of the Treaty with respect to US-source income, but the classification also is relevant for non-treaty purposes (*e.g.*, if a CTA pays US-source FDAP, is it treated as the withholding agent? Is a CTA a foreign financial institution for FATCA purposes?).

The question of entity classification of a CTA for US federal tax purposes is relevant for determining eligibility for treaty benefits. In this regard, the wording of the Competent Authority Agreement arguably leaves open the question of whether the CTA or the employer that sponsors the employee pension plan is required to satisfy the requirements of the Limitation on Benefits article. As noted above, on the one

hand, the Agreement provides that the employer that establishes the CTA claims the benefits of Article 10(3)(b), whereas the Agreement subsequently states that dividends derived by a pension fund, which includes a CTA, "are eligible for benefits under Article 10(3)(b), *as if the entity is the beneficial owner of the dividends*, if all other requirements of the Treaty are satisfied. . . ." It should also be noted that the Treaty (unlike other US treaties) does not specifically define a "resident" of a Contracting State to include a pension fund, such as a CTA, although a CTA nevertheless may qualify as a resident under the Treaty to the extent it is organized under German law and liable to tax in Germany, although income derived from pension assets is directly allocated to the employer. The issue around the definition of "resident" is another point to consider in the context of which person or entity -- the employer or CTA -- should be eligible to claim the benefits of the Treaty.

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