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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
August 17, 2000

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
DC =
FC =

Date 1 =
Date 2 =
Date 3
Date 4 =
Date 5 =
Date 6 =

$x =

A =
B =
C =
State D =

ISSUES:

I. What date controls for determining whether the 10 percent ownership requirement has been satisfied for purposes of the reduced 5 percent rate of tax under paragraph 2 of Article 10 of the 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 ("the 1991 Treaty")?

II. If it is determined that the dividends paid by DC to FC were subject to the 15 percent rate of tax, is the Taxpayer liable for the additional 10 percent rate of tax?

FACTS:

The Taxpayer is a domestic bank that acts as a stock transfer/dividend paying agent for various U.S. corporations, including DC, a State D corporation. As a dividend paying agent, generally, Taxpayer is responsible for withholding U.S. taxes on payments of U.S. source income to foreign persons and filing Forms 1042 and 1042-S.

On Date 1, DC declared a $x cash dividend subject to and contingent upon the closing of an initial public offering ("IPO") of DC's common stock on or before Date 2 to its shareholders of record on Date 3. The dividend was payable on the earlier of 5 business days following the closing of the IPO or Date 4. At the time of the declaration, FC, a German corporation, was one of DC's shareholders and owned A shares, or B percent, of DC's C shares. On Date 5, FC sold all of its shares in DC to an underwriter involved with the IPO of DC shares. The shares were subsequently sold to the public in the IPO. When FC no longer held any shares of DC stock on Date 6, DC, through Taxpayer, made a dividend payment to FC and the other shareholders of record. Taxpayer withheld U.S. taxes at the rate of 5 percent pursuant to Article 10(2) of the 1991 Treaty.

The Taxpayer contends that its application of the lower rate of 5 percent on the dividend distribution was appropriate. Because the term "holds" is not defined in the 1991 Treaty, Taxpayer argues that under U.S. tax law, the shareholder who owns a dividend is generally the person who "holds" the underlying stock on the record date, citing Rev. Rul. 82-11, 1982-1 C.B. 51, and Technical Advice Memorandum 78-40-002.

The Taxpayer also represents that a shareholder's dividend entitlement is governed by a corporation's by-laws and by resolutions of its board of directors that authorize the payment of a dividend. Also, as a State D corporation, the State D Corporate Code permits DC to use the record date to determine its shareholders' entitlement to declared dividends. Because the record date determines a shareholder's

ownership of a dividend, Taxpayer argues that FC only needs to "hold" directly at least 10 percent of the shares as of the record date to be eligible for the lower rate of 5 percent under the 1991 Treaty. Here, on the record date, Date 3, FC owned B percent of DC, an amount greater than 10 percent. Therefore, Taxpayer contends that it correctly withheld 5 percent on the gross amount of $x. Further, the Taxpayer contends if the payment date is used to determine ownership, the effect would be to create a holding period requirement. Such a requirement does not exist under the 1991 Treaty, nor is it required under the OECD Model Tax Treaty.

It is Exam's position that the dividend payment date controls the application of the reduced rate under the 1991 Treaty. Because the Convention provides little guidance, Exam contends that according to the Commentary to Article 10 (2)(a) of the 1995 OECD Model Tax Treaty, the company receiving the dividends must satisfy the requisite ownership on the date of distribution. Paragraph 16 of the 1995 OECD Commentary provides that

> [paragraph (2)(a)] does not require that the company receiving the dividends must have owned at least [the threshold percentage] of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, [*i.e.*] in most cases the situation existing at the time when the dividends become legally available to the shareholders.

Exam cites as further authority for its position, that under United States tax law, a shareholder includes a dividend distribution in its gross income when the cash or other property is unqualifiedly made subject to his demand, *i.e.* usually the date of actual receipt or payment. *See* Treas. Reg. §1.301-1(b). In addition, the liability for withholding tax under section 1442 arises when constructive or actual payment is made. Consequently, Exam contends that the date of payment controls for determining FC's corporate ownership in DC. Because on the payment date, Date 6, FC no longer owned any stock in DC, Exam contends that the Taxpayer should have withheld at the 15 percent rate on the gross amount of the dividend distribution.

LAW AND ANALYSIS:

In general, section 881 of the Internal Revenue Code ("Code") imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.

The mechanism for collecting the tax imposed by section 881 is provided in

sections 1441 and 1442. Section 1442(a) provides that, in the case of foreign corporations, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 a tax equal to 30 percent thereof. Section 1441 states, in part, that all persons, in whatever capacity acting, having control, receipt, custody, disposal, or payment of any items of income specified in [section 871] of any nonresident alien individual or of any foreign partnership shall deduct and withhold from such items a tax equal to 30 percent thereof. Dividends are an item of income specified in section 871. Treas. Reg. §1.1441-1(a) provides that withholding is required when such income is paid to the nonresident alien individual or foreign partnership. Section 1461 provides in part that every person required to deduct and withhold tax under section 1442 is liable for such tax.

However, an applicable income tax treaty may reduce the rate of tax. Section 894 states the provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer. Treas. Reg. §1.1441-6 provides that the rate of 30 percent shall be reduced in accordance with the treaty that the U.S. has entered into with another country.

Article 10(1) of the 1991 Treaty provides that dividends paid by a company that is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other Contracting State. Article 10(2) of the 1991 Treaty further provides that such dividends may also be taxed in the Contracting State which the company paying the dividends is a resident and according to the laws in that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed 5 percent of the gross amount of the dividends if the beneficial owner is a company that “holds” directly at least 10 percent of the voting shares of the company paying the dividends; and 15 percent of the gross amount of the dividends in all other cases.

It is undisputed that FC held directly at least 10 percent of DC on the record date, Date 3, and thus, met the minimum ownership requirement under the 1991 Treaty at that time. However, by Date 6, the date of payment, FC no longer owned any shares of DC. Taxpayer contends that the date of record, Date 3, should control for purposes of determining the requisite minimum ownership. Consequently, the issue of whether the lower rate of 5 percent was appropriate depends on which date, the record date, the payment date, or another date controls for determining the requisite minimum ownership under Article 10(2) of the 1991 Treaty.

The 1991 Treaty is silent about what date controls for applying the stock ownership test. It is clear, however, under treasury regulations that the identity of the taxpayer and the right to receive the dividend are fixed on the record date.

Treas. Reg. §1.61-9(c) provides guidance on who is required to include dividend income, if there is a sale of stock between the date of declaration and the date of

payment. "When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend is ordinarily income to the seller. When stock is sold between the time of declaration and the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend is ordinarily income to him." The regulations, however, do not provide any examples to illustrate when the seller or purchaser is entitled to a dividend. Instead, this subject has been addressed in Rev. Rul. 82-11, 1982 -1 C.B. 51, as well as Technical Advice Memorandum 78-40-002 (June, 1978).

In Rev. Rul. 82-11, the Service states that, where the shareholder is contractually entitled to the dividend as of the record date, the shareholder's right to receive the dividend for federal income tax purposes becomes fixed as of that date. The ruling dealt with a corporate taxpayer who sold its stock after the record date but before the payment date. The Service reasoned that the selling taxpayer cannot shift the burden of income taxation on dividends by selling the underlying shares of its stock to another corporation after the dividend has been declared and it has been determined that the selling taxpayer, as the record holder of the shares on the record date, is entitled to the dividend. Similarly, in Technical Advice Memorandum 7840002, the Service stated that when a corporation declares a dividend payable to stockholders of record on a date subsequent to that of the declaration, the holder of the stock on the date of record, and not on the date declaration, is entitled to the dividend.

It is also clear that the payment date controls for purposes of including the dividends in income and determining when taxes are due and payable. Treas. Reg. §1.301-1(b) provides that a shareholder includes a dividend distribution in its gross income when the cash or other property is unqualifiedly made subject to his demand, *i.e.* usually the date of actual receipt or payment. In addition, liability for the withholding tax under section 1442 arises when payment is made.

Neither authority provides conclusive evidence, however, of the appropriate date on which to determine the requisite percentage ownership for purposes of Article 10(2) of the 1991 Treaty. The Technical Explanation to the 1991 Treaty states that as a starting point for negotiating the 1991 Treaty, the United States and Germany used the 1977 Model Double Taxation Convention on Income and Capital of the Organisation for Economic Co-operation and Development ("the 1977 OECD Model Tax Treaty"), as well as other model treaties for guidance. Thus, it may be helpful to look to the 1977 OECD Model Treaty and the official commentary thereto for guidance regarding the interpretation of the 1991 Treaty.

The language of the Dividends Article of the 1991 Treaty in substance parallels Articles 10(1) and (2) of the OECD Model Tax Treaty, except for the stock percentage ownership requirement. Paragraph 16 of the Commentary to Article 10(2)(a) of the 1977 OECD Model Tax Treaty provides language identical to that contained in the Commentary to the 1995 OECD Model Tax Treaty cited in both the Taxpayer's and

Exam's submissions. Paragraph 16 provides that

> [paragraph (2)(a)] does not require that the company receiving the dividends must have owned at least [the threshold percentage] of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, [*i.e.*] in most cases the situation existing at the time when the dividends become legally available to the shareholders.

The main purpose of paragraph 16 of the OECD Commentary to Article 10 is to make clear that the Model does not require a specified holding period of the stock prior to the date of dividend distribution. However, the Commentary is ambiguous about whether the time for determining the requisite ownership of stock is the record date, the date of distribution, or some other date. The Commentary merely says that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax. This would appear to take into account all of the facts and circumstances surrounding the creation of the liability for tax.

None of the above cited authorities directly answer the question. However, after considering all of the above, we believe the better view is that the percentage of stock ownership should be determined on the record date, the date that dividend ownership is determined. If the date of payment controlled for determining stock ownership under Article 10(2) of 1991 Treaty, only the person who held the stock on the payment date would be eligible for the lower rate of 5 percent. This could lead to unintended and inappropriate results. For example, if a German company owned 1 percent of a domestic company on the date of record but 10 percent when paid, the recipient would receive the reduced rate of tax on the dividends relating to only 1 percent ownership.

Here, FC sold all of its shares in DC after the record date and before the payment date. FC's selling of its stock in the IPO cannot change its entitlement to the declared dividend. FC's right to receive the dividend for federal income tax purposes became fixed as of the record date. Accordingly, the record date should control for purposes of determining FC's requisite minimum ownership to be eligible for the lower rate of 5 percent under Article 10(2) of the 1991 Treaty on the dividend distribution to FC. Although the law of State D supports this position, it does not control the analysis in this case. *See Estate of Putnam v. Commissioner*, 324 U.S. 393 (1945).

CONCLUSION:

I. As set forth above, in this case, the record date controls for determining whether FC met the stock ownership requirement under Article 10(2) of the 1991 Treaty. On the record date, Date 3, FC held directly B percent, an amount greater than

10 percent, and thus, met the minimum corporate ownership required by Article 10(2) to be eligible for the lower rate of tax of 5 percent. Accordingly, the Taxpayer properly withheld tax at the 5 percent rate on the gross amount of the dividend distribution pursuant to section 1442(a).

II. Because we have determined that the Taxpayer properly withheld 5 percent on the gross amount of the dividend distribution pursuant to section 1442(a), we do not need to address the issue of Taxpayer's liability if the amount of tax due was greater than 5 percent.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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