Germany:
Amendment to anti-treaty shopping rule proposed

The German government recently submitted an amended draft version of the domestic anti-treaty shopping rule in section 50d paragraph 3 of the Income Tax Act to the European Commission, which – if enacted in the current form – likely will result in the termination of the infringement procedure initiated by the Commission in March 2010. However, the language in the draft leaves room for interpretation, and it is possible that the government may further clarify the wording of the proposed rule during the legislative process.

Background

Germany levies a 26.38% withholding tax (including the solidarity surcharge) on dividend distributions by a German corporation, although a lower rate frequently applies on distributions to foreign companies, either because the rate is reduced under a tax treaty or the distribution qualifies for the application of the EU Parent-Subsidiary Directive. Technically, the lower rate may be achieved by a refund of the withholding tax to the foreign recipient or by a (full or partial) exemption from withholding tax at the time of the distribution if an exemption certificate has been obtained. Relief from the full withholding tax, however, is subject to Germany’s anti-treaty/anti-directive shopping rule in section 50d paragraph 3 of the Income Tax Act.

Under the current anti-treaty/anti-directive shopping rule, a foreign company that receives a payment subject to German withholding tax will be entitled to withholding tax relief only to the extent that (i) the company is owned by shareholders that would be entitled to a corresponding benefit under a tax treaty or an EU directive had they received the income directly; or (ii) if all of the following three tests are met:

- **Business purpose test** – There are economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company;
- **Gross receipts test** – The foreign company generates more than 10% of its gross receipts from its genuine business activities; and
- **Substance test** – The foreign company has adequate business substance to engage in its trade or business and engages in general commerce (mere administrative functions, outsourced activities or activities carried out by related parties in the same jurisdiction are not taken into account in determining business substance).

In principle, the relief mechanism (i.e. refund or exemption), as well as the anti-treaty shopping rule, apply equally to royalty payments and to certain interest payments (payments on profit-participating loans or convertible bonds). The withholding tax rate may be limited in cases qualifying for the EU Interest and Royalties Directive (in particular, royalties) or under a treaty (royalties and interest). With the exception of profit-participating loans and convertible bonds, interest payments made on “regular” loans (including “regular” shareholder loans) are not subject to withholding tax. The anti-treaty shopping rule generally is mainly relevant for dividend payments since the full or partial exemption depends on the existence of a corporate shareholder resident in an EU or a treaty country.

Infringement procedure with respect to gross receipts test

In March 2010, the European Commission initiated an infringement procedure against Germany and formally requested that the anti-treaty shopping rule be amended. The Commission emphasized that it was not challenging the objective of the anti-abuse measure, but rather the disproportionate requirements imposed on foreign companies to prove, in particular, the existence of a “genuine economic activity” (gross receipts test).

Draft of amended anti-treaty shopping rule

If passed in its current form, the amended draft version of section 50d paragraph 3 could result in the termination of the infringement procedure. According to the draft, a foreign company that receives a payment subject to German withholding tax will be entitled to withholding tax relief to the extent (i) it is owned by shareholders that would be entitled to a corresponding benefit under a tax treaty or an EU directive had they received the income directly; or (ii) if the foreign company’s gross receipts in the relevant year are generated from its genuine own business activities. If the foreign company fails both tests, the company would be entitled to withholding tax relief only if both of the following two additional requirements are met:
• **Business purpose test** – There are economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company in relation to the mentioned receipts; and

• **Substance test** – The foreign company has adequate business substance to engage in its trade or business and does participate in general commerce.

In addition to the changes to the wording of section 50d paragraph 3, a new sentence would be added that would codify the tax authorities’ view that the burden of proof would be on the foreign company to demonstrate that there are economic or other relevant (i.e. nontax) reasons and adequate business substance.

**Consequences of proposed changes**

The wording of the proposed amendment is ambiguous and leaves room for interpretation. Even though from a technical and historic perspective, the terms “gross receipts,” “receipts” and “income” have different meanings, it appears they are used synonymously in the draft law. In practice, the issues relating to the language used in the proposed rule will become extremely relevant. Based on the actual wording of the draft and its explanations, the following tax consequences may ensue:

**Example 1** – Assume a Luxembourg management holding company has three German subsidiaries, two of which are actively managed. All three subsidiaries distribute dividends to the Luxembourg holding company. The Luxembourg company has limited substance and is held by shareholders in the Cayman Islands.

- Dividend distributions from the two actively managed German subsidiaries should qualify for withholding tax relief provided it can be demonstrated that the Luxembourg entity acts as a true management holding company. This outcome would be based on an interpretation of the proposed amendment, according to which a foreign company that has treaty-protected shareholders or that earns income from its own business activity is entitled to relief.
- Dividend distributions from the German subsidiary that is not actively managed should qualify for withholding tax relief only if it can be demonstrated that there are business reasons for the interposition of the Luxembourg entity and there is sufficient substance in relation to the business purpose of the Luxembourg company.

Based on this interpretation, the situation for the actively managed subsidiaries should be similar to that under the current rule because such entities typically meet the gross receipts test (i.e. the dividends they receive qualify as “good income” for purposes of that test). Discussions with the tax authorities are likely to be ongoing and will focus on whether the activity of the management holding company is sufficient to qualify as a genuine own business activity. In the worst case, the tax authorities could argue that income not derived from own business activity taints the entire income of the nonresident holding company so that a withholding tax exemption would not be available for dividends distributed by any of the German subsidiaries. This restrictive view may be based on the ambiguous wording of the draft. Under the draft, a withholding tax exemption will be denied (only) to the extent there are nonresident shareholders that are not entitled to a comparative exemption; however, the second criterion for the denial (“the income is not derived from own business activity”) lacks a specific reference that a withholding tax exemption will not be available to the extent it is not derived from own business activity. Thus, it may be argued that any income that is not derived from genuine own business activities is harmful. As it is doubtful that this is really the intention of the revised rule, the wording of the draft should be amended to eliminate this ambiguity.

**Example 2** – A German company that is part of a multinational group develops patents and transfers them to a Swiss related party, which centrally manages the IP for the group. The Swiss company is directly held by the group parent company resident in Canada. The German company subsequently pays royalties to the Swiss company for which the Swiss company wants to obtain withholding tax relief (0% under the Germany-Switzerland treaty). The applicable treaty rate on royalties from Germany to Canada is 10%.

- The Swiss IP company is not held by shareholders that would qualify for a corresponding benefit and the royalties are not earned in connection with a genuine own business activity (according to the German tax authorities’ view of what constitutes a genuine own business activity).
- The Swiss IP company, therefore, would only enjoy full withholding tax relief if it can show that there are business reasons for its interposition in relation to the royalties earned (e.g. because there are synergies from a centralized IP structure) and that it has sufficient substance for its activity as an IP management company. In all other cases, the 10% withholding tax rate under the treaty with Canada should apply.
For this group, the amendment would be an improvement because currently, withholding tax relief for royalties received by pure IP companies whose activity is deemed to generate passive income under the anti-treaty shopping rule would not be available because it usually would be impossible to meet the 10% of gross receipts from own business activities test without adding additional substance to these entities.

**Example 3** – An operating entity in France holds shares in a German subsidiary. The German subsidiary is not actively managed by its French parent, but the parent is active in the same line of business and coordinates the distribution of the group’s products on a worldwide basis. The French parent company wants to obtain withholding tax relief for dividends received from its German subsidiary. The French parent is held by the Japanese head of the group.

Alternatively, assume there are no business or other relations between the German subsidiary and its French parent.

- Based on the wording of the draft law, it is unclear whether the dividends received would qualify as receipts that result from own genuine business activity in the absence of a management holding activity in France.
- If the dividends were not deemed to be earned in connection with a genuine own business activity, the French parent company would have to show that there are business reasons for its interposition, as well as sufficient substance at its level.

In this case, the taxpayer’s situation would remain unchanged or may potentially become worse as compared to the current situation.

Currently, the gross receipts test, the business purpose test and the substance test must be met. Based on the facts in the example, the gross receipts test would be met since the French parent company’s active business should be sufficient to produce more than 10% of the total gross receipts. In addition, past experience has shown that in these situations the tax authorities often do not scrutinize closely the business purpose of the interposition of the holding company. Thus, it generally should be possible under current law to obtain withholding tax relief in the base case of Example 3 (e.g. because of the supporting nature of the parent company for the subsidiary’s distribution) and, in many cases, in the alternative fact pattern as well.

Under the draft, “reasons for the interposition of the foreign company” will have to be proven “in relation to the mentioned receipts,” i.e. presumably in relation to the dividend income. It remains to be seen whether the tax authorities will – with reference to the mere new wording – ask for nontax reasons for the interposition of the French company as a holding of the German subsidiary or whether it will be sufficient that the foreign and the German business complement each other. Regardless of which view will be supported in future, it appears unlikely that full withholding tax relief will be granted in the alternative fact pattern (with only a refund to the treaty rate with Japan instead).

**Enactment**

The amended version of the anti-treaty shopping/anti-directive shopping rule is likely to be enacted with the law by which the Directive on the EU Recovery of Tax Claims will be implemented into national law. It will become effective on 1 January 2012.

— Katja Nakhai (Munich)  
Director  
Deloitte Germany  
knakhai@deloitte.de  

— Dr. Thomas Wagner (Duesseldorf)  
Senior Manager  
Deloitte Germany  
thewagner@deloitte.de
About Deloitte
Deloitte refers to one or more of Deloitte Global Services Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Global Services Limited and its member firms.

“Deloitte” is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management, and tax services to selected clients. These firms are members of Deloitte Touche Tohmatsu Limited (DTTL), a UK private company limited by guarantee. Each member firm provides services in a particular geographic area and is subject to the laws and professional regulations of the particular country or countries in which it operates. DTTL does not itself provide services to clients. DTTL and each DTTL member firm are separate and distinct legal entities, which cannot obligate each other. DTTL and each DTTL member firm are liable only for their own acts or omissions and not those of each other. Each DTTL member firm is structured differently in accordance with national laws, regulations, customary practice, and other factors, and may secure the provision of professional services in its territory through subsidiaries, affiliates, and/or other entities.

Disclaimer
This publication contains general information only, and none of Deloitte Global Services Limited, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. None of Deloitte Global Services Limited, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.