Germany amends anti-treaty shopping rule

The German Upper House adopted the “Act for Implementation of the EU Directive on the Recovery of Tax Claims” on 25 November 2011, which amends the German anti-treaty shopping rule. The act will enter into effect on 1 January 2012. The amendment to the anti-treaty shopping rule represents the German government’s response to infringement proceedings initiated by the European Commission in March 2010 and aims at making the rule compliant with the case law of the European Court of Justice (ECJ). Now that the rule has been enacted, the infringement procedure is likely to be dropped, although this has not yet taken place.

Background – Withholding tax refund and exemption

Germany levies a 26.375% withholding tax (including the solidarity surcharge) on dividend distributions made by a German corporation. A lower rate frequently applies on distributions to foreign corporate shareholders that hold directly at least 10% of the capital of the distributing corporation, either because the rate is reduced under an applicable tax treaty or because the distribution qualifies for the application of the EU Parent-Subsidiary Directive.

Technically, the lower rate may be achieved by refunding the withholding tax to the foreign recipient or by granting a (full or partial) exemption from withholding tax at the time the distribution is made. Relief from the withholding tax, however, is subject to Germany’s anti-treaty/anti-directive shopping rule in section 50d paragraph 3 of the Income Tax Act.

Existing anti-treaty shopping rule

To the extent the anti-treaty shopping rule is triggered, the nonresident taxpayer forfeits its benefits arising under a tax treaty or one of the EU directives. Under the existing 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) all of the following 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 to both royalty payments and certain interest payments (payments on profit-participating loans or convertible bonds). The rate of withholding tax may be limited under the EU Interest and Royalties Directive (in particular, for royalties) or under a tax treaty (both interest and royalties). 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 in Germany.

Infringement procedure

The gross receipts test has been the topic of controversy, and 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.” In particular, the fact that a taxpayer did not have the right to demonstrate the absence of abuse in its specific case if it failed to meet the criteria of the gross receipts test concerned the Commission in light of ECJ jurisprudence.

Amended anti-treaty shopping rule

In response to the infringement procedure, the German government submitted an amended draft version of section 50d paragraph 3 to the European Commission in the summer of 2011, which has become part of the “Act for Implementation of the Directive on the EU Recovery of Tax Claims.” The Commission has indicated that it will terminate the infringement procedure if the draft was enacted in this form.
According to the revised rule, a foreign company that receives a payment subject to German withholding tax will be entitled to withholding tax relief to the extent:

- 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
- 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 (i.e. if the foreign company is not owned by shareholders that would have benefited from the same relief had they earned the income directly and if the company did not earn the gross receipts in connection with its genuine own business activities), 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 participates in general commerce.

**Consequences of the amended rule**

The wording of the amendment is ambiguous and leaves scope 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 revised rule. In practice, the issues relating to the language used in the rule will become extremely relevant. Based on the actual wording of the rule 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 holding 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 shown that the Luxembourg entity acts as a true management holding company. This result would be based on an interpretation of the amendment, according to which a foreign company that earns gross receipts from its own business activity is entitled to relief. The active management in relation to the two German subsidiaries should mean that the dividend paid by those subsidiaries is income from the Luxembourg holding’s own business activity.
- Dividend distributions from the German subsidiary that is not actively managed should qualify for withholding tax relief only if it can be shown that there are business reasons for the interposition of the Luxembourg entity and there is sufficient substance in light of the business purpose of the Luxembourg company.

Based on this interpretation, the situation for the actively managed subsidiaries under the new rule 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 the gross receipts test). Although the existing rule technically requires that the two other tests (business purpose and substance test) also be met, past experience has shown that the tax authorities often do not scrutinize closely the business purpose of the interposition of the holding company. As a result, even under the existing rule, the implementation of a management holding in combination with a certain level of substance (own employees, own office space, etc.) has resulted in the availability of withholding tax relief.

Although technically the withholding tax relief under the new rule is no longer bound to the substance test if the gross receipts (e.g. the dividends) are deemed to be generated by an own business activity, it appears unlikely that the tax authorities will accept management holdings without any own substance. Thus, it is unlikely the authorities would accept mere contractual arrangements with third party service providers for taking over the management function (but a contract under which employees and office space are sublet for rendering the management holding services in relation to the German subsidiaries might be considered sufficient).

Surprisingly, the situation in future for the German subsidiary that is not actively managed by the Luxembourg holding company may become worse. The withholding tax relief available under the existing rule may not be available under the revised rule. Currently, it is sufficient (in practice) if the Luxembourg holding company has 10% gross receipts from its genuine own business activities (based on the overall gross receipts of the company). In the absence of other income, the
dividend paid the two other subsidiaries should have the effect that this test is generally met, i.e. also in relation to the dividend paid by the German subsidiary that is not actively managed. By contrast, under the new rule it will need to be demonstrated that each investment is actively managed. As a result, dividends from an entity that is not actively managed are unlikely to qualify as gross receipts earned from own business activities under the new rule, so that the business purpose and the substance test will have to be met for these shareholdings.

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 held directly 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 enjoy full withholding tax relief only 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 of companies, the revised rule will 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 and functions 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 the German subsidiary. The French parent is held by the Japanese head of the group.

- Based on the wording of the revised rule, 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 situation of the taxpayer would remain unchanged or may potentially even become worse as compared to the current situation.

Under the existing rule, the gross receipts test, the business purpose and substance tests all must be met. 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 these situations the tax authorities often do not scrutinize closely the business purpose of the interposition of the holding company under the current rule. Thus, it generally should be possible 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 revised rule, “reasons for the interposition of the foreign company” will have to be demonstrated “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 new wording – ask for non-tax 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 businesses complement one another. Either way, it appears unlikely that full withholding tax relief will be granted in the alternative fact pattern (only a refund under the treaty with Japan).
Burden of proof on foreign company

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

Conclusion

The revised rule will be an improvement for many nonresident taxpayers investing into Germany as it eliminates the difficult gross receipts test. In all cases where the dividends (or other income subject to withholding tax) are not deemed to be earned from a genuine own business activity, it is unclear how the tax authorities will handle cases in practice and the level of scrutiny they will place on the business purpose test.

Even though the German legislator decided to amend the rule with effect from 1 January 2012, the law change, as well as the infringement proceedings of the European Commission, provide a strong indication that the rules in effect from 2007 through 2011 were not in compliance with the fundamental freedoms in the TFEU if taxpayers meet the standards in the revised rule. Such taxpayers should therefore consider filing for withholding tax refunds for pre-2012 years.

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