Corporate Tax - Germany

Government proposes amended anti-treaty shopping rule

Contributed by P+P Pöllath + Partners Attorneys - Tax Advisors

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In response to the initiation of the infringement procedure of the European Commission on March 18 2010 (2007/4435), the German government is proposing to amend the domestic anti-treaty/anti-directive shopping rule.

Domestic withholding tax regime

Under German law, withholding tax is imposed on dividend, interest and royalty income payments. Such withholding tax on dividend and interest income (other than on a plain vanilla loan) is generally levied at a rate of 25% plus a 5.5% solidarity surcharge thereon (with an effective withholding tax rate of 26.375%). Where the dividend and/or interest income is received by a foreign corporation that is subject to non-resident taxation in Germany, two-fifths of the imposed and paid withholding tax shall be refunded if the conditions of the domestic anti-treaty/anti-directive shopping rule are met; thus, the effective rate is 16.375%. The German tax on royalty income is levied at a rate of 15% plus a 5.5% solidarity surcharge thereon (with an effective withholding tax rate of 15.825%). Moreover, such domestic withholding tax can be reduced under an applicable double tax treaty or eliminated under the EU Parent-Subsidiary Directive (90/435/EEC) or the EU Interest and Royalties Directive (2003/49/EC), subject to the domestic anti-treaty/anti-directive shopping rule.

Domestic anti-treaty/anti-directive shopping rule

A reduction or elimination of German withholding tax on dividends, interest and royalties under the applicable double tax treaty or under the applicable EU directive is subject to the German domestic anti-treaty/anti-directive shopping rule (Section 50(d)(3) of the Income Tax Act). The anti-treaty/anti-directive shopping rule does not apply to capital gains.

A foreign company is entitled to a reduction or exemption from German withholding taxes on dividends, interest and/or royalties only if it is owned by a foreign company that would be entitled to relief under a double tax treaty or an EU directive if it received the income directly, or if:

- there are economic or other relevant reasons for interposing the foreign company in the shareholding structure ('business purpose test');
- the foreign company generates more than 10% of its gross receipts from its genuine business activities other than asset management (ie, holding and administering investments) ('gross receipts test'); and
- the foreign company has an adequate business substance – with respect to its own business purpose – to be engaged in general commerce.

The rule does not apply where the principal class of shares of the foreign company is materially and regularly traded on a recognised stock exchange or where the Investment Tax Act applies.

Where the foreign company does not fulfil the prerequisites, the German tax authorities will look at its shareholders. They will pursue a bottom-up approach and will stop the analysis if a (higher-tier) shareholder meets all of the conditions or is resident in a non-treaty country. In the latter case, no partial or full relief from German withholding tax is granted.

Practical issues

Hitherto, in many cases, full or partial relief from the German withholding tax has been refused even where the foreign company has had adequate business substance and has not intended to avoid tax. Holding companies have often failed to generate more than 10% of their gross receipts from their genuine business activities and have therefore been denied full or partial relief from withholding tax.

Infringement procedure

For these reasons, the European Commission has initiated an infringement procedure against Germany and has formally requested the amendment of Section 50(d)(3) of the Income Tax Act. The request was made in the form of a reasoned opinion, which is the second step of an infringement procedure pursuant Article 258 of the EU Treaty. The commission did not criticise the existence of the German anti-abuse rule measures as such. It held that the German requirements for a 'genuine economic activity' – in particular, the gross receipt test – were disproportionate and exceeded the level of an anti-abuse rule which should be tolerated under the EU directive and the EU Treaty. In particular, as there was no possibility for the taxpayer to rebut the presumption of a missing economic activity if the gross receipts test failed, the commission held that the German anti-abuse measure goes beyond what is necessary to achieve the objective of preventing tax evasion.

Proposal to amend domestic anti-treaty/anti-directive shopping rule

It is proposed that the anti-treaty/anti-directive shopping rule be amended in response to the EU infringement procedure as part of the draft bill on the implementation of the EU mutual assistance directive and other changes in tax law, which is next due to be heard in the Finance Committee on September 26 2011.

Under the proposal, the foreign company will be entitled to a full or partial relief from German withholding tax insofar as it is owned by shareholders that would be entitled to a corresponding benefit under a double tax treaty or under an EU directive if the income was received directly, or as far as the foreign company's gross receipts in the relevant year are generated by its own business activities.

The foreign company will also be entitled to a tax refund or tax exemption if:

- there are economic or other relevant reasons to interpose the foreign company in relation to the receipts; and
- the foreign company has – with respect to its own business purpose – adequate business substance to engage in general commerce.

Implications

If enacted, the draft version will improve conditions for foreign companies that are not owned by shareholders entitled to relief under a double tax treaty or under an EU directive, where the payments are not generated in connection with an own business activity. They will nevertheless qualify for tax relief if they can prove that there are business reasons to interpose them and that they have adequate substance to be engaged in commercial activity.

The situation of actively managed subsidiaries should not change much because such subsidaries' gross receipts are typically generated by their own business activities.

Based on the wording, it is unclear how to interpret 'gross receipts generated by own business activities'. One interpretation of the term might include the entire gross receipts of the foreign company. Thus, a foreign company would be denied (full or partial) tax relief if it held only one non-actively managed company – even if it engaged in its own operating activities and easily met the 10% gross receipt test. A more likely interpretation of the term might comprise only the receipts for which relief is claimed.

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