European Tax Newsalert

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GERMANY

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Changes to Germany's anti-treaty shopping regulations expected to be effective January 1, 2012

Background

Generally, when a foreign company receives specific German-sourced income that is subject to German withholding tax (e.g., dividends, licenses or specific interest payments), the payer of the remuneration is required to remit the relevant withholding tax to the German tax authorities. The foreign company may be entitled to relief under the European Union ("EU") Parent-Subsidiary Directive, the Interest- and Royalty Directive, any applicable Double Tax Treaty or domestic tax law. The foreign company must apply to the German Federal Central Tax Office for relief before (by applying for a tax exemption certificate) or after (by applying for a tax refund) receiving the payment.

In order to claim relief from German withholding tax, a foreign company must document its compliance with the German anti-treaty shopping regulations. These regulations aim to prevent recipients of German-source income, who otherwise would not be entitled to obtain relief from German withholding tax, from interposing foreign companies for the dominant purpose of obtaining German withholding tax relief.

Based on the current German anti-treaty shopping regulations, a foreign company is entitled to full or partial relief from German withholding tax if it satisfies the following conditions:

a. the foreign company's shareholders would be entitled to the same relief if they received the income directly; or

b. the foreign company passes all of the following tests:

   i. there are economic or other significant non-tax reasons for interposing the foreign company ("business reason test"), and

   ii. the foreign company derives more than 10% of its gross receipts from "own (active) business activities" for the respective business year ("10% test"), and

   iii. the foreign company has suitable business premises and equipment to perform its (own) business activities ("substance test").

In addition, the above conditions for the anti-treaty shopping regulations are complemented by the following:

- In general, only the foreign company holding the shares in the German corporation is eligible for potential relief. In other words, attributes from other group companies, even if located in the same country, will not be considered for satisfying the above conditions.
- Gross receipts from a foreign company's own (active) business generally do not include gross receipts from mere asset management. Interest, dividends and royalties are generally not considered "active" income; exceptions exist where "management holding companies" actively manage subsidiaries (Decree of the German Ministry of Finance, April 3, 2007). There is no exception where business functions are outsourced to third parties.
- The anti-treaty shopping regulations should not apply where the foreign company's principal class of shares is primarily and frequently traded on a recognized stock exchange, or where the German Investment Tax Act regulations apply to the foreign company.

Potential infringement and reaction of German legislative branch

The European Commission ("EC") formally requested that Germany amend its existing anti-treaty shopping regulations due to alleged infringement on both the freedom of capital and the EU Parent-Subsidiary Directive.

Although the EC does not object explicitly to the anti-treaty shopping regulations' intent, it considers the requirement to prove the existence of the foreign company's own active business activity beyond what is necessary to attain the regulations' objective of preventing tax evasion.

Therefore, the German government is considering revising the core of these anti-shopping regulations, effective January 1, 2012.

In response, the upper house of the German parliament passed a draft tax bill on November 25, 2011 containing revised anti-treaty shopping regulations. A summary of the draft bill's current wording is as follows:

- A foreign company is not entitled to whole or partial German withholding tax relief *to the extent* that its shareholders would not have been entitled to a refund or exemption had they received the income directly, and to the extent that the foreign company's gross receipts in the respective business year do not stem from own active business activities, and,

  i) with respect to these receipts, no economic or other significant non-tax reasons exist for interposing the foreign company; or

  ii) the foreign company lacks suitable business premises and equipment to perform its own business activities ("substance").

- The burden for proving the existence of significant economic or other non-tax reasons and the existence of sufficient substance rests explicitly with the foreign company.

Potential impact of the revised regulations

The wording of the regulations leaves room for interpretation. In particular, two aspects lack clarity:

- The initial limitation ("to the extent that") may or may not also refer to the (own) active business gross receipts. Based on our interpretation the limitation ("to the extent") should also refer to the gross receipts from own business activity.

- The interpretation of the term "gross receipts generated by own active business activities" is unclear. It could refer to the (entire) gross receipts of the foreign company or it could refer only to the German-source income for which relief should be claimed. While the former interpretation results in tax relief for the German-source income to the extent that part of the foreign company's gross receipts is derived from own active business activities, the latter interpretation grants tax relief if a foreign company can demonstrate an own active business activity for the receipts for which relief is claimed.

The government does not indicate whether or not taxpayers will generally be better or worse off under the revised regulations. Given the uncertainty about how the tax administration will interpret the draft tax bill's wording, taxpayers should consider:

- Although under the current regulations a foreign company qualifies as either (completely) entitled or (completely) not entitled to German withholding tax relief, based on the official reasoning the government intends to introduce an "apportionment scheme" that could relieve only a portion of the German withholding tax. Foreign companies that are entitled to complete relief under today's regulations, may, under the revised regulations, be entitled to partial relief based on the apportionment scheme only.

- Groups with German-source income subject to withholding tax should (i) review the potential impact of the revised regulations on their taxation status in Germany and (ii) consider whether they should accelerate payments (e.g., dividend distributions) into calendar year 2011 in order to benefit from the current regime.
- Existing tax certificates will generally remain valid. However, such certificates do not qualify as a German tax administration binding decision on the taxation of the receipts in question. If, at the time of payment, the recipient relies on a certificate that contradicts the legal status in force, and that reliance results in tax underwithholding, the German tax administration may levy additional tax on the recipient.

For more information, please do not hesitate to contact:

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