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Anti-Treaty Shopping Rule in Germany

The anti-treaty shopping rule of Sec. 50d (3) of the German Income Tax Act, which has been subject to much controversy and has been amended and tightened repeatedly since its introduction, has been amended yet again in coordination with the European Commission as a result of the formal EU treaty violation proceedings initiated against Germany by the Commission. The new rule has eliminated the 10% threshold but has introduced a complex rule allowing a pro-rata relief on a case-by-case basis. The elimination of the 10% threshold will only mean an improvement for a handful of foreign companies. Only if the "good" income of the foreign company does not exceed 10% of the foreign company's gross earnings, the new rule will grant pro-rata relief. In many cases, the new rule will mean a tightening of the previous legislation. In addition, the new rule will lead to significant additional documentation obligations and a permanent monitoring of income streams and activities of the foreign company.

1. Background

The excessive effects of the German anti-treaty shopping rule of Sec. 50d (3) of the German Income Tax Act are well known by foreign investors. Once again, the German legislator has amended said rule with effect as of January 1, 2012. The German Ministry of Finance has published new guidance for the clarification and application of the complicated und difficult to understand rule on January 24, 2012.

In March 2010, the European Commission initiated formal EU treaty violation proceedings against Germany in the matter of Section 50d (3) of the German Income Tax Act. Prior to the proceedings, the anti-treaty shopping rule under Section 50d (3) of the German Income Tax Act did not grant withholding tax relief if a foreign company's earnings, which were generated from its own business activities, were below 10% of the company's total earnings. This former rule was based on an "all or nothing" principle – if the 10% threshold was not met, the relief was denied; if the 10% threshold was exceeded, Germany granted full withholding tax relief. According to the European Commission, this 10% threshold unreasonably violated the principle of freedom of establishment under EU law. As a consequence thereof, Germany amended Section 50d (3) of the German Income Tax Act. The new anti-treaty shopping rule no longer applies the 10% threshold, but a more complicated "pro rata test."

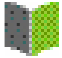
The following general information is meant to explain the structure and impact of the new Sec. 50d (3) of the German Income Tax Act.

2. The new rule in detail

Under German law, dividends paid by a German corporation to a foreign shareholder are subject to a 26.375% withholding tax (including solidarity surcharge). However, if the foreign shareholder complies with the requirements of the EU Parent Subsidiary Directive or with the requirements of a double tax treaty, withholding tax relief can be obtained either by applying for a withholding tax exemption certificate before the payment is made or by requesting a refund after the payment is made. However, both forms of withholding tax relief are subject to the German anti-treaty shopping rules of Sec. 50d (3) of the German Income Tax Act.

According to the amended wording of Sec. 50d (3) of the German Income Tax Act, a foreign company that receives a payment subject to German withholding tax will be entitled to withholding tax relief to the extent that

- it is (directly or indirectly) owned by shareholders who would be entitled to a corresponding benefit under a double tax treaty or the EU Parent Subsidiary Directive had they received the income directly (shareholder test); or
- certain substance requirements under Sec. 50d (3) of the German Income Tax Act are met.



These substance requirements are met if

- the foreign company's gross earnings in the relevant year are generated from its own business activities (business income test); or
- there are economic or other sound reasons for the interposition of the foreign company in relation to the above-mentioned earnings and the foreign company has adequate business substance to engage in its trade or business (business purpose test and substance test).

Foreign company

A foreign company within the meaning of Sec. 50d (3) of the German Income Tax Act is a company within the meaning of a respective double tax treaty or within the meaning of the EU Parent Subsidiary Directive, which in general can rely on withholding tax relief according to a double tax treaty or the EU Parent Subsidiary Directive.

Shareholder test

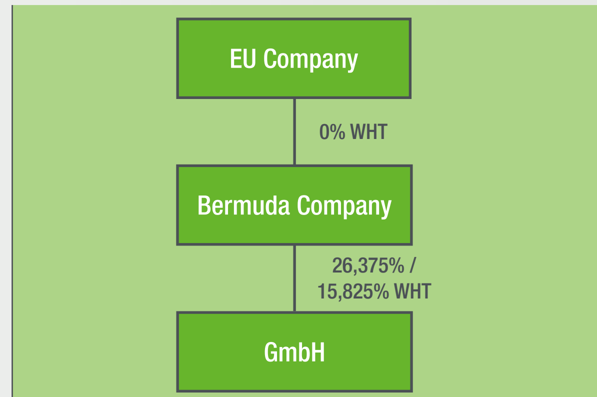
A foreign company is personally entitled to withholding tax relief to the extent it is owned by shareholders that would be entitled to a corresponding benefit under a double tax treaty or the EU Parent Subsidiary Directive. The new guidance clarifies that the personal entitlement needs to be fulfilled for each shareholder within the ownership chain. It is not required that each shareholder in the chain is personally entitled to the same level of relief. However, if one shareholder within the ownership chain is only personally entitled to a lower or no withholding tax relief compared to the shareholders higher up in the chain, said reduced withholding tax rates are decisive. This look-through approach is only necessary to the extent the foreign company does not generate its earnings from its own business activities or there are no economic or other sound reasons for the interposition of the foreign company and the foreign company has no adequate business substance to engage in its trade or business and it participates in general commerce.

However, if a company within the ownership chain is not personally entitled to withholding tax relief, withholding tax relief of shareholders higher up in the chain is precluded.

Example 1:

Treatment:

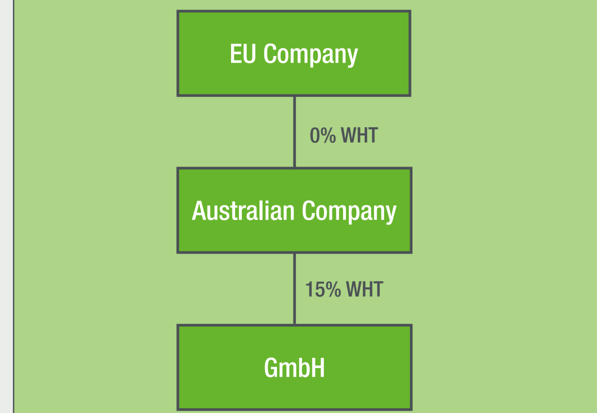
- WHT relief is not available at the level of the Bermuda Company according to a DTT or the EU Parent Subsidiary Directive
- EU Company may rely on Sec. 44a (9) of the German Income Tax Act (= refund of 2/5 of WHT resulting in finally 15,825 %)



Example 2:

Treatment:

- Australian Company is personally entitled to WHT relief
- Australian Company cannot apply for full WHT relief (0%)
- Australian Company can only apply for lower WHT relief (15%)



Own business activities

A foreign company is entitled to withholding tax relief only to the extent its gross earnings are generated from its own business activities. A company is deemed to engage in its own business activities if it participates in general commerce. Intra-group services provided on an arm's length basis would qualify as an own economic activity. An own business activity is missing if the foreign company receives its gross earnings from the mere asset management of its own or third party assets or if it transfers/outsources its core business activity to third parties.

According to the new guidance of the German Ministry of Finance interpreting Sec. 50d (3) of the German Income Tax Act, a management holding company participates in gene-

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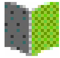


ral commerce and thus generates its gross earnings from its own business activity. Qualifying as such a management holding company requires that the foreign company is set up for the purpose of acquiring economic significant participations (more than one participation) and that it engages in the active management of its subsidiaries, i.e. the determination, through overt acts and activities, of the principal business policies of its subsidiaries and the coordination of the principal activities and of the individual activities.

As stated above, the foreign company is entitled to withholding tax relief to the extent the gross earnings are generated from its own business activities. Gross earnings that are functionally linked to the foreign company's own business activities can qualify as "gross earnings generated from the foreign company's own business activities." The same applies to interest income if it is generated from the investment of liquidity resulting from the foreign company's own business activity. Dividend income as well as other income (e.g. interest income) paid by companies managed by the foreign company also qualify as gross earnings from the company's own business activities.

Business purpose and substance test

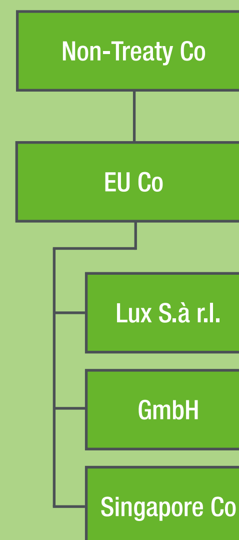
Earnings that are not deemed to be "generated from the foreign companies' own business activities" may qualify for withholding tax relief to the extent it can be proven that there are economic and other sound reasons for the interposition of the foreign company in relation to these earnings, and that the foreign company has adequate business substance to engage in its trade or business and participates in general commerce. According to the new guidance, economic reasons are not present, inter alia, if the foreign company serves primarily for the safeguarding of domestic assets in times of crisis, if the foreign company is to be used for future succession arrangements, or if it is to secure the retirement assets of its shareholders. The same applies to business reasons of the group that are not sufficient to constitute economic reasons. However, if the foreign company intends to be engaged in its own business activities and is in the position to prove corresponding activities, economic reasons for the interposition can be assumed. In addition, the new guidance mentions legal, political and or religious reasons as relevant other reasons for the interposition of a foreign company.

If economic or other sound reasons support the interposition of the foreign company, the foreign company must still provide proof of the existence of adequate business substance to engage in its trade or business and to participate in general commerce. In its new guidance, the German Ministry of Finance gives three examples that may create adequate business substance. An indication for adequate business substance may be given if (i) the foreign company employs experienced managers and other qualified personnel on a continuous basis, (ii) managers and personnel are able to manage the business and execute the affairs of the company on an independent basis and subject to their own responsibility, and (iii) business transactions between related parties are based on arm's length principles.

Example 1:

Facts:

- EU Co actively manages GmbH and Lux S.à r.l.; it does not manage Singapore Co
- Dividends from GmbH 40% of EU Co's income
- Dividends from Lux S.à r.l. 30% of EU Co's income
- Dividends from Singapore Co 30% of EU Co's icome



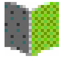
Tax Treatment:

- Full WHT relief is not available
- Dividends from Singapore Co do not qualify for relief
- Pro rata WHT relief of only 70 % even though GmbH is actively managed

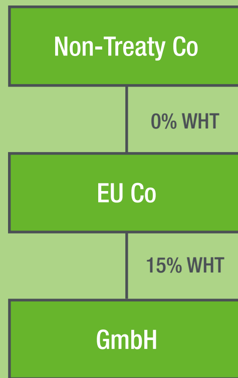
Example 2:

Facts:

- EU Co engages in active busines
- EU Co does not actively manage GmbH



- No business reasons for EU Co's shareholding in GmbH
- German dividend is 30% of EU Co's income
- Non-Treaty Co is entitled to demestic WHT relief for non resident corporations



Tax Treatment:

- Full WHT relief not likely to be available acc. to the new guidance;
- German dividend inome should not be deemed to be „good" income even though EU Co is fully active;
- Therefore, dividend from GmbH prevents full WHT relief:
- Pro rata WHT relief of only 70% (a WHT of 4.75 % remains, i.e. 30% of 15.825)

New pro rata approach

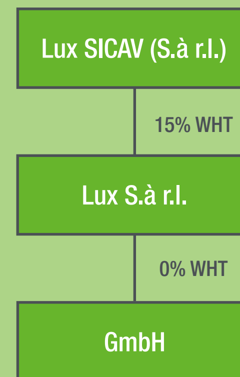
The amended Sec. 50d (3) of the German Income Tax Act includes a new pro rata approach. According to this new pro rata approach, a withholding tax reduction will only be applicable to the extent there are non-harmful gross earnings ("good" income) compared to the overall gross receipts earned. To the extent the foreign company does not generate "good" income, the shareholder and business income test and the business purpose and substance test have to be repeated at the next shareholder level in order to determine the pro rata withholding tax relief. In order to determine if and to what extent withholding tax relief will be applicable, the Withholding tax relief: Method of determination can be used.

Exception for listed companies and investment vehicles

Sec. 50d (3) of the German Income Tax Act still allows two exemptions. Tax relief will be granted either to companies whose shares are traded on a stock exchange or to qualifying foreign funds within the meaning of the German Investment Tax Act. Qualifying foreign funds are foreign funds in the form of a corporation, i.e. comparable to a German Investmentaktiengesellschaft. Said listed companies and qualifying investment vehicles do not have to fulfill the business income, business purpose and substance tests, provided they are personally entitled to withholding tax relief. The investment vehicles exemption is of particular interest for real estate fund structures and is decisive for structuring a fund investing in German real estate.

Example 1:

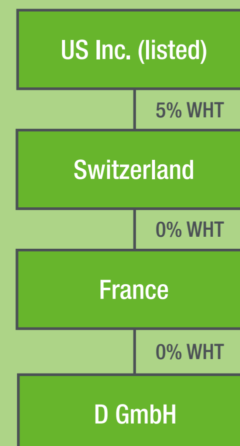
- Scenario 1:
  Lux S.à r.l. fulfills the substance requirements of Sec. 50d (3)
- Scenario 2:
  Lux S.à r.l. does not fulfill the substance requirements of Sec. 50d (3)

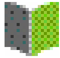


Tax Treatment:

- Scenario 1:
  Full WHT relief is available since Lux S.à r.l. is a foreign company within the meaning of sec. 50d (3) and fulfills substance requirments
- Scenario 2:
  WHT relief (15%) is available since Lux SICAV (S.à r.l.) qualifies as an investment vehicle withn the meaning of Sec. 50d (3)

Example 2:





Tax Treatment:

- full WHT relief is applicalbe
- No substance requirements have to be fulfilled since US Inc is listed

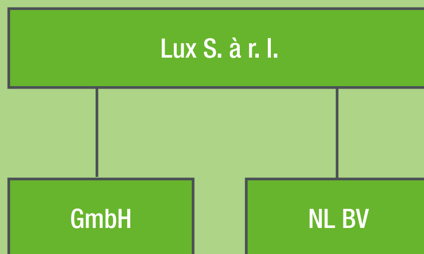
No 10% all-or-nothing rule

The new rules have eliminated the 10% threshold but have introduced a complex rule allowing pro-rata relief on a case-by-case basis. The elimination of the 10% threshold will only mean an improvement for a handful of foreign companies. Only if the "good" income of the foreign company does not exceed 10% of the foreign company's gross earnings, the new rule will grant pro-rata relief. In many cases, the new rule will mean a tightening of the previous legislation.

Example 1:

Facts:

- Lux S.à r.l. actively manages GmbH and receives dividend income of 100 from GmbH
- Lux S.à r.l. does not actively manage NL BV and receives dividend income of 1000 from NL BV



Tax Treatment under previous version of Sec. 50d (3):

- only 9 % of gross earnings resulting from own business activities
- no withholding tax relief (all-or-nothing)

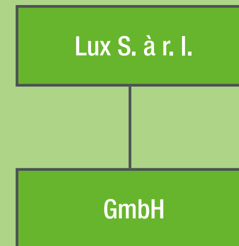
Tax Treatment under new version of Sec. 50d (3)

- pro-rata withholding tax relief for distribution from GmbH
- pro-rata withholding tax relief of 9 % of dividend income from GmbH

Example 2:

Facts:

- Lux S.à r.l. does not actively manage GmbH
- Lux S.à r.l. receives dividend income of 200 from GmbH
- Lux S.à r.l.'s gross earnings from own business activities are 3800



Tax Treatment under previous version of Sec. 50d (3):

- 95% of gross earnings resulting from the foreign company's own business activities (200 of 3800)
- full withholding tax relief - insofar as the remaining prerequisites of Sec. 50d (3) German Income Tax Act are fulfilled - possible

Tax Treatment under new version of Sec. 50d (3)

- only pro-rata withholding tax relief of 5 % possible according to the new pro-rata approach (relief of 5 % of 200 dividend income from GmbH)

De minimis amount

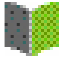
In general, the foreign company is obliged to inform the German tax authorities if the prerequisites for the withholding tax relief are no longer fulfilled. This may be the case if the prerequisites for personal entitlement or for factual entitlement are no longer met. However, a notification of the German tax authorities is not required if the percentage of "good" income under the gross earnings in relation to the overall gross earnings deviates less than 30% or the shareholder percentage (directly or indirectly) in the shareholder chain deviates less than 20%.

Effective date

Sec. 50d (3) German Income Tax Act is applicable as of January 1, 2012. However, the German tax authorities will also apply the amended provisions of Sec. 50d (3) German Income Tax Act to all cases that are not yet finalized if the amended provisions are beneficial to the taxpayer.

3. Consequences for foreign taxpayers

The new rule will only be advantageous for a few foreign companies. It will benefit those foreign companies whose gross earnings generated from the company's own business activities do not exceed 10% of the total gross earnings generated during the relevant fiscal year and, as a result, these foreign companies could not enjoy withholding tax relief. In such cases, pro rata relief will now be granted under the new



rule. At the same time, foreign companies whose gross earnings from their own business activities do not exceed 10%, but can prove economic and other sound reasons for the interposition of the foreign company, will only be granted pro rata relief instead of the previous full withholding tax relief. It should also be noted that the foreign company or the foreign companies also have significant additional documentation obligations under the new rule. In addition, the foreign company has to constantly monitor its activities and its income streams.

4. Recommendations for foreign taxpayers

- Foreign taxpayers should carefully check the consequences of the amended rule of Sec. 50d (3) German Income Tax Act to their existing structures.
- Foreign taxpayers should check if they should structure the investments in a way that allows separating “good” from “bad” income.
- Foreign taxpayers should take the timing of income into consideration so as to have periods with only active income in order to benefit from full withholding tax relief.
- Foreign taxpayers should check if it is reasonable to use alternative investment structures in order to avoid the application of Sec. 50d (3) of the German Income Tax Act. In order to avoid the application of Sec. 50d (3) of the German Income Tax Act, the foreign company could consider investing via a German business partnership into the German corporation paying the dividend or via an atypical silent partnership into the German corporation.
- Particularly foreign holding companies have to structure their own business activities and their substance carefully. Once a foreign holding company has been established it is important to monitor the substance as well as the business activities. One suggested recommendation would be the setup of management guidelines in order to monitor substance and business activity in a proper and on a continuous basis.

You seek alternative structures, would like us to implement management guidelines, check your existing structures or exemption certificates? - be in touch!

be in touch: If you have any questions, please do not hesitate to contact us.

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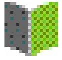

Withholding tax relief: Method of determination

Test 1
Is the foreign company personally entitled to benefits under a tax treaty or an EU directive?
No → NO RELIEF
Yes ↓

Test 2
Is the foreign company a listed entity or an entity that qualifies as an investment vehicle?
Yes → RELIEF
No ↓

Test 3
Are the foreign company's gross receipts generated from its own business activities?
to the extend Yes → RELIEF
to the extend No ↓

Test 4
Are there
1. economic or other sound reasons for the interposition of the foreign company and
2. has the foreign company adequate business substance to engage in its trade of business?
to the extend Yes → RELIEF
to the extend No ↓

Test 5
Does the (direct and indirect) shareholders of the foreign company meet the requirements of Test 1-4?
No → NO RELIEF
to the extend Yes → RELIEF

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