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German Tax and Legal News

BMF issues guidance on amended anti-treaty shopping rule

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On 24 January 2012, the German Ministry of Finance (BMF) issued guidance on the interpretation of the amended anti-treaty shopping rule that came into effect on 1 January 2012. The guidance aims to clarify relevant terms and some of the practical questions associated with the amended rule. In their guidance, the tax authorities also state that they will apply the amended rule (and the guidance) to all pre-2012 cases if they are not yet final and if the application of the rule is to the taxpayer's benefit.

Summary

The tax authorities' interpretation of the anti-treaty shopping rule may actually make the requirements for withholding tax relief even more difficult to meet in practice. This will be the case, in particular, for companies that do not qualify as a management holding company. It is likely that the new approach for the determination of withholding tax relief will lead to significant additional documentation obligations for all foreign holding companies, except for those with an ultimate parent company that is listed on a stock exchange or a qualifying investment vehicle.

For foreign holding companies with an ultimate parent company that is listed on a stock exchange (or that is a qualifying investment vehicle), the withholding tax situation should remain unchanged in many cases. Provided all interposed entities are resident in a tax treaty/EU directive country with the same level of withholding tax relief, the new apportionment mechanisms described in the guidance should not be relevant.

For all other taxpayers, it will be important to analyze the gross receipts of the foreign holding company to determine whether "harmful" activities exist when applying for a German withholding tax exemption certificate. In many cases, structuring possibilities should be available to reduce the impact of these activities on the German withholding tax position. However, ongoing monitoring of activities and income streams will be required to ensure that taxpayers will be able to comply with their notification obligations under the guidance.

Although the wording of the amendment to the anti-treaty shopping rule was agreed with the European Commission, it is doubtful that the interpretation of the rule is in line with EU law. Specifically, there is a high likelihood that the new interpretation violates EU law in cases where the German entity is actively managed and German withholding tax relief is denied merely because the foreign holding company – in addition to the German dividend income – earns other income from "harmful" activities that are unrelated to Germany.

Background

Under domestic law, Germany levies a 26.375% withholding tax (including the solidarity surcharge) on dividends (and certain types of profit participating interest) and a 15.825% withholding tax (including the solidarity surcharge) on royalties paid by a German corporation to foreign shareholders/recipients. Withholding tax relief under the EU Parent-Subsidiary Directive, the Interest and Royalties Directive and applicable tax treaties usually can be obtained either by applying for a withholding tax exemption certificate before the payment is made (and complying with certain requirements) or by requesting a refund after the payment is made. Both forms of withholding tax relief are subject to the German anti-treaty shopping rule.

In response to an infringement procedure initiated by the European Commission in 2010, the German government amended the anti-treaty shopping rule (effective from 1 January 2012). According to the revised wording of the 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 (shareholder test); or
- The gross receipts generated by the foreign company in the relevant year derive from the company's genuine own business activities (business income test).

If the foreign company fails both tests, the company will be entitled to withholding tax relief only if it meets both of the following two additional tests:

- *Business purpose test:* There are economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company in relation to the relevant income; and
- *Substance test:* The foreign company has adequate business substance to engage in its trade or business and it participates in general commerce.

The shareholder test, therefore, will determine the personal entitlement for withholding tax relief/reduction. The business income, business purpose and substance tests will determine the factual entitlement to withholding tax relief.

Shareholder test
The new guidance clarifies that the look-through approach still applies when determining personal entitlement to relief:

- As in the past, it will be possible to look through interposed companies that do not meet the anti-treaty shopping test, provided the higher tier company is personally entitled to the same level of relief. If one of the interposed companies is personally only entitled to lower or no relief, the lower relief will be decisive even if shareholders higher up in the ownership chain are entitled to reduced withholding tax rates (see examples below).
- The new guidance clarifies that the look-through approach applies only to the extent the relevant foreign shareholder does not meet the criteria for factual entitlement.
- As in the past, domestic shareholders will be considered "harmful" shareholders who are formally not entitled to withholding tax relief.
- The guidance includes a number of examples where the personal entitlement to withholding tax exemption would not be met.

The following cases illustrate how the formal/personal entitlement of the shareholder should be determined, see examples.

Exception for listed companies
As in the past, a foreign holding company which is a listed entity or a qualifying investment vehicle enjoys certain benefits for determining whether it is entitled to withholding tax relief. Such taxpayers will not be required to meet the new business income, business purpose and substance tests provided they are personally entitled to withholding tax relief (i.e. protected by a tax treaty or an EU directive).

If a foreign holding company is held directly or indirectly by a listed company, the personal entitlement of each interposed company would need to be reviewed (see above). If each interposed entity is personally entitled to the same (or a higher) withholding tax relief as the ultimate parent, the additional tests regarding business income, business purpose and substance would not need to be tested at each level (see Example 1 below).

However, if one of the interposed entities is only entitled to lower withholding tax relief than the ultimate listed parent, the factual entitlement at the level of the lower tier entities should be reviewed (i.e. perform the business income, business purpose and substance tests) to determine whether one of them is factually entitled to a higher withholding tax relief (see Examples 2 and 3 below).
Examples

New pro rata approach to determine entitlement to withholding tax relief
According to the guidance, the tax authorities will test the factual entitlement to withholding tax relief based on the new business income, business purpose and substance tests (for details on the tests, see below). The tax authorities now interpret these tests as an "apportionment rule."

On the basis of the business income, business purpose and substance tests, a company's gross receipts will be separated into "good" income/receipts and "bad" income/receipts, which will determine whether a company will be entitled to full or partial withholding tax relief.

New approach

- An analysis must be made at the level of the qualifying foreign shareholder (or – if looked through – at the level of its shareholders) of the percentage of income the foreign company generates from its genuine own business activities (good income).
- With respect to the portion of income that is not deemed to be generated from genuine own business activities, it still may be possible to qualify for withholding tax relief to the extent it can be demonstrated that there are economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company in relation to the receipts, and that the foreign company has adequate business substance to engage in its trade or business and it participates in general commerce (good income).
- The remaining income of the foreign holding company will be considered bad income.
- Withholding tax relief for dividends/royalties will be granted only in respect of the percentage of good income.
- A 100% exemption from withholding tax, therefore, will be available only where there is no bad income at the level of the qualifying foreign holding company (e.g. in the case of a management holding that receives management fees, dividends, interest and license fees only from managed subsidiaries).
- To the extent there is bad income, the analysis must be repeated at the next level of shareholders (provided that level qualifies under a tax treaty or EU directive).
- As demonstrated in the examples below, this approach is likely to make applications for withholding tax relief more burdensome than in the past.

Business income test
As noted above, withholding tax relief should be granted to the extent the foreign company can be deemed to engage in own business activities. The guidance clarifies the tax authorities' view on how to interpret the concepts of "genuine own business" and "gross receipts from genuine own business activities:"

- According to the anti-treaty shopping rule, withholding tax relief may be granted to the extent the recipient company's gross receipts result from its own genuine business activities.
- A company will be deemed to engage in genuine own business activities if it participates in a general trade in its host country and if the activities exceed mere asset managing functions.
- Genuine own business activities may be presumed if services are rendered to one or more subsidiaries for an arm's length consideration. As in the past, mere asset management activities (i.e. the management of own or third party assets) should not be sufficient.
- A management holding company still will be deemed to engage in genuine own business activities. The tax authorities again take the position that a foreign holding company's active management of two or more subsidiaries may qualify as a management holding company. In this case, it will be important that the management holding company can exercise a certain degree of influence over the subsidiaries, and that long-term strategic decisions and certain fundamental decisions regarding the managed subsidiary will be taken at the level of the management holding company and will be sufficiently documented.
- The tax authorities also note that if the subsidiary is active in the same line of business as its foreign parent company (i.e. there is a functional link between the activities of the subsidiary and the foreign parent), any dividend/interest or royalty income from the subsidiary qualifies as income from genuine own business activities.
- Interest income of the foreign parent company also should qualify as income from own business activities if it results from the investment of excess liquidity from a qualifying genuine business activity.
- As in the past, management and other activities of the foreign holding company may not be outsourced to group companies or third parties.

Business purpose and substance tests
The explanations in the guidance on the business purpose and substance tests for the most part remain unchanged from the old guidance.

Business purpose test: According to the tax authorities, a business purpose is absent, in particular, if the foreign company serves mainly to safeguard domestic assets in times of crisis, or if the foreign company is to be used for future succession arrangements or for securing the retirement assets of the shareholders. The same applies for business reasons resulting from the circumstances of the group, such as coordination, organization, establishing customer relations, costs, local preferences and overall corporate set ups that do not qualify as economic or other relevant reasons according to the tax authorities. The guidance states that legal, political or religious reasons are relevant reasons for these purposes.

The guidance does not indicate the date on which the business reasons must have existed. This may be relevant in group structures where activities have changed over time and where previously there may have been business reasons for the structure, but these reasons no longer exist because the business activities (and/or the political, social and economic environment) have changed. Moreover it also should provide taxpayers with additional arguments in acquisition scenarios: Where a taxpayer acquires a foreign holding company that holds a German company, it could be argued that if the seller was only willing to sell the foreign holding company (rather than the German subsidiary), this should qualify as a business reason because the foreign holding company was not interposed at the option of the acquirer.

Substance test: What is new in the guidance is that the tax authorities provide three examples of what could be considered an indication for sufficient business substance:

- Existence of sufficient management and other staff personnel;
- The personnel has sufficient qualifications to engage in the business of the company in a competent and independent manner; and
- Transactions between related parties are based on the arm's length principle.

The guidance also clarifies that substance that exists at the level of other group companies cannot be taken into account when determining substance at the level of the direct shareholder, even in the case of a tax group or other form of tax consolidation.

It also appears that, because the business purpose and substance tests must be interpreted as applying on a pro rata basis, the percentage of gross receipts for which substance and business reasons can be demonstrated and that should therefore be viewed as constituting "good income" will have to be determined.

Timing aspects: According to the tax authorities, the factual entitlement must be analyzed with respect to an application for a refund of withholding tax for the year in which the dividends/royalties were received by the foreign shareholder. Where an exemption is requested, the factual entitlement must be determined for the year in which the application is filed. If the foreign company's financial statements are not available at the time the application is made, the financial statements of the preceding year will be used.

Examples: The following examples represent our understanding of how the factual entitlement to a withholding tax reduction/relief is calculated. It should be noted that the interpretation is in many cases unclear, so the actual practice of the tax authorities will have to be monitored carefully.

Testing mechanism
The guidance includes a fairly detailed and complex example in which the tax authorities explain in what order the above tests have to be performed.

- The analysis should start with the personal entitlement at the level of the direct shareholder.
- In a next step, the business income test should be performed at the level of the direct foreign shareholder.
- In the following step and only to the extent the foreign shareholder earns income that does not qualify as income from genuine own business activities, the business purpose and substance tests must be reviewed.
- To the extent the foreign shareholder receives bad income (i.e. income for which the factual entitlement cannot be established), the tests have to be repeated at the level of the shareholder of the foreign parent company.

This sequence of steps can be illustrated in the following flow-chart.

De minimis amount
Taxpayers generally will have to notify the tax authorities of changes in the gross receipts or shareholders that are relevant for the withholding tax relief. According to the guidance, notification will not be required if:

- The percentage of good income under the gross receipts test that was included in the original application for an exemption certificate decreases in the following years within a range of less than 30%; or
- A shareholder percentage in the corporate chain above the direct foreign shareholder changes within a range of less than 20%.

The de minimis rule will not apply where a shareholding percentage falls short of a minimum percentage provided by a tax treaty or an EU directive.

Practical implications for taxpayers
Affected taxpayers should consider the following:

- Whether existing withholding tax exemption certificates for German-source income are still valid;
- The impact of the new rule and the tax authorities' interpretation on the withholding tax position of existing structures; and
- Whether it is possible to structurally separate "good" and "bad" income to potentially increase the pro rata entitlement to withholding tax relief and make it easier to monitor in subsequent periods, and if a structural separation is not possible, whether other options (e.g. timing dividend income from passive investments) are viable.

If you have any questions or are interested in an unofficial English translation of the guidance, please contact the authors of this article at gtln@deloitte.de or your regular Deloitte contact.

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