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German Tax and Legal News

Draft law proposes changes to anti-treaty shopping rules

Proposed legislation responds to recent CJEU jurisprudence.

On 20 November 2020, the German Ministry of Finance (MOF) published a draft law that would modernize the rules for relief from withholding tax and the related certification of withholding tax relief from the tax authorities. In addition to significant changes proposed to procedural aspects of the withholding tax certification, exemption, and refund processes, the draft law also would provide for several substantive amendments to the withholding tax rules, including significant changes to the anti-treaty shopping rules in response to jurisprudence from the Court of Justice of the European Union (CJEU). In some cases, the proposed changes could restrict the circumstances in which nonresident companies may qualify for withholding tax relief.

Based on the current anti-treaty shopping provisions of section 50d (3) of the Income Tax Code (ITC), which apply to withholding tax relief sought under an applicable tax treaty or an EU directive, a nonresident company that receives a payment subject to German withholding tax will be entitled to withholding tax relief if one of the following requirements are met:

- The nonresident company is owned by shareholders that would have been entitled to a corresponding benefit under an applicable tax treaty or an EU directive had they received the income directly ("shareholder test"); or
- The gross receipts generated by the nonresident company in the relevant year derive from the company's own genuine business activities ("business income test").

Even if the nonresident company fails both of these tests, it still will be entitled to withholding tax relief if it passes both of the following tests:

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

In a 14 June 2018 decision (case C-440/17), the CJEU concluded that Germany's anti-treaty-shopping rules in section 50d (3) of the ITC that have been applicable as from 2012 violate EU law (see GTLN dated 7 August 2018). The CJEU held that the rules violate both the EU parent-subsidiary directive and the freedom of establishment principle in article 49 of the Treaty on the Functioning of the European Union (TFEU). This was the third case in which the CJEU ruled that the German anti-treaty shopping rules are not compatible with EU law (see also GTLN dated April 11, 2018).

The proposed changes to the current anti-treaty shopping rules would take into account the requirements of EU law: the legislative material makes explicit reference to the requirements of the general anti-abuse rule in article 6 of the EU anti-tax avoidance directive (and BEPS action 6 (preventing the granting of treaty benefits in inappropriate circumstances)) as well as to the case law of the CJEU, especially its 14 June 2018 decision, the combined Deister Holding and Juhler Holding cases (see GTLN dated 27 December 2017), and Danish beneficial ownership cases (joined cases C-116/17 and C-117/17).

The amended German anti-treaty shopping rules would apply in the same way as the current rules for benefits claimed under a tax treaty or EU directives (parent-subsidiary directive and interest and royalties directive), as well as for unilateral relief from withholding tax under section 44a (9) of the ITC. According to the legislative material, due to the requirements of EU law, the proposed amended anti-treaty shopping rules would apply even in a case where a tax treaty contains a specific anti-abuse rule (such as the "limitation on benefits" clause in article 28 of the Germany-US tax treaty). This would be a new approach that would not be in line with the current case law of the German federal tax court.

The text of the proposed rules would be significantly shorter than the existing version and would rely more on subjective elements than the current rules. A two-step approach would apply consisting of a basic rule under which there would be a general presumption of treaty abuse under certain circumstances, with the possibility of rebutting the presumption in a second stage by providing counter-evidence of relevant non-tax reasons for the interposition of the nonresident company with respect to the relevant income.

Basic rule: Presumption of treaty abuse
The basic rule would provide for a general presumption of treaty abuse based on certain circumstances relating to the situation of the shareholders of an entity and the activities of the entity. Under the basic rule, no benefits under a treaty or EU directive would be granted if, and to the extent that, the conditions of both the "shareholder test" and the "activity test" are fulfilled.

<u>Shareholder test</u>

Treaty abuse would be presumed only where the shareholders of a foreign company would not be entitled to the same benefits claimed by the foreign company had they received the payments directly ("look-through approach"). Compared to the current version of the rules, the conditions would be significantly tightened, as the rules would refer to a "specific entitlement." According to the legislative material, this means that only an entitlement to benefits under exactly the same provision as is available to the foreign company would be considered as the same specific entitlement, while an entitlement under another tax treaty (even to the same rate of reduced withholding tax) would no longer be recognized as equivalent. However, the explanatory statement to the law states that where the shareholders of the recipient would be eligible for the same benefits as the direct recipient, but under a different rule, this could be used as rebuttal evidence that the interposition of an entity was not motivated exclusively by tax reasons.

The following examples illustrate how the test would apply:

- *Example 1*: A German GmbH is 100% held by a Luxembourg S.à.r.l., which itself is 100% owned by a stock-listed French S.A. As the French S.A. would benefit from the same specific entitlement under the parent-subsidiary directive, the look-through approach should result in full entitlement to the benefits of the directive for the Luxembourg S.à.r.l. (however, see the discussion below regarding the stock exchange exception).
- *Example 2:* The facts are the same as example 1, except that the Luxembourg S.à.r.l. is now 100% owned by a stock-listed US corporation ("US Inc."). As the US Inc. would be entitled to benefits only under the Germany-US tax treaty, it would not qualify for benefits under the look-through approach. However, since the US Inc. would be entitled to a 0% dividend withholding tax rate under the Germany-US tax treaty (articles 10 (3) and 28 (2)(c)), the taxpayer should be able to demonstrate that tax advantages are not the main benefit of the structure.

<u>Activity test</u>

The second element of treaty abuse under the basic rule is a missing link between the German-source income and the activities of the foreign recipient. A foreign entity (whose shareholders are considered "harmful" based on the look-through approach described above) would not be entitled to benefits if the source of its income subject to withholding tax (e.g., the participation in a German entity or the intellectual property giving rise to German-source royalties) does not have a material link or connection with the foreign entity's own economic activity. According to the legislative material, there would be some subjectivity in this test. It is mentioned that, e.g., unrelated economic activity would not be sufficient and that a multi-year period could be applied for the analysis, if, e.g., the source of the German income was acquired in connection with an economic activity that was later discontinued.

It is specifically stated in the proposed rules that the activity of the foreign entity would not be considered sufficient where the foreign recipient (i) simply passes its income on to shareholders or beneficiaries, or (ii) lacks adequate physical substance (business premises, personnel, etc.) for the activity it carries out.

Rebuttal of presumption of abuse for non-tax motivated structures
In line with CJEU jurisprudence, the proposed new German anti-treaty shopping rules would include an exception from the basic rule where it can be proven that "none of the main reasons" for interposing the foreign entity in a structure was to obtain a tax advantage. This

exception is similar to the "principal purpose test" (PPT), as provided in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). According to the legislative material, non-tax reasons resulting from the overall group structure would be able to be considered in the analysis. In addition, where shareholders are entitled to essentially the same benefits as the foreign entity, but under different provisions (e.g., different tax treaties), it should be "easier" to provide sufficient evidence of non-tax reasons, according to the legislative materials. However, as "none" of the main reasons could be to obtain a tax advantage, it remains to be seen how relevant this rebuttal will be in practice.

As is the case under the current rules, where the foreign entity is listed and regularly traded on a stock exchange, it generally would be entitled to benefits without being specifically required to prove that none of the main reasons for its structure was to obtain a tax advantage. However, contrary to the existing rules, the legislative material states that the exception for stock-listed entities would apply only if the listed entity itself receives the German-source income; the exception does not extend to subsidiaries held by stock-listed entities. This would significantly narrow the exception, as example 1 above might not be covered by the stock-exchange exemption, but rather would require proof of non-tax reasons. The existing exception from the anti-treaty shopping rules for companies subject to the German Investment Tax Act also would be eliminated, based on the current proposal.

The proposed draft law is still at a very early stage and is subject to approval by the federal government before it can be introduced into the formal legislative process. It seems unlikely that the legislative process will be initiated in 2020; it seems more realistic that the proposed draft law will move forward in 2021. Potentially affected taxpayers should monitor further developments.
