

Germany: Revised German anti-treaty shopping rules - Recent case law and first practical experiences

In Brief

Under the new German anti-treaty shopping rules, it has become more difficult to obtain withholding tax (WHT) relief for dividends / royalties in many holding structures, including those where WHT relief was granted under the old rules. This could impact many structures where cash is going to be repatriated from Germany, or where a German entity pays royalties abroad.

As example for the tightening of the rules, the so-called look-through approach, which in the past oftentimes relatively easy provided for WHT relief, can under the new rules in many structures not be applied anymore. Furthermore, the requirements for substance-based entitlement to WHT relief are interpreted strictly by the German tax authorities. In their view, holding companies conducting so-called passive participation management are not entitled to WHT relief even in EU-structures. In this respect, the German tax authorities also seem to ignore recent taxpayer-friendly case law of the Lower Tax Court of Cologne (judgement as of 16 February 2022, 2 K 1483/19).

The newly introduced Principal-Purpose-Test (PPT) could theoretically provide relief in many structures. But it is very difficult to predict whether it is possible to convince the Federal Central Tax Office (FCTO) that the PPT is met because the FCTO seems to be unsure how to apply the PPT in practice. In addition, first experience shows that the German tax authorities request extensive supporting documentation in connection with the taxpayers attempt to evidence that the requirements for WHT relief are met.

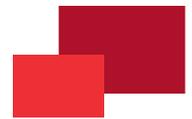
Consequently, it has become even more crucial for taxpayers to properly document business activities of relevant holding companies as well as non-tax reasons for setting up relevant structures. Such documentation should be prepared well in advance to be equipped for upcoming WHT relief procedures. Furthermore, obtaining WHT relief is time consuming, so that applications for relief should be prepared properly and started with sufficient lead-time.

I. Background

The German domestic anti-treaty shopping rules in Sec. 50d (3) of the German Income Tax Act (ITA) have been introduced to avoid the abusive use of a reduced WHT rate or an exemption. It principally applies whenever a foreign taxpayer seeks an exemption from or reduction of German WHT with respect to dividend or royalty income (and certain other payments that are subject to WHT under German tax law) under an applicable treaty, the Parent-Subsidiary-Directive (PSD) or the partial German domestic exemption under Sec. 44a (9) ITA on dividends to non-resident corporations.

When the foreign taxpayer deriving the dividend or royalty income claims for a refund of German WHT it has to prove to the FCTO its eligibility for the WHT relief. In this process, it also has to evidence that Sec. 50d (3) ITA does not prevent the WHT relief. The same applies where, in advance of making a relevant dividend or royalty payment, the recipient applies for a so-called WHT exemption certificate in order to avoid the deduction of WHT when the payment is made once the certificate has been issued.

The anti-treaty shopping provision of Section 50d (3) ITA was introduced in 1994 and has since then been subject to several amendments. In 2017, the European Court of Justice (ECJ) ruled that Sec. 50d (3) ITA in the version applicable as from 2007 did infringe the EU Freedom of Establishment. As a reaction, the German Ministry of Finance (MoF) in 2018 issued a circular in which it expressed a less strict interpretation of Sec. 50d (3) ITA in the versions applicable



from 2007 and from 2012 in cases where an exemption from WHT on dividend payments was claimed based on the PSD.

On 2 June 2021 and with effect as from 9 June 2021, Germany introduced a completely revised version of Sec. 50d (3) ITA. This revised version of the provision introduced new concepts, including a PPT, and principally applies to all open cases. However, for payments that have been received before 9 June 2021 the old rules can still be applied if they are more favorable for the taxpayer.

II. The anti-treaty shopping rules

The new rules grant WHT relief only to the extent that the foreign corporation, which receives the dividend or royalty income:

1. Is owned by persons that would be entitled to this WHT relief if they would receive the relevant payment directly (so-called personal entitlement or look-through approach); or
2. The relevant source of income has a substantial economic connection to an economic activity of the foreign corporation (so-called factual entitlement).

With respect to the requirement under 2., the receipt and passing along of the payments to shareholders or other beneficiaries or an activity that is not conducted with a properly equipped business establishment does not qualify as relevant economic activity, which is required for being able to fulfil the factual entitlement-test.

If the requirements under 1. and 2. are not fulfilled (i.e., neither personal, nor factual entitlement can be demonstrated), the rules presume an abuse by the foreign corporation and principally deny WHT relief to this extent. However, this presumption can be rebutted to the extent that the foreign corporation proves that it has not been interposed with one of the main reasons to achieve a tax benefit (so-called Principal-Purpose-Test).

Further, the provision does not apply if the shares of the foreign corporate taxpayer are substantially and regularly traded on a commonly accepted stock market (so-called Stock-Listing-Exemption).

The general German anti-abuse rule of Sec. 42 of the German General Tax Act (GTA) can explicitly apply notwithstanding the provision of Sec. 50d (3) ITA.

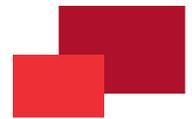
III. First practical experiences and recent case law

There are several aspects of the new rules that factually result in a tightening of the requirements for WHT relief, in particular, taking into account the interpretation of the rules expressed by the MoF in the explanatory notes to the draft bill. The first practical experience shows that the FCTO in fact interprets several aspects of the new rules in a very strict manner. Accordingly, obtaining relief from German WHT has become more difficult than before, even in Treaty-protected structures. Some of these aspects shall be described in the following paragraphs.

1. Look-through approach

Under the old rules, WHT relief was granted to the extent that the foreign corporation was owned by persons that could apply for a similar WHT relief if they had (hypothetically) earned the relevant income directly (look-through approach). Under the new rules, as interpreted by the German tax authorities, this does only apply going forward to the extent that the shareholders of the foreign corporation would be entitled to the **same** WHT relief based on the **same legal grounds, i.e., the same treaty or the same directive**.

To describe the implications of this strict interpretation, take the example of a US resident parent company, whose shares are listed on the NYSE and which owns shares in a Luxembourg-resident holding company that, amongst others, holds shares in a German GmbH. Principally, dividends from the German GmbH to the Luxembourg intermediate holding company could benefit from a 0% WHT rate under the PSD. If the shareholder of the Luxembourg holding company, the US parent company, did hypothetically hold the shares in the German GmbH directly, it could also benefit from a 0%



WHT rate under the Germany-US Treaty. As its shares are listed on the NYSE, the Stock-Listing-Exemption could apply at the level of the US top company, so that the German anti-treaty shopping rule would (hypothetically) not deny its entitlement for the 0% WHT rate. Under the look-through approach of the old rules, it made no difference that the legal grounds for the exemption were different so that the Luxembourg holding company could, therefore, benefit from the 0% WHT rate under the PSD.

However, under the new rules the look-through approach, in the view of the authorities, cannot be applied anymore in the example above as the basis for the (hypothetical) 0% WHT claim of the US parent company would be the Germany-US Treaty, whereas the basis for the 0% WHT rate of the Luxembourg holding company would be the PSD. Only if the direct shareholder of the German GmbH would also have a 0% WHT claim under the Germany-US Treaty (and not any other Treaty or the PSD), the look-through approach could still apply in view of the authorities.

2. Factual entitlement

Given the above, the question of factual entitlement to WHT relief has become more relevant.

Under the old rules, it was principally sufficient to evidence a substantial economic activity of the foreign corporation, whereas under the new rules this economic activity needs to have a substantial economic connection to the source of income (i.e., to the shareholding in the distributing company, or to the licensed IP for which royalties are paid). According to the explanatory notes, support services rendered by a holding company to its subsidiaries shall not be sufficient to demonstrate such a substantial economic connection.

Furthermore, first practical experiences show that the FCTO no longer accepts a so-called passive participation management as sufficient economic activity, even in EU-cases. Under the old rules, a passive participation management (sufficiently evidenced by demonstrating the actual exercise of shareholder rights) was held sufficient with respect to the 0% WHT rate under the PSD (i.e., on dividend distributions in EU-cases). However, under the new rules instead holding companies must demonstrate either an active participation management (i.e., actively managing the business operations of at least two subsidiaries) or another sufficient economic activity (e.g., a financing function) and this activity must have a substantial economic connection to the shareholding in the German distributing subsidiary.

Experience shows that so far mostly cases in which the taxpayers were able to demonstrate a very strong economic connection between the shareholder and the German subsidiary had been accepted by the FCTO in this respect. Such connection could, for example, be a properly evidenced regular and ongoing management of the subsidiary's actual business operations, or a business relationship as manufacturer-distributor.

Recently, the Lower Tax Court of Cologne with judgement dated 16 February 2022 (2 K 1483/19) ruled that even under the new rules a so-called passive participation management cannot *per se* be rejected as sufficient economic activity. Instead, referring to relevant ECJ-case law only in cases where the foreign shareholder is a mere pass-through entity a passive participation management should not be sufficient, as these structures could be qualified as artificial. Though, German tax authorities so far seem to ignore the taxpayer-friendly case law and still reject applications for WHT relief where the relevant foreign shareholders' activities are limited to exercising shareholder rights and reinvesting received funds.

3. Principle Purpose Test

Considering the tightening of the rules as described above, it is expected that in many cases going forward taxpayers can only obtain WHT relief by relying on the newly introduced PPT. In this regard, it has to be noted that in the view of the MoF, as expressed in the explanatory notes, every **German and/or foreign** tax benefit could be a relevant tax benefit in this respect. Based on first experiences, in practice relevant harmful tax benefits seem, however, to be limited to those (German or foreign) tax benefits that relate to the relevant (dividend or royalty) income. However, first experience also shows that it is difficult to demonstrate convincingly that the PPT is met in a way that is accepted by the tax authorities. This is because it is principally hard to evidence the non-existence of any tax benefit in relation to the income.

Furthermore, the questionnaire issued by the FCTO explicitly asks for evidence for non-tax reasons for interposing the foreign recipient of the income (shareholder or licensor) in the structure, even though the requirement of non-tax reasons is not explicitly stipulated in the law. These non-tax reasons may again be difficult to evidence, for example as non-tax reasons for establishing a holding company can be general efficiency and governance reasons, which however may not be easy to prove in the particular case.



As a result, the FCTO so far seems to have a certain reluctance to grant relief on the basis of the PPT. This results in lengthy procedures (of regularly more than 12 months) and many follow-up questions, even in situations where structures were clearly not set up to avoid German WHT. Further, it is currently very difficult to predict whether eventually WHT relief can be obtained on the basis of the PPT.

Overall, the first practical experiences show that German WHT relief procedures have become more difficult and time consuming than before, even in many structures apparently not designed to avoid German WHT where taxpayers may principally expect this not to be an issue (e.g., since the chain of entities up to the ultimate parent is completely treaty or directive protected). Taxpayers should consider the requirements set by the FCTO ideally already in advance when setting up the structure and try to prepare sufficient documentation well in advance of going into the WHT relief procedures.

IV. Key takeaways

- Under the new rules, it has become more difficult to obtain WHT relief for dividends and royalties in many holding structures.
- The German tax authorities interpret the new rules in a strict manner and request comprehensive documentation to evidence that the requirements for WHT relief are in fact met.
- It is crucial for taxpayers to document business activities of relevant holding companies as well as non-tax reasons for setting up relevant structures. Having in mind the new rules, such documentation should be prepared well in advance to be equipped for upcoming WHT relief procedures.
- Obtaining WHT relief is a lengthy process and, therefore, should be prepared properly and started with sufficient lead-time (e.g., where the end of the term of an existing WHT exemption certificate is approaching).



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