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German Tax and Legal News

Government approves significant updates to domestic withholding tax rules

Draft law would tighten application of anti-treaty shopping rules substantially and modernize existing WHT procedural rules.

The German government approved a draft law ("Law on the Modernization of withholding tax relief and certification of withholding tax") on 20 January 2021 that includes significant proposed changes to the anti-treaty shopping rules, as well as modernization of the domestic withholding tax (WHT) procedural rules. The approved draft law is based on a draft law proposal that was published by the German Ministry of Finance (MOF) on 20 November 2020 (see GTLN dated 11/23/20, GTLN dated 11/24/20 and GTLN dated 12/01/20). The changes to the anti-treaty shopping rules would tighten the application of the rules and restrict the circumstances under which nonresident companies may qualify for WHT relief. The draft law does not contain a proposed effective date for the changes to the anti-treaty shopping rules, so the changes would be expected to become effective in the year in which the law is enacted.

The draft law also includes changes to the transfer pricing rules and the introduction of broad advance pricing agreement procedures into domestic tax law, which are not covered in further detail in this article. The proposed relaxation of the German extraterritorial tax rules relating to intellectual property rights that are registered in a German public book or register that had been included in the original draft law proposal is not included in the approved draft law (see GTLN dated 01/20/21).

Anti-treaty shopping rules
The update of the anti-treaty shopping rules is a reaction of the German government to several decisions of the Court of Justice of the European Union in which the court concluded that the current version of the anti-treaty shopping rules violates EU law. The update takes into account such jurisprudence, as well as the requirements of the general anti-abuse rule in article 6 of the EU anti-tax avoidance directive (ATAD).

Similar to the current rules, the proposed anti-treaty shopping rules would apply where WHT benefits are claimed under a tax treaty or an EU directive (parent-subsidiary directive or interest and royalties directive), as well as where unilateral relief from WHT is claimed under section 44a (9) of the income tax code (ITC). However, the proposed rules 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.

The wording of the proposed anti-treaty shopping rules, which would amend section 50d (3) of the ITC, is as follows:

"A corporation, partnership or other taxable entity is not entitled to relief from WHT based on a double tax treaty to the extent that

- i. its shareholders or persons, that are beneficiaries under the applicable statute would not be entitled to the same treaty relief if they had been the direct recipients of the income, and
- ii. there is no material link or connection between the income generating source and the economic activity of the receiving corporation, partnership or other taxable entity; the mere realization of the income, the distribution to shareholders or persons, that are beneficiaries under the applicable statute, and activities that lack adequate physical substance do not qualify as economic activity.

Sentence 1 is not applicable to the extent the corporation, partnership or other taxable entity provides evidence that none of the main reasons for its interposition is to obtain a tax advantage or, if the main class of its shares are materially and regularly traded at a

recognized stock exchange. Section 42 of the General German Tax Code remains unaffected."

The conditions described under item (i) above can be referred to as the "shareholder test," and the conditions described under item (ii) above as the "activity test." Only if the conditions of both tests are fulfilled would treaty benefits for WHT purposes potentially be unavailable. In this case, as noted above, there would be a presumption of treaty abuse that could be rebutted only if, and to the extent that, the conditions of a "main purpose exception" or a "listed entity exception" are fulfilled (as provided in sentence 2 of the proposed anti-treaty shopping rules).

The approach provided in the draft law would result in a significant tightening of the conditions to benefit from a reduced WHT rate under a tax treaty or an EU directive. Foreign investors should consider their structures and any payments made by a German company that may trigger WHT. A more detailed analysis would be particularly appropriate where foreign investors are relying on the "look-through" approach that applies under the current anti-treaty shopping rules, which permits certain interposed companies to be disregarded in order to determine the eligibility for treaty benefits of a shareholder further up the ownership chain that fulfills the conditions of the current anti-treaty shopping rules.

Under the draft law, the look-through approach would be limited to structures where the shareholder of the entity that receives the payment would be entitled to benefits under the same tax treaty or the same EU directive as the recipient entity. Even if the same WHT benefit (e.g., the same reduced WHT rate) would be available for the shareholder under a different tax treaty, the proposed version of the anti-treaty shopping rules would not allow the application of the look-through approach. The look-through approach would effectively be limited to shareholders that are resident in the same country as the direct recipient of the payment triggering WHT or, in the case of an EU directive, to shareholders that are resident in an EU member state (assuming that the direct recipient also is resident in an EU member state). For all other scenarios where the look-through approach could be applied, it would be necessary to rely on the main purpose exception (see the examples in GTLN dated 11/24/20), under which "none of the main reasons" for the interposition of an entity could be to obtain a tax advantage. This could be a critical issue if the interposition of a company that has no economic activity was made for other tax reasons unrelated to the WHT analysis. The analysis that would be required under the draft law does not seem limited to WHT considerations, or even to German tax considerations. The broad applicability of the wording could make it difficult, if not virtually impossible, for taxpayers to rely on the main purpose exception to rebut a general presumption of treaty abuse.

The listed entity exception to a general presumption of treaty abuse would be limited to situations where the direct recipient of a payment triggering WHT is listed on a recognized stock exchange. Subsidiaries of a listed company could rely on the listed company exception only if, and to the extent that, the conditions of the main purpose exception are fulfilled. This significantly tightened approach for listed companies could result in a loss of WHT benefits that are available under the current rules.

According to the explanatory statement to the draft law, due to the requirements of EU law, the 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 and more strict approach that would not be in line with the current case law of the German federal tax court. It also is unclear how the proposed anti-treaty shopping rules and the more specific anti-treaty shopping rules in tax treaties would apply in conjunction with each other in practice.

Withholding tax procedures

In addition to the amendments to the anti-treaty shopping rules, the draft law would introduce several measures to update and modernize the current procedural rules to claim a reduced WHT rate under a tax treaty or an EU directive. The general framework of the rules, under which a WHT exemption certificate is required in advance to claim a reduced WHT rate under a tax treaty or an EU directive, would not change. In a case where no such exemption certificate is available, the domestic WHT rate applies at the time of withholding and a reduced WHT rate under a tax treaty or an EU directive must be claimed in a refund procedure.

The updated WHT rules would introduce an electronic filing process and an electronic database for carrying out refund and exemption certificate procedures. Electronic submission of applications for WHT exemption certificates and WHT refund applications would be expected to be available as from 2023.

Under the existing rules, applications for a WHT exemption certificate and WHT refund applications must be stamped by the relevant foreign tax authority to certify the tax residency of the applicant for treaty/EU directive purposes. Separate tax residency certificates generally are not accepted by the federal tax office (with the exception of US tax residency certificates, issued by the Internal Revenue Service through Form 6166, for US resident applicants). Based on the proposed rules, the procedure would be simplified by the federal tax office accepting separate foreign tax residency certificates from other jurisdictions, instead of requiring the German application forms to be stamped by the foreign tax authorities.

The existing rules provide that WHT exemption certificates generally are valid for a three-year period as from the application date. The three-year period would remain unchanged under the proposed rules; however, an exemption certificate would become valid as from the date of its issuance, instead of from the original application date. This change also would have consequences for WHT that becomes due in the interim period between the date when the application is filed and the date of issuance of the exemption certificate. Under the current rules, it is possible to either amend the WHT returns that were filed in the interim period (i.e., the period between the application date and the issuance date) or to file a formal refund application with the federal tax office to claim a reduced WHT rate listed in the exemption certificate. The option to amend WHT returns in such a situation would be eliminated under the proposed rules, meaning that it would be necessary to file a formal refund application to claim a reduced WHT rate.

The amended procedural rules for WHT purposes would allow the federal tax office to issue WHT exemption certificates in situations where it is unclear whether the underlying payment is subject to WHT based on the domestic rules. Under the current rules, the decision on whether a payment generally is subject to WHT based on the domestic rules is reserved to the local tax office, although the federal tax office already has decided whether to issue certificates on a case-by-case basis in the past.

WHT refund applications based on a tax treaty or an EU directive must be filed within a four-year period that begins at the end of the calendar year in which the payment triggering WHT was made. Although this time period would not change under the proposed rules, the current six-month period for WHT refund applications in a case where WHT payments are made after the end of the four-year period would be extended to one year. This taxpayer-favorable change could be particularly beneficial for WHT that is assessed, e.g., in a tax audit carried out a couple of years after the payment triggering WHT was made.

The draft law would retain the general principle that WHT claims/refunds do not trigger interest; interest will continue to accrue only for WHT refunds that are based on the EU interest and royalties directive (as required in the directive itself).

In addition, the draft rules include detailed provisions regarding the issuance of tax payment certificates for WHT on dividends, and would introduce penalties for noncompliance with these rules.

The proposed rules also would centralize the responsibility for EU law-based WHT refund applications ("*Denkavit/Fokus* bank claims") with the federal tax office (see GTLN dated 12/01/20).

Next steps

The draft law now must pass through the legislative process in the upper and lower houses of parliament. Further changes and amendments are possible throughout the legislative process, and future developments should be monitored. It is recommended that taxpayers analyze their holding structures and operating models to be prepared for the potential changes to the German anti-treaty shopping rules.

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