



Petersen + Partner

German Anti-Treaty Shopping Rule

Guideline

October 2016

German withholding tax relief

German anti-treaty shopping rule



- Dividends paid by an German entity ('GmbH') to a foreign entity ('ForCo') are generally subject to 26.375% German withholding tax (WHT). In case of royalties, the WHT tax rate is 15.825%.
- The withholding tax burden may be significantly reduced (or fully avoided) where treaty protection is available or where the respective EU/EEA-Directive grants relief. In addition, for dividends paid to corporations, partial relief lowering the tax rate to 15.8125% is available under German domestic law.
- However, any such relief is granted only if the requirements of the German anti-treaty shopping rule are met (unless the treaty includes an own anti-abuse rule itself as for instance the treaty between Germany and the US or between Germany and the Netherlands; in this case these rules must be fulfilled instead).

Principles of anti-treaty shopping rule

German anti-treaty shopping rule



- Treaty relief, directive relief or domestic relief is fully granted where the ultimate shareholder (i.e. individuals, listed companies, investment funds or the first entity up in the corporate chain which is entitled for full protection under the anti-treaty shopping rule) would likewise fully benefit from the protection had the foreign entity ('ForCo') not been interposed in-between.
- Any such protection is also granted where this is not the case but 'ForCo' fulfills the requirements of the German anti-treaty shopping rule (see below in detail). However, in this scenario, the WHT relief is always granted only **pro rata** in the ratio of all qualifying income to all non-qualifying income as derived by the foreign interposed entity (pro rata approach).



How to fulfill the rule?

Options available

How to fulfill the rule?

In practice, the taxpayer should always argue that both options are fulfilled

Where this is not feasible, one could try to rely only on one of these options but court proceedings may be required in this case

According to the wording of the law, two alternative options are available to fulfil the requirements of the German anti-treaty shopping rule, i.e.

- the interposed foreign entity must either be engaged in own and genuine business activities
- or
- the foreign entity has been interposed for valid economic or other qualifying means and the entity is showing sufficient economic substance (i.e. qualified staff and equipped business premises).

However, in practice, German tax authorities are very reluctant to accept only 'valid economic or other qualifying means' but usually request evidence for both, i.e. that the entity is (1) engaged in own and genuine business activities and (2) shows sufficient economic substance for these activities in the country of residency of the entity.

Pro rata approach

How to fulfill the rule?

In practice, the pro rata approach is often the most critical issue of the German anti-treaty shopping rule

- Even where an entity is fulfilling all these requirements, in the view of German tax authorities, relief is granted only limited to the pro rata approach.
- For instance, where qualifying income in the amount of 200 is derived by the interposed entity from own and genuine business activities and further non-qualifying income in the amount of 100 through a 'harmful' dividend from a foreign subsidiary (i.e. a subsidiary that is neither required from a functional perspective for the business of the interposed entity nor actively managed by the interposed entity), treaty protection, directive protection and domestic relief is granted only pro rata. As a result, in the case at hand, the available relief is limited to 66% (=200/300).
- Thus, to obtain full directive or treaty protection, the interposed entity should derive solely income from qualifying sources and should not obtain any 'harmful' income in the respective year.

Own and genuine business activities

How to fulfill the rule?

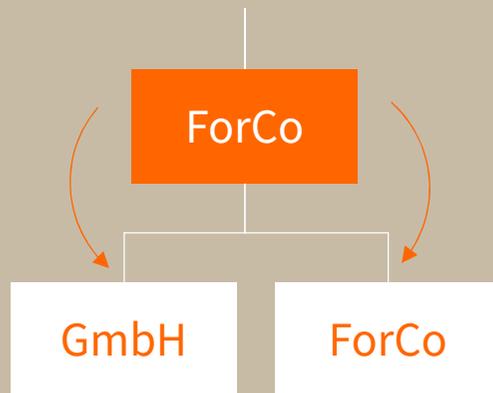
- Commercial or industrial activities
- Rendered by own staff of the entity

According to the German anti-treaty shopping rule, relief is granted to the extent that the interposed foreign entity is engaged in own and genuine business activities:

- Fulfilled where income is derived from core commercial and industrial business activities, such as production, distribution, or rendering of services by own staff of the foreign entity.
- Furthermore, the entity must be engaged with its business in the market place of its country of residency on an active and sustainable basis (but sufficient to perform intragroup services against arm's length remuneration).
- Relief is not available where income is derived from mere portfolio management or the exploitation of acquired intellectual property or where the activities of the entity and/or its management is outsourced to a third party or an affiliated entity.
- Dividends or royalties which functionally related to the activity of the interposed entity should also not qualify as 'harmful' for the pro rate approach (e.g. from a subsidiary which is distributing products that are manufactured by the interposed entity). Seite 7

Management holding exception

How to fulfill the rule?



Management holding

According to a decree issued by German tax authorities, the foreign entity qualifies as being engaged in an own and genuine business activities where it acts as a management holding for its subsidiaries:

- The entity must hold and actively manage at least two subsidiaries. Therefore, the interposed entity must take over all significant long term and strategic or other meaningful decisions of these subsidiaries (to be documented on an ongoing basis).
- Taking over only distinctive management functions (e.g. IP management, accounting, advisory activities) is not sufficient, however, the more such functions are performed, the better.
- It is not required to take over the subsidiaries management of its day-to-day business (common pitfall where taken over: potential shift of the subsidiaries' tax residency).
- In practice, the foreign entity should enter into management agreements with the respective subsidiaries based on an arm's length remuneration.

Valid economic means and substance

How to fulfil the rule?

- Sufficient and qualified own staff
- Telecommunication equipment and business premises

According to the German anti-treaty shopping rule, relief is granted where the foreign entity has been interposed for valid economic or other qualifying means and is showing sufficient economic substance:

- In practice, it is quite unclear which reasons count as valid means (potentially e.g. an entity acting as a joint venture vehicle), nonetheless, where the interposed entity is engaged in own and genuine business activities (first requirement, see above), this criterion is usually no longer tested by German tax authorities.
- To qualify for sufficient economic substance, the entity should show sufficient and qualified staff (management and other) to undertake its activities; outsourcing is harmful but split payroll in line with arm's length standards is usually accepted.
- Furthermore, telecommunication equipment and properly equipped premises should be obtained which must be located in the country of tax residency of the foreign interposed entity. Subleasing of office space from other group affiliates is usually accepted if remuneration is in line with arm's length standards.

Tax authorities' questionnaire

How to fulfil the rule?

- Comprehensive evidence must be provided
- To be considered before applying for refund or exemption certificates

German tax authorities tend to rely on a questionnaire when testing the substance of the foreign entity, requesting in particular:

- Copies of the entity's last balance sheet and P+L.
- Copies of rental or purchase agreements to document the availability of business premises.
- List of telephone/facsimile numbers and copies of telecommunication invoices; list of emails/internet domains.
- List of employees including their roles, copies of employment contracts, social security registration and documents showing the actual payments of the relating wages.
- Information on who is acting as director of the entity, i.e. managing the foreign companies day-to-day business and where these activities are carried out; detailed information on whether and to which extent these persons are acting for other companies.
- Information on whether the director is a layer, (tax) advisor or a trustee and evidence for amounts of paid compensation.



Special topics

Limitations in multi-tier structures

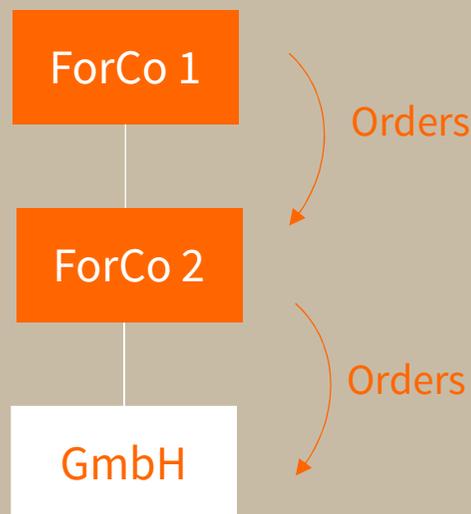
Special topics



- In a multi-tier structure, the German anti-treaty shopping rule must be tested at each level up to the ultimate shareholder or the first entity being fully entitled for protection; the relief granted is limited at each level.
- Regardless of the ultimate shareholder's tax residence no treaty or directive relief is granted where there is an entity in the chain that is neither benefiting from treaties nor directives itself (e.g. a Cayman Island entity).
- For instance, where 'ForCo 2' is entitled for a treaty based reduction of WHT to a rate of 5% but itself does not fulfill the requirements of the anti-treaty shopping rule, relief can be obtained solely to that extent (i.e. to a rate of 5%), even if 'ForCo 1' is fulfilling all requirements and entitled for protection to 0% WHT would 'ForCo2' not have been interposed.

Routing of decisions in multiple-tier management holding structures

Special topics



- Where 'ForCo 2' is generally subject to treaty or directive protection but 'ForCo 1' is not and the group wants to rely on the management holding exception, the management holding exception must be met at 'ForCo 2' level.
- It should not be harmful if 'ForCo 1' is giving orders to the directors of 'ForCo 2' with respect to the management of GmbH if the directors of 'ForCo 2' are carrying these instructions out through giving own orders to GmbH (to be documented in writing).
- In contrary, where the management of 'ForCo 1' is directly instructing GmbH, this should be harmful. Thus, thorough documentation of each order is recommended where management orders are routed through the company chain.

Tax exemption certificates

Special topics

- Tax exemption certificates avoid cash leakage and allow clarification of the entitlement upfront
 - However, reporting obligation exist where change of income ratio exceeds the de-minimis-rule
- The foreign interposed entity may either claim for a refund after the WHT has been transferred to German tax authorities or apply for a respective (partial) tax exemption certificate upfront.
 - The German subsidiary is entitled to refrain from withholding the tax where it has a valid certificate of the foreign entity in its files. An exemption certificate is usually issued valid for three years.
 - In case of the refund process, for the pro rate approach, the ratio of 'qualifying' to 'harmful' income of the interposed entity in the year of the respective dividend or royalty payments is decisive.
 - For the exemption certificate, the profit ratio in the year where the application is filed should be decisive (in practice, usually based on the P+L of the previous year which has to be filed with the application) but the taxpayer must report if over time the ratio of qualifying income to all income of the entity is reduced by at least 30% percentage points over time (de-minimis-rule).



Planning technics

Various planning opportunities

- Implementation of management holdings (often relied on by multinational companies).
- Sound planning of corporate structure (e.g. avoiding 'harmful' income at the level of the respective management holdings; typically through split structures with different holdings for qualifying and no qualifying subsidiaries).
- Ballooning concepts, i.e. postponing payments of qualifying or 'harmful' dividends and royalties so that solely qualifying income is derived in certain years and solely harmful income in others (usually easier if relying on refunds rather than exemption).
- Relying on partnerships or permanent establishments rather than German corporations for undertaking business in Germany.
- Repatriation by other means, e.g. through capital gains, etc.; to be considered only where no other relief can be obtained.

Notes to this presentation

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