

Tax Alert

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German Parliament Votes on Tax Bill 2007 New Anti-Treaty Shopping Rules

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German Tax Bill 2007

German Tax Bill 2007 includes important changes in the German international tax rules, most notably a significant tightening of German anti-abuse rules on withholding tax exemptions under a tax treaty or EC Directive. The German parliament passed on November 9, 2006, the entire bill with certain modifications to the original draft. The German State Assembly confirmed the bill on November 24, 2006. Most measures will come into effect as of January 1, 2007.

New Increased Substance Requirements for Foreign Holding and Licensing Companies

The German domestic withholding tax of 21.1% on dividends, royalties and certain other payments is reduced to a 0%–15% rate under EC Directives and tax treaties. Under the new rules of Sec. 50d (3) Income Tax Act (ITA), any foreign company which (i) receives a payment subject to German withholding tax, and (ii) which is owned by shareholders that would not be entitled to a corresponding benefit under a treaty or the EC Directive, had they received the payment directly, will not be entitled to a reduced or 0% withholding tax rate if one of the following three tests is failed (i.e., all three tests must be satisfied cumulatively to obtain treaty or EC directive benefits):

1. Business Purpose Test

Treaty and EC Directive benefits will be denied if there are no business or other important (non-tax) reasons for the interposition of the foreign entity. When judging the validity of a business reason, any factual matter related to a shareholder or affiliate of the interposed entity cannot be taken into account. As a consequence, any valid business purpose at the shareholder level, which could justify the interposition of a foreign company, such as legal liability shielding, asset protection, estate tax reasons, etc., are not taken into account. In the end, this should mean that only activities or objectives that are pursued by the foreign entity itself would qualify under the business purpose test.

2. 10% Gross Receipts Test

Treaty and EC Directive benefits can only be obtained if more than 10% of the gross receipts of the foreign entity stem from «its own business activities». Income derived from the administration or management of assets and income derived through outsourced activities are not taken into account for purposes of the 10% test. According to the legislative materials, the 10% threshold will mean that the foreign entity should not be able to satisfy the trade or business requirement with «minimal» activities.

As a primary element of the rule, the 10% threshold test can only be met with «business» income. According to settled case law and acknowledged by the legislative materials, the existence of a so called «management holding company» still qualifies as a business activity. To qualify as a management holding, the holding company's management must determine, through overt activities, the principal business policies and issues of the group and must coordinate, accordingly, the principal activities of the individual group members. Concerning the 10% threshold, it appears, however, that dividend income received from the subsidiaries of a management holding company would not qualify as «business activity gross receipt», since the statute explicitly excludes income from managed assets from the «business income» definition. To qualify under the test, it would then also be necessary for a management holding to provide (with its own resources) services to subsidiaries that generate income from service activities in excess of 10% of the annual dividend income. Income from financing activities will in most cases be treated as non-qualifying income derived through the management of assets (i.e., the inter-company receivables).

The new rules do not explicitly define how the 10% gross receipt threshold must be calculated or in which period the 10% gross receipts test must be met. Legisla-

tive materials make reference to certain German CFC rules, which determine that gross receipts must be calculated on the basis of the GAAP P&L, net of VAT and net of any GAAP income stemming from constructive contributions. More importantly, it seems that the law requires that the 10% hurdle must be passed in and for the year of distribution. Since the exemption certificates, which allow a German payer to refrain from withholding, are issued by German tax authorities in advance, it is unclear yet on what basis German tax authorities will actually issue the certificates after the change in law becomes effective, as future gross receipts can only be forecasted on a subjective basis. If applied on an annual basis, the rule will make dividend planning (i.e., the selective distribution of income from several years in one particular year) particularly difficult.

Although the EC Parent – Subsidiary Directive allows the member states to introduce anti-avoidance measures, it is at least questionable whether the introduction of an arbitrarily chosen 10% gross receipt test, which puts up a significant barrier for withholding tax exempt investment from other EC member states, will be acceptable under EC law principles. Litigation at the EC Court of Justice should be expected to come in this context.

3. Substance Test

The foreign entity must maintain a commercial business operation and participate in the market. The business operation must be established for the purpose of carrying on that «business activity». Pursuant to the legislative materials, this requirement will ensure that the foreign intermediary company maintains substantially equipped business premises («substance») from which it carries out its business activities and that it has established for that purpose. The new law falls short in defining what substantially equipped

business premises are, which will result in unavoidable uncertainties. As already outlined above, the activities of a management holding should qualify as «participation in the market». Under other authorities, service activities rendered to subsidiaries should also qualify as market participation (even if rendered to only one subsidiary), provided that the services are rendered and invoiced according to customary (market) standards.

As stated, failure to meet only one test will result in the denial of withholding tax benefits. The new law would apply for all distributions made on or after January 1, 2007.

Procedural Issues

German tax authorities issue advance exemption certificates, which allow the payer to refrain from withholding, typically for periods between one and three years. The new statute does not explicitly address the validity of exemption certificates issued under old law. However, under current rules, the foreign payee would have to inform German Tax Authorities if the prerequisites for an exemption are no longer met. Given this, a foreign payee would have to review after January 1, 2007, whether the company qualifies for exemption under the new rules, and in the event of a negative answer, inform German tax authorities accordingly.

Non-compliance with this obligation could result in a secondary liability of the payee for unpaid withholding taxes. It is thus recommended that every foreign payee review the ongoing validity of an exemption certificate that has been issued under old law (i.e., until December 31, 2006).

In addition, German exemption certificates can be revoked by German tax authorities. It remains to be seen whether German tax authorities will take the initiative and revoke certificates issued under old law.

Public Company and Investment Fund Exception

The statute does not apply if the recipient of the payment is an entity the shares of which are regularly and to a significant extent publicly traded on a recognized exchange. As a new development, the final version of the bill also stipulates that the statute does not apply to payments made to entities to which the provisions of the German Investment Tax Act apply. It thus seems that the statute should not apply to payments made to entities that qualify as a (foreign) investment fund under the Investment Tax Act. ■

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