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Ministerial Draft Bill for an Act to Modernize the Relief from Withholding Tax

on 20 November 2020, the Federal Ministry of Finance [BMF] published the ministerial draft bill for an "Act to Modernize the Relief from and the Certification of Withholding Tax". The draft bill contains – among others – amendments regarding the **anti-treaty shopping rule** and the **limited tax liability** in cases where the right is merely registered in a domestic register.

The purpose of the Act is to revise the provisions for the relief from withholding taxes on the basis of double tax treaties and EU directives. This particularly applies to withholding tax reductions for dividends and royalties that can either be claimed by way of an exemption procedure or a refund.

Anti-Treaty/directive shopping

The anti-treaty/directive shopping rule shall be substantially revised. Most of the amendments mean a significant tightening. Basically, however, it remains unchanged that no withholding tax reduction shall be granted if a hardly functioning company is interposed between the shareholder and the distributing or paying domestic company. According to the revised provision, a foreign company, irrespective of existing DTA provisions, **is not entitled to claim** withholding tax relief to the extent that

- persons hold shares in the company who would not be entitled to the relief if they earned the income directly (so-called personal entitlement to relief) **and**

- the source of income has no substantial nexus to an economic activity of that foreign company (so-called material entitlement to relief).

For the **personal entitlement to relief,** the shareholder would need to have, according to the explanatory memorandum, an entitlement to relief pursuant to the "same entitlement norm". This would not be the case even if the shareholder was entitled to claim the equivalent amount of relief, but the entitlement resulted from another DTA. In comparison with the current version, this means a significant tightening. Also, in the event of so-called meander structures (with

Content

domestic shareholders of the foreign company), the personal entitlement to relief would not be given according to the revised version. This, however, does not yet lead to a refusal of withholding tax reduction. The next step would be to examine the material entitlement to relief of the foreign company.

For the **material entitlement to relief,** a "substantial nexus" of the income from the shareholding (or the licensing right) to the economic activity of the foreign company shall henceforth be required. The currently applicable anti-treaty/directive shopping rule, however, is based on "gross income from own economic activity" of the foreign company. In so far, there is a tightening. According to the explanatory memorandum, the entitlement to relief could now be refused despite full economic activity of the foreign company, if e.g. no transparent economic function in the context of the activity of the foreign company can be attributed to the shareholding in the domestic company. To the extent that a substantial nexus with the own economic activity of the company can only be established in parts, a pro rata refusal of the relief could be considered, according to the explanatory memorandum.

A "forwarding activity" of the foreign company without an adequately established business operation shall be expressly excluded as an economic activity. Up to now – somewhat more extensively – an administrative activity has been excluded as an own economic activity just as the transfer of substantial business activities to a third party. This is no longer the case in the planned revision of the anti-treaty/directive shopping rule. The active management of its shareholding should continue to be recognized as an economic activity without changes.

According to the revised version, the anti-treaty/directive shopping rule shall not be applicable if it can be shown that **none of the main purposes** for the interposition of the foreign company constitutes **a tax advantage.** This means a tightening, too. In the currently applicable version, the interposition of the foreign company is only considered abusive if there are no economic or other valid reasons.

Further tightening is provided for the exception in the form of the **stock exchange clause** which, according to the explanatory memorandum, shall henceforth only be applicable to the foreign company. Listing of a shareholder on a stock exchange, however, shall not suffice. The exception for investment funds is no longer included in the planned revision of the anti-treaty/directive shopping rule.

The **first-time application** of the revision is not regulated separately. The general rule of application would therefore be at the point in time when the law enters into force.

Non-resident tax liability in the event of the licensing of rights

Non-resident tax liability may result from the licensing or sale of a right (e.g. patents) that is registered in a **domestic public register** or exploited within Germany.

According to the explanatory memorandum to the Act, the circumstance of a non-resident tax liability solely based on the **registration of a right in a domestic register** shall be deleted. Accordingly, only cases with a substantial domestic nexus would be subject to non-resident taxation, i.e. in cases where the licensed right is exploited in a domestic permanent establishment or facility of the licensee. The explanatory memorandum details that currently all cases of mere registration in a domestic register are indeed covered by the wording of the Act, however, running counter to the **intent and purpose of the law**.

With its **letter of 6 November 2020**, the **BMF** has only recently affirmed that non-resident tax liability is given in all cases of registration in a domestic public register.

The revised provision shall be applicable to all **open cases.**

Outlook

The publication of the ministerial draft bill constitutes the first step in the legislative procedure. Subsequent to the adoption of the government draft by the Federal Government, the Bundesrat [upper house of the German parliament] is given an opportunity to comment on the draft legislation; therefore, changes may still occur during the legislative procedure.

Federal Tax Court (I R 32/18): Deduction of Definitive Losses incurred by an Exempt Permanent Establishment under EU Law

The Federal Tax Court (BFH) has again identified a need for clarification in respect of the consideration of definitive losses of an EU permanent establishment and has submitted several questions to the European Court of Justice (ECJ) regarding this matter.

The case at hand involves the definitive losses that a stock corporation resident in Germany incurred from a permanent establishment in the United Kingdom: the plaintiff, a German bank, maintained a branch in the United Kingdom in financial years 2004/2005 to 2006/2007 that generated no profits. The branch's operations were therefore discontinued in mid-2007. Owing to this closure, it was no longer possible to carry forward the tax losses in the United Kingdom. According to the applicable DTA provisions with the United Kingdom, income from a UK permanent establishment is (subject to progression clause) exempt from taxation in Germany. As a consequence, the plaintiff was of the opinion that the branch's losses (despite the income being exempt from domestic taxation under the DTA) were required to be considered as definitive losses on the grounds of EU law. However, the tax office disregarded the losses. The action against this was successful.

In a reference for a preliminary ruling procedure submitted to the ECJ, the BFH has requested clarification on whether the European freedom of establishment would require losses disregarded in the United Kingdom due to the closure of the permanent establishment in that country to be considered as definitive losses and thus have a tax-reducing effect on the tax base in Germany.

This disputed subject dates back to the landmark ruling of 13 December 2005 "Marks & Spencer" (C 446/03), in which the ECJ established the construct of definitive losses for the first time. In the past, the ECJ in its judgment on the Timac Agro case (17 December 2015, C-388/14) – and the BFH in its implementation ruling of 22 February 2017, I R 2/15 – had initially rejected consideration of a permanent establishment's definitive losses. However, in its more recent ruling in 2018 on the Bevola/Trock case (12 June 2018, C-650/16), the ECJ then stated to the contrary that EU law does require definitive losses to be considered.

The BFH therefore considers a reference for a preliminary ruling necessary in a total of five questions, as it holds the opinion that the principle of the requirement to consider definitive losses of a non-resident exempt permanent establishment, the amount of any losses to be considered and the criterion of "definitive" are not sufficiently clarified. The BFH also explicitly asks whether consideration of definitive EU permanent establishment losses applies for both corporate income tax and trade tax purposes.

Order for Reference of the Lower Tax Court of Cologne to the ECJ on Withholding Tax for Dividend Payments to EU Corporations

With its decision dated 20 May 2020 (File ref: 2 K 283/16), the Cologne Lower Tax Court submitted two questions to the ECJ on the legality under EU law of the obligation in § 32 (5) of the German Corporation Tax Act [KStG] to provide evidence of the refund of withholding tax on capital gains.

§ 32 (5) KStG governs the refund of withheld and paid capital gains tax in cases in which an EU/EEA corporation has generated capital income on an investment of less than 10% in a domestic corporation and this income is taxed and thereby no longer needs to be declared. The ECJ had already rejected this discharging effect of withholding tax in cases of free float holdings of non-resident shareholders in its ruling of 20 October 2011 (C-284/09). The resulting economically higher taxation of free float dividends of

German corporations paid to other EU/EEA states compared to the tax treatment of domestic dividend payments, for which the withholding tax is offset or refunded as part of the tax assessment, violates the free movement of capital of Article 63 of the Treaty on the Functioning of the European Union (TFEU).

As a consequence, the German legislator amended the legislation by ordering equal taxation of free float dividends both in domestic and in cross-border cases from 1 March 2013. For old cases in which a dividend payment to the EU/EEA-non-resident shareholder had already been made before 1 March 2013, the German legislator introduced a refund option according to § 32 (5) KStG, though claiming this refund involved a number of formal and substantive requirements.

In its order for reference dated 20 May 2020, the Cologne Lower Tax Court questioned one of the specific criteria, namely the obligation stipulated in § 32 (5) sentence 2 no 5 KStG to provide evidence that the withholding tax may not be credited to the recipient or a shareholder directly or indirectly invested in the recipient or be deducted as operating expense or as income-related expense. First, the Lower Tax Court sees a potential violation of Article 63 TFEU, as such evidence continues to not be required for a comparable domestic case. Second, the Lower Tax Court sees in this specific case a violation of the principle of effectiveness, as it deems it not possible in reality for the plaintiff – whose shareholder is a listed UK company – to determine all direct and indirect shareholders.

It remains to be seen how the ECJ will decide. As § 32 (5) KStG is an old provision that is no longer applicable, it is also always necessary to check whether a statute of limitations on assessment has already expired when claiming the relevant entitlement to refund.

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