

Real Estate Tax Services News

Keeping you informed

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Draft law on the modernisation of the relief from and the certification of withholding taxes

In brief

On 20 November 2020, the Federal Ministry of Finance published a draft bill on the modernisation of the relief from and the certification of withholding taxes. The amendments relate, among other things, to the withholding and refund procedure, the anti-treaty-shopping regulations and the provisions on non-resident taxation for income arising from licensing or the disposal of rights which are entered in a domestic public register. The new version of the German anti-treaty-shopping rule is examined in more detail below.

New version of the German anti-treaty-shopping rule

The draft bill proposes substantial changes to the current German anti-treaty-shopping rule taking into account the requirements of EU law.

The proposed new anti-treaty-shopping rule contains elements which are already known from the current regulation. However, the law intends to introduce some significant changes to the provision. The changes intend to reflect the principles developed by the CJEU judgments in the “Danish beneficial ownership” cases and the requirements of Article 6 of the EU Anti-Tax Avoidance Directive (EU ATAD).

Basic rule

The basic rule still limits treaty entitlement if none of the below mentioned tests are met:

Personal entitlement to relief

Under the test referring to the personal entitlement to relief, it needs to be verified whether the shareholders of the foreign company seeking relief would be (hypothetically) entitled to treaty relief if they received the payments directly ("**look through approach**").

However, the provision refers to the specific entitlement, ie, the claim for relief under the specific double tax treaty (DTT). With this change the legislator intends to tighten the provision according to the explanatory materials of the draft bill. As a consequence, the shareholders' entitlement to an equivalent relief under another DTT should no longer be sufficient to meet this test. This could have an impact on situations where the foreign entity claiming treaty relief and its shareholders are resident in different jurisdictions insofar the exemptions from the basic rule discussed hereafter are not applicable.

Substance: Material connection with the own activity

The substance test is not fulfilled if the source of income (eg, in case of a dividend, the participation) has no material connection with an own economic activity of the foreign company. In other words, the underlying source of income needs to serve an economic function with regard to an economic activity of the foreign entity.

The explanatory materials of the draft bill indicate that it needs to be explainable why the foreign company receives the income in question in order to meet the "material connection with an economic activity test". Going forward it needs, therefore, to be assessed on a case-by-case basis, whether the test is fulfilled.

Further, no economic activity of the foreign company is assumed if

- a) income is generated and passed on by the foreign company to participating or beneficiary persons, or
- b) an activity is performed even though the company is not equipped with sufficient business premises, personnel, etc.

The explanatory notes remain vague, eg, under which circumstances shares held by a foreign holding company are considered to have a material connection to the own activity of that holding company. According to the explanatory notes such context is given in the case of active management by the holding company of its participation in the subsidiaries where the holding company determines the actions of the subsidiaries. However, purely passive management is, according to the explanatory notes, insufficient.

Exemptions from applying the basic rule

Finally, the proposed new German anti-treaty-shopping rule contains two exceptions:

1. A provision similar to the "principal purpose test" which grants treaty entitlement upon proof that none of the principal purposes of the foreign company's interposition is to obtain a tax advantage and
2. A "stock exchange clause", which grants treaty entitlement if the shares of the entity claiming treaty entitlement are traded regularly on a recognised stock exchange.

The latter exception is already foreseen in the current legislation. However, the materials of the draft bill include an important statement that the "stock exchange clause" should in future only apply at the level of the foreign company claiming withholding tax (WHT) relief (ie, this clause would not apply anymore at the level of the (indirect) shareholder of the foreign company).

The currently existing exemption from the German anti-treaty-shopping rule for companies, which are subject to the German Investment Tax Act, will be deleted.

Scope of application of the revised anti-treaty-shopping rule

The revised German anti-treaty-shopping rule applies for benefits claimed under a DTT, the EU Parent-Subsidiary Directive, the Interest and Royalty Directive and the unilateral relief under Section 44a(9) of the German Income Tax Act.

According to the explanatory materials the new anti-treaty-shopping regulations should also apply if a DTT contains a special provision to prevent treaty abuse such as the "limitation on benefits" (LOB)-clause according to Article 28 of the U.S.-German DTT. In addition, the explanatory materials state that the German general anti-abuse rule is also applicable besides the anti-treaty-shopping provisions.

Miscellaneous

The draft bill foresees several other changes to the procedural provisions for obtaining an exemption certificate or getting taxes refunded and a higher level of digitalisation of the procedure. According to these changes, it would not be possible anymore to obtain exemption certificates retroactively; they would be valid only from the date of issuance (ie, and not from the date of application anymore).

Further changes to the German Reorganisation Tax Act aim to prevent the use of losses via reorganisations with retroactive effect for tax purposes and other measures are also included in the draft bill.

What next?

The draft law does not explicitly state the date of application of the revised requirements. Other amendments to the German WHT regime included in the draft bill apply for instance after December 2022. It remains open, whether this date will also apply to the named substance requirements.

The bill is only a draft law from the German Ministry of Finance and has not been decided to be submitted to Parliament by the German government yet. Therefore, further amendments to the draft bill are still possible. The further legislative process of the draft bill should be closely monitored.

Our view

The implementation of this draft law will have to be monitored by all foreign real estate investors who invest in Germany through German corporations subject to WHT. As noted, the explanatory notes remain vague and leave considerable room for interpretation by the tax authorities. Seeing that the reasoning extensively refers to the recent EU Anti-Tax Avoidance Directive as well as the Base Erosion and Profit Shifting (BEPS) Action Plan regarding the justification of anti-abuse measures, the draft seems to focus on limiting the scope of application of the ECJ decisions on the previous German WHT regime. It will therefore have to be monitored closely, whether and to what extent the German requirements for WHT exemption certificates and WHT refunds will tighten again after having been relaxed in 2018 based on the named ECJ decisions.

Investors investing in German real estate via German corporations will therefore have to monitor going forward when it is the most adequate time to repatriate gains via dividend distributions and what substance requirements need to be met in existing structures to ascertain the application of the EU Parent-Subsidiary Directive and reliefs under the applicable DTTs going forward.

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