

Real Estate Tax Services News

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PwC Germany | January 2021

German draft bill on the modernisation of the withholding tax relief procedure

In brief

On 20 January 2021, the German Federal Government adopted the draft bill on the modernisation of the relief from withholding taxes and the certification of withholding tax paid (*Abzugsteuerentlastungsmodernisierungsgesetz*, or *AbzStEntModG*). The draft bill includes changes to the withholding tax and relief procedure and an adjustment of the German anti-treaty shopping rules. However, the envisaged retroactive abolishment of the German sourcing rules for licenses and intellectual property (IP) sales transactions based on the mere registration of underlying rights in a German register was dropped. The approval of the bill by the German Federal Government is the first step of the legislative process; so further changes of the draft bill may occur and need to be monitored.

New German anti-treaty shopping rules

The adjustment of the German anti-treaty shopping rules intends to align them with recent related decisions of the European Court of Justice (ECJ) taking into account requirements under European Union law.

The basic structure of the provision requires the taxpayer to demonstrate that the foreign beneficiary has not been interposed with the main goal of obtaining relief from German withholding tax under an applicable treaty and/or an applicable EU directive. For this purpose, a treaty or EU directive entitlement is generally denied unless the personal entitlement or substance test may be fulfilled.

Personal entitlement test

According to the personal entitlement test, a withholding tax relief is not available if the shareholder of the foreign beneficiary seeking relief from withholding tax would not be entitled to the same relief if they received the payment directly (“look through approach”). Even though this test seems to be similar to the current version of the rules, the application shall be stricter in the future. Going forward the “same” specific entitlement needs to be applicable at the shareholder level, i.e., based on the same treaty or EU directive. This is a significant change which may impact multi-tier holding structures including different tax jurisdictions. As a consequence, a broad application of the look through approach adopted under the current rules where inbound multinationals may rely on substance (or the publicly listed exception) at the top tier level of their headquarter location would not be possible anymore if those rules were to be enacted.

Substance test

Under the substance test it is determined whether the income received is attributable to own commercial activities carried out by the foreign beneficiary. Such test does not only entail to provide evidence of respective economic activities but also requires a link of the underlying income being subject to the German withholding tax to these activities. The provision denies a qualification as a commercial activity if the income received is forwarded by the foreign recipient to other related beneficiaries (adopting the view of the ECJ in the Danish conduit cases) or an activity performed lacks sufficient reasonable business infrastructure.

Principal purpose/Publicly listed exceptions

If the personal entitlement test and the substance test are not met, two exceptions might still allow for withholding tax relief.

The first escape foresees a principal purpose test. According to this test the reduced withholding tax may be claimed upon proof that the principal purpose to interpose the foreign beneficiary was not the realization of a tax advantage. The second exception applies if the foreign beneficiary is an entity whose principal class of shares are regularly traded on a recognised stock exchange (publicly listed test).

The publicly listed test is already incorporated in the current version of the rules but its application in the new version is more narrow as the test must be generally fulfilled by the foreign beneficiary receiving the income or its shareholder if the “look through approach” can be applied. The exception for foreign entities falling within the scope of the German Investment Tax Act is not included in the new version of the rules anymore.

Scope and timing of application

The new German anti-treaty shopping rules shall apply to any withholding tax relief whether based on a treaty, EU directive or even the domestic reduction. The relevant tests have to be met in addition to any requirements according to an anti-treaty shopping clause included in a treaty (e.g., “Limitation on Benefits”, or LOB, clause in US treaty).

The new version of the anti-treaty shopping rules shall apply to all open cases unless the (current) version applicable at the time of the receipt of the income would have allowed a withholding tax relief. It remains to be seen whether the tax authorities will accept existing withholding tax exemption certificates which may still be formally valid when the new rules become effective.

The revised version of the German anti-treaty shopping rules would create higher obstacles to obtain treaty relief compared to the current rules. In particular, the narrower application of the look through approach may provide hurdles for multi-tier holding structures. The principal purpose test exception may provide for a solution to obtain relief depending on the facts and circumstances. However, the explanatory notes to the draft bill mention that not only German but also foreign tax benefits needs to be considered when applying the principal purpose test.

No abolishment of extraterritorial taxation of IP registered in Germany

Last year, an old German tax provision drew some attention. Based on the wording of the German law, income generated upon the licensing of rights or the sale of rights may be considered to be in scope of non-

resident German taxation if the underlying IP is registered in a German register even in foreign to foreign transactions not including a German resident counterparty.

The view that a German nexus for non-resident taxation is based on the mere German registration of rights results in extensive withholding tax and filing obligations for foreign taxpayers. Due to the German withholding tax relief procedure, these compliance obligations would exist regardless of a possible relief under an applicable treaty.

The German Ministry of Finance confirmed their view in an official circular dated 6 November 2020 that this broad interpretation should apply and requested to comply with filing requirements and resulting withholding tax duties for all open tax assessment periods.

The draft of the bill published on 20 November 2020 still envisaged to abolish the broad application of the IP German sourcing rules by a change of law for all open cases. The current version of the draft bill adopted today does not include this amendment anymore. However, with regard to cases in which an exemption of a double tax treaty exists, the Ministry of Finance is aiming to issue a decree that will simplify the tax deduction procedure. In addition, an overall evaluation of all affected cases is to be carried out by 31 December 2022, indicating the number of taxpayers resident in a non-treaty state or a treaty state and the total amount of taxes assessed since 2020.

In the meantime, the German tax authorities are expected to pursue their path laid out in their official circular. Based on the practical experience this view may trigger significant administrative compliance burden for respective foreign taxpayers. Furthermore, there are still many uncertainties on the practical handling of these cases in particular regarding the determination of the tax base.

The proposal for the revised German anti-treaty shopping rules needs to be considered in this context as well as it might impact the effective treaty eligibility and create further complexity and uncertainties in the future.

Other changes

The draft bill includes other amendments to the procedure of the withholding tax relief and required scope of documentation. These amendments lead to a more digitalised process to realise efficiencies for the responsible Federal Tax Office.

Besides the withholding tax provisions, the draft bill contains a specific anti-abuse rule for the Reorganisation Tax Act preventing the use of losses in the context of retroactive reorganisations as well as changes to the German transfer pricing regime to align the “arm’s length” principle with the OECD principles adopting an economic focus (including a price adjustment mechanism).

Our view

The envisaged amendments to the German anti-treaty shopping rules may impact the current withholding tax position of foreign beneficiaries. Relevant transactions and group structures should be reviewed and evaluated based on these new requirements.

As the envisaged abolishment of the German extraterritorial IP taxation for German registered rights is not included anymore in the draft bill, the German tax authorities are expected to focus again on the enforcement of those rules. Multinational companies should continue to evaluate their IP structure and transactions in order to identify potential German registered IP and evaluate respective German compliance requirements.

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