

Circular of the Ministry of Finance on ECJ decision regarding German withholding tax on cross-border dividends

Germany: April 2018

In Brief

The ECJ recently ruled that the German anti treaty and directive shopping rule, which denies the exemption from WHT on dividends received by parent companies in other Member States, is incompatible with both the European freedom of establishment and the Parent-Subsidiary Directive. The German Ministry of Finance has now issued a circular applying the ECJ verdict to the German anti treaty and directive shopping provisions by lowering the hurdles for WHT exemption in Germany. For further details regarding the ECJ verdict, please refer also to our previous Real Estate Tax Services NewsAlert No. 16 dated December 2017¹.

Cross-border dividends within the European Union

Background

The Parent-Subsidiary Directive establishes the principle that withholding tax on profits distributed by a subsidiary established in one Member State to its parent company established in another Member State, is prohibited. Nevertheless, there is an exception to this principle, which provides Member States with the ability to apply domestic or contractual provisions, where required, for the prevention of fraud or abuse, as well as in order to protect the domestic tax base created by a directive. However, Member States may only exercise this option whilst observing the general principles of EU law and, more specifically, the principle of proportionality.

In general, under current German tax law dividends distributed by a German subsidiary to a non-resident parent company are either exempt from income

tax (on application by the taxable person), or subject to withholding tax, which can be refunded (also upon application). However, under current German tax law an exemption or a refund is only granted if the recipient of the dividend providing evidence of substance according to Sec. 50d para. 3 Income Tax Act.

Such evidence of substance must be provided by a foreign company which is a recipient of payments subject to German WHT to the extent its own direct or indirect shareholders would not have been entitled to refund or exemption if they had received the income directly.

Relief of WHT will only be granted insofar as “non-tainted” revenue is generated (using a pro-rata approach). Non-tainted revenue is generated:

- to the extent the gross revenue originates from an own genuine business activity,
- in case of revenue not originating from an own genuine business activity insofar as there are business or other

¹ <https://www.pwc.de/de/newsletter/finanzdienstleistung/2017-re-16-germany.pdf>

relevant reasons for the interposition of the foreign company, and the company participates in the open market place with a business establishment adequately equipped for its business purpose.

New circular issued by the Ministry of Finance

Under the new circular, the Ministry of Finance partially adjusts its interpretation of the German anti treaty and directive shopping rule to align the present interpretation with EU law.

According to the circular:

- A company is considered as participating in the open market space even if its activity is limited to administration of own assets such as shares in subsidiary entities. However, this applies only if the company adequately exercises its rights as shareholder in its subsidiaries.
- It is no longer required that such a company has own staff on its payroll at any time.
- It is now permitted to refer to the corporate group in order to define the business reason for the implementation of the company and adequate substance instead of applying these tests on a standalone bases as previously required.

Our view

In light of the magnitude of the ECJ verdict, the circular is surprisingly brief with multiple questions unresolved.

However, the circular comprises the take away that:

- the German tax authorities will apply the ECJ decision to all open cases even though the decision refers to a previous version of the anti-treaty and directive shopping rules,
- the conditions to receive exemption from German WHT on dividends under the Parent–Subsidiary Directive are lowered, especially for passive holding companies established in other Member States, and so it is not only companies that actively manage their participations which will receive exemption from German WHT.

However, the general substance and business reason test is still relevant to consider. Entities interposed for tax reasons only are still not entitled to exemption from German WHT on dividends.

Furthermore, it presently remains open whether the legislator will amend the German anti treaty and directive shopping rule in the near future.

Foreign companies that expect dividend distributions from German subsidiaries in future should therefore check in advance whether they meet the substance requirements as outlined in the circular. Further to this, such companies should consider applying for exemption certificates from German WHT in advance in order to test their case in front of the German tax authorities.

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