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Comparative Tax Law for the International Practitioner

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I. Trade Tax

A German corporation, such as a GmbH, an AG or an SE, is subject to German corporate income tax with respect to its entire income, all such income always qualifying as business income. A foreign corporation is subject to German corporate income tax only with respect to its income generated in Germany (unless its registered office or place of management is in Germany, in which case the foreign corporation is subject to resident taxation). The corporate income tax rate is 15.8% (including solidarity surcharge).

Since it is deemed to generate business income, a corporate entity is also subject to German municipal trade tax. A business that does not have its registered office or place of management in Germany but earns income that is allocated to a German permanent establishment (PE) is also subject to municipal trade tax at a rate ranging from 7% to 17.2% (the average rate being approximately 14%), depending on the location of the PE. The entire income of a partnership that conducts business activities is categorized as business income (i.e., including its income from non-commercial activities) and is thus subject to trade tax. To a large extent, the trade tax burden can basically be set off against the personal income tax liability of an individual partner in proportion to his or her equity interest in the partnership.

Germany provides a tax exemption for trade tax purposes for dividend income and capital gains from the disposal of shares held by a corporation in another corporation (known as the "*Schachtelprivileg*") by excluding such income from business income, resulting in an effective tax burden of only approximately 1.5% on such income. However, the dividend exemption for trade tax purposes requires the recipient corporation to hold a minimum shareholding of 15% at the beginning of the fiscal year (in contrast, the threshold for the dividend exemption for corporate income tax purposes is only 10%).

The overall combined corporate income tax and trade tax rate for corporations is approximately 29.8%.

Trade tax is generally a covered tax under Germany's tax treaties.

II. Real Estate Transfer Taxes

A. Direct Acquisition of Real Estate

The direct acquisition of real estate (and certain rights in real estate, for example, heritable building rights) located in Germany is subject to real estate transfer tax. Real estate transfer tax is immediately triggered by the signature of the legally binding agreement between the seller and the acquirer to transfer title to the real estate concerned (i.e., the sale and purchase agreement).

In case of an asset deal, the real estate transfer tax is due from the seller as well as the acquirer; in practice, the parties usually contractually agree with each other that only the acquirer is to bear the burden of the real estate transfer tax.

B. Acquisition of Shares in a Company Owning Real Estate

Real estate transfer tax also becomes due if 95% or more of the shares in an entity (a corporation or a partnership) owning real estate are acquired by "one acquirer." Acquisition by one acquirer for these purposes has an extended meaning and encompasses, for example, not only a direct or an indirect acquisition by a single acquirer but also an acquisition by a controlling entity and its dependent entities or by such dependent entities only (i.e., a tax group for real estate transfer tax purposes).

If more than 95% of the shares in a real estate holding entity are acquired by one acquirer, the acquirer is liable for real estate transfer tax.

C. Acquisition of Interests in a Real Estate Holding Partnership

Real estate transfer tax also becomes due if 95% or more of the equity interests in a real estate holding partnership are transferred directly and/or indirectly to new partners within a five year period. For purposes of this rule, partnership interests are counted by reference to the percentage of equity interests held by the transferring partner. Where an equity interest in such a partnership is held by an entity, the equity interest is deemed to be transferred to a new partner if 95% or more of the shares in the entity are acquired by a new investor (indirect investment).

In the above circumstances, it is the real estate holding partnership that is liable for the real estate transfer tax.

The transfer of equity interests in a real estate holding partnership may be structured without triggering real estate transfer tax by a deferred transfer of a minimum partnership interest of more than 5%.

D. Economic Ownership

Since 2013, the previously available real estate transfer tax blockers have been eliminated. Any transaction where a taxpayer has, directly and/or indirectly, an "economic participation" of at least 95% in a real estate holding entity triggers a liability to real estate transfer tax. The economic participation equals the sum of the direct and indirect participation percentages in the capital or assets of the entity concerned. The indirect participation percentage in the capital or assets of the entity is computed by multiplying the percentage holdings down through the holding tiers. As a consequence, the *per capita* rule for partnership interests no longer applies.

E. Intragroup Restructuring Exemption

Under the intragroup restructuring exemption, certain direct or indirect transfers of real estate or shares in real estate-owning entities are exempt from real estate transfer tax. One condition for the application of the exemption is that the restructuring transaction must involve one controlling company and one or more controlled entities, and a direct or indirect shareholding of at least 95% must exist between the entities for the five years immediately before and after the transaction.

On May 30, 2017, the Federal Tax Court (*Bundesfinanzhof* BFH) referred a case to the Court of Justice of the European Union (CJEU) requesting a preliminary ruling on the compatibility of the German real estate transfer tax intragroup restructuring exemption with the EU state aid rules.

F. Tax Rates and Tax Bases

Generally, real estate transfer tax is levied at a rate ranging from 3.5% to 6.5% on the tax base, depending on the location of the real estate. In the case of a sale and purchase agreement, the tax base is the agreed consideration, i.e., the purchase price. Any part of the purchase price paid for buildings is included in the tax base.

The base for real estate transfer tax levied on taxable transfers involving shares in real estate holding companies is the specified tax value of the real estate as determined in accordance with the revised valuation methods provided for inheritance tax purposes. These methods provide for a more precise determination that ultimately achieves a result that is closer to the actual net asset value.

III. Anti-Treaty Shopping Rules

Dividends distributed by a German corporation are generally subject to a 26.4% withholding tax, which is creditable against the German income tax/corporate income tax liability of a domestic shareholder in receipt of such dividends. The withholding tax rate is reduced to 15.8% where the dividends are paid to a foreign corporation if the conditions set out in III.A., below are fulfilled. Furthermore, most of Germany's tax treaties provide that: (1) such dividend income is subject to taxation only in the shareholder's country of residence; (2) the rate of withholding tax is limited to a lower rate of typically 15%; or (3) the rate of withholding tax is even reduced to zero if certain requirements are met (basically, the shareholder must be a foreign corporation holding a certain minimum shareholding in the German corporation distributing the dividends). Moreover, no German withholding tax is imposed if the shareholder is a non-domestic EU-based corporation with a minimum direct shareholding in the German distributing company of 10% for at least 12 months uninterrupted.

A. Entitlement to Relief

Under Germany's anti-treaty/anti-directive shopping rules, a foreign company is entitled to (full or partial) relief from German withholding tax under an EU Directive/German tax treaty only to the extent:

- The foreign company is owned by shareholders that would be entitled to a corresponding benefit if they earned the income directly (individual relief entitlement); or
- The substance requirements under § 50d paragraph 3 sentence 1 of the Income Tax Act (*Einkommensteuergesetz* EStG) (factual relief entitlement) are met (that is, if the relevant income is not "harmful income").

Income is not harmful income if it consists of gross receipts generated by the taxpayer's own business activities or, in the case of income generated by non-business activities, if there are non-tax-related reasons for interposing the foreign company and the foreign company has adequate business substance. Earnings that are economically functionally linked to the taxpayer's own business activities (for example, interest income generated by income that was subject to relief) qualify as gross receipts generated by the taxpayer's own business activities.

Where the taxpayer does not satisfy the requirements for individual relief entitlement, no indirect relief is available to higher-tier shareholders. Moreover, indirect domestic shareholders are not entitled to relief.

The restrictions do not apply to a direct foreign shareholding corporation whose shares are publicly traded or that qualifies as an investment fund.

B. Pro Rata Test

Unless individual relief entitlement applies (see III.A., above), withholding tax imposed on German-source income earned by a foreign company will be reduced only to the extent of the proportion that the company's non-harmful gross receipts bear to its overall gross receipts earned (the "*pro rata* test"). Unlike under the previous rules, under the current rules there is no "all or nothing" principle, and where a foreign company has earned harmful income only *pro rata* relief will be granted.

For example, assume that a foreign company with shareholders that are not entitled to withholding tax relief receives dividends of 1,000 from an actively managed German subsidiary. In addition, the company earns passive income of 100. According to the German tax administration, only 91% of the German dividend withholding taxes would be refunded (in other words, a 91% withholding tax exemption would be granted). The availability of relief with respect to the remaining 9% would depend on the individual and factual relief entitlement of the shareholders.

For purposes of the *pro rata* test, the gross receipts of the year in which the income is earned will generally be decisive for purposes of determining the availability of a withholding tax refund, and the gross receipts of the application year will be decisive for purposes of determining the availability of a withholding tax exemption. The tax administration must be notified of any (partial) loss eligibility for purposes of determining the availability of withholding tax relief, a *de minimis* rule being provided.

C. Withholding Taxes on Royalties

The reduction of withholding tax on royalties under an applicable German tax treaty or the elimination of such tax under an applicable treaty or the EU Interest and Royalties Directive is also subject to the anti-treaty shopping rule in § 50d paragraph 3 of the EStG.

D. Capital Gains

Capital gains are not subject to German withholding taxes and are, therefore, not subject to the anti-treaty shopping rule.

E. Questionnaire From German Tax Office

When a foreign company applies for a full or partial exemption from German withholding taxes or for a refund, the German Tax Office sends a lengthy questionnaire to the applicant company, which includes a general note to the effect that "the official language is German. A German translation must therefore be attached to your response. . . The same goes for the requested documents."

The questionnaire includes questions such as:

- Please describe the business activities/object of the applicant company (i.e., the holding company) and submit its balance sheet and profit and loss account for the financial year concerned.
- What were the main reasons for the applicant's involvement? Please provide a detailed statement.
- Since when has the applicant had its own business establishment? Please submit suitable proof in this respect (for example, a tenancy agreement).
- How many members of staff does the applicant employ and what activities do they carry on? Please submit contracts of employment and registrations with social security institutions. Please provide proof that the salaries of such staff members were in fact paid.
- Does the managing director exercise any other functions, for example, in other companies? If so, please provide specific details.
- Is the foreign managing director a lawyer, legal adviser, or tax or financial advisor, or a trust company?

F. Referrals to the Court of Justice of the European Union

1. Recent Referral

The Tax Court of Cologne[1] has raised the question of whether the current version of Germany's anti-treaty shopping rules[2] is compatible with EU law and has requested a preliminary ruling from the CJEU. This is the third case in which the Tax Court of Cologne has referred the anti-treaty shopping rules to the CJEU: In 2016, the court referred two cases involving the rules applicable during the period from 2007 to 2011.[3]

2. Decision of the Court

Because the shareholder of the Dutch entity concerned was resident in Germany, the Dutch entity failed the shareholder test. Its income from procurement activities was considered to be from its own business activities, but its other income from financing and holding activities was not considered to be business income, so the Dutch entity would have been entitled only to a very low *pro rata* refund under the business income test. Nor did the entity pass the business purpose and substance tests. It is important to note that the Tax Court did not have to apply the new Germany-Netherlands tax treaty (which entered into effect from 2016), which would have required that, under Germany's anti-treaty shopping provisions, associated enterprises in the Netherlands should be treated on a consolidated basis. Under Germany's rules, the court would then have had to reject the refund reclaim.

3. Implications for Taxpayers

Since the Tax Court of Cologne had already referred the anti-treaty shopping rules that applied until 2012 to the CJEU, a decision in the new case would resolve the issue of the compatibility of the current provisions with EU law. Since these rules were introduced in response to infringement proceedings launched by the European Commission, it is interesting to note that the Tax Court of Cologne explicitly stated that the *pro rata* approach of the new rule is not in line with the proportionality requirement, this approach being a key element of the revised rules. The Tax Court of Cologne is of the opinion that the domestic anti-treaty shopping provisions are not in line with the freedom of establishment provision in Articles 49 and 54 of the Treaty on the Functioning of the European Union.

While relief from German withholding tax on dividends paid to a nonresident company is dependent on the fulfillment of very strict conditions, a German company in similar circumstances would be granted a tax exemption without having to fulfill any conditions. In addition to the freedom of establishment issue, the Court has also raised the question of whether the anti-treaty shopping provision is in compliance with article 5(1) in conjunction with Article 1(2) of the EU Parent-Subsidiary Directive.

IV. Disclosure Obligations

German tax law provides for multiple disclosure obligations. In practice, the obligations under § 138 paragraph 2 of the General Tax Act (*Abgabenordnung* AO) are currently strictly monitored by the tax authorities. In particular, the authorities will check whether such a notification has ever been made. If no notification has been made, they may initiate criminal tax proceedings.

Section 138 paragraph 2 of the AO requires the responsible tax office to be notified of the formation or acquisition of a foreign business or PE, at the latest on the filing of the first income tax, corporate income tax or partnership income return following the notifiable event. A full or partial breach of this notification requirement, or undue delay in meeting it, may be pursued as an offense under § 379 of the AO, which covers minor tax fraud.

NOTES

[1] Case 2 K 773/16 of May 17, 2017.

[2] § 50d paragraph 3 EStG, which applies with effect from 2012.

[3] Pending CJEU Cases C-504/16 and C-613/16.