

German Government issues draft law on modernization of withholding tax relief and various additional topics

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Executive summary

On 20 January 2021, the German Government agreed on a draft law proposing a revision and modernization of withholding tax (WHT) procedures with respect to income from capital investment and royalties in Germany. The Government draft is based on the first working draft issued by the Ministry of Finance (MoF) and published for consultation on 20 November 2020 but includes several changes, additions and deletions. Specifically, the draft law still includes the proposed changes to the German anti-treaty shopping rules and the framework for the administration of WHT and relief thereof. In addition, several changes regarding Transfer Pricing (TP), already proposed within the first working draft of the German Anti-Tax Avoidance Directive (ATAD) implementation law published on 11 December 2019,¹ are now included (but not the still outstanding anti-hybrid legislation). Further, the retroactive elimination of the nonresident taxation of royalty income and capital gains relating to rights solely because these rights are registered in a public German book or register has been removed.

Detailed discussion

Background

The proposed changes regarding the anti-treaty shopping rules could in many cases tighten the already rather strict rules. In simple terms, the revised anti-treaty shopping rules would generally assume an abuse for any foreign recipient of relevant German-source income whose shares are not materially and regularly traded on a recognized stock exchange unless the absence of an abuse can be demonstrated. In this regard, the applicability of the look-through- or equivalent beneficiary-approach would effectively be narrowed down significantly but a general “main benefit test” would be introduced. Taxpayers should carefully review the potential impact of these changes on their current WHT position and obligations in Germany within holding structures and operating models.

The initially proposed elimination of nonresident taxation of royalty income and capital gains relating to rights solely because these rights are registered in a public German book or register has been removed in the updated draft. The underlying rule is currently subject to a controversial debate and causes significant efforts for both taxpayers as well as the German tax authorities. The elimination of this proposal is therefore an unfortunate development, but there are indications that the MoF will issue additional guidance to address concerns as to the practicalities of complying with the law, in particular where the intellectual property (IP) licensor or seller is covered by a German tax treaty, which grants exclusive taxing right to the foreign jurisdiction.

The draft further includes significant changes to the German interpretation of the arm’s-length standard. It aims to update the German TP rules to appropriately reflect recent international developments (mainly the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) initiative). Among other items, the suggested changes relate to clarifications on applicable methods to determine transfer prices and details regarding the actual calculation of transfer prices. It also anchors the DEMPE (development, enhancement, maintenance, protection and exploitation of intangibles) concept in German law.

In addition, a basis for advance pricing agreements (APAs) would be introduced into domestic law and provide for a corresponding procedure. Currently, APAs are solely based on applicable treaties. Most notably, under the draft law, taxpayers would have the ability to apply for an APA not only

in the context of transfer pricing (i.e., double taxation arising from Article 7 or 9 of the OECD Model Tax Treaty), but rather for all cross-border transactions, if the treaty concluded between the countries includes a Mutual Agreement Procedure Clause similar to Article 25 of the OECD Model Tax Treaty.

Revision and modernization of WHT relief

Germany’s attempts at creating a treaty-overriding anti-abuse provision against perceived treaty shopping planning received repeated setbacks over the years as the European Court of Justice (ECJ) has consistently held such rules to be a violation of European Union (EU) fundamental freedoms. The draft law now proposes a new approach which takes into account recent ECJ case law (e.g., the so-called “Danish cases,” C-116/16 and C-117/16) as well as Article 6 of the ATAD and would be applicable as of the year in which it is enacted. The wording of the new rule can be translated as follows:

*A company... has... **no claim for a relief from WHT under a tax treaty...** to the extent that*

1. *it is owned by persons, or persons are beneficiaries under its statute, which would not be entitled for this relief, **had they been the direct recipients of the income, ... and***
2. *the source of income is not **materially linked to economic activity of this foreign company**; receiving the income and its **onward transfer to investors or beneficiaries** as well as any activity that is not carried out using **business substance commensurate with the business purpose cannot be regarded as an economic activity.***

*Sentence 1 shall not apply to the extent the foreign company proves that none of the **main purposes** of its interposition is obtaining **a tax advantage**; the same applies if... its shares [the company’s shares] are materially and regularly traded on a recognized **stock exchange**. Sec. 42 of the Fiscal Code [General Anti-Abuse Rule, GAAR] remains unaffected.*

If this new rule becomes law, it will in many cases require reconsidering current holding/IP structures, in particular where taxpayers/investors have so far relied on the German “equivalent beneficiary” or look-through interpretation of the existing anti-treaty shopping rule. According to the explanatory notes issued together with the draft, it could in the future be harmful for a holding/IP company in country A to be interposed between a country B parent and a German income source even if both German treaties with countries A and B provide for the same WHT benefits because the

entitlement would be based on different treaties and, hence, not “the same” entitlement. Should this proposal become law, it could effectively narrow down the application of the look-through approach to European structures where all involved entities have access to EU directives and may require creating sufficient economic link between the German-source income and the economic activity at the level of the recipient entity.

Concerning the exception for publicly traded companies, the explanatory notes further provides that this exception should, going forward, only apply if the shares in the direct recipient of the income are materially and regularly traded on a recognized stock exchange, meaning that the exception would no longer be available where currently the look-through approach is applied.

To incorporate the general requirement stipulated in ECJ case law that a taxpayer must have the possibility to counter an assertion of abuse, the law foresees the introduction of a mechanism similar to a principle- or main-purpose test. According to this test, the rule would not apply to the extent the foreign entity can demonstrate that none of the main purposes of its interposition in the structure was to obtain a tax benefit.

Moreover, the existing framework for refunds and exemption relating to WHTs would utilize a higher level of digitalization and further centralization at the Federal Central Tax Office. A core component would be the implementation of a central digital database covering refund applications, tax certifications and other required information.

The general principle will remain unchanged, i.e., a taxpayer can only withhold at the treaty rate if the recipient of the remuneration has presented a valid WHT exemption certificate issued by the Federal Tax Office to the paying entity before the payment is made. However, a new de-minimis rule for royalties is proposed as an exception from this general principle: This exception sets forth that a taxpayer does not need to withhold if royalty payments are exempt under the applicable treaty and the annual payment to the recipient is €5,000 or less. This de-minimis rule shall apply for remuneration paid after 31 December 2021. Existing authorizations by the Federal Tax Office according to which taxpayers could withhold at the treaty rate for license payments up to €5,500 per payment per recipient and up to €40,000 per taxpayer per year will be phased out by 31 December 2021. No new authorizations will be granted once the law has become effective. The replacement of the existing rule with the de-minimis rule will especially affect

taxpayers in industries where a large number of relatively low value payments are part of the business model (e.g., the media industry) as the new de-minimis rule only applies to situations where there is a full exemption under the treaty and sets the threshold at €5,000. Further changes relate to technicalities and procedures:

- ▶ The applications for WHT relief shall be submitted electronically from 2023. WHT exemption certificates and tax assessments regarding a WHT refund shall only be provided electronically from this point in time.
- ▶ Certificates of residency of the foreign tax authorities will no longer need to be on the official German application forms, “standard” tax residence certificates issued by the tax authorities abroad and confirming the tax residency for the applicant can be used for the application process. By proposing this change, the MoF acknowledges practical difficulties taxpayers are currently facing where the certificate of residency is required on the German application form.
- ▶ WHT exemption certificates shall only be valid from the date of issuance. The current practice of issuing the WHT exemption certificate from the date the application was received by the tax authorities would therefore be eliminated. In light of the fact that WHT exemption certificates may take six to nine months to be issued, this change is to the taxpayer’s detriment.
- ▶ If the WHT exemption certificate is received only after the taxes have been remitted to the tax authorities, it will - unlike today - not be possible for the paying entity to amend its WHT return to receive a refund. In these cases, the licensor will have to apply for a refund.
- ▶ The tax authorities may include certain conditions in the WHT exemption certificates.
- ▶ The proposed wording further suggest that the possibility to certify a lower applicable WHT rate if the requirements for a full exemption are not met but a reduced rate of, e.g., 5% or 15% would be possible is no longer given, however the explanatory notes provided to the draft clearly state that this possibility would continue to exist.
- ▶ Because of a slight wording change in the rule, the Federal Tax Office may in the future also issue a WHT exemption certificate where it is doubtful whether a remuneration is subject to WHT based on domestic law. In many cases, the Federal Tax Office has already done this to reduce practical uncertainties, although it was not obliged to do so by the wording of the law.

- ▶ The three-month deadline for deciding over applications for a WHT exemption certificate remains in the law, however, it is specified that the three months will start from the day when all necessary supporting documents have been received. In practice, this is how the Federal Tax Office has handled applications to date anyway.
 - ▶ The regular time limit of four years for refund applications remains unchanged, however, the additional possibility to claim refunds after the four-year time limit has expired (e.g. in cases of a tax audit) is extended from currently six months after the actual payment of the tax to one year after this point in time, so that refunds can be applied for within one year from the payment of the tax even if the regular four-year time limit has expired. This change will be helpful for taxpayers in practice, as the current six-month period is in many cases too short to align between the recipient of the payment and the paying entity for purposes of the refund application.
 - ▶ The draft law also includes detailed rules on the issuance of tax certificates for WHTs on dividends which aim at reducing the risk for multiple refunds of dividend WHTs and making the process more efficient. The proposed law also includes certain fines for infringements of resulting obligations.
 - ▶ Refunds of WHT will only be granted if the taxpayer is not entitled to a credit of WHT in Germany (e.g., in the case of permanent establishments of nonresident entities or dual resident entities).
 - ▶ Unchanged from today, neither WHT refunds nor late payments of WHTs will be interest bearing (other than WHT refunds under the interest and royalty directive where this is set forth in the directive).
 - ▶ Last but not least the competencies of the Federal Tax Office will be extended to also cover refund applications where the WHT burden is considered final (such as refund claims for WHT on certain EU dividends, which has been a point of discussion for almost two decades) and refunds where the underlying remuneration is not subject to German tax under domestic law (which will apply only in a limited number of cases, e.g., in case of certain interest payments).
- ▶ Based on the wording of the German statute provisions (Sec. 49 (1) No. 2 f and No. 6 ITA), where a non-German resident person licenses or sells IP that is **registered in a German public register** (German-nexus IP), Germany can claim a taxing right under domestic law.
 - ▶ Under the plain language of the statute, a German taxation right may cover German-nexus IP right licensing or sale transactions which take place solely between, or in the case of a sale by, German nonresident parties. The statute also does not differ between transactions which occur between related or unrelated parties. The MoF issued on 6 November 2020 a public letter confirming such German extraterritorial taxation of German-nexus-IP.

The first working draft proposed to delete the terms “registered in a German public book or register” from the wording of the law, i.e., to remove the German taxation nexus for IP rights which are solely “registered” in a German public register or book. It is unclear why this change is no longer under consideration, as the German IP nexus rule is currently subject to a controversial debate and causes significant efforts for both taxpayers as well as the German tax authorities. The elimination of this proposal is therefore an unfortunate development, but there are indications that the MoF will issue additional guidance to address concerns as to the practicalities of complying with the law, in particular where the IP licensor or seller is covered by a German tax treaty, which grants exclusive taxing right to the foreign jurisdiction.

Transfer pricing

The Draft Law includes significant changes to the German interpretation of the arm’s-length standard as well as to the German TP documentation rules. It aims to update the German TP rules to reflect international developments appropriately (mainly the OECD BEPS initiative which resulted among others in the BEPS report for Actions 8-10 “Aligning Transfer Pricing Outcomes with Value Creation” (BEPS Report 8-10), which is included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD TP Guidelines). The international developments emphasize the increased economic point of view in transfer pricing with the concept of aligning taxation with value creation. According to the German legislator, the contemplated changes in the German TP rules are intended to clarify these aspects and provide for a general set of rules.

Extraterritorial taxation of IP

The first working draft of the law also tackled the question whether the German Sec. 49 (1) No. 2 f and No. 6 of the *Income Tax Act* (ITA) mandate German nonresident taxation of so-called “extraterritorial” IP transactions. “Extraterritorial” IP transactions include the licensing or sale of IP rights between, or in the case of a sale by, German nonresident parties.

The existing section 1 of the *German Foreign Tax Act (FTA)* includes the German interpretation of the arm's-length standard. This section has been completely rewritten, and while some modifications are rather editorial, other modifications constitute significant changes to the current rules. The most notable changes are briefly summarized below:

- ▶ The definition of the arm's-length price relies mainly on the accurate delineation of the intercompany transaction and the identification of underlying commercial and legal circumstances and actual behavior of the related parties by performing a detailed function and risk analysis of all parties involved in the transaction.
- ▶ It is emphasized that such analysis has to be performed at the time the transaction is agreed upon and the explanatory notes specify that only information that was existent at the time the transfer prices were agreed upon can be utilized.
- ▶ The selection of the TP method now follows the OECD TP Guidelines and determines that the most appropriate method for the underlying case should be applied. If comparable third-party data is not available, a hypothetical arm's-length method should be applied utilizing generally accepted valuation techniques.
- ▶ In line with the OECD TP Guidelines, adjustment calculations to improve comparability with third-party data shall only be performed if they enhance the reliability of the results.
- ▶ The DEMPE concept is newly introduced into German regulations including a definition of what constitutes an intangible. An intangible constitutes an asset that is not a tangible asset or shares, that could be subject to an intercompany transaction without being necessarily separately transferrable and provides a person a factual or legal right regarding the specific asset. Lastly, it is specified that essentially the entity performing the DEMPE functions, assuming risks and providing these assets should be entitled to the intangible-related return. A cash box should be limited to a routine return. Notably this definition focuses on the value contributed by an intangible and not the accounting definition of an intangible asset.
- ▶ While most of these aspects have been commonly applied in practice already, the contemplated changes of the Draft Law now incorporate these into German regulations, hence, enhanced legal certainty applies.

Further key changes and clarifications are:

- ▶ The determination of the interquartile range is transposed into German law. Whereas in the past the German law required an adjustment to the median if actual transfer prices are set outside said range, the current Draft Law includes a rebuttable assumption allowing the taxpayer to demonstrate that any other value within the overall price range (the range between minimum and maximum price of the involved parties) is better reflecting the arm's-length principle.
- ▶ In the first draft of the rules within the ATAD implementation law, the existing escape clauses with respect to the German transfer of function rules that explicitly allow for single asset valuations instead of the transfer package approach under certain circumstances have been deleted in the draft law. In the new draft, an escape would still be possible if it can be demonstrated that no significant intangibles or advantages have been transferred. The escape clause is however limited to cases where the receiving entity performs the transferred function exclusively on behalf of the transferring entity and the remuneration is determined based on the cost plus method.
- ▶ Germany already has a price adjustment clause in its current TP regulations to ensure arm's-length pricing of transactions involving intangibles for which the valuation is considered per se highly uncertain at the time of the transaction. This price adjustment clause is now adjusted to align with the outcome of the BEPS Report for Actions 8-10. Its application is reduced from the current term of 10 years to 7 years to reduce complexity of the application of this rule and enhance tax certainty. An explicit definition is now included to define when a significant difference between the financial projections and actual outcomes is actually assumed, namely if the transfer price determined using the actual outcomes deviates by more than 20% compared to the outcome based on the financial projections.
- ▶ Notably not included is the highly debated change on the arm's-length pricing of financial transactions that was included in the German ATAD implementation law published on 11 December 2019. It is, however, emphasized in the explanatory notes that any arm's-length analysis of financial transactions should be based on the principles as described in Chapter X of the OECD TP Guidelines³ emphasizing the importance of the actual functions performed and risks assumed.

Advance pricing agreements

Under existing German law, an APA is the combination of an advance agreement between countries regarding the transfer price between internationally affiliated companies and an advance commitment based thereon. APAs find their legal basis in the respective treaties, in the respective articles on mutual agreement procedures. The existing APA procedures in Germany are based on a circular decree issued by the MoF, which contains detailed information and guidance about how APAs are carried out in Germany.

The Draft Law now introduces a legal basis in Germany for the conclusion of APAs with certain changes to the existing APA procedures. The German legislator aims to emphasize its willingness to conduct APA procedures and to demonstrate that legal certainty is of significant importance.

A key change is the possibility for a taxpayer to apply for an APA not only in the context of transfer pricing (i.e., double taxation arising from Article 7 or 9 of the OECD Model Tax Treaty), but rather for all cross-border transactions, if the treaty concluded between the countries includes a clause similar to Article 25 of the OECD Model Tax Treaty. The draft law explicitly offers the possibility for a taxpayer to apply for a multilateral APA to facilitate the administrative burden for an applicant.

An APA process can be initiated upon application, if the APA request is subject to the tax assessment of a clearly defined and – at the time of application – unrealized fact pattern for which double taxation risk exists, which can be prevented

by the APA procedure. The APA term shall regularly be not more than five years and can also be rolled-back to previous years upon request considering the legal deadlines in the respective treaty. A signed APA can be renewed upon request as well.

The APA request has to include all information and supporting documents required to assess the specific case from a tax perspective as well as a description and justification of the double tax risk for the case subject to the APA. The APA request may be rejected if the double taxation risk is not sufficiently presented and if it is likely that the APA may not prevent the double taxation for the specific case.

The APA request can be filed either in written form or electronically and must enable the competent authority, which remains the German Federal Central Tax Office (BZSt), to initiate and conduct the APA process.

For transfer pricing cases, the BZSt now charges a fee of €30,000 (increased from €20,000) for processing a new APA request and €15,000 for an APA renewal. The fee for non-transfer pricing cases is reduced to 25% of the fee for TP cases and special fees apply under certain conditions for companies that have been subject to a coordinated bilateral or multilateral joint tax audit as well as for APA requests with smaller transaction volumes.

The new regulation would be applicable for applications filed after the official announcement of the new law. For applications filed before, the current regulations will continue to apply.

Endnotes

1. See EY Global Tax Alert, [Germany publishes draft ATAD implementation law](#), dated 12 December 2019.
2. See EY Global Tax Alert, [German Ministry of Finance publishes draft law concerning the modernization of withholding tax relief and extraterritorial taxation of IP](#), dated 20 November 2020.
3. See EY Global Tax Alert, [OECD releases final transfer pricing guidance on financial transactions](#), dated 11 February 2020.

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