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February 2012

Tax News.

German Tax Authorities’ Guidance on the New Anti-Directive/ Treaty Shopping Rule

With effect as of 1 January 2012 the so-called anti-directive/treaty shopping rule has been amended. Already on 24 January 2012 the Federal Ministry of Finance has published a circular letter on the interpretation of the revised rule. Hereinafter we explain the new rule, summarise the key statements of the circular letter, assess their likely impact, point to the required actions and set out initial structuring considerations.

Introduction

German domestic tax law provides *inter alia* for withholding tax on dividends from German companies and on interest from certain hybrid instruments from German issuers as well as on royalties paid for the exploitation of rights in Germany. The applicable rate for dividends and interest is 26.375% and for royalties 15.825%.

A full or partial withholding tax relief is generally available under the applicable EU directives and/or German tax treaties. However any relief is subject to the limitation of the anti-directive/treaty shopping rule of sec. 50d para. 3 of the German Income Tax Act (“**EStG**”). The rule was challenged by the EU-commission as violating the freedom of establishment because of its “all or nothing”-approach (the relief was factually subject to a 10% active earnings threshold). In response to the respective infringement procedure, the German legislator enacted an amended version in the context of the German Act Implementing the Recovery Directive and Amending Tax Provisions (*Beitreibungsrichtlinieumsetzungsgesetz*). The amended rule came into force on the 1 January 2012.

On 24 January 2012 and thus within record time, the Federal Ministry of Finance (*Bundesfinanzministerium* – the “**BMF**”) has published a circular letter on the interpretation of the new sec. 50d para. 3 EStG (the “**Circular**”). A working translation of the Circular is annexed to this newsletter.

New Anti-Directive/Treaty Shopping Rule

The wording of the new rule is hugely complex and an example of convoluted drafting using double negatives as well as con- and disjunctions. The rule reads as follows (the underlining parts are not contained in the original):

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"A foreign company is not entitled to full or partial [German withholding tax] relief to the extent its shareholders would not be entitled to a refund or exemption if they were direct shareholders [of the German company] and to the extent the gross earnings of the foreign company for the respective fiscal year do not originate from own business activity, as well as

(1) there are no economic or other bona fide reasons for the interposition of the foreign company in relation to these earnings or

(2) the foreign company does not participate in general commerce with a business establishment that is appropriately organised for its business purposes."

The important conceptual change contained in the revised sec. 50d para. 3 EStG is that the "all or nothing"-approach, according to which a relief was denied if the foreign company did not pass the 10% active earnings threshold, is replaced by a general "proportioning"-approach. As a consequence, in cases where a foreign company derives both "harmful" and "harmless" earnings, only a pro rata relief from German withholding tax will be available, irrespective of whether the income from German sources, which is subject to withholding tax, is itself considered harmless. It remains to be seen how workable the new rule will be in practice.

Circular's Key Statements

The key statements of the Circular can be summarised as follows:

Concept

According to the new rule an entitlement to a withholding tax relief is subject to the following tests:

> whether the foreign company benefits from the applicable EU directives (i.e., parent-subsidiary directive and interest and royalties directive) and/or German tax treaties (the "**Company Test**"); and

> whether and to what extent certain tests based on the nature of the earnings of the foreign company, the reasons for its interposition and its substance are met (the "**Earnings and Substance Test**"); or

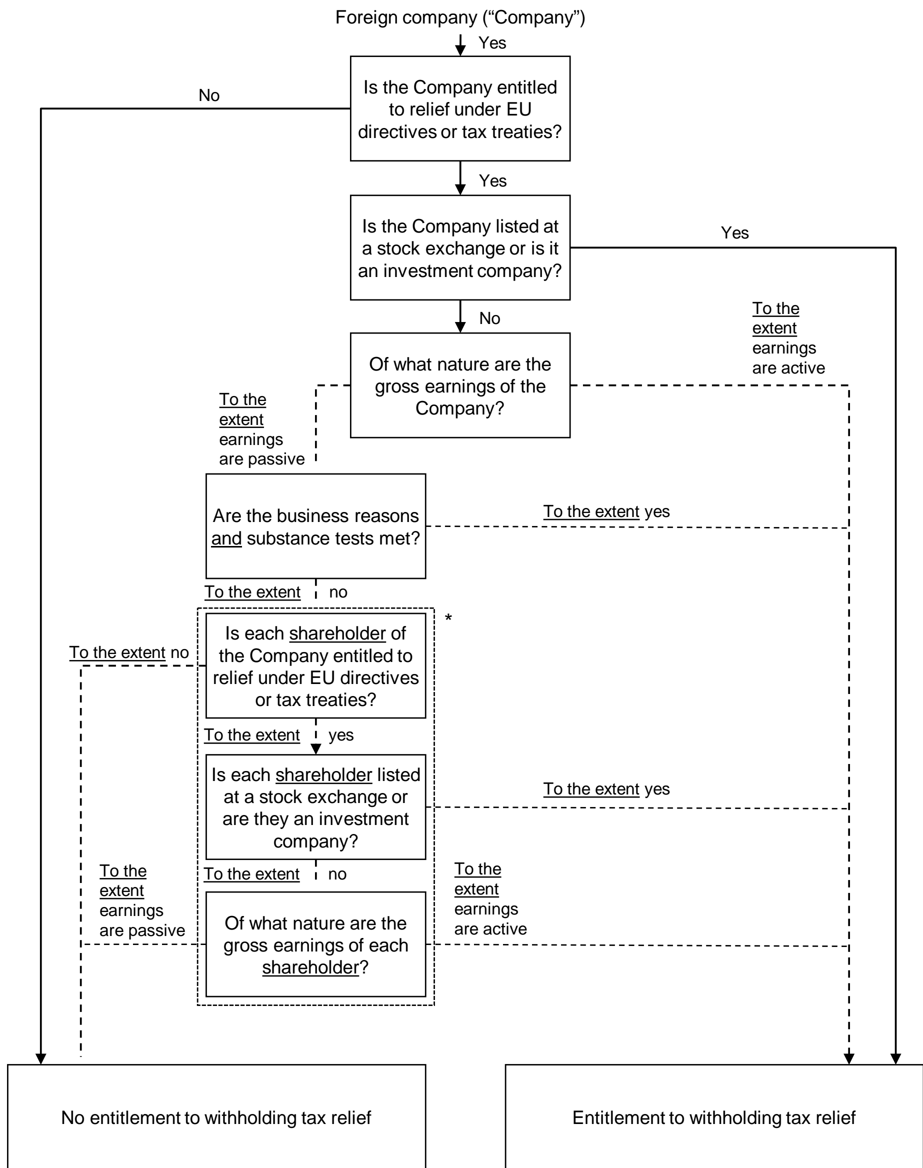
> whether and to what extent the shareholders of the foreign company would be entitled to such relief if they were direct shareholders (the "**Shareholder Test**").

By way of an exception, if the Company Test is fulfilled, neither of the other tests needs to be met, provided the foreign company is listed at a stock exchange and its shares are regularly traded or it qualifies as an investment corporation within the meaning of the German Investment Tax Law.

Legal Tests

The different tests under the new rule and their interplay are difficult to comprehend just from reading sec. 50d para. 3 EStG.

The following flow-chart illustrates the tests:



* This is to be checked in multi-layer structures until the first (indirect) shareholder is encountered which does not benefit from an EU directive or tax treaty

The Circular gives in its section 12 a detailed example of how to apply the tests in practice.

Company Test

The Company Test requires the existence of a foreign company.

According to the Circular the term “company” is to be interpreted in accordance with the domestic provisions that implement the applicable EU directives and the applicable tax treaty. As far as a protection under a treaty is concerned, even a foreign entity that does not qualify as a company under the applicable German comparison approach (e.g., partnership), is regarded

as a company if the entity is treated as a corporate taxpayer under the applicable foreign tax laws.

A company is “foreign” if it has neither its seat nor its place of management in Germany. In case of a double residence, the tie-breaker-rule under the applicable tax treaty is decisive.

The Company Test presupposes further that all prerequisites of the applicable EU directives and/or tax treaties are met.

Earnings and Substance Test

Starting point of the Earnings and Substance Test is a distinction between so-called “harmless” and “harmful” earnings of the foreign company. The test then allows a withholding tax relief in the proportion of the harmless gross earnings to the overall gross earnings. The proportioning applies to the overall withholding tax levied irrespective of the whether the earnings on which such withholding tax was levied is harmless or harmful.

> *Example: A foreign company receives payments on which 100 of withholding tax have been levied. Its harmless gross income amount to 70% of its overall gross earnings. Consequently, a relief of 70 of withholding tax would be available. Whether the payments on which the withholding tax is levied are harmless or harmful is insofar irrelevant.*

Pursuant to the Circular, harmless earnings are the gross earnings according to sec. 9 of the German Foreign Tax Act (*Außensteuergesetz*) which either originate from (i) active earnings or (ii) from passive earnings but there are business reasons for the interposition of the foreign company and it has sufficient substance.

Active earnings: This type of earnings is defined as earnings from own business activity. According to the Circular an own business activity presupposes an activity in the general commerce that goes beyond mere assets administration (e.g., holding of shares and/or other assets). Besides real trading activities also the following activities count as active:

- **Intra group service companies**: Intra group services rendered to at least one affiliate are active provided there is a separate compensation at arm’s lengths terms charged for them.
- **Management holding companies**: The active management of shareholdings in at least two subsidiaries is considered to be active. Active management is defined as the making of leadership decisions. The consequence of an active management is that all earnings (e.g., dividends, interest and royalties) from the managed subsidiaries are active earnings.
- **Functionally connected subsidiaries**: Earnings from subsidiaries that are functionally connected to the foreign parent company (e.g., production and distributor companies) are also considered to be active.

> **Reinvestment of active earnings**: Finally, interest accruing on active earnings being reinvested is regarded as active as well.

As a matter of principle, the business activity needs to be carried out by the foreign company itself. The outsourcing of the substantial part of the business activity to third parties (e.g., management service providers or law firms) is detrimental in this respect.

Passive earnings: All other earnings are passive. Passive earnings are however not harmful *per se* but harmless provided there are business reasons for the interposition of the foreign company and it has sufficient substance.

> **Business Reasons Test**: This test requires that the interposition of the foreign company is justified by economic or other *bona fide* reasons. According to the Circular such a reason is in particular given if the foreign company envisages engaging in own business activities and this fact is substantiated. Other *bona fide* reasons can be of legal, political or religious nature. These will be difficult to justify in practice. The more obvious business reasons based on circumstances arising from relations within an affiliated group (e.g., co-ordination, organisation, customer relationships, local preferences, costs) are however explicitly disqualified as valid reasons in the Circular.

> **Substance Test**: This test presupposes that the foreign company has sufficient substance for its business purposes (qualified personnel, business premises and technical means of communication) in its state of residence. Circumstances which indicate sufficient substance are: (i) the company permanently employs both managing and other staff, (ii) the company's personnel has the qualifications required for performing the functions entrusted to the company independently and on their own responsibility and (iii) transactions between related parties comply with the at arm's length principle.

Similar to the old rule, the above tests are to be conducted on a stand-alone basis with regard to the relevant single foreign company; circumstances arising from relations within a affiliated group continue to be irrelevant. Pursuant to the Circular this does even hold true where companies are members of a tax group or otherwise consolidated for tax purposes.

Test period: The above tests are to be performed in relation to the respective fiscal year of the foreign company. According to the Circular, the question which fiscal year is relevant depends on the method of the withholding tax relief:

> **Refund method**: In the context of this method, the fiscal year is relevant in which the earnings subject to the withholding is received.

> **Exemption method**: Under this method, the fiscal year is relevant in which the application for the exemption certificate is filed.

Furthermore the amount of the gross active earnings needs to be substantiated on the basis of the annual accounts for the relevant fiscal year

according to the Circular. Should these accounts not yet be available, principally the circumstances of the preceding fiscal year are decisive.

As regards changes of the harmful-to-harmless-earnings-ratio see 3.3 below.

Shareholder Test

Finally, under the Shareholder Test it is to be checked if and to what extent the shareholders of the foreign company would be entitled to a withholding tax relief if they were direct shareholders of the German company. Thus the relief is only possible to the extent each shareholder meets the preconditions of the applicable EU directives and/or tax treaties himself. Consequently, e.g. to the extent there are shareholders that are tax resident in Germany no relief is available according to the Circular. The same holds true e.g. for shareholders in tax havens where there is no treaty. The Circular lists further examples.

If and to the extent the prerequisites of the EU directives and/or tax treaties are given at the level of the shareholder, a relief further presupposes that the shareholder passes the Earnings and Substance Test. Failing this, it is to be examined whether and to what extent the shareholders of the shareholder of the foreign company are entitled under the applicable EU directives and/or tax treaties and whether and to what extent they pass the Earnings and Substance Test. This up-stream-look-through assessment is to be undertaken until shareholders are encountered which do not benefit from the EU directives and/or tax treaties.

Section 12 of the Cirlcular gives a detailed example of how to apply this in practice.

Relief Procedure

As far as the relief procedure is concerned, a refund of the withholding tax or an exemption to the withholding tax is available. The refund method is the default. To benefit from the exemption method, the foreign company receiving the payments subject to withholding tax needs to present an exemption certificate issued by the Federal Tax Office (*Bundeszentralamt für Steuern* – the "**BZSt**") to the German company making the payment.

In contrast to the former situation, exemption certificates will generally no longer entitle to a fully relief but to a *pro rata* relief in accordance with the general "proportioning"-approach only.

The foreign company is obligated to inform the BZSt without undue delay about any facts and circumstances that challenge the existence or alter the portion of the relief certified in the exemption certificate. The Circular however stipulates certain *de minimis* limits where no information requirement exists. This is

> if the proportion of the gross active earnings to the overall gross earnings of the foreign company, which was the basis of issuing the exemption certificate, decreases by less than 30 percentage points; or

> if a (direct or indirect) participation of a shareholder in the foreign company changes by less than 20 percentage points.

In case the *de minimis* limits are observed, the BZSt might refrain from recalculating the proportion of the relief laid down in the existing exemption certificate.

First-time Application

According to the Circular, the revised sec. 50d para. 3 EStG and its interpretation contained in the Circular is applicable as of 1 January 2012 and for prior fiscal periods, for which tax assessments or exemption certificates have not yet become final and conclusive, provided the new rules are more beneficial to the person entitled to the withholding tax relief.

Likely Impacts

The effects of the revised sec. 50d para. 3 EStG and the Circular will be beneficial for certain foreign companies and disadvantageous for others:

> Foreign companies that were not entitled to a withholding tax relief due to failing the 10% active earnings test may be positively impacted. Going forward and also for the past they might be able to obtain at least a *pro rata* relief in accordance with the general “proportioning”-approach.

> To the contrary, foreign companies, which exceeded the 10% active earnings threshold and therefore generally obtained a full relief, will be negatively impacted. Going forward they might no longer be entitled to full withholding tax relief. This will even apply to foreign companies that receive predominantly active earnings and have sufficient substance to the extent that they generate passive earnings.

The general “proportioning”-approach will likely result in additional tax compliance and monitoring duties of the foreign companies if they want to benefit from a withholding tax relief. The amended sec. 50d para. 3 EStG now provides explicitly in its sentence 4 for a burden of proof clause in relation to the Business Reasons and Substance Tests that was only included in the revenue’s guidance so far. The proof has to be furnished in accordance with the taxpayer’s co-operation requirements in cross-border cases under sec. 90 para. 2 of the General Fiscal Code (*Abgabenordnung*).

Taking into account all the above, we anticipate that the changes unfortunately will bring about an additional complication of the withholding tax relief in practice. This is evidenced by the complex example in section 12 of the Circular.

Required Actions and Structuring Considerations

Generally, existing structures should be thoroughly analysed on the basis of the Circular. Certain structure might benefit from the Circular and its retroactive application provided no final assessments exist.

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In the past it was relatively difficult to avoid the application of sec. 50d para. 3 EStG by adequate structuring. Even if business reasons for the interposition of a foreign company and sufficient substance of that company could be demonstrated, the rigid 10% active earnings threshold made it difficult to achieve a withholding tax relief at all.

Going forward the replacement of this "all or nothing"-approach by the general "proportioning"-approach seems to make it easier to at least achieve a *pro rata* relief. For instance in new private equity structures, one could try to implement management holding structures and/or to have intra group services rendered so to benefit from the concept change. Since this will likely make the private equity fund a trading partnership for German tax purposes, this structuring measure has to be balanced against potential impacts on the fund's investor base.

Finally, there might be room for ballooning strategies (i.e., active earnings are reinvested instead of distributed so to increase the proportion of the withholding tax relief over time) due to interest earned from the reinvestment of active earnings being considered active as well.

* * *

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[*Letterhead of the Federal Ministry of Finance*]

Only by e-mail

Supreme tax authorities
of the German *Länder*

DATE 24 January 2012

Federal Tax Office
(*Bundeszentralamt für Steuern – BZSt*)

For information purposes only:
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within the Federal Ministry of Finance
(*Bundesministerium der Finanzen – BMF*)

Federal Ministry of Economics and Technology
(*Bundesministerium für Wirtschaft und Technologie – BMWi*)

Eligibility of foreign companies for tax relief (section 50d para. 3 of the German Income Tax Act)

IV B 3 – S 2411/07/10016
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(please indicate in case of reply)

In reference to the outcome of the discussions with the supreme tax authorities of the German *Länder*, the following applies with respect to the application of section 50d para. 3 of the German Income Tax Act (*Einkommensteuergesetz – EStG*)[1], as amended by the German Act Implementing the Recovery Directive and Amending Tax Provisions (*Gesetz zur Umsetzung der Beitreibungsrichtlinie sowie zur Änderung steuerlicher Vorschriften*) dated 7 December 2011, Federal Law Gazette (*Bundesgesetzblatt – BGBl.*) 2011 Part I p. 2592:

1. General

The provision of section 50d para. 3 EStG limits the entitlement of a foreign company under sections 43b, 50g EStG or under a double tax treaty (Treaty) to exemption from, or refund of, withholding taxes according to section 50a EStG,

[1] This circular applies with respect to the direct application of section 50d para. 3 EStG. To the extent this provision applies only *mutatis mutandis*, e.g. as set out in section 44a para. 9 sentence 2 EStG, the contents of this circular should only be considered in accordance with the spirit and purpose of the reference provision.

- to the extent that persons are shareholders in the company who would not be eligible for tax relief if they directly generated the income (**personal eligibility for tax relief**) and
- to the extent that the functional requirements of section 50d para. 3 sentence 1 EStG (**functional eligibility for tax relief**) are not met (*harmful earnings*).

Alternatively, the **functional requirements** for *harmless earnings* are met

- to the extent that the gross earnings generated by the foreign company in the relevant fiscal year result from its own business activity or
- where, in relation to earnings not generated from the foreign company's own business activity, there are economic or other *bona fide* reasons justifying the interposition of the foreign company and the foreign company participates in general commerce with a business establishment that is appropriately organised for its business purposes or
- where section 50d para. 3 sentence 5 EStG applies.

2. Scope of application

According to the requirements of section 50d para. 3 EStG, a foreign company shall not be entitled to a full or partial tax relief under section 50a EStG for withholding tax purposes. Accordingly, any entitlement to a full or partial refund of withheld taxes (section 50d para. 1 EStG) and to a full or partial exemption from tax withholding (section 50d para. 2 EStG) shall be excluded.

If the foreign company generates earnings that are subject to tax withheld at source, the amount of such tax will be reduced, subject to personal eligibility for tax relief, in the proportion of the harmless gross earnings to the overall gross earnings generated by the foreign company in the relevant fiscal year ("proportioning clause").

The scope of application of section 50d para. 3 EStG does not encompass any entitlement to tax relief resulting from the allocation of the right to tax other income (such as profits from the sale of shares) under a Treaty.

3. Foreign company

As regards the application for the respective claim, the term "company" (*Gesellschaft*) is to be interpreted in accordance with the applicable Treaty or sections 43b para. 2 or 50g para. 3 no. 5 letter a) double letter aa) EStG. Pursuant to article 3 para. 1 letter b) of the OECD Model Convention, the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes. The requirements for qualifying as a company may vary from contracting state to contracting state. For German tax purposes, companies are qualified exclusively in accordance with German tax law (comparison approach [*Typenvergleich*]). Irrespective of that, relief from German withholding taxes must be granted where the income is taxable as income of a resident under the law of the other contracting state. As a consequence, a foreign partnership (*Personengesellschaft*) treated under foreign law as a company qualifies as a company for the purposes of section 50d para. 3 EStG[2].

As regards applications for claims made pursuant to sections 43b or 50g EStG, it is to be considered whether the company has any of the legal forms specified in Annex 2 to section 43b or

[2] The qualification of a foreign company under German tax law (analogy comparison) is not relevant in that respect. See Commentaries on the OECD Model Convention, paragraph 5 of the commentary on article 1.

Annex 3a to section 50g EStG, as applicable, and the further applicable requirements are met in addition.

A company qualifies as foreign if neither its corporate seat nor its place of management is located in Germany or, in the case of dual residency, if it is deemed a resident of the other contracting state under the applicable Treaty.

The residency of a foreign company in another contracting state is determined in accordance with article 4 paras. 1 and 3 of the OECD Model Convention or the relevant provision of the applicable Treaty.

4. Personal eligibility for tax relief (section 50d para. 3 sentence 1 EStG)

4.1 Shareholder-related assessment

A foreign company meets the criteria for personal eligibility for tax relief to the extent that its shareholders would be entitled to tax relief pursuant to sections 43b and 50g EStG or under a Treaty if such persons directly generated the earnings (assessment of the shareholder's indirect eligibility for tax relief). According to the wording of the provision ("to the extent"), the eligibility for tax relief is to be assessed for each shareholder separately. Shareholders whose domicile, seat or place of management is located in Germany are not eligible for tax relief.

4.2 Shareholder's indirect personal eligibility for tax relief

If the shareholder of the foreign company is a company itself, it is relevant whether such company is **personally eligible for tax relief** (notional entitlement to tax relief) under a Treaty or an EU directive. If the indirectly involved company is **functionally <u>not</u> eligible for tax relief**, it is to be assessed whether any company holding a stake in it, provided that such company itself is personally eligible for tax relief, meets the functional requirements of section 50d para. 3 sentence 1 EStG. As regards companies in an ownership chain, each company in the chain must always be personally eligible for tax relief (see Federal Tax Court [*Bundesfinanzhof – BFH*] decision dated 20 March 2002 - I R 38/00 -, Federal Tax Gazette [*Bundessteuerblatt – BStBl.*] II p. 819). It is not relevant in this context whether companies within the chain are eligible for tax relief to the same extent. The notional entitlements to tax relief of the lower-tier shareholders in the ownership chain, however, limit the amount of the entitlements to tax relief of higher-tier shareholders (see section 12 below).

4.3 Exclusion of the indirect eligibility for tax relief

The lack of a **personal eligibility for tax relief** excludes any potential indirect entitlements to tax relief of higher-tier shareholders. As a consequence, a shareholder is not (indirectly) personally eligible for tax relief where such shareholder

- is not a resident of a Treaty state,
- as a resident of a non-EU member state does not meet the requirements of the relevant directives,
- has the legal form of a company, such company is functionally not eligible for tax relief (see section 1 above) and its shareholders are not residents of a Treaty state or as residents of a non-EU member state do not meet the requirements of the relevant directives, or

- cannot claim the benefits under a Treaty or the relevant EU directives although the shareholder is a resident of a Treaty state and/or the EU (for the purposes of the direct application of section 50d para. 3 EStG, such shareholders include also German companies).

Example:

One shareholder of a Dutch B.V. is a company domiciled in Bermuda. The shareholders of the Bermuda company include, among others, individuals who are U.S. residents. The Bermuda company's lacking eligibility for tax relief excludes the U.S. resident shareholder's potential entitlement to tax relief.

5. Foreign company's own business activity (section 50d para. 3 sentence 1 EStG)

A foreign company is entitled to tax relief to the extent that the gross earnings generated by it in the relevant fiscal year result from its own business activity (see section 5.5 below). Included in this context are also the gross earnings of a company that are generated in a functional economic connection with the same company's own business activity (see section 12 below) as well as interest income of a company generated from a capital investment of profits eligible for tax relief of the same company. Gross earnings refers to gross earnings (*Bruttoerträge*) as defined by section 9 of the German Foreign Tax Act (*Außensteuergesetz – AStG*) (see section 9.01 of the BMF circular dated 14 May 2004 – IV B 4 – S 1340 – 11/04 –, BStBl. I 2004, special issue no. 1, Federal Decree regarding the German Foreign Tax Act). Dividends and other income (e.g., interest and royalties) from actively managed companies (see section 5.3 below) are included in the gross earnings from the own business activity.

In refund procedures pursuant to section 50d para. 1 EStG, the influx year of the earnings (*Jahr des Ertragszuflusses*) is the relevant fiscal year. In tax exemption procedures pursuant to section 50d para. 2 EStG, the relevant fiscal year is the year the claim is filed. The gross earnings from own business activity must be demonstrated based on the annual accounts for the relevant fiscal year. If such annual accounts are not available yet, the situation of the preceding fiscal year is to be taken as a reference; if it is more favourable to the taxable person, the earnings of the fiscal year in which they accrued may be applied with retroactive effect. As regards a newly formed company, the situation in the first fiscal year following its formation is relevant.

5.1 "Genuine business activity"

An own business activity requires the participation in general commerce beyond mere asset administration ("genuine business activity"). In view of the judgment of the European Court of Justice in the case of Cadbury-Schweppes (ECJ decision dated 12 September 2006, case C-196/04), the interposition of a company resident in another EU member state is justified only where such company participates actively, permanently and sustainably in market transactions in such other EU member state as a part of its ordinary activities.

A company also participates in general commerce where it provides services to one or several group companies. It is required, however, that the services are provided in return for a separate compensation and charged at arm's length terms.

An own business activity is lacking pursuant to section 50d para. 3 sentence 3 EStG to the extent the foreign company generates its gross earnings from the administration of its own and/or third-party assets, e.g. in the case of the pure acquisition of shareholdings (Federal Tax Court decision dated 5 March 1986, - I R 201/82 -, BStBl. II 1986, p. 496) or in the case of holding stock or

holding and managing assets (Federal Tax Court decision dated 27 July 1976 - VIII R 55/72 -, BStBl. II 1977, p. 266; Federal Tax Court decision dated 29 July 1976 - VIII R 142/73 -, BStBl. II, p. 263).

5.2 Active management of shareholdings

If the foreign company holds shareholdings in German companies as business assets, it carries out own business activity only where substantial shareholdings (*Beteiligungen von einigem Gewicht*) have been acquired to carry out management functions in relation to the companies in which the stakes are held (active management, see Federal Tax Court decision dated 9 December 1980 - VIII R 11/77 -, BStBl. II 1981, pp. 339, 341).

5.3 Management functions

Management functions are carried out by taking leadership decisions. Leadership decisions are characterised by their long-term nature, essentiality and importance in relation to the existence of the invested-in company (actively managed company). They are to be distinguished from short-term and non-strategic decisions. Carrying out only individual business functions, e.g. licence management and/or granting loans, is not a sufficient qualification for active management. Oral leadership decisions that have not been properly documented do not sufficiently provide evidence for the existence of a management function.

5.4 Outsourcing of material business activities

An own business activity is also not carried out where the substantial business activities are outsourced to third parties, e.g. law firms or management service providers (section 50d para. 3 sentence 3 EStG).

5.5 Shareholder-related assessment

To the extent an own business activity is not carried out, the functional eligibility for tax relief is to be assessed considering its shareholders.

6. Economic or other *bona fide* reasons justifying the interposition of the foreign company (section 50d para. 3 sentence 1 no. 1 EStG)

Where the foreign company participates in general commerce with a business establishment that is appropriately organised for its business purpose, it is entitled to tax relief to the extent that the earnings not resulting from its own business activity are generated in a business area for which the interposition of the foreign company is justified by economic or other *bona fide* reasons. There is an economic reason in particular where it is planned that the foreign company commences to carry out its own business activity within the meaning of section 5 above and clear evidence for activities to implement such plans has been provided.

An economic reason is lacking in particular where the foreign company serves primarily the purpose of protecting German assets in times of crisis, or where it is to be used for a future inheritance arrangement or to build-up old-age provisions for the shareholders (Federal Tax Court decision dated 24 February 1976 - VIII R 155/71 -, BStBl. II 1977, p. 265).

Other significant reasons may include, amongst others, legal, political or even religious reasons.

Circumstances arising from the relations within a corporate group (such as reasons of co-ordination, organisation, establishment of customer relationships, costs, local preferences, overall corporate strategy) do not qualify as economic or other *bona fide* reasons (see section 8 below).

Example:

None of the shareholders in a foreign company is eligible for tax relief. 80% of the company's earnings are generated from other activities than its own business activity, with the interposition of the foreign company being justified by economic reasons for 60% of such earnings. A business establishment appropriately organised for the business purpose exists. German payments subject to withholding tax are eligible for tax relief in the amount of 68% [=20% (earnings generated from own business activity) and 60% × 80% (section 50d para. 3 nos. 1 and 2 EStG)].

7. Appropriately organised business establishment (section 50d para. 3 no. 2 EStG)

It is required that the foreign company maintains a business establishment in the state of residence that is appropriately organised for its business purpose (qualified personnel, business premises and technical means of communication, Federal Tax Court decision dated 20 March 2002 - I R 38/00 -, BStBl. II 2002, pp. 819, 822), i.e. evidence that the foreign company "physically exists" is required (ECJ decision dated 12 September 2006, Case C-196/04). There are indications for such "physical existence" where

- the company permanently employs both managing and other staff for carrying out its activity;
- the company's personnel has the qualifications required for performing the functions entrusted to the company independently and on their own responsibility;
- the related party transaction within the meaning of section 1 para. 2 AStG complies with the arms' length principle (like between unrelated parties).

8. Group situations (section 50d para. 3 sentence 2 EStG)

Exclusively relevant for the assessment of the disqualification criteria referred to in sections 6 and 7 above is the situation of the foreign company and not that of the corporate group of which it forms a part. As a consequence, the structure and strategy of the group do not give rise to a tax relief for a functionally not eligible group company. This applies also in cases of group taxation or fiscal unity. The substance over form principle is not applicable.

9. Exceptions (section 50d para. 3 sentence 5 EStG)

Only the following foreign companies are excluded from the scope of application of section 50d para. 3 EStG:

9.1 Companies whose shares are exchange-traded

Companies for whose main class of shares material and regular trading takes place on a recognised stock exchange do not fall within the scope of application of section 50d para. 3 EStG. The term "recognised stock exchange" means organised market as defined by section 2 para. 5 of the German Securities Trading Act (*Wertpapierhandelsgesetz – WpHG*) and similar markets based outside the European Union and the European Economic Area.

9.2 Investment companies

Excluded are only foreign investment funds of a corporation type (i.e., structures similar to an investment stock corporation as defined by section 2 para. 5 of the German Investment Act [*Investmentgesetz – InvG*]). The provision requiring the determination of the investment fund's income in accordance with the provisions on excess income (section 3 para. 1 of the German Investment Tax Act [*Investmentsteuergesetz – InvStG*]) do not lead to a qualification of the investment fund's activity as asset administration. Due to the varying regulatory provisions in foreign jurisdictions, this applies also where the management of the investment fund has been outsourced to a special management company.

If none of the exceptions of section 50d para. 3 sentence 5 EStG (sections 9.1 and 9.2 above) applies to a foreign company eligible for tax relief under a Treaty or an EU directive, it has to be taken into account if one of the exceptions of section 50d para. 3 sentence 5 EStG (sections 9.1 and 9.2 above) applies to a company holding a direct or indirect stake in the foreign company, provided that such company is personally eligible for tax relief as well. There must be a personal eligibility for tax relief also in the case of a company holding an indirect stake.

10. Relation of section 50d para. 3 EStG to abuse provisions in the Treaties

A potential eligibility for tax relief under a Treaty is generally subject to the reservation that the requirements of section 50d para. 3 EStG are met (Federal Tax Court decision dated 17 May 1995 - I B 183/94 -, BStBl. II p. 781). This reservation does not apply where the relevant Treaty contains an exhaustive regulation (Federal Tax Court decision dated 19 December 2007, BStBl. II 2008, p. 619).

11. Relation of section 50d para. 3 EStG to section 42 of the German General Tax Code

Section 50d para. 3 EStG is the more specific provision compared to section 42 of the German General Tax Code (*Abgabenordnung – AO*) and has thus to be given priority in application. If the requirements of section 50d para. 3 EStG are not met, the general abuse provision of section 42 AO is to be considered, as its application is not excluded by section 50d para. 3 EStG or any other legal provision (section 42 para. 2 AO).

12. Amount of the entitlement to tax relief

A foreign company is entitled to tax relief to the extent that

a) persons personally eligible for tax relief are direct or indirect shareholders in it (see section 4 above) or

b) it demonstrates that there is a functional eligibility for tax relief of the earnings subject to withholding tax (harmless earnings according to section 1 above) or

c) it meets one of the exception criteria specified in section 50d para. 3 sentence 5 EStG (see section 9 above).

Where the shareholders of the foreign company include also persons not eligible for tax relief (for the assessment of eligibility for tax relief, see section 4 above) and the foreign company does not provide evidence as mentioned above, for the purposes of determining the amount of the

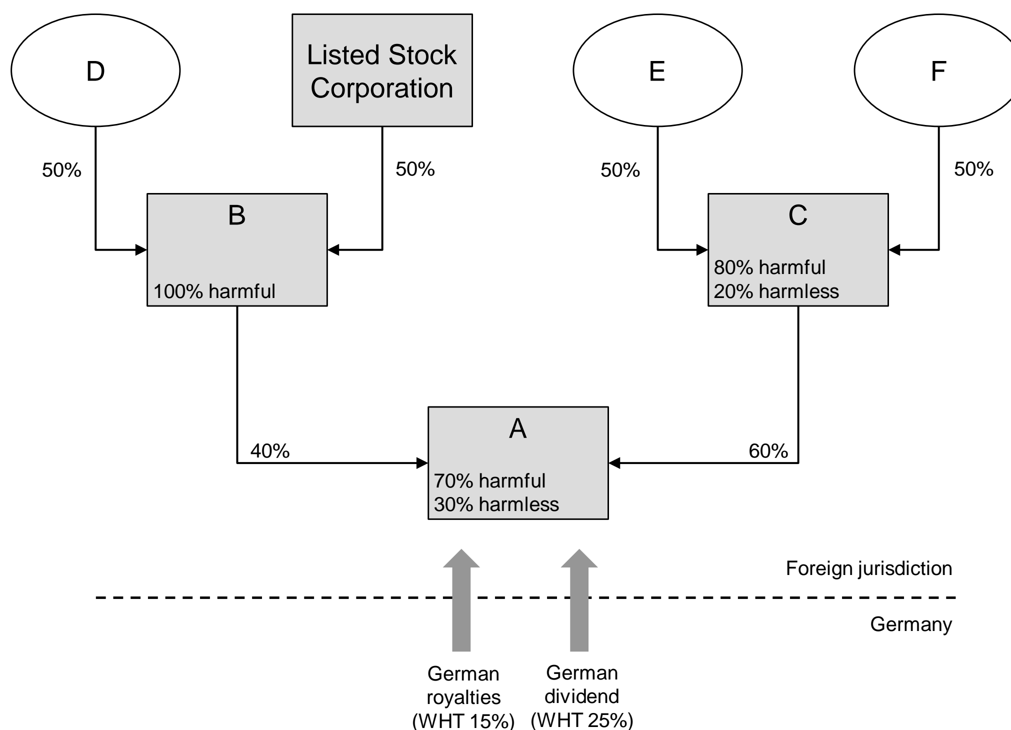
entitlement to tax relief it is to be assessed for each shareholder separately to what amount of tax relief the shareholder would be entitled if the shareholder directly generated the earnings (notional entitlement to tax relief). The company's entitlement to tax relief is calculated as the sum of the notional entitlements to tax relief of the shareholders holding a direct or indirect stake.

Example:

The shareholders of a foreign company A, which is 100% personally eligible for tax relief under a Treaty, are two companies B and C, holding 40% and 60%, respectively. 70% of the gross earnings generated by A are harmful. There are no economic or other *bona fide* reasons in relation to these earnings. 30% of A's gross earnings result from its active business as a production and distribution company. The distribution of the products on the German market is carried out by a German subsidiary. In connection with this activity, A grants a licence to its German subsidiary. In the year 01, the German subsidiary pays royalties to A for the licence, with such royalties being subject to German withholding tax at a rate of 15%. In addition, A receives a dividend that is subject to withholding tax at a rate of 25%.

The shareholders of company B, which is personally eligible for tax relief under the Treaty and generates exclusively harmful gross earnings, are an individual D, who is not personally eligible for tax relief, and a listed stock corporation, which is eligible for tax relief, each holding 50%.

The shareholders of company C, with 20% of its earnings being qualified as harmless and 80% as harmful, are the individuals E and F, each holding 50%, who are eligible under the Treaty for a reduction of the tax withheld at source to 15%. The company C itself is eligible under the Treaty for a reduction of the tax withheld at source to 5%.



The eligibility for tax relief in relation to earnings (**royalties and dividends**) which are subject to withholding tax is assessed as follows:

1. **Functional** eligibility for tax relief as a result of gross earnings generated from own business activity of **A**

   30% of the earnings subject to withholding tax are eligible for tax relief since the proportion of gross earnings generated from own business activity in the relevant fiscal year to overall gross earnings results in a ratio of 30 (harmless earnings) to 70 (harmful earnings) to be applied to earnings subject to withholding tax.

2. **Personal** eligibility for tax relief of company **A**

   70% of the earnings subject to withholding tax is eligible for tax relief to the extent that there are shareholders eligible for tax relief (see section 4 above):

   - **B** is personally eligible for tax relief but generates exclusively harmful earnings. Therefore, the notional entitlement to tax relief of B's shareholders is decisive. The listed stock corporation indirectly holding 50% is fully eligible for tax relief (see section 4.2 above); but D is not personally eligible for tax relief. Hence, A's eligibility for tax relief in this respect is 14% (= 40% * 50% * 70%).
   - **C** is personally eligible for tax relief, but 80% of the earnings it generates are harmful. Therefore, the notional entitlement to tax relief of C's shareholders E and F is decisive in this respect. Since both E and F are personally eligible for tax relief, eligibility for tax relief is 48% (= 80% * 60%), which, however, owing to the reduction of the withholding tax to 15%, is limited by 15/25 (= 15% of 25% withholding tax). Therefore, such eligibility of 48% is reduced to 19.2% (= 10/25 * 48%). With respect to the proportion of harmful earnings of A (70%), this results in eligibility for tax relief of 13.44% (= 19.2% * 70%).
   - With respect to the remaining 20% of earnings which are harmless, C is personally eligible for tax relief and hence recourse to its shareholders is not necessary. This results in A's eligibility for tax relief being 12% (= 20% * 60%), which owing to the reduction of the withholding tax to 5%, is limited by 1/5 (= 5% of 25% withholding tax). Therefore, such eligibility of 12% is reduced to 9.6% (= 4/5 * 12%). With respect to the proportion of harmful earnings of A (70%), this results in eligibility for tax relief of 6.72% (= 9.6% * 70%).

3. In total, this results in eligibility for tax relief with respect to withholding tax on royalties and the dividend of 64.16% (= 30% + 14% + 13.44% + 6.72%).

13. Duty to furnish proof (*Feststellungslast*)

The foreign company shall be under the duty to furnish proof that the requirements of section 50d para. 3 sentence 1 nos. 1 and 2 EStG are not met. Owing to the increased duty to co-operate in cross-border cases (section 90 para. 2 AO), the foreign company shall be responsible for furnishing proof of any further possibilities of tax relief (shareholders personally eligible for tax relief or gross earnings generated from own business activity).

14. Exemption certificate

As a general rule, exemption certificates (*Freistellungsbescheinigungen*) under section 50d para. 2 EStG may only be issued subject to the reservation that they may be revoked. In the certificate, it shall be pointed out to the foreign company that it has to notify the Federal Tax Office without undue delay (*unverzüglich*) if any or all requirements for being exempt cease to be met; section 50d para. 2 last part of sentence 4 EStG shall apply *mutatis mutandis*, see also the *de minimis* provisions in section 15 below. In addition, reference is made to the general principles arising from the German General Tax Code with respect to correcting declarations (cf. section 153 AO).

15. *De minimis* limits

The foreign company shall notify the Federal Tax Office without undue delay if any or all requirements for being eligible for tax relief within the meaning of section 50d para. 3 EStG for exemption purposes cease to be met. This shall not apply if:

- the proportion of gross earnings generated from own business activity to overall gross earnings, which was the basis of issuing the exemption certificate, is reduced by less than 30 percentage points or
- a shareholder’s share (held directly or indirectly) changes by less than 20 percentage points.

The Federal Tax Office shall also be notified without undue delay if the minimum participations required by law/a Treaty fail to be reached.

In cases in which no notification duty exists under the *de minimis* limits it is not necessary to calculate again the proportion of earnings eligible for tax relief.

16. First-time application

Section 50d para. 3 EStG as amended on 7 December 2011 shall apply for the first time from 1 January 2012 onwards and to all previous periods to the extent that the relevant tax assessment notices or exemption certificates are not final and non-appealable and these provisions result in better eligibility for tax relief.

This circular replaces the BMF circulars dated 3 April 2007 (IV B 1 - S 2411/07/0002, BStBl. I 2007, p. 446) and 21 June 2010 (IV B 5 - S 2411/07/10016: 005, BStBl. I 2010, p. 596).

This circular will be published in the Federal Tax Gazette, Part I. The current version of the application forms is available on the web site of the Federal Tax Office. This circular is temporarily available on the web site of the Federal Ministry of Finance at www.bundesfinanzministerium.de.

Signed on behalf of the Ministry