KPMG

Tax Practice Letter

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Relief from German Withholding Tax for Hybrid Entities – Current Developments

The German Federal Central Tax Office (BZSt) is increasingly denying exemption certificates to US corporations when the German company paying dividends or license fees is considered a partnership (disregarded entity) from a US perspective. Below is an overview of the contentious issue of withholding tax (WHT) relief under sec. 50c German Income Tax Act (ITA) involving hybrid entities.

1. Refund and Exemption Procedures

If a double tax treaty (DTT), the Parent-Subsidiary Directive (sec. 43b ITA), or the Interest and Royalties Directive (sec. 50g ITA) allows for a reduction in WHT, a foreign corporation receiving dividends or license payments can apply to the BZSt for a full or partial refund of the WHT paid in Germany (sec. 8 para. 1 sentence 1 German Corporate Income Tax Act (CITA) in conjunction with sec. 50c para. 3 sentence 1 ITA, known as the refund procedure). For corporations with limited tax liability that cannot use the Parent-Subsidiary Directive, Interest and Royalties Directive, or a DTT (like a corporation based in Brazil), there's a possibility to get a refund of two-fifths of the German WHT (sec. 8 para. 1 sentence 1 CITA in conjunction with sec. 44a para. 9 sentence 1 ITA).

When a foreign corporation applies for an exemption certificate from the BZSt, the distributing German corporation can immediately apply the reduced WHT deduction according to the DTT, Parent-Subsidiary Directive, or Interest and Royalties Directive once it receives the exemption certificate (sec. 8 para. 1 sentence 1 CITA in conjunction with sec. § 50c para. 2 sentence 1 no. 1 ITA, known as the exemption procedure). Keep in mind, the refund and exemption procedure requires the foreign corporation to meet the substance criteria of sec. 50d para. 3 ITA (German anti-treaty / anti-directive-shopping rule).

2. Hybrid Entities

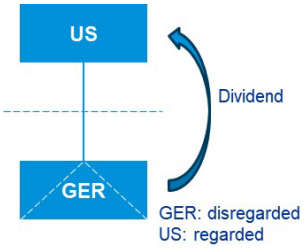
Currently, there is no legal regulation, ruling of the German Federal Tax Court, or official statement from the German tax authorities regarding the possibility of obtaining relief from WHT when the German company paying dividends or license fees is a hybrid entity. In this context, a hybrid entity is defined as one that Germany classifies as a non-transparent corporation, while the foreign country - particularly the USA - either disregards the entity for tax purposes or treats it as a transparent partnership.

The issue is also contentious when the foreign company is a reverse hybrid entity, meaning it is considered a non-transparent corporation from a German perspective and a transparent partnership from a foreign perspective.

Furthermore, the foreign company may be a hybrid entity that is viewed as a transparent partnership from a German perspective and a non-transparent corporation from a foreign perspective.

3. Examples

Case 1: German Company as a Hybrid Entity with US Parent Corporation as the Recipient of Dividends



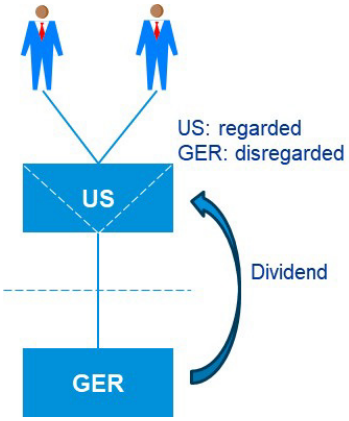
From a German point of view, the German company is treated as a non-transparent corporation, so that there is a dividend to a US parent company.

Exemption certificates have therefore (so far) been granted by the BZSt on the basis of the DTT Germany-USA in these cases, regardless of the fact that the dividend payment is disregarded for purposes of US taxation because the German company is classified as a disregarded entity from a US perspective.

The BZSt appears to have revised its opinion and is no longer issuing exemption certificates in this context. However, no official statement has been made. In the cases that have come to light, the new position is primarily justified by art. 1 para. 7 DTT Germany-USA, which states: "In the case of an item of income, profit or gain derived by or through a person that is fiscally transparent under the laws of either Contracting State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income, profit or gain of a resident."

This revised perspective based on art. 1 para. 7 DTT Germany-USA contradicts the previously prevailing view. According to the dominant opinion in tax literature, art. 1 para. 7 DTT Germany-USA applies whenever at least one of the two Contracting States considers the person deriving the income as transparent. The provision thus focuses on the recipient of the income rather than the German company paying the dividends or license fees.

Case 2: Foreign US Company with US Shareholders (Individuals) as a Reverse Hybrid Entity and Recipient of Dividends

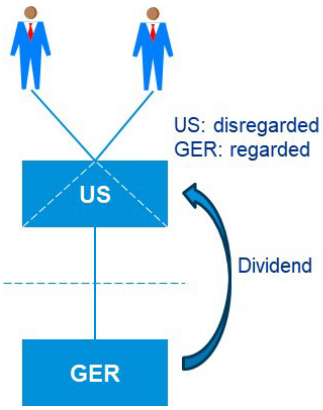


For this scenario, where the US company is treated by Germany as a non-transparent corporation and by the US as a transparent partnership, there is currently no uniform approach at the BZSt.

The BZSt tends to the view that the application should be submitted by the shareholders of the US company. Additionally, the extent of the relief entitlement depends on their relief claims. In the case of individuals, or persons residing in another state, their relief claims often result in less favorable outcomes compared to the DTT relief claim of the US company.

The Fiscal Court of Cologne (ruling of November 16, 2022, 2 K 750/19; the appeal is pending at the German Federal Tax Court under case number I R 13/23) ruled that the application should be submitted by the shareholders of the US company, the extent of the relief entitlement should be based on the DTT relief claim of the US company. The fact that under US tax law the dividend is taxed not at the US company but at its shareholders does not change this. For the interpretation of the treaty term "beneficial owner" only the domestic law of the source state, in this case Germany, is decisive. The actual lack of residency of the US company is also substituted by art. 1 para. 7 DTT Germany-USA through regulatory fiction.

Case 3: Foreign US Company with US Shareholders (Individuals) as a Hybrid Entity and Recipient of Dividends



In this scenario, where the US company is treated by Germany as a transparent partnership and by the USA as a non-transparent corporation, relief is typically granted based on the DTT between Germany and the country where the partnership is domiciled (Ministry of Finance, guidance of January 24, 2012, concerning sec. 50d para. 3 ITA old version, margin no. 3). The US company itself can submit the application. The tax residency of the shareholders, whether within or outside the country where the partnership is domiciled, is irrelevant for the WHT relief. There are no indications of a revised viewpoint on this matter by the tax authorities.

4. Existing Exemption Certificates / Ongoing Proceedings

We currently assume that existing exemption certificates should not be affected by the new interpretation in scenario 1. However, we recommend reviewing existing exemption certificates.

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We are happy to assist with any issues arising in current exemption or refund proceedings. For (imminent) profit repatriations, several alternatives to a profit distribution and the associated exemption procedure can also be considered.

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