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Proposal of significant tightening of the rules on tax credits regarding German equities

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*On 17 December 2015 the German Ministry of Finance (*Bundesfinanzministerium*) circulated its consultation draft bill on the reform of fund taxation ('**Ministry's Draft**').[1] The Ministry's Draft still contains a complete revision of the German fund taxation regime.[2] On a positive note, the abolishment of the 95% participation exemption for gains from portfolio shareholdings has been dropped due to a change of political agenda.*

On a negative note, in addition to the revision of the German fund taxation regime, the Ministry's Draft contains significant changes to the rules on domestic tax credits and refunds on dividends. These changes are aimed to counter-act so-called "Cum/Cum" transactions, a form of withholding tax arbitrage.

If introduced as currently drafted, the rules could result in massive distortions of the German equity markets.[3] Hereinafter we discuss the proposed changes in relation to domestic tax credits and refunds. We will inform you about the revision of the German Investment Tax Act separately in due course.

1. Current Regime on Tax Credits and Refunds

Discrimination of foreign taxpayers: Under the current regime, German taxpayers are entitled to credit or, if the German withholding tax ('**WHT**') is in excess of their tax liability, refund WHT on German dividends, provided they are economic owners of the equities on the dividend record date.[4] To the contrary, the German revenue does not in practice grant a reduction of the German WHT on dividends to non-German taxpayers beyond the treaty rate (15%).[5] In our view, this behavior constitutes a violation of the freedom of capital movement, which is not only applicable in the context of member states of the European Union but also vis-à-vis third party states.[6]

Usual trading strategies: It is a common trading strategy of non-German equity investors to sell or lend German equities prior to the dividend record date with the entitlement to future dividends (cum dividend) to German counterparties which collect the dividends and claim WHT credits or refunds. The German politicians regard these so-called "Cum/Cum" transactions as undesired and even as abusive[7]; the latter is in our view not the case also with regard to the European law background (see also 2.5 below). The amount of tax revenues that are allegedly at stake for the German fisc (EUR 5 billion p.a.)[8] has, however, forced the German Ministry of Finance to react.

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1 The Ministry's Draft can be found at: http://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Referentenentwuerfe/2015-12-17-investmentsteuerreformgesetz.html

2 Cf. Dechert OnPoint from July 2015, to be found at: http://sites.edechert.com/10/5202/july-2015/2015-07-23---german-investment-taxation---reform-ahead---external-version.asp, and *Haisch*, RdF 2015, p. 294 et seqq., with further references.

3 Cf. the reasoning of the Ministry's Draft, p. 144, which however assumes that the capital markets can adjust to the proposed changes.

4 Section 20 para. 5 of the German Income Tax Act (*Einkommensteuergesetz* – **'EStG'**).

5 Cf. *Thömmes/Linn*, IStR 2012, p. 777 et seqq.

6 Art. 63 of the Treaty on the Functioning of the European Union.

7 Cf. the reasoning of the Ministry's Draft, p. 141 and 142.

8 Cf. http://www.wiwo.de/politik/deutschland/steuern-wolfgang-schaeuble-will-steuerschlupfloch-schliessen/12611656.html

2. Restrictions on Tax Credits and Refunds

The Ministry's Draft provides for significant restrictions on tax credits and refunds in relation to WHT on German dividends by amendment/introduction of Section 36 para. 2 and 2a of the German Income Tax Act (*Einkommensteuergesetz* – '**EStG**'). These changes shall apply as from 1 January 2016.

2.1 Personal Scope of Application

Taxpayers subject to assessment: In our view, the proposed changes do generally only apply to German tax resident and non-German tax resident income and corporate income taxpayers (*unbeschränkt und beschränkt Einkommen- und Körperschaftsteuerpflichtige*), which are taxed by way of tax assessment (*Veranlagung*).[9] Foreign taxpayers, for which the WHT on German dividends generally settles their tax liability finally (*Abgeltungswirkung*)[10], are in our view not subject to the proposed changes (see also 2.3 below).[11]

Custodian banks: Moreover, the proposed amendments do not, in our view, cause implications for custodian banks which are obliged to withhold the WHT on German dividends. This is because the provisions on the WHT procedure[12] shall not be changed. Further, in cases where tax-exemptions or refunds are applied in the context of the WHT procedure, the respective taxpayers themselves are obligated to inform the local tax office and pay the tax (see 2.3 below).[13] Also this fact shows that the custodian banks are not liable in this context.[14]

2.2 "Full" ownership and 30% exposure

According to the draft of Section 36 para. 2a EStG, a credit or refund of the WHT on German stock and equity type profit participating notes in collective custody ('**Equities**') requires that the taxpayer

- has been both civil law and economic owner, and
- has been exposed to an at least 30% risk of change in value in relation to the Equities
- during a 45 days period.

This is a significant tightening of the current rules on tax credits and refunds.

2.2.1 Minimum Period

91 days observation period: A credit or refund is excluded if the taxpayer was the civil law and economic owner of the Equities for less than 45 days ('**Minimum Holding Period**') within a period of 45 days before and 45 days after the due date of the dividends.

45 days minimum holding period: In general, the due date of dividends is the day of the AGM, which resolves on the distribution.[15] The relevant observation period is 45 days before and 45 days after this date. The taxpayer has to be "full" owner (see 2.2.2 below) for 45 days during this period. In our view, the Minimum Holding Period

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9 Section 36 EStG exclusively applies to cases of tax assessment, cf. *Lammers*, in H/H/R, Commentary to EStG/KStG, Section 36 EStG annotation 9 and 19, with further references.

10 Section 50 para. 2 sent. 1 EStG.

11 Cf. *Gosch*, in Kirchhof, Commentary to EStG, 13th ed., 2014, Section 36 marginal no. 12, with further references.

12 Sections 43 et seqq. EStG.

13 Draft of Section 36 para. 2a sent. 3 EStG.

14 Additional obligations for the custodian banks would also not be practical since they would not be in a position to verify the 30% limit and the existence of hedge transactions respectively (see 2.2.3 below).

15 Cf. *Bayer*, in Münchener Commentary to the German Stock Corporation Act, 4th ed., 2016, Section 58, marginal no. 106, with further references. This is also in line with Section 20 para. 5 EStG.

does not have to be an uninterrupted period but has to include the due date of the dividends; otherwise the dividends would not be attributable to the taxpayer and no tax credit or refund would be available.

Irrelevant days: Days on which the taxpayer is exposed to less than 30% of the risk of changes in value in relation to the fair market value as of the date of acquisition of the Equities, as well as the day of disposal shall not be taken into account when calculating the Minimum Holding Period pursuant to the draft of Section 36 para. 2a sent. 2 EStG (see 2.2.3 below). In our view, the day of disposal is the day on which the taxpayer gives up the civil law and economic ownership in the Equities.[16]

2.2.2 "Full" ownership

Cumulative preconditions: In future, the taxpayer has to be both civil law and economic owner in order to be eligible for a tax credit or refund.

Civil law ownership is given if the taxpayer is civil law co-owner of the Equities at fractions.[17]

Economic ownership is to be determined in accordance with Section 39 of the German General Tax Code (*Abgabenordnung* – '**AO**'). Pursuant to the general rule contained in this provision economic ownership is – as a matter of principle – attributed to the civil law owner.[18] This is only different in cases where a person other than the legal owner exercises factual control over an asset in such a way that he can exclude the legal owner economically from the control over the asset.[19]

2.2.3 Risk of change in value

30% limit: Moreover it is a precondition for a tax credit or refund that the taxpayer has been exposed to an at least 30% risk of change in value in relation to the Equities. In relation to this 30% limit the following specifics apply.

Reference value: The basis for the 30% limit is the fair market value (*gemeiner Wert*)[20] at the time of the acquisition of the Equities. In our view, the relevant point in time for the determination of the fair market value is the day on which civil law and economic ownership is acquired.

Hedge transactions: An at least 30% risk of change in value is not given if the taxpayer hedges himself for more than 70% of that risk. The reasoning to the Ministry's Draft provides as an example for hedge transaction the entering into options and futures with the effect that the risk "remains with the former owner of the stock".[21] However, the wording of the draft is not limited to hedge transactions between the taxpayer and the former owner of stock but also encompasses such transactions of the taxpayer with third parties.[22]

Securities lending transactions: According to the reasoning of the Ministry's Draft securities lending transactions also result in the 30% limit not being observed.[23] It is true that the risk of change in value of the Equities in the context of such transactions remains with the lender since the borrower has only to return Equities of the same quantity, type and quality, and is not obligated to make the lender whole for a decrease in value. In our view, the same would apply in relation to genuine repo transactions (*echte Wertpapierpensionsgeschäfte*) if

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16 This means that a sale as well as an on-lending constitute disposals in this context.

17 Section 6 para. 1 of the German Depot Act (*Depotgesetz*).

18 Section 39 Abs. 1 of the German General Tax Code (*Abgabenordnung* – 'AO').

19 Section 39 Abs. 2 no. 1 sent. 1 AO.

20 Section 9 of the German Valuation Act (*Bewertungsgesetz*).

21 Cf. the reasoning of the Ministry's Draft, p. 144.

22 In our view, all types of hedge transactions are covered, i.e. micro, macro or portfolio hedges. However, the hedge transactions have to be entered into by the taxpayer; a transaction with a related person is not sufficient.

23 Cf. the reasoning of the Ministry's Draft, p. 144.

one assumes a transfer of economic ownership under these transactions.[24] This would also be in line with the proposed amendment in Section 8b para. 10 of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* – '**KStG**') (see 3 below).[25]

2.3 Cases of tax-exemption and refunds

Notification and payment duty: In so far as no WHT has been levied or the WHT has been refunded and the taxpayers do not meet the above-mentioned preconditions, they are obligated to notify their local tax office of this fact and to make a payment in the amount of the WHT on dividends not levied or already refunded pursuant to the draft of Section 36 para. 2a sent. 3 EStG. According to the reasoning of the Ministry's Draft, this rule shall address cases with "tax-preferred persons" and "investment funds" in particular.[26] In our view, one has to draw the following distinctions as far as the personal scope of application is concerned.

Life and health insurance companies: First of all, in our view the rule encompasses life and health insurers which generally hold special WHT exemption certificates (so-called *Dauerüberzahlerbescheinigungen*) and in relation to which the custodian banks have consequently to refrain from levying WHT on dividends.[27] However, life and health insurers are then taxed in the context of an assessment procedure[28] with the consequence that the draft of Section 36 para. 2a sent. 3 EStG as part of the provisions on tax assessments should be applicable.

Tax-exempt entities: As far as tax-exempt entities are concerned, one has to distinguish between charities, in particular within the terms of Section 5 para. 1 no. 9 KStG, and all other tax-exempts. In relation to the first category of tax-exempt entities, the custodian banks have to refrain from levying WHT on dividends if a respective WHT certificate is presented to them; as regards the second category the custodian banks are only allowed to levy WHT at a rate of 15%[29] which settles the tax-exempts' tax liability finally (*Abgeltungswirkung*).[30] While in our view the draft of Section 36 para. 2a sent. 3 EStG applies to charities, an application to all other tax-exempt entities is doubtful due to the final nature of the WHT. This is because from a systematic perspective, the draft of Section 36 para. 2a sent. 3 EStG requires that tax is levied by way of assessment procedure (*Veranlagungsverfahren*) (see also 2.1 above).

Investment funds: According to the reasoning of the Ministry's Draft, the proposed provision shall in particular apply to investment funds. In our view, this is not free from doubt as investment funds are not subject to a tax assessment procedure. Moreover, the application of the draft of Section 36 para. 2a sent. 3 EStG to investment funds would result in WHT being triggered twice which would be inconsistent with the tax system: In the first instance, investment funds would need to pay the WHT on dividends pursuant to the draft of Section 36 para. 2a sent. 3 EStG. Secondly, WHT would also be levied on the dividends at investment fund level.[31] In order to avoid this double taxation, the tax payable under the draft of Section 36 para. 2a sent. 3 EStG would have to be credited against the WHT to be withheld at investment funds level. There is however currently no legal basis for such a credit neither under the current framework nor under the Ministry's Draft.[32]

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24 Cf. *Haisch*, in H/H/R, Commentary to EStG/KStG, annex 1 to Section 5 EStG annotation 1560, with further references.

25 Cf. Section 8b para. 10 sent. 4 of the German Corporate Income Tax Act (Körperschaftsteuergesetz – 'KStG') according to which the rules apply also to genuine repo transactions.

26 Cf. the reasoning of the Ministry's Draft, p. 144.

27 Section 44a para. 10 sent. 1 no. 2 in conjunction with para. 5 EStG.

28 Section 31 para. 1 KStG in conjunction with section 36 EStG.

29 Section 44a para 10 no. 3 and 4 EStG.

30 Sections 32 para. 1 no. 1, 5 para. 2 no. 1 KStG.

31 Section 7 Abs. 3, 3a und 3b of the German Investment Tax Act (*Investmentsteuergesetz* – 'InvStG').

32 According to Section 4 para. 2 sent. 8 in conjunction with Section 7 para. 1 InvStG, German income taxes are only creditable at investment fund level in relation to foreign units in investment funds. This provision would have to be applied *mutatis mutandis*.

Foreign taxpayers are in our view generally not subject to the draft of Section 36 para. 2a sent. 3 EStG. This is because, in relation to these taxpayers, the WHT on German dividends as a rule finally settles their tax liability (*Abgeltungswirkung*)[33] with the consequence being that there is no tax assessment procedure. Thus, they can still claim unilaterally tax refunds[34] and tax refunds on the basis of double taxation treaties[35] or European law[36] irrespective of the proposed changes.

Formalities: The formalities of the notification and the payment of the tax, in particular the term, is unclear. Possibly the notification has to be regarded as a tax self-assessment within the meaning of Sections 150 para. 1 sent. 3, 167 AO (*Steueranmeldung*). Hence, the term for the notification might be five months after the lapse of the fiscal period[37] and the due date for the payment of the tax one month after the notification.[38] In any event, the tax office in charge should be the tax office defined in Sections 19, 20 AO (i.e., the local tax office).

2.4 Exceptions

The above provisions do not apply in case

- the dividends on Equities do not exceed EUR 20,000 within the fiscal period, or
- the taxpayer had been civil law and economic owner of the Equities for at least one year at the time the dividends are received.[39]

According to the reasoning of the Ministry's Draft, the first exception is aimed to protect small savings and relieve the tax authorities from additional administrative burden.[40]

By way of contrast, in case of a long term investment, it is assumed that there is no avoidance of taxes. The existence of a long term investment only requires that civil law and economic ownership in the Equities is given for at least one year; it is not detrimental that the taxpayer bears less than 30% of the exposure in the Equities (see 2.2.3 above).

2.5 Relationship to GAAR

According to the draft of Section 36 para. 2 no. 2 sent. 5 EStG, a credit or refund of WHT is excluded in so far as it would lead to avoidance of taxes; Section 42 AO, the general anti-abuse rule (GAAR), shall remain unaffected. Pursuant to the reasoning of the Ministry's Draft, the change is inspired by Swiss law[41] and shall efficiently counter-act avoidance structures. The explicit stipulation that Section 42 AO remains applicable shall make sure that said section still applies if the condition of the draft of Section 36 para. 2 no. 2 sent. 5 EStG are not met.[42]

In our view, the Ministry's Draft is of no avail in this respect: On the one hand, the draft of Section 36 para. 2 no. 2 sent. 5 EStG has no other content than Section 42 para. 1 sent. 1 AO. The requirement is always that a tax

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33 Section 50 para. 2 sent. 1 EStG.

34 Section 44a para. 9 EStG.

35 Section 50d para. 1 EStG.

36 So-called Fokus Bank or Denkavit claims on the basis of the judgements of the EFTA Court dated 23 November 2004, E-1/04, Fokus Bank ASA and the ECJ dated 14 December 2006, C-170/05, Denkavit, IStR 2007, p. 62.

37 Cf. Section 149 para. 2 sent. 1 AO in conjunction with Section 36 para. 1 EStG and Section 31 para. 1 KStG.

38 Cf. Sections 36 para. 4 sent. 1 EStG, 31 para. 1 KStG.

39 Section 11 para. 1 EStG; the day of receipt is not identical to the due date of the dividends.

40 Cf. the reasoning of the Ministry's Draft, p. 145.

41 Cf. art. 21 para. 2 of the Swiss Withholding Tax Act (*Verrechnungssteuergesetz*).

42 Cf. the reasoning of the Ministry's Draft, p. 142.

avoidance exists. However, in our view, dividend arbitrage generally does not meet this precondition.[43] On the other hand, the last limb of the proposed rule does not provide for anything else than Section 42 para. 1 sent. 3 AO. According to the prevailing opinion, the GAAR does not apply if the requirements of a special anti-abuse are not fulfilled.[44]

2.6 First application

The above-mentioned provisions shall apply to dividends that are received for the first time from 1 January 2016.[45] Whether this first application is compliant with the constitutional prohibition of retrospective provisions is in our view questionable. It goes without saying that the reasoning of the Ministry's Draft holds the dissenting view.[46]

3. Consequential Change of Section 8b para. 10 KStG

As a consequential change to the draft of Section 36 para. 2a EStG a provision shall be added to the special anti-abuse rules for securities lending and repo transactions under Section 8b para. 10 KStG.

Pursuant to the proposed amendment, Section 8b para. 10 sent. 1 to 9 KStG shall not apply if a credit of the WHT on dividends is excluded under the draft of Section 36 para. 2a sent. 1 EStG or the taxpayer is obligated to make a payment in the amount of the WHT on dividends not levied under the draft of Section 36 para. 2a sent. 3 EStG.[47] This in particular results in payments under securities lending and repo transactions (fees and manufactured dividends) being tax-deductible at the level of the borrower.

In our view, the draft of Section 8b para. 10 sent. 10 KStG avoids a double taxation which would exist otherwise due to the WHT or substitute tax payment in relation to the dividends on the one hand and the corporate income and trade tax payable on the gross dividends without the deductions of the fees and manufactured payments at the level of the corporate body on the other hand;[48] however, there are still other scenarios of double taxation.

4. Final Comments

The proposed changes shall pass the legislative process until mid-2016.

Given the potentially significant impact on the German equity markets, we expect that the changes will be subject to fierce discussions. Therefore, it is possible that the draft will suffer substantial amendments.

Moreover, the German tax authorities still consider other concepts to counter-act "Cum/Cum" transactions. We will duly and timely keep you posted on any new developments.

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43 Cf. BFH, judgment dated 15 December 1999, I R 29/97, Federal Tax Gazette II 2000, 527; BFH, judgment dated 20 November 2007, I R 85/05, BFHE 223, p. 414, each with further references.

44 Cf. *Ratschow*, in Klein, Commentary to AO, 12th ed., 2014, Section 42 marginal no. 91, with further references.

45 Draft of Section 52 para. 32a EStG.

46 Cf. the reasoning of the Ministry's Draft, p. 150 et seq.

47 The proposed amendment shall be applicable for the first time in the fiscal period 2016, cf. Section 34 para. 1 KStG and reasoning of the Ministry's Draft, p. 151.

48 Cf. the reasoning of the Ministry's Draft, p. 151.

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