German Dividend Withholding Tax Credit to be substantially limited

The Federal Ministry of Finance ("FMF") presented its long expected draft statute for the Reform of Investment Taxation on December 17, 2015. In deviation from the discussion draft of July 2015 (see Client Alert "Reform of the Taxation of Fund Investment"), the current draft no longer provides for the abolition of the 95% tax exemption for profits from the sale of small (i.e. less than 10 %) shareholdings, but instead provides for substantial changes in the credit and refund rules governing German withholding tax on dividends.

As stated by the FMF it seeks to eliminate certain trading strategies, which it deems "abusive" concerning the credit of German withholding tax on dividends in so-called cum-cum transactions. Different from so-called cum-ex transactions which through 2012 were used to obtain multiple credits of dividend withholding tax even if this was paid only once, the discussion of cum-cum transactions only concerns the question whether dividend withholding tax paid by a German stock corporation may at all be credited to the shareholder. In the event that the credit should be disallowed, the effective total tax burden for a corporate entity which receives a small shareholding dividend increases to more than 70%. For the investor in a corporate entity in case of an onward distribution of the small shareholding dividend by way of distribution the tax burden even amounts to 80%. The planned new rules concern all German shares kept in collective custody in Germany or to enjoyment rights with a character similar to an equity instrument and is likely, for this reason, to have substantial impact on the liquidity of the German stock market.

Background to planned draft New Rules

Systematically, dividend withholding tax is a pre-payment on the income or corporate income tax owing by the shareholder which is paid at the time when the corporate entity distributes a dividend. Correspondingly, the shareholder may credit the dividend withholding tax paid on his behalf against his taxes owing and he receives a tax credit to the extent that the dividend withholding tax paid exceeds his tax liability. However, this balanced picture does not apply to non-residents, who are not in a position to credit German dividend withholding tax in against German taxes the absence of their domestic tax assessment and who are normally not able to credit the dividend withholding tax against their taxes owing abroad. It is these shareholders who are frequently also denied the reduction of the dividend withholding tax to the lower treaty tax rate of 15% or less by the German tax administration. For this reason, non-resident shareholders frequently sell or lend their shares prior to the dividend day including the right to future dividends (cum
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dividend) to domestic taxpayers who receive the dividend and who have the dividend withholding tax credited or refunded. It so happens that such strategies are regarded by the tax administration as abusive which it seeks to defeat by the planned new rules. However, the design of the new rules triggers substantial disadvantages for domestic taxpayers quite irrespective of whether there is a case of abuse or not.

Limitation of Tax Credit and Fund Entitlement

Specifically, the draft statute provides for the limitation of tax credits and refund entitlement for dividend withholding tax on German dividends with retroactive effect to January 1, 2016. The credit or refund of dividend withholding tax on German shares in collective custody or equity-like jouissance rights is disallowed pursuant to Section 36 (2a) Income Tax Draft if the taxpayer:

- within an review period of 45 days before and 45 days after the due date of the dividend or of the capital income
- was both legal and beneficial owner of the shares or enjoyment rights for less than 45 days
- not counting those days during which the taxpayer carried less than 30% of the risk of change of value when compared to the ordinary value at acquisition.

The 45-day period is modelled on specific rules applicable in the US and Australia pursuant to which exempt or low tax dividend income becomes fully taxable in case the holding period is not observed. In German law, small shareholding dividends are fully taxable anyway with the consequence that the disallowance of the dividend withholding credit results in double taxation. In the case of a corporate entity which draws a small shareholding dividend, its books – even without taking account of the initial tax burden of the income of the dividend bearing listed stock corporation and the subsequent taxation in the hands of the private investor – will show a tax burden of approx. 53%.

The above rules do not apply if

- the dividends during the (annual) assessment period were less than EUR 20,000; or
- the taxpayer at the time of receipt of the dividend had been the legal and beneficial owner of the shares for at least one year.

These exceptions are designed to protect small shareholders and to reduce the administrative burden on the tax office. On the other hand, in all other cases it is not permissible to supply evidence on the absence of abusive structuring.

In all those cases where there was no tax withheld or where the tax was credited, even though the above requirements were not met, the shareholder is obliged to notify his local tax office and to make payment in the amount of the withholding not undertaken on the dividends according to Section 36 (2a) 3rd sentence Income
Tax Draft. According to the FMF draft motives, this requirement seeks to capture in particularly cases with "tax-advantaged persons" and "investment funds".

The legislative draft also provides for consequential amendments of Section 8b (10) Corporate Income Tax Act. According to Section 8b (10) sentence 10 Corporate Income Tax Draft, its sentences 1 through 9 shall not apply if the dividend withholding tax credit is disallowed according to Section 36 (2a) first sentence Income Tax Draft or if there is an obligation to pay up on the tax withholding not undertaken according Section 36 (2a) first sentence Income Tax Draft. This has the consequence, in particular, that compensating payments as part of share lending or share pension transactions become deductible again for the Borrower whenever Section 36 (2a) Income Tax Draft applies. In this way, additional double tax burdens are supposed to be avoided.

Relevance for resident Taxpayers

Although the new rules are aimed at disallowing tax credits equivalent benefits for non-residents, quite likely their impact is exclusively on domestic taxpayers whenever they are subject to tax assessment according to Section 36 Income Tax Act. For this reason, the trade with German shares at the time of the dividend due date will most likely be more beneficial for non-resident shareholders (treaty tax rate of 15% or less) than for German investors (domestic dividend withholding tax rate of 26.375%). Based on an applicable treaty, non-resident investors normally have an exemption or refund claim which is not addressed by Section 36 (2a) Income Tax Draft.

The new rules also have an impact on domestic banks in transactions typical for banks, even if these do not amount to "Cum-Cum-Transactions" and even if these transactions are in compliance with banking supervisory rules:

- As explained, the credit of dividend withholding tax pursuant to the new rule of Section 36 (2a) Income Tax Draft is only available if the taxpayer had collateralized less than 30% of the risk of value changes. However, a complete collateralization of the value change risk is required for banks under supervisory rules (CRR / Basel 3). The result is a conflict between supervisory rules and tax rules.

- In addition, on the basis of the planned new rules, a credit of the dividend withholding tax in case of share lending and share pension transaction is not possible since there is no risk transfer for the Borrower. However, share lending and pension transactions are essential for the refinancing of banks. If these transactions are made more expensive the bank lending function may be impaired.

- Shares frequently serve as collateral for loans granted to large customers or to secure derivative finance instruments. Derivative finance instruments, in turn, serve to secure interest and exchange risks. In these cases, the dividend withholding credit will frequently be disallowed by Section 36 (2a) Income Tax Draft and, in this way, make the respective credit or collateral transactions more expensive. The same is true for options and other transactions to collateralize market risks.
• Banks which issue certificates frequently use German shares as "underlying". For example, certificates enable in particular small investors to participate in the value increases of share indices, for example of the DAX. In this way, investors are able to diversify their risk in various markets without having to dispose of substantial holdings. In order to collateralize certificates – as required by supervisory rules – it is customary that the issuer will acquire the underlying share positions. For economic purposes, however, it is not the issuer of the certificate, but the investor who carries the valuation risk. As a result, neither the issuer of the certificate nor the investor can receive a credit of German dividend withholding tax. The planned new rules can result in the consequence that certificates on German shares - when compared to certificates on foreign shares - will become more expensive and their performance will substantially decline.

• In their market making, banks coordinate supply and demand for shares. It is customary that a bank may hold shares also during and beyond the dividend payment date, so-called excess holdings in shares. In case of the passage of the new rules pursuant to Section 36 Income Tax Draft, the dividend withholding tax on these positions (since as a rule they only held for a short period of time) would not be creditable. Banks which operate as market makers will thus suffer a tax detriment.

These detriments also apply to insurance companies, churches, general purpose organizations and, as noted in the motives, investment funds. In future, the timing of the purchase of small shareholdings and any the long-term investment will be of crucial importance for all shareholders.

On the other hand, it is not expected that the planned new rules have a substantial impact on depositary banks. These will be obliged to administer the dividend withholding tax deduction and settlement, but the basic rules concerning dividend withholding tax will remain unchanged. To the extent withholding tax is not paid or refunded, the respective shareholders and not the depositary banks are obliged to inform the tax office and to settle the tax according to Section 36 (2a) third sentence Draft Income Tax.

The new law shall apply retroactively on 1 January 2016. The next governmental draft is expected to be issued in March 2016.

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