Client Alert

Latham & Watkins
Tax Department

New Double Tax Treaty Between Germany and the United Kingdom – Impact on Cross-Border Structures

The revised double tax treaty between Germany and the UK became effective on December 30, 2010. The revised treaty applies in Germany from January 1, 2011 and in the UK from April 1, 2011 (corporation tax) or April 6, 2011 (income capital gains tax). It differs in a number of respects from the former treaty, importantly, rules aimed at preventing treaty abuse have been tightened. This *Alert* focuses on the impact of the new provisions on cross-border structures.

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Anti-abuse rules

Subject-to-tax clause

As was previously the case, under the new treaty, Germany generally mitigates double taxation by applying an exemption method. However, under the revised treaty a subject-to-tax test must be met according to which income is exempted from taxation in Germany only if the income is effectively taxed in the UK. The former treaty contained a subject-to-tax clause but this related only to income from the sale of real estate. The revised treaty extends this test to all classes of income and tightens it such that the test is now met only if the relevant income is *effectively* taxed; previously it was sufficient if the income was generally subject to taxation. Existing structures should be reviewed in light of the new rules, including UK real estate investments of German investors (*e.g.* through German closed-end funds) where the investors are taxable under UK claw-back rules upon exit, as such structures may not satisfy the subject-to-tax test, restricting the availability of treaty benefits (which were only recently restricted by the German Federal Fiscal Court under the subject-to-tax clause of the former treaty).

Switch-over clause

The new treaty introduces switch-over regulations under which Germany may substitute the exemption method for a credit-method. These apply where the income from a permanent establishment located in the UK is (mainly) derived from passive activities. The taxpayer must prove that the gross income does not constitute income from passive activities in order to be exempted from taxation in Germany. These rules include dividend income, *i.e.* dividends are taxed under the exemption method only if the relevant entity is actively engaged in business activities. It remains to be seen what proof will be required here as the revised treaty does not give any guidance in this respect. Although potentially material, in many cases, the effect of this change should be limited as under the German domestic participation exemption dividends are generally 95 percent tax exempt.

Main purpose test
The revised treaty introduces specific anti-treaty shopping rules under which no withholding tax relief will be available if the main reason for creating or assigning shares or other rights was to take advantage of the reduced treaty rate. Whilst the effect of this from a German tax perspective remains to be determined, as German domestic law already provides for anti-treaty shopping rules, the UK generally includes according provisions in its tax treaties. From a UK tax perspective, particularly, the revised treaty provides an increased ability to attack abusive structures.

Profit Repatriation

The previous provisions regarding payments of dividends, interest and royalties have been revised in their entirety, which may impact profit repatriation structures.

Dividends
The definition of dividends no longer includes all profit-carrying rights. In particular, certain payments by silent partnerships have been excluded from the definition of dividends (see further below). The definition now includes payments by a German investment fund, so investors in such a fund can benefit from the reduced treaty rates (although dividend distributions from UK companies do not currently attract a withholding tax under UK domestic law). Additionally, distributions from German and UK REITs generally qualify as dividends.
Under the revised treaty the following withholding tax rates apply to dividend payments:

	Revised Treaty Tax Rate	**Old Law**
Participation exemption, *i.e.* participation ≥ 10% of share capital	5%	15%
Free float, *i.e.* participation < 10% of the share capital	15%	15%

The reduced treaty rates are unlikely to be material given the EC Parent/Subsidiary-Directive and UK domestic law regarding withholding taxes on dividend payments. However, where the requirements of the Directive are not satisfied, *e.g.* because the minimum holding period is not met, taxpayers may benefit from the reduced rates — this may benefit certain pension schemes.

Interest and royalties

The taxation of interest and royalties remains unchanged, *i.e.* such payments are generally exempted from taxation in the source state, however new exceptions are introduced. Interest derived from hybrid instruments in the form of claims carrying a right to participate in profits (including income derived by silent partners (*stille Gesellschafter*)), from loans with an interest rate linked to the borrower's profits (*partiarisches Darlehen*) or from profit-sharing bonds (*Gewinnobligationen*) shall be taxed in the state in which they arise and in accordance with local law. The relevance of these exclusions from a UK tax perspective may be limited, depending on the nature of the payment as classified for UK taxation purposes. However, from a German tax perspective the use of hybrid instruments may cease to be a viable option for tax-efficient repatriation of profits from Germany to the UK (Germany levies 25 percent (plus solidarity surcharge) withholding tax on such payments).

Capital Gains

The revised treaty generally follows the OECD model treaty with respect to treatment of capital gains. However, it is worth noting that the revised treaty allocates the right to tax capital gains on the disposal of shares to the state in which the relevant corporation is located if the corporation derives more than 50 per cent of its value directly or indirectly from immovable property situated in that state (unless there is substantial and regular trading of the relevant shares on a stock exchange). Accordingly, foreign shareholders may under certain circumstances no longer be able to effect tax exempt disposals of their shares.

Procedural Aspects

The revised treaty also includes certain procedural rules relating to information exchange among other things. Relief from withholding tax is granted by way of reimbursement rather than by way of reduction of deduction. Effectively, this incorporates the German domestic reimbursement procedure into the revised treaty, avoiding a potentially illegal treaty override. The revised treaty facilitates the reimbursement procedure by extending the clauses of person entitled to a refund, a refund claim may now be submitted by trustees or managers of investment schemes or the managing partner of a partnership established in a contracting state. This is particularly noteworthy as partnerships are generally not eligible for treaty benefits; consequently this change may be a key factor when establishing foreign partnership structures involving a number of separate investors.

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