C L I F F O R D

C H A N C E

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Taxation of portfolio dividends

By the end of last week, the Upper and Lower House of the German Parliament (the *Bundesrat* and *Bundestag*) passed a new law abolishing the tax benefit on dividends where the shareholding is less than 10% (portfolio dividends (*Streubesitzdividenden*)).

The new law is designed to remedy Germany's tax treatment of portfolio dividends which contravenes EU law. In its ruling of 20 October 2011 (C-284/09), the European Court of Justice (ECJ) held that Germany violates the principle of free movement of capital within the EU (*EU-Kapitalverkehrsfreiheit*) by levying non-refundable withholding tax (*Abgeltungswirkung*) on dividends paid to corporate shareholders domiciled in the EU/EEA. The German withholding tax regime is discriminative in that German resident corporate shareholders receive a tax credit or tax rebate in the amount of such withholding tax whereas non-German residents do not.

Key issues

- No participation exemption for portfolio dividends (shareholdings of less than 10%) after 28 February 2013
- Cascading effect may result in 100% taxation of operating profits
- Income from hybrid instruments in most cases fully taxable
- Dividends received by public funds shall always be subject to taxation at investor level irrespective of the holding percentage
- There shall be special rules for special funds

Background

Withholding tax on portfolio dividends

When German corporations distribute dividends, they are subject to a statutory withholding tax rate of 26.375% (including solidarity surcharge). With respect to portfolio dividends (shareholdings of less than 10%), only German resident corporate shareholders receive a tax credit or tax rebate in the amount of such withholding tax whereas for non-German residents such withholding tax is final and non-recoverable.

ECJ ruling

The European Commission brought legal action against Germany for what it perceived to be a violation of the principle of free movement of capital within the EU. The ECJ upheld the view of the European Commission (case C-284/09) and, as a consequence, non-German resident corporate shareholders can also now apply for a withholding tax refund (see our Newsletter of December 2011).

Legislation process

During the legislative process for the draft Annual Tax Act 2013 (*Jahressteuergesetz 2013*), the *Bundesrat* already tabled a legislative proposal to impose a final tax on portfolio dividends either earned by German or foreign shareholders. It sought to abolish the participation exemption for portfolio dividends.

In contrast to the *Bundesrat*, the German government instead proposed the introduction of a full exemption on portfolio dividends received by non-German residents in order to comply with the EU free movement of capital and tabled a separate draft bill at the end of

October 2012 ("Act for the implementation of the ECJ decision dated 20 October 2011 re C-284/09") pursuant to which also non-German residents could apply for a tax refund of withholding tax on portfolio dividends.

On 26 February 2013, the Mediation Committee (*Vermittlungsausschuss*) of the *Bundesrat* and *Bundestag* essentially agreed to adopt the *Bundesrat's* original proposal to abolish the tax-exemption on portfolio dividends. The *Bundestag* and the *Bundesrat* gave their approval on 28 February 2013 and 1 March 2013 respectively, and the draft law is now expected to be enacted into law shortly.

The New Rules

Denial of the participation exemption for portfolio dividends

The German participation exemption (section 8b Corporate Income Tax Act, *Körperschaftsteuergesetz*, KStG), shall no longer apply to dividends where the shareholding is less than 10% at the beginning of the respective calendar year.

This new rule shall apply to all dividends received after 28 February 2013.

If a 10% shareholding is acquired during the calendar year, the acquisition is deemed to have taken place at the beginning of the calendar year. In this respect, it is not clear what happens if, for example, there is a 5% shareholding at the beginning of the calendar year and another 5% stake is acquired in the course of the calendar year. The official reasoning refers to an add-on acquisition (*Hinzuerwerb*), which might be seen as supporting the view that in the above example, the participation exemption should not be denied, as one might consider there to be a deemed participation of 10% as of the start of the calendar year. On the other hand, the official reasoning also refers to an add-on acquisition of a stake of at least 10%, which could be interpreted as meaning that the rule about the deemed acquisition shall only apply if stakes of at least 10% are acquired during the calendar year.

The 10% threshold cannot be circumvented by borrowing shares since borrowed shares are by statutory rule to be recognised at lender's level for calculating the threshold. In this respect, it is not clear whether this applies also to genuine repo transactions in terms of section 340b para 2 German Commercial Code (*Handelsgesetzbuch*, HGB) as there is - contrary to the wording in section 8b para 10 KStG - no explicit reference to this provision. If under a repo transaction the purchaser is entitled but not obliged to return the transferred shares, then these shares should count towards the threshold.

Where shares are held in a partnership, they shall be taken into account at the respective partners' level. The law does not provide for allocation criteria. A previous draft referred to the general profit allocation rule, but such reference has been deleted.

Shareholdings held by various group companies are not added, as the threshold test applies on a company-by-company basis, even if the group companies are fiscally integrated (*Organschaft*), except where the group companies qualify as credit institutions as defined in section 1 para 1 sentence 1 German Banking Act (*Kreditwesengesetz*) and the group qualifies as an associated group in the banking industry in terms of section 1 para 10 no 13 of the German Payment Service Supervision Act (*Zahlungsdiensteaufsichtsgesetz*) (e.g. cooperative banking associations), but only with respect to shareholdings within such group.

Cascading effect

Prior to the introduction of the participation exemption, a shareholder received a tax credit for taxes paid by the distributing entity. The new rules do not provide for such tax credit regime.

Therefore, this could potentially result in an adverse "cascading effect" of taxation on 100% of operating profits. For example, an investor holds 5% of company A, company A holds 5% of company B, which means that the investors holds an indirect stake in company B of 0.25%. Assuming that company B makes a profit of 40.000, this means a pre-tax pro-rata profit for the investor of 100. Such profit will be taxed at the level of company B at a rate of approx. 30% leaving 70 to be distributed to company A. At the level of company A, the profit will be taxed again at a rate of approx. 30% leaving 49 to be distributed to the investor. At investor level, the profit will be taxed again at a rate of 30% (assuming the investor is a corporation) leaving an after-tax profit of approx. 34.3, which results in an effective tax rate of approx. 65.7%. If there are more than just the two levels in our example, the effective tax rate will be even higher until the profit is fully cancelled out due to tax.

Hybrid instruments

Although the official reasoning refers only to dividends, the new rules should also apply to distributions on hybrid instruments such as equity-like jouissance rights (*eigenkapitalähnliche Genussrechte*). As these instruments classify as equity, the respective issuer is not entitled to deduct any remuneration paid thereunder. Even so, such distributions will be fully taxable in the hands of the investor unless the investor held (in addition) at least 10% of the shares in the distributing company at the beginning of the respective calendar year.

Otherwise, there would still be a restriction on the EU free movement of capital because German resident corporate investors would receive a credit or refund for the withholding tax levied on such payments whereas non-German investors would not.

Non-German investors nonetheless still face discrimination where a hybrid instrument investor is also invested in at least 10% of the equity as German investors should, in such a case, benefit from the participation exemption and, thus, should receive a tax credit or refund for withholding tax whereas non-German investors would instead incur a final withholding tax.

Capital gains

Capital gains realised upon the sale of shares still stand to benefit from the participation exemption even if the shareholding is less than 10%. Thus, selling shares before the dividend distribution date ("cum"), generates tax-exempt income, unless the seller is a bank or financial enterprise and the sold shares qualify as a trading position or as a current asset (*Umlaufvermögen*).

Capital losses

Capital losses on portfolio shareholdings are not tax-deductible, since capital gains are still tax-exempt.

If following the distribution of a jumbo dividend a write-down of the shareholding is required, this would have the detrimental effect that the dividend is fully taxable whilst the write-down is tax-wise not recognised.

Deductibility of expenses

As there is no specific rule applicable to expenses incurred in conjunction with portfolio dividends, expenses incurred in conjunction with portfolio dividends should be fully tax-deductible and there should be no ring-fencing. Section 8b para 5 KStG (5% leakage) should not apply.

Public funds

Funds (irrespective of whether public or special fund) have hitherto calculated and published the so-called equity gain (*Aktiengewinn*) taking into account dividend income earned by the funds. German resident corporate investors could benefit from the participation exemption on such equity gain.

Pursuant to the new law, investors in public funds (*Publikumsfonds*) no longer stand to benefit from the participation exemption with respect to dividend income earned by a public fund. That holds true even if the fund holds a shareholding of more than 10%. The official reasoning cites the fact that public funds typically hold only portfolio participations and that the stake allocable to the investors is typically less than 10%.

The new rules will take effect as of 1 March 2013.

Pursuant to the new rules, public funds are required to adjust their fund reporting since the equity gain now needs to be calculated differently for corporate investors and individual investors holding the fund units as business assets. In addition, there shall be a new reporting item for dividends received prior to 1 March 2013, but distributed or deemed to have been distributed after 28 February 2013 since such dividends may still benefit from the participation exemption; this applies only once for the transitional period. Complying with the new reporting requirements at such short notice poses a considerable challenge for the fund industry.

Special funds

Special funds (*Spezialfonds*) will be subject to special rules.

Investors in a special fund may benefit from the participation exemption with respect to dividend income received by the fund provided that the fund's stake is at least 10% **and** the percentage of the shareholding allocable to the respective investor is also at least 10% (double testing). For the fund's threshold, the participation at the time the dividend is received is decisive. For the investor's threshold, the year end of the fund is decisive.

Where fund units are held in a partnership, they shall be taken into account at the respective partners' level and shall be aggregated with fund units held directly by the investor. Here, the allocation based on the general profit allocation ratio has been maintained.

However, an aggregation of shares held via different special funds (sub-funds qualify as different funds) and/or held directly will not be possible.

If the investors holds directly at least 10% of the shares in a corporation, the investor can prove that to the respective special fund holding also shares in such corporation and, in such a case, the participation exemption shall be available to the investor also for dividend income received via the fund irrespective of any thresholds at fund level.

Securities lending

The existing section 8b para 10 KStG dealing with securities lending will be extended to cover the new rules for portfolio dividends in order to prevent transactions where portfolio shares are lent to shareholders holding at least 10% who could receive the dividend tax-exempt.

Next steps

Since the *Bundestag* and the *Bundesrat* have already given their consent, the new law has now been passed. One final step before the law can enter into force is that it needs to be signed into law by the Federal President (*Bundespräsident*) and promulgated in the Federal Tax Gazette (*Bundessteuerblatt*) which is expected to occur soon.

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