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NEW AGREEMENT BETWEEN GERMANY AND TAIWAN FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION - A BRIEF OVERVIEW

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On January 11, 2012, the German Federal Ministry of Finance – Bundesministerium der Finanzen (FMF) released a press statement explaining that an Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and on Capital has been signed between the German Institute of Taipei and the Taipei Representative Office in the Federal Republic of Germany.[1] The negotiations process for this agreement required almost ten years for completion, with initial discussions undertaken during the course of the year 2002.

Although the aim of the agreement is to promote and enhance the economic and trade cooperation between Germany and Taiwan, it must be pointed out that this document cannot be formally treated as an international tax convention per se since Germany has not officially recognized Taiwan as a sovereign state. The agreement, however, is in line with what other countries have done to overcome potential double taxation issues arising from cross-border investments flowing from Germany into Taiwan and vice versa. In other words, and as a matter of fact, it cannot be denied that this agreement will play a de facto role of a double taxation convention.

Moreover, it must also be laid down that in an increasingly globalized economy, double-taxation conventions are of utmost importance within the context of cross-border investments, preventing first and foremost the double-taxation of revenues. A double tax burden on revenues is potentially an important harm, which cannot always be totally solved through the unilateral relief granted by one country or the other. Consequently, entrepreneurs and investors from both Germany and Taiwan will soon be able to rely on this agreement for the avoidance of double taxation to best mitigate double taxation issues arising from both territories. Thus, it is no surprise that this agreement is strongly influenced and inspired by the OECD[2] Model Tax Convention.

While German and English versions of this agreement are readily available, a Chinese translation will follow at a later stage. Finally, the agreement's entry into force is subject to further confirmation by the German Institute of Taipei and the Taipei Representative Office in the Federal Republic of Germany. Despite the fact that the agreement is still not

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[1] Federal Ministry of Finance, retrived 6 February 2012, <http://www.bundesfinanzministerium.de/nn_146632/DE/BMF__Startseite/Aktuelles/BMF__Schreiben/Internationales__Steuerrecht/Staatenbezogene__Informationen/Taiwan/001.html>.

[2] Organisation for Economic Co-operation and Development

in force, it is however interesting examining some of its salient features, including notably the cross-border treatment of dividends, interests, royalties and finally the content of the exchange of information clause.

Dividends

Dividend taxation might differ drastically depending whether it is examined in a resident context or a cross-border situation. This is notably the case in both Taiwan and Germany. While no withholding tax is imposed on dividends paid by a Taiwan company to a resident shareholder, it is not the case for outbound dividends. Taiwan withholds 20 percent on dividends paid to a non-resident, unless the withholding tax is reduced by a treaty or a bilateral instrument substantially similar to the agreement contemplated in this case. Article 10 of this agreement provides that the withholding rate, applicable on dividends paid by a company resident in Taiwan to a German shareholder resident, shall be reduced to 10 percent (instead of the 20 percent Taiwanese rate). In other words, the withholding rate is reduced by half for German residents holding shares in Taiwanese companies.

Under German domestic law, all dividends are subject to a 25-percent withholding tax plus a solidarity surcharge of 5.5 percent of the tax due, as a flat tax, which results in a 26.375-percent effective rate. A refund of 40 percent is possible for non-resident companies, leading therefore to an effective withholding rate of 15.825 percent, unless this rate is reduced by a tax treaty. In the present case, the agreement reduces the rate to 10 percent provided that the beneficial owner is a resident of the other territory, namely Taiwan in this case. Further reductions are available to EU shareholders satisfying the conditions of the EU Parent/Subsidiary directive[3]. In that case, the withholding rate equals zero. Interestingly, the European Court of Justice (ECJ) held recently in its decision of October 20, 2011, (C-284/09) that the disparities resulting from the German dividend withholding tax regime, imposing in different ways on German and non-German shareholders, infringes on the free movement of capital (Article 63 TFEU[4]).

It is necessary to further examine the German dividend withholding regime and shed some light on the potential disparities which might result from the application of this regime. Indeed, according to the ECJ, the German withholding system distinguishes arbitrarily

[3] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[4] Treaty on the Functioning of the European Union (TFEU).

arbitrarily between German and non-German shareholders. First, it must be specified that dividends paid by German corporations to German corporate shareholders are generally subject to an effective corporate income tax rate of approximately 0.8 percent, plus any trade tax which may apply. While such dividends are subject to German withholding tax and a solidarity surcharge at a combined rate of 26.375 percent, all tax withheld will be credited against corporate income tax (including the solidarity surcharge) and any excess will be refunded. Conversely, non-German corporate shareholders, however, are generally not entitled to such a tax credit or refund in Germany.

An exception results from the application of the EU Parent-Subsidiary-Directive. Under this directive EU corporate shareholders holding at least 10-percent interest in German companies are not subject to German withholding tax, if the criteria required by the EU Parent-Subsidiary-Directive are fulfilled. More importantly, all other non-German corporate shareholders are subject to German withholding tax and the solidarity surcharge, with an effective tax burden reaching 15.825 percent, as initially explained above. In other words, non-German investors, ineligible to claim the benefits of the EU Parent-Subsidiary-Directive, were treated less favorably compared to those qualifying under the said directive. Although Germany tried to present arguments supporting its reasoning and explaining why such distinctions were necessary, the ECJ simply rejected them by arguing that the German dividend taxation regime infringes the free movement of capital. This decision has potentially far-reaching consequences, allowing under certain circumstances non-German shareholders to claim substantially increased refunds on German withholding tax.

Moreover, it seems that the ruling of the ECJ should also apply to dividends distributed in past-periods. On top of that, it must also be stressed that this case is of utmost importance to shareholders residing outside the European Union, since they may equally benefit from this decision. Indeed, the free movement of capital applies equally to EU and non-EU residents. However, the benefits of this decision are not necessarily systemically applicable, since certain preconditions must be satisfied first. In a different case (C-540/07) the ECJ held that disparate treatments might be justified where the residence country of the non-German shareholder does not cooperate within the frame of the exchange of relevant tax information.

Before turning to the taxation interest in Germany and Taiwan, it must also be put forward that Article 10 of this agreement embeds a most favored nation clause, specifying that if either of the territories enter into a double convention agreement with a member of the OECD and such agreement provides for a more favorable taxation of dividends to either Taiwan or Germany, such benefits shall apply equally under the current agreement.

Interest

Taiwanese interest withholding taxation varies upon three different factors, namely whether interest is paid on a resident or non-resident person and the source of revenue generating such interest. In the first case, interest is paid domestically to a Taiwanese resident. Under such circumstances, Taiwan levies a 10-percent withholding tax on interest paid. The second case refers to cross-border interest paid to non-residents on short-term bills, interest on securitized certificates, interest on corporate bonds, government bonds or financial debentures, as well as interest derived from repurchase transactions with the above bonds or certificates. In that case, the withholding rate equals 15 percent, except if a double-taxation agreement provides otherwise. In all other cases the rate reaches 20 percent, unless an agreement mitigates the burden imposed by the Taiwanese withholding regime on interest.

Conversely the situation is quite different in Germany, since there is no withholding tax on interest paid, except for publicly traded debt, interest received through a German payment agent (usually a bank), convertible bonds and certain profit participating loans where a German resident company is the debtor. In these cases, a withholding tax is levied at a rate of 25 percent (with an effective rate of 26.375 percent, since it is subject to the 5.5 percent of the solidarity surcharge). However, this is actually not the final rate, since the withholding tax rate levied by Germany under very specific conditions may be reduced either by a tax treaty or if the requirements of the EC Interest and Royalties Directive[5] are met. The current agreement mitigates the tax burden generated in Taiwan mainly by reducing the applicable rate to 10 percent instead of the normal domestic levies.

[5] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

Royalties

Royalty payments made by a Taiwanese entity to a resident are subject to a withholding retention of 10 percent. Non-residents face a 20 percent withholding tax perceived by Taiwan on royalties paid abroad, unless the rate is reduced under an applicable tax agreement, which is the case under the current one. Similarly, Germany distinguishes between royalties paid to residents and non-resident corporations, those qualifying under the EC Interest and Royalties Directive or royalties paid to non-resident individuals. *Prima facie*, Germany retains a withholding tax on royalties paid to non-resident corporations at a level of 15 percent. Since the solidarity surcharge, amounting to 5.5 percent of the tax amount due, is equally applied to royalties, the final and effective withholding tax equals 15.825 percent on royalties paid to non-resident corporations. However, this rate might be mitigated, provided that the corporation being the recipient of the royalties qualifies as a beneficiary of the EC Interest and Royalties Directive, or the rate is lowered by a tax agreement.

Finally, it is important to mention that non-resident individuals face a higher withholding rate, amounting to 30 percent. In fact the withholding levy reaches effectively 31.65 percent, once the solidarity surcharge is applied to it. Fortunately, the Agreement between Taiwan and Germany provides for a consequent relief. Indeed, if it can be demonstrated that the beneficial owner of the royalties paid by a Taiwanese company is a German resident or *vice versa*, then the Agreement mitigates the withholding tax to a maximum of 10 percent of the gross amount of the royalties. In other words, the Agreement entered into both Germany and Taiwan gives a non-negligible relief by comparison to the situation which was existing before the adoption of this tax Agreement.

Exchange of Information

The general movement of worldwide economic globalization has set a new trend throughout the last couple of decades inducing an ever-growing flow of money between countries. In order to facilitate the collection of taxes and support fiscal transparency, the OECD Model Convention has taken a stand to promote new standards for the exchange of fiscal information. The agreement between Germany and Taiwan embodies this new trend by implementing in its agreement the Article 25, which is by all means directly influenced by the recent work of the OECD.

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