How to address German Construction Withholding Tax effectively

Introduction
In general, when construction works are performed in Germany, the recipient must withhold 15% of the gross amount of the consideration for tax purposes – unless an exemption certificate has been presented beforehand.

This construction withholding tax regime has operated in Germany since the beginning of 2002, and has become an integral part of German construction contracts.

This briefing provides more detail on the tax regime and answers some frequently asked questions, which may be of particular interest to foreign companies offering services in the German market and other new market entrants who may not be familiar with German tax law.

Legal Concept
The purpose of the withholding tax regime is to ensure proper taxation of all construction works in Germany. Whilst this could be easily achieved for German resident companies, it is more complicated for foreign companies who are not tax resident or registered in Germany. Therefore, to ensure proper taxation, the withholding obligation rests with the recipient of the works (the “Employer”), and forces the company or businessmen offering the works (the “Contractor”) to comply with the requirements of the German taxation system – either by applying for an exemption certificate or for a refund of the withholding amount.

Unless an exemption certificate has been presented beforehand, the Employer must withhold 15% from each payment to the Contractor and forward the withheld amount to the competent tax authority. The withholding obligation applies to all construction works, regardless of whether the Contractor is tax liable in Germany – for example, works which complete within the time limit for construction works of an applicable double taxation treaty are not excluded from the withholding tax.
Further, if the Employer does not withhold the tax from payments to the Contractor, they themselves become liable for the withholding amount.

On the other hand, if the Contractor presents an exemption certificate valid for the period of the actual payment (including any pre-payments, set-offs or installments) prior to the Employer paying them, the Employer is not liable for withholding tax and need not withhold any percentage of payment. However, the Employer must verify the validity of the exemption certificate before they decide whether or not to apply the withholding tax. In cases where the exemption was fraudulently obtained and the Employer knew about it (or was grossly negligent in not knowing) the Employer remains liable for the withholding tax amount. The Federal Central Tax Office (Bundeszentralamt für Steuern) offers an online check for exemption certificates on its website.

The exemption certificate rule can be seen as an incentive to encourage tax registration of foreign Contractors in Germany. In practice, contracts typically include an obligation on the part of the Contractor to provide the Employer with an exemption certificate prior to the payment of any installment. If the certificate is not presented in time the Employer is required to withhold 15% of the gross consideration.

Construction Work
The law very broadly defines construction works as “any services that serve the construction, restoration, maintenance, modification or destruction of artificial structures (Bauwerke)”. The legislator notes refer to the term “construction business” as used in the definition of section 211 of the Social Security Code (Sozialgesetzbuch III) and the Construction Company Regulation (Baubetriebe-Verordnung). However, there is no legal definition of “structures”. Tax authorities take a broad view which is not only limited to buildings, but also includes any physical asset produced by making use of construction tools which is fixed to the ground or which rests on the ground by its own weight. Withholding tax applies to all contracts which fall under this broad definition, regardless of whether the contract is technically a service contract rather than a construction or installation contract.

For example, according to the regional tax authorities’ decrees, construction works include the installation of wind turbines and photovoltaic panels as these are secured to the ground. However, shipbuilding does not qualify as construction works as they are not.

In instances where a contract combines various different services with construction works the main purpose of the contract shall be used to decide whether withholding tax applies. As such, an operation & maintenance contract which includes working on or replacing components on the asset could qualify as construction work.

A lead contractor which is subcontracting construction works is subject to the withholding tax regime as Contractor and is also responsible for withholding taxes as the Employer of its subcontractors. The Employer of the lead contractor is only responsible for the withholding of the consideration in relation to the lead contractor and is not responsible for subcontractors as it does not make payments to them directly.
**Employer and Contractor**

The withholding tax regime is applicable to all entrepreneurs (as defined in the Value Added Tax Act) and to any corporate body organised under public law which receives construction works. As such, those entities performing commercial or professional services independently are affected by the regime. This is the case for all construction works performed in Germany, regardless of whether the Employer is resident in Germany. Exemptions from the withholding obligation are granted for Employers who are landlords offering two flats or fewer, or those receiving construction works which are worth less than a pre-defined minimal annual consideration (currently €5,000 or €15,000).

Similarly, it does not matter whether the Contractor is resident in Germany, or whether the construction business forms the main purpose of the Contractor’s business, the withholding tax regime still applies. Additionally, a consortium of contractors could be employed, but then the consortium becomes a Contractor and its partners become Employers, meaning the consortium must withhold 15% of any consideration it pays.

**Exemption Certificate**

The simplest way to exclude any risk relating to construction withholding tax as a Contractor is to apply for an exemption certificate and attach it to any contract which includes elements of construction work. Additionally, employers should always ask their counterpart to present such certificate in case any construction work is included in a contract.

Exemption certificates are issued by the competent tax authorities upon individual application by the Contractor. For foreign Contractors, the relevant tax authorities are defined by their country of residence.

An exemption certificate shall be issued where the potential taxes to be paid by the Contractor appear not to be at risk and where a domestic receiving agent has been nominated. Contractors resident within the European Union do not require a receiving agent. Typically, the process of issuing a certificate takes approximately seven days. However, an application could be denied in cases where the Contractor has not complied with its notification or disclosure obligations in the past, or where a foreign Contractor does not forward a tax residence certificate obtained from its domestic tax authority.

The exemption certificate issued can either be limited to a particular project, or by a certain period of time. Usually the tax authorities issue a certificate valid for a three year term. The certificate itself will include the term of validity, the tax registration number, a security code needed for the online verification and the tax authority’s seal.

If the exemption certificate is not limited to a certain project, providing a copy of the certificate to an Employer shall be sufficient to demonstrate exemption from the regime. However, the exemption, or the copy, must be kept by the Employer for at least six years.
**VAT Implications**

An exemption certificate for construction withholding tax can also be used by the Contractor to certify its status as construction entrepreneur for value added tax purposes. According to the federal tax authorities, a certificate which covers the time in which a certain supply or service was delivered is sufficient proof for the supplier that the recipient of the service or supply is a construction company. As a result, the service or supply becomes subject to the reverse charge mechanism.

**Conclusion**

An exemption certificate is key to mitigate the German construction withholding tax. It can be easily received by individual application with the appropriate tax authority. As Employers typically want to avoid acting as the withholding agent of the German tax authorities and do not readily accept becoming liable for the Contractor’s taxes, such certificate is commonplace in the documentation relating to construction contracts in Germany.

**Contacts**

Should you wish to discuss any of the matters raised in this briefing, please speak with a member of our team below, or your regular contact at Watson, Farley & Williams.

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