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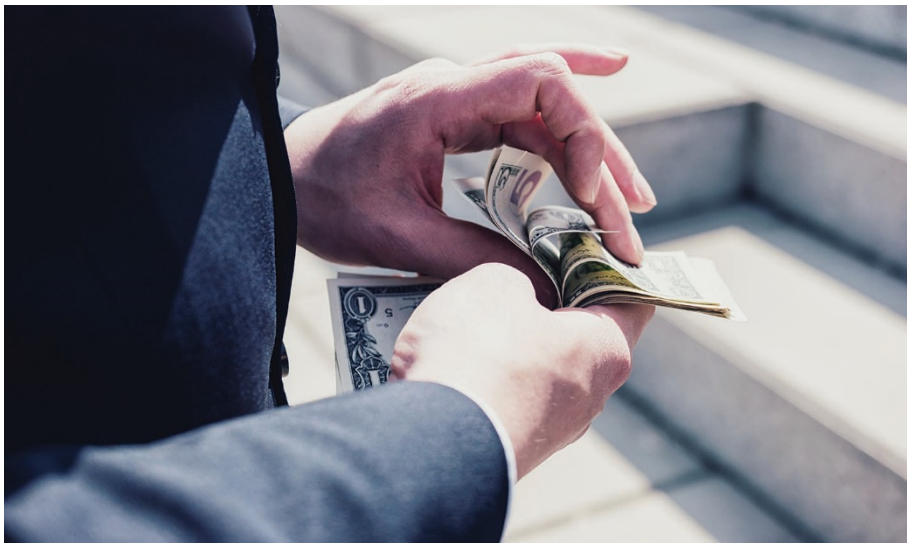
BRIEFING

GERMAN ANTI-TREATY/DIRECTIVE SHOPPING RULE BREACHES EU LAW

JULY 2018

- LOWER SUBSTANCE REQUIREMENTS FOR EU INVESTORS INTO GERMANY TO BENEFIT FROM A WITHHOLDING TAX REDUCTION/EXEMPTION
- EU INVESTORS MAY BE ABLE TO REQUEST A REFUND OF GERMAN WITHHOLDING TAX



The European Court of Justice ("ECJ") has ruled that the German Domestic Anti-Treaty/Directive-Shopping Rule regarding German withholding tax is in breach of EU law.

"UNDER THE CURRENT GERMAN ANTI-TREATY/DIRECTIVE-SHOPPING RULE, A FOREIGN COMPANY CANNOT CLAIM A REFUND ON GERMAN WITHHOLDING TAX OR APPLY FOR AN EXEMPTION CERTIFICATE TO THE EXTENT IT DOES NOT MEET CERTAIN CRITERIA."

German Anti-Treaty/Directive-Shopping Rule

There are two methods of obtaining a reduction in, or an exemption from, German withholding tax on certain cross-border income items (e.g. dividend distributions or royalties); using German domestic law (which takes into account EU directives) or relying on the relevant double tax treaty. The party claiming the reduction or exemption must make a request to the German tax authorities who then decide whether to approve it. If the request is approved, the reduction or exemption is made either by way of a refund or the issuance of an "exemption certificate". However, the German Anti-Treaty/Directive-Shopping Rule (sec. 50d par. 3 German Income Tax Act) may impose restrictions on any such reduction or exemption.

Under the current German Anti-Treaty/Directive-Shopping Rule (sec. 50d par. 3 German Income Tax Act 2012) (the "2012 Rule"), a foreign company cannot claim a refund on German withholding tax or apply for an exemption certificate to the extent that:

(i) the foreign company has shareholders who would not be entitled to the refund or exemption if they earned the relevant income directly;

(ii) the foreign company does not generate gross income from its own business activities; and

(iii) (a) there were no economic or other valid reasons for the involvement of the foreign company regarding such income; or

(b) the foreign company does not participate in general commerce by means of an appropriate business organisation.

Certain characteristics of a group (e.g. organisational and economic) shall not be regarded for the classification of the aforementioned preconditions in relation to the foreign company.

Under the old rule, which applied from 2007 to 2012 (the "2007 Rule"), a foreign company could not claim a refund on German withholding tax or apply for an exemption certificate to the extent that:

(i) it had shareholders who were not entitled to the refund or exemption if they earned the relevant income directly; and

(ii) (a) there were no economic or other valid reasons for the involvement of the foreign company regarding such income;

(b) the foreign company did not derive more than 10% of its overall gross earnings for the respective fiscal year from its own business activities; or

(c) the foreign company did not participate in general commerce by means of an appropriate business organisation.

In other words, a refund/exemption would not have been excluded under the 2007 Rule to the extent that the shareholders of the foreign company were entitled to a refund/exemption if they earned the relevant income directly, or all of conditions (ii) (a)-(c) were met. Any organisational, economic or similar characteristics of a group shall not be regarded for the classification of the aforementioned preconditions in relation to the foreign company.

Please note that, in general, the German Anti-Treaty/Directive-Shopping Rule is not applicable to foreign companies with publicly listed ordinary shares regularly traded at an accepted stock market or foreign investment funds subject to the German Investment Tax Act.

"IN A RECENT ECJ DECISION (C-440/17) DATED 14 JUNE 2018, THE 2012 RULE WAS ALSO FOUND TO BE A BREACH OF EU LAW."

ECJ Decisions

In two ECJ decisions (C-504/16 and C-613/16), both dated 20 December 2017, it was held that the 2007 Rule (sec. 50d par. 3 German Income Tax Act 2007) was in breach of EU Law. In a recent ECJ decision (C-440/17) dated 14 June 2018, the 2012 Rule was also found to be a breach of EU Law. According to the ECJ, this rule violates the EU-Parent-Subsidiary Directive as well as the right to freedom of establishment stipulated in European Law.

The EU-Parent-Subsidiary Directive considers an exception from the general exemption from withholding tax on dividend distributions within the EU to avoid tax

evasion and tax abuse. The ECJ stated that this exception is met by a domestic rule implementing the EU-Parent-Subsidiary Directive of an EU State if the rule is limited to wholly artificial arrangements, which do not reflect economic reality, and with the purpose of which is to obtain an undue tax advantage. A general rule which excludes certain shareholders from tax benefits automatically without any individual investigations by the tax authorities goes beyond the exception considered in the EU-Parent-Subsidiary Directive. In the case of the 2007 Rule and the 2012 Rule, the ECJ came to the conclusion that such criteria are not met.

"FURTHERMORE, ACCORDING TO THE ECJ AND THE RESPECTIVE CASES WITH MAJORITY SHAREHOLDERS, THE FREEDOM OF ESTABLISHMENT IN EUROPEAN LAW IS VIOLATED SINCE THE GERMAN ANTI-TREATY/DIRECTIVE-SHOPPING RULE IS ONLY APPLICABLE TO NON-RESIDENTS AND NOT TO RESIDENT SHAREHOLDERS."

Furthermore, according to the ECJ and the respective cases with majority shareholders, the freedom of establishment in European Law is violated since the German Anti-Treaty/Directive-Shopping Rule is only applicable to non-residents and not to resident shareholders. In respect of resident shareholders, the criteria to gain tax benefits in relation to German withholding tax are not as strict as for non-residents.

Reaction of the German Tax Authorities

The German Federal Ministry of Finance published guidelines on 4 April 2018 accepting the first two decisions of the ECJ and also considering the (prospective) outcome of the latest court decision published in June 2018. According to these guidelines, the German Anti-Treaty/Directive-Shopping Rule has been abolished for dividend distributions under the EU-Parent-Subsidiary Directive for the years 2007-2011. The 2012 Rule shall generally still apply but the strict criteria for dividend distributions shall be relaxed to meet the provisions of the EU-Parent-Subsidiary Directive as stated by the ECJ.

This means that (i) any organisational, economic or similar characteristics of a group shall, despite the wording of the rule, be regarded for the classification of the preconditions in relation to the foreign EU company of this rule; (ii) income from mere asset management activities are no longer detrimental *per se* in terms of tax benefits; and (iii) only structures in which the foreign company was involved solely to obtain a tax benefit shall be caught by the 2012 Rule. Therefore, the foreign company needs adequate business substance to engage in its trade or business and it must participate in general commerce.

However, the German Anti-Treaty/Directive-Shopping Rule remains unaffected in other cases, e.g. taxation limitations for dividends under a tax treaty or for royalties.

Actions

It is advisable to keep up to date on this case law dealing with the possibility of applying for a refund of, or exemption from, German withholding tax. If such a claim were rejected, it might be sensible to challenge said decision. Where any refunds or exemption certificates have not yet been claimed, such claims should be reviewed in light of the amended legislation. In both cases procedural law should also be considered.

It should be noted that the court decisions referred to above and the guidance of the German Ministry of Finance consider only dividend distributions to shareholders resident in the EU but do not consider non-EU-residents or royalty payments. It is hoped that further ECJ decisions or guidelines from the tax authorities may provide clarification in such cases. For now, it is worth considering taking action against a rejection by the tax authorities in such cases.

FOR MORE INFORMATION

Should you like 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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