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German Tax and Legal News

Revised anti-treaty shopping rules referred to CJEU

CJEU asked to rule on whether anti-treaty shopping rules are compatible with EU law

The Tax Court of Cologne (case ref. 2 K 773/16) has questioned whether the current version of Germany's anti-treaty shopping rules (section 50d (3) EStG that applies as from 2012) are compatible with EU law, and has requested a preliminary ruling from the Court of Justice of the European Union (CJEU). This is the third case in which the Tax Court of Cologne has referred the anti-treaty shopping rules to the CJEU; in 2016, the court referred cases involving the rules applicable during the period 2007 and 2011 (pending CJEU Cases C-504/16 and C-613/16).

Facts of the case

The taxpayer in the case before the Tax Court of Cologne was a holding company established in the Netherlands that held a 93% interest in a German entity that distributed profits. The shares in the Dutch entity were held by another German-resident company (similar to the facts of Case C-504/16). The taxpayer had its own staff of three, as well as business premises (about 50 m^2 of office space) that it used for its functions as a holding and finance company and for its central procurement activities. The taxpayer did not provide management services to its subsidiaries and only exercised its rights as a shareholder. The Federal Tax Office denied a refund of dividend withholding tax paid in Germany based on the anti-treaty shopping provision section 50d (3) EStG because it determined that the Dutch entity did not meet the strict requirements of this rule.

Background of anti-treaty shopping provisions

The anti-treaty shopping provisions, which also apply to withholding tax relief sought under the EU parent-subsidiary directive (PSD), provide that a nonresident company that receives a payment subject to German withholding tax will be entitled to withholding tax relief if the following requirements are met:

- The company is owned by shareholders that would be entitled to a corresponding benefit under an applicable tax treaty or an EU directive had they received the income directly ("shareholder test"); or
- The gross receipts generated by the nonresident company in the relevant year derive from the company's genuine own business activities ("business income test").

If the nonresident company fails both of these tests, it still will be entitled to withholding tax relief if it pass both of the following tests:

- Business purpose test: There are economic or other relevant (i.e. nontax) reasons for the interposition of the nonresident company with respect to the relevant income; and
- Substance test: The nonresident company has adequate business substance to engage in its trade or business and it participates in general commerce.

The only relevant facts and circumstances for these two tests are those at the level of the nonresident company. (For a detailed discussion of these tests, see Deloitte Tax-News).

Decision of the Court

Because the shareholder of the Dutch entity was resident in Germany, the Dutch entity failed the shareholder test. Its income from procurement activities was considered to be from its own business activities, but the other income from financing and holding activities was not considered business income, so the Dutch entity would have been entitled only to a very low pro-rata refund under the business income test. The entity also did not meet the business purpose and substance tests. It is important to note that the Tax Court did not have to apply the new Germany-Netherlands tax treaty (that applies as from 2016), which would require that, upon application of the German anti-treaty shopping provisions, associated enterprises in the Netherlands be treated on a consolidated basis. Under Germany's rules, the court then would have to reject the refund reclaim.

The Tax Court of Cologne is of the opinion that the domestic anti-treaty shopping provisions are not in line with the freedom of establishment provision in articles 49 and 54 of the Treaty on the Functioning of the European Union. Relief from German withholding tax on dividends paid to a nonresident company is dependent on very strict conditions, whereas a German company in similar circumstances would be granted a tax exemption without having to satisfy any conditions. In addition to the freedom of establishment issue, the court questions whether the anti-treaty shopping provision complies with article 5(1) in conjunction with article 1(2) of the PSD.

EU law aspects of the case

Because the Tax Court of Cologne considers that the German rules constitute a restriction of the freedom of establishment, the question is whether the restriction can be justified by the objective of preventing tax avoidance. While it is clear that the prevention of tax avoidance is a legitimate justification for restrictive measures, the court doubts that the German rules would pass the "proportionality" test. The CJEU held in the *Cadbury Schweppes* case that rules designed to prevent tax avoidance must not go beyond what is necessary to prevent "wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."

Despite recent initiatives to combat abusive tax schemes (e.g. the OECD BEPS project and the EU anti-tax avoidance directive), the tax court articulated several reasons why the German rules would violate the proportionality requirement. First, where German shareholders own the intermediary holding entity, there is no scope for abuse since any subsequent distribution to the German shareholders would be subject to German taxation. The court also cited the following:

- The cumulative requirements under the business purpose and substance tests, and the fact that there are no rules to allow the taxpayer to demonstrate that its activities were not abusive;
- The narrow interpretation of economic or other relevant nontax reasons, which explicitly do not take into account considerations related to the overall group set up;
- The pro-rata entitlement under the business income test, which has the effect of partially denying a reduction of withholding tax if the foreign entity earns non-active income completely unrelated to its German-sourced income; and
- The reversal of the burden of proof (the nonresident entity has to prove the business purpose whereas tax authorities do not have to prove the existence of avoidance).

For similar reasons, the court took the position that the German rules violate secondary EU law, i.e. articles 5(1) and 1(2) of the PSD.

Implications for taxpayers

Since the Tax Court of Cologne already referred the anti-treaty shopping rules that applied until 2012 to the CJEU, a decision in the new case would resolve the issue about the compatibility of the current provisions with EU law. These rules were introduced in response to infringement proceedings launched by the European Commission, so it is interesting to note that the Tax Court of Cologne explicitly stated that the pro-rata approach of the new rule if not in line with the proportionality requirement, given that this approach is a key element of the revised rule.

Nonresident taxpayers that suffered withholding tax on German dividends due to the application of the anti-treaty shopping provisions should monitor developments and keep relevant assessments open.

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