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By PwC Deutschland | 24. November 2017

German exclusion from withholding tax relief in conflict with EU law? UPDATE

The German anti- treaty shopping rule denying full or partial relief from withholding tax, as otherwise prescribed under a double tax treaty or applicable EU directive, is questioned by the Lower Tax Court of Cologne as being in violation of community law. The question has been referred to the ECJ in number of cases.

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The anti-treaty shopping rule: Section 50d sub-sec 3 of the German Income Tax Act denies the foreign company full or partial relief from withholding tax otherwise applicable under a double tax regime to the extent (i) its own shareholders would not have been entitled to refund or exemption, had they received the income directly, and (ii) the gross income of the foreign company did not stem from its own genuine business activity. A foreign company does not exercise its own business activity where, inter alia, its gross earnings emanate from asset management or from significant activities outsourced to third parties. These rules were challenged by the Lower Tax Court of Cologne as violating the freedom of establishment because of its former "all or nothing"-approach for the years up to and including 2011 (the relief was factually subject to a 10% active earnings threshold). With effect from 1 January 2012 this was amended and somewhat moderated and replaced by a pro rata approach. The EU Parent/Subsidiary Directive on the other hand, exempts qualifying dividend payments by a domestic company to another EU resident company, if certain holding requirements are fulfilled. A direct minimum holding of at least 10% (formerly 15%) and as a further condition the holding must exist for an uninterrupted period of at least 12 months. Two cases before the Lower Tax Court concern repealed law, i. e. from the year 2007.

A Dutch managing holding company held a 26.5% interest in a German subsidiary and claimed refund of the withholding tax deducted from dividends received from the latter. The sole shareholder of the Dutch company was a German private individual. The Dutch company had an office and staff but there were no business or other good reasons for its interpolation. In accordance with the legal requirements in Sec. 50d (3) ITA the Federal Central Tax Office refused the refund. The Lower Tax Court took the view that Sec. 50d sub-sec. 3 ITA infringes a company's freedom of establishment and has referred the case to the ECJ for further clarification

Holdings giving definite influence on another company's decisions and allowing to determine its activities are primarily governed by the provisions on freedom of establishment. The Lower Tax Court refers to an earlier ECJ judgment from May 10, 2007 (C-492/04, *Lasertec*) where such definite influence is given where the company has a substantial holding in the nominal capital of over 25%. Such a restriction of the freedom of establishment may only be justified in a case of abuse. But, as the court points out, the fact that the company was established in a Member State for the purpose of benefiting from more favourable tax legislation does not in itself suffice to constitute an abuse (ECJ judgment from September 12, 2006 (C-196/04, *Cadbury Schweppes*). In light of this the Lower Tax Court considers the requirements in Sec. 50d sub-sec. 3 ITA to be too strict and unjustified as such a restriction goes beyond its stated objective. Also, Sec. 50d sub-sec. 3 ITA denies exemption under certain scenarios although the requirements of the Parent/Subsidiary Directive are met.

On the same subject, but in the case of a Danish holding company, the Lower Tax Court of Cologne took the opportunity to make an additional referral to the ECJ (case *2 K 721/13*). Contrary to the previous referral the holding did not employ staff and did not have its own business premises. Nevertheless, the court believes that Sec. 50d sub-sec. 3 ITA does not sufficiently take into account the functions of the holding company within the whole group (i. e. organizational or economic aspects and all other relevant features

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and functions of the foreign related companies).

Note: The Lower Tax Court of Cologne continues to maintain its concerns also for years from 2012 under the amended rules of Sec. 50d sub-sec. 3 German Income Tax Act and has referred a third case involving dividend payments to a Dutch company to the ECJ. On the one hand, with regard to a possible violation of the freedom of establishment and the EU Parent/Subsidiary Directive. Secondly and in particular the judges criticize that under the anti-abuse provisions there is no possibility for the claimant to provide evidence to the contrary, especially if the foreign company maintains a business establishment suitably equipped for its business purposes. Lastly, the judges doubt whether it is compatible with EU law if the burden of proof lies with the applicant.

Lower Tax Court of Cologne, decision of July 8, 2016 (2 K 2995/12); the ECJ case reference is C-504/16, *Deister Holding* (years up to 2011)

Lower Tax Court of Cologne, resolution of August 31, 2016 (2 K 721/13); the ECJ case reference is C-613/16, *Juhler Holding* (years up to 2011)

Lower Tax Court of Cologne, resolution of May 17, 2017 (2 K 773/16); the ECJ case reference is C-440/17 (years from 2012)

Update - 24 November 2017

In its ruling of 7 September 2017 (C-16/16 Eqiom SAS and Enke SA) the European Court of Justice (ECJ) decided that a treaty/directive-shopping provision in French tax law – which is similar to Section 50d (3) ITA – is not compatible with EU law (Parent/Subsidiary Directive ("PSD") and the fundamental freedom of establishment).The French tax authorities refused an application for an exemption from French withholding tax on the basis that the exemption in question did not apply to dividends received by a legal person, which was directly/indirectly controlled by one or more persons resident in a third country (i.e. outside the EU), unless the parent company can prove that the main purpose or one of the main purposes for the chain of interests was not to take advantage the tax exemption. The Court held that both the PSD and Article 49 TFEU (freedom of establishment) precluded such a rule. The ultimate shareholder of the company making the claim in this case was a Swiss company.

Schlagwörter

anti-treaty shopping rule, dividend withholding tax, treaty relief