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ECJ – German Anti-Treaty-Shopping Rule infringes EU law

On 20 December 2017 the European Court of Justice (ECJ) issued its decision on two cases referred to it by the Cologne Tax Court on the compatibility of the anti-abuse rule in Section 50d Income Tax Act (ITA) with EU law. According to Section 50d (3) ITA certain intermediary foreign companies are not entitled to a (full or partial) refund of German withholding tax; without a preceding oral hearing the ECJ took the view that the section was incompatible with both the Parent-Subsidiary Directive and the freedom of establishment. - See update further below!

Background

Both referrals of the Cologne Tax Court related to the so-called anti-treaty shopping regulation in Section 50d (3) ITA (in the version of the 2007 Finance Act), according to which a foreign company was refused relief under a directive or tax treaty to the extent that persons had holdings in it who would not be entitled to the relief if they earned the income directly, and

1. there were no economic or other substantial reasons for the involvement of the foreign company; or

2. the foreign company did not earn more than 10% of its entire gross income for the financial year in question from its own economic activity; or

3. the foreign company did not take part in general economic commerce with a business establishment suitably equipped for its business purpose.

In this regard the circumstances of the non-resident company were the sole decisive factor; organisational, economic or other substantial features of undertakings that were affiliated with the foreign company were not to be considered.

The questions referred by the Tax Court indicated a concern about a potential restriction of the freedom of establishment and a violation of the Parent-Subsidiary Directive (Directive 90/435/EEC – “PSD”).

Facts and Decision

In case C-507/16, the appellant, *Deister Holding*, had its registered office in the Netherlands and had holdings in several companies established in various States; it financed those companies, inter alia, by making loans to the companies of the group in question. The appellant held at least 26.5% of the capital of a company incorporated under German law. The appellant had a rented office in the Netherlands and two employees. Deister Holding’s sole shareholder was resident in Germany.

In case C?613/16, the appellant, *Juhler Holding,* was a holding company with its registered office in Denmark. Its sole shareholder was a company incorporated under Cypriot law without its own economic activity. The sole shareholder of the Cypriot company was an individual resident in Singapore, who would not have been entitled to a refund of the dividend withholding tax, had he received the dividend directly. Juhler Holding had holdings in more than 25 subsidiaries and a property portfolio; it exercised financial control within the group so as to optimise the group’s interest costs, was responsible for supervising and monitoring the performance of the individual subsidiaries and had a phone line and an email address. However, it did not have its own offices.

Infringement of the Parent-Subsidiary Directive

The ECJ considered the German provision to be too one sided and restrictive. The aim of the PSD is to eliminate any (tax) disadvantages arising from the distribution of profits between companies of different Member States and to facilitate the grouping together of companies at EU level. The judges pointed out that

whilst the PSD did provide the Member States with the right to introduce rules to prevent abuse, the measures must be appropriate for attaining that objective and must not go beyond what is necessary to attain it. The German provision does not meet this criteria.

A general tax measure which automatically excludes certain categories of taxable person from the tax advantage, without the tax authorities being required to provide even prima facie evidence of fraud and abuse, goes further than is necessary for preventing fraud and abuse. The Court has previously stated that, the specific objective of any national measures must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, and the purpose of which is to obtain an undue tax advantage.

In the view of the ECJ, Section 50d (3) introduced a general presumption of abuse. However, national authorities may not confine themselves to applying predetermined general criteria, but must carry out an individual examination of the whole operation at issue. Further the applicant should be entitled to provide evidence to the contrary. The situation should be examined on a case-by-case basis, with an overall assessment being made of the relevant situation, based on factors including the organisational, economic or other substantial features of the group of companies to which the parent company in question belongs and the structures and strategies of that group

The ECJ also noted that the PSD itself did not contain any requirement as to the nature of the economic activity of companies falling within its scope or the amount of turnover resulting from those companies' own economic activity

Impediment to the freedom of establishment

The ECJ took the view that Section 50d (3) ITA leads to a difference in treatment, likely to dissuade a non-resident parent company from carrying on an economic activity in Germany through a German subsidiary and therefore constitutes an impediment to the freedom of establishment. The Court was unable to establish any justification for this restriction. This could be the case where situations are not objectively comparable or where it can be justified by overriding reasons in the public interest recognised by EU law. Such justifications could not be demonstrated here.

The non-resident parent company is in a situation which is comparable to that of a German resident parent, as Germany has chosen to exercise its tax jurisdiction over the profits distributed by the resident subsidiary to the non-resident parent company. Thus it had to be concluded that that the non-resident parent company is, vis-à-vis those dividends, in a situation comparable to that of a resident parent company.

As regards the justification for and the proportionality of the impediment, Germany argued that the provision could be justified, inter alia, by its objective to safeguard the balanced allocation of taxation powers between the Member States. However, the ECJ noted in this regard, that the PSD itself governs the issue of that allocation, in that it prohibited Member States from levying WHT on profits distributed by a resident subsidiary to its non-resident parent.

Note/Update: The Cologne Tax Court has also expressed its ***doubts in relation to the current version*** of Section 50d (3) ITA (applicable from 2012) and referred the question to the ECJ on 17 May 2017 (2K 773/16). The case with the ECJ reference **C-440/17** has meanwhile been decided on 14 June 2018. Here, the ECJ ruled that ***the 2012 version of Sec. 50d (3) ITA likewise contradicts the principle of freedom of establishment as well as the Parent-Subsidiary Directive*****.**

Keywords

Fundamental Freedoms, anti-treaty shopping rule, freedom of establishment