GERMAN ANTI-TREATY SHOPPING RULE INFRINGES ON E.U. LAW

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INTRODUCTION

On June 14, 2018, the European Court of Justice ("E.C.J.") ruled on the compatibility of the current version of the German anti-treaty and anti-directive shopping rule, section 50d paragraph 3 German Income Tax Act ("I.T.A.") 2012, with E.U. law, in particular the E.U. Parent Subsidiary Directive ("E.U. P.S.D."). German national law was found to be incompatible with those provisions of E.U. law.

The ruling marks the end of a saga that began on December 20, 2017, when the court rejected the 2007 version of German national law, section 50d paragraph 3 I.T.A. 2007. This article outlines developments beginning with the E.C.J.'s December 2017 ruling in companion cases involving Deister Holding and Juhler Holding, proceeding to the German Federal Ministry of Finance's response, and concluding with the June 2018 ruling in the GS case. Steps for foreign parent companies inside and outside the E.U. are suggested, as well.

DECEMBER 20, 2017: *DEISTER HOLDING* AND *JUHLER HOLDING* RULING

Facts and Background

The appellants, Deister Holding (formerly Traxx Investments) and Juhler Holding,[1] were both companies registered in E.U. countries. Deister was resident in the Netherlands and Juhler was resident in Denmark. Each that held shares in companies resident in Germany for tax purposes. Deister Holding held a 26.5% or greater interest in several German companies. Its only shareholder was a person who was tax resident in Germany. Juhler Holding held up to a 90% interest in 25 German companies and also maintained a property portfolio. Its only shareholder was a company registered in Cyprus, whose only shareholder was, in turn, an individual tax resident in Singapore.

The German tax authorities refused to grant refunds to Deister Holding and Juhler Holding for withholding taxes paid on dividends received from their respective German subsidiaries, as both ran afoul of the conditions of section 50d paragraph 3 I.T.A. 2007. That rule stated that withholding tax relief will not to be granted in the following combined circumstances:

- Person(s) holding ownership interests in the foreign parent company would not be entitled to the refund or exemption if they derived the income directly.

[1] *Deister Holding A.G. & Juhler Holding A./S. v. Bundeszentralamt für Steuern,* Joined Cases, C-504/16 & C-613/16, [2017] E.C.J.

- Any one of the following three conditions exists:
    - **Intent**: There are no economic or other valid reasons for the interposition of the foreign parent company.
    - **Business Activity**: The foreign company does not earn more than 10% of its gross income from its own business activity.
    - **Business Premises**: The foreign company does not take part in the general economic commerce via a suitably equipped business establishment.

Section 50d paragraph 3 I.T.A. 2007 does not apply to a foreign parent company having its principal class of stock regularly traded in substantial volume on a recognized stock exchange. Similarly, it does not apply to a foreign company that qualifies as an investment corporation within the meaning of the Investment Tax Act.

Both Deister Holding and Juhler Holding filed appeals in the Cologne Tax Court. The Cologne Tax Court then asked the E.C.J. whether section 50d paragraph 3 I.T.A. 2007 infringes on the E.U. P.S.D. and/or the E.U. fundamental freedoms, namely the free movement of capital or the freedom of establishment.

The E.C.J. Decisions

Regarding the *Deister Holding* (C-504/16) and *Juhler Holding* (C-631/16) cases, the E.C.J. stated that the aim of the E.U. P.S.D. is to provide a level playing field for E.U. and domestic parent companies, thereby facilitating the creation of cross-border groups. This goal requires the elimination of any tax obstacles to cross-border dividend distributions. Therefore, Member States are obliged to provide tax refunds for withholding taxes levied on dividends paid by domestic subsidiaries to their E.U. parents.

The E.U. P.S.D. allows Member States to enact exemptions from this rule where appropriate to combat tax abuse and fraud. However, those exemptions must be in line with the general principles of E.U. law, especially the principle of proportionality. The court further specified that an exemption could be considered proportional only if it solely targets "wholly artificial structures."

Concerning the German rule, the E.C.J. found this requirement was not fulfilled. Instead of requiring the tax authorities to provide at least a *prima facie* indication that a certain structure is fraudulent or abusive, section 50d paragraph 3 I.T.A. 2007 constituted an irrebuttable presumption of fraud or abuse once one of the three generic criteria was met. Moreover, it did not allow the taxpayer to prove on the basis of its unique facts, that its structure was not wholly artificial. Under these circumstances, the E.C.J. declared section 50d paragraph 3 I.T.A. 2007 was not proportional and thereby violated the E.U. P.S.D.

In addition, the court found the principle of freedom of establishment was at issue. Both Deister Holding and Juhler Holding held stakes in German subsidiaries that allowed them to exercise a certain degree of control over their subsidiary's business as opposed to a mere financial investment. The German rule was found to restrict the principle of freedom of establishment, as it discriminated against E.U. parent companies with German subsidiaries when compared to German parent companies.

When setting up a German subsidiary, an E.U. parent company and a domestic parent company would be in the same position at the outset. However, while the latter would always receive tax relief for withholding taxes on dividends paid by domestic subsidiaries, the former would only be granted a relief if it did not fall within the scope of Section 50d paragraph 3 I.T.A. 2007. Therefore, the rule was likely to hinder an E.U. parent company's ability to set up a subsidiary in Germany and thereby constituted a restriction of the principle of freedom of establishment.[2]

APRIL 4, 2018: THE GERMAN FEDERAL MINISTRY OF FINANCE'S CIRCULAR LETTER

In reaction to the E.C.J. decision, the German Federal Ministry of Finance published a circular letter[3] on April 4, 2018, governing the application of Section 50d paragraph 3 I.T.A. 2007 and, its successor clause, Section 50d paragraph 3 I.T.A. 2012 in E.U. P.S.D. cases.

The Ministry ruled that the 2007 rule should no longer be applied in pending E.U. P.S.D. cases. Concerning the 2012 version, the German Ministry of Finance modified its criteria in E.U. P.S.D. cases in order to secure compliance with E.U. law. This time, section 50d paragraph 3 I.T.A. 2012 stated that withholding tax relief will not to be granted in the following combined circumstances:

- Person(s) holding ownership interests in the foreign parent company would not be entitled to the refund or exemption if they derived the income directly.
- The gross earnings of the foreign parent company for the respective fiscal year do not originate from its own business activity.
- One of the following two conditions is met:
    - **Intent**: There are no economic or other valid reasons for the interposition of the foreign parent company.
    - **Business Premises**: The foreign company does not take part in the general economic commerce via a suitably equipped business establishment.

Again, the rule does not apply to a foreign parent company having its principal class of stock regularly traded in substantial volume on a recognized stock exchange. Similarly, it does not apply to a foreign company that qualifies as an investment corporation within the meaning of the Investment Tax Act.

According to the circular, a less rigid standard would be applied when determining whether relief would be granted. As a result

- economic or other substantial reasons for the interposition of the parent company could now also be found in the context of group strategy or group structure;

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2 The court further considered, but later denied, a justification of this restriction along the line of arguments already given in regard to the E.U. P.S.D.

3 German Federal Ministry of Finance (*Bundesfinanzministerium*, B.M.F.), B.M.F. IV B 3 – S 2411/07/10016-14, circular letter of April 4, 2018.

- the holding of shares in other companies can be considered participation in economic commerce, as long as shareholder rights are actively exercised; and
- the parent company would no longer be required to permanently employ staff to establish an appropriate business presence.

The circular letter was received with skepticism from the tax community. Several commentators doubted that the circular was enough to ensure Germany's compliance with E.U. law. Despite the modifications, Section 50d paragraph 3 I.T.A. 2012 struggled to meet several stipulations in the *Deister Holding* and *Juhler Holding* case. The most striking of its shortcomings pertained to the methodology for determining abusive structures, which continued to follow general criteria and not case-by-case facts and circumstances. Additionally, Section 50d paragraph 3 I.T.A. 2007 was only suspended for E.U. P.S.D. cases. The fundamental freedoms could continue to be violated in cases outside the scope of the E.U. P.S.D. Examples include a refusal of tax relief on grounds of a double tax treaty with an E.U. Member State or a non-E.U. country with a most-favored-nation clause.

"The approach taken in the past must be modified so that a 'one-size-fits-all' approach based on concerns over abusive tax planning is abandoned in favor of a facts and circumstances approach."

Moreover, the circular did not address royalties and interest paid by domestic subsidiaries to their E.U. parents, which also are exempt from tax according to E.U. directives but may fall under the scope of Section 50d paragraph 3 I.T.A. 2012. Hence, it was widely believed that the amended view of the Ministry of Finance on the 2012 version would not achieve compliance with the E.C.J. ruling in *Deister Holding* and *Juhler Holding*.

JUNE 18, 2018: E.C.J. RULING ON *GS*

Facts and Background

In many ways, the *GS* case (C-440/17)[4] resembles *Deister Holding* and *Juhler Holding*. GS was a holding company registered in the Netherlands. It held stakes in several subsidiaries in different jurisdictions – among those, a 90%-stake in a company tax resident in Germany. GS's sole shareholder was an individual tax resident in Germany. Apart from administering its shares, GS mainly purchased raw materials, resold them to its subsidiaries, and provided loans to its subsidiaries. For these purposes, GS had three employees in the Netherlands.

The German tax authorities refused to grant GS relief from withholding tax on dividends paid by its German subsidiary on the grounds of Section 50d paragraph 3 I.T.A. 2012. GS appealed this decision to the Cologne Tax Court, who in turn again referred the case to the E.C.J.

The E.C.J. Decision

The E.C.J. mainly relied upon the arguments already given in the *Deister Holding* and *Juhler Holding* ruling. The E.C.J. stated that Section 50d paragraph 3 I.T.A. 2012, as well as its predecessor rule, contravened the E.U. P.S.D. and restricted E.U. fundamental freedoms. Following the argumentation in *Deister Holding* and *Juhler Holding*, the court stated that a restriction of the E.U. P.S.D. and the fundamental freedoms could only be proportional, and therefore justifiable, if only

[4] *GS v. Bundeszentralamt für Steuern*, C-440/17, [2018], E.C.J.

"wholly artificial structures" fell within scope of the rule.

In the view of the court, Section 50d paragraph 3 I.T.A. 2012 constituted an irrebuttable assumption of fraud and abuse once the generic criteria were fulfilled. It did not allow taxpayers to prove on a case-by-case basis that the respective structure was not wholly artificial. Therefore, the E.C.J. again held the German rule to be disproportionate, in accordance with the *Deister Holding* and *Juhler Holding* ruling. Consequently, Section 50d paragraph 3 I.T.A. 2012 was found to be noncompliant with the E.U. P.S.D. as well as the principle of freedom of establishment.

PATH FORWARD

Foreign Corporate Shareholders May Collect Tax Refunds and Obtain Relief

Both E.U. and non-E.U. parent companies located in a treaty country with a most-favored-nation clause should now be eligible for a withholding tax exemption or tax refund if economic or other valid reasons for the interposition of the foreign parent company exist per the *GS* case. Therefore, it is highly recommended that shareholders apply for a withholding tax refund if tax relief has been refused in past.

Statute of Limitations for Tax Refund

The statute of limitations for filing the refund request is four years from the end of the year in which the dividends were derived. All pending refund requests must be approved by the tax authorities now.

Royalties

The same applies to German-source taxation of royalties and interest, if any.

REACTION TO *GS* PENDING

The German legislature is now required to act. In light of clear rulings by the E.C.J. on the German anti-treaty shopping rule, the approach taken in the past must be modified so that a "one-size-fits-all" approach based on concerns over abusive tax planning is abandoned in favor of a facts and circumstances approach. The Ministry of Finance is expected to repeal the April 4, 2018, circular letter and significantly narrow the scope of the 2017 version or to suspend the provision until modifications are finalized. In addition, it appears likely that the amendment of the anti-treaty and anti-directive shopping rule will be introduced into the 2018 Annual Tax Bill.