Baker McKenzie.

Hot Topics

Tax Law
Germany

January 2018

CJEU decision on section 50d(3) EStG – Is this the end of the German anti-treaty shopping rule?

In its decision of December 20, 2017 (C-504/16 and C-613/16), the Court of Justice of the European Union (CJEU) ruled that section 50d(3) German Income Tax Act (*Einkommensteuergesetz*; "EStG"; 2007) violates the Parent-Subsidiary Directive as well as the freedom of establishment and is, thus, contrary to European Union law. The decision referred to the version of the 2007 Annual Tax Act (*Jahressteuergesetz*), effective until the end of 2011, but, in view of the reasons given by the CJEU, it must equally be doubted that the current provision is in conformity with European Union law. Preliminary ruling pro-ceedings regarding the current provision are already pending before the CJEU (Finance Court Cologne, decision dated May 17, 2017, 2 K 773/16; reference at the CJEU C-440/17).

General description of section 50d(3) EStG

Section 50d(3) EStG (2007) limits the relief from withholding tax on dividends and licenses. The purpose of the provision is to prevent that, by involving suitable legal entities, relief granted under a double taxation treaty or directive (in particular the Parent-Subsidiary Directive) is claimed by unauthorized persons (so-called "treaty shopping" and "directive shopping").

Background of the preliminary ruling

The CJEU ruled on two proceedings referred by the Finance Court Cologne, *Deister Holding* and *Juhler Holding*. Both cases related to section 50d(3) EStG as amended by the Annual Tax Act 2007. According to this provision, prerequisite for granting the withholding tax relief was that the shareholders indirectly participating in the dividend-paying company would also be entitled to relief if they earned the income directly (so-called personal entitlement to tax relief) and that the following three conditions (so-called factual entitlement to tax relief) are met:

- there are economic or other substantial reasons for the involvement of the foreign company and
- more than 10% of the foreign entity's entire gross income is derived from its own economic activity; in this respect, the Finance Court Cologne was of the opinion that the active shareholding management of holding, investment and financing companies does not qualify as economic activity, and
- the company takes part in general economic commerce with a suitably equipped business establishment.

Our Expertise
Tax Law

The proceedings concerned the following structures:

Deister Holding was a so-called "meander structure", i.e. the indirect shareholder, in the case at hand a natural person, was resident in Germany – just as the dividend-paying company, a German limited liability company (GmbH). The activities of the involved Dutch *Deister Holding* mainly consisted in the holding and management of shareholdings as well as in financing those companies. It rented office space in the Netherlands and had two employees, but no own economic activities.

The Danish *Juhler Holding* had, in addition to a shareholding in a German GmbH, holdings in more than 25 operative subsidiaries. Some of these companies were also resident in Denmark. Sole shareholder of *Juhler Holding* was a Cyprus-based corporation without any own economic activities. The corporation's shares were in turn held by a natural person resident in Singapore. *Juhler Holding* was responsible for the financial control within the group as well as for the supervision of the subsidiaries. However, it neither had own premises nor own staff. Instead it used the resources of the subsidiaries in this respect.

In both cases, no relief from withholding tax on the dividends from the respective German GmbH was granted. The Dutch *Deister Holding* had no own economic activities. The Danish *Juhler Holding* was further lacking a suitably equipped business establishment.

The Finance Court Cologne hearing these cases referred the cases to the CJEU asking whether section 50d(3) EStG is compatible with EU law. According to the referring court, an unequal treatment existed in both cases because a holding company resident in another EU country, whose sole business activities was the mere management of its own assets, was refused relief from deducted withholding tax, while a German holding company was fully credited the deducted withholding tax within the tax assessment procedure and, in case of excess payments, was refunded the tax, without the receiving company requiring any substance or function.

The decision of the CJEU

The CJEU ruled that the provision of section 50d(3) EStG (2007) is incompatible with the freedom of establishment and the Parent-Subsidiary Directive. A provision which results in such a restriction can be justified for anti-abuse purposes if the specific objective of the restriction is the prevention of wholly artificial arrangements, but, in the CJEU's view, such justification does not exist in the present cases for the following reasons:

- The provision does not only cover wholly artificial arrangements but in general any shareholding structure, in which the indirect shareholder is not entitled to the relief if they received the dividend directly. However, the mere fact that such persons hold such holdings does, per se, <u>not</u> indicate a wholly artificial arrangement.
- It is not allowed to provide counter-evidence.
- Neither taken individually nor as a whole, the conditions in the provision in themselves imply the existence of abuse or fraud.

What is next?

The Finance Court Cologne will now apply the CJEU's decision to the cases pending before it. However, it is unlikely that the legislator will change the current provision in the light of the CJEU's decision. The Commission had already complained that the previous provision violated EU law and initiated infringement proceedings in this respect. For this reason, the previous provision was amended by the Act for the Implementation of the Tax Recovery Directive (*Beitreibungs-richtlinie-Umsetzungsgesetz*; "BeitrRLUmsG"; 2012). The previous version was softened in so far as the requirements must no longer be met cumulatively and a partial relief is possible. However, the CJEU's statement that the requirements do not imply abuse if taken individually suggests that today's requirements also violate EU law because, with the exception of the 10% threshold of the revenue generated from own economic activities, they largely correspond to the requirements of the previous provision. In addition, it is still not allowed to provide counter-evidence.

With respect to the current provision, a reference for a preliminary ruling of the Finance Court Cologne (referral of May 17, 2017 - 2 K 773/16, reference at the CJEU C-440/17) is already pending. Therefore, the CJEU will have the opportunity to also rule on the current legal provision. If the CJEU will consider the current provision to be incompatible with EU law, the legislator will have to amend the provision.

Outlook

The CJEU provides an indication how a provision that is compatible with EU law should have to be worded. According to the CJEU, the determination of a wholly artificial arrangement would have to be made on a case-by-case basis, taking into account the organizational, economic or other substantial characteristics of the group as well as the structures and strategies of the group. This leads to the conclusion that the current sole evaluation of the foreign company as still stipulated under section 50d(3) sentence 2 EStG is not sufficient. This applies, in particular, in constellations where other operative subsidiaries are also resident in the country of residence of the holding company. Such a provision is already included in the protocol to the DTT Netherlands on Art. 23. However, an evaluation on a case-by-case basis would mean increased legal uncertainty for the taxpayer. Until the provision is amended, any notice rejecting an exemption or refund of withholding tax should be appealed.

For further information, please contact:

Christian Brodersen LL.M.
christian.brodersen
@bakermckenzie.com

Jana Fischer LL.M.
jana.fischer
@bakermckenzie.com

Friederike Goering
friederike.goering
@bakermckenzie.com

Baker & McKenzie - Partnerschaft von Rechtsanwälten, Wirtschaftsprüfern und Steuerberatern mbB

Berlin
Friedrichstrasse 88/Unter den Linden
10117 Berlin
Tel.: +49 30 2 20 02 81 0
Fax: +49 30 2 20 02 81 199

Frankfurt am Main
Bethmannstrasse 50-54
60311 Frankfurt / Main
Tel.: +49 69 2 99 08 0
Fax: +49 69 2 99 08 108

Dusseldorf
Neuer Zollhof 2
40221 Dusseldorf
Tel.: +49 211 3 11 16 0
Fax: +49 211 3 11 16 199

Munich
Theatinerstrasse 23
80333 Munich
Tel.: +49 89 5 52 38 0
Fax: +49 89 5 52 38 199

www.bakermckenzie.com

Get Connected:

This client newsletter is prepared for information purposes only. The information contained therein should not be relied on as legal advice and should, therefore, not be regarded as a substitute for detailed legal advice in the individual case. The advice of a qualified lawyer should always be sought in such cases. In the publishing of this Newsletter, we do not accept any liability in individual cases.

Baker & McKenzie - Partnerschaft von Rechtsanwälten, Wirtschaftsprüfern und Steuerberatern mbB is a professional partnership under German law with its registered office in Frankfurt/Main, registered with the Local Court of Frankfurt/Main at PR No. 1602. It is associated with Baker & McKenzie International, a Verein organized under the laws of Switzerland. Members of Baker & McKenzie International are Baker McKenzie law firms around the world. In common with terminology used in professional service organizations, reference to a "partner" means a professional who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

© Baker McKenzie