

URL: <http://www.deloitte-tax-news.de/german-tax-legal-news/cjeu-concludes-germanys-post-2011-anti-treaty-shopping-rules-violate-eu-law.html>

📅 07.08.2018

German Tax and Legal News

CJEU concludes Germany's post-2011 anti-treaty shopping rules violate EU law

The CJEU issued a decision on 14 June 2018, concluding that Germany's anti-treaty-shopping rules violate both the EU parent-subsidiary directive and the EU treaty, similar to prior decisions on the pre-2012 version of the rules.

The Court of Justice of the European Union (CJEU) issued a decision on 14 June 2018 (case [C-440/17](#)), concluding that Germany's anti-treaty-shopping rules in section 50d(3) of the income tax code (EStG) that have been applicable as from 2012 violate EU law. The court held that the rules violate both the EU parent-subsidiary directive (PSD) and the freedom of establishment principle in article 49 of the Treaty on the Functioning of the European Union (TFEU).

This is the third case in which the CJEU has ruled that the German anti-treaty shopping rules are not compatible with EU law, but the first case involving the post-2011 version of the rules (CJEU cases C-504/16 and C-613/16, see [GTLN dated 27 December 2017](#)), involving the rules applicable during the period from 2007 to 2011). It will be interesting to see how the tax authorities will react to this decision, which conflicts with recent guidance (see [GTLN dated 11 April 2018](#)) issued by the German Ministry of Finance in April 2018.

Facts of the case

The taxpayer in the case before the CJEU 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 square meters 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) of the EStG) because it determined that the Dutch entity did not meet the strict requirements of the rules.

Background on German anti-treaty shopping rules

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

- The nonresident company is owned by shareholders that would have been 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 own genuine business activities ("business income test").

Even if the nonresident company fails both of these tests, it still will be entitled to withholding tax relief if it passes 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 [GTLN dated 6 February 2012](#)).

Decision of the CJEU

The CJEU held that the current German anti-treaty-shopping rules violate both the PSD and the freedom of establishment principle in the TFEU.

Parent-subsidiary directive

As in its prior decisions on the pre-2012 version of the anti-treaty shopping rules (CJEU cases C-504/16 and C-613/16, see [GTLN dated 27 December 2017](#)), the court first emphasized the objective of the PSD, which is to avoid double taxation by prohibiting the levy of withholding tax on qualifying dividends. The court also reiterated the principle that article 1(2) of the PSD provides for an exception to the withholding tax exemption based on the general rules laid down by the directive, and thus article 1(2) must be subject to strict interpretation. Accordingly, the specific objective of an exception to the withholding tax exemption must be to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, the purpose of which is to unduly obtain a tax advantage.

As with regard to the previous version of the rules, the CJEU concluded that the German anti-treaty shopping rules are not specifically designed to exclude from the benefit of a tax advantage wholly artificial arrangements whose purpose is to unduly obtain that advantage. Consequently, the CJEU found that the PSD precludes national tax legislation such as the German anti-treaty-shopping rules, both in their pre-2012 version and in the version applicable since 2012.

Freedom of establishment

When testing the German anti-treaty shopping rules against the fundamental freedoms in the TFEU, the court reached the same conclusion as in its prior cases on the pre-2012 version of the rules. Given that a grant of the German withholding tax exemption to nonresident shareholders was subject to the anti-treaty shopping rules, while a resident shareholder would have received the dividends tax exempt without being subject to the rules, the CJEU found that the post-2011 German rules constitute a restriction of the freedom of establishment that cannot be justified by the objective of combating tax evasion and avoidance. Consequently, the CJEU found that the freedom of establishment precludes national tax legislation such as the German anti-treaty shopping rules.

Implications for taxpayers

Germany's tax authorities issued a decree on 4 April 2018 (see [GTLN dated 11 April 2018](#)) that sets out their views on how to apply the domestic anti-treaty shopping rules in line with EU law, following the previous decisions of the CJEU. It seemed questionable at the time whether the measures described in the decree would be sufficient to bring the German anti-treaty shopping rules in line with EU law. Those doubts have now been confirmed by the June 2018 CJEU decision, so the tax authorities and the legislature will need to react to this decision.

Applications for dividend withholding tax relief that are based on a tax treaty between Germany and an EU/European Economic Area member state are not covered by the decree, nor are applications for relief from royalty withholding tax based on a tax treaty or the EU interest and royalties directive. However, it seems likely that the court's reasoning also could be applied to claim withholding tax relief in these cases. Nonresident taxpayers that suffered withholding tax due to the application of the anti-treaty shopping provisions should monitor developments and keep relevant assessments open.

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