

Lower tax court rejects tax authorities' interpretation of CJEU ruling on anti-treaty shopping rules

Court decides rules violate EU law for all payments triggering withholding tax, regardless of whether a reduced rate applies based on an EU directive or an applicable tax treaty

The Lower Tax Court of Cologne, in a 23 January 2019 decision (which recently has been made public, but has not yet been officially published by the court), rejected the German tax authorities' (MOF's) interpretation of a Court of Justice of the European Union (CJEU) decision on the domestic anti-treaty shopping rules. The MOF set forth its interpretation of the CJEU decision in a decree dated 4 April 2018 (see [GTLN dated 11 April 2018](#)), in which the MOF limited the application of the ruling to claims for a reduced dividend withholding tax rate that are based on the [EU parent-subsidiary directive](#) (PSD). The decree responded to two decisions of the CJEU that were published on 20 December 2017 ([combined cases C-504/16 and C-613/16](#)) (see [GTLN dated 27 December 2017](#)), in which the CJEU concluded that Germany's pre-2012 anti-treaty shopping rules (set out in section 50d(3) of the Income Tax Code (ITC)) violate EU law. The decree also indicates that the MOF agrees that the CJEU's reasoning in those decisions also could be applied to the post-2011 rules, and it addresses the MOF's interpretation of the effects of the CJEU decision on both the pre-2012 and the post-2011 versions of the rules.

The CJEU held in the December 2017 decisions that the pre-2012 anti-treaty shopping rules violate both the PSD and the freedom of establishment principle in article 49 of the [Treaty on the Functioning of the European Union](#) (TFEU). The CJEU then ruled on 14 June 2018 ([case C-440/17](#)) (see [GTLN dated 7 August 2018](#)) that the post-2011 version of the rules in section 50d(3) also violates the PSD and the freedom of establishment. The decision of the lower tax court effectively confirms that the measures described in the MOF decree are not sufficient to bring either the pre-2012 or the post-2011 versions of the rules in line with EU law.

Broadly, both the pre-2012 and the post-2011 versions of the anti-treaty shopping rules, which also apply to withholding tax relief sought under an EU directive, provide that a nonresident company that receives a payment subject to German withholding tax must meet certain requirements to be entitled to withholding tax relief. Although there are variations in the pre-2012 and the post-2011 requirements, both sets of rules provide alternative tests that companies may meet to qualify for withholding tax relief, relating to ownership, business activities, business purpose and substance.

The MOF's April 2018 decree is limited in its scope and, due to its unclear wording, created a high level of uncertainty for affected taxpayers relating to the MOF's interpretation of the CJEU decisions.

Lower Tax Court of Cologne case

In the case decided by the Lower Tax Court of Cologne, a Cyprus resident corporation held convertible bonds that were issued by a German AG (stock corporation) and that yielded 5.5% annual interest. The Cyprus entity also held a 15% share in the same German AG. The Cyprus entity did not have any employees or its own office space and outsourced all of its activities (management services) to another related Cyprus entity. In 2010 and 2011, the German entity withheld tax at the domestic 26.375% rate (including the solidarity surcharge) on interest payments to the Cyprus bondholder. The Cyprus bondholder applied for the reduced 10% rate for interest under the Germany-Cyprus tax treaty and initiated a refund procedure with the federal German tax authorities, in addition to applying for a withholding tax exemption certificate. The federal tax office rejected the applications, stating that, based on the limited or lack of substance at the level of the Cyprus bondholder, the conditions of the German anti-treaty shopping rules were not met.

There are several interesting aspects of the case decided by the lower tax court, including that the case deals with withholding tax on interest, which applies under Germany's domestic tax rules only in specific and limited circumstances. The ITC explicitly applies

withholding tax to interest payments related to convertible bonds. The court confirmed in its decision that the Cyprus bondholder was subject to limited German tax liability with regard to the interest income and that, therefore, a refund application with the federal tax office was the appropriate procedure to apply for a reduced withholding tax rate under the Germany-Cyprus tax treaty.

The lower court also addressed the application of the anti-treaty shopping rules. The court confirms that the pre-2012 version of the anti-treaty shopping rules applies for the two interest payments that were the subject of the case. The court rejects the tax authorities' view, as described in an MOF decree dated 24 January 2012, that the post-2011 version of the anti-treaty shopping rules applies for all open cases with retroactive effect, and states that the related administrative guidance is not in line with the wording of the law and the intention of the lawmakers.

The court describes the principles of the CJEU decisions regarding the anti-treaty shopping rules. The lower tax court clearly rejects the German tax authorities' view that the CJEU decisions apply only in relation to withholding tax on dividend payments in cases where a reduction in the rate is being sought based on the PSD. As the CJEU decisions state that the anti-treaty shopping rules violate EU law, the lower tax court concludes that the CJEU decisions must be considered in all situations where the anti-treaty shopping rules apply. The fact that the CJEU decisions were based on a fact pattern where a dividend withholding tax reduction was being sought based on the PSD is irrelevant, in the view of the lower tax court.

Finally, the court analyzes whether the structure chosen by the taxpayer could be considered an artificial arrangement whose purpose was to unduly obtain a tax advantage, i.e. a reduced withholding tax rate. In its decisions regarding the anti-treaty shopping rules, the CJEU focused on this principle and stated that it has to be the basis for any domestic anti-abuse legislation. The lower tax court evaluated the anti-treaty shopping rules in light of this principle, and concluded that outsourcing activities to a related party that is resident in the same country as the taxpayer should not be seen as an artificial arrangement and as being an abusive situation. Therefore, in such a situation, it should be possible to consider the substance and the activities of the related party to the taxpayer. As a result of its analysis, the lower tax court concluded that the structure in the case at hand was not abusive and the conditions under the anti-treaty shopping rules to benefit from a reduced withholding tax rate were fulfilled. Therefore, the taxpayer was entitled to a reduced withholding tax rate for the interest payments based on the Germany-Cyprus tax treaty.

Comments

The decision of the Lower Tax Court of Cologne is noteworthy for several reasons. It sets out the court's position on several different issues that are relevant for inbound investors and for withholding tax payments in general. It rejects views of the tax authorities that have been heavily criticized by tax commentators as not being in line with EU law and the CJEU decisions, and hopefully will pave the way for a federal tax court decision on these matters. Even though the tax authorities have not yet officially filed an appeal of the lower tax court's decision, it is expected that they will do so and that the case will be decided by the federal tax court. Affected taxpayers that invest into Germany via entities that have low or no substance and that receive payments triggering withholding tax should carefully analyze the lower tax court's decision and monitor further developments.

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