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*German Tax and Legal News*

### Lower tax court rules on compatibility of German anti-treaty shopping rules with EU law

Anti-treaty shopping rules do not violate EU law in case of royalty payments to non-EU/EEA recipients.

With a decision dated 14 November 2018 and published on 15 July 2019, the lower tax court of Cologne ruled on the compatibility of the pre-2012 version of the German anti-treaty shopping rules with EU law in cases where royalty payments are made to non-EU/European Economic Area (EEA) recipients. The tax court decided that for royalty payments, the freedom to provide services, which does not apply with regard to non-EU/EEA countries, is the relevant fundamental freedom under the Treaty on the Functioning of the European Union for purposes of evaluating the compatibility of the rules with EU law. In the court's view, the fundamental freedom of the free movement of capital, which also applies in relation to non-EU/EEA countries, could not be applied because the freedom to provide services is considered the more specific principle and, therefore, has priority over the free movement of capital principle.

The lower tax court did not consider December 2017 and June 2018 decisions of the Court of Justice of the European Union (CJEU) on the incompatibility of the German anti-treaty shopping rules with EU law (see GTLN dated 27 December 2017 and GTLN dated 7 August 2018) to be applicable in the case at hand. The difference between the cases decided by the CJEU and the case decided by the lower tax court of Cologne is that the CJEU cases involved the payment of dividends (parent-subsidiary relationship) whereas the case at hand involved royalty payments. The freedom of establishment principle, which was invoked by the CJEU in the two cases decided in 2017 and 2018, does not apply to royalty payments and is applicable only for EU/EEA resident companies.

Under the pre-2012 version of the German anti-treaty shopping rules, a payment that is subject to German withholding tax will be denied the benefits under an EU directive or an applicable tax treaty in cases where the receiving entity's shareholders would not be entitled to similar benefits, or where the recipient is unable to demonstrate that it earns sufficient active business income. If both tests are failed, relief will be granted only if both a business purpose test and a substance test can be met at the level of the recipient (not taking into consideration any substance existing at the level of other group entities).

In the case decided by the lower tax court, a Swiss tax resident company provided certain asset management activities with respect to the brand name and intellectual property (IP) rights of a network of tax advisory and audit firms in Switzerland and Germany in consideration for a royalty. The group members that were making the royalty payments also owned shares in the Swiss IP holding company. The shareholders at the time were a German company (25%) and three Swiss companies (a total of 75%). The Swiss IP-owning company did not have any employees or its own office space; it carried out its activities by using the resources of related group members.

The German company making royalty payments to the Swiss IP owner withheld royalty withholding tax at the German domestic rate. The Swiss company filed a refund application for the withholding tax with the German federal tax office, based on the withholding tax exemption for royalties provided under the Germany-Switzerland tax treaty, and also applied for a royalty withholding tax exemption certificate for future royalty payments. The federal tax office, however, limited the German withholding tax relief to 75% of the tax withheld, in light of the German anti-treaty shopping rules. In the tax authorities' view, in the absence of sufficient active business income/a proper business purpose and sufficient substance at the level of the Swiss recipient, relief could be granted only based on a "look through" approach. Under this approach, relief could be granted only to the extent the royalty payments were attributable to the Swiss tax resident shareholders of the Swiss IP company. No relief was permissible with respect to the payments attributable to the 25% German shareholder, given that the German shareholder would not be entitled to the benefits of a tax treaty if it had received the royalties directly.

The Swiss IP company argued that it satisfied the conditions of the pre-2012 anti-treaty-shopping rules based on its own substance and business purpose, so the look-through approach applied by the federal tax office should not be applicable. The Swiss company also argued that the German anti-treaty shopping rules had to be applied in accordance with the principles laid out by the CJEU in the Cadbury Schweppes case. The CJEU held in that case that rules designed to prevent tax avoidance must not go beyond what is necessary to prevent "wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory." The German tax authorities, however, rejected the taxpayer's argument by taking the position that the free movement of capital principle was not applicable in the case.

In accordance with the German tax authorities' view, the lower tax court of Cologne held that the Swiss company itself did not comply with the strict requirements of the pre-2012 German anti-treaty shopping rules and, therefore, the relief from German royalty withholding tax was limited to 75% of the tax withheld (based on the look-through approach). The court concluded that the German anti-treaty shopping rules were applicable in the case and were not restricted by the free movement of capital principle. The court based its decision on the grounds that, in the case of a royalty payment, the freedom to provide services precludes the application of the free movement of capital. However, the freedom to provide services is not applicable in a situation where the recipient of the payment is resident in a non-EU/EEA country. As a result, the court denied the application of both the freedom to provide services and the free movement of capital principles, and considered the German anti-treaty shopping rules to be applicable. In addition, the lower tax court rejected the possibility of taking into account the substance and activities at the level of the shareholders of the Swiss company to establish that the conditions to avoid application of the anti-treaty shopping rules were met at the level of the Swiss IP company. The lower tax court did not provide for the possibility for the taxpayer to appeal the case to the federal tax court.

The decision of the lower tax court of Cologne might come as a surprise to tax practitioners. The decision, however, highlights the fact that taxpayers should not simply assume that the German anti-treaty shopping rules are generally not applicable as a result of the two CJEU decision from 2017 and 2018. Each case has to be analyzed based on all specific facts and circumstances.

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