Executive summary

On 4 April 2018, the German Ministry of Finance (MOF) issued official guidance regarding the German anti-treaty shopping rule and its implications for European Union (EU) investors claiming a reduction of withholding tax on dividends under the German implementation of the EU Parent Subsidiary Directive (PSD). The MOF’s guidance is a direct response to the Court of Justice of the European Union (CJEU) decision in the joint cases of Deister Holding and Juhler Holding (case references C-504/16 and C-613/16) regarding the prior 2007 German anti-treaty shopping rule, which preceded the current version of the statute which is in effect since 2012.

In its decision of 20 December 2017, the CJEU held that Germany’s prior law (2007) on anti-treaty shopping, which was amended as of 1 January 2012 constituted an infringement of the PSD as well as the Freedom of Establishment principle (cases C-504/16 and C-613/16). Technically, the 2007 rules are relevant today only for pre-2012 withholding tax relief applications which are still pending in controversy or litigation procedures. However, the published guidance comments also on the application of the 2012 law on distributions of a German corporation covered by the PSD.
Detailed discussion

In its guidance, and following the cited CJEU decision, the MOF has confirmed that the 2007 German anti-treaty shopping rule should no longer be applied in any pending cases, where withholding tax relief under the PSD was claimed. Importantly, the guidance also comments on the implications of the decision for the current anti-treaty shopping rule, in effect since 1 January 2012.

According to the MOF’s new interpretation of the current 2012 anti-treaty shopping rule, holding companies engaged in mere asset managing activities should in many cases now be able to claim dividend withholding tax relief under the PSD. This is a taxpayer-friendly development.

However, the MOF has limited the scope of its guidance to dividend withholding tax relief under the PSD. Thus, the MOF’s position concerning the application of the anti-treaty shopping rule for withholding tax relief on royalties remains unchanged, as well as for treaty-based withholding tax relief on dividends which are not covered by the PSD.

The history

In its decision of 20 December 2017, the CJEU held that Germany’s prior law (2007) on anti-treaty shopping, which was amended as of 1 January 2012, constituted an infringement of the PSD as well as the Freedom of Establishment principle (cases C-504/16 and C-613/16). Technically, the 2007 rules are relevant today only for pre-2012 withholding tax relief applications which are still pending in controversy or litigation procedures.

A separate case dealing with the interpretation of the current 2012 anti-treaty shopping rule is still pending at the CJEU (case C-440/17, GS). The main difference between the 2007 and current 2012 rules is that the 2007 rule required the foreign corporate shareholder applying for withholding tax relief (among other criteria) to earn at least 10% or more of its gross receipts from “genuine self-business activities” (so called “active” gross receipts). The current 2012 rule eliminated this fixed percentage and replaced it with a case-by-case test on a proportional basis of active and passive gross receipts. This resulted de facto in a harsher treatment of many foreign corporate shareholders seeking dividend withholding tax relief.

The current 2012 rule denies the entitlement of a foreign company to withholding tax relief under an applicable tax treaty or the EU Directive to the extent that:

- The company is owned by shareholders that would not be entitled to corresponding relief under a tax treaty or an EU Directive had they received the income directly (the shareholder test)
- The gross receipts generated by the foreign company in the relevant year are not derived from the company’s genuine own business activities (the active business test).

If the two above tests are failed, the current 2012 rule also denies the entitlement of a foreign company to withholding tax relief under an applicable tax treaty or the EU Directive to the extent that:

- There are no economic or other relevant (i.e. nontax) reasons for the interposition of the foreign company in relation to the relevant income (“business purpose test”)
- The foreign company does not have adequate business substance to engage in its trade or business and it participates in general commerce (“substance test”).

In summary, withholding tax relief shall be available to the extent that either the shareholder test or the active business test is met. If neither of the two tests is met, withholding tax relief shall still be available to the extent that both the business purpose test and the substance test are met.

Substance and business activities of related parties in the same jurisdiction as the holding company are not taken into account.

In 2012, the MOF issued detailed guidance on the 2012 rule, where it took a very restrictive approach regarding the question as to what constituted a “genuine self-business activity” under the “active business test.” In particular, under this guidance, all passive asset management activities did not qualify as “self” and “active” business activities. The second test for treaty or EU Directive qualification, the “business purpose test” was subjected to an even more restrictive position, which held that shareholder related reasons for the interposition of a foreign holding company (such as effective group coordination and organization, customer development, cost savings and local preferences, etc.) should not count for the business purpose test. As a consequence, the business purpose test was nearly impossible to meet in practice. All in all, it became increasingly difficult to obtain dividend withholding tax relief, in particular if more complex group ownership chains were involved.
The new guidance

The reaction of the MOF to the CJEU decisions C-504/16 and C-613/16 has been eagerly awaited by taxpayers, because it was until now unclear whether the MOF would not only comment on the prior 2007 law, but also address the current 2012 rule, even though the CJEU has not yet issued its decision concerning the application of the 2012 rule.

The MOF decided to take a comprehensive approach and also address the current 2012 rule in its guidance.

Albeit the new guidance to the 2012 rule is somewhat broadly styled and will leave some situations unaddressed, the new guidance should largely be beneficial for foreign-EU shareholders who are covered by the PSD. It appears that the standards are relaxed regarding what will be considered as sufficient business activities and substance for dividend withholding tax relief under the PSD.

The key provisions of the new guidance are:

- The prior law (2007) anti-treaty shopping rule should no longer apply. This statement covers only such pre-2012 PSD application cases which are still open and the subject of a pending controversy procedure.
- The current 2012 anti-treaty shopping rule should apply on pending and future applications with the following amendments:
  - Business activities, substance and other relevant criteria of affiliates of the foreign shareholder which are located in the same country should be taken into account (non-application of Section 50d Para. 3 Sent. 2 Income Tax Act and the relevant section in the MOF’s 2012 guidance). This means that where a holding company is part of a larger group which also owns, e.g., an operating subsidiary in the same country as the holding company (but where the holding and the operating entity were set up separately, e.g., for liability protection reasons), the activities of the operating subsidiaries should be taken into account when evaluating the treaty entitlement of the holding company.
  - Mere (passive) asset management activities (e.g., holding company activities) should also qualify as a genuine business activity, provided that “the company actually exercises its shareholder rights” (e.g., participates in shareholders meetings, takes shareholder resolutions etc.). This is probably the most important change of the guidance, as it should enable “passive” holding companies to claim PSD relief even in cases where no so-called “management holding” functions are exercised by the holding company management vis-à-vis the relevant subsidiaries.
  - Adequate business substance in the case of passive asset management activities does not mean “necessarily” that the holding company would be obliged to employ management and other personnel at all times in its country of residence.
  - The restrictive view on what constitutes a valid business or other economic reason for the business purpose test, as expressed in the MOF’s 2012 guidance should no longer apply. This means that the tax authorities would most likely still take a case-by-case approach, but could now also accept for the business purpose test the following reasons which were previously deemed non-acceptable: Reasons associated with the set-up of the group of the foreign shareholder, such as coordination, organization, establishing customer relations, cost, local preferences, corporate set-up, safeguarding of domestic assets in times of crisis, preparation for future succession arrangements or for accumulating retirement funds for the shareholders.
  - The principles stated by the MOF’s new guidance should apply to all open cases. Thus, where applications for dividend withholding tax relief or dividend withholding tax exemption certificates under the PSD have already been filed with the MOF, but where no decisions have been issued yet, German tax authorities must take the principles of the new guidance into account when deciding on the applications.

Open issues under the MOF guidance

Though the MOF’s new guidance is generally beneficial for taxpayers, it does not address a number of points summarized below, which are in practice relevant for taxpayers:

- Based on its wording, the MOF guidance should only apply to dividend withholding tax relief under the PSD but should not apply to withholding tax on license fees or royalties. Given that a number of non-German cases regarding anti-treaty shopping provisions and their compatibility with the Interest and Royalties Directive are currently pending before the CJEU (Rs. C-299/16 (Z Denmark), C-115/16 (N Luxembourg I), C-118/16 (X Denmark A/S), C-119/16 (C Danmark I)), it will remain to be seen whether the tax authorities will update the guidance in the future to cover royalties as well.
The MOF guidance does not address dividends paid to shareholders in the European Economic Area (EEA) but only refers to the PSD. However, given that the CJEU based its decision on the PSD and on the Freedom of Establishment, it appears likely that EEA shareholders also should benefit from the decision.

The MOF guidance does not address third country/non-EU situations.

Implications

Based on the guidance, taxpayers should consider the following actions:

1. In cases where the tax authorities rejected a refund of withholding taxes or the granting of a withholding tax exemption certificate under the PSD, based on the anti-treaty shopping rule, and where the rejection can still be appealed, a protest should be filed so that the principles of the new guidance can still be considered. The same should be done in EEA shareholder situations where withholding tax on dividends has been levied.

2. Where previously no claims for a refund of withholding taxes under the PSD have been filed, an application for a refund of withholding taxes previously levied should be filed, provided the statute of limitations has not yet expired for such a claim (The period for the statute of limitations is generally four years, counted from the end of the year in which the dividend was paid. If this time limit did already expire, the statute of limitations may still be open for six months starting from the date of an actual payment of the tax, e.g., if a withholding tax payment was made later in a tax audit situation). The same should be done in EEA situations where withholding tax on dividends has been levied in the past.

3. Taxpayers who have previously not applied for withholding tax exemption certificates under the PSD should consider applying now for the exemption certificate in light of the new guidance. The same should apply to EEA shareholders with a treaty based tax relief claim.

4. Foreign taxpayers receiving royalties should also consider taking action as per the above paragraphs 1-3, notwithstanding the fact that German tax authorities officially limited their guidance to dividend withholding tax cases. These taxpayers may bring forward the argument that a decision on their applications should be put on hold until the above-mentioned anti-treaty shopping cases relating to the Interest and Royalties Directive have been decided. This is because it is likely that the CJEU decisions of these cases will include substantial guidance on questions around beneficial ownership and the application of the anti-treaty shopping rule on interest and royalty payments.

5. Third country jurisdiction shareholders and taxpayers may also consider taking action under 1-3 above after a thorough analysis of their facts and circumstances. However, these taxpayers should be prepared to pursue claims in a litigation procedure, because there are no third country cases currently pending at the CJEU to address these specific questions. In this respect, one should also keep in mind that the CJEU may take a more restrictive approach regarding, e.g., the interpretation of the Freedom of Capital Movement doctrine of the EU treaty in third country situations.
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