NEW TAX DECREE CONCERNING INTERPRETATION OF GERMAN SUBSTANCE REQUIREMENTS (ANTI TREATY / DIRECTIVE SHOPPING RULE, SECTION 50D PARA 3 GERMAN INCOME TAX ACT) RELEVANT FOR APPLICATIONS FOR WITHHODLING TAX REFUNDS OR CERTIFICATES CONFIRMING THE EXEMPTION FROM, OR REDUCTION OF, WITHHOLDING TAXES.

As reported in our newsletter dated 18 January 2018 the European Court of Justice held on 20 December 2017 that the anti-treaty shopping rule section 50d para 3 German Income Tax Act (applicable until 2011) is not in line with the EU Parent Subsidiary Directive and the Freedom of Establishment. Meanwhile the Federal Ministry of Finance made a statement as to the application of the anti-avoidance rule in its version applicable until 2011 as well as in its current version.

BACKGROUND

On 20 December 2017 the European Court of Justice ("**ECJ**") concluded that section 50d para 3 German Income Tax Act ("**ITA**") as applicable until 2011 ("**section 50d para 3 ITA 2011**"), which restricted the withholding tax exemption for distributions made by a company resident in Germany to a foreign company, is not in line with the EU Parent Subsidiary Directive and the Freedom of Establishment.

Another case (C-440/17) is currently pending at the ECJ regarding the current version of section 50d para 3 ITA. With effect as of 2012, section 50d para 3 ITA 2011 has been amended and slightly eased by the German legislator.

For details please refer to our newsletter dated 18 January 2018.

NEW TAX DECREE

On 4 April 2018, the Federal Ministry of Finance published a new tax decree concerning an EU-compliant application of section 50d para 3 ITA and section 50d para 3 ITA 2011.

Key issues

- The Federal Ministry of Finance has published a new tax decree dealing with the interpretation of the German substance requirements pursuant to section 50d para 3 German Income Tax Act
- The current version of section 50d para 3 German Income Tax Act must be interpreted in line with the ECJ decision and, therefore, applied restrictively
- In order to assess whether relief from withholding tax exists, the tax authorities shall consider group structure and strategy concepts as acceptable arguments
- The administration of own assets such as shares (holding entities) shall qualify as participating in general economic commerce provided the respective entity actually exercises its shareholder rights
- It shall no longer be required to have own staff on the payroll at any time
- The exemption from, or refund of, German withholding tax shall be denied if, based on the overall evaluation of all the facts and circumstances of the specific case, the non-German EU company (i.e. the applicant) has been included in the holding structure mainly with the intention to obtain a tax advantage

No application of the former anti avoidance tax rule

As regards section 50d para 3 ITA 2011, the new tax decree states that this old rule shall no longer be applied in cases where the recipient of dividends had applied for a withholding tax refund, or for a certificate confirming the exemption from, or reduction of, withholding tax on the basis of the EU Parent Subsidiary Directive (section 43b ITA). Although the law has been changed already some years ago, there are still cases pending for which this would be relevant.

Restrictive application of the current anti avoidance tax rule

Although the ECJ ruled only in relation to section 50d para 3 ITA 2011, the tax authorities have also reviewed and adjusted their interpretation of section 50d para 3 ITA in its current version.

Group Structure and Strategy Concepts

According to 50d para 3 sentence 1 ITA a relief from withholding tax is denied if the foreign company does not take part in general economic commerce with a business establishment suitably equipped for its business purposes and if there are no economic or other substantial reasons for the involvement of the foreign company.

So far, this criteria had to be analysed for each entity on a stand-alone basis as provided for in section 50d para 3 sentence 2 ITA. Pursuant to the new tax decree, sentence 2 shall no longer be applied. As a result, group structure and strategy concepts can now be taken into account as acceptable arguments. For example, prior to the introduction of section 50d para 3 sentence 2 ITA, the Federal Tax Court (*BFH*) had accepted that certain activities of group will be outsourced to special purposes entities for organisational and liability reasons (decision dated 31 May 2005 - I R 74, 88/04).

However, the new tax decree further provides that an absence of "economic or other substantial reasons" shall be deemed if an overall assessment of all the relevant circumstances reveals that the main objective of the involvement of a foreign entity is to achieve tax benefits.

Participation in General Economic Commerce

So far – pursuant to the tax authorities' view – the mere holding and administration of shares did not qualify as participating in general economic commerce, except where the respective holding entity actively managed several subsidiaries. That made it generally impossible for passive holding entities to achieve relief from withholding tax.

Pursuant to the new tax decree, also the mere (passive) administration of subsidiaries shall qualify as taking part in general economic commerce provided, however, the holding entity actually exercises its shareholder rights.

Suitably Equipped Establishment for Business Purpose

Another substantial hurdle for, in particular, holding entities was the requirement to have own staff on the payroll in order to demonstrate the existence of a business establishment suitably equipped for its business purpose. The new tax decree repeals this requirement, i.e. own staff on the payroll should no longer be required.

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Applicability

The new tax decree shall be applied to all pending cases.

BOTTOM LINE

The new tax decree makes it easier, in particular for holding entities, to achieve a withholding tax relief, and it is good to see that the tax authorities also refer to the current version of section 50d para 3 ITA even though the ECJ has so far only ruled in relation to the former version.

However, there are still a number of open questions and the outcome of the pending case concerning the currently applicable version of section 50d para 3 ITA remains to be seen.

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