The Revised German Anti-Treaty Shopping Provisions – A Critical Review

In this article, the authors examine the recently revised German anti-treaty shopping provisions from a practical point of view, with particular emphasis on whether the new legislation is “proportionate” from an EU and a national perspective and whether it breaches international law.

1. Introduction

The German anti-shopping legislation has recently been amended at the “request” of the Commission following the introduction of infringement proceedings against Germany. The new law has effect from 1 January 2012 and tax professionals are trying to decipher what the text actually means for practical purposes.

The Commission appears to be satisfied that its concerns have been met with the amendment to the section in question. However, in the professional world, the question has been (or “is being”) raised as to whether the European Court of Justice (ECJ) and the German national courts will consider the new legislation to be “proportionate” and whether it breaches international law.

2. Background to the Legislation

The original legislation came into force in 1994 and since then has applied to both relief under an applicable tax treaty and under any EU directive. At that time, the government explained in a white paper that the new legislation was not intended as a treaty and/or directive-override, but rather as explanation of the anti-avoidance and/or anti-abuse clause present, whether inherently or in writing, in tax treaties and/or EU directives.

Despite this statement, the legislation has always been vulnerable to the criticism that it constitutes a treaty and/or directive-override. To this can be added that the current amendment is highly restrictive.

3. The Legislation

The legislation states that:

A foreign company has no claim to full or partial relief [from withholding tax], insofar as its shareholders would not be entitled to the refund or exemption, were they to receive the income directly and [insofar as], the gross revenues earned in the relevant financial year do not arise from its own economic activity, as well as:

1. with reference to these revenues there is no economic or other significant reason for interposing the foreign company; or
2. the foreign company does not participate in general commerce through an appropriately equipped business establishment.

(Authors’ unofficial translation)

Before the legislation was enacted, there was considerable confusion as to what it actually meant. In this regard, the German text is neither grammatically correct nor logically intelligible.

Various professional authors have attempted to decipher the meaning of these terms and, while the result of the discussions on the text has been anything but unanimous, there is a more or less universal consensus that the...
new legislation is, except in a small number of cases, more restrictive than the previous legislation if applied literally. What, however, does seem to be apparent is that a too literal interpretation of the legislation would result in unintended results. The law as it currently stands is much too restrictive and cannot reasonably be viewed as an anti-avoidance provision. In this respect, unless the provision is accepted as a treaty and/or directive-override provision, it is clear that the wording should be interpreted in a relatively restricted manner.  

12. There is currently a discussion as to whether or not the numerous German treaty-override provisions violate the German Constitution. See K. Vogel, Völkerrechtliche Verträge und innerstaatliche Gesetzgebung – Eine neue Entscheidung des BVerfG hat Bedeutung auch für die Beurteilung des treaty override, 14 ISR 1, p. 29 (2005); K. Vogel, Einleitung des OECD-MA, Para. 194 et seq. in Doppelbesteuerungsabkommen, 5th ed. (K. Vogel & M. Lehner eds., C.H. Beck 2008); D. Gosch, Über das Treaty Overriding Bestandsaufnahme –V erfassungsrecht – Europarecht, 17 ISR 12, p. 413 et seq. (2008); G. Frotscher, sec. 50d, para. 3 et seq., in EStG, Einkommensteuergesetz, loose-leaf commentary (G. Frotscher ed., Haufe 29 Apr. 2012); and A. Kempf & M. Bandl, Hat Treaty Override in Deutschland eine Zukunft?, 60 DB 25, p. 1377 et seq. (2007). This matter has recently been raised by the Supreme Tax Court (Bundesfinanzhof), and with regard to a specific sub-question, referred to in DE CC, 10 Jan. 2012, 12:05 C.E.T, available at http://juris.bundesfinanzhof.de.
Diagram 1). This interpretation is the authors’ own, based on their reading of the legislation and taking into account both the government’s and the legislator’s repeated assertions that the section is not intended as a treaty-override. The authors share the view that this interpretation is the only one that can be, or, at the very least, should be, generally supported given the background of the legislation’s objective as an anti-avoidance provision.13

With regard to the question of whether or not a particular shareholder would be entitled to relief, the whole scheme would have to be applied to each shareholder.14

5. Interpretation

In an apparent effort to bring some clarity into the issue, the German Federal Finance Ministry has issued an Authoritative Ruling.15 Prior to the release of the ruling, it was generally hoped that the Ministry might interpret the wording in a less restrictive way.

The interpretation has, however, proved to be more restrictive. While the main text of the ruling is generally coherent and consistent with the wording of the law, the practical example of how the tax authorities should apply the law indicates an intention to apply the law in an extremely restrictive manner.

In defining the term “own economic activity” (emphasis added) the Ministry has “raised the bar high” in its Authoritative Ruling. Specifically, it is stated, inter alia, that the interposition of another EU resident company can only be justified here “where the [foreign] company – within the framework of its own business activity – takes part in the local economic life actively and on a stable and continuing basis” (authors’ unofficial translation).16

With regard to the meaning of “participation in general commerce through an appropriately equipped business establishment” (emphasis added) (authors’ unofficial translation), the Ministry requires the existence of suitably qualified personnel, offices and technical communications equipment, so that a “tangible existence” can be established.18

The explanation of these definitions is neither surprising in itself nor are they new. Rather, it is the result of the interpretation of the perceived combination of these terms, which lies at the root of the problem. Accordingly, the real purpose of the section as a whole, based on a comparison of the legislator’s averred purpose and its actual wording, remains questionable.

The interpretation of the main terms in the Ministry’s ruling does not necessarily break new ground.19 What results in genuine consternation is, rather, the apparent way in which the Ministry plans to interpret the law in practice based on the wording of the ruling and specifically the example20 given.

Even where the German-source income that is subject to withholding tax can be allocated to the foreign company’s income from its own economic activity, i.e. to “good income”, full relief is not granted if the foreign company has any “bad income”, such as other dividend or interest income unrelated to its own economic activities. In the view of the tax authorities, relief would only be granted in the proportion that the foreign company’s good income bears to its “bad income”, i.e. pro-rata relief.

If the foreign company has its own business infrastructure and where there are economic or other significant reasons for interposing the company with regard to specific German-source income subject to withholding tax, then, to that extent, such income would also qualify as “good income”. As a result, the pro-rata relief would be increased accordingly.

The authors believe that this interpretation on the part of the tax authorities is over-restrictive and not in line with the objective of the legislation.21

A flow chart based on the Ministry’s interpretation would, therefore, appear to be as set out in Diagram 2.

6. Comment

6.1. Proportionality

In its ruling, the Federal Finance Ministry specifically states that its definition of “own economic activity” as a participation “in the local economic life on an active, stable and continuing basis” is provided against the background of the ECJ’s decision in Cadbury Schweppes (Case C-196/04).22 This reference, in the authors’ opinion, is taken out of context. The ECJ does state that the right

16. Square brackets indicate an explanation and, therefore, an interpretation by the authors.
17. Federal Finance Ministry’s Authoritative Ruling, supra n. 15, at para. 5.1.
18. Id., at para. 7.
21. See Loschelder, supra n. 13, at para. 47, towards the end.
22. UK: ECJ, 12 Sept. 2006, Case C-196/04, Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue, ECJ Case Law IBFD.
to freedom of establishment 23 “is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom” 24 However, the Court made this statement when referring to the objective of the freedom of establishment and not as a minimum requirement.

The ECJ states rather that the restriction on the freedom of establishment can only be justified where its “specific objective” is to “prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality” (emphasis added). 25

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25. Id., at para. 55.
However, if the Ministry’s interpretation is applied, it becomes apparent that relief may be partially withheld, even though the German-source income subject to relief arises from the foreign company’s own economic activity and there is no indication of abuse, merely because the foreign company has “bad income”.

From this, the interpretation of the tax authorities regarding the new legislation is clearly excessive and cannot be justified by the argument that it is intended to prevent treaty abuse.

Another question for consideration is whether Cadbury Schweppes can, in fact, be applied to the interpretation of this section. This issue is untested, however, its basis is that Cadbury Schweppes was not a case about the admissibility of anti-tax avoidance legislation, but, rather, about discrimination. There are certainly arguments for saying the judgement may be relevant to cases involving the Parent-Subsidiary Directive (90/435)26 or the Interest and Royalties Directive (2003/49),27 but can it equally apply to cases involving tax treaties?

6.2. Practicality

Leaving aside the aspect of whether or not the new legislation would be able to withstand scrutiny under either EU or international law, the issue of practicality must also be considered. The schemata shown in Diagram 1 or Diagram 2 are complicated enough in relation to a single tier situation. What, then, if the foreign company in question is a lower tier subsidiary in a large international group? If so, each level of shareholder would have to be scrutinized.

In practical terms, how easy would it be for the foreign company to obtain such detailed information from an indirect minority shareholder?

The wording of the legislation also requires that a comparison is made between the income in the “relevant financial year”. The ruling of the Federal Finance Ministry does provide for a de minimis limit for shareholders with exemptions whereby the foreign company does not have to report the proportion that “good” income bears to total income, provided that any reduction in the relevant proportion is less than 30% of the proportion existing at the time when the exemption certificate was granted.28 In addition, no changes in shareholders would have to be reported, provided that any changes in, both direct and indirect, shareholdings were less than 20%.

However, this does not really reduce the burden on the foreign company, as it would still have to ensure that the de minimis levels were not exceeded each year, and this all the way up the chain.

Furthermore, the de minimis rule may leave the foreign company in a somewhat uncertain position. For instance, what is the position in a tax audit, say, four years down the line? If a certificate of exemption from German withholding tax is available, the German company is not liable for the withholding tax that it should have withheld (the taxpayer being the foreign company). If during the tax audit, it becomes evident that there has been a change of, say, 29% in the proportion of “good” to “bad” income with regard to the foreign company, can the foreign company rather than the German company be held liable for any shortfall in tax?

Moreover, the timing of the assessment at the level of entitlement is also complicated. Where the applicant is applying for a refund, the financial year in which the payment was received becomes the relevant date for assessing the proportion of “good” income to “bad”. In contrast, where an exemption is being applied for, the relevant financial year for the assessment of the proportion of “good” income to “bad” is the year of the application. Where no financial statements are available for the relevant year, the relevant financial year is the previous financial year. In the latter situation, it is open to the foreign company to apply the ratio of the income of the relevant year where the financial statements of the year of application subsequently prove to give a more advantageous proportion.

It is correct to say that the burden of proof lies with the taxpayer. However, the tax authorities must check the information. This is potentially an enormous administrative burden and would probably only result in extensive delays in the processing of applications.

Lastly, it is debatable as to whether or not legislation can be executed in a uniform, consistent and equitable manner. If such uniformity of treatment cannot be ensured, the question as to the constitutionality of the legislation would, therefore, also arise.29

6.3. Discrimination

Finally, another issue that should be addressed is the significant additional burdens, both evidential and financial, that a foreign company receiving German dividend income would have in contrast to a German-resident company.

In a recent decision (Commission v. Germany (Case C-284/09)),30 the ECJ held that Germany’s participation exemption on dividends paid by German-resident companies to their German-resident corporate shareholders and the entitlement of the German-resident corporate shareholders to set off the withholding tax against the corporate income tax charged on their other income was in breach of article 63 of the Treaty on the Functioning of the European Union.


ing of the European Union (TFEU) (2007) (previously, article 56 of the EC Treaty) and article 40 of the Agreement on the European Economic Area, i.e. the free movement of capital.

Under the German rules, 95% of dividend income received by a German corporate shareholder from a German-resident company is generally exempt from corporate income tax in the hands of the recipient company. The recipient company may also apply for a set-off of the tax withheld by the distributing company against other income tax in its annual tax declarations.

7. Conclusions

The authors’ conclusions regarding the issues considered in this article can be summarized as follows:

– Undoubtedly the biggest loser from this new legislation is the taxpayer. It is possible to think of numerous other examples where no intention to evade tax exists, but where companies will find their relief restricted or even refused. For instance, consider foreign companies that have chosen to invest their business profits, for example, in interest-bearing accounts, rather than distribute. Such companies would find themselves only entitled to partial relief. Even supposing full relief were granted, the price is an excessively onerous administrative burden on the taxpayer.

– The tax authorities will also pay a price with the very significant additional administrative burden it has imposed on itself.

– Lastly, in view of the over extensive ruling of the tax authorities, it is likely that the final interpretation of the legislation will have to be made by the German tax courts, or even by the ECJ or the German Constitutional Court. Consequently, the judicial system will also suffer from the legislation.

Perhaps, however, in conclusion, one final thought should be given to the other potential loser in this saga, i.e. the prized doctrine of legal certainty.
