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Cross-Border Profit Distribution of German Corporations

In two cases decided in December 2017, the European Court of Justice (ECJ) ruled that the German anti-treaty shopping rules violate European Union (EU) law.

In April 2018, the German Federal Ministry of Finance reacted and implemented the ruling of the court. The ruling has an impact on profit distributions of German corporations to foreign parent companies located in another EU country or within the scope of a directive.

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Treaty Shopping and Anti-Treaty Shopping Rules

The term "treaty shopping" (or directive shopping) originates from United States treaty law. It refers to tax structures implemented to benefit from tax relief under a treaty or benefits provided by a directive. The term "anti-treaty shopping rules" refers to national provisions by which the legislator seeks to avoid abusive treaty shopping.

Treaty shopping is particularly important in the context of reducing withholding tax. A taxpayer, who is not covered by the treaty, uses a corporation covered by the treaty and establishes it as an intermediate company. Foreign income goes directly to that intermediate company and only indirectly to the taxpayer not covered by the treaty. In this way, the taxpayer can benefit from the advantages granted by a double taxation treaty or a directive.

By Way of Illustration: German Company with a Foreign Parent

A German corporation distributes profits to its foreign parent. The domicile of that foreign parent is selected in a country where it profits from the advantages granted by a double taxation treaty and/or a directive. In this case, distributions by the German subsidiary to its parent are, in principle, exempted from capital gains tax. The shares in the foreign holding company are held by an individual not entitled to benefit from the advantages granted by the double taxation treaty or the directive. In the cases the ECJ had to decide in December 2017, the shares were held by individual residents in Germany and/or Singapore.

In the past, the German legislature has tried to prevent this practice.

According to the pertaining national legislation, the tax exemption and/or tax relief is therefore prohibited in case of abusive or merely artificial structures. This is aimed at preventing the abusive interposition of a foreign parent company. If the conditions of the respective national legislation are met, no relief from capital gains tax will be granted where the foreign parent's shareholders would not be entitled to similar benefits if they received the income directly.

ECJ Rules that German Anti-Treaty Shopping Rules Breach Union Law

These national rules of German tax law breach Union law, according to the ECJ ruling in the above referenced cases. However, said ruling was issued with respect to the previous national rules applying only to pre-2012 cases. The rules were revised effective January 1, 2012. A new case is presently pending before the ECJ for a ruling on the current version of the rules (Case number C 440/17).

Whether the ECJ will also overturn the current rules is still open. The judgment in this case is expected to be given in the near future. There is reason to assume that these rules will equally fail to meet the court's requirements and that the ECJ will find the rules inconsistent with EU law.

Breach of Parent-Subsidiary Directive of the EU Council of Ministers

The Parent-Subsidiary Directive was adopted in 1990 by the EU Council

of Ministers. It governs the taxation of profit distributions between companies of different EU member states. Its aim: removing multiple taxation of dividend distributions between related companies based in different EU member states. This is intended to help companies operate effectively within the EU.

Therefore, the directive abolishes withholding tax on distributions from a subsidiary based in one member state to its parent based in a different member state. The member states are permitted to establish national exceptions to this directive to prevent tax evasion and abuses. However, the respective rules must be proportionate and suitable to avoid tax evasion and abuses. The German rules did not meet these requirements. As a consequence, the court ruled that the German rules were incompatible with the Parent-Subsidiary Directive.

Restriction of Freedom of Establishment

The German rules also violate the freedom of establishment. The ECJ affirms an unequal treatment between a non-resident and a resident parent with respect to distributions from subsidiaries: Only in the first case (resident subsidiary distributes profits to non-resident parent) is the exemption from withholding tax dependent on additional requirements set out by national rules. According to the ECJ, this unequal treatment may, in principle, prevent a non-resident parent from operating through a subsidiary based in Germany. This entails a restriction of the freedom of establishment.

The Federal Republic of Germany asserted that this restriction of the freedom of establishment was justified. It was aimed at combatting tax evasion and circumvention and resulted in balanced allocation of the power of taxation between the EU member states. The ECJ did not accept this reasoning and criticized the specific provisions of the national legislation.

Federal Ministry of Finance Implements ECJ Ruling

In April 2018, the German Federal Ministry of Finance reacted to the ECJ judgment. Now, the following applies:

- The rules criticized by the court are no longer applied to pending cases involving applications for a refund or exemption from capital gains tax.
- For the time being, the current follow-up rules remain applicable with certain limitations.

Recommendation: Keep Rejection Decisions Against Refund of Withholding Tax Open

Applications for refunds or exemptions need to be newly evaluated against the background of the ECJ ruling and the reaction by the German Federal Ministry of Finance.

With respect to applications for refunds of, or exemptions from, withholding tax under the former legal situation (i.e., as of the 2007 assessment period), the following applies: To the extent that proceedings are still pending, a refund of withholding tax should be applied for. The Federal Central Tax Office will no longer reject such applications by making reference to the national anti-abuse provisions.

Concerning the respective applications as of the 2012 assessment period, the following applies: Until the ECJ ruling, rejection decisions against the refund of withholding tax should be challenged and kept open. P