be informed:

Refusal to refund withholding tax on dividends – current version of Section 50d (3) of the German Income Tax Act also violates European Law

July 25, 2018

Only half a year after the 2007 version of Section 50d (3) of the German Income Tax Act was declared as unlawful by the European Court of Justice (see our **beinformed** dated February 14, 2018), the current version has also suffered the same fate. As an anti-treaty-shopping rule, Section 50d (3) German Income Tax Act prevents, under certain conditions, exemptions or refunds of withholding taxes on dividends paid by German subsidiaries to their European parent companies. The European Court of Justice already decided on December 20, 2017, that the 2007 version of the Section 50d (3) German Income Tax Act violates both the Parent-Subsidiary Directive and the freedom of establishment (joint cases C 504/16 "Deister Holding" and C 613/16 "Juhler Holding"). On June 14, 2018, the European Court of Justice reached the same conclusion (C 440/17) with regard to the provision's current version.

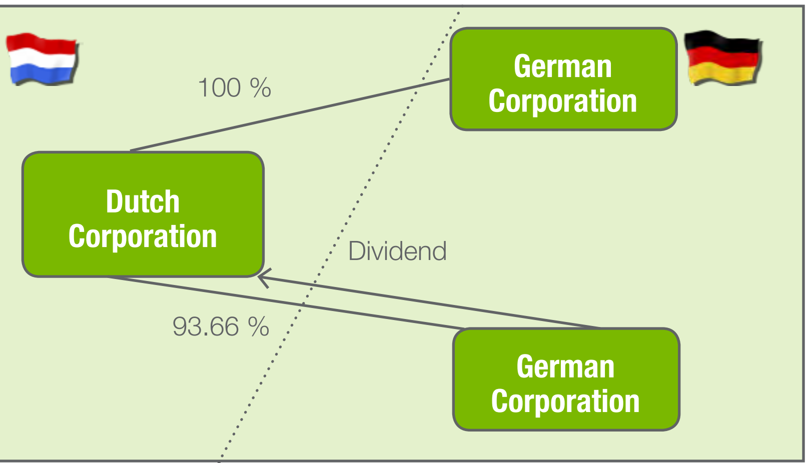
The current version of Section 50d (3) German Income Tax Act denies an exemption or a refund of withholding taxes on dividends paid by German subsidiaries to their European parent companies if the shareholder of the European parent companies would itself not be eligible for the exemption upon direct receipt of the dividend and if the European parent companies do not earn income from their own economic activities. Furthermore, there either has to be no economic or other substantial reasons for using the European parent company or the European parent company does not take part in general economic commerce with a business establishment suitably equipped for its business purpose. In this respect, Section 50d (3) German Income Tax Act explicitly provides that a mere holding activity will not be regarded as an "own economic activity". In addition, the organizational, economic or other substantial features of undertakings that are affiliated with the European parent company will not be considered when determining whether there is tax abuse or not. In view of all of these preconditions, the current provision of Section 50d (3) German Income Tax Act is in its general structure comparable to the provision which was valid until 2011 and which was declared to be in violation of European law by the European Court of Justice in late December 2017.

Documents to beinformed:

- EuGH C 440/17 (German)
- beinformed of February 14, 2018
- beinformed of April 17, 2018

The facts of the case before the European Court of Justice on the current version of Section 50d (3) German Income Tax Act was as follows: A Dutch parent company held 93.66 per cent of the shares of a German subsidiary and was itself a wholly-owned subsidiary of another German corporation. The German subsidiary distributed a dividend to the Dutch parent company and withheld a tax and solidarity surcharge. Normally, under Section 50d (1) German Income Tax Act (in connection with

Section 43b German Income Tax Act, which implements the Parent-Subsidiary Directive into German law), the German fiscal authorities would refund the withheld tax to the foreign corporation. However, the German authorities denied this refund because they argued that the Dutch parent company would not have an own economic activity, even though, in addition to its holding activity, it was also active in financing and in sourcing of raw materials for affiliated companies. An appeal against this refusal by the Dutch parent company was denied by the German fiscal authorities.



As the basic structure of the current version of Section 50d (3) German Income Tax Act does not differ fundamentally from the previous version, it is not surprising that the new ruling of the European Courts of Justice follows the previous ruling of December 2017, which declared that the previous version violates European law, very closely. The rule that EU member states cannot unilaterally introduce restrictive measures and subject the right to exemption from withholding tax to various conditions still applies. Member states are only permitted to impose provisions required for the prevention of fraud and abuse. However, these provisions must be appropriate for attaining said objective and must not go beyond what is necessary to attain it. In this context, the European Court of Justice decided that the use of a foreign parent company, the mere purpose of which is managing the assets of its subsidiary, would trigger Section 50d (3) German Income Tax Act as the parent company meets its preconditions but as such cannot be regarded as an abusive measure. This illustrates that the preconditions set out it in Section 50d (3) German Income Tax Act constitute a general presumption of fraud or abuse and thus undermine the Parent-Subsidiary Directive's objective of preventing double taxation of dividends distributed by a resident subsidiary to its non-resident parent company. In contrast thereto, the determination of an abusive measure requires, on a case-by-case basis, an overall assessment of the relevant situation, based on factors, including the organizational, economic or other substantial features of the group of companies to which the parent company in question belongs, and the structures and strategies of that group. This, however, is explicitly prohibited by Section 50d (3) German Income Tax Act as the features of affiliated companies have to be neglected when making a determination thereunder. Furthermore, according to the opinion of the European Courts of Justice, Section 50d (3) German Income Tax Act does not allow counterarguments and supporting evidence to be provided by the affected corporations. In summary, the current version of Section 50d (3) German Income Tax Act violates the Parent-Subsidiary Directive. As the aforementioned reasons are also applicable to the freedom of establishment, Section 50d (3) German Income Tax Act also violates the freedom of establishment.

The decision of the European Courts of Justice is not surprising to many observers and probably also not to the Federal Ministry of Finance in Germany as it was widely anticipated that the current provision will also fail to satisfy European law. As a result, the Federal Ministry of Finance published a circular in April 2018 announcing that the previous provision will no longer apply and also relaxing the preconditions of the current provision that need to be met in order to qualify for a tax exemption on dividends (see our **beinformed** dated April 17, 2018). Even though, in our opinion, the circular is remarkable on several points (for instance, the confirmation that holding activity can be regarded as an "own economic activity" or the fact that the neglect of the features of affiliated companies will no longer be applied), an administrative regulation by the German fiscal authorities cannot remedy the fact that the provision violates European law. According to reports, the German Federal Ministry of

Finance is well aware of this and is currently working on a new draft of Section 50d (3) German Income Tax Act. In the meantime, we recommend that taxpayers, who are affected by Section 50d (3) German Income Tax Act, file appeals against denials of refunds of withholding taxes in view of the new ruling by the European Court of Justice.

Finally, we would like to point that, in our opinion, the scope of the decision of the European Court of Justice is not limited to the facts of the case presented. This opinion is based on two reasons. Firstly, Section 50d (3) German Income Tax Act is an anti-treaty-shopping provision not only in connection with the Parent-Subsidiary Directive but also in connection with the Interest and Royalties Directive (Section 50g German Income Tax Act) as well as in connection with double tax treaties. Secondly, the European Courts of Justice argued in both of the aforementioned rulings that not only is the Parent-Subsidiary Directive violated by Section 50d (3) German Income Tax Act, but the freedom of establishment, and potentially the free movement of capital, are also violated. As a result, this could open a possibility for taxpayers to appeal refusals of withholding tax refunds pursuant to Section 50d (3) German Income Tax Act that are not in connection with the Parent-Subsidiary Directive. One example could be the refusal of a withholding tax refund based on lower double tax treaty rates to parent companies in third countries as the free movement of capital could be violated in this case.

be in touch: Any questions? Please do not hesitate to contact us!

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