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tax notes international

Volume 46, Number 4 ■ April 23, 2007

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by Wolfgang Kessler and Rolf Eicke

Reprinted from *Tax Notes Int'l*, April 23, 2007, p. 377

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Germany: Treaty Shop Until You Drop

by Wolfgang Kessler and Rolf Eicke

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Being freshmen in this club of *TNI* correspondents, we promise not to squander readers' precious time. Instead, we are dedicated to presenting topics that make our columns worthwhile reading. Our focus will be on European and international tax law issues analyzed from a German perspective, yet presented in a very non-German manner — with irony and humor.

Fortunately, there will be no shortage of interesting topics, since German international tax law is changing at an unprecedented pace. The impact of these developments is relevant for any multinational corporation doing business in Germany. Major themes are the 2007 tax act (*Jahressteuergesetz* 2007), the SEStEG regime that reforms the rules on corporate reorganizations, and the 2008 tax reform. This article discusses the new anti-treaty-shopping provision in section 50(d)(3) of the Income Tax Act.

Treaty Shopping as Tax Planning

In general, shopping tends to make consumers happy. Treaty shopping tends to make taxpayers happy, until they trigger the German anti-treaty-shopping provision. To make it clear: Treaty shopping, in itself, is not a bad thing; it is an important and often-used legal tool in international tax planning.

Treaty shopping implies the selection of the most tax-favorable dividend route to repatriate profits. In the wake of the parent-subsidiary directive, treaty and directive shopping has become a popular tool for U.S. investors in Europe because direct profit distributions to U.S. parent companies are often not the best choice, either due to a withholding tax that leads to excess tax credits, or because of requirements concerning the holding period. In practice, powerful databases, such as COMTAX, are used as treaty-shopping tools to help find the most tax-effective route to repatriate profits. The continuous update of tax rates, such as the withholding tax rates, constitutes the basis for secure tax planning.

Nonetheless, treaty shopping sometimes merely breaches the spirit of the law, rather than a specific provision, as long as the holding company has some assets, such as staff and equipment. Similar to forum shopping, this opportunity is not offered by chance, but by a strict application of the law. Furthermore, if viewed from a more positive angle, treaty shopping, understood as location shopping, is part of the full deployment of the fundamental freedoms within the European Union. Nevertheless, it cannot be readily assumed that it is permitted by the European Union or the United States. Tax jurisdictions can restrict treaty benefits to persons that do not possess a genuine link to one or both of the treaty partners, either through anti-treaty-shopping rules on a unilateral level or limitation on benefits clauses in a double tax treaty context. The United States is a leader in setting policies to prevent treaty shopping, not only in substantive treaty provisions but also in domestic law.

Some observers think that, in light of the potential scope of the freedom of establishment and freedom of capital movement, treaty shopping makes the internal market a fiscal paradise for aggressive tax planning. Whether anti-treaty-shopping and anti-avoidance rules are in accordance with EC law is an ongoing debate. The new German anti-treaty-shopping rule is about to cause a moment of truth regarding the conformity of EC law with unilateral anti-treaty-shopping provisions.

The Noose Tightens

Up until January 1, 2007, triggering the German anti-treaty-shopping provision in section 50(d)(3) ITA, and thereby losing all tax benefits arising out of either EC law, particularly the parent-subsidiary directive, or out of a double tax treaty, was difficult to do. Last year we described the history of the German antiavoidance legislation. (See "Closer to Haven? New German Planning Opportunities," *Tax Notes Int'l*, May 8, 2006, p. 501.) Under the old regime, the odds were only bad for those who owned a letterbox company in the Netherlands, Luxembourg, Switzerland, Ireland, or Bermuda. Today, owners of a letterbox company abroad who intend to claim directive or treaty benefits better think twice, as their chances are so bad that not even a British

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bookmaker would offer a quote. In a nutshell, the provision has been tightened in a way that effectively excludes foreign letterbox companies from any benefits at all.

However, this is nothing new. When you examine the nature of antiavoidance legislation, you often find that it can have a boomerang effect; as Trevor Johnson put it, "[t]he problem with antiavoidance legislation is that it must be drafted widely enough to combat the ingenuity of the tax avoider and yet not cause any unintended casualties." (See *Tax Notes Int'l*, Jan. 8, 2007, p. 45.)

> ***German lawmakers, as advised by the German tax authorities, have enacted a provision that could best be described as 'anti-treaty-shopping overkill.'***

And that's exactly what has happened. German lawmakers, as advised by the German tax authorities, have enacted a provision that could best be described as "anti-treaty-shopping overkill." Under the new criteria, companies *other* than purely foreign letterbox companies are in danger of sharing the same fate. Notwithstanding that the legislation and the tax authorities established a "no management holding company left behind" theme, such holding companies might be deprived of treaty benefits as well. Even if the management holding company can provide economic or other relevant reasons for its existence (business purpose test), and even if the company is substantial due to an adequate infrastructure and the employment of qualified and skilled personnel (substance test), the chances of a reimbursement of withholding taxes will be slight if such companies fail to conquer the final hurdle: The holding company has to prove that it generates more than 10 percent of its gross receipts with own business activities (10 percent gross receipts test).

In practice, there has been a lot of legal uncertainty about this requirement. Thanks to the circular of the German Federal Tax Office, some clarity has been brought into the debate. (For prior coverage, see *Tax Notes Int'l,* Feb. 12, 2007, p. 552.) Even though the circular does not have the force of law, it is useful in determining administrative practice.

The circular provides that dividend income from *managed* subsidiaries qualifies for the 10 percent gross receipt test. A subsidiary is managed if the holding company performs long-term, principal, and meaningful "leadership decision-making" in respect to the lower-tier entities. Routine decisions or individual business functions, such as license management, are not sufficient. At first glance, this seems acceptable; however, upon closer examination, two things become apparent.

'Safe Haven' for Switzerland

First, whether the requirements comply with the nature of today's holding activities is open to debate. The reality in groups of companies is that management decisions are decentralized. Thus, it is difficult to prove long-term, principal, and meaningful "leadership decision-making" for the lower-tier entities.

Second, performing "leadership decision-making" and thus complying with the German anti-treaty-shopping rule might very well deprive the holding company of so-called holding privileges in holding regimes like Switzerland. Under some conditions, the Swiss holding regime exempts dividend income from taxation if its main purpose is to simply hold participations. At first glance, that sounds like a "privilege" and even the Swiss themselves call it a "holding privilege." In fact, it is not. The Swiss holding regime merely protects companies from one of the biggest threats to trade and commerce: double taxation. It creates economic distortions and infringes on the principle of neutrality of taxation. Double taxation is often unavoidable in a cross-border trade context due to the interplay of (foreign) corporate taxes imposed on the subsidiary, and (foreign) withholding taxes and corporate taxes that are imposed on the parent company. By exempting dividend income from lower-tier entities, the Swiss holding regime simply creates multiple layers of taxation of corporate profits and helps to comply with the principle of neutrality of taxation.

Yet, in a Swiss-German holding structure, the problem is that the Swiss holding company has to confine itself to its holding function, which now constitutes a conflict with the new German requirement of active "leadership decision-making." However, we contend that there is a double-taxation-avoiding *safe haven*. As an exception, the Swiss holding regime permits the performance of sideline activities if they effectively support and promote the primary holding function. Therefore, groupwide corporate services for participations *outside* Switzerland are permitted, provided that the purpose of these activities is the functional and successful management of the participations.

A circular of the Zurich tax office states that the following activities are permitted:

- management of the holding company, own accounting, and activities that are derived from the shareholder position of the holding company (administrative functions and participation at shareholder meetings);
- auxiliary functions like typical corporate services (provision of a central management and reporting system for the group organization, legal and tax consulting for the group, human resource consulting for the executive management, group finance); and

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- leading subsidiaries if this activity is minor compared with the holding function.

In a nutshell, the concern that due to the tightening of the German anti-treaty-shopping provisions, German-Swiss holding structures will become a road less traveled turns out to be partly unfounded. This is because there is a tax planning, double-taxation-avoiding safe haven for those Swiss holding companies that have an adequate infrastructure and perform long-term, participation-related corporate service activities for non-Swiss participations. Within this safe haven, a holding company can benefit from the Swiss holding regime and from withholding tax exemption (or reduction) in Germany. However, pure Swiss finance holding companies that neither have qualified personnel nor significantly perform group services will trigger the German anti-treaty-shopping rule and will not be exempted from withholding taxes.

But this is not the end of the story. Even if the taxpayer manages to sail into the proposed double-tax-avoiding safe haven, there is another tax planning risk associated with the Swiss holding regime. According to the European Commission, the Swiss holding regime "has proved to be a formidable incentive for the headquarters, coordination and distribution centers of multinationals to be based in Cantons such as Zug and Schwyz, in order to minimize their tax liabilities." But since the underlying profits are almost completely earned in the European Union, the European Commission alleges that trade between the EU and Switzerland has become distorted. Therefore, the European Commission has been targeting this regime on the basis that it is incompatible with state aid regulations and infringes on the 1972 agreement between the EU and Switzerland. Switzerland rebuts these allegations, claiming that there is no contractual basis for any infringement. As a non-EU member state, it is not subject to the restrictive EC state aid regime. In fact, the legal grounds for the allegations against Switzerland are weak. The European Union could learn a lot from Switzerland about how tax competition works, but instead the European Commission chooses to vigorously fight a regime that is a very important home for many multinational corporations. In turn, holding companies have become an important source of revenue for the Swiss government. As many as 20,000 holding companies are located in Switzerland, and they pay approximately CHF 3 billion in federal taxes, or 5.5 percent of the federal budget each year. These facts make it hard to believe that the Swiss government will give in easily in the battle with the European Commission.

EC Conformity and Counterevidence

Having circumvented the Swiss holding issue, the tax planner finds himself in yet more trouble: the absence of any chance to provide counterevidence in the new German anti-treaty-shopping rule. In its *Cadbury Schweppes* judgment, the European Court of Justice pointed out that an antiabuse provision that applies objective factors to typify an abuse must be accompanied by a right to provide for counterevidence. (For the judgment, see *2006 WTD 177-8* or *Doc 2006-19082*.) It must give taxpayers the opportunity to demonstrate that, despite the existence of tax motives, the arrangement is not "wholly artificial," but instead based on genuine economic activities.

> ***The European Union could learn a lot from Switzerland about how tax competition works.***

The German tax authorities are very well aware of the ECJ's strong position on this matter, but they have refused to include a right to provide counterevidence in the circular. Knowing that the rule, as well as the circular, disregards any organizational or other economic concerns of the entire group as a reason for such an arrangement, you don't need a fortune-teller to predict what kind of companies are going to be trapped in the future: any holding company that acts on the basis of organizational or economic group reasons, but fails for some reason to satisfy at least one of the three tests. In breach of EC law, the German anti-treaty-shopping rule does not accept any proof rendered to show that the use of the holding company is not part of a "wholly artificial arrangement." Accordingly, many holding companies will be deprived of the withholding tax reimbursement even though their operation is not based on any abusive grounds. Needless to say, this wait-and-see mentality of the German tax authorities results in a serious lack of certainty for multinational companies that do business in Germany.

So what can the German legislature do to get out of the EC law infringement zone? First, it must acknowledge the existence of group-related factors for using a holding company; second, it must enact a right to provide counterevidence; and finally, it must deem the three tests to be cumulative, rather than alternative, thus only triggering the anti-treaty-shopping rules when all tests fail.

What's Next?

How to advise a company that is in danger of triggering the new German anti-treaty-shopping provision? First, be aware that the German tax authorities will enforce the new provision with all measures they have at their disposal. If your client receives an advance exemption certificate and it's uncertain whether it might fail one of the three

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Holding Regime (CH) Applies, but German Section 50d (3) ITA Triggered	Double Taxation-Avoiding Safe Haven = Holding Regime (CH) Applies and Withholding Tax Reimbursement (No Section 50d (3) ITA)	No Holding Regime (CH), but Withholding Tax Reimbursement (No Section 50d (3) ITA)
Exclusive managing of participations and no commercial activities in Switzerland	Problem: Incongruity between the Swiss requirement of an "allowed support activity" and the German condition of an "own business activity." Possible Safe Haven: "Leadership decision-making" (corporate services) for participations outside of Switzerland permitted, if the purpose of these activities is the functional and successful management of the foreign participations. Important: Clarification of the legal situation with advanced rulings ("*verbindlichen Auskunft*") in Germany and Switzerland.	"Leadership decision-making" in respect to the lower-tier entities that is long-term, principal, and meaningful for these subsidiaries and that is performed on the Swiss commercial market.
Pure finance holding		
Routine decisions		
(Minor) royalties management		
Short-term and task-driven activities, if they are connected with the participation		
Outsourcing		

tests, inform the tax authorities. At the same time, check if the intermediate holding company employs skilled personnel that perform groupwide corporate services.

Second, if the risk profile of your client allows it, you might want to take a gamble and rely on the less restrictive general antiabuse rule in section 42 General Tax Code (GTC). In the event that the ECJ finds that the tightened anti-treaty-shopping provision does not comply with EC law, only section 42 GTC will be relevant for all tax cases since 2007.

And finally, watch out for the next major treaty-shopping decision of the German Federal Tax Court (Bundesfinanzhof). It will be interesting to see if in the "Luxembourg Holding" case the court upholds its recent liberal and taxpayer-friendly interpretation of the former version of section 50(d)(3) ITA. Hopefully, the court will refer the case to the ECJ to find out whether or not it complies with EC law. Either way, this issue remains anything but boring. ◆

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