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BRIEFING

GERMAN TRADE TAX ON NON-EU  
DIVIDENDS BREACHES EU LAW  
OCTOBER 2018

- REDUCED REQUIREMENTS TO BENEFIT FROM DOMESTIC EXEMPTION FROM GERMAN TRADE TAX FOR NON-EU DIVIDENDS
- RESPECTIVE TAX ASSESSMENTS SHOULD BE HELD OPEN AND (RETAINED) PROFITS OF NON-EU SUBSIDIARIES CAN BE DISTRIBUTED



The European Court of Justice (“ECJ”) has held that the conditions for the German trade tax domestic exemption rule for dividends from non-EU subsidiaries to German shareholders is in breach of EU law (C-685/16 - *EV./Finanzamt Lippstadt*). The requirements for these non-EU dividends must be reduced to match the more relaxed requirements for domestic dividends.

German companies who have received dividends from non-EU shareholdings should review their trade tax positions on dividend receipts and contemplate distributions of previously retained profits.

“THE GERMAN LOWER TAX COURT OF MUNSTER HAD DOUBTS THAT THE DOMESTIC EXEMPTION RULE MIGHT BE IN BREACH OF EU LAW AND SUBMITTED THIS QUESTION TO THE ECJ.”

**Court Case and Background**

A German corporation (in the legal form of a GmbH) being in a German income tax group received a dividend distribution from an Australian limited liability corporation. The dividend distribution consisted of funds from a dividend paid to the Australian company from a Philippine subsidiary and profits carried forward. The responsible German tax authority treated the dividend distribution as being subject to German trade tax since the preconditions of the domestic exemption rule (sec. 9 no. 7 German Trade Tax Act) could not be fulfilled. This was because neither the income of the distributing Australian entity was treated as so called “active income” nor was the Australian entity qualified as a so-called “regional holding” or “functional holding” for the purposes of the trade tax exemption.

The German lower tax court of Munster considered that the domestic exemption rule might be in breach of EU law and submitted this question to the ECJ (on 20 September 2016 – 9 K 3911/13 F).

### Domestic Exemption Rule for Non-EU Dividends

Dividend distributions from non-EU corporations are exempt from German trade tax, provided that:

- (i) the German shareholder holds at least 15% in the non-EU subsidiary for an uninterrupted period since the beginning of the tax year (regularly 1 January) in which the dividend is distributed; and
- (ii) the non-EU subsidiary derives almost exclusively income from so called “active” activities as set out under sec. 8 par. 1 no. 1 to 6 German Foreign Tax Act (generally relevant for the German CFC-rules).

“Active income” is generally income derived from agriculture, forestry, manufacturing, the operation of banks and insurance companies, trade, services and rental. Further, “active income” is usually maintained by a business organisation that is equipped in a commercial manner for such activity and participates in general commerce without detrimental involvement of the German taxpayer or a related person. If trade, service or rental is concerned, the “active” or “passive” qualification depends on the set-up. Typical passive income (which is detrimental in light of the requirements to benefit from the domestic exemption rule) is generally derived from activities which can easily be transferred, such as financial and license activities.

If the non-EU subsidiary’s income consists of dividend income, the exemption rule applies if the non-EU subsidiary holds at least 25% in the lower tier company for a period of at least 12 months before the financial year ending (minimum holding period) and it can be proven that the non-EU subsidiary qualifies as a so-called “regional holding company” or “functional holding company” (in which the lower-tier subsidiary derives almost exclusively active income as set out under sec. 8 par. 1 no. 1 to 6 German Foreign Tax Act).

### Decision of the ECJ

The ECJ decided on 20 September 2018 (C-685/16) that the mismatch of requirements between the domestic exemption rule for domestic dividends and the stricter domestic exemption rule for dividends from non-EU corporations violates the free movement of capital and is, therefore, a breach of EU law.

To exempt domestic dividend distributions from German trade tax, the minimum shareholding of 15% has to be fulfilled on the day of the beginning of the tax year (regularly 1 January) in which the dividend is distributed. In contrast to such domestic dividend requirements the exemption rule for non-EU dividend distributions is more strict, as the minimum shareholding (of 15%) has to be fulfilled for a certain period of time and the distributing non-EU subsidiary must either qualify as regional holding or functional holding company or derive almost exclusively active income (as referred to above).

“THE ECJ DECIDED THAT THE DOMESTIC EXEMPTION RULE FOR DIVIDENDS FROM NON-EU CORPORATIONS VIOLATES THE FREE MOVEMENT OF CAPITAL AND IS, THEREFORE, A BREACH AGAINST EU LAW. THE STRICTER REQUIREMENTS OF THE DOMESTIC EXEMPTION RULE FOR NON-EU DIVIDENDS CANNOT BE JUSTIFIED WITH THE AIM TO AVOID ABUSE.”

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The stricter requirements of the domestic exemption rule for non-EU dividends in comparison to the domestic exemption rule for domestic dividends cannot be justified with the aim to avoid abuse. The ECJ supports this position by identifying that the rule does not require the possibility of proving that no abuse is concerned with the structural set-up. Furthermore, the stricter requirements of this rule cannot be accepted due to the so-called stand-still clause of EU law. The stand-still clause would apply if the domestic rule is applicable for direct investments and has in its principal form been in place for an uninterrupted period since 31 December 1993 or earlier.

With the assistance of the decision of the ECJ, the lower tax court of Munster will have to decide the respective court case.

#### **Actions**

Following this decision of the ECJ, the domestic exemption rule should be amended to be in line with EU law. Until this has happened, any affected German taxpayer should be able to rely on this ECJ decision.

In circumstances where the responsible German tax authority treats non-EU dividend distributions as taxable for German trade tax, it should be checked whether such dividend distributions fulfil the requirements of the exemption rule for domestic dividend distributions (i.e. minimum shareholding of 15% at the beginning of the tax year; lower requirements). If so, objection against the respective tax assessments should be filed or such tax assessments should be held open, with reference to this ECJ decision.

The same is true for non-assessed future cases. Non-EU dividends should be treated as being exempt from German trade tax under the domestic exemption rule, provided that the minimum shareholding of 15% at the beginning of the tax year is fulfilled. It might be considered to distribute (retained) profits with reference to the ECJ decision.

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## FOR MORE INFORMATION

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Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.



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