On November 25, 2011, the German Federal Council has passed an important amendment of the German anti-treaty-shopping rule (the "Amendment"). The Amendment is Germany’s response to the infringement procedure initiated by the European Commission against Germany. The revised anti-treaty-shopping rule no longer requires that a non-German resident company generates more than 10% of its gross revenues through its own business activities.

Background
Dividends paid by German resident corporations are subject to an effective withholding tax and solidarity surcharge at a combined rate of 26.375%. Subject to certain restrictions, non-German resident companies holding shares in German resident corporations are entitled to a reduction of, or a full exemption from, withholding tax under German domestic law, an applicable double tax treaty or the EU Parent-Subsidiary Directive dated July 23, 1990, as amended (together, the "Tax Benefits").

If and to the extent a non-German resident holding company is held by shareholders who would not be entitled to Tax Benefits had they directly received the dividends, Tax Benefits are currently only granted if all of the following three requirements are fulfilled:

- there are economic or other substantial reasons for the interposition of the holding company;
- the holding company generates more than 10% of its gross revenues through its own business activities (the "10%-Revenue-Test"); and
- the holding company has adequate business operations for its business purpose and participates in general commerce.

Modifications of the German Anti-Treaty-Shopping Rule
The rigid 10%-Revenue-Test will be abolished. Based on the wording of the Amendment, a non-German resident holding company will be entitled to Tax Benefits, if and to the extent the relevant income results from its own active business activities (the "Active Income Test"). This may include the case of dividends received from a corporation that the holding company actively manages. Such dividends currently are considered active business income by the German tax authorities.

In our view, a non-German resident holding company also will be entitled to Tax Benefits if it establishes that (i) there are economic or other substantial reasons for the interposition of the holding company in relation to the relevant income, and (ii) the holding company has adequate business operations for its business purpose and participates in general commerce.
Under the Substance Test, even non-active income should be eligible for Tax Benefits if the required substance is given. Both the wording of the Amendment and EU laws suggest that the Active Income Test and the Substance Test are separate and independent alternative grounds on which the entitlement to Tax Benefits can be based. However, the Amendment is susceptible to multiple interpretations and the German tax authorities may take a different view.

Subject to the proclamation by the Federal President, the Amendment will become effective as of January 1, 2012. However, the Amendment may also be relevant in relation to income (including dividends) received before January 1, 2012.

Significance

It remains to be seen whether the amended German anti-treaty-shopping rule will be upheld by the European Court of Justice ("ECJ"), particularly in respect of the standards set out by the ECJ in Cadbury Schweppes (dated September 12, 2006, C-196/04). Applying the Cadbury-Schweppes principles, a denial of benefits may only be justified in relation to "wholly artificial arrangements". Even with the Amendment, German rules may have a broader application.

The amended German anti-treaty-shopping rule, as well as the recent decision of the ECJ dated October 20, 2011 (C-284/09) in which the ECJ holds that the taxation regime for non-German corporate shareholders infringes EU law (Client Publication dated October 21, 2011), may have a significant impact on the cross-border dividend taxation in Germany. The obstacles for non-German resident shareholders to claim Tax Benefits may, in many cases, become less onerous. Accordingly, tax structures of existing and future German inbound-investments should be reviewed and analyzed in light of the recent developments.

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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