



German Federal Tax Court rules on proof of substance requirements



In a decision published by the end of 2018, the German Federal Tax Court had a chance to rule on the proof of economic substance requirements according to the ECJ decision *Cadbury Schweppes*. The interpretation of the principles set by the ECJ has been subject to debate in Germany since the decision was handed down in 2006. Now, the Federal Tax Court had a chance to rule on the issue but failed to clarify the requirements for cross-border investments through a German holding company (as of 13.6.2018 – I R 94/15).

The German parent company had a 100% stake in a Dutch BV, which in turn had a 100% stake in a Cypriot C-Ltd. C-Ltd. acquired copyright licenses and granted sublicenses to group distribution companies in Europe. The license income was qualified as passive income pursuant to the German CFC rules, which was taxed at a low tax rate (below 25%). The plaintiff objected to adding passive income to its German tax base on the grounds that C-Ltd. had sufficient economic substance in Cyprus allowing for an escape from German CFC rules.

The Federal Tax Court failed to clarify the principles from the ECJ decision *Cadbury Schweppes* on the requirements for an economic activity in the source state, which many had hoped for. Rather, the Federal Tax Court reduced C-Ltd.'s income by assuming, in the given triangular constellation, a hidden profit distribution to the German parent company and subsequently a (indirectly) hidden capital contribution to C-Ltd. In view of the licenses not held by C-Ltd., the license payments made by other group companies to C-Ltd. were deemed to be not arm's length. As a result, the court did not have to rule on the economic substance requirements.

With regard to a routine remuneration received by C-Ltd. for administrative functions alone, the Federal Tax Court saw sufficient substance in form of rented office space and local part-time staff. In practice, this means that - as expected - the Federal Tax Court determines the substance requirements on a function-related basis. Apart of this, there is still only limited legal certainty regarding the German interpretation of *Cadbury Schweppes*.