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Tax changes for 2012

The requirement to transpose the EU Council directive on mutual assistance in the recovery of tax and duty claims has given the government the opportunity of enacting a number of other changes, mostly of a technical, or routine, nature. The most important are:

- Income flowing to individuals changing their private retirement pension insurance arrangements has been declared tax-free as far as it is manifested in the transfer of assets from one insurer to another.
- The application of the provision to curb the misuse of double tax treaties ("treaty shopping") by denying treaty (or EU directive) relief to foreign companies held by shareholders who would not have been entitled to relief had they received the income from Germany directly has been revised. Henceforth, a foreign company loses its relief entitlement to the extent it is disqualified by its shareholders and in so far as its gross earnings do not stem from its own active business activity, and, either with respect to the "passive" earnings there is no business or other good reason for its interposition, or it lacks suitable premises and equipment for its business activities.
- The corporate recovery exemption from the loss relief curtailment provisions on change of shareholders has been suspended following the European Commission's decision that the exemption constitutes state aid. This suspension
- has now been given a statutory basis. It will last until either the ECJ quashes the Commission's decision, or the Commission withdraws it of its own accord. Once the suspension is lifted, the exemption will apply to all open cases.
- The VAT Act has been amended in respect of trade fair or exhibition services provided in Germany in respect of events to be held in non-member states of the EU/EEA. Performance is now deemed to be in the country where the event is held.
- The withholding tax provisions on employee wages have been refined and extended in respect of the tax authority digitization of the system.

Bank levy double tax treaty with the UK

On December 7, 2011, Germany and the UK signed a "Convention for the Avoidance of Double Charging of Bank Levies". The German levy affected is the restructuring fund contribution. Under the treaty, the levy is to be raised on individual banks, including branches following the OECD income tax definition of permanent establishment. Double taxation is to be avoided by,

- Crediting the UK levy on a German banking subsidiary of a UK group against the German levy,
- Exempting the German branch of a UK bank from German levy,
- Crediting the German levy on the UK banking subsidiary of a German group against the UK levy, and

- Crediting the German levy on the UK branch of a German bank against the UK levy.

The treaty is completed with provisions on a mutual agreement procedure and on the exchange of information. It requires ratification and enters into force on the day the instruments of ratification are exchanged. It takes effect, though, as of January 1, 2011.

Double tax treaty with Liechtenstein

Traditionally, Germany has been willing to sign a double tax treaty with any trading partner nation except for tax havens. She has now broken with this tradition with the finance minister's signature on a double tax treaty with Liechtenstein on November 17, 2011. Presumably, the feeling is that the cooperation and information exchange agreement of 2009 is sufficient protection of the German interest against tax fraud.

- The new DTT follows the OECD model. A building site is a p.e. after twelve months. Dividends to a corporation in the other country holding at least 10% of the shares for at least 12 months are free of withholding tax. The 12 months must be for an uninterrupted period straggling the dividend payment, but can be completed after the event. If the shares are held for a shorter period, the withholding tax is 5%. Other dividends are subject to a 15%tax deduction at source.
- Non-civil service pensions are basically taxable in the country of residence. If, however, they are paid by the social security authorities, they will be taxable in the country of payment.
- Double taxation in Germany is to be avoided by exempting the income taxable in Liechtenstein whilst taking it into account in fixing the German rate. The exception is the partially taxable dividend in Liechtenstein – taxable again in Germany with a credit for the Liechtenstein tax already borne.
- DTT relief is not to be granted on business income not earned through a trade. Non-trading income in this sense is that earned in the other state through an entity's own asset management (finance service providers are excluded), on a loan if not fully taxable in the country of receipt, and from dealing with intangibles that the company has not produced for itself.
- The treaty is to enter into force on the day of exchange of the instruments of ratification. It will be applied from the following January 1.

The treaty does not mention the on-going problem between Germany and Liechtenstein of the (presumed) large balances of undeclared income held on Liechtenstein bank accounts by German residents. Resolution of the problem is to be by further negotiation leading to a separate treaty.

Official Pronouncements

Agreement with UK on redundancy payments

The German finance ministry has agreed with the British treasury that employee redundancy payments are to be taxed in the country of the employment as additional compensation for work already done. This applies to payments expressly for services rendered or to those made in recognition of the termination of the employment. This includes "golden handshakes" and "compensation for loss of office". By contrast, payments made for the provision of an employee's future are to be taxed in the country of residence when paid. If the employee had periods of service in more than one country, the payment is to be split in proportion to the time spent in each one. Periods spent in third countries are fall to the country of residence when the employment ceased.

Minimum tax – payment suspension

Under the German concept of "minimum tax", the maximum relief in any one year from losses brought forward is €1 m plus 60% of the remaining current income. Unrelieved losses may be carried forward in full, though the following year's deduction is subject to the same limitation. Thus companies with annual incomes of more than €1 m retain their loss relief entitlement, whilst being obliged to pay at least some tax (on 40% of taxable income over €1 m). In principle, this denial of loss relief is temporary, though it becomes permanent if future loss offset is excluded. The Supreme Tax Court has seen serious constitutional doubts on the propriety of a minimum tax assessment where the increased loss carry-forward cannot be relieved by reason of law (in a case involving denial of relief for the loss brought forward on change of majority shareholder – reference I B 49/10, resolution of August 26, 2010). The court granted the aggrieved taxpayer a stay of execution on payment of the minimum tax due, pending its final decision on the main case (not yet heard) on the constitutionality of the provisions in these circumstances.

For the interim, the finance ministry has issued a decree instructing tax offices to grant applications for payment suspension of minimum tax assessments where the loss carry forward cannot be realised. The decree lists the relevant circumstances of loss offset curtailment as change of shareholders, merger, liquidation, or (natural persons) death of the taxpayer. Loss curtailment for other reasons – the decree mentions withdrawal from a partnership (trade tax) and the pre-2008 provision to counter the sale of companies for their tax losses – is excluded from present application.

No provision for set off of excess receipts against future income

The finance ministry has decreed that an agreement, or legal obligation, to set overcharges from the past against future amounts due is an obligation within the context of an uncompleted transaction. As such, it cannot be taken up with tax effect as a liability. It is also not deferred income, as it does not meet the definition of payments received in advance of future earnings. It merely reduces future income when earned. This contrasts with an agreement to refund the overcharge. That obligation is to be taken up as a liability when the agreement is reached, regardless of whether or not the business relationship with the customer continues.

Finance ministry refuses foreign parent of Organschaft

In February 2011, the Supreme Tax Court held that a British parent company could lead a trade tax *Organschaft*, provided that it fulfilled the then qualifying conditions of financial control, common management and integrated business objectives. The requirement in the Corporation Tax Act that an *Organschaft* parent be a domestic entity was a discrimination prohibited by the UK/German double tax treaty. The German subsidiary’s trading income was thus to be added to that of the UK, with the total being split over the local elements of the combined entity. The court accepted that this result could well lead to the loss of trading income to German taxation – the foreign parent would have to file a German trade tax return in its own name – but felt that it could not override the discrimination prohibition of the treaty.

The finance ministry has now issued a decree instructing tax offices not to follow this judgment except in the three cases decided. They should therefore continue to apply the old view of the law in all cases still open to the effect that a trade tax *Organschaft* should always be centred on a domestic parent. It argues that the court’s interpretation of the treaty discrimination prohibition is contradicted by the official commentary of 2010 on the OECD Model Treaty, but does not, perhaps wisely, attempt to explain the relevance of a 2010 commentary to a 1964 treaty.

This case could be seen as a fundamental blow to the trade tax system. However, its long-term effects are likely to be minimal. On the one hand the trade tax *Organschaft* has been equated with that for corporation tax since 2002 – including the requirement for a formal five-year profit pooling agreement – and on the other, a new, modern treaty took effect for 2011. The case can thus be seen as obsolete as a guide to the future, though undoubtedly provides ammunition for those still in dispute with the tax authorities over the past.

The Supreme Tax Court’s case reference is I R 55/10, judgment of February 9, 2011 and the ministry’s decree is dated December 27, 2011.

Only one regular place of work with same employer

In June 2011, the Supreme Tax Court held that an employee can have no more than one regular place of work with the same employer. Trips between the employee’s home and regular workplace fall under the rules for travelling to work, whilst even regular trips from home to other locations, or between an employer’s different premises, fall under the more favourable rules for business travel. The finance ministry has now issued a decree accepting the judgment and defining a regular place of work as one to which the employee is permanently attached or as one that he required to

- Work in daily,
- Work in for one full day per week, or
- Work in for at least 20% of his working time.

If none of these criteria are met in respect of any one of an employer's premises, the employee will have no regular place of work and his entire travel will be on business.

2011 export documentation rules can be followed first quarter 2012

The rules for documenting and recording export turnover have been modified for 2012 in order to take account of the EU-wide export documentation system. A number of changes have also been made to the documentation and recording requirements for VAT-free supplies to businesses in other member states. These changes were not enacted until December 2, 2011. The finance ministry has now issued a decree to the effect that no objection is to be taken to businesses continuing to follow the old rules for the first quarter of 2012.

Debts automatically bad on opening insolvency proceedings

In October 2009, the Supreme Tax Court held that amounts due from an insolvent business were automatically irrecoverable on opening of insolvency (receivership) proceedings. The court's main point was that the debtor was now legally unable to pay the amount due. This position was to be followed, even if the trustee held out hopes for a dividend. Thus the taxable turnover of the creditor was to be adjusted in the next (usually monthly) VAT return with the write-off. Subsequent payments by the trustee (dividends) were additional turnover as and when received.

The finance ministry has now revised its VAT Implementation Decree accordingly. In doing so, it emphasises that the same principles do not apply to the customer of an insolvent business. The customer continues to be liable to pay his debt in full – merely the identity of the payment recipient has changed – and his input tax deduction is unaffected.

Supreme Tax Court Cases

Vehicle lessor to provide for planned loss on sale

A motor vehicle leasing company leased trucks for a fixed term at the end of which it repossessed the vehicles and sold them on the open market. It undertook to surrender the proceeds to the lessee in excess of the residual value specified in the leasing contract. Past experience showed that the sale proceeds realised were almost invariably higher than the contract residual value. The residual values were set below the tax written down values on expiry of the lease. A book loss on sale was thus pre-programmed, unless the lease came to an unscheduled end, e.g. as a result of an accident or other insurable event.

The Supreme Tax Court has now held that the lessor must see the contractual arrangements as a whole. It must therefore reckon with total proceeds of the agreed rentals plus the contractual residual value. Additional sales proceeds were not part of the arrangement and fell to the lessee in any event. Its running costs were the regular tax table depreciation and its closing costs were the tax written-down values on the date of closure less the contractual residual values of the assets. These closing costs were in effect a refund of leasing fees. Because they had been agreed to in advance, they should be taken into account currently, i.e. matched with leasing income. The company was therefore required to provide for the loss as an effective refund of leasing fees. The obligation was cash rather than a (non-deductible) provision for future losses. It was to be discounted over the remaining lease term (period of receipt of the payments) at 5.5% p.a., the rate for long term liabilities.

Supreme Tax Court judgment I R 50/10 of September 29, 2011 published on December 14

Compulsory product registration costs incurred on date of application

The tax office refused a manufacturer of pesticides a provision for the costs of registering a new product with the Federal Biological Institute for Agriculture and Forestry. Registration is compulsory as a pre-condition for marketing a product, but can be refused if the Institute is not satisfied with the results of its tests. The registration fee arises with receipt of the application by the Institute; the amount is partially dependent on the processing costs of the Institute; the Institute has discretion to waive part of the amount if it refuses the application. The tax office saw the fee as a future marketing expense that could not yet be accrued as it related to future income.

The Supreme Tax Court has now sided with the taxpayer. Registration was compulsory if the owner wished to market the product and the right to claim a fee arose for the Institute on receipt of the application. The applicant had incurred the cost on submission of the application and an accrual, estimated as necessary, should be taken up immediately. By its nature, the cost of registration was part of the cost of developing a product, that is, it was an intangible asset. However, the prohibition on capitalising intangibles developed or produced by the owner required the expense to be written off against income as incurred.

Supreme Tax Court judgment IV R 5/09 of September 8, 2011 published on November 16

Declining rate loan interest to be spread over term of the loan

A bank took out a ten-year loan at an annual interest rate of 7.5% for the first two years. Thereafter the rate was to progressively decline to 3% by year ten. The tax office saw this “step down” interest rate arrangement as essentially bringing the interest payment burden forward to the earlier years of the loan. Since the loan was a fixed sum repayable in full at the end of term, the value of the service and the cost to the provider remained constant throughout the period. Thus, the expense should also be constant, and to achieve this, the debtor should take up an appropriate prepayment in the earlier years of the loan, to be progressively expensed when the interest rate fell below the ten-year average.

The Supreme Tax Court has now agreed with this view. In the absence of any indication to the contrary, the value of the service to the borrower was the same throughout the term of the loan and his expense should therefore be constant. This was generally the case for a fixed-term loan with no provision for early repayment. If the contract contained an early repayment option with a partial refund of the high interest paid in the initial period, the refund could be seen as indicating the extent to which the parties had agreed to spread the interest burden equally. If no interest was refundable on early repayment, the indication would be that the parties had, in fact, seen the service as more valuable to the borrower, or more hazardous to the lender, during the early part of the term. In this case, the conclusion could be that the interest should be expensed as paid.

The court was careful to point out that these calculations were to be distinguished from penalty interest payable on early loan repayment. Penalty interest was to compensate the lender for lost income; thus basing it on future amounts due gave no indication of which services had already been remunerated in the past.

Supreme Tax Court judgment I R 77/10 of July 27, 2011 published on October 26

Private equity fund earns trading income

A series of German institutional investors (subsidiaries of banks) bought shares in a closed private equity fund in the UK. The fund took up equity shares in start-up companies with the general intention of seeing them through the first four years of their development. It would then either float the company on the stock exchange, or sell the shares as a trade investment. The fund was managed by a management company with appropriately qualified professional staff and operating facilities, but did not have its own employees or premises. It was organised as a limited partnership, the German investors being the limited partners. The UK authorities exempted the fund’s income from taxation under a concession for the encouragement of equity capital; the German tax offices saw the fund’s activities as asset management, rendering its income and capital gains immediately taxable in Germany in the hands of the partners.

The Supreme Tax Court has now held that the fund should be viewed as a trading entity, that being its appearance to the outside world. That it had outsourced its investment decisions and, for that matter, its administration, to a management company did not detract from this. Rather, it was bound by the actions taken by the management company on its behalf. The management company employed qualified professionals to select, and then support and encourage, its investments. It thus took part in their internal management affairs. It operated not only with its partnership capital, but also with funds borrowed from banks and other sources. It regularly bought and sold investments in order to earn sufficient profits to pay for its interest costs. From all points of view, it acted as a business in the full ownership of other businesses, trading in securities, and should be taxed as such. Having reached this conclusion based on the operating circumstances, the court went on to add that the fact that as a limited partnership with a limited company as its sole general partner the fund would have been classified as a trading entity by German legal definition was not relevant to the present case. Rather, a German domestic rule on the qualification of income could not affect treaty interpretation.

The court qualification of the fund as a trading entity led, in this case, to complete exemption of the earnings of the German partners. Under the treaty they were taxable in the UK on the income from their partnership shares, ranking as permanent establishments. Under a UK concession for the promotion of venture capital, the income was exempt. This double exemption was not the result of a treaty qualification conflict, and so was not caught by the switch-over clause in the treaty (in any case only relevant to capital gains) or by the German anti-treaty abuse provision of Sec. 50d (9) Income Tax Act (treaty override). Accordingly, the court was able to defer yet again a final answer to the all important question of whether the treaty override is in conflict with the constitution or, for that matter, international law.

Supreme Tax Court judgment I R 46/10 of June 30, 2011 published on October 26

Marketable securities to be written down to year-end rate

The Income Tax Act provides that investments may be written down to their current value, provided the loss in value is expected to be permanent. The finance ministry interpreted this in a decree of 2009 to mean that the market value of quoted securities should have fallen by at least 40% below cost on balance sheet date, or should have fallen by at least 25% on each of two consecutive year-ends. The Supreme Tax Court has previously held this approach to be unfounded in law and that the only generally appropriate measure for quoted investments is a lower market rate at year-end, regardless of the level of the loss in value. The court has now followed its earlier case, confirming in particular its rejection of the finance ministry's 40%/25% minimum write-down levels, and that subsequent rises in market value before the accounts are drawn up are subsequent events for consideration in the following year, rather than indications of an inherent value at year-end. It has, however, refined its previous finding to hold that:

- The year-end rate is to be taken as indicating a permanent fall in value at year-end unless signs that it was unrealistic become apparent by the time the accounts are drawn up. The two examples it gives are manipulation of the market, e.g. through insider trading, and where there has been very little trading for some time in the security concerned.
- Falls in value of up to 5% below cost (or the previous written-down value) are to be ignored as trifling. However, once the value falls below that level, the full amount of the fall is to be taken into account.

In the meantime, this case has lost its immediate relevance for corporations in view of the Corporation Tax Act classification of capital gains on the sale of shares as tax-free income. However, it is still relevant to investments held by unincorporated businesses.

Supreme Tax Court judgment I R 89/10 of September 21, 2011 published on December 28

Write-down of units held in investment funds

The Supreme Tax Court has paralleled its decision that falls of more than 5% in the market price of marketable securities held as investments should generally be taken as a demonstration of a permanent loss in value with a ruling in the same vein on holdings in an investment fund without its own quote, but with shares and other securities as its main investment object (closed fund). If the units were held as temporary investments of surplus funds, the valuation measure should be redemption price at year-end. If, however, the units were held on the insistence of business partners in support of a commitment (here as a reserve to fund repayment commitments on possible contract cancelation), they were necessary for the business and should be written down to the year-end issue price only, Supreme Tax Court judgment I R 7/11 of September 21, 2011 published on December 28

EU royalty payments to be taxed net

In 2006, the ECJ held that German rules on the taxation on the gross amount of income earned by residents of other EU member states were in breach of community law to the extent they did not allow a taxpayer the possibility of claiming a deduction for the directly related costs of earning the income (case C-290/04 *Scopio*, judgment of October 3, 2006). Since then, other judgments have been passed in the same vein and the Income Tax Act has been amended to allow for the directly related expenses of income earning for artists and athletes (*Scorpio* was a concert agency), those exploiting the broadcasting and other publication rights to German performances and to board members earning directors' fees. The Supreme Tax Court has now filled in a gap in the law by adding the one important missing item, royalties, to the list.

A local business acquired the exclusive right to operate proprietory pin-ball and similar games within a given area in return for a royalty of 28.5% of the takings. The royalty was paid to a Dutch B.V. that had acquired the licence from the owner of the technology in England on terms allowing sub-licensing in return for 93% of the fees received. The parties concerned maintained that the fee surrendered by the B.V. was a direct cost of its earning its licence fee income from Germany, and that its German tax liability should be based on the 7% net income remaining to it after settlement. The tax office and lower tax court insisted on following the letter of the law to the effect that the tax should be based on the gross amount.

The Supreme Tax Court has now held that the *Scorpio* precedent should be extended to the present case. The head licence fee paid by the B.V. was a direct cost of earning its sub-licence fee from Germany, and it should be taxed on the net in conformity with other EU residents earning income from German sources. This net taxation could be achieved by allowing the B.V. the right to claim a refund of the excess tax withheld, or by allowing the payer to base his withholding on the net amount. This latter was appropriate if the payer knew of the direct costs at issue and had access to the relevant documentation, in this case to the head licence agreement. The court went on to emphasise that the German payer must be satisfied that the costs claimed were plausible and in apparent agreement with the contract, but that he was not required to verify that the head licence had actually been paid or that it was at arm's length. He was also not required to investigate the shareholdings in the B.V.

Supreme Tax Court case I R 32/10, judgment of July 27, 2011 published on November 23

Organisational integration of VAT group must be enforceable by parent

A senior member of the management team of a trading entity entered into a special purpose joint venture with his employer. They formed a GmbH for the venture, the company holding 51% of the shares and the individual 49%. However, resolutions appointing and removing directors, and agreements on their remuneration, required the approval of both founding members. The individual was appointed the GmbH's sole director and elevated to the position of deputy director of the parent. The parent then sought to bring the subsidiary into its VAT group on the basis that the two businesses were integrated, organisational (management) integration being ensured by the discipline on the subsidiary's managing director in his capacity as a senior employee of the parent. The tax office rejected this approach because the common management necessary for management integration meant that the two entities had to have at least one common director.

The lower tax court agreed with the tax office' conclusion, but disagreed with the reasoning. Management integration was feasible as long as the director of the subsidiary held a senior management position with the parent. He did not, though, have to be a director of both companies. On the other hand, the company, as majority shareholder, would be unable to impose its will on the subsidiary where that company's minority shareholder was its sole managing director.

The Supreme Tax Court has now rejected the reasoning of the lower tax court (and also that of the tax office), but has found its own grounds for rejecting the VAT group. Its position is that the managing director of the subsidiary cannot be removed from office without his own approval as a founding shareholder. Conflicts between the two managements cannot therefore be resolved by parental action on its own, but only by compromise. Thus, the managerial will of the subsidiary is not totally subordinate to that of the parent.

The upshot as summarised by the court is that managerial integration will be assumed if the sole director of the subsidiary holds a leading managerial position with the parent, provided the parent holds far-reaching powers of direction over the management of the subsidiary and has the right to appoint and remove the subsidiary's director(s). However, the court has explicitly left open, the question of whether it continues to adhere to its own older case law to the effect that it is sufficient demonstration of management integration to show that the subsidiary cannot, in the circumstances, form its own will independent of that of the parent.

Supreme Tax Court judgment V R 53/10 of July 7, 2011 published on October 26

Intra-community supply, even if pick-up agent conceals prior resale

A motor car dealer sold a car to a Spanish dealer, after taking all appropriate steps to establish that customer's identity and VAT status. The customer sent a driver to pick up the car and to drive it back to Spain. The driver showed the supplier the necessary credentials and signed the necessary receipts for the car to be taken to the customer's address in Spain. However, he actually took it to an end customer in France, who had, in the meantime, bought the car from the Spanish dealer without the knowledge of the German supplier. The tax office discovered the truth of what had actually happened and insisted on treating the transaction as a chain transaction, the first part of which was a sale to the Spanish customer in Germany. That customer then took the car from Germany in an intra-community supply to France. The sale in Germany was subject to VAT. The German dealer protested on the grounds that he had done all he could to determine the nature of the transaction in which he was involved. He had been misled, but had had no possibility of recognising that fact at the time. His records and documentation were fully in order, and he should therefore be allowed to treat the transaction as the intra-community supply he had genuinely believed it to have been.

The Supreme Tax Court has now sided with the dealer. He had fully complied with all legal requirements and had otherwise taken all due care. That his Spanish customer had already sold the car on to another party in France was not something he could have discovered for himself. The court agreed that there could be only one tax-free intra-community supply in the transaction chain; however the German dealer, and not his Spanish customer, had made it. The court went on to say that the consequence of its judgment was that a foreign intermediary had, effectively, a choice in taxation; if he revealed the fact of resale to the supplier, the first leg of the transaction, a sale in Germany "on hold", would be subject to VAT; if he chose to remain silent on the resale and allow the supplier to think that delivery would be to his own address for resale later, the sale would be free of VAT in Germany. Unsatisfactory though this might be, the truly innocent German supplier could not be held accountable for his customer's misdemeanour.

Supreme Tax Court judgment V R 3/10 of August 11, 2011 published on October 19

No VAT exemption for fraudulent intra-community supply

A German resident car dealer was the managing director and sole shareholder of both a GmbH and of a Dutch BV with a French subsidiary. The French subsidiary identified retail customers, which it notified to a Spanish dealer. The Spanish dealer purchased the cars from the GmbH as VAT-free intra-community supplies against a declaration that he was taking them to Spain, but actually delivered them to the French customers in the name of the French subsidiary. He invoiced that subsidiary with margin-scheme VAT for used cars, the vehicles having been previously registered in Germany in the name of the GmbH. No acquisition tax was declared or paid in either Spain or France.

The Supreme Tax Court has now held that the tax office was right not to allow the GmbH the exemption claimed on the transactions as intra-community supplies. The GmbH had, through its managing director, full knowledge of the transaction chain. It therefore knew of the deliberate concealment of the intra-community acquisition from the Spanish and French authorities. It was not able to claim adherence to the formal delivery documentation and recording requirements when it knew of the evasion in another member state. The court dismissed as irrelevant a contention by the GmbH that the transaction was legal in Spain; the cars had never entered Spain and the acquisition should have been taxed in France.

Supreme Tax Court judgment V R 19/10 of August 11, 2011, published on November 2

VAT on building with solar generator deductible on notional turnover

The Supreme Tax Court has handed down three decisions on the deductible portion of the input VAT on the costs of a building carrying a solar generator mounted on the roof, but not otherwise serving a business purpose. The power generated was sold to the local electricity company with VAT. The three buildings were a newly-built wooden shack, a carport and a renovated barn. The shack and the barn were not used for any other purpose; the carport was used as such privately by the owner. The court held that selling power was a business activity entitling the operator to a deduction of the related input tax. However, the entire cost of the building could not be ascribed to the business, as it could be used for other purposes even if it were for the moment empty. Basing the proportion of deductible input tax on the floorspace or surface area was inappropriate, as use of the roof as a mount for the generator (essentially a series of photo-electric cells) did not affect the use of the interior. Accordingly, the proportion had to be based on a turnover key. The court suggested the ratio of notional rent achievable from letting the roof as a place to mount a solar generator to that achievable from letting the building as a shack, carport or barn. It did not give any hint as to the matters to be taken into account in establishing these notional rentals, but did qualify its finding with the suggestion that the taxpayer might be able to advance a more suitable basis of apportionment when the case was re-heard by the lower court in order to establish the figures.

Supreme Tax Court judgments of July 19, 2011 XI R 29/09 (shack), XI R 21/10 (carport) and XI R 29/10 (barn) all published on November 9

Cinema snacks taxed at reduced rate of VAT

A cinema sold popcorn and other heated, or re-heated, snacks from stands in the foyer. The tax office saw these sales as a restaurant service subject to full rate VAT, whilst the cinema saw them as sales of food, to be taxed at the reduced rate. Ultimately, the ECJ handed down a ruling to the effect that the sales were of food, the service elements of the supply being insignificant. The tax office then tried to argue before the Supreme Tax Court that the ECJ had misunderstood the nature of the facilities available to snack customers, seating, tables and toilets, as being only primitive.

The Supreme Tax Court has now rejected the tax office' attempt to turn it aside from its duty to follow the ECJ ruling it had requested on the case before it. It agreed that the ancillary facilities available to snack customers were not primitive. However, it pointed out that they were not made available to snack customers, but rather were available to all patrons of the cinema in that capacity. Cinema patrons used the foyer as a waiting room and as a meeting point, and the foyer furniture was there for their comfort and convenience. The toilets, similarly, were there for all. The only service related to the snacks was warming them up, and this was insignificant beside the sale of the food.

Supreme Tax Court judgment V R 3/07 of June 30, 2011 published on October 19, following the ECJ judgment C-497/09 *Bog* of March 10, 2011

No exemption for danger or readiness money for essential services

A member of a bomb disposal squad received two supplements to his regular salary, a readiness allowance for holding himself available for call out at all hours, and a danger premium for each bomb actually defused. He claimed that these allowances were comparable to allowances paid for night work and for work on Sundays or bank holidays and should rank for the same favourable tax treatment. He also pointed out that the activities of a bomb disposal unit were essential to public safety and thus at least as deserving of a tax benefit as salary supplements paid for working at unusual hours.

The Supreme Tax Court has now held that there can be no extension of the tax exemption to other circumstances, no matter how justified by public need. The legislative had chosen to exempt wage supplements paid up to set levels for night, Sunday and bank holiday work, but without mentioning any other circumstances. It was free to grant exemption, and it was also free to limit the qualifying circumstances. The court went on to point out that the social justification for the present exemptions had been, at best, only inadequately explained; thus there was little basis for drawing parallels. In any case, not all work qualifying for a tax-free supplement was essential to the public interest, and not all supplements paid to those in arduous public service were tax-free.

Supreme Tax Court judgment VI R 6709 of September 15, 2011 published on November 2

Only partial foreign tax credit on repeated gifts

Gift tax in Germany is – as is inheritance tax – levied on progressive scales with generous personal allowances for close relatives. However repeated gifts from the same donor to the same beneficiary accumulate over a ten-year period in the manner that in each year of receipt, the cumulative total tax is calculated anew with a credit being given for the tax already paid. Thus the tax due on repeated gifts tends to rise in relative terms over the ten years, following the exhaustion of personal allowances and the progressive rate scale. However, the credit for foreign tax on the same gift is limited to that assessed on the gift made in the year in question. Thus, lost credit in one year cannot be recovered in another, even though the gross tax due is based on the accumulation of both.

A German resident receiving an annual cash gift from her mother in Holland has been unsuccessful in her attempts to obtain judicial redress for this imbalance. The gifts were taxable in both countries with credit in Germany for the Dutch tax paid, but limited to the corresponding German tax due. The different rate scales meant that the relative burden on lower amounts was higher in Holland that in Germany, whilst the position reversed as the gift rose. Thus the daughter received little or no benefit in Germany from the credit of the higher tax paid in Holland by her mother during the early years of the cycle, but could not recover this lost tax credit when the taxable gift began to accumulate. Had she received the entire gift in a single lump sum, the lost credit, if any, would have been limited to the excess of the Dutch tax payable on the whole over the corresponding German total.

The Supreme Tax Court has held to the letter of the statute. Gift tax is assessed annually, thus there is no provision for subsequent recognition of prior years' credits. The effect of prior years' assessments on the current year's calculation is a matter of calculation, not of law. On rather firmer ground, the court went on to hold that this imbalance was not excluded by European law. The ECJ had repeatedly held that the European systems of gift and inheritance taxes were not harmonised; thus, those crossing borders could not rely on fiscal neutrality. Imbalances of the type here under discussion had to be accepted as European law at present stands.

Supreme Tax Court judgment II R 58/09 of September 7, 2011, published on October 19

From Europe

Parent/Subsidiary Directive recast

The Council of the European Union has adopted a recast of the Parent/Subsidiary Directive, No. 90/435/EEC of July 23, 1990. The recast incorporates existing amendments into the main text, clarifies the wording of the provision allowing member states to deem the non-deductible management costs of a holding generating tax-free income to be not more that 5% of that income, and brings the appendices listing the applicable taxes and legal forms up to date. There are no changes of substance. The recast has received a new number – Council Directive 2011/96/EU of November 7, 2011 – and will enter into force on January 18, 2012, i.e. 20 days after its publication in the Official Journal (OJL of December 29, 2011 p. 345). Member States are expected to amend their national law promptly, although there is no formal deadline for transposition.

Germany's dividend withholding tax hinders free movement of capital

Dividends paid by a German corporation are subject to a 25% withholding tax. On application, this can be reduced to the lower treaty level, or, if applicable, waived under the provisions transposing the Parent/Subsidiary Directive. German resident corporations are exempt from corporation tax on their dividend income, but can claim a full offset of the withholding tax deducted at source from their corporation tax otherwise due. If a net debit remains, they can claim a cash refund. A German company receiving a dividend from anther German company is therefore never faced with a tax burden, whereas a foreign company receiving the same dividend might be, if it does not qualify for Parent/Subsidiary Directive exemption.

The European Commission sees this difference in treatment as discriminatory. The more favourable treatment of domestic corporations as shareholders tends to discourage corporate residents from other member states from investing in Germany. It therefore hinders the free movement of capital. The ECJ has now agreed with this view. It has rejected German arguments in support of this discrimination (domestic and foreign investors are in different positions – the distinction is to maintain the coherence of the tax system – the credit of withholding tax is a matter for the state of residence) as unfounded. The government thus now faces a potentially difficult policy decision on how to remove the discrimination without suffering an unacceptable loss in tax revenue.

The ECJ case reference is C-284/09 *Commission v. Germany*, judgment of October 20, 2011.

Dutch exit tax excessively burdensome

A UK owned finance company was established as a B.V. in the Netherlands. Sometime later, its management was replaced with staff from the UK parent and it closed its offices in Holland. It thus became tax resident in the UK by virtue of its place of management and the office closure meant that there was no longer even a Dutch permanent establishment. However, it retained its corporate identity as a B.V. The Dutch tax office assessed it to corporation tax on its results for its final year of Dutch residence together with its unrealised capital gains at the time of its departure. The company protested on the grounds that there would have been no tax on the unrealised gain, had it moved within Holland and that the gain now never would be realised, it being mostly an exchange gain (in euro) on a pound sterling loan to an associated company.

The ECJ has now held the assessment to be fundamentally acceptable. A tax charge on exit is, of course, a restriction on a company's freedom of establishment, but is, however, in principle justified by the need to protect the allocation of taxing rights between member states. A company deploys its assets to make profits and the right to tax any increase in value falls to the state of residence when the increase occurs. Events thereafter are a matter for the new state of residence (contrary to the advocate general's view that future losses on realisation should also be taken into account, if they effectively reversed the unrealised gain on change of corporate residence). Thus it is also of no moment that with the move to the UK there can be no possibility of actually realising the gain established (in euro) when the company's Dutch residence ceased. There could be no gain or loss on exchange in the UK in respect of a sterling loan. On the other hand, the exchange rate was not the only factor affecting the value of a loan. Should a bad debt risk arise, it would be a matter for the state of residence at the time it arose.

Whilst it was reasonable to establish the tax due on the hidden reserves at the time of the change of residence, it was not reasonable to demand immediate payment. The gain had not been realised and had not produced funds to pay the tax. The actual liability should be deferred until the gain or gains had been realised. Objections to the effect that this would be too complicated administratively for a company with many individual assets were met with the response that it was up to the company to decide. If it were too complicated administratively, the company would be able to avoid the problem by immediately paying the tax. If, on the other hand, it saw the additional administrative load as bearable, the same must also apply to the tax office responsible for overseeing compliance. At this point, the ECJ interrupted its own argument with a reference to the help available under the Mutual Assistance Directive. Finally, the court answered a mention of tax avoidance with the remark that "the mere fact that a company transfers its place of management cannot set up a general presumption of tax evasion".

The ECJ case reference is C-371/10 *National Grid Indus*, judgment of November 29, 2011.

VAT-free business transfer despite only short-term lease of premises

The owner/operator of a shop in Germany sold her business to a successor free of VAT under the exemption for sales of complete businesses or self-contained business units capable of their own independent economic existence. The actual transfer was of the ownership in the stocks and in the shop fittings at an agreed value and of the premises by way of a lease. The lease was for an indefinite period, but cancellable by either side at three month's notice. The tax office refused to accept that the sale was free of VAT, as the premises – necessary for the business operation – had not been effectively transferred for any significant length of time. It referred in this connection to a Supreme Tax Court judgment holding that a 10-year lease of necessary premises could be seen as indicating an effective business transfer with VAT exemption for the other assets sold. The seller disagreed with the implication that a lease cancellable at will indicated only a short-term business transfer where there was no actual intention to give notice on the lease. She claimed that official insistence on a long-term lease went beyond the requirements of the Sixth Directive (now the VAT Directive).

The ECJ has now held that each case must be decided on its own merits. VAT-exemption cannot be dependent on the lease term alone, as that would necessarily differentiate between businesses on owned, and on leased, premises. The court saw the conditions for VAT-exemption as met where the assets transferred were sufficient to enable the transferee to carry on a business operation on a lasting basis. It made the point that whilst a shop needed premises, it was not necessarily tied to any specific location and added that the intentions of the transferee were also important. An immediate decision to sell the assets acquired would indicate a taxable purchase of individual assets, whilst a continued business operation under the new owner for the following 23 months (the actual period until the shop was finally closed in the case at hand) showed that there was no immediate intention of winding it up. Thus VAT-exemption could not be refused on that ground alone.

The ECJ case reference is C-444/10 *Schriever*, judgment of November 10, 2011.

Sale of bad debts without recourse not a provision of services

A bank sold a collection of mortgage debts that had fallen in due to debtor default on the instalments. The debts were, in accounting terms, at least doubtful, but the purchaser felt himself in a better position than the bank to ruthlessly pursue recovery, perhaps because he did not feel under the same social and local political pressures. Be that as it may, the debts were valued individually, on the basis of the estimated chance and period of recovery, but were sold as a package without guarantees and without recourse to the seller. The tax office saw the transaction as a disguised debt collection service, subject to standard rate VAT; the taxpayer maintained he had simply purchased debts to be realised for his own account. This was free of VAT.

The ECJ has now held that a sale of debts at an agreed valuation and without recourse back to the seller is not a disguised debt collection service. Over and under recoveries compared with the written down sales value (on average some 60% of the nominal) were for the sole account of the purchaser. He had purchased assets with the intention of realisation. He was under no further duties towards the seller, but the latter was also free of all further obligations towards him and towards the mortgage debtors.

The ECJ case reference is C93/10 *GFKL*, judgment of October 27, 2011

Aviation fuel duty exemtion only for aircraft used to provide services.

A computer component and software developer operated an aircraft for the use of senior executives when visiting customers and other business partners. It maintained that this business use constituted commercial use within the meaning of the Excise Duties Directive and that it was entitled to a refund of the duty on the fuel used for business flights and trips to an aircraft maintenance facility for routine servicing. The German customs office refused the refund because the aircraft operator was not a licensed carrier.

The ECJ has now held that the exempt commercial use does not necessarily have to be that of a carrier, but does have to be the direct provision of services by way of trade. It drew a parallel to an earlier case involving an undertaker engaged in burials at sea. The ships used to take the coffins to the burial grounds were not, strictly, carriers, but were engaged in the direct provision of services. Accordingly, their diesel oil was free of duty. In the present case, though, the aircraft were flown on business, but were not being used to provide services. Their service contribution was indirect and did not entitle the operator to duty exemption. The fuel used on flights to the maintenance facility was also not exempt. The maintenance exemption applied to the fuel used on the maintenance (engine and flight testing) but not to that used on bringing the aircraft to the facility. The exemption entitlement fell to the operator of the maintenance hangar and not to the operator of the aircraft.

The ECJ case reference is C-79/10 *Helmholz*, judgment of December 1, 2011

This judgment has since been repeated in a similar case involving a partnership formed by three companies to hold an aircraft to be chartered to the partners as required and to third parties as available. The case reference is C-250/10 Haltgemeinschaft LBL, judgment of December 21, 2011.

Court of Auditors can insist on auditing a nation's VAT systems

The European Court of Auditors notified the Central Tax Office (responsible for intra-state VAT liaison) of its intention to audit on site the office's procedures in theory and practice in respect to international co-operation on VAT matters, particularly the office's reliance on, and response times to, requests under the VIES (Value-added tax Information Exchange System) arrangements. The Central Tax Office prevaricated – mostly by simply not replying to letters from the Court of Auditors, or from Commission. The finance ministry then stepped in with a blunt refusal to allow the Court of Auditors to act in the desired manner for want of a valid legal basis.

The ECJ has now held that the refusal to cooperate cannot be accepted. Part of the VAT collected by each member state falls to the ECU; thus a member state's administration of its system has a direct impact on EU resources. The Court of Auditors is therefore entitled to audit that administration on or off site as an audit of the EU's own resources, notwithstanding the relatively small percentage of a nation's VAT collections that actually falls to the EU. The ECJ added that information exchanges between states could benefit either or both member states. Other states therefore had an interest in correct monitoring of the German system. The planned audit was not solely a matter between Germany and the Commission.

The ECJ case reference is C539/09 *Commission v. Germany*, judgment of November 15, 2011.

From PwC

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