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Annual Tax Bill 2013

The cabinet resolved an annual tax bill 2013 on May 23, 2012 with many editorial and similar changes of formality. Mostly, the changes are necessary to update the references to the latest EU provisions and to reflect recently decided ECJ and Supreme Tax Court cases. Changes of substance are:

Transposition of the revised EU Mutual Assistance Directive (2011/16/EU) into national law

The former provisions reflecting the Mutual Assistance Directive 77/799/EEC will be withdrawn. Liaison with the central tax authorities of the other EU member states and with local tax offices will be in the hands of the Central Tax Office. Information requests from abroad are to be answered promptly, at the latest within six months of receipt. There is to be an automatic information exchange with the taxpayer's state of residence on employment income, director's fees, life assurance policy redemptions and sales, pensions, and property and rentals.

There is to be a spontaneous information exchange on:

- Any matter likely to be of use to the tax authorities in the other state, in particular if there is any suspicion of evasion there
- Tax benefits or reliefs granted in Germany in respect of income that might be taxable in the other state
- Business dealings that might lead to tax savings in one or both states
- Suspicions of artificial profit shifts
- Further information discovered following information received from another member state that might be important to the authorities there.

The revised EU Mutual Assistance Act will also contain provisions allowing foreign tax officials to act in Germany if accompanied by a German colleague and on coordinated tax audits. It will take effect in respect of business years beginning on or after January 1, 2014 and will govern information exchanges from January 1, 2015.

The Income Tax Act

Employee allowances and reliefs are to be set for a two year period for the purposes of calculating the tax to be deducted from an employee's salary.

Double tax treat relief is to be granted to the beneficial owner of income or assets where the legal owner is not the taxpayer under German or foreign law.

The Foreign Tax Act

A foreign partnership will now rank in its own right as a taxpayer or related party.

A German company is to trade with its foreign branch at arm's length as though the branch were a separate legal entity ("presumed contractual relationship"). Transactions between permanent establishments or between a permanent establishment and its head office thus fall under the transfer pricing rules applicable to corporate related parties. A finance ministry decree is to give more detailed guidance on the consequences of extending the arm's length principle to different parts of the same legal entity, including especially on the subject of the necessary branch capital. The transfer pricing documentation requirements are to be applied to dealings with and between branches and/or a foreign head office.

Document retention periods
Whilst the minimum retention period for financial statements, inventories and other documents of major importance will continue to be ten years, that for booking vouchers is to fall to eight years in 2013 and to seven in 2015. The retention period for business correspondence will fall to six years.

New double tax treaty with the Netherlands

The representatives of Germany and the Netherlands put their signatures to a new double tax treaty on April 12, 2012. The new treaty follows the OECD model in its current state and thus includes the more sophisticated exchange of information, mutual agreement and anti-abuse provisions of recent years. Specific details are:

- A building or assembly site becomes a permanent establishment after twelve months.
- The withholding tax is 5% on dividends to a company holding at least 10% of the shares, 10% on dividends paid to pension funds and 15% in all other cases.
- Interest and royalties are free of withholding taxes.
- Pensions are taxable in the state of residence, unless paid by the social security authorities. If, however, the annual pension is more than €15,000, it may also be taxed in the state of payment. This tax is then credited against the tax in the state of residence if relevant.
- Double taxation is basically avoided by exemption, provided the other state exercises its right to tax. Exempt income is taken into account when setting the rate to be applied to the remainder. Conflicts of law are resolved by switch-over to the credit method if "white" income would otherwise ensue.
- Businesses (and their employees) on German/Dutch trading estates straddling the border are taxable in the country of their management. If this is not clear, the right to tax falls to the country in which the greater part of the main building lies. The tax auditors of the country with the right to taxation have access to the entire building, but must notify the start and finish of the audit to their colleagues from the other state.
- The treaty enters into force on the first day of the second month following the exchange of instruments of ratification. It takes effect on the following January 1.

New double tax treaty with Luxembourg

The representatives of Germany and Luxembourg put their signatures to a new double tax treaty on April 23, 2012. The new treaty follows the OECD model in its current state and thus includes the more sophisticated exchange of information, mutual agreement and anti-abuse provisions of recent years. Specific details are:

- A building or assembly site becomes a permanent establishment after twelve months.
- The dividend withholding tax is 5% on payments to a company holding at least 10% of the shares and 15% in all other cases.
- Interest is free of withholding taxes.
- Royalties (but not asset rentals) may be taxed at source at up to 5%.
- Pensions are taxable in the state of residence, unless paid by the social security authorities. However, the pension may be taxed in Germany if the contributions were deductible or otherwise privileged there for longer than twelve years, unless this twelve-year criterion was also met in Luxembourg. There is also no German tax, if the contributions were met from taxed income in Luxembourg.
- Double taxation is basically avoided in Germany by exemption, provided Luxembourg exercises her right to tax. Exempt income is taken into account when setting the rate to be applied to the remainder. Conflicts of law are resolved by switch-over to the credit method if "white" income would otherwise ensue.

Avoidance in Luxembourg is also by exemption, though, except for pensions, without the condition of actual taxation in Germany.

The treaty enters into force on the day of ratification. It takes effect on the following January 1.

Swiss treaty enactment procedure starts

September 2011 saw the conclusion of an agreement with Switzerland to end that country's deliberate sheltering of German tax evaders. The agreement would have allowed German holders of Swiss bank accounts to legalise their position with a lump sum payment without revealing their identity. Income credited to their accounts from then on would be subject to a withholding tax to be collected on behalf of the German treasury at the same rate as would be levied on investment income within Germany. Those preferring not to take advantage of this amnesty would be given the opportunity to remove their assets to another country of their choice, again without revealing their identity. This treaty was widely criticised as being too generous to tax fraudsters, but vehemently defended as being the best available and certainly much better than no treaty at all. However, the government saw the criticism as sufficiently powerful to force it to reopen negotiations with the Swiss finance ministry. These were concluded with an amending protocol of April 5, 2012 improving slightly on the original terms:

- The lump sum taxation to legalise the past would rise from the range of 19%-34% to one of 21%-41%
- Inheritance tax fraud (not touched upon in the first treaty) could be resolved at the choice of the present account holder by disclosure to the German authorities or by a lump sum payment of 50% of the legacy received (50% is the highest rate of German inheritance tax).
- The maximum number of specific requests for information on account holders – must be based on a founded suspicion – has been increased from 999 to 1,300 over a two-year period.
- The deadline by which those not wishing to regularise the past or to tax future income must remove their assets from Switzerland and close their accounts has been shortened by five months to the day the treaty takes effect (proponents of the treaty hope for January 1, 2013).
- Clarification that the provisions now agreed do not impinge on the withholding tax already being levied on the interest income of German resident account holders under an agreement with the EU (the difference between the two agreements is that that with the EU allows Switzerland to retain 25% of the amount collected).

Whether these improvements will be sufficient to silence the – still vocal – opposition to the treaty in many political quarters remains to be seen. At any rate, the cabinet has now started the ratification process with its resolution of April 25 on a bill to be laid before Parliament for the enactment of the treaty into national law. This bill must be passed by both chambers – opposition in the *Bundesrat*, the second chamber, is likely to be more intense than in the *Bundestag*, the first.

Tax Amendment Act

The "Act Amending the Communal Finance Reform Act and Tax Rules" of May 8, 2012, promulgated on May 11, enacts three minor and non-controversial changes to the tax statutes. They are:

- Sales of horses are subject to standard rate VAT from July 1, 2012. This follows in reaction to an ECJ case holding that horse sales may only be taxed at the reduced rate if made for food or for the manufacture of foodstuffs or fodder. This exception has been ignored as it has no real relevance to the German economy or eating habits.
- The Income Tax Act exemption of the private use by employees of internet and telephone facilities provided by the employer has been extended to include computer programmes. Thus, private use by an employee of an employer programme installed in his home office is no longer a taxable benefit in kind. The changes is retrospective to 2000, the year in which the internet exemption was introduced, and thus applies to all cases still open to "wage tax" audit or other investigation.
- The Income Tax Act provision to counter tax treaty abuse has been extended with a new sub-section to the effect that tax treaty exemption of dividend income

attributable under domestic law to a person other than the actual recipient shall only be available to the extent the true beneficiary would have been entitled to an exemption had he received the income direct. This change is intended to curb abusive exemption claims by companies acting as undisclosed agents for private individuals and applies as of January 1, 2012.

Official Pronouncements

US treaty pension funds include those legally held by others

Under the US double tax treaty, dividends paid to pension funds in the other country are free of withholding tax. The German and US authorities have now reached agreement that this pension fund exemption should apply to dividends paid to employers operating a retirement savings plan for their employees under a "contractual trust arrangement" and to investment trusts on their investments held on behalf of pension funds as pension fund assets.

Agreement with Switzerland on taxpayer identification

The provisions in the double tax treaty with Switzerland on the supply of information on specific taxpayers provide for identification of the taxpayer concerned "typically by name, date of birth, address, account number or similar identifying information". The German and Swiss finance ministries have now agreed that a taxpayer on whom information is sought can be identified by reference to other factors than his or her name and address; thus Swiss banks will no longer be able to protect their German customers from information requests by accepting a false address for their customer records.

Valuation of Greek bonds

On February 24, the Greek government published an „invitation memorandum", inviting the private holders of government bonds to agree to an exchange of their securities for a new issue of lower nominal amount and on less favourable terms. There are four elements to the new issue, new Greek government bonds, PSI payment notes of the EFSF (European System of Financial Supervision managed by the ECB), GDP linked securities and a zero-bond of the EFSF in compensation for unpaid interest. The finance ministry has issued a decree on the value at which the new issue is to be taken up:

- The old bonds withdrawn are to be treated as sold at the value at which the new government bonds and the PSI payment notes are to be taken up. This is the market rate on the day of issue, or on the first day of trading if later.
- If these two securities are sold before the first day of trading, the capital gain on sale is to be taken at 30% of the proceeds.
- The GDP linked securities and the EFSF zero-bond are to be taken up at nil. They thus have no effect on the loss on withdrawal of the old bonds. However, if they are sold, the entire proceeds are taxable as investment income.

Investment write-down in 2001 to be allowed

The 2000 corporation tax reform abolishing the old, imputation system rendered dividend income and capital gains on the sale of shares in other companies tax-free in the hands of another corporation. Correspondingly, investments could no longer be written down with tax effect. Because of the need to align the taxation of the shareholders with that of the company making the distribution, these aspects of the reform only came into effect in 2002, a year after the main body of the legislation. However, they took effect in 2001 as regards shares held in foreign companies, as there was no need for systematic alignment of companies not subject to German corporation tax. A German corporate shareholder was thus able to write-down its investment in a domestic corporation in 2001 for the last time, but could no longer do so on its holding in a foreign company.

On January 25, 2009, the ECJ held this discrimination to be an unjustified infringement of the freedom of capital movement (case C-377/07 *STEKO*). The finance ministry has now followed this judgment in a decree of April 16, 2012 calling for application in all cases still open. The decree goes slightly beyond the ECJ judgment on write-downs to a lower stock market value in allowing write-downs for any reason. It applies to any investments held in EU/EEA companies and to those of up to 10% in companies located elsewhere.

No deduction for court costs as private expenses

Traditionally, the Supreme Tax Court has long taken the view that the court and other legal costs of pursuing or defending civil law claims did not generally qualify as tax-deductible special expenses. Deductible special expenses are those necessarily incurred in fulfilment of an obligation or duty which the taxpayer is unable to avoid on legal, existential or moral grounds. Fighting a legal action before the civil courts is only unavoidable if the taxpayer would otherwise lose his or her basis for ensuring access to life's necessities. In May 2011, the Supreme Tax Court took a different view and allowed a deduction for court and other legal costs, provided the taxpayer could show sufficient likelihood of legal success and provided his action did not seem to be merely spiteful.

The finance ministry has now issued a decree instructing tax offices not to follow this latest ruling as a precedent in other cases. Its main argument is that to do so would be impossible, as the tax office has no means of reliably pre-judging the outcome of a case or of establishing the motives of the parties. The decree also hints at a "possible change in the statute" to re-establish the previous position in retrospect.

Sale of shares as sale of business

The sale of a self-contained business unit from one business to another is not turnover within the meaning of the VAT Act. In January 2011, the Supreme Tax Court held that this could also apply to the sale of the shares in a VAT group subsidiary. The condition was that either the entire share capital was sold, or that a majority holding was sold and the acquirer purchased with the intention of bringing the new subsidiary into a VAT group. The consequence of a non-VAT-able sale outside the scope of the VAT Act as opposed to a VAT-free sale of shares under the act was the deduction of the input tax on the (in this case, legal and consultancy) costs associated with the sale.

The finance ministry has now amended its VAT implementation decree to reflect this judgment. The sale of shares now ranks as the non-VAT-able sale of a business where the acquirer is able to assume the position of the seller as lead company in a VAT group comprising the subsidiary acquired. This condition is deemed to be met if the newly acquired business is integrated into that of its new parent, that is, the subsidiary supports or complements the operation of the parent. It is not essential that the new subsidiary actually join the VAT group, provided it does not do so for other reasons. Transactions currently in process are protected by the provision that no exception will be taken to continued adherence to the old view of the law (a sale of shares is privileged for VAT if it is also privileged for income tax) up to the end of March 2012.

All land valuations and land tax assessments to be provisional

Land tax is levied by the local authority at local rates on land as valued under the Valuation Act. Theoretically, these taxable values should reflect the market; however they have been established individually only once, in 1931-34, with all subsequent adjustments and extrapolations being based on macro statistics without taking account of value shifts between properties or types of property. There is a strong body of opinion holding that the taxable values are now so far removed from reality as to constitute an infringement of the constitutional requirement for equal treatment in like circumstances. The Constitutional Court has confirmed this view in respect of net assets tax (since abolished) and inheritance (gift) tax (since reformed), but has not yet spoken in respect of the less frequent application to real estate transfer tax (the taxable value is only relevant if there is no specific consideration for the transfer) or of the much less important land tax.

The provincial finance ministries have decided to stem the flood of appeals against land tax assessments with a joint decree calling on all tax offices to issue valuation and land tax assessment notices provisionally, subject to Constitutional Court clarification of the issue. Valuations and notices will be automatically confirmed, adjusted or withdrawn in the light of the ruling when it comes. The taxing authorities will then follow suit in amending their payment demands.

Supreme Tax Court Cases

Foreign corporate shareholder has claim on refund of dividend withholding tax

A GmbH paid a dividend to its sole shareholder, a French company in the legal form of a *société par actions simplifiée* – SAS. It deducted withholding tax at the 5% treaty rate for dividends to other corporations as, at the time, the SAS had not yet been included in the

annex to the EU Parent/Subsidiary Directive or in the corresponding provisions of national law. However, there was and is no doubt that the SAS is a corporation entitled to treaty relief.
In the meantime, the ECJ has held that the German withholding tax on dividends paid to other corporations abroad is an infringement of the freedom of capital movement, because a German corporation will always receive a full credit or refund of the tax deducted at source, whereas a foreign recipient will never do so from Germany and will only do so in the home country if the dividend income is subject to tax there at a higher rate (case C-284/09 *Commission v. Germany*, judgment of October 20, 2011). The Supreme Tax Court has followed this judgment in the present case, holding that the foreign dividend recipient corporation must be treated in the same way as a domestic entity. Accordingly, it cannot claim refund or exemption from the Central Tax Office as though it fell under the Parent/Subsidiary Directive, but can turn to the locally competent tax office for a refund after the event.

Supreme Tax Court judgment I R 25/10 of January 11, 2012 published on April 11

No treaty override if foreign state waives right to tax

A German resident pilot for an Irish airline received his salary net of Irish tax under the airlines clause of the double tax treaty. At the end of the year he applied for, and obtained, a full refund of the Irish tax paid, on the grounds that he was not an Irish resident employee and had not performed any of his duties in Ireland. The German authorities attempted to tax this salary for themselves under a combination of two treaty override clauses in domestic law. Both substitute the credit method for the exemption method, the first where the (resident) taxpayer cannot show that he has paid the foreign tax on employment income or that the foreign state has waived its right to tax, and the second where any form of income is not taxable in the foreign state because of a conflict of definition or because the recipient is not resident there.

The Supreme Tax Court has held that the second of these overrides is subordinate to the first. Thus, if the taxpayer can, as in this case, show the foreign state to have waived its treaty right to taxation (the refund of the employee withholding tax deducted – PAYE), there is no scope for applying the second of these provisions, at least, as regards income from employment. Indeed the court drew the conclusion that the second part of the second override has little application in practice to employment income, unless the waiver under the first provision is less than complete. Accordingly, resident aircrew of foreign airlines have potential to earn “white” (legally untaxed) income despite the apparently uncompromising prohibition of the Income Tax Act.

Supreme Tax Court judgment of January 11, 2012 published on March 28

Constitutional Court to rule on treaty override

As a rule, German double tax treaties exempt the employment income of residents where the right to tax falls to the other state, but take the amount exempted into account in calculating the rate to be applied to the other, non-exempt income. However, the Income Tax Act contains a treaty override provision substituting the credit method for the exemption method of avoiding double taxation where the employee earning the income cannot show either that the foreign state has actually taxed the income in question, or that it has waived its treaty right to do so. A case has been brought before the Supreme Tax Court by a resident claiming exemption of employment income earned whilst working on a nine-month temporary assignment to Turkey. Under the German/Turkish double tax treaty, this income was taxable in Turkey and exempt in Germany. However, the taxpayer produced no evidence of Turkish taxation, so the German tax office applied the treaty override provision and refused to exempt the amount claimed.

The Supreme Tax Court sees two constitutional conflicts in the override provision. The first lies in a conflict with the provision defining the “general rules of international law” as part of Federal law with priority over federal statutes, and the second is a breach of the equal treatment provision in that the override at issue applies to employment income only, rather than to income of all sources. Accordingly, it has stayed its case, laying its doubts before the Constitutional Court.

The double tax treaty with Turkey in the version valid up to December 31, 2010 contained no “switch-over” or other clause transferring a taxing right to the state of residence in the event of non-collection in the state of activity. There is thus no authority under the treaty for application of a domestic law override. The “general rules” of international law require, however, adherence to international agreements – *pacta sunt servanda* (pacts are to be kept) – and the agreement here in question allocates the taxing right to Turkey and supports this provision with an information exchange clause and other measures designed to make evasion more difficult. A claim justifying the override as a measure against evasion is, in the view of the court, only plausible if Germany were to forward the amount collected to the Turkish authorities. This, though, was not the legislative intention. Anti-avoidance or anti-evasion considerations could not justify a unilateral appropriation of a taxing right by Germany for levy at German rates and for the benefit of the German treasury. That the effect of the override provision is arbitrary is also evident from the consideration that it would not apply if the taxpayer could show actual taxation abroad at a very low rate.

The Supreme Tax Court's view of the equal treatment breach is based on the consideration that the override applies to employment income only, but not to other forms of income taxable in the other state, such as trading profits, fees for independent personal services, or income from property. These forms of income are also potentially exposed to evasion by non-residents through failure to file tax returns or to meet other compliance obligations, particularly if their ties to Turkey are only temporary. There is also no evidence to suggest in general terms that employees tend more towards tax deceit than other taxpayers.
The Supreme Tax Court has already suggested several times that it harbours grave constitutional doubts on the treaty override. However, in all cases up to now, the court was able to disapply it for other reasons; thus there was no occasion to seek the verdict of the Constitutional Court.

Supreme Tax Court decision I R 66/09 of January 10, 2012 published on May 9

Capital gains from foreign holdings include exchange gains and losses

The Supreme Tax Court was charged with reviewing an investment in the Bahamas denominated in US $. The holder calculated her gain on sale as the difference between the dollar amount invested and the dollar amount received, translated into euros at the current rate. The Supreme Tax Court on the other hand sided with the tax office in holding the gain to be the difference between the original amount invested in euros and the proceeds on sale also in euros. Both amounts were to be translated at the official exchange rate on the day of the transaction. This also applied where the original investment was in a different currency to that received on dissolution, and to capital repayments on winding-up.

The taxpayer raised the objection that the exchange gain or loss on the transaction would be included in the gain under the Supreme Tax Court method of calculation. The court agreed, but said that exchange gains or losses in the hands of private individuals were not tax exempt if they arose in direct connection with other transactions, in this case, a foreign investment, subject to taxation (n.b. exchange gains and losses are, in the meantime, taxable as investment income).

Supreme Tax Court IX R 62/10 judgment of January 24, 2012 published on April 4

Fire insurance policy reinsured with group captive not an abuse

A German operating subsidiary of a worldwide group held by a Liechtenstein trust through holding companies in Germany and Luxembourg was faced with the refusal of its (independent) insurance company to continue to offer fire insurance cover for the factory on the same terms as in the past. Rather, the insurer insisted on significantly higher premiums, a higher excess (the uninsured initial amount of the risk to be borne by the insured company itself) and a more comprehensive risk management system in the factory. After a round of difficult negotiations, a solution was found based on continued cover from the previous insurer at market rates acceptable to the company's management, but with reinsurance of the entire risk through a group captive insurance company without its own employees based on the Isle of Man. The arrangement was mirrored for four other operating subsidiaries. The independent insurance company forwarded its premium receipts to the reinsurer, receiving in return a commission. The tax office saw the scheme as a sham and disallowed the premium expense borne by the company as a hidden distribution of profits. The lower tax court agreed.

The Supreme Tax Court, however, took a different view and allowed the premiums borne by the company as genuine business expenses. The immediate insurer was an independent entity and was the sole contracting party of the insured company. It therefore bore the full risk under the policy and was unable to refer the insured company to the reinsurer in the event of loss. It had also taken steps to ensure recourse to the reinsurer – it had asked for accounts, a bank letter of credit for the risk and for information on the reinsurer's own reinsurance measures. The overall picture was one of a genuine business arrangement. The court emphasised that a payment to an independent third party could not usually be construed as a hidden distribution, as it could not generally be assumed to have been made at shareholder behest. In the present circumstances there were good business reasons for the independent insurance company's involvement and for the Isle of Man reinsurance. The insurance company had competent staff for assessing risks and adjusting claims, on whom the reinsurer could rely, whilst the reinsurer was able to enjoy the benefits of the more relaxed Manx supervisory requirements and formal obligations to which reinsurance companies need adhere. The court also discussed the Manx tax exemption for the reinsurance company, but did not draw negative conclusions on the grounds that those involved were free to take advantage of favourable tax regimes, provided the business arrangements were genuine.

Supreme Tax Court judgment I R 19/11 of February 15, 2012 published on April 4.

Loss carry-forward transfer only if loss maker still owned at date of transfer

In its version applicable to corporate reconstructions reported to the trade registry on or before December 12, 2006, the Reconstructions Tax Act provided that an unused loss carry-forward passed to the surviving entity(ies) in proportion to the assets transferred. However, the transfer was conditional on the loss-making entity (or business segment) continuing with its operation in a substantially unchanged form for the next five years. The Supreme Tax Court has now held the loss carry forward transferred to a newly formed subsidiary to be forfeit, because the business unit that caused the loss had been sold by the transferor some two years earlier.

The court accepted that the unused loss carry forward should be divided between the original holder and the new subsidiary at the time of the drop-down in proportion to the assets transferred, given that both the assets transferred and those remaining constituted a recognisable business unit capable of its own sustained economic existence. The court also accepted that the five year continuity requirement in respect of the business activity that caused the loss could be met by either the transferor, the transferee, or, for that matter, by a third party. However, the question only arose after the date of the transfer. If the loss making activity had already been sold or abandoned, the transferor was no longer in a position to ensure continuity for a further five years. Accordingly, the successor subsidiary could not benefit.

Supreme Tax Court case reference I R 13/11, judgment of March 14, 2012

Court doubts on interest limitation to third party lenders with recourse to shareholders

A company was held jointly by two – otherwise unrelated – shareholders. Each held 50% of the share capital, so neither included the company as a subsidiary in its group accounts. The company was thus not part of a group. However, it could not claim exemption from the 30% EBITDA limitation on its net interest expense, as its not inconsiderable bank loans were secured by guarantees from the shareholders supplementary to the mortgages on its properties. It has attacked this exclusion as an unnecessary restriction on its freedom to do business, and the Supreme Tax Court has now granted a stay of execution on an interim payment demand because it holds doubts as to whether the inclusion within the interest limitation merely because of the recourse of lenders to significant shareholders might not go far beyond the extent necessary to achieve a legitimate object and thus infringe the equal treatment requirement of the constitution.

The primary aim of the interest limitation is to put a brake on the repatriation of earnings by way of interest as opposed to dividend. The German authorities see interest payments abroad as a loophole leading to taxation in the home country as opposed to Germany, whilst investors tend to see them as necessary in order to obtain a deduction for their interest expense at home. Those drafting the interest limitation felt they were combating an avoidance tactic and thus felt justified in surrounding their rule with precautions. Accordingly, interest expense (if more than €3 m) falls under the limitation if the taxpayer is a group company, or if more than 10% of its interest expense is incurred on loans from significant shareholders (over 25%). Shareholders as loan creditors include the shareholders themselves, their related parties and third parties with recourse to a significant shareholder or his related party. The net is cast wide in order to prevent circumvention of the rules through nominee constructions. However, it also catches professional lenders acting in the ordinary course of their business who merely wish the personal guarantee of the major shareholders of closely held companies that they will not use their influence to effectively deprive the lender of his security. It is this latter effect stemming from common banking practice that gives rise to the constitutional doubt.

A company borrowing funds from a bank in the ordinary course of its business bore the interest cost as a business expense. A shareholder guarantee as an additional security precaution for the bank did not change the nature of the transaction and, in particular, did not open a tax avoidance loophole. The situation of closely held companies was thus different from that of German subsidiaries of foreign parents. Indiscriminately including loans guaranteed by shareholders within the interest limitation thus led to dissimilar situations being treated alike, an apparent infringement of the corollary to the constitutional demand that similar situations be treated alike.

The present resolution is not the Supreme Tax Court's final decision on the matter. The court has granted the stay of execution on the basis that there are important points in favour of the plea as well as against it. Which side carries greater weight is a matter for the main hearing, at which stage it will also be open to the Supreme Tax Court to turn to the Constitutional Court for guidance.

Supreme Tax Court resolution I B 111/11 of March 312, 2012 published on May 9

Subordinated debt repayable only out of future profits not generally a liability

Under an Income Tax Act provision, a liability may not be taken up if it is only repayable out of future profits or liquidation surplus The Supreme Tax Court has now held that this also applies to subordinated debt ranking behind all other creditors in the event of insolvency. In the case decided, the debtor would have been insolvent, had it taken up the subordinated debt from its sole shareholder as a liability at face value. Effectively, therefore, repayment was dependent upon future earnings or other future event and was not, at the present time, enforceable. The debt was not a burden on the company until the business became profitable, and could not therefore be carried as a liability with tax effect until then.

Supreme Tax Court judgment I R 100/10 of November 30, 2011 published on February 29, 2012

Acquired obligation to be taken up as debt

German accounting principles require adequate provision to be made for all anticipated, or threatened, expenses or losses. The tax computation rules, on the other hand, disallow such provisions until the liability materializes or other formal conditions are met. Accordingly, a tax office insisted that an acquiring company release provisions for future expenses (employees' anniversary bonuses and contributions to a compulsory pension insurance scheme) carried in the balance sheet of an acquired business and reflected in the purchase price.

Contrary to the view of the tax administration, the Supreme Tax Court has confirmed that the acquirer may continue to reflect these provisions in his tax computations. Fundamentally, the court was led by the consideration that the debt had been assumed in the course of a business acquisition and had therefore been "paid for". An asset acquisition should not lead directly to a gain or loss. Rather more legalistically, the court argued that the items had changed their nature with the acquisition. The acquirer was now under an actual obligation to hold the seller harmless from his future expenses and was therefore faced with an actual liability. The threat, or in this case the contingency, had materialised. Accordingly, the liability should be carried forward with tax effect and adjusted year by year to reflect changes in circumstance.

Supreme Tax Court judgment I R 72/10 of December 14, 2011 published on February 29, 2012

Only days of actual presence to be included in 183-day test

Under the double tax treaty with France, the employment income of cross-border commuters is taxable in the country of residence, rather than in that of employment. A cross-border commuter is a person who lives in the border zone of one state and works in the border zone of the other. Minor exceptions are covered by a rule preserving the cross-border commuter status, if the precise definition is not met for up to 45 days in any one year. A French border zone resident who worked on assembly projects on the German side of the border for 166 working days in 2001 and 157 working days during 2002 did not qualify as a cross-border commuter, as he spent more than 45 days in each year in Germany beyond the border zone. Nevertheless, he maintained that his salary was to be taxed in France under the general 183-day rule as he had been physically present in Germany for less than that time. The tax office, however, saw the same rule as calling for German taxation, as routine breaks in the working period for weekends, holidays and sick leave did not interrupt the employment under a mutual agreement between the tax authorities of the two states on the interpretation of the treaty.

The Supreme Tax Court has now sided with the taxpayer, holding that only days of physical presence will be counted. Above all, the mutual agreement between officials could not supersede the wording in the treaty which in this regard followed the OECD model. Hence, the OECD reference that "the recipient be present in the other state" implied physical presence of the employee. The court conceded that this indeed meant including weekends, holidays and other temporary absences from work, but only if the employee actually visited Germany on those days.

Supreme Tax Court judgment I R 15/11 of October 12, 2011, published on March 7, 2012

Supreme Tax Court doubts on 1999/2000 "significant holding"

For decades the gain on sale of shares held as a private asset for longer than one year by a natural person was only charged to income tax if the shares sold were part of a "significant holding" at any time during the previous five years. Up to the end of 1998, a significant holding was defined as "over 25%" of the issued share capital of the company in which the investment was held. In 1999 and 2000, the definition fell to "at least 10%". A case is currently before the Supreme Tax Court brought by an investor who sold his remaining investment of less than 10% in a company in 1999 after having reduced his holding in 1997 from 13.5%. The investor claims that he never held 10% or more in the company during 1999, or more than 25% at any time during the previous five years. Thus he never held a significant holding according to the definition of the moment. The tax office maintains that the taxable gain should be defined under the rules valid on the date of sale, so there is a chargeable gain, as at least 10% was held in 1997 and earlier years.

The Supreme Tax Court has now passed a resolution granting the taxpayer a stay of execution of the assessment notice and payment demand pending its final judgment on the substance of the case. It sees telling reasons in support of both points of view and thus is in serious doubt as to which is right. It also points out that a gain on sale reflects the appreciation of the asset over the entire period in which it was held. Deferral of taxation until realisation does not defer the value appreciation as such. If this value accumulated during a period in which the holding was not considered significant, it does not seem reasonable to tax it later under a different definition. This argument follows from a Constitutional Court judgment on the same issue limiting the chargeable gain to the value appreciation since March 31, 1999, the promulgation of the new law.

In 2001 a different definition applies. The amount has been reduced to at least 1% and the term significant holding has been dropped altogether. Thus, the final outcome of the present case may, or may not, have repercussions for the future. The Supreme Tax Court mentioned the possibility, though, in its resolution.

Supreme Tax Court resolution IX B 146/11 of February 24, 2012 published on March 21

Four-year carry forward for replacement reserve

Traditionally, the courts and tax authorities have allowed deferment of a gain on the loss of an asset by fire or other catastrophic cause (act of God) in order to allow replacement of the asset with a similar item with the full proceeds received from the insurance company or other body offering compensation for the damage. The gain is deferred with a "replacement reserve" to be written back against the capitalised cost of the replacement asset once acquired. Future depreciation or amortisation is thus reduced accordingly. Although there is no statutory basis for this replacement reserve, the official Income Tax Guidelines accept it, setting a replacement period of two years. If the asset is not replaced within that time, the reserve must be released back to income and taxed.

The Supreme Tax Court has now held that the replacement period should follow the provisions for roll-over relief on the sale of land and buildings. These provisions are designed to enable a business to move or otherwise reorganise its operation without having to tax a gain on sale if the full proceeds are needed for a replacement asset. The replacement period is the four business years following the year of sale for assets purchased, extended to six years for newly constructed buildings, provided construction is started by the end of the fourth year. The court pointed out that both forms of relief serve the same purpose, so there is no reason to require earlier replacement of an asset lost through act of God than of one sold. On the contrary, the act of God necessarily catches the business unprepared, whereas a sale is generally planned in advance with thought being given to the asset's replacement before the sale is made.

The roll-over relief provisions penalise failure to utilise the gain deferral for asset replacement with a premium of 6% of the amount released back to income for each year in which the reserve was carried. The Supreme Tax Court has not extended this penalty to apply to a replacement reserve, too, but has required release of that reserve as soon as the replacement intention is dropped. Creation of the reserve is sufficient evidence of the intention in the first year and there is a presumption that the intention remains during the following four years. However, this presumption can be upset by concrete indications of a change in business planning.

Supreme Tax Court judgment IV R 4/09 of January 12, 2012 published on May 9

Hotel entertainment in own restaurant subject to general restriction

A hotel arranged a gala reception for local business and other people able to take entertaining decisions, nominally to celebrate its tenth anniversary. It also invited selected individuals to meals in its own restaurant. The tax office saw these activities as business entertaining and disallowed 20% of the cost under a specific provision allowing only 80% (now 70%) of business entertaining expense reasonably incurred. The hotel argued that it should be allowed a full deduction for its costs as it had not entertained, but, rather, had demonstrated the quality of its services to selected actual and potential customers.

The Supreme Tax Court has accepted the product demonstration argument as a distinction from business entertainment, but has held that it can only be applied restrictively. Tasting sessions of specific products in the hope of selling precisely those products would qualify for the exception if organised by, or for, suppliers. Airline meals as an ancillary to a paid service – the flight – are also not "entertaining" in this sense. However, a hotel or restaurant seeking to promote its own services does so as entertaining and must therefore accept the 20% (now 30%) disallowance of the cost. It could only claim a full deduction, if it sought to promote specific products, such as particular meals.

Supreme Tax Court judgment I R 12/11 of September 7, 2011, published on January 25, 2012

Interest on tax overpayments taxable income of corporations

There has long been a feeling of injustice within the taxpaying community over the view of the tax authorities of interest on tax overpayments as taxable income whilst disallowing the interest paid on underpayments as a deductible expense. The Supreme Tax Court confirmed the disallowance of the deduction in 2008, as far as the taxes themselves were not deductible expenditure, but held that corresponding interest income could not be charged to income tax. Its reasoning was that income tax was a private, not a business, expense of the payer and thus directly related receipts and payments were also private matters outside the sphere of income-earning activity.

The Supreme Tax Court mentioned in its 2008 resolution that its reasoning was irrelevant to corporations, as these did not, by definition, have a private sphere. It has now elaborated on this position in a case specifically challenging the dissimilar treatment of income and expense in the hands of companies. A company, or other corporation, does not have a private sphere by definition. Thus every transaction is business related, including the payment of corporation tax. Corporation tax and related payments including interest are disallowed as deductions from the corporation tax basis of assessment by a specific provision in the Corporation Tax Act. However, corresponding income is not covered by that disallowance and is thus taxable as income from the business. In further explanation the court pointed out that the intent of the interest charge on tax payments was to compensate the beneficiary for being unable to use the capital represented by the debt. Had there been no overpayment, the taxpayer would have been able to invest the amount at issue. This would have earned the company income subject to corporation tax. Taxing the interest received from the tax office thus ensured like treatment with interest received from other sources.

The Income Tax Act was changed in 2010 to specifically include interest on tax overpayments in the catalogue of taxable interest income items. There is thus no longer a distinction between natural persons and corporations.

Supreme Tax Court resolution I B 97/11 of February 15, 2012, published on March 14

Retroactive taxation of interest on refunds of non-deductible taxes unconstitutional?

In 2010 the Supreme Tax Court revised its existing case law by holding the interest received on a tax refund to be tax-free, if the underlying tax was not a deductible item. These are income and corporation taxes, and the VAT charge arising from the input tax on non-deductible business expenses or from drawings in kind. The interest received on refunds of these taxes continues to be regarded as investment income; however - according to the Supreme Tax Court - it is to be considered as falling under the specific Income Tax Act exclusion for the parallel expense item and therefore to be exempt.

The finance ministry reacted to this judgment with an amendment to the Income Tax Act restoring the *status quo* prior to the court decision: interest received on refunds of non-deductible taxes remains taxable as investment income with retroactive effect, as the amendment is to apply to all open cases. This retrospective legislation was widely felt to be unfair and two taxpayers have challenged it before the Supreme Tax Court as unconstitutional. The main case has not yet been heard; however the court has granted a stay of execution on a payment demand, stating that there are important grounds in favour of both sides of the argument.

Supreme Tax Court resolution VIII B 190/11 of December 22, 2011, published on February 15, 2012

Trade tax restriction on interest deductibility upheld

A German subsidiary received a long term loan from its Dutch parent. At the time, the Trade Tax Act disallowed one-half of all long-term loan interest paid as a business expense (the disallowance is now one-quarter of all interest paid over €100,000). The subsidiary maintained that this disallowance thwarted the object of the Interest and Royalties Directive – the avoidance of double taxation on interest and royalty payments within groups – and appealed against its trade tax assessment. The Supreme Tax Court saw at least some merit in this argument and referred the question to the ECJ. However, the ECJ held that the German Trade Tax Act disallowance was not in conflict with the Directive which was only concerned with avoiding legal double taxation in the hands of the recipient. Nowhere does the Directive refer to the payer of the charge or to a concept of economic double taxation for a group. The trade tax disallowance of one-half the interest expense had no effect on the net proceeds received by the parent as interest creditor. It was therefore irrelevant to the Directive, rather than being in conflict therewith.

The Supreme Tax Court has followed this ruling against the German subsidiary and has also rejected the additional argument of discrimination under the double tax treaty. This latter follows from the assertion that the add-back would have been avoided, had the subsidiary been allowed to form an *Organschaft* with its Dutch parent. The court made the points that there was no double taxation as the income in Holland was not subject to German trade tax and that there was no discrimination under the wording of the treaty. However, the court also pointed out that the double tax treaty dates from 1959 and is not in accord with the current version of the OECD model. It may therefore be open to taxpayers to return to this point when the recently signed revised treaty enters into force (see PwC Reports above).

Supreme Tax Court judgment I R 30/08 of December 7, 2011, published on March 7, 2012

Fixed monthly wage supplements not tax-free

An employer granted his employees wage supplements for work at night, on weekends and on public holidays. The supplement was paid regularly and at fixed amounts without allowing for actual work done at the times requested. The employer exempted these portions of the salary from wage tax up to certain limits. The tax office refused to accept this on the grounds that the supplements had not been paid for specific work and in the absence of detailed time records. The Supreme Tax Court upheld the position of the tax office: detailed time records must be kept and the remuneration actually paid should follow these. It should be immediately clear that payment was made for a specific task rather than for job performance in general. A global payment monthly would be acceptable only if adjusted to actual at the end of the year or on leaving the company if earlier. This adjustment should, at the very least, involve taxing in retrospect any part of supplement that had not actually been covered by night, bank holiday or weekend time.

Supreme Tax Court judgment VI R 18/11 of December 8, 2011, published on February 15, 2012

Sale of bad debts without recourse not a provision of services

A German bank sold a portfolio of debts from private customers secured by mortgages on crisis-hit housing for just over one-half of their face value. In each case, the mortgage had fallen in and the full debt was currently due, following debtor default on the repayment instalments. The buyer, a financial services company, clearly considered itself better able than the bank to pursue defaulters ruthlessly, presumably because it would not need to protect future business relations with the debtors as customers and because it would not be exposed to the same public pressures when evicting the previous owners from the properties. The tax office saw the transaction as a disguised debt collection service for the bank and demanded VAT on the difference between the selling price of the portfolio and its "economic value". This latter was a notional amount based on the collection expectation discounted over the estimated time needed to collect. Since the question turned on the interpretation of the relevant clauses in the Sixth Directive the Supreme Tax Court brought the case before the ECJ who in its judgement of October 2011 decided that the 'supply of services effected for consideration' requires the existence of a direct link between the service provided and the consideration received. Since the buyer received no consideration from the bank, he therefore did not carry out an economic activity or effect a supply of services within the meaning of the relevant sections in the Sixth Directive.

Following the verdict of the ECJ, the Supreme Tax Court has confirmed the view of the taxpayer and ruled that a sale of debts at an agreed valuation and without recourse 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 amount) 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 court also emphasized, that as a consequence of the non-taxable debt purchase, the buyer could not claim recovery of input VAT attributable to either the purchase of the collection of the debts.

Supreme Tax Court judgment V R 18/08 of January 26, 2012, published on March 7, 2012

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

The owner 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 sale was of the ownership in the stocks and shop fittings at an agreed value, the premises being transferred under a lease cancellable at will at three months' 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 ten-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). In view of this, the Supreme Tax Court referred the case to the ECJ. The ECJ was of the opinion that a sale of a shop's stock and fittings accompanied by an indefinite lease on the premises cancellable at three month's notice can indeed be VAT-free as the sale of an entire business, if, in the circumstances, the items transferred are sufficient to enable the purchaser to operate on a lasting basis. Accordingly, the final decision of the Supreme Tax Court was in favour of the seller.

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 since 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.

Supreme Tax Court judgment XI R 27/08 of January 18, 2012, published on March 7, 2012

No input tax deduction on share disposal

The tax authorities generally refuse a deduction for the input VAT on expenses incurred in connection with the sale of investments, since that sale is an exempt transaction. The Supreme Tax Court has now confirmed this view in a case involving the claim of a holding company for deduction of the input tax on an advisory fee paid in connection with the sale of a shareholding. The holding company's input tax deduction was limited to tax incurred in connection with its taxable outputs, in this case with its management services supplied to its subsidiaries. Thus the tax on an advisory fee in connection with the sale of shares was not-deductible in its entirety, whereas that incurred on general expenses attributable to both taxable and tax-free outputs could be deducted in proportion to the two totals.

Supreme Tax Court judgment V R 40/10 of February 9, 2012, published on March 7, 2012

Hotel voucher subject to VAT as prepayment

A ticket agency ran a hotel voucher scheme entitling voucher holders to a three-night stay at a hotel to be chosen from a catalogue of some 2,500 houses at home and abroad. The guest surrendered his voucher on booking. The hotel did not charge for accommodation, but did require a minimum consumption in the hotel restaurant. This amount was charged to the guest, regardless of whether he ate there or not. The agency sold each voucher for €49.90 and retained this amount as its own reward for running the scheme. It claimed that the amount was not a charge for a taxable service, as the service had not yet been, and quite likely never would be, performed. Vouchers lapsed after a year and only about 14% were actually redeemed. The tax office argued that the sale of each voucher was a sundry supply to be taxed at the standard rate.

The Supreme Tax Court has held that the sale of each voucher is to be regarded as a payment in advance of the anticipated service of the accommodation agent. It is therefore taxable at the standard rate on services to be taxed at the standard rate (hotel accommodation in Germany) and is to be exempted in respect of accommodation provided abroad. Given that the use of the voucher is unknown at the time of sale, the sale is to be taxed at the standard rate. This is subsequently to be reversed under the provisions for bad debts, returned goods and retrospective changes in the VAT status of a transaction, should the voucher be redeemed abroad. If the voucher is not redeemed at all, the taxation becomes absolute, the service of offering accommodation having been performed in Germany, the country of the agency. Voucher redemption is through the agency which therefore has the necessary information to make the adjustments as and when required.

Supreme Tax Court judgment of September 8, 201,1 published on January 11, 2012

Party service subject to full rate VAT

A butcher operated a party service as a sideline. The service consisted of the delivery of hot and cold food supplemented as needed with the loan of crockery, cutlery, folding tables and staff. He claimed the supply of food to predominate; thus the relevant turnover should be subject to reduced rate VAT. The tax office brought the service features of the supply to the fore, and demanded standard rate VAT on the entire delivery. The Supreme Tax Court referred the question to the ECJ, which gave judgment to the effect that a party service carried out a service if there was any service element additional to the supply of (hot or cold) food, unless there were particular circumstances to show that the service element was negligible (case C-497/09 *Blog et al.* judgment of March 10, 2011 joined with three cases of fast food sold at stands).

The Supreme Tax Court has now followed the ECJ in holding the entire turnover of the party service to be taxable at the standard rate. The three examples remaining in dispute involved the delivery of food together with the loan of two folding tables for the party, the supply of a "hot and cold buffet for 70 persons" and a delivery of wine. With regard to the first, the court emphasised the ECJ's position that the service element in a party service was already appreciable – if only because the customer took delivery at a precisely agreed time – so that any other service element – charged or not – was sufficient to render the transaction a mixed supply taxable at the standard rate. The loan of two tables in the same connection as the delivery of cooked meat was sufficient for requalification from the straight sale of food. The second example, the buffet, was a service in its own right. The buffet was assembled by qualified personnel able to match and contrast the various dishes as required for a harmonious whole. This alone distinguished it from the sale of food as a reduced rate transaction. The supply of wine was dismissed as irrelevant; alcoholic drinks were always charged to standard rate VAT, regardless of whether they were delivered or served.

Supreme Tax Court judgment XI R 6/08 of November 23, 2011, published on January 25, 2012

From Europe

Tax offices do not have to coordinate application of VAT rules

A German employment agency supplied lorry drivers to a series of Italian haulage companies. At the time, the hire of staff was taxable in the country of the customer, whereas the provision of general services was taxable in the country of the provider. The agency's local tax office took the view that the service was general and taxable in Germany, as the lorry drivers were not its own employees. Rather they were self-employed independent contractors taking on temporary assignments. Accordingly, the agency invoiced the Italian customers with German VAT. Initially, the customers accepted this invoicing on the basis that the VAT position had been confirmed by the German tax authorities and that they would be able to recover the amount charged through the refund scheme for foreign businesses. Unfortunately, their refund claims were rejected by the German Central Tax Office, the competent authority for dealing with refund claims from abroad, on the grounds that the VAT had been charged in error as the services were hire of staff – regardless of the formal employment status of the individuals – taxable in the country of the customer.

In consequence, the Italian customers refused to accept further invoices from the agency with VAT, leaving the agency with the choice of persuading its own tax office to follow the view of the Central Tax Office, bearing the cost of the VAT as its own expense, or allowing its customers to turn to other suppliers. In the event, it was unsuccessful in persuading the two German tax offices to apply the same law in the same way to both sides of the same transaction. It was unable to bear the cost of the VAT as a business expense as its margin was less than the VAT standard rate. It therefore had to face the loss of its market and ultimately went bankrupt.

The ECJ has now decided the VAT issue by holding that the supply of staff was taxable in the country of the customer, even if the supplier is not their formal employer. Unfortunately, this part of the decision came too late to save the taxpayer's business. As a precedent for the future it is now only relevant to cases of staff hire to non-business customers outside the EU/EEA. The court side-stepped the more basic issue of whether two tax authorities from the same country can be required to take a uniform approach to the same problem by saying, that it was up to member states to ensure that VAT is collected accurately and with respect for the principle of fiscal neutrality. The authorities must act if two subordinate offices consistently take conflicting positions, but do not have to establish a mechanism for automatic coordination. Rather, they only have to ensure that aggrieved parties can turn to the courts. The court did not comment further on the realism of this last demand.

The ECJ case reference is C-218/10 ADV Allround, judgment of January 26, 2012.

Freedom of establishment excludes free movement of capital?

The German inheritance tax rules privilege significant holdings in unquoted companies, provided the heir maintains his or her interest for a set period of time. The main objective is to support the continuity of family businesses. Accordingly the privilege is restricted to companies (and other businesses) within the EEA. A German resident inheriting the rights to the entire share capital in a Canadian company from her late father, also a German resident, has challenged this geographical restriction on the grounds that it infringes her freedom of capital movement under the EU treaties.

The ECJ advocate general on the case has recently published her opinion to the effect that whilst the freedom of capital movement is infringed, the freedom of establishment is the more important of the two here relevant fundamental freedoms. This, though, is not infringed as it does not apply to establishments outside the EU or EEA but nevertheless precludes direct application of the freedom of capital movement. Accordingly, the heiress in the case at issue cannot claim the privilege she seeks.

The ECJ case reference is C-31/11 Scheunemann, opinion of March 20, 2012.

Portfolio management services chargeable to VAT?

A German bank is in a dispute with its tax office over the VAT status of its portfolio management services to private clients. It sees the services as primarily VAT-free dealing in securities whilst the tax office sees them as consultancy led. The ECJ advocate general on the case has now published her opinion to the effect that the general service element predominates; hence the services are not exempt as dealing in securities. On the other hand they do rank as financial services from the point of view of place of performance. Thus when rendered to private clients outside the EU they are deemed performed at the residence of the client. Under current law, this means they are not taxable within the EU, but the EU bank supplying them is entitled to deduct input tax. The advocate general accepts that the relevant provisions of the VAT Directive can be construed in different ways. The portfolio management here at issue was a service offered by the bank to wealthier private clients for a flat rate fee based on the value of the portfolio. Buying and selling was at the bank's discretion without specific reference to the client, though in pursuit of an agreed strategy. The fee charged was split into trading and custodial/advisory portions, though both portions were at standard rates applied to the same basis. The advocate general saw this and other possible splits as artificial, emphasizing that the average client would see the management as a single service designed to maintain and, if possible, increase his wealth. From the same point of view, the primary element was the application of the experience and expertise of the bank's staff to decisions to buy or sell, or to wait for a more favourable moment. The actual transactions were a necessary routine function. This "consultancy" element of the service was sufficient to take it beyond pure trading, thus taking it beyond the exemption for trading in securities, not least in view of the principle of keeping exemptions to the general norm of standard rate taxation to a minimum.

On the other hand, the advocate general saw the portfolio management service as falling under the general definition of financial services within the context of the rules on the place of supply. Under the VAT Directive as it at present stands, portfolio management services for private customers resident within the EU are deemed performed at the place of the bank establishment where they are carried out. If the customer is resident outside the EU, the place of supply is his country of residence. In this latter case, the service is not taxable within the EU and the bank has an input tax deduction.

The ECJ reference is C-44/11 Deutsche Bank, opinion of May 8, 2012

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