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PwC Reports

Discussion draft on partnerships

The finance ministry has published a discussion draft of a decree on the tax treaty consequences of investing in partnerships. The draft is based on the classic German view of a partnership as a transparent vehicle for income and corporation tax (though not for trade tax) and on the distinction between trading and other (e.g. asset management) partnerships. The income of a trading partnership is treated as the trading income of the partners earned through their permanent establishment in the country of the partnership's location; the income of other partnerships is attributed to the partners in profit sharing ratio without requalification. Conflicts of definition or concept with the other state are basically resolved by the switch-over provisions of German law substituting the credit method for the exemption method of avoiding double taxation where adherence to the exemption method would lead to effective exemption in both states. The draft makes, however, no mention of the Supreme Tax Court's doubts on the legality of the switch-over provision in the absence of a specific provision in the relevant double tax treaty or of the case it has laid before the Constitutional Court. The draft classifies entities as partnerships by comparing the foreign legal form with its nearest German equivalent. The comparison is based on company law. Relief from German withholding tax will be primarily claimed by each partner under his, her or its relevant double tax treaty. If, however the partnership is treated as a corporation in its own country, the German relief will follow that classification.

Silent partnership income will be treated as a dividend if the silent partner has rights to the assets of the company (i.e. shares in a liquidation surplus) or as interest if he does not.

Qualification conflicts leading to total exemption of income are avoided by switching from the exemption to the credit method. Conflicts leading to double taxation are to be resolved in a mutual agreement proceeding with the competent authorities of the other state.

Official Pronouncements

Provisions for profit-based pensions

No provision may be made for future pension costs based on future profits. A valid pension promise must be in writing and must define the future benefits. The pension provision may not take post-balance sheet date events into account. In March 2010, the Supreme Tax Court held these provisions to exclude a provision for an increase in pension obligations on the basis of the current year's profits.

The finance ministry has now reacted to this decision with a decree accepting it as a precedent. The decree goes slightly further, though, in as much as it emphasises

the need for written confirmation of the additional benefits in the form of an amendment (or supplement) to the written pension promise. Employers with pension provisions based on past years' profits have until December 31, 2014 to issue the required amendment.

Transactions in own shares

Traditionally a company treated its own shares purchased as an asset, unless the purpose of acquisition was their cancellation. Accordingly, companies generally carried their own shares purchased at their purchase cost and showed a gain or loss on any sale. However, the Accounting Modernisation Act of 2009 (BilMoG) changed the approach to require companies to show their own shares held at nominal value as an openly disclosed deduction from issued share capital. Amounts paid in excess of the nominal value are to be deducted from the distributable reserves. Sales proceeds in excess of the nominal value are to be added to the distributable reserves up to the amount of the original deduction. Remaining amounts are to be taken to capital reserve. The costs of purchase or sale are current expenses. In principle, the purchase of a company's own shares is to be equated with a reduction of capital and the sale with a capital increase. The finance ministry has now issued a decree calling on tax offices to follow the new accounting rules in computations of taxable income.

A purchase of a share for more than its nominal value is to be seen as a capital repayment up to the nominal amount and then as a dividend. If distributable reserves are insufficient, the excess is a repayment of capital reserve. If the share is purchased for less than its nominal amount, the difference is to set against the share capital from the capitalisation of revenue reserves. Remaining amounts are to be taken to capital reserve. There is to be no withholding tax on a deemed dividend from the purchase of an own share, as the seller has made a sale of an asset and will tax a capital gain as applicable.

A sale by a company of its own shares does not lead to a tax-relevant gain or loss. The nominal value of the sale reduces the deduction from the issued share capital. An excess receipt is taken to capital reserve and a deficit is to be deducted from a positive balance on that account. Any remaining deficit is a balancing item representing capitalisation of reserves.

The tax accounts and computations are to follow the legal accounts. The new approach to a company's own shares is thus to be applied in the same year for both purposes. An existing balance carried as an asset is to be treated as a reduction of share capital and the "reserve for own shares held" is to be released back to (taxed) income. An excess of the previous book value over the nominal value is to be deducted from distributable reserves.

Tax consequences of dissolution of German resident British company

Forming a British limited company as a vehicle for a German operation is sometimes seen as an easier and quicker alternative to the GmbH as a means of incorporation. It also avoids the German minimum capital requirement of €50,000. However, the company must observe regular reporting and compliance requirements, even if it is not resident in the UK, e.g. by virtue of its German place of management. If it fails to comply, it risks being struck off the register. If that happens, the company immediately ceases to exist, its unsecured liabilities are cancelled and its assets fall to the Crown. The finance ministry has now published a decree outlining its views of the German tax consequences of such a dissolution.

The ministry does not wholly accept the consequences of British law. Rather, it sees the removal of the company from the register as the start of the winding-up period. The company is therefore deemed to continue in existence, though it may no longer trade. Its tax liabilities and assets (repayment claims) remain valid, as does the obligation to file tax returns for the liquidation period. Winding-up will be in the hands of previous management, unless the tax office or other creditor presses for the appointment of a liquidator. Continued business in the company name will be seen as the business transactions of the individuals responsible, to be taxed as their own trading income.

Salary fraud free of payroll withholding tax

A long-serving, trusted payroll clerk took advantage of a weak system of internal control to award himself a series of unauthorised salary increases. The fraud was discovered after some four-and-a-half years and the company requested the tax

office to return the payroll withholding tax deducted from the fraudulent amounts. The tax office refused in respect of all past years on the grounds that the salary as actually paid and the withholding tax as actually deducted had already been certified to the employee and that this certificate could not now be altered. The company went to law and was ultimately successful when the Supreme Tax Court held (in November 2012) that an employer was not required to withhold tax from an amount paid as salary against his will. Accordingly, the company was entitled to return of all amounts paid over to the tax office on the fraudulent "wage" in respect of all years for which the payroll tax audit had not yet been finalised. The finance ministry has now issued a decree on the application of this judgment to similar cases.

An employer can correct payroll errors at any time up to year-end, or until the employee's earlier leaving date. The payroll records of all but very small employers are subject to regular audit at three to five yearly intervals. Once an audit has been closed out, the assessments are final and binding and cannot generally be reopened. The Supreme Tax Court judgment at issue therefore covered the calendar years for which annual salary tax certificates had been issued but the payroll records had not yet been audited.

The decree distinguishes between fraudulent payments disguised as salary or other benefits and unintended payments made in error. Errors cannot be corrected, once the final figures for the year have been certified (now notified to the tax authorities). Fraudulent payments against the will of the employer are not elements of employee remuneration and are not subject to withholding tax. Taxes withheld and accounted for to the tax office are to be refunded on application, provided the employer amends the annual remuneration notification. The decree closes with a reference to employer liability for tax revenue lost as a result of incorrect salary tax certification or notification; this reference, though, will often prove to be an empty threat, given that the fraudulent salary is not itself taxable as employment income.

Discounting of insurers' claim provisions

Long-term provisions – those not expected to be used or released within one year – must be discounted at the rate of 5.5% p.a. This also applies to provisions created by insurance companies to meet unsettled claims for damages arising before year-end. In general, each claim should be evaluated separately, although the finance ministry has adopted a temporary rule allowing insurers to base their discount calculations on an average settlement period. This rule has now been extended for another two years, to run for all business years up to that ending on or before December 31, 2015.

Finance ministry circular on redundancy payments

The finance ministry has issued a circular on employee redundancy payments, dealing essentially with the question of income accumulation in a single tax year.
A lumpsum payment in compensation for loss of future income received by an employee may rank as "extraordinary" income. If the payment meets the criteria, the employee's tax charge is five times the incremental tax on one-fifth on the amount. This relieves him from an excessive burden from the progressive rate scale, that would be borne, were he to be required to tax a single redundancy payment in the year of receipt. It is therefore dependent upon actual receipt of the entire amount within the same tax year. The finance ministry has now issued a circular explaining the concept in more detail. Points worthy of note are:

- A privileged redundancy payment compensates for loss of future income. A settlement payment for entitlements already earned or existing, such as salary arrears or untaken holiday, does not rank for the relief.
- The entire redundancy payment must be made within the same tax year. However, a second payment of not more than 5% of the main amount made earlier or later will not be considered harmful. Spreading the payment over two years will also be accepted, if necessary to relieve unusual hardship for the employer or employee.
- Granting or altering a pension promise on the occasion of redundancy will not affect the tax treatment of the compensation payment as "extraordinary" income.

Spouse living in Switzerland can rank as liable to German tax

In February 2013, the ECJ held in favour of a German couple living in Switzerland but with income from German sources only, who were claiming the right to a full

set of German personal allowances – including especially the relief for married couples – on the grounds that any Swiss allowances would be of no benefit for lack of income taxable in Switzerland. The basis for the ruling was the EU/Swiss agreement on the free movement of citizens. The finance ministry has now issued a decree to the effect that spouses of EU/EEA nationality living in Switzerland may opt for unrestricted German taxation if their partner is resident in Germany. The same decree also provides for a German deduction of alimony or maintenance payments to former spouses of family members resident in Switzerland on condition that the recipient taxes the income. In this regard, Switzerland is thus equated with the EU/EEA countries.

Finance ministry rejects bond stripping scheme

The scheme criticised by the ministry involves a short-term investment by a German taxpayer in a privileged investment fund. This acquires at least 25% of a Luxembourg fund (SICAV) with the cash and – if necessary – a bank loan. The SICAV then invests its funds in long-term fixed interest securities. Shortly afterwards, it sells the interest coupons for cash, which it remits to the German fund as a dividend. This dividend is free of withholding tax under the treaty and tax-free in Germany under the rules for investment funds. However, the investment in the SICAV must now be written down to reflect the depletion of its assets. This write down is a tax deductible expense. The fund thus shows a large tax loss which it attributes to the investor before winding itself up. Ultimately, the investor is left with a small net outflow of cash (the expenses of running the scheme) and a large tax loss from netting a tax deductible write-down against tax-free income.

The finance ministry sees this scheme as abusive and has requested tax offices to challenge it. It offers three angles of attack:

- The income of the German fund is not a dividend, but interest collected in advance. Interest income is not protected as dividends under the rules for significant holdings
- The scheme was brokered as a model – this has to be shown in each specific instance – and thus falls under the offset prohibition rules for brokered tax deferral schemes
- The scheme is abusive as it cannot make a profit for the investor if the tax saving is ignored.

Option for VAT on sale of real estate

The sale of an entire business (to include the transfer of all significant assets needed for the business to survive as an independent entity) is free of VAT. The sale of real estate is, in principle, also free of VAT, although the parties to a conveyance of commercial property may jointly opt for VAT – in the interests of saving the input tax deduction previously claimed by the seller. Because it is not always clear that a sale of assets ranks as a sale of an entire business, the practice has grown up for buyer and seller to agree to VAT the sale of the property, should it be seen by the authorities as a separate transaction. The finance ministry has now accepted this practice in an amendment to the VAT Implementation Decree, provided it is clear that the parties exercised the option in the notarised conveyance of the property purely in case their joint view of the transaction as the sale of an entire business should prove to be unfounded. The option ranks as having been exercised on the day the conveyance took effect.

VAT on waste disposal

Industrial and commercial waste often has value, particularly if valuable substances can be recovered from it. The finance ministry has added a section to its VAT Implementation Decree distinguishing between the sale of materials – the seller receives payment – and the service of waste disposal – the owner of the waste pays for it to be taken away. Most of the new section, however, deals with the more complicated mixed form of agreement, where both sides are aware of the mixed commercial interests of the waste disposal business in earning a fee for the service and in acquiring or recovering valuable substances that can be used or sold. In this case, there are effectively two transactions as in an exchange of goods for a service.

The amended decree assumes an exchange where the one transaction influences the price of the other. This is the case where specific prices for both parts of the transaction are agreed, or where the price for the disposal service varies with the type and quality of the waste delivered, or where the supplier of the waste shares

in the resale proceeds of the disposal service. However, there is no exchange where the collection is unspecific – such as general rubbish removal – or where the value of the waste can only be established subsequently.

VAT on returnable containers

The finance ministry distinguishes between transport accessories, such as palettes, to be used within the trade and containers which necessarily (or typically) pass to the final consumer on retail sale of the goods (e.g. bottles). Transport accessories are to be treated as independent of the sale of the goods they accompany. The deposit paid on sale or return is subject to standard rate VAT. Containers, on the other hand are seen as inseparable from the goods they contain. VAT is charged on the deposit at the rate applicable to the main supply. The return of the deposit is a subsequent reduction of the same turnover.

The finance ministry also deals with exchange systems involving the delivery of transport accessories against return of similar items, e.g. delivery of goods on palettes in exchange for empty palettes after the previous delivery has been sold on. These deliveries are treated as non-monetary loans. Payments for handling fees or similar are subject to standard rate VAT. However, payments to the original owner to compensate for items that cannot now be returned (theft or destruction) are untaxable compensation for damages. This contrasts with a payment made by a customer who wishes to keep the palette or other accessory (sale of goods at standard rate VAT). Exchange/repair programmes (e.g. delivery of six broken palettes in exchange for two refurbished ones) are to be treated as an exchange of goods of the same value (in the absence of any compensating payment). The first delivery is to be regarded as a payment on account of the second, so both parties tax their own sale in the period of the first delivery.

VAT exemption for investment consultancy to investment trust funds

In April 2013, the Supreme Tax Court held that the services of an investment consultant to an investment trust fund could be VAT-free as the administration of fund assets, if the consultancy led to a concrete recommendation to buy or sell investments based on the overall position and requirements of the fund. The point of the decision was that the consultant was effectively taking the decision – subject to management review – and was thus acting as investment manager. The finance ministry has now amended the VAT Implementation Decree to accept this decision as a precedent where the recommendation is based on

- the concrete requirements of the fund, including any legal restrictions,
- permanent review of the performance of the fund's assets, and
- up-to-date knowledge of the fund's investments.

Permanently moored houseboat to be let as property

In November 2012, the ECJ held that a houseboat permanently moored was to be let as a building attached to a fixed site, that is, free of VAT unless the tenant is renting for business purposes and both parties jointly agree on the option to waive the VAT exemption. The finance ministry has now amended its VAT Implementation Decree to follow this judgment in all other similar cases. A vessel is seen as being permanently moored if it is firmly attached to an identifiable site on the bank or bottom of a waterway. The contractually agreed and actual usage must be permanently at the same place, so that the boat is effectively used as an immovable building. If the conditions are not fully met, the lease is the hire of a means of transport, subject to standard-rate VAT.

VAT on catering sales – transition

In March 2013, the finance ministry followed up on a series of court cases with a decree giving guidance to caterers on the distinction between sales of food and drink as goods (food sales at reduced-rate VAT) and the supply of restaurant services taxed at the standard rate. This decree replaced earlier guidance which took a somewhat more rigid position. The ministry has now issued a decree saying that no exception will be taken to businesses following the old rules in respect of sales up to September 30, 2013. This applies both to inputs and outputs; thus a seller may apply a more favourable rate under the old rules whilst a buyer will be able to deduct the input tax at the higher rate actually charged.

Changeover rules for margin taxation

The margin scheme for dealers in collectors' pieces and other used items allows them to charge their gross margin to standard rate VAT and to ignore the input tax actually borne. However, many dealers in antiques and other collectors' pieces

opted for mainstream taxation, given that many, if not all, of their sales would then only be chargeable to reduced rate VAT. However, the VAT Act was amended in June 2013 to reduce the application of the reduced rate to sales by dealers of items of philatelic and numismatic interest. The finance ministry therefore expects many dealers to adopt the margin scheme as of January 1, 2014 and has now issued a decree to ease the changeover.

Dealers and auctioneers of collectors' pieces who wish to change to the margin scheme for 2014 are entitled to assume that 60% (by number) of all items on hand at December 31, 2013 qualify. The items must then be selected (arbitrarily) and recorded. The remaining 40% of items on stock must also be recorded. Sales of these items will be taxed under the standard system. Sales of the "margin scheme items" will be taxed on a margin of 30%. These rules for administrative convenience are intended to run until the end of 2016. Later sales of items brought forward from December 31, 2013 will be taxed under the standard rules for margin taxation, that is the dealer will be required to establish the actual margin (based on his original purchase price) and to show that no VAT was charged on the purchase other than under the margin scheme.

Supreme Tax Court Cases

Costs associated with mutual agreement proceeding are not costs of earning income

US resident realised a gain on the sale of a share in a GmbH. The German tax office sought to tax the gain, but the taxpayer objected on the grounds that it was taxable in the US under the double tax treaty. This tax office did not accept this objection, so he requested a mutual agreement proceeding in an effort to clear the issue. Ultimately, the two governments agreed to split the taxing right in the ratio 60:40 in favour of Germany. However, the taxpayer had incurred various consultancy and legal costs in the course of the process and these should, he claimed, be deducted from the taxable gain, as they would not have arisen without it. The tax office refused this, too.

The Supreme Tax Court has now held that the costs at issue were not direct costs of making the gain. They were incurred in the course of resolving a dispute over the right to tax it and thus did not arise until after it had been made. Admittedly, without the gain, they would not have been incurred at all, although this connection was too remote to allow classification as direct costs. The court explicitly left the question open as to whether they might have been allowable against total income as "unusual expenses", as that deduction is only available to German residents.

Supreme Tax Court judgment IX R 25/12 of October 9, 2013 published on December 4

Dividends to US "S corporation" rank for full treaty relief

A US corporation may opt for "S" status if it has no more than 100 shareholders, all of whom must be resident individuals. An S corporation – the most common corporation in the USA today – is exempt from corporate income tax in its own name, but passes its income, allowances and credits direct to its shareholders. In other words, it is a fully transparent vehicle.

The Supreme Tax Court has now held – for the second time – that an S corporation basically qualifies for double tax treaty relief as a corporation on the basis of its corporate form – akin to a GmbH. However its rights in this respect are restricted by the condition that the income be chargeable to US tax, albeit in the hands of a shareholder or other party. Normally, the condition will be fully met, but exceptions are possible, such as a minority shareholder moving abroad without telling the company.

The Supreme Tax Court thus reduced the withholding tax to be charged on a dividend to an S corporation with a 50% shareholding to 5% as opposed to the Central Tax Office demand for 15% as an "other" dividend within the meaning of the US double tax treaty. The Central Tax Office had argued that the S corporation was not taxed as a corporation in the USA and thus could not be treated as one for withholding tax. However the Supreme Tax Court took the view that the legal

form of the entity was a question of company law, and not of tax status. The corporate form was clearly closer to a German company than a partnership, and the condition restricting treaty relief to the degree to which the beneficial owners (the shareholders) taxed their income followed from an explicit treaty provision.

Supreme Tax Court judgment I R 48/12 of June 26, 2013 published on October 30

Foreign partner receives business income from the interest on a shareholder loan to associated company

One of the three limited partners in a GmbH & Co. KG was resident in Thailand. The GmbH & Co. KG operated an active business, selling at home through its own branches and abroad through a British selling company jointly held by the three partners. The partners granted the company interest-bearing shareholders' loans. The German partners attributed these loans to the partnership, as they were necessary for the finance of the British company and therefore to maintain the sales network of the partnership. The Thai partner protested that his share in the company as well as his loan were his Thai assets and were nothing to do with the German partnership.

The Supreme Tax Court has now rejected his appeal. The investment in the British company was for a German business reason. Neither the partnership nor the partners operated through permanent establishments in other countries. In particular, the Thai partner had no business operation in Thailand, and his asset management (of the shareholding and the loan) could not rank as such. The consequence was requalification of his interest income from Great Britain to trading income from Germany. This meant that the loan interest was fully taxable. It was not protected by the interest article of the German/Thai double tax treaty, as that only dealt with interest arising in the one state for a beneficiary resident in the other. However, the interest here arose in Great Britain and could not be attributed to a permanent establishment elsewhere as the British payer only maintained one single establishment. Any resulting double taxation (in Germany and Thailand) was to be accepted in view of the provisions of the German/Thai treaty (no reference in the "business profits" article to income falling under other articles and no "other income" provision).

Supreme Tax Court judgment I R 47/12 of June 12, 2013 published on October 30

Global estimate of taxable income from foreign fund inhibits free movement of capital?

A resident investor held units in a Cayman Island investment trust through a depot with a Liechtenstein bank. The tax office applied a provision in the Foreign Investment Funds Act setting the taxable income of a domestic unit holder in a "black" foreign fund at 90% of the increase in the redemption price of units over the year, but at a minimum of 10% of the unit redemption price at year-end. A "black" fund is one that does not comply with the German registration, publication and disclosure requirements on foreign funds with German resident investors, or appoint a German agent to represent it before the German authorities. The fund in question was not compliant in either regard. The investor protested against this assessment as excessive, claiming that the provision on which it was based infringed her fundamental freedom of capital movement. The tax office responded that the restriction on her freedom of capital movement was permitted under the provision of the Treaty on the European Union allowing such restrictions in connection with direct investments or financial services to continue in force in a substantially unchanged form since December 31, 1993. In any case, the restriction was justified by the overriding need to protect tax revenue from evasion.

The Supreme Tax Court feels that the taxpayer is in the right. The provision in question clearly inhibits the freedom of capital movement. It also sees no justification for penalising an investor with excessive taxation for a fund's failure to comply. As regards the "stand-still" clause permitting continuation of third country restrictions in force on December 31, 1993 it takes the view that an investment in a fund does not constitute a direct investment within the meaning of the provision, as it confers no management rights over either the fund, or the fund's own investments. The financial services condition is also irrelevant as that condition can only apply to the provider, not to the recipient or customer. It also feels the tax evasion justification advanced by the tax office to be disproportionate

in two respects. Firstly, it offers the taxpayer no possibility of furnishing the required information from his own sources, and, secondly, it applies to all non-compliant (non-EU) foreign funds, regardless of any mutual assistance or information exchange agreement with Germany that the home country might have. The provision therefore goes beyond what is necessary to achieve its legitimate aim. However, these are questions of community law which the Supreme Tax Court felt obliged to lay before the ECJ.

Supreme Tax Court decision VIII R 39/12 of August 6, 2013 published on October 30

Exclusion of deduction for private pension paid by non-resident in breach of community law?

A father transferred the family business to his two sons in equal shares, receiving in return a small pension. One of the sons was resident in Germany, but the other was a non-resident, taxable in Germany on his German source income only, but with only restricted rights to personal allowances and relief for non-business expenses. Accordingly, the resident son was able to deduct the pension paid to the father as a privately incurred "unusual" cost, whereas the non-resident was not. On the other hand, the pension received by the father was taxable in his hands only to the extent it had been deducted by the payer. The non-resident son has claimed that his exclusion from deduction is a discrimination restricting his freedom of capital movement under the TFEU and has cited the ECJ Schröder judgment (case C-450/09, judgment of March 31, 2011 holding the exclusion of deduction for a non-resident paying a pension in return for a let property to be, indeed, discriminatory) in support of his argument. However, the Supreme Tax Court is unsure as to whether Schröder is a precedent for the present case and has turned to the ECJ for clarification.

As the court explained in its referral decision, there are various arguments in support of the taxpayer's contention based on the link between the pension expense paid and the profits of the business. However, under the Income Tax Act, the pension is not deductible as a business expense but as the cost of meeting a personal obligation. Under this logic, the relevant link is to the income tax charge on the pension in hands of the recipient. Here, though, the situation is less clear, as allowing a non-resident a deduction could lead to a systematic loss of tax revenue, such as where the recipient was also non-resident, the pension then being taxable under the laws of his country of residence.

Supreme Tax Court decision I R 49/12 of May 14, 2013 published on October 30

No provision for the costs of following an official injunction until the deadline has passed

A hirer of commercial aircraft provided for the future costs of complying with official instructions to modify certain items of the aircraft equipment. The tax office rejected the provision on the grounds that it was for future costs, which should not be taken to expense until actually incurred. The Supreme Tax Court has agreed with the tax office in respect of the cost of the modifications to be completed by a set date in the future, but agreed with the taxpayer in respect of those for which the deadline for completion had already expired at balance sheet date. The court's reasoning was that the modifications were required primarily in the public interest and therefore led to business expense when they were carried out. From the point of view of the business, their purpose was to ensure the future viability of the operation. If, however, the deadline had already passed, there was a current public duty at balance sheet date. The cost of meeting this duty was an expense of the period(s) then ending.

It should be noted that the modifications in question did not lead to any particular benefit for the business (other than its being able to continue operating) and were not capitalisable. Thus, in the circumstances, there was no need to reduce the provision in the light of an incremental future benefit.

Supreme Tax Court judgment IV R 7/11 of October 17, 2013, published on December 18

Payment recipient must be clearly identified

The Tax Management Act contains a provision that the recipient of a payment must be named "precisely" on the demand of the tax office. Failure to satisfy this

demand leads to non-deductibility of the expense or liability. The tax office has discretion as to whether it makes the demand. The Supreme Tax Court has now expanded on these principles in a case involving an investment in Spain held through a Liechtenstein letterbox. The German taxpayer acquired the shares in the Liechtenstein company for nearly ten-times the amount that company had paid a year earlier for the Spanish shares bought from another Liechtenstein letterbox. The Spanish venture proved unsuccessful over the course of the following three years, at the end of which the Liechtenstein shareholder was put into liquidation. The German taxpayer received the (by now worthless) Spanish shares as a liquidation dividend in kind in final settlement of its claims on the liquidation estate. The tax office cited the Tax Management Act and demanded to know the identity of the persons behind the letterbox to which the company had paid for its investment. The company claimed to be unable to provide this information, but did offer its written assurance that none of its German related parties were direct or indirect beneficiaries. It also proffered the statement of the Spanish investment broker to the effect that he, the broker, held powers of attorney to represent the interests of all involved. Neither the tax office at the time, nor later the courts, were prepared to accept these statements as "precise" identification of the payment recipient. Accordingly, they disallowed the write-down on the worthless investment as a deductible expense.

The Supreme Tax Court confirmed this disallowance, making the point that the purpose of the identification provision was to enable the authorities to ensure that income did not go untaxed. Accordingly, the condition could only be met with the identification of the ultimate beneficiaries of the payment, be they the owners of the letterbox, or be they the persons for whom the letterbox was acting as agent. This identification must be sufficiently precise and extensive to demonstrate that the income was either not taxable in Germany at all, or, if taxable, that it had in fact been taxed. The court also made the point that there was no difference in principle between capital expenditure and outlays for current expense. Thus the deduction for a later write-off of an investment could be denied because of an unidentified recipient of the payment years earlier. It did add that the passage of time could make identification of ultimate beneficiaries more difficult and that tax offices should bear this in mind when exercising their discretion. However, this was not relevant to the present case of only a four-year time span within a single tax audit period.

Supreme Tax Court judgment IV R 27/09 of July 11, 2013 published on October 9

No tonnage tax for short-term operations

The (optional) German tonnage tax rules set the taxable income from operating ships on international routes from Germany at a fixed amount per day of operations calculated from the net registered tonnage of the ship. (1 NRT is 100 ft^3 – 2.83 m^3) of available passenger and cargo space.) The Supreme Tax Court has held that this option is only available to those intending to operate the ship long-term. It derives this view from the ten-year period during which the option cannot be revoked and from the one-year period following the commissioning of the ship during which it must be exercised. In consequence it refused the option to a company which had sold its one ship before putting her into commission at the builders' yard in Poland to sail her to Germany, where the buyer took possession before renaming and reregistering her. Her single voyage whilst in the company's ownership lasted two days and her only cargo was an empty container.

The main purpose of the company in claiming the option was to avoid taxing the gain on sale as business income. It maintained that the sale was ancillary to the operation of the ship on international shipping routes and therefore fell within the ambit of the tonnage tax. This argument collapsed with the court's finding that a sale of the ship before, or within one year after, commissioning could be generally taken as indicating only a short-term operating intention. One the other hand, a sale after the ship had been in commission for over a year could generally be seen as indicating an original intention of long-term use. The company then attempted to argue that part of the proceeds of sale had been used two years later to make a down payment on another vessel. The sale was thus ancillary to the (later) tonnage tax operations of the new vessel. The court rejected this argument, too. Tonnage tax was by vessel, not by fleet, and each vessel had to qualify on her own merits. Typically, the sale of a vessel was the final step in her operational cycle, so a gain would be part of the results of that

cycle and would fall under the taxation regime of, in this case, ordinary business income.

Supreme Tax Court judgment IV R 46/10 of September 26, 2013 published on January 8, 2014

Tonnage tax hidden reserve taxable in Germany on retirement of Belgian partner

Shipping lines opting for tonnage tax must establish the hidden reserves inherent in their assets directly serving the purposes of international traffic. The reserves are the difference between book and market value and are to be established for each asset in the year of the option. A reserve is to be released back to income if the asset ceases to be mainly used for international shipping operations (in this case the release is spread over five years), on disposal of the asset or (in proportion to the ownership rights) on the withdrawal of a shareholder or partner from the entity. A Belgian partner sold her share in a German shipping line partnership taking advantage of the tonnage tax rules. The tax office saw the release of the hidden reserve as taxable business income of the German partnership, whilst the Belgian partner maintained that it was a capital gain on the sale of an investment (the partnership share), taxable in Belgium.

The Supreme Tax Court has now held that although the partnership ranks as an entity under the double tax treaty, its tax attributes follow national law. As a German entity it is a transparent vehicle for German taxation and a contrary classification in Belgium is irrelevant. The release of the hidden reserves in the present case was occasioned by the sale of the partnership share. If it ranked as current income, it was German permanent establishment income of the Belgian partner. If it was a capital gain, it arose from moveable assets held in a German permanent establishment, again taxable in Germany under the tax treaty. Since the effect in Germany was identical, it was unnecessary for the court to distinguish between the two concepts.

Supreme Tax Court judgment I R 67/12 of November 13, 2013 published on December 11

Trade tax deduction for shipping in international waters independent of term of operation

A partnership purchased a merchant ship with the intention of selling her to an investment fund, once the fund had been set up. In the meantime it operated the ship on charter in international waters. Its claim to compute its taxable income on tonnage tax principles was rejected for lack of any intention to operate the ship in international waters over the longer term and the tax office also rejected the partnership's claim for an 80% deduction from the income chargeable to trade tax for the same reason. This stance was based on the reference in the trade tax provision to the tonnage tax provision of the Income Tax Act.

The Supreme Tax Court has upheld the tax office' refusal to allow the partnership to compute its income on tonnage tax principles – as these presuppose an intent to operate the ship in international waters in the long term – but has allowed the partnership the benefit of the 80% trade tax deduction. This relief is intended to remove income from foreign operations from the trade tax base and corresponds to the elimination of foreign permanent establishment income from the taxable income earned ashore. Accordingly, it is independent of the intended term of operation and remains available in the present case where the international operation was merely a temporary measure to make use of the ship whilst the intended purchaser, the investment fund, was still being established. However, the reference in the Trade Tax Act to the tonnage tax computation in the Income Tax Act was relevant, as it meant that the gain on sale of the ship could not be regarded as ancillary to the international operation. Rather, the sale had originally been intended as the main purpose of buying the ship in the first place and must be seen separately from the temporary, "stop gap" international operation. The gain was thus to be charged to trade tax in full.

The court also drew attention to the provision in the Trade Tax Act requiring privileged international operations to be recorded separately where these were not the sole activity of the accounting unit. This provision had no meaning in the present case, where it was only necessary to isolate the gain from a single transaction, the sale of the ship, from the international operating result.

Supreme Tax Court judgment IV R 45/11 of September 26, 2013 published on January 8, 2014

Tax on gifts only if gift taxable income of recipient

Under the provisions of the Income Tax Act, non-cash gifts to non-employees are only deductible as business expenses up to an annual limit of €35 for each recipient. The same act also provides for a 30% flat rate tax to be paid by the donor in settlement of the income tax obligation of the recipient. The rules for the flat rate tax do not set any upper or lower limits, though the view is sometimes taken that the same limit of €35 should apply, if only for the sake of consistency. The Supreme Tax Court has recently held in three cases before it that the flat rate tax is a form of collection and not a separate form of taxation in its own right. Accordingly, it is to be levied on all non-cash gifts that rank as a taxable benefit for the recipient. Specifically:

- there are no monetary limits on the taxation obligation,
- gifts to non-residents (employees of associated companies from abroad attending a group conference) are not chargeable to the tax, as the benefit is not chargeable to German income tax in the hands of a non-resident recipient, and
- employees detailed to attend customers invited to watch a regatta from a sailing ship did not receive a taxable benefit from the cost of their participation; thus the 30% is not due on their consumption whilst entertaining the guests.

Supreme Tax Court judgments VI R 52/11 (no limits by value), VI R 57/11 (non-resident recipients) and VI R 78/12 (regatta) of October 16, 2013 published on January 15, 2014

Employee events: fewer costs to be taken into account

Many employers foster employee relations and boost morale with staff parties, outings and similar functions. Obviously, there is a degree of personal benefit for participants and the Supreme Tax Court has long seen €110 per staff member/participant as the acceptable limit beyond which the event can no longer be seen as being “mostly” in the interests of the employer. If this limit is exceeded, the entire amount is taxable as an employee benefit in kind, in most cases at a flat rate of 25%. Legally, the taxable value is the local retail price of the services supplied; in practice this is generally taken as the actual cost to the employer (cases of self-supply being the main exception). In two recent decisions, the Supreme Tax Court has confirmed the €110 limit, but has narrowed the scope of the expenses to be taken into account. In both cases, this brought the taxable value below €110 per head and thus rendered the entire cost a fully deductible expense for the employer with no tax consequences for the employee.

The *first case* concerned an invitation to the entire staff to join in a celebration of the company’s 125th anniversary. Because of space considerations, the celebration was held in the local football stadium and was organised by a professional event manager. Busses were laid on to take the staff to the stadium and to bring them back afterwards. The entire cost exceeded €110 per participant and the tax office raised an assessment to 25% payroll withholding tax on the full amount as the deemed benefit. However, the Supreme Tax Court held that the taxable benefit could only be the cost of those items which enriched the employee. Essentially, this covered items for personal consumption only, in this case being the cost of the food, drink and music provided. The event manager’s fee, the hire of the stadium and the transport costs were necessarily incurred by the employer – in view of the large number of participants – but did not enrich the employee. Accordingly, they were taken out of the calculation and the cost per head fell below the €110 limit.

The *second case* was on a smaller scale. It involved a summer barbecue for all staff and their families. About half the employees turned up and rather more than half of those that did, brought one or more family members. The direct costs to the employer – food, drink, music and a children’s entertainer – were less than €110 for each person attending; however they were above this limit for accompanied employees if the costs falling on the family members were attributed to the person accompanied. The tax office made this attribution, calling on previous case claw. The Supreme Tax Court has now clarified its

attitude by holding that the costs of family members accompanying employees to staff functions are a cost to the employer, but not a benefit for the employee. Rather, they are incurred in the interests of the employer in encouraging family support for employees. Thus the costs of the function were to be determined per participant, but only those falling to employees could be seen as a taxable benefit in kind. Since the cost per participant was less than €110 there was no attribution of benefit to any employee. The court did, however, add the rider that the costs of family members could be attributed to the persons accompanied if the invitation was to an outside function with its own market value. Communal visits to “musicals or to concerts by performers of world renown” were cited as examples.

Supreme Tax Court judgments VI R 94/10 (football stadium) and VI R 7/11 (barbecue), both of May 16, 2003 and published on October 9

Compulsory employer contributions to Swiss pension fund tax-free in Germany

A German resident worked as an employee in Switzerland. In this capacity he was obliged to join a Swiss occupational pension scheme, funded by contributions from both employee and employer. The pension rights were enhanced voluntarily with supplemental contributions, again from both sides. The resident claimed the total employer contributions as a tax-free benefit under an Income Tax Act provision exempting employer contributions to compulsory schemes. The tax office saw the voluntary contributions as taxable income.

The Supreme Tax Court held in favour of the tax office, though for slightly different reasons. In principle, both sets of employer contributions were potentially a tax-free benefit, as the scheme was compulsory. However, the tax-free amount should not exceed, under the letter of the statute, one-half of the total contribution made. Since this limit had already been exceeded by the compulsory contributions no further scope remained for exempting those made voluntarily. For the same reason, there was no need to test the other limit set by the statute, that the total exemption should not exceed the exempt employer’s contribution under the equivalent German scheme.

Supreme Tax Court judgment VI R 6/11 of September 24, 2013 published on January 8, 2014

Regular place of work not affected by renewed secondment

An employee may charge or deduct some of the expenses incurred on business travel as incurred and others at basically adequate flat rates. The cost of getting to work by car is deductible as a cost of earning income at half the rate allowed for business travel. The distinction when travelling between separate locations of the employer is based on the employee’s regular place of work, that is, the location to which he is permanently assigned. The Supreme Tax Court has now held that a secondment of one year to a different location does not make that new location the regular place of work of the employee, provided the intention is that he return to his original workplace at the end of the assignment. The thinking is that an employee travelling to and from his regular place of work can reduce his costs by car sharing and other measures not open to someone on only temporary secondment. The court has also held that successive renewals of the secondment – for a further year in each case – do not, as such, change this appreciation. The important point is the expectation at the time of agreeing the secondment.

For 2014, the business and the employee travelling expense rules have been revised, so this judgment will not, in most cases, be a guide to the future.

Supreme Tax Court judgment VI R 51/12 of September 24, 2013 published on December 18

Foreign business to recover input tax with VAT return if any output tax owed

A foreign business without taxable outputs in Germany recovers its deductible German input tax through a special procedure for foreign business undertakings. Businesses from other EU countries file their refund claims through their own tax authorities by September 30 of the following calendar year; those from

outside the EU file their claims with the Central Tax Office by June 30. However, businesses from outside the EU are excluded from the refund procedure altogether if their own country levies a tax similar to VAT without offering German business reciprocal refund rights. On the other hand, a foreign business with taxable turnover in Germany files a regular VAT return of all its taxable inputs and outputs, even if the two are not connected. This procedure is more complicated than the simplified refund claim system, but does free the applicant from the tight deadlines and also opens the door to refunds to non-EU businesses that would otherwise be disbarred for lack of home country reciprocity.

In a recent case involving a foreign road haulage company, the Supreme Tax Court has confirmed that the two systems are mutually exclusive. Thus a foreign business can only apply one or the other for any one year. However, the court went on to add that a foreign business must follow the mainstream system of filing a full return for any year in which it owed output tax to the authorities at any time for any reason. In particular, this included cases of output tax owed because it had been invoiced in error. The details of the case are (now) unimportant following changes in the law in the meantime, but the point made by the court was in response to a tax office claim that VAT owed as a result of an incorrect charge could not open the way to an otherwise barred input tax deduction. To this, the court replied that any VAT owed had to be shown on a return, and any return was incomplete without the full amount of input tax deductible. It is, however, emphasised that foreign businesses are still excluded from the mainstream system if their outputs are taxed by reverse charge or by transaction (special system for non-EU busses), that is, if they are not the tax office' debtor.

Supreme Tax Court judgment XI R 5/11 of August 28, 2013 published on October 16

VAT refund claim from third country must be signed by authorised signatory

The VAT Act requires VAT refund claims from businesses outside Germany to be signed personally by the applicant. This personal signature "in his or her own hand" is taken to mean that of the authorised signatories of a company. The Supreme Tax Court has now confirmed this view in an appeal by a Swiss company against the refusal of the Central Tax Office to grant it a refund because the application had been signed by a deputy, rather than by the authorised signatory himself.

The company argued that the wording of the VAT Act did not, in this regard, differentiate between businesses from other EU/EEA countries and those abroad. The ECJ had already held that the Eighth Directive (then in force) did not require that refund claims be signed by the applicant or his legal representative personally (case C-433/08 *Yaesu*, judgment of December 3, 2009) and this judgment should be applied to third country applications, too, to avoid discrimination. The court, though, took the view that *Yaesu* required Germany to forego her demand for a personal signature on applications from businesses within the EU/EEA, but did not require her to extend the same liberty to those from third countries. Rather, the Thirteenth Directive explicitly allowed member states to set further conditions and additional or alternative procedures for third country applicants. The only limitation was that third country applicants should not be treated more favourably than those from member states. Similarly, the discrimination prohibitions banned measures to the disadvantage of EU/EEA businesses, but not to those to the disadvantage of businesses from outside the area. The court also pointed out that the demand for a personal signature was important from the point of view of ensuring that the managing director or other authorised signatory was aware of his or her responsibility before the law for the accuracy of a tax return of the company.

Supreme Tax Court judgment V R 3/11 of August 8, 2013 published on November 6

Community law precedence for VAT input tax deduction

The German VAT Act used to tax the sale of horses at the reduced rate of 7%. However, the ECJ held on May 12, 2011 that only horses intended for food or fodder ranked for the reduced rate under the VAT Directive (case C-453/09

Commission v. Germany). A supplier followed this judgment and charged standard rate VAT on the sale of a show-jumper shortly after the ECJ judgment, but before the VAT Act had been amended to comply. The tax office reduced the input tax deduction of the purchaser to the reduced rate on the grounds that he could not claim a benefit from a community law provision if the corresponding, but invalid, national law provision was more favourable to the supplier.

The Supreme Tax Court has now held in favour of the purchaser and granted him a full deduction for the standard rate VAT actually charged. It made the point that the courts are under a duty to ensure that community law is effective in all respects. It is thus not open to an authority to refuse to allow a taxpayer a more favourable deduction available under community law, merely because national law foresees a lower amount. Thus, in the present case, the full amount charged must rank for input tax deduction, provided only that the other formalities, such as invoicing, are also satisfied.

Supreme Tax Court judgment V R 17/13 of October 24, 2013 published on January 8, 2014

Payment to agent for free-of-charge mobile phone is third-party pay -ment

A mobile phone sales agency offered potential customers a number of different schemes. One of them was a free-of-charge handset against a commitment to a two year contract with the network operator at an inflated price for phone calls. The agency purchased the free-of-charge phones from the network and deducted the input tax. It treated the output as a VAT-free sample given away to the customer. The agency was compensated with an "equipment bonus" from the network operator approximating to the cost of the handsets given away. This bonus was added to the agency's regular commission on the credit notes issued by the network for the agency's remuneration. This entire amount was shown as subject to VAT, the amount of which the agency deducted as input tax. The Supreme Tax Court has now held this VAT treatment to have been wrong in three respects.

The supply of the set to the customer was not a gift or a sample; it was the supply of equipment for valuable consideration. As such, it was subject to VAT. The corresponding credit from the network, the "equipment bonus", settled the agency's claim on the customer and was thus a third-party payment. As such, it should not have been subjected to VAT. This meant that the agency was liable to pay the VAT shown on the credit note as an incorrectly invoiced tax charge. On the other hand, the agency should have charged VAT on the supply of the telephone to the customer. This gave the customer the right to input tax deduction – if the phone was acquired for a tax-paying business.

Supreme Tax Court judgment XI R 39/12 of October 16, 2013 published on November 27

No input tax deduction on intra-community sale of VAT-free goods

A supplier of blood plasma sold plasma to a customer in Austria. This sale was VAT-free as an intra-community supply. However, the same sale would also have been VAT-free if delivery had been to a German customer. The Supreme Tax Court has now followed an ECJ judgment (case C-240/05 *Eurodental*, December 7, 2006) in holding that the exemption of a product by its nature takes precedence over exemption by destination. In consequence, the right to deduct input tax incurred in connection with the sale was excluded, just as it would have been, had the sale been made on the home market. As the court pointed out, allowing an input tax deduction on an intra-community supply of an exempt product would distort the system as suppliers would then have an incentive to sell in member states other than their own.

The supplier requested the court not to follow the *Eurodental* judgment in view of the criticism of it in the professional press. The court, however, dismissed the request, as the criticism concerned the application of the judgment to a case involving a supply tax-free in the country of supply but taxable in the country of receipt. This was beside the present point. The court explicitly left the question open as to the application of its judgment to export sales outside the EU/EEA.

Supreme Tax Court judgment V R 30/12 of August 22, 2013 published on November 6

Input tax on transfer agents' fees not automatically deductible by club

Most professional footballers appoint managers to run their business affairs. Typically a manager is either a well-connected close relative, or a registered transfer agent. Under FIFA rules a club must appoint a registered transfer agent if it requires agency services in seeking new talent; a player seeking support in negotiations with a club must also look for a registered transfer agent if he is unwilling to have himself represented by a close family member or a lawyer. Registered agents are prohibited from acting for both sides in any given case. The Supreme Tax Court was recently called upon to adjudicate on the VAT input tax consequences of a manager's contract with his player which specified that the manager use his best efforts to get the club's agreement to accept the player's management charge or, at least, to boost the player's remuneration to cover it.

In the event, the club had accepted a fee invoiced on behalf of nearly every player, be it for support in negotiating the player's contract extension, be it for the recruitment of new players. However, the tax office refused to allow an input tax deduction in respect of the agent's fees. It argued that it was unclear from the circumstances for whom the agent was truly acting.

The Supreme Tax Court adopted the argument of the tax office. If the club had appointed the agent to act on its behalf, the club would be entitled to deduct the input tax on the agent's fee. If, however, it had merely agreed to accept a fee charged for services rendered to the player under an agreement with the player, it would not have incurred the input tax for its own business activity. The tax would not be deductible. It was thus important to review each case individually. However, the court made two further points. Firstly, it was highly improbable that a player's family member or lawyer would be acting for anyone but the player, and secondly it was highly probable that in any given case an agent would not be acting for both sides. To do so would be to risk the agent's license and therefore his livelihood. The court did, though, add the rider to the second point that the German Football Association had publicly stated that a club's transfer agent could advise a player in general terms without breaching the prohibition on acting for two principals.

Supreme Tax Court judgment XI R 4/11 of August 28, 2013 published on October 16

VAT input tax apportionment by value for gaming hall

The VAT Act requires that a business allocate its tax on inputs used for both tax-free and taxable turnover on an "appropriate" basis. Allocation in proportion to the turnover itself is only "appropriate" if no other "appropriate" basis can be found. This contrasts with the provision in the VAT Directive calling for allocation by turnover, unless some other basis is "more precise". A gaming hall operator chose to divide his dual-use inputs by floor space used for tax-free gaming machines and taxable game players. The tax office took the view that the division should be by turnover. Most of the space was taken up by the game players, but most of the turnover came from the gaming machines.

The Supreme Tax Court has now confirmed the tax office in its view. The floor space was divided only by partitions and rows of pot plants. The division was far from permanent and thus not an "appropriate" basis for the allocation of input tax. Since no other "appropriate" basis had been suggested, allocation by turnover remained the only option. In any case, as the court pointed out, the taxpayer himself had said that the two areas were mutually complementary, rendering allocation by floor space even more illusory.

Supreme Tax court judgment XI R 4/10 of September 5, 2013 published on October 30

Missing VAT payments as obvious error in a receipts and payments account

The tax authorities may correct "clerical, mathematical and similarly obvious errors" in official notices at any time and must do so if in the interests of the taxpayer. By contrast, errors of judgment or interpretation can usually only be corrected if the assessment or other official notice is still open to appeal. The

Supreme Tax Court has now ordered a correction to be made to an otherwise final and binding income tax assessment on a sole trader on the grounds that the receipts and payments account submitted in support of the trading income shown on his return contained an “obvious error”. This “obvious error” lay in his having forgotten to include his monthly VAT payments in his (cash basis) outlays to be charged against the trading receipts for the year. The tax inspector dealing with the assessment had failed to notice anything amiss and raised the assessment on the basis of the return as filed. This meant that the tax office had accepted the error of the taxpayer as its own. The Supreme Tax Court held the error to have been “obvious” as the annual VAT return filed at the same time had shown the missing payments. The court therefore refused to accept the tax office’ description of the lapse as “inadequate investigation” as the alternative to “obvious error”. It also refused to accept the tax office’ contention that the error was not “obvious”, as the VAT payments at issue might have been made in their entirety in different years. Rather, it saw the lapse as nothing more than a “mechanical oversight” calling for correction after discovery.

Supreme Tax Court judgment VIII R 9/11 of August 27, 2013 published on November 13

From Europe

Anti-avoidance amendment to Parent/Subsidiary Directive

The European Commission has been deliberating for some time over the possibility that the Parent/Subsidiary Directive, designed to avoid double taxation on corporate income within the EU, might be offering aggressive tax planners potential for abusing the system. Since the Commission has been unable to assess the scope of the problem, it has come up with two potential abuses, which it wishes to curb by amending the Parent/Subsidiary Directive. The first item of concern is the avoidance of withholding tax on dividends outside the EU. Broadly, a non-EU parent establishes a subsidiary – as a holding company or a subsidiary for asset management in a member state offering a nil rate of withholding tax on dividends to be paid abroad. The company then establishes its operation in its country of choice as a subsidiary of the new holding vehicle. This latter – in its extreme form – exists only on paper and uses an automatic forwarding service for official mail. However, dividends to it are free of withholding tax under the directive and their onward distribution is free under domestic law. Thus the EU double tax elimination rules are misused to avoid tax altogether. The Commission suggests curbing this type of abuse by denying withholding tax privileges under the directive to a company with no other business purpose than to hold the shares in the subsidiaries to the overall group tax advantage.

The other Commission proposal concerns “hybrid” finance. A “hybrid” loan in this sense is given to an ailing subsidiary in a tax environment enabling it to claim an expense deduction for the repayments. These repayments are then booked as tax-free income in a country specifying that dividends are per se tax-free income in the hands of a corporation. The income is thus untaxed *in toto*. The Commission would amend the Parent/Subsidiary Directive to specify that a dividend received cannot be tax exempt if the payment was a deductible expense in the country of payment.

No right of taxpayer to be involved in mutual assistance requests

A Czech footballer claimed travelling expenses in his tax return for visits to clubs in Spain, France and England for the purposes of seeking employment. He also claimed business expenses invoiced from Hungary. The Czech tax office contacted its opposite numbers in the countries mentioned under the Mutual Assistance Directive for local confirmation of the reasons for the expenses claimed. The tax offices from Spain, France and England replied that the clubs concerned had no knowledge of a visit by the taxpayer; the Hungarian tax office replied that the Hungarian invoice issuer was only acting as an intermediary for a supplier from outside the EU/EEA and that it would be necessary to turn to that supplier for meaningful information on the business background to the costs at issue. On this basis, the Czech tax office disallowed the expenses claimed, as their business relevance had not been substantiated.

The taxpayer complained that he had not been informed in advance of the requests for mutual assistance, that he had not been able to name witnesses or otherwise contribute to the information gathering process and that the replies from the other tax authorities gave no indication of how, or from whom, they had obtained their information. Accordingly he asserted that he had been deprived of his right to a fair hearing under Czech and community law.

The ECJ has now held that there is nothing in the Mutual Assistance Directive, or under the general rule of law entitling the taxpayer to a fair hearing, requiring either tax authority to involve the taxpayer when presenting or answering requests for information. Indeed, such a requirement could well be counter-productive in certain circumstances. There was also no requirement as to the minimum content of the information supplied (such as naming the precise source). Rather, the tax authorities were free to gather information as they saw fit, it being up to the taxpayer to challenge the accuracy of the facts presented or the validity of the conclusions drawn when challenging the assessment issued. At this stage, his rights were governed by the rules on evidence under national law.

The ECJ case reference is case C-276/12 *Sabou*, judgment of October 22, 2013.

Failure to relieve loss on sale of property abroad does not inhibit free movement of capital

A resident of Finland owed property in France which he sold at a loss. This loss went unrelieved in France, both as a matter of law and from the practical consideration that the taxpayer had no other taxable income in France against which it could be offset. Finnish law would have allowed him a loss offset against capital gains from the sale of securities had the property been located in Finland. As it was, the tax office refused him a deduction because the double tax treaty allocated the sole taxing right on capital gains from the sale of property to the country of location. The taxpayer saw this attitude as discriminatory and claimed that his freedom of capital movement had been restricted.

The ECJ has now held that the difference in treatment in the country of residence between losses on the sale of local property and on that sited abroad is a restriction on the freedom of capital movement. However, that restriction is justified by the need to preserve the allocation of taxing rights between member states. If Finland does not tax a gain she does not need to relieve a loss. The court added, though, that the refusal of French law to allow a loss incurred in France was a matter for France alone. Certainly, there was no obligation on Finland to relieve a French loss merely because no local offset was available.

The ECJ case reference is C-322/11 *K*, judgment of November 7, 2013.

Inheritance tax personal allowances inhibit freedom of capital movement

German inheritance (and gift) tax personal allowances vary by degree of kinship between €500,000 (spouses) and €20,000 (unrelated persons). However, the allowance drops to €2,000 regardless of kinship in all cases where both testator (donor) and heir (beneficiary) are not resident in Germany. A Swiss-resident widower has protested against this distinction in respect of his inheritance of a German property from his deceased Swiss-resident wife.

The ECJ has now held that capital transfers by gift or inheritance fall under the freedom of capital movement – as in *Mattne*r, C-510/08 judgment of April 22, 2010, a case involving a gift of a German property from a Dutch-resident mother to her Dutch-resident daughter – notwithstanding the real estate object of the transfer. The restriction of the personal allowance to a purely nominal amount for transfers between Swiss residents was therefore in breach of the TFEU unless it could be justified by overriding considerations. The German government sought to justify it with the contention that residents and non-residents were not in comparable positions. In particular, it was for the state of residence to grant personal reliefs on the basis of a person's overall position. The court, though, rejected this argument, partly because the German legislation treated the two groups identically in all other respects (valuation, rates and class of kinship) and partly because the higher allowances were only excluded where both parties to the transaction were non-residents. There was no justification for a difference in treatment between transfers between non-residents and transfers between a resident and a non-resident. The court also rejected the other part of this

argument, that the higher personal allowance available to residents compensated for the tax on their inheritance of other assets. Rather, there was no link between the two aspects, as the personal allowances were unaffected by relative amounts. Finally, the government argued that the curtailment of the personal allowance for non-residents was necessary in the public interest due to the difficulties for German authorities in verifying Swiss death certificates. This argument was also rejected, the court pointing out that there was the same difficulty with any foreign death certificate and that the authorities were clearly able to surmount it in the event of a German-resident heir.

The ECJ case reference is C-181/12 *Welte*, judgment of October 17, 2013.

Gaming taxes do not conflict with VAT Directive

German gaming machine operators must follow strict rules on public access, stake limits and the proportion of stake receipts (takings) to be paid out as winnings. Gaming machine takings are subject to VAT, generally on the net cash remaining in the collecting trays after a set period. The operators are also subject to provincial taxes on net gaming takings and to local entertainment taxes. VAT due is usually deducted from the provincial gaming tax due. A machine operator has claimed that these provincial taxes are in conflict with the VAT Directive and undermine the VAT system. The ECJ has now held that they do not conflict with the VAT Directive or with community law as a whole.

The ECJ pointed out that the VAT Directive explicitly allows further taxes on betting and gambling as long as they are not taxes on turnover. Since the German taxes here at issue are levied on net proceeds and are only payable to the extent they exceed the net VAT due, they are not taxes on turnover. Gaming taxes are not harmonised, so member states are free to set them as they wish. The fact that the VAT due is deductible from the provincial tax payable does not impinge on the VAT itself. It impinges on the unharmonised tax beyond the jurisdiction of the court. The court went on to hold that the VAT due on the basis of the net takings after deducting the winnings paid out was the equivalent of taxing the net proceeds of the operator for placing the machines at the disposal of customers. In this light it was acceptable and the calculation (treating the net takings as the receipts gross of VAT) ensured that the full VAT was passed on to the consumer – at least, mathematically. Thus, the system was preserved intact.

The ECJ case reference is C-440/12 *Metropol Spielstätten*, judgment of October 24, 2013.

Penalty tax on "intransparent" investment fund hinders free movement of capital?

Investment funds are in principle free of tax. However, unit holders (the investors) are charged to tax on their share of the fund's income and gains during the year. To this end, funds are required to notify unit holders annually of their performance in the prescribed detail and in German. They are also required to publish their results in the on-line version of the Federal Gazette. If these obligations are not met, the fund is deemed to be "instransparent" and unit holders are charged to tax on the total of the distributions actually received and 6% of the closing redemption price (or market value if available) of the units. German funds meet the requirements as a matter of course – failure to do so leads to action against them under other regulations – and most foreign funds also comply, if only in the interests of marketing their units. However, a Belgian unit holder resident in Germany who had invested in a Belgian fund not otherwise active on the German market objected to this "penalty" taxation for non-compliance on the grounds that it was excessive (it led in the case under review to an income tax charge on an amount over three times greater than the actual income of the fund).

The advocate general on the ECJ case has suggested the court rule this tax to be a hindrance on the freedom of capital movement. It discriminates against foreign funds in so much as, in the ordinary course of events, it is never charged to investors in German funds. An annual growth assumption of 6% is clearly excessive in the present low interest climate. This hindrance on the freedom of capital movement is not justified by an overriding need to protect tax revenue. The legal obligation to supply the required details is on the fund. However, that entity is not subject to German law. Penalising the German unit holder is not an appropriate means of persuading the fund to comply with a German legal

requirement. Even if it were, it would go beyond what is necessary to ensure fair and equal taxation of all unit holders, as the provision gives the taxpayer no chance of obtaining the information for himself, for example with a request as unit holder to the fund management.

The ECJ case reference is C-326/12 *van Caster*, opinion of November 21, 2013.

Denial of corporation tax credit for foreign dividend justified by systematic differences?

Under the German system of corporation tax in force up to 2000 (imputation system) a dividend recipient grossed up the income with the corporation tax borne by the dividend payer. This grossed up amount was then added to the recipient's taxable income. The gross-up factor – representing the underlying corporation tax charge – was then deducted from the corporation, or income, tax due by the recipient. This was repeated for every onward distribution, so that, ultimately, each item of corporate income bore a single tax burden – at the personal income tax rate of the ultimate natural person dividend recipient. If, however, a recipient at any stage in the chain had no liability because of available loss relief, the tax credit resulted in a net claim on the tax office, payable in cash. Foreign dividends, by contrast were exempted from corporation tax, and for that reason no credit was given for underlying foreign tax. Accordingly, the foreign tax remained a final burden if the German corporation had losses.

A US registered corporation with losses, resident in Germany by virtue of its place of management, has now claimed that this denial of relief for dividends received from its wholly-owned subsidiaries in other EU/EEA member states as well as in other countries is an unwarranted restriction on its freedoms of establishment and of capital movement under the TEU and TFEU. The ECJ advocate general on the case has now the suggested that the court hold that a US corporation cannot claim freedom of establishment rights by virtue of its nationality. However, it can claim the right to free movement of capital as that right is not restricted to EU/EEA entities. Also that right is not, in this case, eclipsed by the right to freedom of establishment, as the point at issue – the German tax credit on a foreign dividend – is the same, regardless of the size of the holding. There is thus no distinction between a controlling interest and a small minority holding. The measure itself, the denial of refund of the corporation tax underlying the dividends received from foreign subsidiaries, is a restriction on the free movement of capital. However, this is justified by the need to maintain the internationally agreed balance of taxing rights. Requiring Germany to refund corporation tax paid abroad would upset this balance significantly.

As of 2001, Germany replaced her imputation system of corporation tax with a full exemption of dividend income in the hands of a recipient corporation (now, though, dependent on a minimum holding of 10%). Thus, taken literally, the point of the present opinion has since been lost, although there is still a parallel in the shape of the dividend withholding tax. That on German source dividends is credited against the corporation tax due as though it were a tax prepayment. A final balance in favour of the taxpayer will be refunded as an overpayment. The withholding tax deducted abroad is credited only against the incremental corporation tax actually due on the income. If no German tax is due, whether because the income is tax-free, or whether because of losses, the foreign withholding tax becomes a final burden with only partial relief from the option of deducting it as an expense.

The ECJ case reference is C-47/12 *Kronos*, opinion of November 7, 2013.

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