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Tax amendments 2015 finalised

After a series of political disputes, the *Bundesrat* gave its approval to a Bill to Amend the Tax Management Act to conform to the EU Customs Code and to Alter other Tax Rules in its final session last year on December 19, 2014. There are no major changes to existing law. Among the minor amendments are:

Income Tax Act

The foreign tax credit due on foreign source income may not exceed the German tax notionally due on the same income. Up to now, the credit was limited to the proportion of the tax due on the total taxable income falling to the foreign source income. This averaging calculation was rejected by the ECJ on December 18, 2013 (case C-168/11 *Beker and Beker*) because it effectively apportioned personal allowances between foreign and domestic source income and therefore curtailed them in proportion to the taxable income earned abroad. The new bill replaces the income apportionment with the average rate falling on the taxable income with the intention of taking the personal allowances out of the calculation altogether. Unfortunately, the wording of the bill is deficient, with the result that *Beker and Beker* will not be fully implemented into domestic law. Further legislative action is to be expected.

The basic tax-free allowance of €110 per head against the benefit in kind from staff outings and similar functions has been given a new legal basis in the Income Tax Act as opposed to the Wages Withholding Tax Guidelines. Unfortunately, the cost basis now includes the cost of facilities as well as the cost of the actual consumption, so the number of cases of taxable benefits arising will increase. The main effect is to complicate the administrative burden on employers.

Shareholder loan losses are now only 60% deductible under the partial charge system for dividend income if the loan was granted on favourable terms by a shareholder acting in the interests of his company, in other words on shareholder loans seen as substituting share capital. This restores the previous position of the tax authorities overturned by the supreme Tax Court in April 2012 (judgments X R 5/10 and 7/10 of April 18, 2012). It has no effect on corporations as lenders.

Foreign Tax Act

The profit correction provision has been amended to remove all foreign/domestic considerations from third party comparisons. This follows from attempts to deny the validity of an unfavourable third party comparison because one of the parties to it was a local resident.

VAT

A securities-based asset management service (managing portfolio investments on behalf of customers without reference back to them on specific transactions) is henceforth a taxable transaction in Germany when performed for a customer in a non-member state of the EU. This responds to an unsuccessful attempt to claim the contrary before the ECJ (case C-44/11 *Deutsche Bank* judgment of July 19, 2012).

Other changes

In the same session the *Bundesrat* gave its approval to provisions for less generous treatment of tax evaders coming forward. The restriction follows from improved methods of detection.

Open issues

Proposals that have not been passed, but which remain on the agenda – for 2015 or later – include

- prohibition of a business expense deduction for an outlay that has been or will be deducted abroad. This is primarily intended to counter hybrid financing schemes.
- taxation of the capital gains of companies from the sale of portfolio shareholdings. This demand of the *Bundesrat* reflects that body's view of a capital gain as a direct substitute for a dividend.
- extension of the intra-group exemption from the loss forfeiture rules for share transfers between related parties.

Inheritance and gift tax in part unconstitutional

The Inheritance Tax Act seeks to protect family businesses from a potentially devastating inheritance (or gift) tax charge by exempting business assets, including shareholdings of more than 25% in German or EEA companies operating an active business. The object is to preserve jobs dependent upon the personal involvement of the business owner (or his or her family members) and, accordingly, the exemption is conditional upon the total wages bill in the five years after the transfer not falling below 80% of the total paid in the five years before it. However, businesses with no more than 20 employees do not have to meet this condition.

An heir to an estate consisting largely of cash assets claimed that the business asset exemption rules unfairly privileged business successors at his expense. His contention was that there was no constitutionally valid reason for exempting business, but not cash, assets. Accordingly, he should enjoy the same exemption.

The Constitutional Court has now held the apparent discrimination against recipients of cash assets to be constitutionally justified in principle as a legitimate means of achieving a legitimate social object. However, the exemption is too wide and can be claimed for too many businesses that do not protect their employees' jobs. In particular:
Well over 90% of all German businesses do not employ more than 20 employees and so are free of the continuing wages bill condition. Thus the legitimate object of the tax exemption is largely lost. Demonstrating the wages actually paid should not be too difficult for most businesses, and there is no reason to free businesses with more than "only a few" employees from the obligation to do so.
It is too easy for those wishing to claim an exemption to which they are not truly entitled to abuse the system by splitting businesses over separate companies each with its own 20 employee limit, by holding surplus cash at different levels within a vertical group structure and thus qualifying cash and investments as business assets, or (until June 20013) by forming a GmbH to manage cash assets as an "active business".

The Constitutional Court has allowed the present rules to continue in force provided they are amended by June 30, 2016. Amendment may be retroactive to the date of the present judgment.

The Constitutional Court case reference is 1 BvL 21/12 judgment of December 17, 2014.

Official Pronouncements

Returnable containers and transport packaging

The finance ministry has reconsidered its view on the VAT position of returnable containers and packaging passed through the trade for a deposit. Accepting a deposit ranks as a sale; its return is a reduction of sales proceeds to be accounted for at the same rate of VAT. Returnable containers are those like bottles and crates that are, or may be, passed on to the final consumer, transport packaging – storage boxes, show cases, palettes – is not intended to leave the trade, although it may be used by retailers to display the goods. A deposit on a container is part of the sale of the content and is subject to VAT at the same rate. Deposits on transport packaging are a separate sale, taxable at the standard rate. The distinction applies at all levels within the trade, that is, there is no change in treatment between manufacturer or importer, wholesaler and retailer.

Discounts for employees from third parties

Discounts granted to employees by outside suppliers are taxable as employment income if they were granted in connection with the employment. The finance ministry has issued a decree explaining its position on this matter in more detail.

Broadly, an employee discount will be a taxable benefit if the employer was actively involved in the transaction, or if the discount was based on factors to which the employer had contributed. However, the discount is not a benefit if it is available to the public on the same terms. A discount will also not be a benefit if the employer's involvement was purely passive. This is, for example, the case where the employer merely allowed the supplier to approach employees at their place of work or allowed him to advertise on the staff notice board. It is also the case where the discounts were negotiated on behalf of the employees by an independent body, such as the works council or a shop steward.

Supreme Tax Court Cases

Income adjustment for interest-free loan to foreign subsidiary

A GmbH granted an interest-free loan to its Belgian subsidiary. The tax office felt that the GmbH should have charged a market rate of interest and adjusted the income accordingly. It based its position on the provision in the Foreign Tax Act calling for arm's length dealing between related parties and providing for a compensating adjustment to taxable income were this not the case. The GmbH countered with the contention that the loan was a substitute for share capital and that, alternatively, an adjustment for uncharged interest was not possible within a domestic environment (interest cannot be "contributed" as a payment in kind on account of capital), so that to require it in respect of a Belgian subsidiary offended against community law.

The Supreme Tax Court has now held that the income adjustment provision of the Foreign Tax Act is valid and should be followed. However, no interest should be charged or imputed on a loan granted in substitution of share capital. A loan was a share capital substitute if seen as such by the national law of the subsidiary, or if it were clearly necessary in the long term for the subsidiary to function properly. In regard to the latter, the lower court had seen 35% of the loan as a share capital substitute on the basis that the future profit projections of the company indicated that only 65% of the loan granted could be serviced under arm's length conditions. The Supreme Tax Court saw no reason to disagree with this estimate and therefore accepted that a shareholder loan could be in part a capital substitute. The income adjustment was confined to the interest on the remaining part. Here, the court saw no clash with community law – and no need to turn to the ECJ – since community law generally accepted that related party dealings should be at arm's length. An adjustment to that standard could not be an offence.

Supreme Tax Court judgment I R 88/12 (NV) of June 25, 2014 published on November 26

Treaty override unconstitutional?

A German resident pilot of an Irish airline earned his salary practically tax-free over the years 2007-10. Under the German/Irish double tax treaty then in force, the earnings of aircrew were taxable in the country of establishment of the airline. Ireland, however, exempted the salaries of non-residents except to the extent the work was actually performed in Ireland. Thus, the pilot earned most of his salary tax-free. At the time, the treaty contained no switch-over or other provision designed to ensure that all income was actually taxed in one of the two signatory states. The treaty override provision of German law substituted the foreign tax credit for the "standard" exemption of employment income unless the taxpayer could demonstrate payment of the tax in the other state or that the other state had waived its right to tax. The pilot met this demonstration requirement with the repayment of the PAYE (salary withholding tax) by the Irish tax office. In 2013 the override provision in the Income Tax Act was tightened to also exclude from treaty exemption cases where the other state did not exercise its right to taxation because it did not regard the taxpayer as its own resident. Because this amendment was depicted as a “clarification” rather than a substantive change, it was applied retroactively to all cases still open.

The Supreme Tax Court has now taken issue with the override provision of the Income Tax Act on two counts. Firstly, the override, itself, is in breach of the treaty – unless specifically agreed with the other state. As such, it is in conflict with international law and – as is apparent from recent Constitutional Court cases – therefore unconstitutional. It cannot therefore be applied in the present case. Secondly, the court sees the 2013 amendment as a substantive change to a clear provision on which a taxpayer was entitled to rely. Retroactive application of legislation to a taxpayer’s disadvantage is excluded under the constitution. It has now referred both questions to the Constitutional Court for a final ruling.

Note: this case is no longer relevant to the future taxation of German resident aircrew of Irish airlines, as a new treaty has been concluded with an override clause. In any case Ireland has changed her law to tax the remuneration of non-resident aircrew (as permitted under the relevant treaty).

Supreme Tax Court decision of August 20, 2014 published on October 15

Demolition provision accumulates straight-line over entire period

A shopkeeper rented a site on a long-term lease. At the end of the lease term, he was required to demolish the building and clear the site for return to the landlord in its original, unbuilt condition. Accordingly, he accumulated a provision straight-line over the lease term expiring in 2003. In that year he agreed with the landlord to let the lease run for a further 15 years, to 2018. At year-end 2003, he discounted the provision at the statutory rate of 5.5% p.a. to the new expiry date, but otherwise made no adjustment to the amount, on the grounds that the obligation had been fully provided for over the prior periods on the basis of the facts as they then appeared. The tax office insisted on a partial release of the provision to reflect the new, extended lease term.

The Supreme Tax Court has now held that a cumulative provision must be built up in equal portions over the years up to the anticipated expense. If circumstances change, the provision must be adjusted in the year of the change, in this case by partial release to the balance that would have accumulated, had the provision been accrued from the inception of the lease up to the new expiry date. This gross provision should then be discounted at the 5.5% statutory annual rate up to the date the obligation would have to be met. This was the new expiry date of the lease.

Supreme Tax Court judgment I R 46/12 of July 2, 2014 published on October 1

Merger loss of life assurance company partially deductible

A life assurance subsidiary was merged onto its parent at a book loss. The tax office disallowed this loss under a provision in the Reconstructions Tax Act stating that merger gains and losses (the difference between the transfer value of the assets as shown in the merger balance sheet and the book value of the cancelled shares in the acquired company) should be ignored for taxation. The Supreme Tax Court has, however, now held that this provision as such only applies insofar as the book value of the cancelled shares was equal to, or below, their market value. If their market value was less than the book value (here, the book value had been inflated with the cost of lengthy legal battles over a squeeze-out of minority shareholders), the book value should be written down, before calculating the merger loss under the Reconstructions Tax Act. This write-down was allowable – in contrast to the general rule in the Corporation Tax Act excluding value adjustments (along with capital gains and losses) on investments in the shares in other companies from taxation – under a special provision for life assurance and health insurance companies.

Supreme Tax Court judgment I R 58/12 of July 30, 2014 published on October 22

No trade tax "Organschaft" privilege for interest paid to foreign subsidiary

At the time in question one-half of long term interest paid (now one quarter of all interest paid over €100,000 p.a.) was disallowed for trade tax. However, there was, and is, an exception for interest paid within an *Organschaft*, as disallowance within a tax group would effectively mean a double charge on the income. This exception is, though, confined to domestic units within the group. A taxpaying parent faced with a disallowance of half the interest paid to its Belgian subsidiary protested that excluding it from the exemption in respect of an EU subsidiary placed it at an unfair disadvantage compared with a purely German group. This was a restriction on its freedom of establishment.

The Supreme Tax Court has now pointed out that the aim of the exemption is to prevent taxing internally generated profits within a tax group. It is therefore right to fully allow an expense deduction if the income is fully chargeable by the same taxpayer. In this case, however, the income was earned by the Belgian subsidiary and thus not charged to German trade tax. Since expense and income were separated, there was no reason not to follow the general rule of disallowing one-half of the interest on long term loans. There was no question of double taxation within Germany and thus no restriction on the taxpayer's fundamental freedom of establishment.

Supreme Tax Court judgment I R 30/13 of September 17, 2014 published on December 18

Trade tax rental disallowance constitutional

A wholesaler effectively controlled a semi-independent network of retail franchisees. It leased the retail premises from each owner for a fixed rental and sublet them to the individual retailers for a rental-based on turnover. It objected to the trade tax disallowance of (now) one-eighth of the rental expense on the grounds that having sublet the premises to retailers it was not effectively using them for its own business purposes. Since the tenants would also face the same disallowance, the expense was in practice disallowed twice. This and the fact that the disallowance only affected specific costs, leaving other business expenses fully deductible, conflicted with the provisions of the constitution guaranteeing non-confiscatory taxation and equality of treatment of like circumstances.

The Supreme Tax Court has now rejected these contentions. The legislative had a wide freedom in the design of the trade tax system, provided its decisions were not arbitrary. It was therefore free to disallow a portion of the financing costs of a business, given that the trade tax object was the business and not the trader. It was also free to include a portion of the rental costs in its definition of financing costs and therefore in the disallowance (currently, one-quarter of all interest costs are disallowed and own-half of rental expense is deemed to be interest). That the actual calculation was general did not invalidate the court's conclusion. The legislative was entitled to make general assumptions in the interests of simplicity and practicality. The sub-tenancy of the premises was irrelevant, as two different taxpayers were involved. Also a fixed rental paid to the landlord against a turnover-based sub-rental meant that the tenant was "using" the premises for its own business purpose. It was the head tenant in its own interests, and not merely acting as agent for the sub-tenants. All in all there was no constitutional objection to the trade tax add-back in its then form. Since the add-back has, in the meantime been reduced the court's conclusion presumably holds good under present law.

Supreme Tax Court judgment I R 70/12 of June 4, 2014 published on September 24

No forgiveness of interest despite compensating income adjustment abroad

A KG partnership traded with its associated company (GesmbH) in Austria. A tax audit revealed a transfer pricing adjustment to arm's length terms and the tax office raised an additional assessment accordingly. The tax office also charged interest on the amount now due in accordance with the general rules on interest on taxes levied (or refunded) in retrospect. A partner requested this interest charge be forgiven under the regulation allowing adjustments in favour of taxpayers where appropriate to avoid inequitable treatment. His argument was that the transfer pricing adjustment led to a corresponding tax refund in Austria, although Austrian law at the time did not credit interest on amounts repayable by the authorities. Thus the interest expense in Germany was not compensated with corresponding income in Austria and represented a net burden on the group, even though there had been no illegitimate tax deferral overall.

The Supreme Tax Court has confirmed the tax office in its refusal to forgive the interest charge. This charge was raised on the partner and the question of equity should be decided in the light of the situation of each taxpayer seen separately. The GesmbH was a separate entity and an income adjustment on that company did not directly affect the earnings position of its German shareholder, the partner in the KG. Accordingly, its circumstances could not be taken into account when considering equitable treatment of the partnership.

Supreme Tax Court judgment III R 53/12 of July 3, 2014 published on October 15

Future obligation not chargeable to real estate transfer tax

An acquirer of a plot of building land accepted as a condition of sale an obligation to make a lump sum payment to the local authority as a contribution towards the cost of building a new kindergarten. This payment would become due on grant of planning permission to the owner of the site to build a house. The tax office claimed the payment to be part of the consideration paid to acquire the site and included it in the total amount chargeable to real estate transfer tax. The acquirer considered the obligation to arise from a future event and thus not to be part of the consideration paid to the seller.

The Supreme Tax Court has now sided with the acquirer. At the date of sale, the seller had no concrete obligation to make any payment to the local authority towards the cost of a kindergarten. Rather, this payment would only become due on grant of planning permission for a concrete building project. The acquirer, not the seller, was to apply for this permission and thus entered into the obligation in his own name. The mention of the obligation in the contract of sale was intended to put the acquirer on notice that an obligation would arise, not to transfer an existing obligation.

Supreme Tax Court judgment II R 12/13 of June 18, 2014 published on October 8

Schematic sale and return of securities cum and ex div fails

A bank arranged a scheme for its customers to buy quoted shares in German companies on the day before the dividend cut-off date (*cum* div) and to lend them back to the seller on the following day. They would then be sold back to the seller immediately after the dividend payment (*ex* div). The shares were held by other German banks under a complicated series of custodial and sub-custodial agreements. The economic risks were borne by the seller. The actual dividends were paid to the seller as the economic holder of the securities on the day of payment; the seller paid a compensating payment to the buyer as the legal owner of the shares (referred to as a "manufactured dividend") and both parties claimed a credit for the withholding tax on the dividend received.

The Supreme Tax Court has reacted by re-qualifying the "manufactured dividend" as trading income. The recipient was the legal owner of the shares on the dividend payment date but at no time bore any risks, or enjoyed any rights, associated with ownership. Rather, the economic ownership lay at all times with the seller. Since the customer was not the economic owner of the shares, it could not receive a dividend on its own behalf. Without dividend income it could not claim a credit for dividend withholding tax. The "manufactured dividend", as trading income, was not a substitute.

Supreme Tax Court judgment I R 2/12 of April 16, 2014 published on October 8

Smoke extractor not part of building

An engineering firm built smoke extractors for blast furnaces in order to improve the working environment in the factory. The extractors were mounted in the building from which they were effectively inseparable, as they could not be easily dismantled. The tax office saw them as part of the building and their installation as subject to reverse charge VAT. The supplier saw them as installations subject to regular, mainstream VAT payable by the supplier, but chargeable to the customer.

The Supreme Tax Court has now held that a building is something permanently affixed to the ground. An addition to a building changes or extends the nature of the building. An installation, on the other hand fulfils a set purpose separately from the purpose of the building. Under this definition, the smoke extractors were installations, rather than parts of the building. Their supply was subject to mainstream VAT, rather than to the reverse charge for building work.

Supreme Tax Court judgment V R 7/14 of August 28, 2014 published on November 12

Minicabs cannot claim reduced rate VAT for taxis

The Supreme Tax Court has dealt in two cases with the argument of a minicab business (hiring a car with a driver for a specific journey) that its services were essentially similar to, and in direct competition with, those of taxi businesses and should accordingly rank for the same reduced rate of VAT for local journeys. The court referred the question to the ECJ and, following the ECJ's answer, has now passed judgment to the effect that the difference in VAT rate is justified by the perception of the average customer that there are significant differences in the service. The courts involved have mentioned variously the registration of taxi businesses and their obligations to accept every fare and to charge according to the set scale. They also mentioned the distinctive appearance of taxis and the prohibition on minicabs from accepting custom off the street. The minicab business argued that in practice there was very little real difference between the two types of business on all these points, although the Supreme Tax Court has now held the legal obligations on taxis to be decisive. The fact that market constraints effective force similar charging rates and conditions on all businesses was not generally significant, and the same applied to the argument that most journeys were pre-ordered anyway.

The Supreme Tax Court made – again following the ECJ – one exception, carrying the sick as an ambulance service on contract with a health fund. In the case at issue, the health fund had uniform set rates and contractual conditions for all carriers and otherwise made no distinction between taxis and minicabs in its terms of appointment. In this case, the court held, the two were in direct competition offering an indistinguishable service and should bear the same rate of VAT.

Supreme Tax Court judgments XI R 22/10 and XI R 39/10 (ambulance services) of July 2, 2014 published together on October 22

From Europe

Arbitrary tax on "non-transparent" investment funds rejected

The Investment Fund Tax Act basically taxes investors on their dividends and accrued income (reinvested dividends) as apparent from the published accounts of the fund. These must include detailed information on the income and capital of the fund and on the tax position and consequences of its earnings and gains during the year. This latter must be confirmed by a professionally qualified tax advisor, accountant or lawyer. The information must be made available and published in German. Failure of the fund to comply with these requirements exposes unit holders to taxation on their estimated income. This is the total of dividends actually received during the year plus 70% of the appreciation of the redemption price over the year. However, the total taxable income may not be less than 6% of the year-end redemption value of the units held. A resident taxpayer holding shares in foreign funds on deposit with a Belgian bank protested against this estimated taxation as being unrealistic. The government admitted the unrealistic taxation before the ECJ, but maintained its interest in ensuring fair taxation from full and proper disclosure of a fund's activities. It also maintained that a foreign fund was subject to only the same reporting and compliance requirements as German funds.

The ECJ has rejected the German government's arguments and the taxation as excessive. It accepted that the government has a legitimate interest in obtaining sufficient information from sufficiently reliable sources to ensure fair taxation, but held that the prescribed form and publication requirements went beyond what was necessary, particularly for funds not themselves interested in actively promoting their units on the German market. The provisions were, as such, a hindrance on the freedom of capital movement and their application left an investor in a "non-transparent" fund no possibility of satisfying the need for information on his own initiative. He could contact the management of the fund and the German tax authorities could usually verify the results through the international information exchange systems.

The ECJ case reference is C-326/12 *van Caster* judgment of October 9, 2014

Pension payment for early inheritance deductible for non-resident?

It is not unusual for the owners of family businesses to pass the ownership rights to the next generation in exchange for a pension sufficient for them to retire. This system of "early inheritance" is founded in German inheritance law. The Income Tax Act reflects it by allowing the heir a deduction for the pension outlay as a "special cost" whilst treating it as taxable income in the hands of the recipient. However, a deduction for "special costs" – unusual outgoings that a taxpayer is legally or morally obliged to bear – is only available to resident taxpayers. On March 31, 2011, the ECJ held that this denial of a deduction to a non-resident heir to property was an unjustified hindrance on the freedom of capital movement – C-450/09 *Schröder*. Its main argument was that neither the pension obligation nor the inheritance would have occurred in isolation, so that if a resident heir was able to deduct the pension paid from his taxable income, there was no reason for denying this right to the non-resident earning taxable income from the assets he had inherited. The Supreme Tax Court accepted that judgment for the case decided, but then repeated its question with a second, directly comparable case of two brothers, only one of whom was resident in Germany, assuming joint proprietorship over a German business from their resident father against a life pension. The Supreme Tax Court justified its second submission with contentions that it was unsure that the two cases were directly comparable and that it felt it had not adequately emphasised the conceptual link between the deduction of the expense for the payer with the tax charge on the recipient.

The ECJ advocate general on the second case has now suggested the court follow its ruling in the first. The disallowance of the pension payment deduction for the non-resident whilst granting it to a resident is discrimination hindering the freedom of capital movement. It makes the "deal" within the family relatively less attractive to the non-resident heir. The first case involved the transfer of rented property, whilst the second concerned the transfer of a business operation. In both, the pension paid to the donor – the father – was oriented more to the needs of the recipient than to the income to be earned from the assets transferred, although the income from the first transfer was considerably more stable than that from the second. However, the advocate general suggests that this distinction is irrelevant. Important is merely that in neither case would the assets have been transferred without the pension promise. He goes on to point out that the conceptual link between the tax deduction for the pension payer and the tax obligation of the recipient is irrelevant to the distinction between two payers. If the concern is that the non-resident payer might attempt to claim a deduction in both countries for the same payment, it is open to the German tax authorities to inform the country of residence of the German claim. This then leaves it to the country of residence to prevent the "double dip".

The ECJ case reference is C-559/13 *Grünewald* opinion of November 18, 2014

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