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Issue 2
March 26, 2015

Tax & Legal News

Official Pronouncements

Finance ministry interprets ECJ ruling on "non-transparent" investment funds restrictively

The Investment Funds Tax Act charges resident unit holders to income tax on their distributions received and on their shares in the accumulated earnings of the fund. The necessary figures for this are available from the information required to be published by the fund as a condition for placing their units on the German capital market. If a foreign fund does not comply with the German formalities – including the publication requirement in the German language – it is deemed to be "non-transparent". In this case the taxable income for the unit holder is the dividend received, the undistributed earnings and 70% of the increase in unit price over the year. 6% of the unit price at year end is the minimum taxable income. On October 9, 2014, the ECJ held that this provision for deemed taxable income offended against the free movement of capital more than was necessary to ensure fair taxation in that it left taxpayers with no possibility of meeting the information requirements of the authorities from their own resources. Accordingly, the provision had to be disapplied (case C-326/12 van Caster and van Caster).

The finance ministry has now reacted with a decree setting out the information that tax offices may require from the unit holders in "non-transparent" funds. This includes the results of the fund, the dividends received, the current sales prospectus and the published reports. However, it also includes a trial balance and certificates by a recognised public accountant in the country in question that the taxable income has been computed in accordance with the German tax rules. Unit holders wishing to claim foreign tax credits or other reliefs must submit the necessary specific documents. The decree is silent on the past, although insistence now on documentation that is now no longer available is perhaps a further unwarranted restriction on the free movement of capital.

No VAT adjustment for agent's discount

On January 16, 2014, the ECJ held that a discount offered by a travel agent at his own expense on a supply by a tour operator did not affect the consideration for that supply or the VAT thereon (case C-300/12 *Ibero Tours*). The Supreme Tax Court decided its own case on that basis and then followed shortly afterwards with a similar judgment on an agent broking supplies to retailers. The finance ministry has now issued a decree adopting the new position as its own, so that henceforth a payment by an agent to the customer at his own expense (as an inducement to purchase through that agent) will not affect the VAT on the main supply. This also applies to any input tax deduction for the customer. The position contrasts with discounts offered by agents (or others) at the expense of the main supplier – these adjust the VAT down the chain. The main businesses affected are travel agents and retailers buying their stock through agents, rather than from wholesalers.

Supreme Tax Court Cases

No refusal of related-party loan write-down for lack of security

A German parent financed its loss-making US subsidiary with a series of loans. The loans were interest bearing, but were unsecured. The parent wrote these loans down in the year of grant because it saw their repayment as doubtful (the present prohibition on deduction of related-party bad debts was not yet in force). The tax office accepted the doubt but added the expense back to income under the arm's length income adjustment provision of the Foreign Tax Act. Its reasoning was that the loans had not been granted at arm's length as a third party would have insisted on security, given the debtor's precarious position.

The Supreme Tax Court has now rejected the tax office' view. The parties to a loan within a group of companies was subject to the presumption of mutual support between group members. On this presumption, an unsecured loan could be granted to a financially frail subsidiary without breach of the arm's length principle, even if there was no uplift to the interest rate to reflect the risk of default. However, this finding did not mean that the company had won its case. Rather, the Supreme Tax Court referred the case back to the lower court for further investigation of the facts. The lower court should clarify the possibility of the loans' having been granted as equity substitutes, as, in that case, they would rank as investments and fall under the consequent prohibition on deductions of losses from sale, disposal or write-down. The court should also look further at the context of the group support. As long as that support remained available, no debt write-down could be taken to expense for the same reason that no interest uplift could be demanded for increased credit risk.

Supreme Tax Court judgment I R 23/13 of December 17, 2014 published on February 25, 2015

No requalification of share capital repayment to dividend if nature of transaction clear

A GmbH resolved a share capital reduction of €16 m in preparation for a capital repayment with a view to avoiding an IFRS consolidation requirement for its sole shareholder, a public utility. It took the reduction to capital reserve, waited as required by the GmbH Act for one year after the public call on the creditors, reported the reduction to the trade registry and repaid an amount of €4 m to the shareholder. This repayment was sufficient to reduce the assets below the level for the consolidation requirement. The tax office saw the payment as a dividend distribution subject to withholding tax under a Corporation Tax Act provision to the effect that payments to shareholders are deemed to be made out of available retained earnings unless unambiguously specified as repayments of share capital.

The Supreme Tax Court has now held that the unambiguous specification need not be solely in the capital reduction/repayment resolution itself. The reduction resolution stated its purpose as being preparatory to a capital repayment to the shareholder, but did not state the, as then unknown, repayment amount. However, it was clear from all the circumstances that the repayment followed the reduction as soon as the GmbH Act permitted. There was every indication that a capital payment was intended and nothing to suggest that anything else had ever been contemplated. Accordingly, the court accepted the payment as a tax-free repayment of share capital, despite the interim booking to capital reserve.

Supreme Tax Court judgment I R 31/13 of October 21, 2014 published on February 18, 2015

Dividend to controlling shareholder taxable on resolution

A GmbH resolved in November an interim dividend for the year with a payment date in the following January. The tax office for the main shareholder – with an 81% controlling interest – ignored the later repayment date of the resolution and assessed him to income tax on the dividend income in the year of the resolution. The Supreme Tax Court followed this interpretation of the law in its confirmation of previous rulings to the effect that a shareholder with a controlling interest would generally be able to demand at will payment of a dividend due and must therefore be seen as being able to dispose over the income as of the date of the resolution. The two exceptions to this general principle were where the company would be currently unable to meet a dividend claim for lack of funds, or where it was precluded from doing so by a provision in its statutes. The court went on to hold that the same principle applied down the chain. Thus the company was still to be regarded as "solvent" in this context where its ability to pay the dividend resolved depended on receipt of a larger dividend from a cash-rich subsidiary held as to 97.5%. This latter dividend had been resolved two months previously, but with the same January payment date. As the nearly sole shareholder, the company would be able to force earlier payment as needed to meet an earlier claim for payment to its own controlling interest shareholder.

This ruling contrasts with the withholding tax provisions. Dividend withholding tax is due by reference to the dividend payment date set in the resolution, regardless of the level of the shareholding. This follows from an explicit provision in the withholding tax rules and cannot be extended to the point in time of the deemed income realisation by the controlling shareholder.

Supreme Tax Court judgment VIII R 2/12 of December 2, 2014 published on February 18, 2015

Foreign employment income of German resident taxable in Germany if work done in third country

A German resident worked in Austria as a reporter for a German magazine. She also visited neighbouring countries to gather news. The Supreme Tax Court has now held that the right to tax the employment income falls to Austria to the extent the work was performed there and to Germany for the time spent on business in third countries. The apportionment was a matter of physical presence and not of legal obligation or employment status. This ruling is subject to a need for further investigation of the taxpayer's residence status under the treaty. If she also has living accommodation in Austria, she could be tax resident there rather than in Germany (focus of vital interests) in which case the German taxing right to this employment income would cease altogether.

Supreme Tax Court judgment I R 27/13 of November 25, 2014 published on March 18, 2015

Employee relief fund surplus based on total obligations

Employee relief funds are exempt from corporation tax, provided they retain sufficient assets to cover the actuarially calculated future obligations. If the assets exceed 125% of that amount at year end, the surplus must be returned to the parent employer or otherwise put to an appropriate purpose. Usually, relief funds are founded by employers for the benefit of their employees, although some funds are regional or sectoral and thus provide cover for the employees of a number of different enterprises. These multi-employer funds generally segregate their assets and obligations by employer-parent, mostly as a basis for setting the annual contributions.

A multi-employer fund established a surplus of more than 125% of the actuarial liability in respect of some of its employer segments. Accordingly, it paid out the excess to each employer affected as a return of contributions. However, it did not have an excess in total as some segments were well below the upper limit. The tax office saw the fund as a whole and withdrew its corporation tax exemption for having returned contributions to its members and thus depriving beneficiaries of the necessary asset cover. The Supreme Tax Court has now confirmed this result on the basis that the fund was a single entity liable towards all actual or potential beneficiaries. Its asset surplus could therefore only be calculated globally. Piece-meal distributions were barred if there was no excess overall. If they were made despite the bar, the fund had failed to maintain the necessary asset cover and forfeited its tax-exempt status.

Supreme Tax Court judgment I R 37/13 of November 26, 2014 published on March 18, 2015

No trade tax disallowance of expenses of earning tax-free dividends within an **Organschaft**

A German *Organschaft* parent held a 70% stake in an Italian S.p.A. through its German subsidiary. Had it held the investment directly, the dividend would have been free of corporation and trade tax against a standardised 5% expense disallowance to reflect the directly connected expenses. The actual directly connected expenses of the investment – such as financing and supervision costs –

are deductible in full. The Supreme Tax Court has now come to the conclusion that the trade tax expense disallowance is effectively nullified where the investment is held through an *Organschaft* subsidiary by a clash of wording between the rules for corporation tax income computation and the provisions for trade tax adjustments. That this conclusion leads to a tax advantage for those investing abroad through an *Organschaft* subsidiary over those making direct investments was recognised by the court, but accepted as the two situations "were not comparable".

Supreme Tax Court judgment I R 39/14 of December 17, 2014 published on March 18, 2015

Sole shareholder for RETT despite own shares held by company

A GmbH was formed by two shareholders, each holding 50% of the issued share capital. The company owned real estate. One of the shareholders wished to withdraw and sold his share to the company. The tax office assessed real estate transfer tax on the chargeable value of the property under a provision in the Real Estate Transfer Tax Act rendering a share transfer a taxable event if it led to a holding of at least 95% of the issued share capital in the hands of a single shareholder. The transfer here at issue did not, in the view of the company, meet this condition as the company now held 50% of its own shares.

The Supreme Tax Court disagreed with the company's view. The company could not act as a shareholder in its own self as it was not a separate body. Thus, its acquisition of its own shares from the original second shareholder effectively left it with a single shareholder with the ability to dispose over the company's assets – including the real estate – as their sole owner. This met the condition of concentrating 95% of the issued share capital in a single hand for a real estate transfer tax assessment.

Supreme Tax Court judgment II R 8/13 of January 20, 2015 published on March 18

Foreign business may recover input tax through VAT return if sales were incorrectly invoiced with VAT

A KG partnership in German/Danish ownership and under German/Danish management operated an offshore wind farm selling electricity to a German public utility owned by the local authority. It did not have its own offices or any fixed onshore establishment. However, it invoiced its sales to the German utility with VAT and filed a VAT return of that turnover and claiming a deduction for its German input tax borne. The tax office rejected the claim, saying the KG was a foreign business that should have recovered its input tax through the refund procedure for foreign businesses.

The Supreme Tax Court has now sided with the KG. If the KG was effectively a German business, its return was correct as filed. If it was resident in Denmark, its sales should have been reverse-charged by its German customer. Even in this case, however, it was liable for the VAT incorrectly charged and therefore required to file a VAT return. If required to file a VAT return for any reason, it was required and entitled to deduct its German input tax from the amount due. Thus, the return at issue was correct in substance, regardless of the (unclear) residence of the taxpayer.

Supreme Tax Court judgment V R 41/13 of November 19, 2014 published on February 11, 2015.

From Europe

Parent/Subsidiary Directive tightened

The European Commission has long felt that the exemption from withholding tax on inter-corporate dividends between entities in different member states with a minimum common shareholding of 10% has opened the way to abuse. It has therefore proposed, and the European Council acting through ECOFIN has now adopted, an amendment to the Parent/Subsidiary Directive to exclude those following arrangements designed to achieve a tax advantage but otherwise without a valid commercial reason from its benefits. Member states have until

December 31, 2015 to adopt the amendment into their own provisions.

No requirement to group relief foreign losses brought forward

On December 13, 2005, the ECJ held against the UK that its group relief rules were contrary to the freedom of establishment in that they excluded the losses of subsidiaries in other member states from group relief offset in the UK in all circumstances (case C-446/03 *Marks & Spencer*). The UK accepted this judgment and changed its law to allow offset of losses of EEA subsidiaries where, as seen immediately after year end, the local subsidiary had exhausted all possibilities of claiming an offset in the same or a previous year and – definitively – would be unable to do so in a future year. According to the European Commission, this transposition of the case into national law renders it virtually impossible for a UK group to actually claim relief in the UK for a foreign loss, as it presupposes either that there is no local legal possibility for the subsidiary to carry a loss forward or back or to transfer it to another company, or that the subsidiary has resolved liquidation before year-end. The UK government disputed that view and the Commission sued before the ECJ.

The Commission lost its case. If the local law of the subsidiary precludes all forms of transfer of unutilised losses to another year or entity, there is no obligation on the country of the parent to make good the deficiency. Indeed, its doing so would of itself be discriminatory. The UK government argued that a decision to liquidate immediately after year-end would allow a UK parent to group relief the loss of the foreign subsidiary for that year and nothing more was required by *Marks & Spencer*, since even minimal remaining income would not totally exclude offset of a loss brought forward. The ECJ accepted this argument, especially as the UK government was able to quote a specific example of a successful group relief claim for a loss of a foreign subsidiary. The Commission also attempted to claim that the UK provisions excluded pre-2006 losses from their scope, but the UK replied that those losses would be covered by a direct application of the *Marks & Spencer* judgment. Since the Commission was unable to produce any evidence to the contrary, it lost that point, too.

In upholding the UK rules, the ECJ did not go quite as far as the advocate general who suggested the court abandon *Marks & Spencer* altogether. However, it is now clear that there is no requirement to allow a parent to offset the previous years' losses of a subsidiary that are now rendered unusable by a current year liquidation decision, so the import of that judgment has certainly been contained.

The ECJ case reference is C-172/13 *Commission v. UK* judgment of February 3, 2015.

Annuity paid for business deductible by non-resident

It is not uncommon for German family businesses to pass to the next generation by way of "advanced inheritance" in exchange for a pension to be paid to the former proprietors. This pension (annuity) is generally oriented more towards the needs of the recipients than to an arm's length consideration for the transfer of ownership in the business. Such pensions are deductible for acquirers as "special expenses" defined as costs beyond the ordinary that cannot in the circumstances be avoided. However, a special expense deduction is, as a personal relief, only available to a resident taxpayer.

Two brothers acquired a family business from their parents in exchange for a retirement pension to be paid out of future profits. One brother was resident in Germany and one in another EU member state. The tax office granted the resident his "special expense" relief, but refused to do so for the non-resident. The latter saw this as discrimination restricting his freedom of capital movement.

The ECJ has now held the discrimination to, indeed, be an unjustified restriction on the free movement of capital. The pension payment was in consideration of the business transfer and would not have been made, had the brother not entered into his inheritance. As such and regardless of amount, it was directly connected with the (taxable) income earned from the business. In that regard, the non-resident was in the same position as the resident and should therefore receive identical treatment. The deduction was in neither case dependent upon taxation of the income by the recipient (payment by a resident to a recipient abroad would still be deductible). Thus arguments in support of the discrimination on the basis of the balanced allocation of taxing powers between states or on the coherence of the

German tax system necessarily fail.

The ECJ case reference is C-559/13 *Grünewald* judgment of February 24, 2015

No reduced rate of VAT on e-books

France and Luxembourg tax supplies of e-books (streaming or download) at a "super reduced" rate of VAT of 3%. The Commission instigated infringement proceedings against both countries.

The ECJ has now held that the supply of e-books is an "electronically supplied service" for which there is no basis in the VAT Directive for charging VAT at other than the standard rate. Arguments against the directive itself based on discrimination against e-books in favour of printed works cannot be brought in infringement proceedings against a member state for failing to apply the EU legislation in question. In any case, the 3% rate (as opposed to the 5% minimum rate) is necessarily invalid for lack of a specific provision in EU legislation.

It is worth noting that this decision appears to conflict, at least in part, with the ECJ judgment C- 219/13 *K Oy* of September 11, 2014 holding that a member state (Finland) was not precluded from taxing books on electronic media (CDs, CD-ROMs and USB sticks) at the standard rate rather than at the reduced rate for printed works, unless the two products were seen as essentially similar in the given consumer market. Why a CD-ROM should be taxed differently from a download has not yet been explained.

The ECJ case references are C-479/13 *Commission v. France* and C-502/13 *Commission v. Luxembourg* (separate) judgments of March 5, 2015.

Nursing staff employment agency charges VAT-able

A German temporary employment agency for nursing staff hired personnel to associations providing nursing and care services to the infirm. The associations generally invoice their services free of VAT, provided that at least 40% of their cases are covered – at least partially – by the social security system. However, the tax office refused to extend this exemption to the employment agency as the agency did not provide exempt services in its own right. The ECJ has now taken the same view on a strict interpretation of the VAT Directive. The staff are not themselves VAT-payers and cannot therefore be exempted and the agency does not provide health care or other medical services. Accordingly, its charges are subject to standard-rate VAT.

The ECJ case reference is C-594/13 *"go fair" Zeitarbeit* judgment of March 12, 2015.

No objection to 10 year tax deferral on transfer of assets abroad?

A German limited partnership transferred substantially its entire business of managing intellectual property rights to its Dutch permanent establishment. The tax authorities found the market value of the assets transferred to be significant and established a tax liability of the partners on the gain on transfer. They then allowed actual payment to be deferred over a ten-year period following the then administrative custom (in the meantime the deferral has been enacted into the Income Tax Act – one-fifth of the gain is to be added to taxable income in the year of transfer and in each of the following four years). The partners objected, largely because the establishment of a gain on transfer ignored the possibility of a later decline in value as the IP became obsolescent, and the case came before the ECJ as a possible infringement of the partners' freedom of establishment.

The ECJ advocate general on the case has now suggested the court accept German taxation on the gain in question as a restriction on the freedom of establishment justified by the overriding need to preserve the internationally agreed division of taxing rights between member states. It would be disproportionate to tax the deemed gain on transfer, since no liquidity resulted from the move. However, ten years was long enough to earn sufficient income from exploiting the assets to meet the payment demand. The appreciation in value up to the date of the transfer was a German taxable event; further developments were a matter for Dutch taxation. The gain in Germany followed from the market value at the date of the transfer. This would be the future base cost in Holland for calculating a future gain or loss with tax effects as determined by Dutch law.

The ECJ case reference is C-657/13 *Verder* opinion of February 26, 2015.

Option for non-resident to be taxed as a resident for only part of a year?

A German living in Aachen worked in Maastricht for many years. Because he had insufficient German income to cover his personal allowances, he elected to be taxed in Holland as a resident. In particular, this gave him a deduction for his mortgage interest on his house in Germany. At the end of March of his final year of German/Dutch residence he moved to the USA to take up employment there. The Dutch tax office refused to allow him to be taxed as a resident in the year of the move as his entire income had not been wholly or substantially earned in Holland. He therefore lost a deduction of three months' mortgage interest. The Dutch courts confirmed the tax office in its view of Dutch law but referred the case to the ECJ on a possible clash with community law.

The ECJ advocate general has suggested the court rule that the refusal to allow the taxpayer to continue to be taxed as a resident during the final three months of his Dutch employment is a hindrance on his freedom of movement within the EU. There is no overriding public interest to justify the hindrance, especially as the taxpayer's Dutch position during the first three months of the year was in no way different from that of a Dutch resident employee. During that period, he continued to earn substantially all his income in Holland and should therefore continue to enjoy his mortgage interest deduction as a deemed resident. His departure for the USA, a non-member state, at the end of that period had no bearing on his tax position up to that date.

The ECJ case reference is C-9/14 *Kieback* opinion of March 5, 2015.

Used car warranty by third party an insurance?

An Italian company offered a warranty service to a series of user car dealers in France. The dealer offered car buyers a warranty for certain parts and assemblies for a certain period. This warranty was over and about that which dealer was legally required to give and therefore had to be paid for separately, either as a direct charge from the service company, or through a higher purchase price paid to the dealer. The service company saw its service as ancillary and incidental to the main sale by the dealer and thus as chargeable to standard rate VAT. The French tax authorities saw it as insurance free of VAT but chargeable to insurance tax.

The advocate general on the case at the ECJ points out in his opinion that the concept of insurance is not defined precisely in community law. However, accepting that the service provider in the present case has no interest in, and is not a party to, the main transaction, and that he effectively spreads the risk over the community of insured persons through premium adjustments in the following year, the advocate general saw the arrangements at issue as generally fulfilling the main criteria for insurance. This included the statistical methods used to calculate the warranty fees on the basis of anticipated claims. Claims are made directly to the warranty provider, who settles them without reference to the dealer who sold the car. Counter-arguments to the effect that the warranty was the equivalent of an enhanced dealer warranty taxable as part of the sale of the car should be rejected as the warranty provider was not the same person as the dealer and did not offer the same service. Rather, he undertook to meet approved repair bills, whereas the dealer guaranteed the running of the car. The dealer could discharge his warranty obligations in various ways – repair, replacement or settlement of repair bills from other garages – and was also able to minimise his risk with appropriate testing of the car before it was sold. He was not therefore offering insurance.

The ECJ case reference is C-584/13 *Mapfre* opinion of February 4, 2014.

VAT-free oil for high seas shipping even if billed to intermediary?

Supplies, including fuel oil, for ships plying the high seas are free of VAT if supplied and invoiced direct. A Lithuanian tax office refused this exemption to a bunkering service in Klaipeda (Memel) because it invoiced a firm of brokers, rather than to the owner of the vessel. The bunkering service objected that charging VAT on its supplies to ships operated by international lines would be, at least, against the spirit of the VAT Directive, and the case came before the ECJ.

The advocate general accepts that perusal of the VAT Directive does not give an immediately clear answer. However, on the basis of a series of substance over form arguments, she comes to the conclusion that the court should hold that the supplies at issue should be exempt, provided that the delivery is to the ship itself in a manner that effectively excludes any possibility of their being seized by an intermediate legal owner or otherwise put to any use other than to power or maintain the ship on the high seas. In this case, as she points out, the largely unknown shipping line had appointed a broker to order the fuel in its own name for the sake of financial security for both parties. The bunkering service delivered the fuel to the ship once in port by pumping it into her tanks. From then on, there was no realistic possibility of using the oil other than as fuel for the ship's boilers.

The ECJ case reference is C-526/13 *Fast Bunkering Klaipeda* opinion of March 5, 2015.

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