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PwC Reports

Real estate transfer tax on share transfers unconstitutional

Real estate transfer tax is levied on the sales price of property conveyances. However, if the transfer of ownership is indirect – the sale of shares in a property-owning company leading to a shareholding of at least 95% – the tax is based on a statutory formula of basically 12.5 times the annual rentable value of the site. However, this formula has no particular connection to the current market value of the land and was held in 2007 to be unconstitutional as a basis for inheritance tax valuations. The Inheritance Tax Act was changed accordingly, although the Real Estate Transfer Tax Act was allowed to remain as it stood. The Constitutional Court has now held this valuation formula to be unconstitutional as a basis for assessment to real estate transfer tax, too, and has given the legislative until June 30, 2016 to enact an alternative formula that closely reflects the actual market value of the land. That alternative shall be retroactively applicable from January 1, 2009, the date by which the unconstitutional formula could no longer be applied for inheritance (gift) tax assessments.

Constitutional Court resolution 1 BvL 13/11 of June 23, 2005 published on July 17

Automatic exchange of bank account information

On October 29, 2014 Germany agreed a “multilateral competent authority agreement on automatic exchange of financial account information” with 50 other states. In the meantime, 10 further states have acceded to this agreement. Basically, the agreement provides for the automatic transfer of the bank account information between the parties to the agreement on accounts held at banks in the state in question for accountholders in the other country. This information includes the name, address and tax number of the accountholder, the account balance at year end and the amounts of investment income (as well as the proceeds from the sale of investments) credited to the account during the year. The accounts affected are all those held with financial institutions and therefore include investment funds, insurance companies and other financial players as well as banks. The information is to be reported annually by September 30 of the following year between the competent authorities named for each state. In Germany, this is the Central Tax Office. Generally, 2017 is the first reporting year (on 2016 information), although some signatories to the agreement have negotiated a delay of one further year as needed for their own organisational or legalistic reasons. Notable among these are Australia, Austria, Canada, New Zealand and Switzerland.

The cabinet has now adopted bills to be laid before parliament ratifying the multilateral agreement and setting out the reporting and discovery obligations of German financial institutions towards the Central Tax Office. Basically, the information must be reported to the Central Tax Office by July 31 of the following year – the first reporting year being 2017 on information on, or for the year ended on, December 31, 2016.

Official Pronouncements

Progress payments lead to profit realisation

Traditionally, it has been considered acceptable for tax purposes to delay profit recognition on long-term contracts in the construction and similar industries until final completion of the contract. This view was overturned in 2014 by a Supreme Tax Court decision holding that an engineer working on a long-term design project should recognise profits by degree of contract completion as measured by his entitlement to progress payments. Architects and engineers are entitled to agree on progress payments when working as consultants, provided the due dates reflect actual and measurable contract progress. The finance ministry has now endorsed this judgment in a decree calling for general application to all cases of progress payments based on degree of contract completion. Architects and engineers on long-term consultancy, design or planning projects and building and similar contractors are those primarily affected. However, recognising that this advancement of profit recognition might lead to serious hardship in the year of change, the ministry has allowed taxpayers to split the additional profit realised over two or three equal annual instalments. The change is to be effected in the first business year beginning on or after December 24, 2014. The decree draws an explicit distinction between progress payments and payments in advance, as the latter do not lead to profit realisation.

Draft FATCA regulations

All but the smallest banks are required to report details of their US accountholders and their transactions and balances to the Central Tax Office for onward transmission to the US authorities (IRS). The basis for this is the agreement of May 31, 2013 with the USA on the establishment of international tax transparency under the US FATCA (Foreign Account Tax Compliance Act) under which "FATCA-compliant" institutes are free from a US withholding tax on their otherwise exempt US income. The reporting obligation begins with respect to 2014 but takes full effect in and for 2016. The finance ministry has now issued a draft decree setting forth the detailed regulations to be followed by reporting banks. Banking associations and other interest groups had the opportunity to comment.

Income documentation exemption for non-transparent investment funds only applies to EEA funds

Under the Investment Funds Tax Act, 6% of the value of the units at year-end is deemed to be the minimum taxable income accruing to resident unit-holders in "non-transparent" investment funds, i.e. funds that do not publish audited information on the taxable income falling to shareholders under the German rules of income determination. Since this provision is, in practice, only applicable to foreign funds, the ECJ (*van Caster*) held it to be an unwarranted restriction on the free movement of capital, as it leaves unit-holders no possibility of demonstrating their actual income on the basis of information obtained from the fund. The finance ministry reacted with a decree of February 4, 2015 setting forth the detailed information and documentation which tax offices may demand from unit-holders as a condition for exempting them from the 6% rule. The finance ministry has now revised its decree to limit its application to units held in funds from other EEA countries.

Building installation continues to be VAT-able as building

VAT on building work for other businesses or public bodies is collected by reverse charge. Building work includes not only building activity, but also work on building installations. Traditionally, a building installation has been seen as equipment mounted in the building and affixed in such a way that it cannot be removed without altering or destroying the building. A lift is a typical example. However, in August 2014, the Supreme Tax Court narrowed the definition of a building installation to an item of major significance for the construction, continued existence, maintenance or use of the building. This definition follows the Valuation Act (valuation of assets for gift or inheritance tax), rather than the EU regulation to the VAT Directive.

The finance ministry has now issued a decree directing tax offices not to follow the Supreme Tax Court ruling other than in the case actually decided. A building installation is defined in the EU VAT Regulation as an item of equipment that cannot be removed without destroying or altering the building in which it is installed. The German VAT rules must follow this definition. The ministry also points out that a supplier cannot follow the Supreme Tax Court's definition without knowing his customer's intentions regarding the use or purpose of the item at issue.

Builders to treat customer retentions as bad debts

Builders frequently have to accept that customers retain part of the final payment due for a period of, typically, two to five years, until they can be sure that there are no hidden faults in the building. In October 2013, the Supreme Tax Court held that a builder was entitled to reduce his taxable turnover by the amount of such retentions, as though they were irrecoverable. The finance ministry has now followed with a decree allowing contractually agreed customer retentions for periods of between two and five years to be treated as bad debts, reducing VAT-able turnover in the period of issue of the invoice. However, the ministry adds that builders could avoid the problem by satisfying their customer's need for security with a bank guarantee. Accordingly, treatment of a customer retention as irrecoverable is conditional on the demonstration that a bank guarantee was not available in the circumstances. Normally, this presupposes refusal of the application.

The ministry also points out that treatment by the builder of part of the contract price as a bad debt leads to a corresponding reduction of the input tax deduction for the customer. However, the supplier is not obliged to inform the customer that he has treated part of the amount invoiced as irrecoverable, although it is open to the supplier's tax office to notify the tax office of the customer.

Supreme Tax Court Cases

Imputation credit for foreign corporation tax refused

Up to 2000, shareholders taxed their dividend income under the "imputation system". Their dividend received was grossed up with the corporation tax borne by the company and the resulting income tax due was then reduced by the corporation tax gross-up amount as though it were a prepayment. This system was protected by extensive documentation rules and other formalities. Foreign dividends were outside it; a foreign dividend was exempt for a company but taxable on its nominal amount in the hands of a natural person. That natural person received no credit for any corporation tax paid by the distributing company and was thus effectively taxed twice, once through the company and once in his own name as an income tax payer. The heirs of a German resident with Dutch and Danish dividend income in 1995-7 saw this as discrimination against those receiving dividends from other EU countries and turned to the courts for redress. In the meantime, the ECJ has ruled twice on the matter (*Meilicke I* C-292/04 of March 6, 2007 and *Meilicke II* C-262/09 of June 30 2011), holding the discrimination to be a restriction on the taxpayer's freedom of capital movement but making his rights conditional on heavy burdens of documentation.

The latest judgment in the case is the rejection by the Supreme Tax Court of an appeal against the lower tax court's refusal to grant imputation relief for the Dutch and Danish corporation tax paid for lack of documentation of the amounts. In summary, the Supreme Tax Court made two points: an imputation credit for foreign corporation tax presupposed the income to have been grossed up with the relevant amount, and that the documentation submitted was clearly inadequate. The gross-up would equate the foreign and German income, but would presuppose revising the computation of taxable income in the assessment. Whether this was still possible was not clear from the judgment, but even if it were, it would be a matter for the tax office and then the lower tax court. On the documentation issue, the Supreme Tax Court was less than concrete; more was needed that a purely theoretical calculation based on the statutory rate of corporation tax in the foreign country concerned, although it would not be necessary to prove actual payment of the foreign tax due. Also the documentation – to be obtained from the foreign company – need not follow German forms, although it should meet the German requirements in substance. Deficiencies were to the disadvantage of the taxpayer.

Further developments are to be expected.

Supreme Tax Court judgment I R 69/12 of January 15, 2015 published on June 10

Film pre-release marketing subsidy as profit-sharing loan

A film owner granted an exclusive twelve-year distributorship against a fixed annual licence charge and a variable fee of 40% of the net proceeds realised by the distributor. The variable fee was payable in a lump sum together with the final fixed instalment at the end of the distributorship. The film owner also agreed to pay the distributor a fixed subsidy prior to the release of the film to cover 85% of the estimated marketing and other pre-release costs. Since the subsidy was not repayable under any circumstances, the film owner claimed that it should be deducted as immediate expense on the analogy of the initial costs of marketing a new product. The tax office saw the subsidy as expense deductible in equal annual instalments over the distributorship period.

The Supreme Tax Court agreed with neither view. Rather, it held the subsidy to be essentially a profit-sharing loan, despite an explicit contract reference to its non-repayment. It had been granted to ensure the commercial success of the film and was to be recouped by the film-owner at the end of the distribution period. The obligations of the distributor were supported by bank guarantee. Only the prohibition on judgments to the further disadvantage of the taxpayer prevented the court from disallowing the annual charge accepted by the tax office.

Supreme Tax Court judgment IV R 25/12 of May 21, 2015 published on August 5

Subordinated debt not a liability whilst debtor's liabilities exceed assets

A company with a negative net shareholder's equity was largely financed by shareholder loans. In order to avoid opening insolvency proceedings, the (sole) shareholder agreed to subordinate the debt to the claims of all other creditors. In particular, the debt could only be serviced from future annual profits or liquidation surplus. Because these terms meant that the debt could only be repaid on the occurrence of a future event, it could not be taken up as a present liability. The existing balance should therefore be written back to income in the year of subordination. In this, the Supreme Tax Court has followed its existing case law.
However, the court has now added a new facet to the calculation. Insofar as the subordinated loan had a market value, the subordination – given that it followed from a shareholder acting as such – should be seen as a (tax-free) capital contribution, rather than as an item of net income. The income from the release of the liability should be reduced accordingly.

Supreme Tax Court judgment I R 44/14 of April 15, 2015 published on July 8

Embezzled funds not taxable income

A lawyer regularly collected debts on behalf of clients. However, he did not forward the proceeds to the owners immediately and did not credit them to a separate bank account for cash held on behalf of clients. Rather, he paid them to his general business bank account and used them for his own, business and private, purposes. A tax auditor discovered this regular embezzlement of clients' money and the tax office viewed the proceeds as business income taxable when received, the lawyer having accounted on a cash basis.

The Supreme Tax Court has now rejected the view of the tax office. Paying money belonging to clients onto his own business bank account did not release the lawyer from the obligation to meet the claims of the true owners. The money remained a transitory item of "cash collected on behalf of others" and was not part of the lawyer's professional earnings. This was still true even where he had never intended to pass the money on, as in such cases his benefit was the proceeds from a privately committed criminal act, rather than from his business activity. The court contrasted this with the taxable income of a partner from the diversion of partnership earnings to his private bank account and with the fraudulent trading by a bank's employee in the name of the bank but for his own account if successful. In both the latter cases, the income was taxable *per se*; the fraud merely changed the person of the taxpayer.

Supreme Tax Court judgment VIII R 19/12 of December 16, 2014 published on June 17, 2015

Pre-2008 disallowance of related-party loan interest

Up to 2008 the then thin capital rules (basically disallowance of interest on related-party loans in excess of one-and-a-half times the company's opening equity) included an exception to disallow all related-party interest cost incurred in financing the purchase of shares. This exception has been variously interpreted as including, or not including, interest on loans taken out to finance investments through subsidiaries (indirect investments). The Supreme Tax Court has now resolved the dispute in favour of a restrictive interpretation of the exception as opposed to the broader interpretation set forth in a finance ministry decree.

A German member company of an international group took out a loan from its Luxembourg fellow subsidiary at a supposedly market-rate of interest. It forwarded the funds to its Italian subsidiary, so that that company could purchase the entire share capital in a Spanish company from its Dutch shareholder (European group holding company). The tax office followed a finance ministry decree and disallowed the interest paid by the German company on the loan, as that loan had been taken out to finance the cost of acquiring the shares in the Spanish company through the Italian subsidiary.

The Supreme Tax Court has now resolved the issue in favour of the taxpaying company. It had not taken up the loan from Luxembourg in order to finance the purchase of shares, but to make a capital contribution to its Italian subsidiary. That company's purchase of the shares in the Spanish company was not the equivalent of a direct acquisition by the German company. Thus while the loan interest in question might be wholly or partially disallowable for other reasons – such as failure to meet the arm's length standard – it could not be disallowed solely because of its use to strengthen the working capital of the Italian subsidiary, enabling that company to buy the Spanish shares.

Supreme Tax Court judgment I R 68/13 of January 29, 2015 published on June 17

Regular remuneration can qualify for multi-year preference

Unusual income, particularly if paid for an activity lasting for longer than twelve months is open to preferential taxation. Essentially, the tax is assessed at five times the incremental income tax on one-fifth of the amount. The purpose of this privilege is to avoid the damaging progressive effect on the tax charge on remuneration for a longer period falling due in a single period of assessment. This privilege was claimed by the chief executive of a charity whose remuneration period for an unchanged lump sum payment had been extended from twelve to fourteen months. This effective salary reduction was intended to forestall a possible accusation of excessive remuneration leading to loss of charity status. The tax office denied the privilege because the fourteen-month remuneration was neither "unusual" nor earned from any activity outside the normal course of events. In particular, the executive's duties and responsibilities remained unchanged.

The Supreme Tax Court has now held the executive to be entitled to the privilege of multi-year taxation. There was no requirement in the law that the earnings be "unusual" or be for activities beyond the executive's normal duties. Rather, the only requirement was for a good business reason for the arrangement chosen. The good business reason could be based on the circumstances of either payer or recipient. In this case, the fear of a possible loss of charity status for the payer was a good business reason.

Supreme Tax Court judgment VI R 44/13 of May 7, 2015 published on August 12

From Europe

Non-residents need not be granted resident's privileges in the year they take up employment elsewhere

The taxpayer was a German national living in Germany, but working in Holland. Under Dutch law he was able to claim the privileges of a local resident – here a deduction for mortgage interest – on the basis that over half his annual income was taxable in Holland. On March 31, 2005 he moved to work in the United States. The Dutch authorities continued to regard his employment income for the first quarter as taxable in Holland as that was where the work was performed, but refused him a deduction for mortgage interest as his income of Dutch source was no longer the major portion of his worldwide income. He protested on the grounds that his personal and financial situation had remained substantially unchanged during the first quarter. He should therefore continue to be allowed a mortgage interest deduction for that quarter, the more so as his title thereto would have been undisputed, had he been a Dutch resident.

The ECJ has now held in support of the Dutch tax office. Generally speaking, personal reliefs were a matter for the state of residence as it was the authorities of that state that were best able to estimate a taxpayer's need for reliefs based on his or her overall ability to pay. The major exception was where a resident taxpayer earned the major part of his income in another state, with the result that not only were the home authorities not in a position to estimate the overall financial position worldwide, but there was also the danger that any reliefs they did grant would come to nothing for lack of locally taxable income against which they could be offset. This did not necessarily apply though in the year of leaving the state of employment. In the case at hand, the move to the USA at the end of March meant that the Dutch authorities were no longer in a position to take the taxpayer's overall circumstances into account. Thus, the question of personal reliefs in the year of the move was a matter for the former and future countries of residence, rather than for the former country of employment. That a Dutch resident in otherwise similar circumstances would have been entitled to a mortgage interest deduction for the first quarter of the year was irrelevant, the circumstances of a resident and non-resident being in this case objectively different. Similarly irrelevant was the question of EU membership of the state of immigration (the USA). That state's non-EU status had no bearing on the taxpayer's ability to pay.

The ECJ case reference is C-9/14 *Kieback* judgment on June 18, 2015.

Non-deductible loss on investment can include exchange loss

A Swedish company wished to close down its UK subsidiary. Over the course of time it had progressively increased its investment with cash contributions to the subsidiary's working capital. Since the Swedish crown had strengthened against the pound, the return of the capital invested (or the sale of the investment) led to a book loss for the parent. The tax authorities refused to allow a deduction for this loss on the grounds that it was a capital loss on liquidation of an investment, non-deductible for a corporation in parallel with the exemption for corresponding capital gains.

The ECJ has now held that the lack of a deduction for the foreign exchange element of a capital loss is not a hindrance on a company's freedom of establishment. The non-deductibility of capital losses is balanced by the exemption for gains. This applies to investments at home and abroad and is non-discriminatory. The fact that an exchange gain or loss is only likely in respect of an investment abroad is not discrimination, but, rather, a consequence of separate currencies. Neither of the two countries involved is required to adjust its tax system to conform to that of the other. A non-deductible expense (in this case) must therefore be accepted.

The ECJ case reference is C-686/13 *X* judgment of June 10, 2015.

VAT group exclusion by legal entity only to prevent abuse

German law requires subordinate members of a VAT group to be subordinate, that is, that their business operation as well as their senior management be integrated into those of the parent. Also only legal persons are admitted, so partnerships are excluded altogether. Two cases have been filed with the ECJ, both challenging both provisions. In both cases the admission of the input VAT on the costs of recruiting new investors was also in dispute.

The ECJ has joined the two cases and held, firstly, that the VAT deduction is justified if the expense was incurred in connection with an economic activity. An economic activity could be seen if the parent actively managed the subsidiary (and regularly supplied it with administrative, financial, commercial or technical services). If the parent met this criterion, its input tax was incurred on general business expenses and was deductible in full. Only if part of the subsidiaries' turnover was VAT-free could the relevant portion of the VAT expense be excluded from the deduction. Apportionment was to be on the VAT Directive basis of turnover split between taxable and tax-exempt business activities.

On the question of eligibility for VAT grouping, the ECJ held that the German restrictions excluding partnerships from group membership altogether and allowing only commercially and organisationally integrated subsidiary companies to join, exceeded in both cases the restrictions set by the Sixth (VAT) Directive. However, the directive's objects were simplification and the prevention of tax abuse. If, therefore, the national authorities could convince their own courts that the particular German circumstances required the more stringent German provisions, these latter would be justified in community law.

The ECJ case references are C-108/14 *Larentia + Minerva* and C-109/14 *Marenave* joint judgment of July 16, 2015.

Nuclear fuel duty upheld

Germany levies a nuclear fuel duty on plutonium 239 and 241 and uranium 233 and 235 and on their compounds or mixtures. The amount is €145/gram of pure fuel included in charges (typically pellets or rods) inserted into reactors in order to start a chain reaction. A nuclear power station contended that this duty was in conflict with a number of provisions and principles of community law and could not be levied. The ECJ has now rejected all the arguments raised against it, making the following main points:

- The duty does not duplicate the excise duty on electricity as it is levied on generation rather than consumption. In any case, it does not burden the consumer, since electric power prices in Germany do not differentiate by source.
- The duty does not discriminate in favour of other forms of non-pollutive electricity generation (wind, water etc.) as these do not lead to radioactive waste. For the same reason, it does not represent illicit state aid for competitors.
- The duty is not a disguised import duty as it is not levied until the fuel is used without distinguishing between the fuel sources.

The ECJ case reference is C-5/14 *Kernkraftwerk Lippe-Ems* judgment of June 4, 2015

5% non-deductible deemed expense for foreign dividends can infringe freedom of establishment?

Under the French General Tax Code, companies can form a tax group centred on the parent if they are linked by common shareholdings of at least 95%. Profits and losses within a group are combined so that the net result is taxed only once. Dividends received from non-group member subsidiaries are exempt, although the taxable income of the parent is increased by 5% of the tax-free dividend received to take account of non-deductible, directly connected expense. Allowing a subsidiary to join a tax group avoids this add-back, although that route is not open to a foreign subsidiary as not being subject to the general rules of (French) corporation tax. A French parent is thus penalised for investing in another member state.

An ECJ advocate general has now published her opinion on a case brought by a French parent with sub-subsidiaries in various other member states. Barring a foreign subsidiary from joining a domestic group is an infringement on the freedom of establishment if, as in this case, it forces the parent to accept an otherwise avoidable expense add-back. This infringement cannot be justified with the need to preserve the internationally agreed split of taxing rights as it is solely a French unilateral measure. The privilege for the domestic subsidiaries of tax groups cannot be justified on the basis of tax system coherence as there is no compensating disadvantage. The German government attempted to argue in support of the French provisions that the 5% add-back followed directly from the Parent/Subsidiary Directive, although the advocate general countered with the point that the directive authorised a member state to set the expense disallowance as a lump sum of 5% of the exempt dividend income, but did not authorise it to do so in a discriminatory manner.

This case is directly relevant to Germany as the same issues arise – exclusion of foreign subsidiaries from tax groups, deemed non-deductible expense of 5% of the dividend received and full expense deduction in respect of profits pooled within a group.

The ECJ case reference is C-386/14 *Groupe Steria* opinion of June 11, 2015.

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