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Tax & Legal News

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PwC Reports

Treaty override constitutional

A German resident earned employment income in both Germany and Turkey. Under the then valid double tax treaty, employment income was taxable only in the country where the work was performed. Exempt income was taken into account in the country of residence to set the rate to be applied to the income taxable there. However, the Income Tax Act also contains treaty override provisions making treaty exemption conditional on proof of taxation – or of explicit exemption – in the other country. The taxpayer in the case at issue failed to provide any evidence of Turkish taxation and the tax office assessed him to income tax on his entire employment income. He protested that the tax treaty did not contain any such fall-back provision and that Turkish taxation was solely a matter for the Turkish authorities. Any German attempt to tax the Turkish source employment income would be in breach of the treaty and thus of the constitutional article acknowledging respect for international treaties.

The Constitutional Court has now held that the constitution requires respect for international treaties, but does not give their individual provisions precedence over German statutes. Rather, the two rank equally, so a later statute can override a treaty provision in the same way as domestic conflicts between statutes are resolved – specific before general (not relevant here) and the later statute supersedes the earlier one. The override provisions of the Income Tax Act were enacted after the entry into force of the then double tax treaty with Turkey and thus took precedence in the event of a clash.

In the meantime, the Turkish tax treaty has been replaced with a new text – with an override clause in common with most of Germany's more recent treaties – with effect from January 1, 2011. Two further cases on the treaty override are pending before Constitutional Court.

Constitutional Court resolution 2BvL 1/12 of December 15, 2015 published on February 12, 2006

Official Pronouncements

Investment income withholding tax update

The finance ministry has reissued its regulations on withholding tax on investment income in the form of a revised decree. There are no significant changes in substance; however, there are editorial changes and a number of other amendments to bring the text up to date in line with the Supreme Tax Court cases since the last revision in December 2014. It is emphasised that those responsible for correctly deducting withholding tax – mainly banks and other financial institutions – act in this capacity as tax collecting agents and, as such, are legally bound to follow the published pronouncements of the finance ministry when applying tax law, even if the persons concerned hold different views.

Foreign businesses may not recover VAT on exports or intra-community supplies of goods

In principle exports and intra-community supplies of goods are free of VAT (zero-rated). However, the exemption is dependent upon the supplier's being able to demonstrate the delivery with documentation in the prescribed form. If the documentation is inadequate, the transaction must be subject to VAT. As an exception, though, the transaction remains VAT-free despite documentation shortcomings if there is other evidence showing the export or intra-community supply to be beyond doubt. Any VAT charged on such a delivery is a charge in error. The supplier is liable for the amount, but the invoice recipient cannot deduct input tax.

The finance ministry has now issued a decree emphasising that the same principle applies to foreign businesses without German taxable turnover recovering their VAT outlays through refund claims. A claimant will not receive a refund for VAT invoiced on an export or intra-community supply clearly to be seen as such at the time. The decree explicitly separates the VAT position of the recipient of the goods from that of the supplier; thus it must be assumed that any VAT paid on goods bought from a German supplier is unlikely to be refunded unless the claimant can show that the delivery was in Germany.

Supreme Tax Court Cases

Interest limitation unconstitutional?

The interest limitation disallows net interest expense in excess of 30% of EBITDA. However, the rule does not apply to companies with a total net annual interest cost of no more than €3 m or to those that are not part of a group. There are also a number of other exemptions, but the overall effect is to render the actual impact somewhat arbitrary. In particular, the asserted purpose of the rule – prevention of profit shifts abroad through deliberate under-capitalisation of the German operation – seemed to the Supreme Tax Court to be something of an illusion in the light of the relatively high threshold and of the indiscriminate application to cases without foreign connotations. The court also pointed out that interest, as such, is a legitimate business expense and that the limitation rule can penalise financing arrangements generally seen as reasonable. Start-ups and crisis management were quoted as examples.

Overall, the court found that the interest limitation rule does not meet the constitutional requirements of equal treatment and consistency of application. It has laid the question before the Constitutional Court for a ruling, together with a detailed explanation of its objections. These are a mixture of doubts on the legitimacy of some of the stated aims of the rule and on its suitability as an instrument in meeting others that are legitimate.

Supreme Tax Court decision I R 20/15 of October 14, 2015 published on February 10, 2016

Reconstruction balance sheet may include newly capitalised intangibles

A GmbH changed its legal form to that of a partnership. In doing so, it took advantage of the valuation option in the Reconstructions Tax Act allowing the conversion balance sheet – closing balance sheet for the old entity, opening balance sheet for the new – to be drawn up based on previous book values or at a higher value not exceeding market value. In doing so, it capitalised its goodwill and its customer order book. This led to a profit to be set against a loss brought forward and a correspondingly higher depreciation base for the successor entity. The tax office refused to accept this capitalisation because of the Income Tax Act prohibition on capitalisation of self-generated intangibles. The GmbH was unable to contest this decision before the courts for lack of any disadvantage from the tax office' refusal to allow it to increase its taxable income, and the partnership was unable to appeal against the tax assessment of a different entity.

The Supreme Tax Court has now allowed the partnership's appeal. It was bound to open its books with the closing balance sheet of the GmbH and to refuse it the right to appeal against a tax office decision against the GmbH would effectively free the tax office from all judicial control. In the substance of the case, the court held the capitalisation of intangibles to be acceptable as the wording of the

Reconstructions Tax Act set the valuation range between the tax book values and the market values as objectively determined. The prohibition on capitalisation of self-generated intangibles was a tax rule without relevance to the determination of a market value.

Supreme Tax Court judgment IV R 49/14 of September 19, 2015 published on January 28, 2016

Home office must be a separate room

Up to 2009 it was generally accepted that the prohibition on splitting costs between personal and business expenditure (a given outlay was incurred for personal or for business reasons, but never for a mixture of the two) meant that a tax acceptable home office had to be in a separate room in the taxpayer's home, not used for any other purpose. In 2009, the Supreme Tax Court sitting in grand senate (a committee of 11 judges, 1 from each of the senates (chambers) of the Supreme Tax Court) held that dual-use expenses could, indeed, be split between personal and business use (in a case involving travelling expenses incurred on a business trip when the taxpayer elected to stay on for a few days' holiday after his work was done). This raised the question as to whether a home office could be accepted as potentially leading to tax deductible expense, even if the office was used for other purposes (e.g. as an ironing room or for guests) for some of the time. A taxpayer has now brought the issue before the IX. Senate of Supreme Tax Court in a claim for an annual expense deduction for the €804 cost of a home office used as such for some 60% of the time. The IX. Senate felt it would be appropriate to allow a deduction of 60% of €804, but felt obliged to call a grand senate, rather than rule on such a momentous issue on its own.

The grand senate does not share the IX. Senate's view. The statute was imprecise, but the assumptions of the lawmaker of a home office as a separate room in the taxpayer's home seemed clear. There was also the question of verification; it would not generally be possible for a tax office to verify a taxpayer's estimate of the proportionate business use of a home office. Accordingly, the grand senate ruled in a decision binding the IX. Senate in the case before it that an expense deduction for the costs of a home office necessarily presupposes that the given room is used for no other purpose (marginal uses excepted).

Supreme Tax Court Grand Senate resolution GrS 1/14 of July 27, 2015 published on January 28, 2016

No reduced rate VAT on online library service

A database manager established a digital library of copyright works for the benefit of public libraries and their users. Users were able to access the material for review (through a reader) or download. The database manager charged each library on the basis of its selection of material; the library made no additional charge to its users over and above its standard membership fees. The database manager claimed entitlement to the reduced rate of VAT under the printed matter provision of the VAT Directive, but the tax office demanded standard rate VAT on the provision of an on-line service.

The Supreme Tax Court has confirmed the position of the tax office, relying on ECJ precedents. The service was not the sale of printed matter (books), nor was it the transfer of a copyright. Rather it was the grant of a right to public libraries to allow their own users access to selected works stored on the database. This "electronic loan" was an electronic service, rather than a sale or permanent transfer with the right to grant sub-licences.

Supreme Tax Court judgment V R 43/13 of December 3, 2015 published on February 10, 2016

From Europe

Loss forfeiture exemption for troubled businesses rejected

If more than 25% of a company's share capital is acquired by a single person (together with his related parties) over a five-year period, the company's losses brought forward are no longer available for future relief in proportion to the equity acquired. If the acquisition is for more than 50% of the equity, the entire right to relief is lost. There are three exceptions to this rule, acquisitions within a group without a change in ultimate shareholder, losses covered by potentially taxable hidden reserves (appreciation in value of assets held, off-balance sheet intangibles) and acquisitions in the course of a rescue operation to save a troubled business. This latter is subject to a number of safeguards to ensure protection of, in particular, the employees. Nonetheless, the European Commission saw it as indiscriminate state aid and ordered the German government to disapply it for the future and in retrospect. The government protested, but lost its case before the ECJ on a procedural point following a missed deadline. However, two taxpaying companies sued the Commission in their own names, having suffered the withdrawal of a binding ruling confirming their future entitlement to loss offset despite a "harmful" change of shareholders. The withdrawal followed the Commission's order to Germany.

The ECJ has now passed judgment on both cases. It confirms the Commission's view, arguing that the general rule is for the forfeiture of loss relief on change of shareholder and that the exception is applied indiscriminately without regard to the individual circumstances. It thus favours certain companies – those in financial difficulties – over their competitors in the marketplace. At one point, a plaintiff argued with government support that the loss forfeiture provision was intended to prevent the abusive practice of buying up tax loss companies. The exception was designed to exempt genuine rescue attempts. However, the argument failed because a rescue attempt was not the only non-abusive share acquisition in a loss-making company. In the other case, the same argument failed because of an inconsistency in the official explanation of the loss forfeiture rule – one official source proclaimed it as an anti-abuse measure, while another explained it as a revenue raiser to compensate for the 2008 drop in the corporation tax rate from 25% to 15%. Both taxpayers claimed that they had relied on their rulings before being thwarted by the Commission. To this the court replied, the question of reliance on a ruling was a matter for national law; a taxpayer's remedy lay in an appeal to the courts against a repayment demand for the illicit state aid now to be recovered.

The ECJ case references are T-287/11 *Heitkamp v. Commission* and T-620/11 *GFKL v. Commission* judgments of February 4, 2016.

Seepage of bonded goods in transport dutiable

An oil company moved a cargo of diesel fuel from Holland to Germany. On arrival, it was found that 2.02% of the cargo had been lost, presumably through seepage, spillage or evaporation. The German customs office allowed a standard 2% for losses in transit, but charged the excess to fuel oil duty as a deemed withdrawal through an unexplained inventory shortage. The company protested against the charge of €24.93 on the grounds that the relevant EU provisions referred to lost cargoes, rather than to losses from a cargo, the bulk of which had remained intact.

The ECJ has now upheld the position of the customs office. The provision at issue should be interpreted in accordance with its meaning and intent, which, clearly, was to prevent undutied withdrawals of bonded goods into free circulation. Thus, goods lost in transit led to a duty charge regardless of whether the whole shipment or only a part thereof was at issue.

The ECJ case reference is C-64/15 *BP Europa* judgment of January 28, 2016.

Formal invoicing errors may be corrected retroactively?

The input tax deduction under the German VAT Act is conditional on possession of a supplier's invoice correctly drawn up. A deficient invoice can be corrected later, but the right to deduct the input tax can only be exercised after the correction. Thus, subsequent discovery, say on tax audit, of an invoicing error by the supplier can lead to deferral of the input tax deduction until the date of correction. This triggers an interest charge for the intervening period.

The advocate general on an ECJ case concerning a trader with defective suppliers' invoices (missing tax numbers) has suggested the court rule that the VAT Directive should be interpreted as requiring retroactive deduction where the error is merely formal and there is no suggestion of bad faith. His reasoning is based on the concept of VAT as a tax neutral system for traders. This requires an immediate right of deduction as soon as the VAT has been paid. Correction of a formal error later should not lead to an interest charge or other burden, since there has been no loss to the state. He goes on to add that the state should be entitled to enforce adherence to the formal requirements with penalties, but these must be proportionate. Charging interest up to the date of correction does not distinguish between innocent error and fraud and also ignores the fact that the error was – usually – made by the supplier. It is therefore inherently out of proportion. Finally, he addresses the question of time limits. As such, a time limit for correction of an invoicing error is acceptable as long as it does not make the exercise of the right to deduct the input tax effectively impossible. Given that most cases of innocent error will not be discovered until audit, an acceptable time limit must allow for invoice correction for a reasonable period after the matter has come to the attention of the authorities.

The ECJ case reference is C- 518/14 *Senatex* opinion of February 17, 2017.

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