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Statutes
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# Tax & Legal News

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## Official Pronouncements

### No conflict between Foreign Tax Act and tax treaty definition of arm's length dealing

The Foreign Tax Act provides for adjustment of income to the level that would have been achieved had the given transaction been conducted at arm's length. It thus provides for adjustment both in respect of pricing as well as in respect of the nature of a transaction. Accordingly, transactions that a third party would not have entered into in the given form can also lead to adjustment (disallowance of the expense, imputation of income) even if their pricing is not in dispute. However, the Supreme Tax Court has seen this conclusion as being in conflict with the arm's length clauses of the tax treaties (on the lines of the OECD model) and thus sought to restrict application of the income adjustment provision to pricing disputes only (judgments I R 23/13 of December 17, 2014 and I R 29/14 of June 24, 2015). The finance ministry does not share this view and has issued a decree directing tax offices not to follow the two judgments in other similar cases. Rather, they should continue to apply the existing statutes and extra-statutory instruments as they stand.

### Recognition of capital repayment by EEA companies must be applied for

Capital repayments by foreign companies to their German resident shareholders are basically taxable in the hands of the recipients as dividend income. However, companies resident in another EEA country (EU, Iceland, Liechtenstein and Norway) can avoid this consequence with an application to the tax authorities for recognition of the capital repayment as such. The finance ministry has now issued a decree reiterating this point, but allowing continued recognition of capital repayments made up to the end of 2013 if the shareholder's tax office had accepted the application of the shareholder, rather than that of the company. Application is to be made to the tax office responsible for the company's German branch or, if there is none, to the Central Tax Office.

### Standard rate VAT on photobooks

The finance ministry has decreed that photobooks, that is books of photographs prepared to commemorate a private, or infrequent, occasion, are to be taxed at the standard rate of VAT. This follows the European Commission regulation on the subject excluding taxation at the reduced rate for books, as photobooks are not meant to be read and thus do not qualify as reading matter. Typical of a photobook is that it is prepared to order with photographs taken by or for the customer to commemorate a special, public or private, business or personal occasion. The book is not usually intended for resale, though it may be distributed free of charge to those attending the event or others with personal connections to the celebrity. The text is usually restricted to brief notes on the context of the pictures.

# Supreme Tax Court Cases

### *Exchange loss on investment in foreign partnership is part of foreign trading result*

A partnership took up a minority share in a US LLP. Later, the LLP was dissolved and the capital returned to the partners. However, the euro had in the meantime strengthened against the dollar, so the capital repayment resulted in an exchange loss for the German investor partnership. Because the tax office notification of the allocation of the partnership's income to the individual partners had, in the meantime, become final and binding, the partners claimed a deduction for their share of the exchange loss in their own returns. They also claimed a deduction for trade tax. The tax office refused both claims.

The Supreme Tax Court has upheld the tax office' point of view in a judgment confirming previous case law on the subject. The exchange gain or loss on the capital invested in a foreign partnership was part of that partnership's trading income. Accordingly, it was part of the trading profit or loss to be allocated by the German investor partnership to its own partners. If that allocation was no longer alterable, there was no possibility of attributing the loss to the partners directly. This applied regardless of whether the foreign income was taxable or, as in this case, exempt under the US double tax treaty (the desired effect was to have the loss taken into account in the calculation of the tax rate). Because the loss in question was part of the US trading income it necessarily fell under the Trade Tax Act exemption for trading income from foreign permanent establishments or partnerships. Thus, no German deduction was available, regardless of the treaty position.

Supreme Tax Court judgment I R 13/14 of December 2, 2015 published on April 13, 2016

### *Forfeiture of loss relief on upstream merger*

Up to 2007, a company lost its loss carry-forward on transfer of more than half its share capital if its business continued or restarted with substantially new business assets. "Substantially new" business assets meant either that more than 50% by value of the existing assets were replaced with different items, or that the new items added were worth more than those previously existing. As the Supreme Tax Court has now emphasised, the test is based on an item-by-item approach, rather than on an overall increase in value. Thus a company with its investment in its subsidiary as its only significant asset lost its right to future relief on its losses brought forward on a group reorganisation involving the transfer of its shares within the group and its merger with its subsidiary. It had previously held an investment and now owned operating assets. The two were entirely different in nature; thus the upstream merger led to continuation or restart of business operations with substantially new assets.

Supreme Tax Court judgment IR 71/14 (NV) of October 14, 2015 published on March 30, 2016

### *Loan and accumulated interest separate debts*

A GmbH made a loan at a market rate of interest to relative of its sole shareholder. The interest accumulated on a separate account. No attempt was made to pay the interest or repay the principal and the GmbH wrote off both balances five years after granting the loan. The tax office took the view that the loan had not been granted as a commercial transaction, that repayment had never been seriously intended or expected and that both write-offs were to be disallowed as "hidden distributions". The GmbH accepted the finding in respect of the principal, but disputed it in respect of the interest. If the loan had not been meant seriously, no interest should have been charged and no write-off would have been necessary. However, the Supreme Tax Court has now held in favour of the tax office. The loan agreement was a legally valid document, governing both the loan itself and the interest to be charged thereon. Nevertheless, the two were separate liabilities, so that the tax disallowance of the one did not preclude tax recognition of the other. Thus the interest taken to income before the write-off remained taxable and the subsequent write-off of the accumulated balance remained disallowable as a hidden distribution.

Supreme Tax Court judgment I R 5/14 of November 11, 2015 published on March 30, 2016

# From Europe

### Tax reporting provision does not restrict freedom of establishment

The Inheritance and Gift Tax Act requires banks to notify the responsible inheritance tax office of assets held for deceased German resident customers on the date of death. The requirement applies to banks operating in Germany and therefore, by implication to assets held for German customers of foreign branches. A German bank faced with a tax office demand for information under this provision protested its inability to comply in respect of accounts held at its Austrian branch, as Austrian law, at the time, made it a criminal offence to do so. The Supreme Tax Court saw this conflict of laws as a possible hindrance on the German bank's freedom to establish an Austrian branch and referred the question to the ECJ.

The ECJ has now held that a reporting obligation of this nature on a bank in respect of accounts held at a foreign branch does not constitute a restriction on the bank's freedom of establishment, even though locally owned banks in the foreign country concerned are under no such obligation. It mentions that breach of the Austrian bank secrecy rules was a criminal offence, but offers no discussion on the implications of this clash of concept. It also offers no comments on the Austrian criminal or civil legal consequences of compliance with the tax office' request made before the current EU Council directive on administrative cooperation between member states in respect of bank accounts takes effect (2017).

The ECJ case reference is C-522/14 *Sparkasse Allgäu* judgment of April 14, 2016.

### Treaty improved tax credit not a TFEU infringement?

A Belgian couple received dividends from an investment in Poland. Belgian law allows a credit of foreign withholding tax on dividends received by natural persons only if the investment is held for business reasons (trade investments). Since the couple held the investment solely in the hope of earning dividends, it ranked as "private" and the dividend was subject to income tax without any relief for the Polish income tax withheld at source. The couple protested at this apparent discrimination against a member state, given that the full foreign withholding tax would have been credited against the income tax due, had the dividend been paid by a Japanese company. This is because the Belgian/Japanese double tax treaty credits the withholding tax without regard to the purpose of the investment, whereas the double tax treaty with Poland merely credits the withholding tax as prescribed by Belgian law.

The ECJ advocate general on the case has suggested the court rule that there is a hindrance on the freedom of capital movement from the discrimination against a member state from the preferential treatment of dividends received from a state outside the EU. However, this discrimination can be justified by the existence of a double tax treaty as long as the treaty requires credit of the withholding tax at issue as opposed to merely permitting it. In consequence, the tax treaty takes precedence over the free movement of capital unless it was entered into for the sole purpose of curtailing a fundamental freedom of the EU.

The ECJ case reference is C-176/15 *Riskin* opinion of April 12, 2016.

### No automatic VAT liability solely because of missing VAT ID No?

A German businessman took his car to Spain for business use. Nine months later he sold it to a Spanish business. He ignored the VAT implications of the move to Spain and issued a VAT-free invoice to the buyer as an intra-community supply from Germany. The German tax office saw the move to Spain and the later sale as separate transactions and – without informing the Spanish authorities – refused exemption from German VAT on the grounds that the German taxable event was the move to Spain. The liability arose from the failure of the taxpayer to provide a valid Spanish VAT registration number.

The ECJ advocate general on the case has suggested the court rule that in these circumstances the requirement on the taxpayer to document the move of the car to Spain with a Spanish registration number be treated as a purely formal requirement. There was no indication of an attempt to evade taxes and all the other conditions for exempting the sale to the ultimate buyer were fulfilled. Rather, the seller had misinterpreted the law, but – given the unrestricted right of both parties to deduct input tax borne – without endangering tax revenue in either member state. To insist on the formality of the registration would therefore be unnecessarily harsh.

The ECJ case reference is C-24/15 *Plöckl* opinion of April 6, 2016.

## From PwC

### Guide to Doing Business and Investing in Germany

The 2016 edition of our popular Guide to Doing Business and Investing in Germany is now off the press and freely available to those interested. It can be downloaded from http://www.pwc.de/en/internationale-maerkte/doing-business-and-investing-in-germany.html

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