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Issue 3
13 April 2018

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PwC Reports

German Constitutional Court rulings on property valuations for real estate tax and on trade tax

On 10 April 2018, the German Constitutional Court issued two separate decisions. In the one decision it pronounced as unconstitutional the provisions on the valuation of property for the purposes of real estate tax and demanded new regulations. In the second decision, it concluded that the complaint that the trade tax treatment of profits from the disposal of partnership interests was unconstitutional because it contravened the principle of equality was not justified.

Provisions on the valuation of property for the purposes of real estate tax are unconstitutional

With its decision of 10 April 2018 (1BvL 11/14, 1 BvL 12/14, 1 BvL 1/15, 1 BvR 639/11, 1 BvR 889/12) the Constitutional Court took the view that the provisions in the Valuation Tax Act on the valuation of real estate in the "old" Federal States (i.e. the former West Germany) had violated the general principle of equality at least since 2002. The adherence to the main valuation reference point of 1964 led to a grave and comprehensive inequality in the treatment of the valuation of real estate, for which there was no sufficient justification. In this decision the First Senate of the Constitutional Court held the provisions to be unconstitutional and gave the legislature until 31 December 2019 to issue a new rule. After the publication of the new law the old provisions may be applied for a further five years from the date of publication but not after 31 December 2024.

Background

The Court was ruling upon three referrals of the Supreme Tax Court and two complaints on the constitutionality of the valuation regulations with regard to real estate tax. In its ruling of 22.10.2014 (II R 16/13) the Supreme Tax Court came to the conclusion that, (at least) since the 1 January 2008 reference point, the authoritative character of these dated valuations (with the valuation reference point set over 45 years previously) no longer met the constitutional requirement that tax legislation be structured in an equitable form.

Valuations for real estate tax purposes are outdated....

The Constitutional Court noted that whilst it is correct that the legislature should have certain room for manoeuvre in deciding the valuation regulations for tax purposes, they are required to provide a valuation system which is realistic in the way it compares different types of assets to each other as well as one which calculates values in an equitable manner. The suspension of a new primary valuation assessment reference point for an extended period of time (i.e. since 1964) had led to systematic and far-reaching unequal treatment because of the unequal valuation results.

The values of real estate applied should be kept as close to reality as possible, taking into account any relevant changes. The legislature had suspended the six year valuation assessment cycle on 1 January 1964 and had not reinstated it since.

....which leads to unequal treatment in the levy of real estate tax...

The decision to suspend the fixing of a new primary valuation assessment reference point was made in order to reduce administrative costs. Whilst the legislature does have certain room for manoeuvre here, it also meant the acceptance of an inappropriate valuation system. By failing to issue primary valuation assessments on a regular basis, the legislature had damaged a central element of the valuation system, which was indispensable for the purposes of issuing realistic valuations. If a statutory provision proves to be significantly inequitable, then neither substantial administrative simplifications nor significantly better cost-benefit ratios between the cost of tax collection and the tax revenue raised can justify this in the long run.

...and is also not justified by the need to standardise

The legislature is entitled to standardise systems in order to simplify administration and thereby disregard the special aspects of each individual case, provided that the advantages arising from the standardisation remain proportionate to the resultant inequalities in tax burden. Furthermore to justify such standardisation, the legislature must orientate itself towards realistic and typical situations and a reasonable and obvious purpose must exist. However, these reasons do not justify the value distortions arising from the current system. For these distortions are certainly not limited to atypical or special cases or to negligible corrections in marginal areas, but concern the essence of the valuation assessment. These distortions have become the rule and not the exception in many areas and they continue to increase in number and extent with the passage of time.

Existing rules continue to apply until 31 December 2018

The Court ruled that the unconstitutional provisions should continue to apply in two stages. Firstly the old rules should continue to apply for valuations that have been assessed in the past and the related real estate tax paid as well as for assessments made up to 31 December 2019. The legislature should issue a new rule by this date. Once the new rule is agreed, the old provisions should apply for a further five years but no longer than 31 December 2024.

Constitutional complaint regarding the trade tax treatment of profits from the disposal of partnership interests unsuccessful

Background

Specifically, the case concerned trade tax, which is payable by partnerships if they sell a business or operational unit or its partners sell their interest in the partnership. The provision which was the subject of the appeal - introduced into the Trade Tax Act with effect from the 2002 period of assessment - taxes the resulting capital gain at the level of the partnership, except where the gain is attributable to an individual with a direct participation in the partnership.

The appellant, which was a limited partnership in which shares had been disposed of, saw in the calculation of the trade tax base a breach of the principle of equality because the tax exemption was dependant on the legal form of the partner: on the one hand the capital gain on the disposal of a direct partnership interest by an individual was tax free but on the other hand the capital gain on any disposals by a corporation or by a partnership was taxable.

Furthermore, the appellant complained about a breach of the ban on retroactivity, because, whilst the sale of shares was completed in 2002, the contract was concluded in 2001, and thus before the legislative procedure for the introduction of the rule had begun.

However neither the Supreme Tax Court in its judgment of 22 July 2010 (IV R 29/07), nor the First Senate of the Constitutional Court in its judgment on 10 April 2018 (1 BvR 1236/11) considered that such breaches had occurred.

Taxation remains in accordance with the principle of capacity

The Karlsruhe judges did not see a sweeping conflict with the principle of capacity; the fact that the partnership is charged to tax on a capital gain realised by its shareholder does not have an impact on capacity. This is because the interest (i.e. in the assets of the partnership sold by the exiting partner does not actually leave the partnership but rather remains with the partnership through the interest held by the acquiring partner. Thus the capacity of the partnership remains basically unchanged. Where the exiting partner has realised a gain through the release of any hidden reserves, the acquiring partner will assume the increased book value in his supplementary tax balance sheet ("Ergänzungsbilanz") and thus carrying that increase into the partnership. If the partnership later sells the relevant assets, a double taxation will be avoided through the release in the supplementary tax balance sheet by the acquiring partner.

No breach of the principle of equality

The principle of equality is not breached because the capital gain realised by an individual is excluded from trade tax. This regulation is indeed disadvantageous, to the extent that partnerships and corporations hold interests in the partnership. However, like the Supreme Tax Court, the Constitutional Court takes the view that there are reasonable grounds to justify this, namely the prevention of tax avoidance schemes. The legislature is entitled to assume the potential for tax avoidance is lower in individuals than in corporations or partnerships.

No breach of the principle legitimate expectation in the law

The relevant provision was introduced in July 2002 with retroactive effect to 1 January 2002. The principles of legitimate expectation in the law can only be relied upon in the case of artificial retroactivity – such as in the present case – where, at the time of publication of the new regulation, the person affected can claim to have achieved or realised a fixed expectation of capital appreciation under the previous rule, or where a fixed expectation of capital appreciation could have been realised or where the person affected had concluded a binding agreement prior to the introduction of the new law into the Bundestag.

The Constitutional Court has decided recently on several occasions that the introduction of a bill into the Bundestag can destroy the confidence of those affected in the continuity of the previous legal position and therefore a new regulation may produce an artificial retroactivity. Once introduced a concrete outline of future legislative changes is foreseeable. In the view of the Constitutional Court the same considerations can also apply where the federal government passes on a draft bill to the Bundesrat. The publication provides the persons affected with the opportunity to prepare for potential changes in the law.

In the case before the Court, whilst the agreement had been signed before the legislation was introduced into the Bundestag, the government draft had already passed to the Bundesrat before the contract was made legally binding through the agreement of the partners.

Official Pronouncements

Automatic exchange of financial accounts information as of 30 September 2018: preliminary list of participating countries

The Ministry of Finance published a circular on 2 February 2018 with a preliminary list of countries participating in the automatic exchange of information in the period to 30 September 2018. The final list should be available by the end of June 2018.

According to the Exchange of Information – Financial Accounts Act ("the Act") the Federal Central Tax Office will exchange information on financial accounts for the calendar year 2017 to certain listed countries on 30 September 2018. Reporting financial institutions are obliged to provide the relevant information by 31 July 2018.

According to Section 1 (1) of the Act, the automatic exchange will involve the following countries:

1. EU Member States;
2. Third Countries which have signed the mutual agreement of 29 October 2014;
3. Third Countries which have signed an agreement with the EU;
4. Third Countries which have signed a bilateral agreement with Germany.

With its circular, the Ministry of Finance has provided a preliminary list for 2018 of the countries participating in the automatic exchange of information. A final list should be due by the end of June 2018.

Source:
Circular of the Ministry of Finance dated 1 February 2018 (IV B 6 – S 1315/13/10021 : 050)

Tax Court Cases

International private law also to be observed in tax law

Courts may not interpret contracts governed by foreign law according to German law. The legal terms used by the contracting parties in the text of the contract are to be given their proper meaning under foreign law. The German courts have to apply the foreign law in the way it would have been interpreted and applied by the courts of the relevant foreign state. Where necessary they must consult an expert for this purpose.

The plaintiff was a German film production company in legal form of a partnership (GmbH & Co. KG). It produced a motion picture and by a contract dated 20 September 2000 granted exploitation rights to a foreign distribution company until March 31, 2009. The contracts were in the main subject to Californian law. As consideration the distributor was to make certain fixed annual payments to the plaintiff, and a final payment on 31 March 2009 for the acquisition of the film rights by way of a call option.

<u>*Balance sheet treatment of the final payment due to the licensor for the temporary assignment of film rights:*</u> The question in dispute was whether and –

where appropriate – to what extent the final payment due should be accounted for in the balance sheet of the plaintiff during the actual term of the contract. The tax office and the tax court interpreted the contracts according to the usual methods applicable in Germany. The Supreme Tax Court, however, took the view that the contract should have been interpreted in accordance with Californian law in accordance with the requirements of international private law. Another issue was whether Californian civil law recognised such terms as "maturity" ("Fälligkeit"), "condition precedent" and "condition subsequent" ("aufschiebende/auflösende Bedingung"), and whether it attached the same meaning to these terms as German civil law did. It was also necessary to clarify how terms such as "Call Option" and "Final Payment" are to be interpreted according Californian law.

Realisation of profit for time-related performance obligations – principles for pending transactions to be observed: Claims arising from a so-called pending transaction, i.e. a mutual contract, which is not yet completely fulfilled by the party obliged to provide the goods or services, should generally not be accounted for. During the period of abeyance, there is a rebuttable presumption that the reciprocal rights and obligations arising from the contract are equal in value. Disclosure in the balance sheet is only required if and to the extent that the equilibrium of such contractual relationships is "disturbed" by the advance performance or the performance in arrears of one of the contractual partners.
In the opinion of the Court the answer to question as to whether (and if so to what extent) the person obliged to provide services has actually performed the service so that his claim to remuneration is as good as certain, will depend upon the nature of actual service he is obliged to provide. This is to be determined through the interpretation of the underlying contract.

Remittal to the Tax Court: The assessment of the foreign rules could not be carried out by the appellate court itself because it was necessary to consult an expert; accordingly the matter had to be referred back to the tax court.

Source:
Supreme Tax Court judgment of 7 December 2017 (IV R 23/14), published on 21 February 2018

Write-up of shares in GmbH not part of tax-neutral profit transfer

The Supreme Tax Court has decided that a gain arising from a share disposal can be rolled-over on a tax-neutral basis under Section 6b Income Tax Act where the privileged asset has been sold to a related entity. However, the Court also ruled that the part of the gain attributable to the write-up of the privileged asset – where the earlier write-down of the shares had reduced the taxable profits - could not be rolled over as a tax-neutral transfer under section 6b of the Income Tax Act.

Facts: The appellant, a limited partnership ("KG 1") was a shareholder in a D-GmbH. In 1996, KG 1 wrote down the value of its share in the loss-making D-GmbH and treated it as tax-deductible. In 2006 the limited partner of KG 1 (an individual – "R"- with a 99% interest in KG 2) formed a second limited partnership (KG 2), in which he held a 100% interest. In the same year KG 1 sold its interest in D-GmbH to KG 2. In the 2006 tax returns the portion of the capital gain attributable to R was rolled-over under Section 6b German Income Tax Act on a tax neutral basis and set-off against KG 2's acquisition cost for D-GmbH.
At a subsequent tax audit, the tax authorities took the view that the 1996 write-down had to be reinstated. As a result the book value of the share was increased, reducing the amount of the capital gain available for roll-over on a tax neutral basis under Section 6b German Income Tax Act. The Supreme Tax Court confirmed this view.

Principle of reversal of impairment: As a matter of principle, a shareholding held as a business asset is to be valued at its acquisition cost, unless the taxpayer proves that there is an impairment in value and a lower going-concern value is applicable. Accordingly write-downs from previous years must be reversed up to the upper limit of the acquisition cost, unless the taxpayer can also prove in the respective subsequent year that a lower going concern value applies on the relevant balance sheet date.

Reversal reduces amount of privileged capital gain: If a partnership sells a joint

asset to another partnership and a partner has an interest in both partnerships, the part of the capital gain allocated to the "double-partner" can be proportionately rolled over on a tax neutral basis against the sister-partnership's own acquisition costs for the said asset. The relevant proportion in this case is based upon the level of the "double-partner's" interest in the second partnership.
The gain available for roll over under Section 6b Income Tax Act is the amount by which the sales price – after the deduction of the costs of sale – exceeds the book value properly applicable at the time of the sale. When subsequently determining the notional book value at the time of the sale, the valuation rules under the Income Tax Act must be observed, as well as the rules for the reversal of impairment.
In the opinion of the Court, a reversal of impairment could not be avoided because the specific share written off in 1996 may have been considered to have been completely or partially destroyed in the meantime. The shares in the D-GmbH are to be regarded as a single share held in the business assets of the appellant. Neither the consolidation of shares, nor increases and reductions of the capital led to a destruction of the appellant's share in D-GmbH or of the acquisition costs attributable to that share.

No partial exemption on the reversal of impairment: It is correct that the Income Tax Act provides for a (50%) partial exemption on the appreciation of business assets after a write-up in value. However, according to the Supreme Tax Court, this does not apply to the extent that the impairment led to a full tax deduction in profits and the tax deduction was not fully reversed later through a write-up to the higher going-concern value. In the view of the Court, this principle also applies where the share in question are later sold.

Source:
Supreme Tax Court judgment 9 November 2017 (IV R 19/14), published on 7 February 2018.

From Europe

European Court of Justice: customs values and the recognition of transfer pricing adjustments

In its decision in Hamamatsu Photonics Deutschland (C-529/16) the European Court of Justice (ECJ) held that Articles 28 to 31 of the Customs Code (old version) must be interpreted as meaning that they do not permit an agreed transaction value, composed of an amount initially invoiced and declared and a flat-rate adjustment made after the end of the accounting period, to form the basis for the customs value, without it being possible to know at the end of the accounting period whether that adjustment would be made up or down.

Facts: The case involved a German resident subsidiary, which belonged to a multinational group whose ultimate parent company, was resident in Japan. The German company purchased imported goods from its parent company at prices calculated in accordance with the advance pricing agreement concluded between that group of companies and the German tax authorities. The total of the amounts charged to the German company by the parent company were regularly checked and adjusted as necessary to ensure the conformity with the 'arms-length' principle laid down in the OECD Guidelines for transfer pricing.
The checks were carried out in a number of stages, based on the 'Residual Profit Split Method', which is consistent with the OECD Guidelines. In the first stage, each participant was allocated a sufficient profit to produce a minimum rate of return. The residual profit was allocated proportionally in accordance with specific factors. In the second stage, the operating margin range was established. If the profit actually generated fell outside that margin, the result was adjusted to the upper or lower limit of the margin and credit notes were issued or additional charges made.
In the year to 30 September 2010, the applicant released for free circulation various goods from more than 1000 consignments from the parent company, declaring a customs value corresponding to the price charged before adjustment.
Due to a fall of the operating margin below the range for the operating margin during the period, the transfer pricing was adjusted and the German company received a credit note from its parent. Accordingly it then applied for a repayment

of the customs duties on the imported goods. There was no allocation of the adjustment claimed between the individual goods imported.
The Principal Customs Office in Munich rejected that application on the ground that the method adopted by the applicant in the main proceedings was incompatible with Article 29(1) of the Customs Code which refers to the transaction value of individual goods, and not that of mixed consignments.

The decision: The ECJ held that Articles 28 to 31 of the Customs Code, as amended, do not permit an agreed transaction value, composed of an amount initially invoiced and declared and a flat-rate adjustment made after the end of the accounting period, to form the basis for the customs value, without it being possible to know at the end of the accounting period whether that adjustment would be made up or down.

Conclusion: This judgment raises important questions for group companies, which determine the transaction value on the basis of a transfer pricing method, which may be adjusted retroactively.
It should be emphasized that the customs value is only to be determined by using the prescribed alternative methods where the transaction value method cannot be applied. It was specifically only the transaction value method which was considered unacceptable in the judgment in question.
It should also be borne in mind that it is already current administrative practice for customs to allow price corrections after a transfer pricing adjustment in favour of domestic companies and, consequently, requires businesses to report a transfer pricing increase.
However, it is unclear what effect downward retroactive adjustments will have on the customs value.
As a result, it can be seen that this ECJ decision on customs value is not necessarily in conflict with previous administrative practice.
The extent to which this will actually have future implications on how customs values will be evaluated in practice will depend heavily on the interpretation of the Munich tax court and that of the customs administration – the latter based in turn on the interpretation by the tax court. The decision of the Munich tax court of 15 September 2016 (14 K 1974/15) shows that the court is in favour of a refund in cases of downward transfer price adjustments. But it remains to be seen.

Compatibility of Dutch group taxation regime with EU fundamental freedom of establishment

The European Court of Justice issued a joint judgment in two cases regarding the Dutch group taxation regime under which a parent company is not allowed to deduct interest in respect of a loan taken from a Swedish related company in order to finance its capital contribution to an Italian subsidiary. This is held to be in conflict with the EU freedom of establishment. On the other hand, the refusal to deduct currency losses resulting from fluctuations in the exchange rate is viewed by the court as being not in violation of EU-law.

In its joint judgment the European Court of Justice followed the conclusions of the advocate general in his opinion of 25 October 2017.

More detailed information on this subject can be found in our *EU Direct Tax Newsalert* from 23 February 2018.

AG Opinion on the compatibility of German Trade Tax exemption with EU law

On 20 September 2016, the Fiscal Court of Muenster referred a case to the ECJ concerning the German Trade Tax participation exemption laid down in Sec. 9 No 7 of the German Trade Tax Act. On 7 February 2018, the advocate general published his Opinion in this case.

The case deals with a German parent company that holds shares in a subsidiary located in Australia. The German tax authorities treated the dividends received from the subsidiary as exempt from German corporate tax. However, the dividends were added back to the taxable base for German Trade Tax purposes. The authorities refused the application of the German Trade Tax participation exemption under Sec. 9 No. 7 of the German Trade Tax Act since the activity requirements contained in the legislation for third country sourced dividends were not met.

In his Opinion, the advocate general pointed out that the activity requirements are not in line with EU law. He concludes that the provision constitutes a restriction of the free movement of capital. The standstill clause does not hinder the application of the free movement of capital since substantial legal adaptations were made since 1993.

Source:
ECJ case C-685/16 *EV* opinion of February 7, 2018

European Commission proposes new rules on the taxation of the digital economy

On 21 March 2018, the European Commission published its EU digital tax package on the taxation of the digital economy.

It comprises four main parts:

- a Communication to the European Parliament and the Council of the EU
- a proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence
- an accompanying Recommendation to the above proposed Directive relating to the corporate taxation of a significant digital presence, and
- a proposal for a Council Directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services.

The package thus contains two new draft EU Directives. The Commission views the first draft Directive as a comprehensive long-term solution and the latter as the short- term/interim solution to quickly address the issue.

More details to be found in our *Tax & Legal Newsflash* under

https://blogs.pwc.de/german-tax-and-legal-news/files/2018/03/tax-digital-econ-newsflash.pdf

EU finance ministers agree on mandatory disclosure for intermediaries (DAC6)

On 13 March 2018, the ECOFIN Council, composed of the EU-28 Finance Ministers, reached political agreement on a Council Directive amending Directive 2011/16/EU on administrative cooperation in the field of taxation as regards mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements in order to disclose potentially aggressive tax planning arrangements (also commonly referred to as DAC6).

For more details take a look in our *EU Direct Tax Newsalert* from 15 March 2018.

Commission launches compliance check to assess VAT-refunds in all Member States

On 15 February 2018 the European Commission launched a compliance check to assess whether VAT refunds to businesses in EU Member States are made quickly enough and are in line with current EU law and with case law of the European Court of Justice.

A lack of access to a simple and fast VAT refund procedure can have a major impact on cash flows and on the competitiveness of businesses. This is especially true for the smallest companies who cannot afford to go through long and burdensome procedures to get the VAT they are owed back from the State. Over the next eight months, tax provisions in each Member State will be scrutinised to ensure that refund procedures allow businesses to quickly and easily recover VAT credits both in their own country and in other EU countries. The study will examine, for example, the length of time it takes to complete procedures in each country and any unnecessary hurdles in the system which can create financial risks for business. The Commission could decide to launch infringements procedures in cases of non-compliance with the rules. This exercise forms part of the Commission's efforts towards a Single VAT area where administrative burdens for business, in particular micro-businesses and SMEs, will be drastically reduced.

Source:
EU-Commission, press release of 15 February 2018

From PwC

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The 2017 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
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