http://tax-news.pwc.de/german-tax-and-legal-news

Tax & Legal News

Statutes
Cases
Decrees

Issue 4
October 8, 2013

pwc

PwC Reports

Draft ordinance on permanent establishment profits

June 2013 saw the enactment of a revision to the Foreign Tax Act adopting the "authorised OECD approach" (AOA) to the allocation of business profits to foreign permanent establishments. Essentially, this approach calls for the allocation of profits between the various parts of a legal entity based on the functions performed by each and by assuming their mutual dealings to have been settled at arm's length as though they were independent enterprises. The German enactment applies from January 1, 2013, though with a rider accepting the continued application of the previous principles (excluding profit recognition within a legal entity and allowing deduction of attributable business expense regardless of where incurred) as necessary to avoid double taxation from the continued application of a traditional treaty clause in the other state in the traditional way. The federal finance ministry has been authorised to issue an implementing ordinance with the approval of the *Bundesrat* on the new approach. Its first published draft was dated August 5, 2013.

The new approach is based on an analysis of the functions and risks of the PE within the context of the entity as a whole. This is to be followed by a comparative analysis of third party data under the transfer pricing rules for associated enterprises in order to find the appropriate arm's length remuneration for its activities. The primary emphasis is to be placed on the activities and responsibilities of the PE personnel. Once these have been established, the analysis extends to the allocation the assets, the risks and opportunities, the branch capital requirement, its share in the financing of the company, the allocation of income and expense, and the determination of the notional contracts to govern the dealings between the PE and the rest of the company.

The taxable income of the PE is to be established from memorandum branch accounts recording the transactions with outside and related parties as invoiced and those within the enterprise at their arm's length price. These memorandum accounts are to be opened on the formation of the branch with the allocation of assets and liabilities at market value. The accounts are to be closed on dissolution of the branch with the transfer of the assets and liabilities to other parts of the entity, again at current market value. Assets are to be allocated according to the personnel using them. However, a different allocation of intangibles may be appropriate if employees in other units were or are substantially involved in their development, protection, administration or marketing. Similarly, the allocation of other assets, business dealings, opportunities and risks primarily follows the staff involved. Exceptions are possible, mainly to take account of the significant involvement of others.

Branch capital is discussed at some length. The main principle is to allocate the equity of the company in proportion to the assets it finances. However, if the company is a member of a group, an allocation of the group equity may be more appropriate. The minimum amount to be ascribed to a domestic branch is its formal allotment. The same measure of formal allotment is the maximum capital for a foreign branch. Subject to this, any foreign (non-tax) rules prescribing a minimum capital for a branch abroad are to be observed. Determination of the branch capital leaves the allocation of the outside liabilities of the company as the difference between the asset and capital allocations. The interest expense is to be allocated accordingly – based on the mean between the opening and closing balances for the year.

Dealings between a branch and the other units of the same company are to be governed by notional contracts similar to the contracts that would have been concluded between third parties in otherwise similar circumstances. This applies to changes in function or assets, trading transactions and to other events putting one party under an obligation towards the other.

The draft ordinance also discusses the special cases of a financing centre PE, bank and insurance branches (equating them with separate legal entities subject to German supervisory requirements), construction and assembly sites (with a strong preference for cost plus remuneration without attribution of equipment not intended to remain permanently on site) and for establishments prospecting for oil, gas or minerals.

Official Pronouncements

Subject to tax rules in treaties

It is increasingly common practice for Germany to agree in her double tax treaties that she will only exempt the foreign income of her residents if they show that it has been taxed in the state of source or activity. If the income has not been taxed abroad – expect, perhaps by withholding – it becomes taxable in the state of residence with a credit for any withholding tax actually paid. Other treaties stipulate that income will be deemed to have arisen in the state of residence unless taxation in the state of source is proven. The Supreme Tax Court at one time took the view that this stipulation was not the equivalent of a subject-to-tax condition of exemption, although it has since revised its opinion and now sees the two concepts as identical. Finally, a few German treaties – especially with countries with British tax traditions – make taxation in the state of residence conditional on the income having been paid out or remitted there (“remittance basis”). The finance ministry has issued a decree explaining its understanding of the meaning of actual taxation in borderline cases.

In principle actual taxation is to be demonstrated with the notice of assessment and the bank payment voucher. However, if the foreign country does not issue assessment notices because it operates a self-assessment system, the tax authorities will accept a copy of the tax return as evidence that the income has been declared. The bank voucher will still be needed, though, as proof of payment.

An income item will be treated as having been taxed in the other state if it has been taken into account in the computation of taxable income. Thus, it will be seen as “subject to tax” in the other state, even if it is offset against allowances or losses, or where it benefits from exemption under the treaty itself or EU directive, as may be the case with dividends on significant shareholdings. Taxation will also be assumed where the actual burden is deferred, e.g. by offset of the income against provisions or depreciation beyond the German limits, or where there is an offset against expenses that would be disallowed under German law. However, taxation will not be assumed if the income is exempt under local law by its nature, if the owner is exempt as a taxpayer, where the income was concealed from the local authorities, or where it does not rank in the other state as being of local source. The examples quoted in the decree are royalty income earned in the USA by a foreigner from licences abroad that is exempt in the US as being unconnected with a local trade or business and interest income earned from loans to US local community authorities.

The decree emphasises that remittance-based taxation is dependent upon actual payment. Questions as to where the income was actually earned are unimportant, although regard will have to be had to the actual wording of the treaty provision.

Withholding tax exemption on dividends on shares held in bank custody

Publicly quoted companies do not typically issue their shares to the actual shareholders, but rather to the bank clearing system which holds them on behalf of member banks offering a custodial service to their customers. Dividends are paid into the clearing system in a lump sum which is then split into its component amounts falling to each bank and, ultimately, to each customer. The withholding tax is deducted by the paying bank when the customer's account is credited, or by the clearing system when the amount is transferred abroad. However, even if the shareholder qualifies for exemption under the EU Parent/Subsidiary Directive, the paying entity cannot refrain from deducting the withholding tax, as under the letter of the law this right is reserved to the company as dividend debtor. The finance ministry has now resolved this anomaly with a decree allowing banks to "displace" shares held in custody for foreign customers qualifying for dividend withholding tax exemption under the directive. The bank continues to act as custodian, but holds the shares on a sub-account within the clearing system. The customer is notified accordingly. The company does not pay the dividend on "displaced" shares into the clearing system, but rather to the customer direct. It is therefore in principle required to deduct the withholding tax from dividends paid, but is able to refrain from doing so, if the shareholding company proves its entitlement under the directive. This proof is furnished with the exemption certificate from the Central Tax Office and a copy of the "displacement" notification.

Maximum foreign tax credit to take account of personal allowances

The ECJ held in February 2013 that the German method of calculating the maximum foreign tax credit on income from abroad infringed the free movement of capital provisions of the TFEU (case 168/11 *Beker*, judgment of February 28, 2013). Its point was that foreign tax could only be credited up to the German income tax charge on the income concerned. This latter was established as a proportion derived from the ratio of total income earned to total German tax due before any foreign tax credits. The calculation tended to under-estimate the German tax, as it ignored the effect of personal allowances on the tax charge. Rather, the maximum tax credit should be based on the overall net effective rate derived from the total tax due in proportion to the total taxable income after deducting all personal allowances including reliefs for special, unusual burdens.

The finance ministry has now reacted to this judgment with a call to tax offices to declare all assessment notices involving a restriction of the credit for foreign tax paid to a lower amount of German tax due provisional pending a change in the law. Applications by taxpayers for a stay of execution of the amount of tax at issue (i.e. the difference between the two methods of calculation) are to be granted. Potentially, all income tax assessments with an under-recovery of foreign tax are affected except those in which the foreign income is taxed at a flat rate (investment income from 2009) or those where no German tax is due. Corporation or trade tax assessments are not affected.

Automatic information exchange with Spain on pensions

Under the German-Spanish double tax treaty, retirement and old-age pensions are taxable in the country of residence of the beneficiary. However, they are also taxable by deduction at source in the state of payment if paid by a social security authority, of if paid on an insurance policy, the premiums on which were tax-deductible in that state over a twelve-year period. The Spanish and German finance ministries have now agreed to ensure taxation in the country of residence with an automatic exchange of information on pensions paid under withholding tax in the country of source. The information is to be provided within the calendar year following that of payment. The agreement takes effect on January 1, 2015, that is, it applies to pensions paid in 2014. Interestingly, it does not cover pensions, such as those paid under company pension schemes, solely taxable in the country of residence, although the rules for claiming exemption in the country of source do at least ensure that both authorities are aware of the fact of the pension, if not of the amount.

Provisions to be taken up by public-private partnerships under normal accounting principles

Public-private partnership is a term used in Germany to describe an arrangement whereby a contractor completes or renovates an object at his own expense and then operates it for the benefit of the public for a specified period against payments from the public purse and/or from the users (tolls). At the end of the period, the concession expires and the object falls or reverts to public ownership. Examples are to be found in stretches of motorway, tunnels and in public buildings such as schools. The finance ministry has now called upon concession operators in a decree to accrue for the full costs of operating the concession over its term. In this, the provisions of the contract are decisive as to the obligations of the operator, and the generally accepted accounting principles of the Commercial Code govern the period in which the cost is taken to expense. The decree gives three specific examples:

- the costs of meeting an obligation to return or surrender an object in a specified condition at the end of the concession term are to be accrued over the term of actual operation
- amounts included in the payments from the public purse for future costs are to be accrued, either as a provision, or as deferred income
- amounts included in the payments from the public purse for current or past costs that have not yet been spent should be accrued as a provision, if the expenditure is contractually required or if there is a repayment obligation in the event the expenditure proves to be unnecessary.

Employee option in valuing staff purchases

Benefits in kind are to be valued at the usual local retail price less customary discount. Staff purchases – of products manufactured or dealt in by the employer – on the other hand are valued at 96% of the customary price charged by the nearest retailer. The benefit is this value less the amount paid by the employee less an annual staff purchase allowance of €1,080. Traditionally, the two rules were seen as mutually exclusive – a staff purchase could not be valued as a sundry benefit in kind – but in 2012, the Supreme Tax Court linked them in a case holding that an employee had an option to value his or her staff purchases under the rules for benefits in kind generally, if this was more favourable in the circumstances. The court also held that the “usual local retail price less customary discount” referred to the best offer locally available to customers, rather than being an average value. The finance ministry has now issued a decree calling on tax offices to follow this judgment in all cases still open.

The ministry confirms that employees purchasing company goods at a discount have the option to value their benefit under the more general rules for benefits in kind. However, the company is not under an obligation to base the payroll withholding tax on an employee’s choice. Rather, it should take the immediately appropriate method and base the valuations on its own local knowledge. If employees disagree with this choice or can establish access to a lower purchase price – including on the internet – it is up to them to enter an adjusted value on their tax return. They must, of course, support this valuation with offers or other suitable documentation. The staff purchase rule is to be based on the price charged by the nearest retailer less his customary discount. However, the manufacturer’s or wholesaler’s recommended retail price can be taken as a starting point for simplicity. The nearest retailer’s customary discounts should then be deducted from this value.

Supreme Tax Court Cases

Organschaft *parent need not be active business until subsidiary’s first year end*

The *Organschaft* provisions in the Corporation Tax Act require that the parent hold a majority of the voting rights throughout the term of the *Organschaft*. They also require that the parent be an active business entity. A tax office rejected an *Organschaft* profit surrender on the grounds that the parent had acquired its subsidiary whilst it was still an asset managing entity and had not begun its own business activities until the following year. Accordingly, it had not been an active business at the beginning of that year and thus could not qualify as the *Organschaft* parent until a year later.

The Supreme Tax Court has now held against the tax office. The letter of the statute does not specify a time and thus does not insist on continuity of activity throughout the period. It is therefore sufficient that the parent be a business entity when the profit surrender takes effect. This is the balance sheet date of the subsidiary. This conclusion satisfied the intention of the statute of ensuring that trading income remains taxable as trading income after surrender to an unincorporated parent.

An act entering into force on February 26, 2013 required a specific form of wording for the loss subvention provision of an *Organschaft* profit pooling agreement. Agreements then existing but not conforming to the requirement were given until the close of business on December 31, 2014 for amendment. The main condition is that of actual subvention of any loss incurred at any time prior to the amendment of the agreement.

The Supreme Tax Court has now held that the fact of loss surrender is irrelevant if no loss was incurred. It also held that the changeover provision applied to defective loss subvention provisions. This included instances of agreements with no mention of loss subvention at all. Finally, it made the point that there was no need for any amendment to an agreement that loses its effect before January 1, 2015.

Supreme Tax Court judgment I R 40/12 of July 24, 2013, published on September 11

No provision for cost of meeting a future technical requirement

A local environmental authority ordered a plank factory in 2005 to reduce its emissions of air pollutants to a set level by 2010. To achieve this it was necessary to equip an incinerator with an expensive filter assembly. The factory took up a provision for the expected cost in 2005. It more than doubled this provision in 2006 and raised the amount yet again in 2007 on the basis of the order finally placed with the supplier for delivery in 2008. The tax office rejected the provisions in the years under review (2005-7) as the reduced emissions level did not have to be met until 2010. The provision now would be for a future expense.

The Supreme Tax Court has sided with the tax office. Legally, the company was not required to comply with the stricter regulation until 2010. That the authority had already notified it of its future obligation did not bring the expense forward. Rather, that expense should be accounted for when the measures for compliance were taken (in 2008), or, in the absence of measures, when the requirement to comply became current (2010). Economically, too, a provision prior to 2008 was unfounded; the obligation was to fit the plant for future use and the cost of meeting it could not be charged against the results of earlier years.

The Supreme Tax Court deliberately ignored the suggestion from the tax office that a provision could not be made in any event for capital expense, saying that it was not necessary to distinguish between the revenue and capital expense of complying with a future requirement.

Supreme Tax Court judgment I R 8/12 of February 6, 2013, published on May 8

Container accounting – provision for return of bottles

A bottling plant sold drinks to wholesalers and retailers against a returnable deposit on the bottles. Some of the bottles were universal, common to a pool formed with other manufacturers and bottling plants, and were not identifiable by individual ownership; others were unique to the plant. The plant was in dispute with the tax office over the correct accounting treatment for deposits received on as yet unreturned bottles and over the payments made for pool bottles accepted in "return" in excess of those originally issued to the trade. The plant argued for the maximum immediate expense; the tax office argued for the maximum expense deferral.

The Supreme Tax Court has now held that the accounting treatment should follow the legal ownership of the bottles. Since the sale of the goods is not a sale of the bottle – the deposit is merely a surety for the return of the bottle to its original owner – the deposits received and paid are not fundamentally income or expense. Thus, those received on custom bottles are to be treated as a liability to be settled by repayment on return of the bottle. However, this liability should be partially released to income to reflect breakages and diversions whilst in customers' hands. This amount was to be estimated on the basis of the past history of the plant. By contrast, deposits received and repaid on pool bottles were to be taken to income or expense on a cash basis. The court arrived at this conclusion on the basis that the true ownership of the individual bottles was unknown; hence there was no way of estimating either the remaining obligation to accept returns or the bottles received belonging to other pool members. However, the cash basis reached its limit with excess returns, that is, where more pool bottles had been received back than had been originally supplied to customers. In this case, the assumption must be that the plant had received bottles belonging to unknown pool members. The plant had the right to recirculate the bottles as though they were its own; thus it could not take up an asset for the bottles themselves, but should take up the usage right as a pre-paid expense. This amount should reflect the share of the plant in the pool less its stock currently held.

Supreme Tax Court judgment I R 33/11 of January 9, 2013, published on May 8

Option premium not part of sale proceeds

An asset management company frequently dealt in shares. It customarily offered prospective buyers and sellers call and put options to give them time to obtain the necessary approvals. In its accounts it treated the premiums received on options exercised as part of the proceeds of sale or cost of purchase. The tax office disputed this treatment, claiming the option to be taxable as a separate transaction.

The Supreme Tax Court has now agreed with the tax office, at least in respect of an option granted to protect a sale. The option premium was not part of the proceeds from the sale of shares, even if the option was exercised and the only reason for its grant was to allow the buyer time to obtain his necessary approvals without fear of price rises in the meantime. A gain on the sale of shares was exempt for a corporation under the Corporation Tax Act. However, the grant of an option was not a sale of shares, but rather the sale of a right to acquire shares for a fixed price. As such, its premium was taxable as sundry income in the hands of a corporate recipient.

Supreme Tax Court judgment I R 18/12 of March 6, 2013, published on May 29

No return of capital contribution in the same year

A corporate shareholder gave an investment to its wholly-owned subsidiary as a capital contribution in kind at market value. The subsidiary sold this investment to a third-party on the same day for the same amount. Later, it declared a dividend to its parent which it treated as a partial return of the capital contribution previously received. The tax office refused to accept this treatment, as a capital contribution could not be returned with tax effect in the same year.

The Supreme Tax Court sided with the tax office. It agreed that the statute was not explicit on the point, but held, nonetheless, that restricting returns of capital contributions to the amount brought forward at the beginning of the year was the interpretation of the law that led to systematic consistency. Primarily, all distributions were deemed to come from opening retained earnings regardless of the wording of the shareholder's resolution. Only once that and other sources had been exhausted, were they a return of a shareholder's capital contribution. However, the Corporation Tax Act specifically ruled that a distribution to shareholders could not lead to a negative balance on the capital contributions account. The two provisions together presupposed a common definition, that is, that the opening balance link for the retained earnings also be applied to shareholders' capital contributions. In consequence, contributions made during the year were not available to fund a distribution to shareholders until the following year. The one exception was the special case of a company in its first year of German residence.

Supreme Tax Court judgment I R 35/11 of January 30, 2013, published on May 29

No correction in later years of tax auditor's error

A company recorded a subsequent event adjustment to the corporation tax reserve in the year the event took place. The adjustment led to an increase in accounting income compensated (correctly) by a corresponding deduction in the tax computation. Two years later the tax auditor found that the adjustment should have been made a year earlier and made the corresponding changes in the "tax audit balance sheet" drawn up to reflect the financial position on the basis of tax valuation principles combined with the tax audit findings. Unfortunately he amended the compensating entries in the tax computations, but overlooked the original accounting entry. Ultimately, therefore both net assets and taxable income as at the end of the audit period were overstated by the amount of the adjustment.

The overstatement came to light two years later. The company made the necessary correction to the accounts, but ignored it in the tax computations. Effectively, the overstatement was thus cancelled in the balance sheet and compensated between the years in the tax computations. However, a tax official insisted on the letter of the law and demanded an adjustment to the tax computations to reverse the correction in the accounts. The Supreme Tax Court has now confirmed that approach.

The Supreme Tax Court took the view that the letter of the law must be followed. The opening balance sheet must agree with the closing balance sheet of the previous year. Accounting adjustments must be made in the year to which they relate, or, if that year is now statute-barred, to the earliest year still open. Accounting adjustments to non-deductible expenses (in this case, corporation tax) must be compensated in the tax computations. If, however, this compensation is no longer possible because the year is now statute-barred, there is no provision for compensation in a later year. Thus the final correcting entry increasing corporation tax expense was reversed in the computations for that year on the basis of the letter of the law, leaving the company in the position of having over-taxed its income. The court explicitly refused to allow a compensating correction in the year of the accounting correction as, in the absence of a legal basis, this would be an error. A deliberate error could not serve to correct an oversight.

Supreme Tax Court judgment I R 54/11 of January 30, 2013, published on May 8

Write-down on some foreign investments permitted for 2001

In 2000 the corporation tax system changed radically from the imputation/split-rate procedure to the present part-charge/single rate system. In both cases, the idea is to tax corporate income only once, at a burden the ultimate shareholder could expect to bear, had he received the income directly. The achievement of this object depended under the old system upon a lack of foreign income taxable abroad and under the new system upon an accurate reflection in the ratios set by the tax acts of the facts in the given circumstances. This desired result is, and was, seldom, if ever, achieved.

In an effort to keep changeover difficulties to a minimum, the Corporation Tax Act provided that annual profits in 2000 be taxed under the old system, whilst those earned in 2001 fell under the new. At the same time the tax deduction for impairment write-downs on investments was withdrawn. This withdrawal took effect as of 2002 for domestic investments but as of 2001 for foreign investments. The ECJ has already held that a distinction in the tax treatment of domestic and foreign investments can be seen as a restriction on the freedoms of establishment or capital movement (case C-377/07 *STEKE*, judgment of January 22, 2009) and doubts have also been raised as to the validity of the prohibition for 2001 in the light of the constitutional ban on taxation in retrospect. The Supreme Tax Court has now been called upon to examine these principles when applied to the write-down of a significant investment in a US subsidiary in the annual accounts at September 30, 2001.

The investment in the US subsidiary amounted to 97.7%. The US double tax treaty sets the level of a significant holding for dividend withholding tax privileges at 10% and this value could be taken as the minimum necessary to secure significant influence over the management of the company. Accordingly, the relevant EU freedom in the present case was that of establishment, rather than that of capital movement. Since the freedom of establishment does not apply outside the EEA, it does not apply to a US investment. Accordingly the denial of the tax deduction on the write-down on the US investment at issue did not offend against community law.

According to the letter of the statute, the tax deduction was withdrawn in respect of foreign investments for all business years ending after August 15, 2001. The withdrawal was debated in a bill laid before the *Bundestag* on September 9, 2001. A write-down for value impairment was a decision to be taken as of the balance sheet date based on the then circumstances. Thus there could be no question of retroactive legislation in respect of any write-down in an annual balance sheet drawn up after September 9. This applied in the present case of a write-down taken in the accounts as of September 30, 2001.
Supreme Tax Court judgment I R 10/11 of March 6, 2013, published on July 10

Mobile phone discount is prepaid expense

Many mobile phone companies offer phones for well below cost (some, indeed, for a purely nominal amount) to customers willing to accept a two-year service contract. The Supreme Tax Court has now confirmed its earlier ruling to the effect that the discount below the cost of the phone is to be seen as a cost of earning the service fees from the two-year contract. This follows – so the court – the view generally taken by society, that a customer accepts an expensive service contract as the price of a cheap phone. In consequence, the phone company making such a sale should capitalise the full amount of the discount as a prepaid expense to be charged back against income over the minimum life of the service contract – typically two years.
Supreme Tax Court judgment I R 77/08 of May 15, 2013, published on August 14

Related party by ownership despite restrictions on exercise of ownership rights

A German asset management subsidiary of a Luxembourg investment fund management company paid substantial fees to a Luxembourg service company. Both Luxembourg companies were wholly-owned by a Luxembourg holding company. The investment fund management company was obliged to follow the policies of the fund. These could only be revised by a two-thirds majority resolution of the investors. The German subsidiary argued that this restriction meant that its Luxembourg shareholder could not be forced to follow a common business policy with the service provider. Accordingly the two were not related parties within the meaning of the Foreign Tax Act and there was no requirement for it to furnish the extensive documentation in support of its transactions with associated enterprises as required by the Tax Management Act. In any case, the fact that these documentation requirements only applied to cross-border transactions was a hindrance on the freedom to provide (receive) services and thus contrary to community law.

The Supreme Tax Court has now rejected both contentions. It has also refused to lay the case before the ECJ, as it sees no doubt as to the community law acceptability of the German transfer pricing documentation provisions. Its main point is that the Foreign Tax Act defines a related party relationship by shareholding at a capital share of more than one-quarter. There is no mention of voting rights or of restrictions on the right of a shareholder to act in respect of its investment. Other parts of the related party definition, such as a relationship by contract, complemented the shareholding criterion, but did not restrict it. Accordingly, an obligation not to set management policy for the German subsidiary against the wishes of the members of the fund did not destroy a shareholding-based relationship. Even if such an obligation did exist, a breach would not invalidate the measure at issue; it would merely make the Luxembourg shareholder liable for damages. The court emphasised that the reason for the shareholding was also irrelevant; even if the shares were held in trust for the investors in the fund, the company remained the related party of the service provider and was subject to the transfer pricing documentation rules.

The court accepted that the application of the transfer pricing documentation rules to foreign relationships only was fundamentally a discrimination restricting the freedom to provide services. Clearly a domestic business would be discouraged from purchasing services from a foreign related party if it could do so within the country without having to accept the burden of complying with the transfer pricing documentation rules. However, this restriction was justified by the need to protect the public revenue from abuses to the tax system. The enhanced duty of cooperation of those with relationships abroad was justified by the consideration that such relationships were best explained and documented by those that had entered into them. The court also pointed out that 26 of the 28 member states of the EU (Croatia and Cyprus being the exceptions) had introduced comparable rules into their own systems (although, it should be noted, not always exclusively in respect of foreign transactions) without apparent legal problems and that the European Commission had published its own summary explaining and supporting such schemes. Clearly, transfer pricing documentation rules were to be regarded as generally acceptable.

Supreme Tax Court judgment I R 45/11 of April 10, 2013 published on August 21

Leasing fee for foreigners only taxable in so far as object used in Germany

The owner-manager of a haulage company held a majority interest in a Liechtenstein company which owned the vehicles used in the business. The drivers were independent contractors. The Liechtenstein company leased the vehicles to the German company which, in turn, leased each to its own driver for – in effect – the same amount. The German company also gave each driver a guarantee of full employment. The business risk from the arrangement thus fell, in the first instance, to the German company. The vehicles were registered in Germany and mostly used on long-haul routes between Germany and Spain. The tax office the reviewed the position and came to the conclusion that the Liechtenstein company had earned leasing income from a German lessee subject to withholding tax in the (then) absence of a double tax treaty.

The Supreme Tax Court has now accepted the tax office’ position in so far as the vehicles were actually used in Germany. This proviso is important as the German part of the route to Spain was usually less than 10% of the whole. Thus in general terms over 90% of the leasing fee paid to Liechtenstein was tax-free. The case was referred back to the lower court for determination of the precise split; the inference was, however, clear – it is to be based on the distance driven.

Supreme Tax Court judgment I R 22/12 of April 10, 2013, published on August 14

No trade tax add-back for foreign dividends in 2001

In 2000 the corporation tax system changed radically from the imputation/split-rate procedure to the present part-charge/single rate system. In both cases, the idea is to tax corporate income only once, at a burden the ultimate shareholder could expect to bear, had he received the income directly. The achievement of this object depended under the old system upon a lack of foreign income taxable abroad and under the new system upon an accurate reflection in the ratios set by the tax acts of the facts in the given circumstances. This desired result is, and was, seldom, if ever, achieved.

In an effort to keep changeover difficulties to a minimum, the Corporation Tax Act provided that annual profits in 2000 be taxed under the old system, whilst those earned in 2001 fall under the new. Similarly dividends received in 2001 would be taxed as stemming from “old” profits, whilst those received in 2002 would be seen as new system dividends. Dividends from abroad, however, were taxed under the new system in 2001, as there was no need to maintain symmetry between the profit as earned and the profit as distributed. The new system exempted dividend income from corporation tax entirely, but charged it to trade tax if the recipient held less than 10% (now 15%) of the equity capital of the paying company. This meant that a dividend on a portfolio investment abroad would be charged to trade tax in 2001, but not until 2002 if the investment was held in a company at home. The ECJ has already held that a distinction in the tax treatment of domestic and foreign dividends can be seen as a restriction on the freedom of capital movement (case C-377/07 *STEKE*, judgment of January 22, 2009), and the Supreme Tax Court has now taken the same position in respect to trade tax. Accordingly, the provision charging foreign dividends on portfolio investments of corporations in 2001 to trade tax must be disapplied. Interestingly, the court largely ignored the main argument of the taxpayer – that the dividends had been received in 2001 before the enactment on December 20, 2001 of the provision charging them to tax, and that the change was therefore retroactive taxation – saying that if a provision was invalid under community law, its constitutionality in Germany was irrelevant.

Supreme Tax Court judgment I R 14/07 of March 6, 2013, published on July 10

Real estate transfer tax basis reduced if conveyancing costs borne by seller

The buyer and the seller of a property agreed that the latter would bear the costs of concluding and registering the contract (conveyance) as well as the charge to real estate transfer tax on the consideration paid. The Supreme Tax Court has now held that this implies a charge on the seller reducing his net proceeds from the sale. Accordingly, the basis of assessment to real estate transfer tax should be reduced by the amount borne in respect of the conveyancing costs. This does not apply, though, to the real estate transfer tax itself in the face of a provision in the Real Estate Transfer Tax Act specifically excluding the tax from adjustments to the assessment basis. (Note: legally, real estate transfer tax is the joint liability of both parties to a conveyance, notwithstanding the common custom that it is borne by the buyer.)

Supreme Tax Court judgment II R 1/12 of April 17, 2013, published on May 29

No RETT if indirect change in partnership incomplete

Real estate transfer tax (RETT) of between 3.5% and 5.5% of the taxable value of property owned by a partnership is due if at least 95% of the ownership interests in a partnership change over a five-year period. The change can be direct or indirect. On this basis, the tax office raised a RETT assessment on a partnership of two partners after the ultimate holding company of a 6% partner sold 50% of the shares in its immediate subsidiary to a third party following the transfer of the 94% partnership interest by the other partner to a different third party. The tax office contention was that the effective composition of the property owning partnership had changed by more than 95%, taking both changes together.

The Supreme Tax Court has now rejected the tax office's contention. Rather, only 94% of the partnership interest had changed hands (the first transaction) and the 6% holding remained unaffected. It reasoned that direct changes of ownership were a matter of legal form, whilst indirect changes could only be seen as a matter of business substance. A sale of 50% of the shares in a company owning the entire share capital of another company owning a 6% partnership share did not give the acquirer a 3% interest in the partnership. Rather, each shareholding level had to be seen separately, and a 50% acquisition did not give the acquirer the right to dictate policy to the company on the management of its investments.

Please note: Whether this judgment applies to indirect changes in shareholdings in a property-owning company is not entirely clear, although such a conclusion would seem logical.

Supreme Tax Court judgment II R 17/10 of April 24, 2013 published on June 19

Hidden distribution from foreign company is investment income in Germany

A German family held the entire share capital in a Spanish company. The company did not trade and was not registered in Spain as a taxpayer for lack of any intention of earning income. Its only asset was a villa on Mallorca, used solely by the family members free of charge. There was no attempt to hire the villa out on a commercial basis. The German tax office found that the company had allowed its shareholders a benefit from their unrestricted use of the villa and assessed them to income tax on the basis of their receipt of investment income corresponding to the annual rental of the villa at market rates.

The Supreme Tax Court has now agreed with the tax office that the shareholders had received a hidden distribution from their Spanish company in the amount of the market value of the rental they did not pay. This hidden distribution was taxable in Germany as investment income. A Spanish determination that the company, itself, did not trade and was not a taxable entity was irrelevant to the German position of the shareholders. The court also emphasised that there was no German distinction between a cash dividend receipt and a hidden benefit through failure to charge for a service rendered. It did, however, insist on further investigation of the Spanish legal position. If Spanish law – as distinct from practice in the case at issue – provided for taxation of a hidden distribution benefit as a dividend, the consequence would be taxation in Germany with a credit for any Spanish withholding tax deducted at source. If Spanish law did not classify the benefit to the shareholders as a dividend, it would be taxable in Germany under treaty as other income, that is, without credit for any Spanish tax.

Supreme Tax Court judgment I R 109-111/10 of June 12, 2013 published on October 2

Gain on sale of profit participating right acquired before 2009 tax-free

Up to December 31, 2008, interest and chargeable dividends were subject to mainstream income tax as was any chargeable gain on the sale of an investment. However, gains from the sale of investments were only chargeable if the investment was held as a business asset, it was part of a holding of at least 1% in the equity of the company, or if it had been held for less than a year (short-term gains). As of January 1, 2009, the law was changed to the effect that all gains on the sale of shares or other securities were classified as investment income and all investment income was taxed at a flat rate of 25%. Changeover provisions held that existing investments on January 1, 2009 should not lose their status, i.e. gains from their sale would continue to be tax-free if exemption would have been available under old law. These changeover provisions were then circumscribed slightly in an attempt to exclude financial innovations from their effect. This led to a dispute between a taxpayer and his tax office as to whether or not a gain from the sale of a profit participation right acquired before 2009 should enjoy the exemption that it would have had on December 31, 2008.

The Supreme Tax Court found that the wording of the statute was not entirely clear. However, if referred to the official explanation attached to the amending bill which explicitly stated that it was not the intention to “catch” previously existing profit participating rights. This was sufficient authority for the Supreme Tax Court to hold that profit participating rights that did not allow the holder to share in a liquidation surplus of the company should continue to be treated as profit-sharing loans, that is, a gain from the sale of those arising on or before December 31, 2008 and held as private assets should continue to enjoy its exemption under old law.

Supreme Tax Court judgment I R 27/12 of December 12, 2012, published on August 14, 2013

Return of employee shares at fixed price leads to employment income

A director purchased shares in his (unquoted) company under an employee participation scheme at a price of €11.50. The purchase was linked to an option to return the shares at any time within the following two business years for the price paid. The company fell on troubled times and by the end of the two year option period it was apparent that the shares had depreciated in value considerably. The director exercised his option to return and the tax office assessed him to income tax on the excess of the return price of €11.50 and the current value of the shares, agreed later at €6.

The Supreme Tax Court has now confirmed the tax office in its supposition of employment income. The shares were sold to the director as an employee and the repurchase guarantee was similarly only available to employees. That the company bore the fall in value over the two year holding period was an advantage accruing to the director as an employee of the company. Accordingly, the benefit was to be taxed as employment income in the year of accrual, that is, in the year in which the shares were repurchased.

Supreme Tax Court judgment VIII R 19/11 of April 9, 2013, published on August 7

Permission to use company car privately is taxable benefit, but no presumption that prohibition on private use will be ignored

The Supreme Tax Court has handed down four judgments on the private use of company cars. In three of the cases the company car was held by a managing director not subject to any particular supervision. Its use for private purposes was prohibited in the employment contract of the holder, although an infringement of this prohibition would not have led to any negative consequences for the employee in the circumstances – sole managing director of the company, managing director and 50% shareholder, and the head of a family business run through a group of closely held companies. In all three cases the payroll withholding tax auditor assumed that there must have been at least some degree of private use and caused additional assessments to be raised. These were based on the “1% rule” (valuing the monthly private-use benefit at 1% of the list price of the car when new) in the absence of adequate mileage logs of the business journeys made. The court held, however, that there could be no automatic presumption of a breach of a private use prohibition, merely because the prohibition was not supervised or because the driver was sufficiently senior within the company to have no fear of repercussions. Rather, such a finding could only be based on concrete evidence that the car had actually been used for private purposes. In any case, infringement of the prohibition by a shareholder or partner would lead to a hidden distribution of profits or to additional partnership income, rather than to taxation of an employee benefit.

In the fourth case, a qualified tax advisor and lawyer led a tax consultancy practice through a GmbH of which he was the managing director but not a shareholder. He held a series of company cars under an employment contract permitting their private use. He claimed, however, that he had made only minimal actual private use of the cars and sought to justify this claim with a list of the days on which he had taken the car on business trips. The tax office rejected this list as a “mileage log” and assessed the benefit on the 1% rule. The Supreme Tax Court confirmed this assessment on the grounds that the right to use the car privately was, of itself, a benefit, even if no private use was actually made. At least, the holder was saved the cost of maintaining his own car in a state of readiness. The Income Tax Act saw only two ways of valuing the benefit – the 1% rule and actual cost split between business and private travel on the basis of a proper mileage log. The log actually furnished was in no way adequate and had been rightly rejected by the authorities.

The same managing director had also joined a golf club at company expense in order to promote client contacts. He did not play golf, or at least not well enough to be allowed on the green unsupervised, and this was, in his view, the demonstration that his interest in club membership was purely professional. The court, though, pointed out that professional and private interests in a club membership of this nature were inevitably mixed. Within a club atmosphere, professional contacts could spring from private friendships, just as a business contact could develop into a private relationship. Since there was no way of valuing the two advantages, there was no way of splitting the cost between the business and private benefits. The entire cost thus ranked as private and its payment by the company was a taxable benefit to an employee. The court did mention that it might have come to a different conclusion had the managing director been put under pressure to join the club to the extent that he would necessarily be fearful of the consequences at his place of work of any failure to apply for membership. However, there was no suggestion of any such pressure in the present case.

Supreme Tax Court judgments VI R 42/12, VI R 46/11 and VI R 31/10 of March 21, 2013 and IV R 23/12 of April 18, all published on July 10

Chauffeur is taxable benefit for employee

An employee was allowed the use of a chauffeur-driven company car for business trips. However, he was also able to use this service for journeys between home and work. The Supreme Tax Court has now held the taxable benefit to be not only the cost of the car (calculated at the flat rate of 0.03% of the list price of the car when new per km distance between home and work per month) but also the value of the chauffeur’s services. The employee argued that the chauffeur enabled him to use the time on the journey for office admin tasks and that the expense was therefore in the interests of the employer. The court did not accept this argument, saying that the journey to and from work was primarily a private matter for the employee. All support given to him to make a private journey easier was a taxable benefit in kind. This benefit was to be valued at the local retail price net of usual discounts. The court did not exclude that this value could be derived from the employment costs of the chauffeur for the time involved, given that circumstances did not suggest otherwise.

Supreme Tax Court judgment VI R 44/11 of May 15, 2013 published on August 21

Three-month limit on subsistence allowance upheld

The Income Tax Act allows those travelling on business to claim a subsistence allowance of €24 for each day spent away from home and place of work. However, the same provision sets a time limit of three months on each assignment, mainly in view the possibilities generally open to those on longer assignments of accommodating to the new situation and so avoiding the additional costs of constantly eating in restaurants. A business consultant working as a free-lancer on a much longer project has attacked the three-month rule as arbitrary (and therefore unconstitutional) and also claimed that it only applies to full-time, five-day-week assignments. He worked for over a year on one assignment, although usually for not more than three days in each week on site. Thus each week saw the start of a new journey. The tax office argued that a new journey to the same place did not start unless there was an interruption of at least four weeks. It based this position on a passage in the official Wages Tax Guidelines applicable to the business travel of employees.

The Supreme Tax Court has sided with the tax office on both points. Tax-free subsistence allowances are available to those on business travel to cover the additional cost of eating out when away from home. The rule is a generalisation for simplicity and, as such, is not invalidated merely because it does not completely fit all circumstances. A three-month time limit is not manifestly inappropriate and has already been upheld by another chamber of the same court. There was no serious doubt that it was within the constitution and therefore no call to refer the matter to the Constitutional Court.

The court accepted that the four-week interruption period of the Wage Tax Guidelines was without an explicit statutory basis, but also pointed out that there was no statutory requirement either that each assignment run continuously throughout a five-day working week. A period of four weeks between separate assignments to the same place was generally not unreasonable in view of the purpose of subsistence allowances generally and of their three-month time limit. On the contrary, accepting any interruption of an assignment as leading to a new journey would effectively deprive the three-month rule of meaning. The four week period could therefore be accepted as a fair compromise.

Supreme Tax Court judgment III R 94/10 of February 28, 2003, published on May 15

Import value of DVDs includes estimated royalties payable by subsequent purchaser

A pair of US film producers gave film copies free of charge to a Taiwanese mass producer of DVDs. This mass producer forwarded the DVDs with the films to its German associate who then sold them to the European subsidiaries of the film producers. Unsold items were to be destroyed. The subsidiaries of the film producers paid royalties to their respective parents based on their proceeds from hiring or selling the DVDs to the public. The importer declared the dutiable value of the DVDs at its own cost of import. Essentially, this was no more than the cost of a blank DVD. Customs reassessed the dutiable value to include an estimate of the royalties ultimately payable by the distribution subsidiaries of the film producers. The importer objected on the grounds that it had no information on the royalties payable by its own customers, pointing out that the estimate by Customs was based on extrapolations from customs audit reports without identifying the individual films or producers.

The Supreme Tax Court has upheld the position of Customs. The importer was a link in a fixed business chain and had no option but to sell the DVDs after import to two specific customers in quantities specified by them. Its own purchase cost included nothing for the use of the copyright inherent in the films carried on the DVDs and its own sales proceeds were based on its own costs together with a small handling fee. The DVDs had been imported in a physical condition suitable for further distribution to those wishing to see the films and their value on import included all payments to be made subsequently in recognition of their condition at the time of import. This value thus included royalties due by the importer's customers, especially as the importer was bound to follow the set business chain. In principle, it was up to the importer to estimate the dutiable value in the absence of an exact figure and then to justify the valuation to Customs; however, if the importer declared himself unable to make the estimate for lack of the necessary information, it was up to Customs to make their own estimate. This could be based on other examples of film royalties – such as those available from Customs audit reports – even if the specific examples remained anonymous. In any case, as the court pointed out, the royalty ultimately paid in a given instance did not decisively indicate the import value of the specific DVD as it was affected by events occurring after import, such as the actual method of distribution chosen (sale or hire). Thus some degree of averaging was inevitable.

Supreme Tax Court judgment VII R 56/11 of July 4, 2013 published on August 14

No allocation of input tax to intended tax-free turnover

An investment broker regularly achieved both taxable and tax-free turnover. The taxable turnover resulted from the provision of information on the investing public for the managers of investment projects and the tax-free turnover resulted from commissions paid by the investing public for shares in new project vehicles. In the year in question, the only two projects failed before they could be launched, leading to the exceptional situation that the only turnover resulted from consultancy fees and was taxable in its entirety. However, the failures also meant that the expenses exceeded income by a considerable margin, leading to a net VAT recoverable. The tax office claimed that allocating the entire input tax to the low taxable outputs was not appropriate and sought to allocate it on the basis of planned tax-free to actual taxable turnover. The taxpayer objected that a comparison between two figures could only be appropriate if they had been established on a common basis.

The Supreme Tax Court has now held that there can be no allocation of input tax to different types of turnover if the entire turnover achieved fell into a single category. VAT was an annual tax to be established on the basis of the inputs and outputs for the year. An intention might be relevant for the initial monthly (or quarterly) returns, but these were only provisional and lost their meaning once the annual return had been filed. Accordingly, the annual return could only be based on the actual figures for the year. The court brushed aside the tax office objection that the income was not nearly sufficient to cover the expenditure with the remark that the tax office had ignored the possibility of loss.

Supreme Tax Court judgment XI R 25/11 of April 24, 2013, published on July 24

Liability for VAT in ceded debts cannot be avoided by contract

The VAT Act contains a specific provision making the beneficiary of a ceded debt liable to the tax authorities for unpaid VAT included in the amount collected. A bank challenged the application of this rule to a lump sum payment from the receiver of one its customers to free fixed and current assets from a pledge given in security for a loan. The pledge was global, assigning the ownership rights over the trade accounts receivable, inventories and moveable equipment of the company. However, the company had unfettered rights of use and disposal in the ordinary course of business over the assets at any given time. Later, it fell on troubled times and went into receivership. The receiver negotiated a lump sum settlement with the bank for the release of the pledge. The sum was set against the amount of the loan. Agreed values were assigned to the equipment and inventories, leaving a remainder falling to the accounts receivable. The tax office regarded that remainder as a collection by the bank and claimed the unpaid VAT included in the amount at the 19% standard rate. The bank argued that it had not collected accounts receivable and that, in any case, it had been agreed between the parties, that the pledge was net of VAT.

The Supreme Tax Court has now upheld the tax office' claim. The statute was widely drawn and cash collected by the bank on its pledged receivables was a collection of the bank debt from an assignment of receivables. That the money due from the customers had actually been collected by the receiver who had then paid over a lower amount to the bank meant merely that the bank had received less than the full nominal value of the receivables now settled. Accordingly, its VAT liability was to be reduced to the VAT inherent in that lower amount. The court also rejected the bank's claim that the parties had agreed on a pledge net of VAT. The accounts receivable had been pledged as they stood. Each one was a separate debt, but the VAT was only one element of that debt. There was no valid way of splitting a debt into its component parts and thus no way of separating the base amount from the VAT charged thereon. Any agreement to the contrary should be ignored. The VAT had not been paid by the company; the bank had received an amount on the debts pledged and that amount had to be regarded as inclusive of 19% VAT now due to the tax office.

Supreme Tax Court reference XI R 11/12 judgment of March 20, 2013 published on June 26

No VAT on sale of bad debts

A bank sold its portfolio of non-performing loans to an English debt collection agency for a fraction of their nominal value. All of the loans were, in principle, currently due, any extended payment terms having been cancelled by the bank following debtor default on the instalments. The sale was agreed by contract dated February 18 and referred to the debts as they stood at the previous December 31. All movements and costs recorded or incurred by the bank in the interim were for the account of the buyer. The contract stated that the parties considered the sale to be a VAT-free sale of debt; however it also set an agreed valuation (of the realistically collectible amount) somewhat higher than the contract price, explicitly in case the tax office took a different view of the VAT position. Otherwise, the sale was absolute, with neither party having any right of recourse on the other.

The tax office took the view that the difference between the agreed valuation and the contract price was a taxable fee to the buyer for assuming the bad debt risk of the bank. As that, or a factoring fee, it was subject to standard rate VAT. However, the Supreme Tax Court has now rejected that view.

The Supreme Tax Court made the point that the agreed contract price between unrelated parties was manifestly the market value of the transaction. Accordingly, there was no scope for deeming a fee for an additional service. However, even if there were, that service could not and would not have been performed without the main transaction. It was therefore ancillary to that transaction and shared the same VAT status. That, though, was a VAT exempt sale of debt. The court added that the agreed evaluation of the collectability likelihood should be ignored. Its only purpose was to reflect a finance ministry decree with which the parties – correctly – disagreed. The market value was the price paid. Any difference between that and the amounts ultimately collected was a – later – gain or loss for the buyer.

Supreme Tax Court judgment V R 8/10 of July 4, 2013 published on September 18

Contractual agreement cannot limit a taxpayer's duty to supply information

A Luxembourg company offered an internet auction service. Much of the work on the website was, however, done by the company's fellow subsidiary in Germany. In this respect, the German company had access to information on the personal data of sellers and buyers, but was bound by contract not to disclose it to third parties. This was to enable the Luxembourg principal to comply with strict local requirements for data privacy. The tax back-duty investigators of Lower Saxony requested the Germany service provider for the names, pseudonyms and addresses and details of the transactions concluded by all sellers in Lower Saxony with an annual turnover of over €17,500. Their authority for this request was a provision in the Tax Management Act requiring third parties to supply on request information on other taxpayers to which they have access, provided the supply does not put them under an unreasonable burden and provided the tax authorities have no other reasonable means of obtaining the details needed. There is also a limitation preventing random trawls.

The company refused to comply with the request on the grounds that it had no rights to the information held on behalf of the Luxembourg company on servers in the USA and India. It also referred to its contractual duty to maintain confidentiality. This was interpreted by the lower tax court as inability to supply the information required. Accordingly, the lower court did not investigate the company's actual access to the information.

The Supreme Tax Court has now rejected the lower court's position. The duty to supply all available information on a valid request of the tax authorities was a public duty of citizenship that could not be excluded by contract with another party. Once furnished to the tax office, the information would fall under the tax secrecy rules; thus there was no need to fear repercussions in the market place. Fear of dissatisfaction of business partners now faced with the consequences of the discovery of their evasion was not an issue worthy of legal privilege. It appeared to the court that the company necessarily had access to the information as a prerequisite for its services. That the information was held on servers abroad was irrelevant; what mattered was the access from Germany. The court also rejected the argument of the company, that the tax authorities could obtain the information for themselves by running their own "crawler" on the auction website. Minutely collating information gathered item-by-item was not an acceptable alternative to properly scheduled information in the form requested. However the court, at this point, did not go into the question of unreasonable extra work for the company. On the other hand it did state that the tax authorities must have valid grounds for suspecting wide scale evasion going beyond a general assumption that many taxpayers will not declare income if the risk of discovery is low. As against this, it also stated, though, that the turnover limit of €17,500, equivalent to the VAT exemption limit for small businesses, was evidence that the tax authorities were not seeking information in unreasonable, or unnecessary, quantities.

Supreme Tax Court judgment II R 15/12 of May 16, 2013, published on July 10

From Europe

Exemption from loss cancellation on change of shareholders may constitute state aid

The Finnish income tax act provides for a 10 year loss carry forward. However, the carry forward is cancelled on a change in ownership of more than 50% of the company's share capital or on the withdrawal of more than 50% of the shareholders. This cancellation is, however, not to be applied for a good reason in the interests of business continuation, and the Tax Directorate of Finland has issued a circular setting out its view of the criteria constituting a good reason. The provision is currently under attack by an unsuccessful claimant for exemption on the grounds that it is arbitrary and thus constitutes unlawful state aid in the absence of a specific approval from the European Commission.

The ECJ has basically declined to rule on the question put, saying that it has not been given the necessary facts for it to come to a founded view on the subject. However, it has made some interesting observations. In particular, it makes the point that it has not been instructed on the background to the legislation or on its application in practice. This means that it is unable to decide on the basis of comparison with the "normal system". If the ten year loss carry forward is the norm, its cancellation on a change in shareholders would be the exception potentially justified by the need to curb trade in tax-loss companies. Exemption from the exception could then be justified on the basis that the legitimate tax objective is not impaired. If the cancellation on change of a majority of the shareholders is the norm, the exemption would need to be justified on the basis of specific tax objectives. However, in all cases, the discretion of the authorities must be limited to verifying the fulfilment of objective criteria. If they have discretionary powers to authorise exemption from a tax provision on the basis of non-tax criteria – such as the furtherance of an employment objective – the measure could constitute selective state aid. That aid would be lawful until the Commission determines otherwise if the present system is substantially similar to that in force in 1995 on Finland's accession to the EU. If it has changed significantly in the meantime, it could constitute "new aid" requiring Commission approval before it could be implemented. However, here too, the court did not have the facts necessary to make the distinction.

The ECJ case reference is C-6/12 P *Oy*, judgment of July 18, 2013.

n.b. The parallel German provision exempts companies from loss cancellation on a transfer of more 50% of the share capital to a single shareholder if the transfer is made in the context of a corporate recovery programme. The Commission refused to authorise the provision on the grounds that it was too general – in some ways the opposite attitude to that taken by the ECJ in the Finnish case – and Germany's appeal against the Commission's decision was rejected on a formality. However, a number of private claims – with government support – against the Commission are still pending. The exemption provision has, for the meantime, been disapplied, although there is a promise to reactivate it, should a future ECJ decision give legal support for doing so.

Full inheritance tax exclusion for non-EU residents?

The Inheritance Tax Act exempts the first €500,000 chargeable transfer by way of inheritance or gift between spouses if either the testator (donor) or the beneficiary is resident in Germany. If both are non-residents the personal allowance drops to a mere €2,000. The official justification for the distinction is that the high initial allowance is intended to ensure that a surviving spouse is able to maintain his or her customary standard of living. Accordingly, it need be given only once, in the country of residence. A Swiss resident widower has challenged this apparent discrimination in respect of a German property inherited from his deceased wife. He based his position on the ECJ case of *Mattern* (C-510/08, judgment of April 22, 2010) which held the distinction to be indeed discriminatory in a case involving the gift of a German property from a mother to her daughter, both of whom were resident in the Netherlands. However, the present case is slightly different in that it involves a transfer between residents of a non-member state (Switzerland) and a transfer by way of inheritance where the remainder of the estate – essentially cash balances – was exempt as a transaction between non-residents.

The ECJ advocate general on the case has now suggested the court hold the decision in *Mattern* be extended to transfers by way of inheritance between residents of non-member states. The German distinction is an infringement of the free movement of capital, the fundamental freedom not restricted to the area within the EU borders. The German government defended the distinction on the grounds of tax system coherence and the need to prevent abuse. The system coherence was felt to be threatened because in the present instance the high personal allowance for transfers to or from a resident went hand-in-hand with a tax liability on the cash balances. The need to prevent abuse argument was based on the premise that significant personal allowances should be granted only once, by the state of residence in order to avoid "double dips". To this, the advocate general pointed out that the property charged was the major asset of the estate. Claiming the exemption of the cash was a justification for withholding a far higher personal allowance was, at the least, out of proportion. He then drew attention to the fact that the higher German allowance was available to German residents transferring or receiving foreign assets. In this case a correct charge to tax was largely dependent on the honesty of the taxpayer, so abuse prevention was clearly not the issue.

The ECJ case reference is C-181/12 *Welte*, opinion of June 12, 2013.

From PwC

Breaking news

If you would like to follow the latest news on German tax as it breaks, please visit our Tax & Legal News site at http://tax-news.pwc.de/german-tax-and-legal-news

Editor's Office

Andrew Miles
PricewaterhouseCoopers AG WPG
Friedrich-Ebert-Anlage 35-37
60327 Frankfurt am Main

Tel: +49 69 9585-6345
andrew.miles@de.pwc.com

Subscribe

You may take out a new subscription to the newsletter with a simple e-mail to SUBSCRIBE_PwC_Mandanteninformation_E@de.pwc.com. Existing subscriptions may be cancelled at UNSUBSCRIBE_PwC_Mandanteninformation_E@de.pwc.com.

www.pwc.de