Statutes
Cases
Decrees

Issue 6
September 2016

Tax & Legal News

Official Pronouncements

Further relief from curtailment of loss utilization planned

The present rules for the curtailment of loss relief on changes of shareholder exist since 2008 (Section 8c Corporation Tax Act – CTA). The basic principle is that loss carry forwards (both for corporation tax and trade tax) cease if more than 50% of the shares in the company making the loss are directly or indirectly acquired by a single acquirer and/or his related party over a period of five years. If more than 25% but no more than 50% are transferred, the loss carry forward is reduced in the proportion to the transfer. There are two exceptions of the curtailment of losses (i. e. despite of a change of shareholder): Loss carry forwards on certain group internal reorganisations are protected as well as losses up to the level of the hidden reserves of the company that would be taxable in Germany on release.

The effects of Sec. 8c CTA are far-reaching, as it comes into play as a consequence of any form of share transfer. In the course of time it was felt that there are still many aspects of the rules on loss curtailment that remain unclear und that the rules themselves were too restrictive. The German government obviously now felt that there might be situations in which the forfeiture of losses – from an economic point of view – is not at all justified. Namely where – after the change in shareholding – the survival and the continuity of the business operation of the corporation is ensured. For this matter the German cabinet (i. e. the government coalition parties) set up a draft of a new Section 8d CTA to deal with an extended loss utilization for corporations under which an offset of losses would still be possible under certain circumstances. The new rules should apply already from January 1, 2016.

The corporation must specifically and formally apply for the new rules. According to the new draft Sec. 8d CTA an acquisition is not harmful in the sense of Sec. 8c CTA if the same business was maintained during the three years preceding the change in shareholding or since inception. Moreover, the corporation thereafter must continue the same business operation uninterruptedly and unchanged. However, the exact duration of the continuation is neither established nor specified in the present proposal. Either the discontinuation (termination) or a change in the nature of business leads to the forfeiture of the loss carry forward, unless protected by hidden reserves of the company. Harmful events upon which the loss carry forward would no longer be preserved are: The termination of the business, changing the line of business or taking up new business, the participation of the corporation in a partnership, the corporation being the parent within a tax group, assets which are transferred to the corporation below fair market value. The loss relief mechanics of Sec. 8d CTA would also apply to the trade tax losses.

The draft will now be discussed (and perhaps modified) by the German parliament (the lower chamber of parliament – the *Bundestag*) and then be brought before the representatives of the provinces (i. e. the *Bundesra*t) who have the final vote.

Negotiations on Inheritance Tax Reform 2016 adjourned

In December 2014 the Constitutional Court has held the exemption of business assets from inheritance and gift tax to be unconstitutional as it is too broad-based but allowed the present rules to continue in force provided they are amended by June 30, 2016. The German government on July 8, 2015 came forth with a corresponding draft “Reform Act”. Following rather lengthy political debates, the lower chamber of parliament (*Bundestag*) – on June 24, 2016 – passed the “German Inheritance and Gift Tax Reform Act”. However, in its meeting on July 8, 2016 the upper chamber (i. e. the *Bundesrat* – consisting of delegated members of the provinces) vetoed the draft. The majority of the representatives of the provinces felt that the new rules still disproportionately favoured businesses over private beneficiaries. Thus the bill was referred to the Mediation Committee (acting as an intermediary between the *Bundestag* and the *Bundesrat*).

Following its summer recess the Mediation Committee convened at 6 p.m. on September 8, 2016 to discuss and debate the issues at hand. However, without specific results – and without arriving at a breakthrough. It was agreed to reconvene on September 21, 2016 at 6 p.m. to resume deliberations. In the meantime a working group is asked to explore possible compromises and look for solutions to untie the stalemate.

Constitutional Court refuses case on non-deductibility of trade tax for companies

A company operating a chain of filling stations on leased property objected to its disproportionate trade tax burden in comparison to that borne by sole traders or natural-person-partners. Its objections were based on the unequal treatment arising from the non-deductibility of the trade tax from the profit chargeable to corporation tax in the face of the (usually) significant relief from a trade tax credit against the income tax due. This lack of deductibility was exacerbated for corporations with significant rental costs due to the disallowance of one-quarter for the assumed implicit interest. The taxpayer also made the point that the lack of a trade tax deduction was inconsistent with the nature of the tax as a business expense. However, the Supreme Tax Court in its judgment of I R 21/12 of January 16, 2014 did not agree that any of these points offended against the constitution, in particular against the equal treatment provision or the ownership guarantee from excessive taxation.

The case was brought to the Constitutional Court who did not accept the constitutional complaint for lack of prospects for success and therefore refrained from making a definite decision on the matter itself. Thus the earlier judgment of the Supreme Tax Court is still valid in its substance.

The Supreme Tax Court had based its judgment (i. e. in the case I R 21/12) on the circumstances of the tax reform of 2007 taking effect for 2008. This reform abolished the deduction for trade tax as a business expense whilst introducing a significant relief from its burden in the form of a credit for natural persons. However, the same reform also cut the corporation tax rate from 25% to 15%. The object of the reform was to improve the apparent German tax climate in comparison to neighboring countries by reducing the nominal rates of taxation whilst broadening the basis of assessment. This objective was constitutionally legitimate, particularly as there was no constitutional requirement for any aspect of the previous trade tax system. The corporation tax rate reduction reduced the effective tax burden on corporations and it was legitimate to partly compensate this with a trade tax increase in the interests of improving the transparency of the tax system. The reformed tax burden on corporations was thus not generally excessive and – in the view of the Supreme Tax Court at the time – there was no constitutional requirement to tax corporations and sole traders in an identical fashion.

Constitutional Court resolution 2 BvR 1559/14 of July 12, 2016; Supreme Tax Court judgment of I R 21/12 of January 16, 2014

Supreme Tax Court Cases

Electronically supplied services for VAT purposes: the provision of a database in the internet

The appellant was a US-resident corporation which carried on its business from the USA and which did not have any presence in the EU. In the year in question (2003) this corporation carried on networking services, which allowed its paying users to obtain personal information on other paying users and to make contact with them (i.e. an online dating agency).

The services included a search function so that the users could search according to certain criteria, various options to make direct contact with other users, a newsletter, as well as a chat room. In addition to these platforms, the appellant provided a complaints' hotline, as well as a department, which monitored user activities and assisted in cases of breaches of privacy or other abuse.

As all these activities were carried out in the USA, the appellant assumed that it would not be necessary to file a VAT return in Germany in relation to the services provided to German users. A VAT assessment was issued for 2003, but the administrative appeal and the appeal before the lower tax court lodged by the appellant were unsuccessful.

The Supreme Tax Court confirmed the decision of the lower court stating that, by providing its paying users with access to its online community, the appellant had supplied services for a consideration. With effect from 1 July 2003, these services were "electronically supplied" within the meaning of the old Section 3a (4) No. 14 VAT Act (now Section 3a (5) 2nd Sentence No. 3 VAT Act) and, therefore, the place of supply was – under old Section 3a (3a) No. 14 VAT Act (now Section 3a (5) 1st Sentence VAT Act) – Germany.

The term "electronically supplied services" in VAT law includes services, which are provided through the internet or a similar electronic network, which are by their nature automatized, which occur with minimal human intervention and which would not be possible without information technology.

When considering to which extent human intervention is involved, the actual services supplied themselves should be examined. Thus, any human intervention in the original start-up of the electronic system or in its maintenance or the input of the users themselves, as in the case, are not considered to be essential to the services supplied and do not therefore affect the assessment of whether there is only minimal human intervention.

The conditions for an electronically supplied service are generally met, where, through an internet platform, an entrepreneur provides – for a consideration – his members with a database with automatic search and filter functions in order to make contact with other members (in this case, online dating agencies). A database is a collection of works, data and other materials arranged in a systematic or methodical way and individually accessible by electronic or other means.

Where an entrepreneur resident in a third country supplies these types of services to a German resident consumer (i.e. who is not an entrepreneur), the place of supply is Germany. The provision of the chat room and the newsletter in this case were to considered ancillary services, which had no impact on the place of supply.

Supreme Tax Court judgment XI R 29/14 of 1 June 2016, published on September 7, 2016

No deduction of foreign withholding tax in case of abuse

Taxpayers whose foreign income is liable to tax corresponding to German income tax in the State in which the income originates, may offset the tax paid abroad against German income tax due in respect of income from that State. Specifically, withholding taxes on certain foreign dividends may be credited against the

German income tax due. Alternatively, if a tax credit is not possible, e. g. for lack of foreign source income, the foreign tax can alternatively be deducted as an expense from the German tax base. This latter rule was the subject of dispute before the Supreme Tax Court.

The German taxpayer sold 55% of the shares in a German GmbH to a Netherlands B.V. and remained with a 25% stake in the GmbH. The dividend was paid by the GmbH via the B.V. and its Dutch parent to a consulting Ltd. having its seat in the British Virgin Islands and whose shares were held entirely by the taxpayer. Though the parties involved were in agreement that the entire transaction was an abuse of legal forms and therefore – for want of foreign source income – a tax credit was not possible, the taxpayer asked for a deduction of the foreign withholding tax levied on the dividend paid from the B.V. to its Dutch parent. The tax office refused, the Supreme Tax Court also rejected the request.

The deduction of foreign withholding tax in order to avoid a double taxation is only possible where the same person paid both domestic and foreign tax on the same type of income. In the case at hand, the tax was rather payable by the intermediate B.V. Under appropriate legal arrangements no foreign withholding tax would have been payable at all. The Supreme Tax Court went on to point out that, on the basis of the inappropriate structure chosen, no German tax would have been payable on the dividends of the GmbH as the dividend income would be taxed in the hands of the B.V. and the subsequent distribution to its parent only be subject to Dutch withholding tax.

Supreme Tax Court judgment I R 73/14 of March 2, 2016, published on July 13

Subject-to-tax clause – Section 50d (8) ITA in the case of double tax residence

The individual involved had a place of residence in Germany, an apartment in Hong Kong and accommodation in China. During the year in question he received a pension and rental income in Germany and he was employed by a Hong Kong firm. Under the terms of his employment contract he was responsible for a factory in China; further his employer agreed to pay all the tax on his employment income. No evidence was available to show that tax was actually paid in China and Hong Kong. During the year in question he was present in Germany for 31 days, in Thailand for 27 days, in Hong Kong for 91 days and in China for 216 days.

The tax authorities in Germany took the view that the employment income for the work performed in China was taxable in Germany as part of his worldwide income. After the lower tax court both refused his appeal and leave to appeal, the individual appealed to the Supreme Tax Court, requesting leave to appeal.

Leave to appeal was refused. The Supreme Tax Court held that the case was not one of fundamental significance, which required clarification by the Court. The appellant had asked the Court to rule on the question whether Section 50d (8) of the Income Tax Act (“ITA”) permitted a reversion of taxing rights to Germany, where, in the case of a double tax residency in Germany and China, not only were the activities under the employment contact performed in China but also the centre of vital interests was also in China, so that for the purposes of the German/Chinese tax treaty, China was both the state of residence and the state in which the activities were performed. The Court held that this question did not require clarification as the answer could be immediately discerned from the wording and meaning of the law.

Section 50d (8) ITA provides that where employment income of a unlimited taxpayer is to be excluded from the tax base for German tax under the terms of a tax treaty, the exemption will only granted – regardless of the treaty – where the taxpayer proves that the tax was actually paid on the relevant income in the other state under the treaty or that the state in question has waived its right of taxation.

It was a matter of settled case law that a domestic place of residence gave rise to an unlimited tax liability (i.e. a liability to tax on worldwide income), even where the centre of vital interests was located abroad.

Further it was clear from the wording, that for its application, Section 50d (8) ITA merely required that the unlimited taxpayer had employment income, which was to be excluded from the German tax base according to a tax treaty, so that in the instant case the conditions were met. Section 50d (8) ITA does not require tax residence in Germany under the terms of the treaty, only the existence of an unlimited tax liability is decisive. Such an unlimited tax liability can clearly exist even if the tax residence is attributed to the other state under the tie-breaker clause of the OECD Model Treaty (Art. 4 (2) of the German/Chinese treaty).

Supreme Tax Court resolution I B 139/11 of 25 May 2016, published on August 17

Negative Goodwill in the case of contribution

The case in question related to a contribution of a business unit into a corporation in exchange for new shares under the Reorganisation Tax Act 1985. (this Act has since been amended, but the judgment should still be relevant to the Reorganisation Tax Act 2006.)

Under Section 20 of the Act the acquiring company may elect to record the contributed assets at their tax book value or a higher value, provided the value recorded does not exceed the fair market value of the business/business unit.

In the instant case, the acquiring company (the appellant) recorded in the relevant balance sheet the assets of the contributed business unit at a value higher than their tax book value, but not in excess of their fair market value. The business unit in question was generating losses with a negative goodwill, so that the fair market value of the business unit as a whole was less than the total market value of the individual assets together. It had been accepted by the lower court (following the agreement of the parties) that the value of the business unit as a whole corresponded to the previous tax book values of the individual assets applied previously by the contributor.

The Court held that in the case of the contribution of a business/business unit, it was not only the values of the individual capitalised assets that were relevant, but also the value of the contributed business/business unit as a whole. Thus, it was not possible for the acquiring company to step up the value of the individual assets contributed to a value which would be higher than the going concern value of the assets as a whole, taking into account the negative goodwill.

The Court, following settled case law, further held that the contribution of a business, of a business unit or of share in a partnership for new shares in the acquiring company amounts to a barter transaction, and is thus a sale on the one side and an acquisition on the other. It follows, therefore, that the value which the company attributes to the contributed assets in its books, constitutes the sales proceeds for the contributor (as well as the acquisition costs for the new shares) and the relevant acquisition costs of the individual assets for the company.

Referring to its earlier dicta, the Court stated that, in the case of a contribution, available hidden reserves relating to particular business assets cannot just be allocated at will, but rather any available good will to be stepped-up is to be allocated equally among the assets. As a consequence, the Court stated, in calculating the maximum step-up, the value of the contribution as a whole must be observed and any negative goodwill should be considered.

Supreme Tax Court judgment I R 33/14 of April 28, 2016, published on August 4, 2016

Sale-and-lease back not rental but other service subject to VAT

A lease concluded after delivery of the asset to the customer is either a sale and lease-back transaction or the grant of a loan. The distinction depends on the circumstances of the case. Normally, a sale and lease-back is to be VAT-ted as a sale by the customer to the leasing company followed by a service by the leasing company to the customer (the monthly rentals). If the sale and lease-back is to be seen as a loan, it will not have VAT consequences.

In the case before the Supreme Tax Court a civil-law partnership (*GbR*) purchased electronic information systems from the seller in 2007 which the latter had developed and therefore – under then applicable law – was not allowed to record in his balance sheet as an intangible asset. The *GbR*-lessor received a loan of 2/3 of the net purchase price from the lessee (seller). The lessor assumed and declared taxable lease payments and thus claimed full recovery of the underlying input VAT. The tax office maintained that – in lieu of a transfer of ownership – the service provided was in the form of a VAT-exempt loan by the lessor and which therefore excluded VAT recovery. The Supreme Tax Court – in effect – accepted the claim by the lessor as regards a VAT recovery, albeit for other reasons.

The lessor did not loan finance the lessee and, secondly, in lieu of a transfer of ownership, no delivery/supply of equipment took place. Actually, it is viewed as a provision of other services by the lessor subject to VAT (which entitles to full recovery of input VAT) rather than being a lease. Using the transaction of a sale-and-lease-back put the lessee in a position to record a respective loan and thus account for the intangible asset in his balance sheet which otherwise would not have been possible under then prevailing law (2007). This resulted in several benefits for the lessee: He was able to report a higher capital, distribute higher profits and enjoy a higher credit ranking. The Supreme Tax Court also pointed to an ECJ judgment of February 21, 2006 (case: C-223/03, *University of Huddersfield*): There, the ECJ held that a transaction may be viewed as a VAT-able service even if carried out with the sole purpose of obtaining a tax advantage. Furthermore and considering the circumstances of the case the sale and lease-back is not the grant of a loan since the lessor did not finance the total purchase price but rather 2/3 of it were in fact raised by the lessee.

Supreme Tax Court judgment V R 12/15 of April 6, 2016, published on July 20, 2016

From Europe

Higher tax-free allowance also for non-resident beneficiaries

The Inheritance and Gift Tax Act provides for certain personal allowances depending on the degree of kinship between testator (donor) and beneficiary. If both parties are non-resident, the personal allowance is only €2,000 regardless of kinship. In 2010, the ECJ held this distinction to be an unacceptable restriction on the free movement of capital (C-510/08 *Mattner* judgment of April 22, 2010) and the government responded by introducing an option for EU/EEA-residents for taxation as German residents for the two periods of ten years before and after the chargeable transfer.

In the case before the Lower Tax Court of Duesseldorf a mother living in England for many years wished to transfer a German property to her two daughters who were similarly long-term British residents. She protested against the low personal allowance for chargeable transfers between residents in another EU country, but refused to exercise the option for taxation as a German resident on the grounds that she could not know what the coming ten years might bring. In support of her position, she claimed that Germany had insufficiently transposed the *Mattner* judgment into national law. The Lower Tax Court then referred the case to the ECJ.

The ECJ followed the approach taken by the advocate general in his opinion of February 18, 2016 and held that a national law provision in conflict with EU law remains in conflict with EU law, even if there is an option for those affected not to apply it. Lastly, the option is more burdensome on residents of other member states as it requires taxation as a resident for a twenty year period, whereas the corresponding provision for residents merely accumulates all chargeable transfers in the ten years up to the date of the transfer at issue.

Specifically, the ECJ saw a conflict with EU-law in two ways: First of all in a situation where the tax is calculated by applying a lower tax-free allowance if the beneficiary does not specifically request otherwise by opting for the higher tax-free allowance, and secondly and foremost if – as a result of an option for the higher tax-free allowance by the non-resident beneficiary – all the gifts received by that beneficiary from the same person over the course of the 10 years preceding and the 10 years following that gift (thus accumulating all chargeable transfers over a period of 20 years) must be taken into account.

The ECJ went on to say that where – under national gift tax legislation – non-resident beneficiaries who received the property from a non-resident donor, and, on the other hand, non-resident or resident beneficiaries who received such property from a resident donor and resident beneficiaries who have acquired it from a non-resident donor are put on equal footing the national legislation cannot — without infringing the requirements of EU law — treat those beneficiaries differently with respect to the application of a tax-free allowance.

Accordingly, the referring Lower Tax Court has now decided in the above sense and held that the higher tax-free allowance of €400,000 be available for the taxpayer. Appeal to the Supreme Tax Court was not granted.

The ECJ case reference is C-479/14 *Hünnebeck* judgment of June 18, 2016

From PwC

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

English language blogs in which you may be interested are
CITT (Customer and Investor Tax Transparency) News http://blogs.pwc.de/citt/
Establishment of Banks http://blogs.pwc.de/establishment-of-banks/

Editor’s Office

Emma Moesle
PricewaterhouseCoopers AG WPG
Friedrich-List-Straße 20
45128 Essen

Tel.: +49 201 438-1975
E-Mail: emma.moesle@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.