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# Tax & Legal News

*Statutes*
*Cases*
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## PwC Reports

### Model treaty on information exchange

The USA has recently enacted a Foreign Account Tax Compliance Act (FATCA) in a bid to improve tax information exchange by imposing reporting obligations on foreign banks in respect of accounts run by them for US tax residents. If the foreign bank fails to undertake to the IRS to comply with these requirements, its US source receipts will be subject to withholding tax not otherwise due. This raises a number of problems for foreign banks including possible conflicts with the law of their own country. Accordingly, France, Germany, Italy, Spain and the UK have established a joint working party to draft a model treaty between the USA and a foreign state for the mutual exchange of information, thus regulating procedures and protecting a local institute from inadvertent breaches of its own laws.

The model treaty provides for the annual exchange of information between the tax authorities of the two signatories on bank accounts held in the one country by residents of the other. The information shall clearly identify the account holder and state the total interest, dividend and other investment income. Both deposit and custodial accounts are included. This will release the institutes of the partner country from the withholding tax burden on their own income under FACTA. Recognised instances of non-compliant institutes are to be notified to the authorities of the home country for appropriate sanctions. The interests of efficiency are served by a provision allowing the authorities of one country to turn directly to an institute of the other in order to clear questions arising from administrative or clerical error. There is also provision to ease the reporting burden on institutes not actively soliciting business in the other market. On the other hand, there is a blanket requirement on signatory states to take all necessary steps to prevent institutes from circumventing their reporting requirements.

## Official Pronouncements

### German/Austrian civil service widow(er)s' pensions

The German/Austrian double tax treaty provides that civil service and similar pensions are taxable in the country of payment, rather than the country of residence, unless paid to a national of the other state resident there. The two finance ministries have now agreed to interpret this as applying to the widows and widowers of former government servants on the same basis as the original beneficiary if they continue to live in the other state after the death of their spouse. Thus a German pension paid to a policeman's widow who continues to live in Austria after her husband's death will continue to be taxable in Germany (with exemption in Austria) even if she is an Austrian national and even if she held Austrian nationality during her husband's lifetime.

### *Dutch civil service pensions taxable in Holland*

Following an administrative reform, Dutch civil service pensions are now paid by a series of private pension funds, known as ABP. The recently signed, though not yet ratified, double tax treaty with Holland recognises ABP civil service pensions as equivalent to those paid from the public purse and contains a provision for their taxation in the country of payment insofar as the pension entitlement stems from periods of public service as a civil servant or as the employee of a public body. The Central Tax Office acting on behalf of the finance ministry has now agreed with the Dutch finance ministry that this new treaty provision shall be applied immediately without waiting for the formal entry into force. Under the terms of the treaty it shall apply retrospectively to all cases still open.

ABP pensions earned other than through public employment are taxed as income from a private pension fund, that is, in the country of residence. Pensions stemming from periods of public and private employment are to be split by length of service. The Dutch finance ministry has entrusted the tax office in Heerlen with the task of establishing and certifying the split in individual cases. Former Dutch civil servants or government employees living in Germany will thus need to contact the Heerlen tax office for the necessary certificate to demonstrate entitlement to exemption from German taxation.

### *No write-down to market value of fixed-interest bonds held as current assets*

In June 2011, the Supreme Tax Court held that fixed-interest securities could not be written down below their repayment value (usually par) merely because their market value had fallen. The finance ministry has now reacted with a call to tax offices to follow the ruling and to disallow write-downs below par of fixed interest securities held as current assets, where redemption is to be at nominal value and where there is no risk of default. Any necessary write-backs are to be taken to income at the latest in the year ending after the date of the official publication of the case in the Federal Tax Journal (expected shortly).

### *Inventor's premium to ex-employee taxable as royalty*

In October 2009 the Supreme Tax Court held that an inventor's premium paid to a former employee for a discovery made in the course of his employment was not additional employment remuneration, but rather a royalty. Since the employee concerned had moved to the USA in the meantime where he was now resident, the income was taxable there, rather than in Germany, under the double tax treaty. The finance ministry has now issued a decree accepting this ruling as a precedent for other cases, but insisting on the employer's holding an exemption certificate before applying the US double tax treaty to the payment. The exemption certificate is to be issued by the employer's local tax office; if the employer does not hold one, he must deduct withholding tax as on employment income paid after the termination of the employment. The ex-employee may claim a refund from the Central Tax Office.

### *Employee withholding tax 2013*

The original intention was that 2010 should be the last year in which employee wage withholding tax should be calculated on the basis of a wages tax card. Accordingly, the system for issuing cards was scrapped. Unfortunately, the replacement system, a database for online interrogation by employers, was delayed, leaving the old 2010 cards as the basis for the calculation of wage tax deductions in 2011 and 2012. This is augmented by a system of tax office certificates to accommodate new arrivals on the job market and tax-relevant changes in personal status. The finance ministry has now announced that the new, centrally organised database ("ELStAM") is ready for operation and has issued two decrees to be followed in the changeover period.

The database ELStAM is available to all employers from November 1, 2012. However, data drawn from it cannot be applied to actual wage withholding tax calculations until January 1, 2013. 2013 is to be the introductory year for the new system. At some point in time of his own choosing, each employer must log all employees onto the new system and from then on deduct withholding tax on the basis of the information it supplies. There is, however, provision for the correction of errors in an employee's personal data. Employers are expected to log on all employees in one block for each location, although the tax offices will accepted an initial log-on in stages. Once an employer has logged-on to ELStAM, he must cease to tax under the old "paper" system. The last log-on possibility is the final withholding tax period of the year – generally, this will be the month of December.

### *VAT-free sale of business even if lease of premises terminable at will*

A sale of a business as a whole is free of VAT. As a whole is generally taken to mean that all significant assets of the business pass with the transfer, so that it can continue its operation in a substantially unchanged form. However, the legal title does not have to be identical; for example the Supreme Tax Court has held in the past that if a transferor retains the ownership of the business premises, leasing them to the new proprietor on an eight-year lease, the sale of the other business assets is VAT-free as the sale of a business as a whole. More recently, the ECJ has held that the lease does not have to be for a fixed term or only cancellable under a long period of notice, provided continued business operation is assured. The finance ministry has now responded with an amendment to the VAT Implementation Decree to the effect that the lease may be for an indefinite period, cancellable at only a short period of notice.

The amending decree specifies that the change should apply to all cases still open. However, now objection will be taken to treatment of transactions up to December 31, 2012 as taxable where the lease is of no fixed term, provided both sides take the same position.

### *VAT on waste disposal*

Up to now, the finance ministry has tended to see waste removal as an exchange of supplies, sale of goods against the service of disposal. It has, however, now issued a new decree on the subject, calling for treatment of each transaction as a single supply, unless both elements clearly played a major role for both parties when coming to the agreement.

Waste removal, which includes the removal of rubble and scrap from demolition of buildings or dismantling of plant, is a service where disposal is the main point of the transaction. Waste sale, on the other hand, is to be assumed where the waste had value in its own right, or where it was more or less directly fed onto the production line as raw material. An exchange of both elements is only to be assumed where both parties saw each element as significant. This, for example, is the case with price adjustment clauses to take account of future sales of the waste for the benefit of the original owner. On the other hand, there will be no exchange, where the disposal business afterwards sells the waste, but without crediting the supplier with any of the proceeds.

### *Prepaid telephone cards are telecommunications services*

Originally, the finance ministry saw the sale of a prepaid telephone card as a prepayment, the actual service being rendered as and when the cardholder made his or her calls. However, it has now revised this view in the wake of an ECJ judgment and has issued a decree to the effect that the sale of a prepaid telephone card is to be charged to VAT as the sale of telecommunications services. The actual usage of the card, i.e. the event of telephoning, is irrelevant, provided the card cannot be used for any other purpose. The treatment of a card sale as the supply of telecommunications services applies throughout the supply chain; thus a card wholesaler will supply telecommunications services to his retailer, regardless of the fact that neither of them has any intention of using the card under discussion to make telephone calls.

### *No specific authentication of electronic invoice*

With effect from July 1, 2011 the formal requirements on electronic invoices as input tax vouchers were eased considerably. In particular, the requirement that they be authenticated with an authorised, qualified electronic signature was dropped altogether. Electronic invoices may now be transmitted by e-mail or in an ordinary e-mail attachment as a text or image file. However, the requirement that the invoice recipient must agree to electronic issue remains. The finance ministry has now updated its VAT Implementation Decree with detailed guidance on the new situation.

If the electronic invoice is authenticated by qualified electronic signature, the signature must be retained as part of the invoice documentation. If, however, the invoice is not authenticated, the recipient must establish his own control procedures for verification. There are no particular forms for this, although the controls adopted must be documented. They may be manual or automated. Independently of invoice authentication, there must be controls in place to verify the invoice content – receipt of the supply, the price as agreed, the identity of the supplier and the correct designation of the recipient. Verification of this content entitles the invoice holder to assume that the invoice was correctly transmitted, that is, that it is electronically authentic. This means that the right to deduct the input tax as shown will not be compromised by lack of specific authentication. However, the right to deduct must be apparent from the other supporting documentation.

### *Tax informers*

In an amendment to the Implementation Decree to the Tax Management Act, the finance ministry has brought a number of its procedures up to date, including in particular those relating to informers. The ministry has now made it very clear that it regards informers as protected by the tax secrecy provisions. There is therefore a more or less absolute prohibition on revealing the identity of an informer, unless he deliberately furnished incorrect information. In such a case, the tax office may, but need not, inform the public prosecutor if it feels an offence such as that of false accusation has been committed. In the absence of an offence, the tax office must remain silent, both on the identity of the informer and on the information provided (as knowledge of the information could reveal the identity of the provider).

The amended decree also discusses the disclosure of an informer to the taxpayer on whom the information was passed. Requests for this disclosure by the taxpayer are to be dealt with as appropriate, although if the information turns out to be substantially accurate and results in an additional tax payment, the right of the informer to protection of his personal data is to be seen as "worthier" than any rights of the delinquent taxpayer to knowledge of the identity of the person who denounced him.

## *Supreme Tax Court Cases*

### *Royalty withholding tax on net income of EU creditor*

The Income Tax Act allows the withholding tax on income paid to creditors in other member states of the EU for the performances of artists and athletes to be calculated on the payment less the direct costs incurred by the recipient (with the rate doubling to 30% if paid to a natural person), but does not contain any similar provision for royalty payments. This has now been challenged by a television station paying film royalties to a Luxembourg distributor. The station claimed that it should be allowed to base the withholding tax on the payment to the distributor net of the fees paid by the distributor to the owners of the film copyrights. These were directly linked to the receipts from broadcasters and were therefore direct costs of earning that income.

The Supreme Tax Court has now confirmed the position of the taxpayer in a judgment setting aside the relevant provision of the Income Tax Act in favour of the higher-ranking community law as first expounded by the ECJ in *Scorpio* (case C-290/04 of October 3, 2006) and subsequently followed in other decisions. On that basis, the Supreme Tax Court held a tax charge of more than that to be levied on the same income in the hands of a domestic recipient to be an unwarranted infringement of the freedom to provide services. Since a credit in the country of the recipient for the German tax deducted at source would not necessarily eliminate double taxation in all circumstances, taxpayers must be allowed the option of claiming relief in the country of source for the direct costs incurred in earning the income. Thus the maximum withholding tax that could be levied was the lower of standard rate corporation tax (currently 15.825%) on the net income and the royalty withholding tax on the gross revenue at the relevant treaty rate.

Supreme Tax Court judgment I R 76/10 of April 25, 2012 published on July 25

### *No withholding tax on payment to Austrian agency for broadcasting rights*

An Austrian distributor sold television broadcasting rights for sporting events in Germany and elsewhere to a German purchasing agency for TV stations. The German authorities saw the payments as subject to withholding tax under the artists and athletes clause of the double tax treaty. The distributor argued that the payments were royalties or "other", neither of which was taxable in Germany.

The Supreme Tax Court has now held that the double tax treaty allows payments to artists and athletes to be taxed by withholding in the country of source regardless of where the event at issue occurred. This is evident from the wording of the treaty, but departs from the OECD model. However, in conformity with the model, the payment must be to or for the artist or athlete concerned, even if it is actually made to a third party. In this case, however, payment was not made to or for the athletes, but to the holder of the broadcasting rights for the use of those rights. Even if that holder is required to forward the amount received in whole or in part to the athletes, it does so within a separate contractual relationship and cannot be seen as acting as an agent on their behalf. There was no need for the court to establish the precise nature of the payment to the Austrian distributor as it was in no case subject to a German withholding tax under the treaty, be it a sale of rights, a royalty, business income or other income.

Supreme Tax Court judgment I R 41/11 of June 13, 2012 published on September 5

### *Brazilian interest on share capital is dividend in Germany*

Within certain limits, Brazilian law allows the shareholders in general meeting to resolve a payment of interest on share capital to the shareholders as an alternative, or in addition, to a regular dividend. If the limits are adhered to, the payment is deductible for the company as an interest expense. It is paid out net of a final-burden withholding tax of 15%. A German corporate shareholder claimed exemption of such a payment in Germany on the grounds that it should be treated as a dividend, falling, in this case, under the treaty exemption for dividends on significant shareholdings. The tax office argued that it should be taxed as interest income.

The Supreme Tax Court has now held the payment to be a dividend. It was resolved from time to time by the shareholders acting as such. Despite its Brazilian classification as interest, it was not a payment for the provision of capital by way of loan and the shareholders as recipients had no claim to its repetition in future years. In any case, it could only be resolved if the company had sufficient earnings to cover it. As a payment to the shareholders other than a repayment of capital, it could only be seen in Germany as a dividend and should be taxed, or exempted, as such. Its legal status in Brazil was irrelevant to German taxation. The Brazilian tax deduction by the company as an interest expense was also irrelevant to the German dividend treatment for the shareholder, there being no treaty requirement for consistent effects on both parties. The German switch-over for the prevention of "white" (ultimately entirely untaxed) income also did not come into play, as the expense deduction was not a consequence of a treaty relief, but of a Brazilian legal provision applied in its own right.

The double tax treaty with Brazil ceased to apply as of January 1, 2006.

Supreme Tax Court judgment I R 6, 8/11 of June 6, 2012 published on September 19

### *Foreign motor racing team taxable on receipts from German sponsors*

A foreign motor racing team signed a sponsoring agreement with a German supplier of motor vehicle parts and accessories. The team bore the sponsor's name and logo on its cars and on the drivers' helmets and overalls. The drivers were also expected to appear in sponsorship livery at press conferences and similar public events, and the sponsor was allowed to refer to the team in its own advertising. For this, the sponsor paid the team a fixed fee annually and also allowed it free of charge access to its products as needed. The tax office saw the arrangement as a taxable activity of non-resident sportspeople – insofar as appearances in Germany were concerned – and claimed from the sponsor the withholding tax that that entity should have deducted from the sponsorship fee paid.

The Supreme Tax Court has now held in support of a revised calculation by the tax office following the (presumably unwitting) assertion on behalf of the team that virtually the entire service provided was a taxable activity in connection with sporting events. The entire fee was thus taxable in Germany as the income from sporting performances insofar as the events took place in Germany. The split between taxable and exempt income was thus purely geographical, although the tax office had already allowed of its own volition a 10% deduction for non-taxable activities included in the sponsorship fee, such as the use of the team's name by the sponsor in its own advertising. The court also followed the lower court's inclusion of the value of the free-of-charge usage of the sponsor's products in the team's income tax and therefore withholding tax base.

The court dealt with an apparent distinction between the drivers as sportspeople, and the team as an organisation, in some detail. In principle, only the drivers could make a personal appearance and thus only they could be taxed. However, as the court pointed out, the drivers and the team were inseparable linked. Each wished to win his own championship. However, the team could not do so without drivers and the drivers could not do so without a car. Accordingly, the amounts paid to the team were inseparable from the performance of the drivers and thus taxable – at the withholding level – as income in their hands.

The sponsor also attempted to claim that the inclusion of Germany in the event calendar for the following year was uncertain when the fee was paid. At that time, no deduction of withholding tax was therefore conceivable. The court replied that the uncertainty was irrelevant; what mattered was what actually occurred. If an event took place in Germany, the participants were taxable on the fee portion deemed to have been earned here. An agreement in advance to hold an event in Germany did not lead automatically to a withholding tax obligation, but neither could the failure to withhold tax from an advance payment be explained away by reference to the as yet non-existent obligation of the team to appear in Germany.

Supreme Tax Court judgment I R 3/11 of June 6, 2012, published on October 24

### *Swiss social security pension premiums not deductible in Germany*

A Germany resident worked in Switzerland, where his employment income was taxable under the double tax treaty. He was subject to the Swiss social security system and was therefore required to pay pension insurance contributions. He claimed a German deduction for these contributions on the grounds that the future income would be taxable in the country of residence, presumably Germany. The tax office refused because he had already deducted the payments in Switzerland as a business expense.

The Supreme Tax Court has now confirmed the tax office in its position, though with a rather different reasoning. It referred to previous case law under which it had previously seen the pension insurance premium as being directly connected to present employment income. This arose from both being the direct consequence of the same event, the Swiss employment. The Swiss employment income was tax-free in Germany; hence its directly connected expenses could not be deducted. This clashed with the concept of future taxation of the pension, although the connection with the present income was, for the court, more immediate. The taxpayer then claimed that disallowing him an expense deduction now would effectively lead to double taxation, given his future liability. However, the court pointed out that any possible double taxation had already been resolved with the Swiss deduction of the premiums.

Supreme Tax Court judgment X R 62/09 of April 18, 2012 published on July 18

### *Revised sales price calculation not retrospective event*

The sole shareholder in a GmbH sold 52% of the capital for an initial sum to be revised in the light of results achieved during the next seven years. The revision and its calculation were established in a series of call and put options and were therefore effectively fixed. Four years later buyer and seller came to a different agreement on a lower additional purchase price based on the results to date. The tax office treated this payment as a subsequent price adjustment taxable in retrospect as additional income earned by the seller in the year of sale. The taxpayer (seller) saw it as a current event in the year the new agreement was reached.

The Supreme Tax Court has held that subsequent price adjustments are retrospective if agreed in advance. Thus a payment under the original agreement seven years later would have increased the gain on sale taxable in the year of sale. Here, however, the original agreement was changed by mutual consent four years later, leading to a lower additional payment. This payment was taxable as a gain in the year of the new agreement.

Supreme Tax Court judgment IX R 32/11 of May 23, 2012 published on July 4

***Provision for future tax audit support***

Companies faced with a tax audit are obliged to answer the tax auditors' questions, provide them with documents and information and to accord them all necessary facilities – including appropriate office facilities – for them to carry out their tasks on site. No charge can be made for this support. Visits by the tax auditors therefore lead to irrecoverable costs for the company, even if there are no negative audit findings. The Supreme Tax Court has now held that a company classified as a "large company" for tax audit purposes is entitled to provide with tax effect for the costs of meeting its obligation to support the tax auditors in respect of all business years already ended on the balance sheet date.

A "large company" for this purpose is one classified as such. Classification is once every three years, so a company meeting the criteria at the start of a classification period (January 1, 2013 is the next cut-off date) will not lose its large company status until the end of the three year period, even if its business declines in the meantime. The classification criteria vary by activity; the 2013 annual turnover limits for large manufacturers and distributors are €4,300,000 and €7,300,000 respectively. In theory, all large companies should be regularly audited in respect of every year, and finance ministry statistics suggest that about 80% of all large companies are regularly audited in practice. A large company thus faces a greater probability of audit than of exemption and thus meets the requirement for a provision for the fulfilment of an uncertain obligation. The costs of auditing a business year are a business expense for that year; thus provision can be taken up at year-end, even though the audit notification will not yet have been issued.

The tax office also argued against allowing full provision on the grounds that some of the taxes subject to audit were, themselves, not deductible (corporation tax and now trade tax). Cost associated with these taxes should thus also not be deducted. The court held, though, that all costs of a corporation were business expenses by definition and were thus fully deductible in the absence of a specific provision to the contrary. Tax auditor support was a public duty, but not a specifically disallowable supplementary tax charge. Its cost was therefore allowable as a business expense.

Supreme Tax Court judgment I R 99/10 of June 6, 2012, published on September 5

***No deduction for ship charter for customer entertaining***

The Income Tax Act allows a deduction for 70% of business entertainment costs, as long as the entertainment is not excessive in the circumstances. However, it explicitly disallows all costs associated with the invitation of customers and other business partners to hunting, yachting or similar activities. As against this, a finance ministry decree on sponsoring allows a partial deduction for the costs of inviting business partners to watch sporting events from a company box on the grandstand. A company attempted to take advantage of this decree in connection with the charter of a sailing ship from which some 50 business associates where able to watch a regatta from Kiel harbour during the annual "Kiel Week" celebrating the age of sail. The tax office and now the Supreme Tax Court took the view that whilst the sailing vessel might or might not be a yacht, it was at least something "similar". Accordingly, all expenses incurred in its charter, including the entertainment on board were disallowable *per se*, given that the taxpayer had made no attempt to claim that the invitation had been in connection with a business activity involving the ship herself, the one exception to the general rule. The court refused to admit parallels to the sporting events of the decree, as these involved sponsorship in the interests of publicity for the company as well as a service package provided by the event organiser, both of which were absent in the present case.

Supreme Tax Court judgment IV R 25/09 of August 2, 2012, published on September 12

### *No abuse in sale of worthless debt to new shareholder*

A sole trader incorporated his business, becoming the sole shareholder of the new GmbH. Later, the company fell upon difficult times and ultimately ceased business operations. In the meantime, the shareholder financed the growing losses with loans to the company rising to a total of €200,000 by the time trading ceased. Since the company then held no significant assets, it was unable to repay the loan, which was therefore worthless as an asset. Recognising this, the shareholder/creditor forgave the debt on condition of future revival if and when repayment became feasible. The company took the debt cancellation to income, setting the resulting net profit for the year against the roughly similar loss brought forward. The shareholder then put the company into liquidation, appointing himself as liquidator. He split his share into two, selling both halves to two new shareholders for a purely nominal amount of €1. He also sold his debt (including the right of revival) to one of the new shareholders for €2,500. The two new shareholders then merged a second jointly-owned, but this time flourishing, company onto their recent acquisition. This brought an immediate return to profitability leading to a revival of most of the debt in that year alone. The company booked this revival as an expense, bringing its taxable income for the year to almost zero, and repaid the revived amount.

The tax office refused to accept the tax return as filed, disallowing the debt revival charge against income as a hidden distribution of profits. The lower tax court took the same view, adding that the entire transaction with the loan was abusive.

The Supreme Tax Court, on the other hand, took the side of the taxpayer. The sale of the debt did not change its character of an operational liability, so its repayment could not be a hidden distribution of profits. The court also did not regard the arrangement as abusive since each step in the chain of transactions had a genuine economic background and had been processed and booked correctly. The primary purpose had not been to illegitimately save taxes, even though the same business result could have been achieved in a less tax efficient manner. The initial debt forgiveness was effectively compelling in order to return the company to solvency. The debt was, though, effectively worthless, so the company had to take the release from the liability to income – a shareholder's capital contribution cannot be taken up at more than the market value of the asset contributed. The subsequent sale of the worthless debt to the new shareholder for only a very low amount was economically plausible. The same applied to the motives of the purchaser – as a new shareholder, it was reasonable for him to pay a small amount to free the company from any remaining influence of its former owner. The revival followed from the relevant provisions in the loan contract within the limits of the capital repayment prohibitions of company law. Its treatment by the company as a business expense mirrored the previous treatment of the forgiveness as income.

The tax office attempted to argue that the entire arrangement was abusive as it effectively circumvented the forfeiture of loss carry-forward on change of shareholder. The Court, however, held that the forfeiture provision was intended to curb the trade in "tax-loss" or "shell" companies, but was not subject to any limitations on its application in other situations. Since disallowance of loss relief on a change of shareholder was accepted regardless of actual abuse in the given case, the provision could not be seen as embodying a point of principle. Action taken to avoid its effects through otherwise appropriate legal vehicles was thus not of itself abusive, as there was no relevant principle at risk.

The loss forfeiture provision has been completely overhauled in the meantime, although the essential points of this judgment remain relevant.

Supreme Tax Court judgment I R 23/11 of July 12, 2012, published on October 10

### *No provision for unredeemed rebate tokens to customers*

A hairdressing chain gave customers during the pre-Christmas season a gift token as an expression of thanks for their loyalty. Each token entitled the holder to a rebate of a fixed amount on any purchase made in any one of the salons during the first two months of the new year. The company took up a provision in the full amount of the tokens issued, as it saw them alternatively as an expense of the old year (Christmas) or as a retrospective price reduction on sales already made (the tokens were only given to existing customers when paying for a hair-do or other service). The tax office rejected the provision for a number of reasons, mostly based on uncertainty of amount in view of the relatively short redemption period, the exclusion of any redemption other than in connection with a new purchase and the lack of records on the identity of the token holders.

The Supreme Tax Court has confirmed the tax office in its position, albeit for a different reason. Redemption of each token was only possible as a rebate off the cost of a future service. This rebate was thus a future cost to be taken up when that future service was provided. The token was to encourage customers to remain customers of the company, rather than to retrospectively reduce their past costs. Limiting token issue to existing customers on the occasion of payment for a service already rendered was not decisive, as it did not alter the fact that the token had no value except in connection with a further service still to be provided. It was thus not an independent instrument of value.

Supreme Tax Court judgment IV R 45/09 of September 19, 2012, published on October 24

***Concession cannot be withdrawn on audit***

A farmer applied for an extra-statutory concession allowing him to value his growing crops at zero by filing a tax return showing a loss from the full write-off of the opening balance with a reference to the regulation governing the grant of that particular concession. The tax office issued assessment notices for that and the following years on the basis of the returns as filed without further comment. The assessments were subject to audit.

Subsequently, the tax auditors found that the concession should not have been granted and issued a report recommending re-assessment on the basis of its withdrawal. The tax office followed this recommendation to the disadvantage of the taxpayer. The Supreme Tax Court has, however, now held that the grant of the concession was final and could not be revoked on audit. The grant was implicit in the acceptance of the tax return as filed, given that the claim to the concession was openly shown. The subject to audit condition noted on the assessment notice did not refer to the concession, but to the remainder of the return and the accounting records in its support. Doubts as to the taxpayer’s entitlement to the concession should have been resolved when reviewing the application; in the present case, the zero valuation of growing crops was a concession in the interests of simplicity and arguably not relevant to a taxpayer who had already valued them in his accounts. However, it was not open to the courts to review the grant of a concession after the event, even if the grant had been in conflict with the law.

Supreme Tax Court resolution I R 32/11 of July 12, 2012 published on September 19

***Full income tax deduction for shareholder loan write-off***

The Income Tax Act contains no provision corresponding to the Corporation Tax Act exclusion of bad debt losses of shareholders with more than 25% on their claims on the company. The Supreme Tax Court has just ruled on two cases brought by natural person shareholders faced with a partial refusal of the tax office to allow them a deduction of their write-offs of company debt held as business assets.

In the first case, the shareholder had originally granted his company a loan at a market rate of interest. The company fell on difficult times later and the shareholder agreed to reduce the interest to a purely nominal amount until the company had returned to profitability. Profits did not, however, materialise and two years later the shareholder was forced to put part of his claim for repayment of the principal into abeyance in order to prevent insolvency. The tax office agreed that the amount concerned should be regarded as a bad debt, but maintained that this bad debt had been incurred by the shareholder acting for the protection of his investment in the share capital and that the tax deduction for the write-down should be limited to the proportion in which the dividend income from the holding would be charged to income tax (currently 60%). It based this contention on the low interest now being earned on the loan, leaving the dividend expectation as the shareholder's sole remaining hope of earning income at some point in the future. It also pointed out that the loan was effectively a substitute for share capital and had thus been allowed to remain outstanding by the creditor acting as a shareholder.

The Supreme Tax Court found, however, in favour of the taxpayer. A shareholding was a different type of asset than a debt, and the write-off was of a debt. The write-off, as such, did not improve the company's earning capacity and would not therefore lead to improved dividends in the future. As a secondary point, the court pointed out that the provisions in the agreement for returning to the old interest rate, and for restoring the original amount of the principal, once the business had recovered, suggested a continued intention to treat the debt as such and to earn from it interest rather than a dividend. Lastly, the court made the point that a write-back of the loan, should its value improve, would be fully taxable income so it would be inconsistent to allow only a partial deduction of the expense. For the tax office' suggestion – supported by a finance ministry decree – that both income and expense should be taken into account in the "dividend proportion" of 60% there was no basis in law.

In a second case, the court extended the principle to cover the write-off of a recovery claim on the company from having met a guarantee claim as shareholder as well as a provision for the expected cost of meeting a further guarantee. In both cases the court emphasised that its findings applied regardless of whether the transactions had been at arm's length, and regardless of their motivation from shareholder considerations.

Supreme Tax Court judgments X R 7/10 (loan) and X R 5/10 (guarantee) of April 18, 2012 published on July 4

***Place of work must be business facility of employer***

An employee of an engineering company worked on long-term assignment on the premises of a power station customer. He claimed a full business expense deduction for his travelling cost to and from work; the tax office rejected the claim on the grounds that the customer premises had long since become his regular place of work. The Supreme Tax Court has, however, now held that an employee's regular place of work can only be on the business premises of the employer. These business premises do not have to be owned by the employer, although they must be permanently at his disposal. If an employee was merely delegated to a customer for an indefinite period – no matter for how long – his assignment was not a change of employment location. He remained therefore entitled to the full business travel deduction as opposed to the significantly lower employee expense allowance.

Supreme Tax Court judgment VI R 47/11 of June 13, 2012 published on September 26

***Sale of partnership share subject to trade tax if coincidental with merger***

If an unincorporated business sells shares in a company, the gain is subject to trade tax. If a partner sells a partnership share, the gain is not generally taxable as his business capacity ceases with the act of sale. However, one of the exceptions is a provision in the Reconstructions Tax Act charging a gain on the sale of a partnership share to trade tax if realised within five years of an acquisition of company assets. If this provision applies, the gain is chargeable in full, that is, including that part attributable to the original partnership's own assets.

A taxpayer attempted to avoid a trade tax charge on the sale of company assets by agreeing the sale of a partnership share a few days before agreeing to having the partnership absorb its wholly owned GmbH. The tax effective date of both transactions was December 31. However, the date of the contract of sale lay in the previous November and the merger was not registered until the following year. Thus, legally, the sale was before, not after, the merger. The Supreme Tax Court has, however, held that where the two events are to be effective as of the same day, the five year period includes that day. Thus, the taxpayer must now charge the entire gain on the sale of the partnership share to trade tax.

Supreme Tax Court judgment IV R 24/09 of April 26, 2012 published on July 4

### *Recultivation costs not rent for trade tax*

50% of the rent paid for immovable property is seen as a substitute for interest and is thus added to the total interest cost, one-quarter of which is to be disallowed for trade tax. The level of rent disallowance has varied during the course of trade tax history, although the court definition of rent has remained roughly constant at all amounts paid by the tenant to cover costs that tenants typically bear. A tax office used this definition to treat the allocations to the recultivation provision of a quarry as “rent”, its argument being that the operator was required, as was customary, to recultivate the land once the quarry had been exhausted, before returning it to the owner. The Supreme Tax Court has accepted that an allocation to a provision can be treated as an actual expense, but has refused to follow the tax office’ view of recultivation costs as “rent”. Its argument was that the recultivation obligation is a public duty resting on both the quarry operator and the owner of the land. If landlord and tenant are equally responsible in their different capacities, one cannot conclude that the tenant bore the cost on behalf of the landlord. If he bore the cost in discharge of his own obligation, the expense was not “rent”. This still applied if his discharge of his obligation also relieved the landlord.

Supreme Tax Court case reference IV R 54/09, judgment of June 21, 2012 published on July 18

### *Factoring is not a loan*

A factoring house purchased invoices from doctors at their face value less its fees. These were established in the contract as a factoring fee, a service charge and an interest charge. The latter was set at 1% of the invoice face value, calculated on an annual interest rate of 8% applied to an average patient payment delay of 45 days. The three fee elements were openly shown on the invoices and the factor claimed that at least the interest charge should be free of VAT as a charge for granting a loan.

The Supreme Tax Court has now held that the factoring house performed a single, fully taxable service. Essentially, it assumed the doctors’ bad debt risks and released them from the burden of debt collection. This was a business activity chargeable to VAT at the standard rate. That the doctors received payment sooner than had they waited for the patients to remit, was a necessary consequence of the factoring arrangement as agreed and did not warrant separate treatment of the interest item, even if shown separately on the invoice and precisely identifiable from the contract. A loan had not been agreed and the apparent interest charge did not change the nature of the arrangement to that of a credit.

Supreme Tax Court Judgment XI R 28/10 of May 15, 2012 published on August 22

### *VAT on travel agency discount*

A travel agency sold package tours, hotel accommodation, transport and other tourist services to the public in return for a commission paid by the providers. It offered customers a share in its commission – as a discount off the end price payable – as an inducement to ignore competitors, and claimed the discount allowed as a reduction of its taxable turnover, that is, of its commission received. The tax office only allowed the claim to the extent the corresponding turnover of the tour operators and other service providers was subject to German VAT. The Supreme Tax Court has asked the ECJ to rule on the matter from the point of view of the Sixth (now, the VAT) Directive in the light of its judgment of October 24, 1996 on case C-317/94 *Elida Gibbs*, called upon by both parties in the present case as supporting their respective points of view.

In *Elida Gibbs*, the ECJ held that a manufacturer reduced its taxable turnover with the discounts given to consumers purchasing its products and claimed with cut-out coupons and similar vouchers distributed to the public in magazine advertisements, bulk mailings and other forms of unspecified address. This applied regardless of the actual mechanism of the discount grant – directly through the retailer on presentation of a coupon by the consumer at the time of purchase, or in the form of a subsequent refund to the customer on submission of a coupon together with proof of purchase. Since in either case the discount was ultimately borne by the manufacturer, allowing him to deducted it from his turnover preserved the neutrality of the system by ensuring that the net tax ultimately collected is the same as that paid by the consumer. This is the point made by the travel agency in the present case.

The contrasting point of view proposed by the tax office sees *Elida Gibbs* as a transaction chain of items taxed at the same rate. The travel agency, however, taxes its turnover (commission received) at the standard rate as a German service, whereas the providers fall under different schemes depending upon their status as German or foreign tour operators (margin scheme) or as service providers direct (hotels and transport). The neutrality of the system would, in the view of the tax office only be preserved if the taxable turnover of the travel agency were to be reduced by the discount in the proportion to which the underlying turnover is, itself taxable.

The Supreme Tax Court has not voiced its own view, but has offered the variation that *Elida Gibbs* might not applicable to a travel agent at all in view of the margin scheme applicable to its suppliers. In that case, the agency in question would have no claim to reduction of its taxable turnover from its discounts granted, regardless of the services it sold.

Supreme Tax Court decision V R 18/11 of April 26, 2012 published on June 27

### *Aviation spirit not duty-free*

A computer company used its own aircraft to fly the managing director on visits to trade fairs and important customers. It claimed a refund of the fuel oil duty on the aviation spirit used on these business flights; however the customs office refused because the company was not registered as an airline and the duty exemption was only available to airlines when flying fare-paying passengers or freight. The company appealed with the claim that the German provision of national law was an incorrect transposition of the EU directive on excise duties which called for duty exemption for the fuel used on all flights with an immediate business purpose.

The Supreme Tax Court has now rejected the taxpayer's claim for two reasons. Firstly, the directive allows member states to restrict the exemption to kerosene (jet fuel) as opposed to the high octane aviation spirit needed for piston engine aircraft. Thus, the company could not claim a direct entitlement under the directive. The second reason came from the ECJ, to which the court had turned for a preliminary ruling. According to the ECJ, the duty exemption was not restricted to registered airlines as such, but was restricted to commercial flights. A commercial flight in this sense was a flight flown to earn income directly, as opposed to a flight with a business purpose, such as to a customer meeting, that would only indirectly lead to earning income, e.g. through the fulfilment of customer orders obtained at the meeting.

Supreme Tax Court judgment VII R 9/09 of February 28, 2012, published on July 18, and ECJ case C-79/10 *Helmholz* judgment of December 1, 2011

### *Inheritance tax liability unaffected by foreign legal basis for the transfer*

A German couple resident in France held property and business assets in Germany. They agreed by contract under French law that their entire assets should fall to the survivor on death of the first spouse. This type of contract excludes all claims from children or other relatives to shares in the estate and exempts the transfer from inheritance tax. As a legal instrument, it has no exact parallel in German law. In the event, the contract was implemented on death of the wife, and the widower as heir to her half of the estate claimed that the transfer of the German assets should be exempt from inheritance tax in Germany as the type of transfer was not mentioned in the Inheritance and Gift Tax Act. The tax office rejected this argument.

The Supreme Tax Court has now confirmed the tax office in its position. The French contract had to be seen in Germany in the light of its legal and actual consequences. In this case the result was a change from joint to sole ownership of the estate on death of a spouse. This was equivalent to a transfer of the ownership in one half of the estate. The transfer was thus chargeable to German inheritance tax insofar as the assets were regarded as domestic under the Inheritance and Gift Tax Act. The French exemption of the transfer was irrelevant to the German liability on the transfer of German assets. There was also no infringement of the parties' freedom of capital movement, especially as no double taxation arose. The same charge would have been incurred on the same transfer between two German residents.

Supreme Tax Court judgment II R 38/10 of July 4, 2012 published on September 12

# From Europe

### *Freedom of establishment can override free movement of capital*

A German resident deceased left his German resident daughter the sole shareholding in a Canadian company. Had the company been established in a member state, the daughter would have been entitled to an Inheritance Tax Act provision now allowing a full waiver of the inheritance tax on the shareholding if the total wages paid during the next five years were at least 400% of the amount paid during the same period immediately prior to the date of death. The purpose of this relief was to encourage business continuity within the same family with the ultimate intention of preserving jobs.

Two fundamental freedoms were potentially involved. The first, the freedom of establishment, was directed at investments intended to assure the holder of an influence on the management of the company. Under German law this level could be taken at over 25% as such an investment would be sufficient for the holder to block a major resolution on future company development. This contrasted with the portfolio holding seen as a pure investment in the hope of dividend or capital gain income. Passive investments of this nature fell under the freedom of capital movement. The freedom of establishment ends at the community border, whereas the freedom of capital movement for EU citizens applies worldwide. Thus, in the case at issue, the daughter could base a claim on an infringement of the freedom of capital movement, but not of the freedom of establishment. The ECJ distinguished between the two freedoms according to the intention of the legislation. In this case, the German rule was clearly aimed at management influence. Thus, the freedom of establishment predominated. This freedom did not, however, extend to investments in Canada. A 100% shareholding entitled the holder to significant management influence. It therefore fell by its nature under the freedom of establishment. However, that freedom did not apply and that its breach necessarily led to a breach of the freedom of capital movement did not entitle the court to review the case in the light of that freedom alone.

The ECJ case reference is C-31/11 *Scheunemann*, judgment of July 19, 2012.

### *Corporate exit tax hinders freedom of establishment*

Portugal levies an exit tax on companies wishing to move their corporate residence from Portugal either by change of registered office or by change of place of management by adding the unrealised gain inherent in their net assets to taxable income in the final year of Portuguese tax residence. Effectively, the final year's taxable income is based on a valuation of assets at market values. The same applies to a permanent establishment of a foreign entity migrating from Portugal to another country.

The ECJ has now passed judgment on a complaint by the European Commission that these provisions are a hindrance on the freedom of establishment of Portuguese and other EU companies with Portuguese business interests. Their application to the closure of a business operation is acceptable, as the same consequence would be felt by a Portuguese company closing down its local branch or ceasing business operations altogether. However a company moving its registered office, place of management or business operation within Portugal would not face tax consequences, whereas a move abroad would trigger immediate taxation from the full release of all hidden reserves to taxable income. The object of this taxation, the need to ensure ultimate Portuguese taxation of all gains earned in Portugal, is legitimate, but the method used to achieve it goes beyond what is necessary. Allowing taxpayers to defer the taxation at an interest rate in accordance with national law would constitute, so the court, a measure less harmful than the present method.

The ECJ case reference is C-38/10 *Commission v Portugal*, judgment of September 6, 2012.

### *No refusal of Eighth Directive refund to businesses without local turnover*

A German motor vehicle manufacturer made frequent use of facilities in northern Sweden for testing its cars under extreme winter conditions. It flew the necessary technical staff and equipment in from Germany, but purchased various support services as needed from its Swedish subsidiary. The testing facility had no other purpose; in particular, it made no sales of its own and its entire costs were borne by the German head office as incurred.

A Danish manufacturer maintained a research station in Sweden. It also held a Swedish subsidiary, the main purpose of which had become the provision of support services to the research station. As in the German case, the research station had no other purpose, was not involved in selling and saw its entire costs borne by the Danish head office as incurred.

Both companies applied for VAT refunds in Sweden under the then valid Eighth Directive rules for businesses established in other member states. The Swedish tax board refused both applications on the grounds that both companies maintained a fixed place of business in Sweden, through which they were able to make sales of their products. The fact that neither had done so was irrelevant. Each Swedish establishment was also dependent on its group subsidiary in Sweden, another reason for seeing a close link from the establishment to taxable turnover.

The ECJ has now held that that the Eighth (and now the VAT) Directive excludes a non-resident business from a local VAT refund if it carries out taxable transactions in the country concerned. However, refund is not excluded by the mere fact that such taxable turnover could have been achieved had there been any attempt to do so. Also, the existence of a group subsidiary in the same country as the establishment did not taint the subsidiary's sales as those of the establishment, and did not taint the establishment's costs as those of the subsidiary. Accordingly, the head office of the Swedish establishment in both cases was entitled to VAT refund under the rules for business undertakings established in other member states.

The ECJ case references are C-318/11 *Daimler* (the German case) and C-319/11 *Widex* (the Danish case), joint judgment of October 25, 2012.

### *June 30 deadline for VAT refund claims upheld*

A Dutch company claimed refund of its Italian VAT in July of the following year. The Italian authorities refused because the June 30 deadline of Italian law and the Eighth Directive had been missed. The company responded with a submission that the Eighth Directive was indicative, rather than mandatory, and that its refund claim should at least be reviewed for justification in substance.

The ECJ has now held that the Eighth Directive (now the VAT Directive) June 30 deadline for filing VAT refund claims by foreign businesses is exclusive. If it is not met, the right to file is lost. The court accepted that the binding nature of the deadline was not clear from the Italian or English texts of the directive, but pointed out that the Dutch, German and French texts were absolutely unambiguous. It then held that EU legislation must be interpreted in like manner throughout the EU regardless of differences in wording between the various languages. In this case, the intent to fix a deadline was clear, both in the interests of legal certainty, and from the harmonisation point of view of establishing a common time limit for all EU business operators.

The ECJ case reference is C-294/11 *Elsacom*, judgment of June 21, 2012.

### *VAT ID No. of customer not indispensable for exempt intra-community supply*

A German company sold machinery to a US company for delivery to an address in Finland. The US buyer did not provide its own VAT ID (registration) No., although it did furnish the number of the Finnish purchaser. Initially, the goods were retained in Germany; they were then collected by a carrier appointed by the US buyer and taken to the ultimate customer in Finland. The tax office refused the VAT exemption on the intra-community supply on the grounds that the customer VAT ID No. recorded by the supplier was not the number of the immediate customer.

The ECJ has held that the lack of the appropriate VAT ID No. is not a decisive criterion for the refusal of tax exemption where there is no question of bad faith. This presupposes that the supplier took all reasonable, albeit unsuccessful steps to obtain the number from his customer and is, on the basis of other evidence, able to demonstrate that the recipient of the goods was a taxable person acting as such.

The ECJ case reference is C-587/10 *VSTR*, judgment of September 27, 2012.

### *Portfolio management services not exempt as banking*

A bank offered a portfolio management service to (mainly) its private customers. Each customer deposited an agreed amount, which the bank then invested at its discretion. It also sold or replaced investments on its own initiative. In doing so, it followed agreed policy guidelines, but did not refer back to the customer on specific transactions. Its fee was a fixed percentage of the total value of the customer's fund, split into two elements, asset management and dealing. It maintained that its charges were free of VAT as banking or investment dealing; the tax office saw the advisory or decision-taking aspects as predominate and the service as a whole therefore as taxable in Germany.

The ECJ has now held the service to be a single supply consisting of two elements, both of which carry equal weight. The two elements are dealing in securities and monitoring the market in order to come to an investment decision. Dealing would, on its own, be exempt whereas monitoring would be taxable as a general service. Since both are equally important to the single service as perceived by the customer, and given the need to keep exemptions to those clearly specified as such in the VAT Directive, the single supply is not exempt. It is, however, a financial service under the wider definition relevant to the place of performance and is therefore deemed to be performed in the country of residence of the non-EU private customer.

The ECJ case reference is C-44/11 *Deutsche Bank*, judgment of July 19, 2012.

### *Building work as a service?*

A German property developer reverse charged an invoice from a building company for the construction of housing. This position was based on German law which treats building work as a delivery of goods if the builder works with his own materials. Later, the property developer's management changed its mind and decided, on the basis of its own interpretation of the Sixth Directive, to regard the building work as a service not open to the reverse charge mechanism. It requested a refund from the tax office on the basis of this decision. The tax office refused this request.

The ECJ advocate general on the case has suggested the court hold that building work is generally a service. It might, in specific cases be a delivery of goods; however, such a conclusion can only be reached on the basis of full consideration of all the circumstances, and can never be dependent upon a single factor taken in isolation. Thus the German legal provision can, as such, in the view of the advocate general, no longer be applied.

The ECJ case reference is C-395/11 *BLV*, opinion of September 12, 2012.

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## 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

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