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PwC Reports

Legislative action delayed further

Following the abandonment of the Annual Tax Bill 2012 after an irreconcilable dispute between the *Bundestag* and *Bundesrat*, the government is at pains to salvage at least the supposedly non-controversial items. Its current proposal – a bill to transpose the amendments to the EU Mutual Assistance Directive – is, as such, not in dispute, but has nonetheless been forwarded to a reconciliation committee between the CDU-led *Bundestag* and the left-wing dominated *Bundesrat*. The committee's decision has now been postponed until June 5.

The *Bundestag* has also passed a bill with two other items from the Annual Tax Bill, reduction of the retention period for most business documents from ten to ultimately seven years and to curb a conceived inheritance tax abuse of converting privately held cash to a business asset by depositing it in a special purpose GmbH shortly before death.

Official Pronouncements

Treaty policy

The finance ministry has published its model double tax treaty serving as a guideline to negotiators. This guideline follows the OECD model treaty in form and – largely – content, although it contains a few additional provisions to take account of recent statutory developments, particularly in respect of securing tax revenue through curbing avoidance and evasion. Specific points worthy of note are:

- A building or assembly site is a permanent establishment if it lasts for longer than 12 months.
- The business profits clause follows the "authorised OECD approach" of attributing profits to a permanent establishment as though they had been earned through a separate entity. If there is a subsequent income adjustment that the other state does not wish to follow, the two competent authorities are expected to strive for a uniform approach to ensure that the full profit is taxed only once.
- The related-parties (associated enterprises) clause also calls for direct negotiations between the two competent authorities if a proposed income adjustment seems likely to lead to double taxation through taxing the same profit in the hands of two different taxpayers.
- The dividend withholding tax on distributions to a corporation with at least 10% of the share capital is set at 5%. However a footnote suggests that a zero rate could be acceptable in justified circumstances. The withholding tax on all other dividends is given as 15%.
- There are no withholding taxes on interest or royalties.
- A capital gain on the sale of shares in a company owning property in the other state is taxable there if that property accounts for more than 50% of

the value of the shares.

- If a natural person moves to the other state after having been resident for at least five years, the first state may tax a deemed sale of shares at market value on the date of the move. If the first state takes advantage of this opportunity, the second state must accept the deemed sale value as the base cost of the shares in the event of a future disposal.
- The dependent personal services (employment income) clause provides that contributions to a recognised pension fund or similar in the other state rank for the same tax privileges that would follow from similar contributions in the employee's state of residence, provided that he only became resident at the start of his employment and contributions had already been made under the same plan.
- Old-age (retirement) pensions are taxable in the country of residence unless paid by the state social security body, or unless they were funded from contributions tax-privileged in the country of source for longer than 15 years. If either of these two exceptions applies, both countries are entitled to tax – the country of residence granting a credit for the tax charged in the country of source.
- Double taxation of business profits, dividends in the hands of companies holding at least 10% of the share capital, and employment income is avoided by exemption in the country of residence. However, the exempt income will be taken into account in setting the rate to be applied to the remaining, taxable income. Double taxation on other forms of income is avoided in the country of residence by crediting the tax borne in the country of source. There is a "switch-over" clause substituting the credit for the exemption where a qualification conflict (difference in income definition) leads to non- or partial taxation in the country of source, or where the country of source does not – for any reason – exercise its right to taxation (note: an explicit statutory exemption is not an "exercise" of a taxing right).
- Either country may switch from the exemption to the credit method of avoiding double taxation on specific forms or sources of income by notification to the treaty partner. This switch is effective from the following 1st January.
- Extensive clauses govern mutual agreement and arbitration proceedings, information exchange and mutual assistance between the authorities of the two states. The mutual assistance provision applies to all taxes, not just to the income and capital tax subjects of the treaty.

This negotiating model does not, of itself, have legal force. However, it is a clear statement of German objectives and hence of treaty policy.

Taxpayers may delay new valuation rules for finished goods

Under an, as yet, unpublished, amendment to the official Income Tax Guidelines, manufacturers must include general administrative overhead, staff welfare and pension costs in their definition of manufacturing costs used as the basis for valuing products held on stock or as fixed assets. The finance ministry has issued a decree allowing taxpayers to continue to follow the old rules until the costs of complying with the new valuation standard have been "verified". This licence expires at the latest on revision of the Income Tax Guidelines.

Supreme Tax Court ruling on option premium applies to hedges only

In September 2012, the Supreme Tax Court held that the premium on an option taken out as a hedge to protect a foreign currency balance should be expensed once the decision was taken not to exercise the option in order to avoid realising a loss that would neutralise the gain from the hedged transaction. The finance ministry has now issued a decree to the effect that this judgment is to be followed in respect of forward contracts taken out as hedges, but not of those taken out as speculations. Speculative transactions lead to a gain or loss on their closure, or when they lapse without exercise at the end of their term.

Income tax of foreign artists

Foreign artists visiting Germany as employees for brief periods may opt for flat rate taxation under a simplification provision. The flat rate applies to their entire earnings in this capacity, regardless of designation. Deductions for personal or business expenses are not allowed. From July 1, 2013, the basic rate is to be 20% (reduced from 25%). If the employer bears the solidarity surcharge (5.5% of the income tax charge) the income tax rate is 20.22%. If the employer bears both the income tax itself and the solidarity surcharge, the rate rises to 25.35%.

Please note: artists visiting from an EU/EEA country may find it in their interests to opt for taxation under the normal rules for non-resident taxpayers with employment income as they would then be able to deduct the relevant business, and possibly some personal, expenses.

Payment of specific car costs does not reduce benefit in kind

There are two alternative ways of calculating an employee's benefit from his or her private use of a company car. These are the "1% rule" (1% p.m. of the list price of the car for the private use plus 0.03% p.m. per km distance between home and work for driving to work, if applicable) or taxing the portion of the actual running cost of the car attributable to its private use. This proportion is to be established from a mileage log. Under either alternative, the benefit charged to tax is the gross benefit as calculated less any amounts paid by the employee towards the car's running cost.

The finance ministry has now issued a decree to the effect that to qualify for benefit reduction, the employee's contribution must have been formally agreed (e.g. by contract, union or shop agreement) and must be a fixed amount or based on usage. The fixed amount is typically expressed as so much per month; the usage contribution can be a fixed amount per kilometre driven. The amounts as set are not open to dispute. However, they cannot be set on the basis of specific running expenses. Thus an agreement that the employee pay for "his" share of the petrol (gasoline) cost of the car does not reduce the benefit in kind, whilst an agreement setting the private use contribution at 0.01%per km driven privately (and/or to work), or at, say, €200 per month, does. The new rule distinguishing between lump sum and specific cost reimbursement applies to all open cases; the requirement for a formal agreement applies as of July 1, 2013.

Meals – sale of foodstuffs or a restaurant service?

2011 saw a series of ECJ and Supreme Tax Court cases on the VAT distinction between the reduced-rate sale of foodstuffs and the standard rate provision of restaurant services when supplying meals in a ready-to-eat condition. The finance ministry has now summarised this new case law in an update to its VAT Implementation Decree. In general terms, the distinction depends on whether the service element or the delivery element of the supply predominates. However, the position is complicated by the fact that the sale of a hot meal in a holder to keep it warm is a delivery of food, the efforts to cook it being part of the production process, rather than a service to the consumer. Also, services may be available to the customers of a snack bar but supplied to them in a different capacity, cinema seating and cloakrooms being cases in point. The ministry emphasises that each case must be judged on its own merits, taking due account of all the circumstances, although it illustrates its decree with 16 specific examples. However, it starts with the more general point that services necessary to market the goods – display, preparation, the provision of cutlery, serviettes and condiments, litter bins, a bar where items can be consumed standing, a description of the wares on offer and a cash collection service for school meals – are not restaurant services rendering the transaction taxable at the full rate. Restaurant services, by contrast, are the provision of seating and tables in a room, serving the meals and drinks and washing up afterwards, hiring cutlery, crockery and furniture, individual advice in choosing meals and drinks and menu consultancy to customers wishing to arrange a function at home. However, the mere existence of a restaurant service in the total package does not mean that that service necessarily predominates. This depends on the overall nature of the transaction. That view is not dependent on the complexity of the meal or on the quality of the service provided – a beer tent with fold-away tables and benches is a service in the same way that a restaurant is.

The ministry's examples of borderline cases are:

- A stand selling hot sausages and chips (French fries) on plates, offering customers condiments and a bar to lean on while eating, supplies food at reduced rate VAT. However any seating facilities change the supply to a service.
- School caterers who clear up afterwards provide a service. However, if they sell food in bulk to, say, a parents' club that serves the meals to the children, they sell food. The club provides a service, but may be entitled

to reduced-rate VAT if it qualifies as a non-profit organisation working for the public good.

- If the same school caterer delivers the meals frozen and loans the fridge and the re-heater so that the meals can be served hot when needed, it sells food. Keeping it cool and then warming it up is an ancillary service.
- Hospital caterers that cook the food in the hospital for distribution by the hospital staff to the patients sell food. If a third party does the washing-up, the caterer still sells food, unless the third party is his sub-contractor.
- A butcher delivers a hot and cold buffet on plates and in warm hold-alls. He collects the plates and hold-alls the next day. The transaction is the sale of food, since the plates and hold-alls were mere containers. Loan of crockery and/or cutlery with the food changes the supply to a service. It is also a service if the supplier sets up the buffet after delivery in the customer's home or if he is required to clear up litter after the event. However, if the customer does the clearing up, the delivery is a sale of food.
- A "meals on wheels" service delivering hot meals on dishes under warm covers which it then collects for washing and re-use sells food. This also applies if the customer's carer does the washing-up.
- A series of shops joined in a "food court" with a communally used space with tables and chairs where customers can sit and enjoy their purchases sells items sold for local consumption as a service. Take-away sales are the supply of food.

Supreme Tax Court Cases

Old corporation tax rate on German branch income of non-EU companies confirmed

Up to 2000, corporation tax was levied on a split-rate imputation system. Initially profits were taxed at 40% (in 1999 and 2000), but this burden was subsequently reduced to 30% when the after-tax profits were distributed as dividends. Because a permanent establishment cannot declare a dividend, its profits were taxed at a single rate of, in 1999 and 2000, 40%. The PE rate in earlier years was always higher than the distribution rate, but lower than the initial, retained earnings rate. In 2006, the ECJ held that these rates discriminated against foreign companies and that charging corporation tax at anything more than the distribution rate constituted an unacceptable restriction on the freedom of a foreign company to establish itself in Germany (C-253/03 *CLT-UFA*, judgment of February 23, 2006). However, this judgment only applies to branches of companies resident in other member states, given that the freedom of establishment concept only applies within the territory of the EU/EEA. A Hungarian company (Hungary was then an EU candidate country, rather than a full member state) has challenged this restriction on the grounds that it conflicts with the then valid association agreement between Hungary and the EU and with the prohibition on discrimination in the double tax treaty. The Supreme Tax Court has now rejected both arguments.

The *CLT-UFA* judgment on its own terms only applied within the EU/EEA, that is, to the income earned by the German branches of companies resident in other member states. The association agreement did not extend this application to associated and candidate countries as it only required both sides to work towards the integration and harmonisation prerequisites of full membership. It did not require immediate application of community law in the associated country unless specifically agreed. The non-discrimination clause in the double tax treaty only required that the permanent establishment income of an entity from the foreign state not be taxed at more than the equivalent income earned by a comparable domestic entity. This condition was at all times met, since the German branch rate of corporation tax was never higher than the rate charged on the earnings of a domestic corporation. The subsequent reduction to the distribution rate was not available to a branch, but this was not discriminatory as a branch could not declare a dividend. Rather, that was the prerogative of the foreign corporation and thus not a German event. Basing the rate comparison on the distribution rate as in *CLT-UFA* mixed the concept of earning income with that of its distribution and was not foreseen by the double tax treaty which accepted that different legal forms could have different tax consequences.

Supreme Tax Court judgment I R 73/11 of December 19, 2012 published on March 20, 2013

Taxable income must take all subsequent events into account

A mobile telephone company distributed mobile phones below cost as an inducement to the recipient to sign a two-year service contract. It took the apparent loss on sale to immediate expense. At the time, this could be considered an acceptable accounting treatment, though largely because of the lack of relevant case law guidance. In the meantime, the legal position has been clarified and it is now generally accepted that the company should have deferred the expense over the fixed term of the contracts. The tax office assessed the company to corporation tax on the basis of income increased by the expense deferral, but the company objected on the basis that the financial statements were tenable from the point of view of commercial prudence at the time they were drawn up. At that time they reflected the current state of the law as well as all known facts and were therefore "subjectively correct". The tax office could not insist on an adjustment in the light of later court rulings or other revelations. This view had some support in earlier case law of the Supreme Tax Court, although the "senate" (chamber) trying the case did not wish to accept it without reservation. Accordingly, it laid the matter before the Grand Senate, a panel of one judge from each chamber charged with ensuring ruling consistency between the 11 chambers of the court.

The Grand Senate has now held that tax offices are bound to assess on the basis of all facts and circumstances known when the assessment is raised. This follows from the legal requirement that an assessment be "objectively correct". Taxable income as originally computed must thus be amended in the light of all matters coming to light afterwards, including changes in legal precedents or the tax authorities' view of the law. Thus it is not open to taxpayers to argue that the financial statements were drawn up to the best of their knowledge and belief at the time, in the face of events occurring later.

It is worth noting that although this decision contradicts the position taken by the taxpayer in the given instance, it does not necessarily go to the disadvantage of taxpayers generally. This is shown by the unsuccessful plea by the finance ministry for a generous transition period, should the Grand Senate hold in favour of the tax office and thus open the way to taxpayers to claim upward adjustment of their accruals on tax audit in the light of the firmer evidence now available on the true extent of the cost. On the other hand, the court explicitly reserved its judgment on provisions based on forecast or estimate.

Supreme Tax Court – Grand Senate – judgment GrS 1/10 of January 31, 2013 published on March 27

Acquired pension provision to be carried at consideration received

A company acquired a business with pension obligations towards its employees. These along with all other assets and liabilities were valued at their fair market value in the acquisition balance sheet on which the contract was based. The tax office accepted this valuation for the date of acquisition only, but insisted that the company reduce the provision to the lower amount called for under the tax rules in the next annual balance sheet. This resulted in a partial release to income to which the company objected.

The Supreme Tax Court has now sided with the company. The tax office argued that the pension provision valuation rules were based on an explicit provision in the Income Tax Act and thus took precedence over the more general rules requiring assets and liabilities to be taken up at cost. The court, though, rejected this argument on the grounds that the provision had been "acquired" in that it had been taken into consideration in setting the overall price for the total acquisition. As an acquired liability, it could not be shown below "cost" unless its value had diminished through payment. This followed from the principle that an acquisition could not, of itself, generate a profit or loss. On the other hand, annual increments were new liabilities arising in the current year and should be accrued on the rules specific to pension obligations. Each obligation – each beneficiary – should be calculated individually. The court also pointed out that this judgment is consistent with its law on other accruals subject to special rules designed to limit or defer tax recognition of the expense.

The Supreme Tax Court decided in the same vein in a second case on the same day, this time involving pension obligations transferred as part of a piece-meal assets transfer not falling under the Reconstructions Tax Act. In this case, the assets were regarded as a contribution in kind to share capital and the liabilities were treated as part-payments. Here, too, the same principle applied, that the acquisition of an asset (assumption of a liability) could not, of itself, lead to a profit or loss; thus the pension liability must be taken up at its contractual value and this value must be retained until the liability is paid.

Supreme Tax Court judgments I R 69/11 and 72/11 of December 12, 2012 published on March 20, 2013

Costs of aborted acquisition immediately deductible

After extensive negotiations a company reached provisional agreement with the sellers to acquire a subsidiary. This agreement was documented in a letter of intent expressly subject to the results of a due diligence review. In the event, these results were unsatisfactory and the deal came to nought. The company wrote off the cost of the accountants' fees for the review to current business expense. The tax office accepted one-half of the amount as general business consultancy and/or strategic planning, but insisted that the other half be notionally capitalised as cost of acquisition and then written off as a failed investment. This write-off was not deductible for tax under the rule exempting dividends and capital gains on the sale of shares from corporation tax in the hands of another corporation.

The Supreme Tax Court explicitly declined to rule on the basic question as to whether due diligence costs were to be capitalised as a direct cost of acquiring the new investment. Rather, it took the view that such costs could not be capitalised if the acquisition was never completed. The potential acquirer had held at no time any form of ownership rights in the target company and therefore had never held an asset. Its costs incurred in the course of an unsuccessful attempt to acquire the asset were therefore current business expense and, as such, immediately deductible. The court went on to explain that this was in conformity with the spirit and purpose of the statute, to disallow the costs of earning tax-free dividend income. If the acquisition was not completed, there was at no time any prospect of earning a tax-free dividend, and thus no reason to see abuse in the costs incurred in that regard in vain.

Supreme Tax Court judgment I R 72/11 of January 9, 2013 published on March 20

Asset transfer costs from sidestream and downstream mergers not deductible

The Reconstructions Tax Act explicitly excludes merger profits and losses from taxation. Merger profits and losses are defined as the difference between the transfer value of the assets transferred and the book value of the shares cancelled, less the direct expenses incurred in completing the transaction. Many commentators take the view that this explicit link to the shares cancelled implies that the exclusion does not apply where there are no shares to be cancelled. Differences between the transfer values of assets and the nominal value of new shares issued should be taken to capital reserve as those arising from any other capital contribution in kind. The direct costs of the transfer are deductible as general business expenses for want of a specific disallowance. Thus the costs of completing a sidestream merger (the assumption of assets from a fellow subsidiary in exchange for new shares issued to the common shareholder) or a downstream merger (the transfer of a business segment to a subsidiary in exchange for new shares in that subsidiary) as opposed to those of an upstream merger (the transfer of assets to the parent and the cancellation of the shares issued by the company) are deductible.

The Supreme Tax Court has now rejected this view. The case involved a sidestream merger, but the ruling applies equally to a downstream merger or dropdown. The court found that the context and object of the disallowance provision in the act made clear that it should apply to all share transfers governed by the act, even if the no shares are cancelled. Thus the costs of completing the asset transfer are disallowable regardless of whether shares are issued or cancelled.

Supreme Tax Court judgment I R 24/12 of January 9, 2013 published on March 20

First €1 m full loss offset for each period of assessment

The “minimum taxation” rules provide that only the first €1 m of taxable income may be set off in full against losses brought forward. Thereafter, the loss offset is reduced to 60% of taxable income, thus ensuring a “minimum taxation” on 40% of income over €1 m. The statute bases the calculations on the period of assessment, rather than on a business, calendar or tax year. Thus the full offset is only granted once, even if the period of assessment covers more than one year.

The Supreme Tax Court has confirmed this conclusion in a case brought on behalf of a company in liquidation making a profit in at least some of the liquidation years. In contrast to the normal period of assessment – the calendar year, the assessment to be based on the results of all business years ending in that period – the period of assessment for a company in liquidation is the full liquidation period, running from the year the resolution took effect to the final winding-up of the estate. However, the liquidation period is not generally to be longer than three years – as stated in the Corporation Tax Act – and this usually prompts tax offices to issue interim assessments at three yearly intervals during a longer lasting liquidation period. The liquidator of a company in this position applied to the court for a full loss offset of the first €3 m for the first three years of the liquidation period on the grounds that his company was at an unfair disadvantage compared with companies with annual assessments. However, the court rejected the claim on the basis of the clear wording of the statute. It also pointed out, though, that the company was not necessarily at a disadvantage over other taxpayers. Ultimately, the entire period of liquidation was subject to a single assessment, the interim assessments being subsequently embodied into the single final assessment for the whole period. That meant that gains and losses within the liquidation period were automatically netted before the minimum taxation rule could be applied to the losses brought forward from the period of active trading.

Supreme Tax Court judgment I R 35/12 of January 23, 2013, published on March 27

No gifts between company and its shareholders

The taxpayer, a natural person, ultimately held the controlling interest in a group of companies. One of the subsidiaries supported another in financial difficulties with a loan. Later, the creditor was forced to subordinate the debt in order to save the debtor from bankruptcy. The taxpayer then acquired both the shares in the debtor and the subordinated loan for a nominal price of 1 euro. Four years on, the fortunes of the debtor improved and the loan repayment obligation revived under a clause in the subordination agreement. The tax office saw the repayments as gifts by the original loan creditor to its ultimate shareholder and raised an assessment to gift tax. The shareholder contested this assessment before the courts.

The Supreme Tax Court has rejected the assessment, unusually, for two entirely different reasons. The first was a matter of fact: the gift tax value of a transfer was the market value of the object when transferred and nothing had been raised during the case to suggest that the subordinated loan had been anything other than worthless when the taxpayer took it over. Subsequent developments had occurred after the taxpayer had become the sole immediate shareholder of the debtor and were thus for his account. On this basis there had been no gift.

The Supreme Tax Court then went on to rule against the tax office on the point of law that there can never be gifts between a company and its shareholders. Rather, the possible relationships can only be commercial governed by contract, or on the basis of the shareholdings governed by company law. A company can benefit its shareholders with an openly declared or hidden distribution, or with a capital repayment, but never with a gift. Distributions are chargeable to income tax as investment income, but not to gift tax. This applies, too, when the distribution is not evenly spread between the shareholders, such as in the present case where any hidden benefit from the transaction would have fallen entirely to the shareholder acquiring the loan. The court also made the point that it would be illogical to subject a hidden distribution to gift tax whilst taxing an openly declared dividend as investment income.

Supreme Tax Court judgment II R 6/12 of January 30, 2013 published on March 26

Bank officer not liable for probable evasion by customers

The head of the customer securities administration of a major bank set up a system allowing customers to transfer their investments to the bank's subsidiaries in Switzerland and Luxembourg. The transfers were identified by code number or password, thus the owner of the investment could not be identified in Switzerland and Luxembourg. Identification after the event was not always possible in Germany either, as the tax investigators found out, following a raid on the bank's premises after their suspicions had been aroused. Ultimately, they were able to identify about 75% of all transferors. Of these, almost none had declared income from the investments transferred, although in about 6% of those cases, the failure to declare had not led to a loss of tax revenue. The tax investigators estimated the total probable evasion by the remaining unidentified 25% of the transferors on the basis of (conservative) extrapolations from the retrospective assessments on the persons indentified, and claimed the amount – together with evasion interest – from the officer as an accessory to the evasion. The local court dismissed this claim on the grounds that evasion had not been proven and the Supreme Tax Court has now upheld this judgment.

The court took the view that tax evasion was a crime that had to be proven in a specific case. Liability as an accessory was secondary to the liability of the perpetrator and thus depended upon the continued existence of that liability. The court did not absolutely refuse to accept extrapolations as a basis for estimating a total liability for mass evasion, but did say that strict standards of evidence were essential. Whilst almost all of the persons identified had not declared their income, 6% had not evaded their tax burden. The liability of those remaining might have become statute-barred or even been paid in the meantime (note: the court did not mention this, but there has been a generous tax amnesty for evaders of tax on investment income in the interim, which presumably encouraged at least some persons to come forward, if only to be able to repatriate their funds to Germany without fears of further investigation). All told, there was no certainty that a global calculation based on probabilities was sufficient proof of an actual liability. To this the court added the, for some, astonishing, rider that the actions of the plaintiff in making discovery more difficult and in some cases impossible, did not add to his legal liability.

[Note: This case goes back for over 20 years. In the meantime developments in the law on banking, particularly in countering money-laundering, have rendered an exact repetition of this form of aiding and abetting tax evaders impossible. However, the essential point of the case remains: the tax authorities must prove evasion – and not merely its probability – by an unknown party if they wish to make a known accessory financially liable.]

Supreme Tax Court judgment VIII R 22/10 of January 15 published on April 10

No resurrection of statue-barred loss on tax amnesty

Tax assessments generally become statute-barred at the end of the fourth year following the end of the year in which the return was filed. If, however, tax is evaded, the statutory limitation period extends to 10 years. An evader who had consistently failed to declare his investment income took advantage of an amnesty in 2010 to come forward and to declare in retrospect his earnings in 1998-2008. The tax office accepted the amnesty return, but refused to allow a deduction for a previously unreported capital loss in 2003 from the sale of investments. No tax on the loss had been evaded and its recognition for relief was subject to the normal four-year limitation period expiring in 2009.

The Supreme Tax Court has confirmed this view taken by the tax office. At the time capital gains and losses on the sale of investments were not part of investment income. Only the tax on investment income had been evaded and only income of that category was subject to the longer limitation period. The court reached this conclusion from the letter of the law, but also pointed out that it would be unfair to allow an evader relief when an honest taxpayer would be debarred from the same remedy.

Supreme Tax Court judgment IX R 30/12 of November 20, 2012 published on March 27, 2013

Rejection of credit note leads to loss of input tax deduction

A scrap metal merchant agreed with a separator that he would receive a credit note for any valuable metals that could be recovered from his scrap. Under the VAT Act, such a credit note has the effect of an invoice, provided its issue is agreed in advance and unless and until the recipient objects. Relying on this, the separator issued a credit note for the metals recovered and paid the dealer the amount due at the agreed rates together with standard rate VAT. He then deducted the VAT as input tax, the credit note having the quality of an invoice issued by the supplier, the scrap metal merchant. The following day, the merchant faxed the separator a refusal to accept any credit notes as invoices, adding for good measure that the separator should correct his input tax deduction. He sent a copy of this refusal to the tax office, but made no move to repay the VAT received from the separator. The tax office refused to allow the input tax deduction claimed, on the grounds that the separator did not hold a valid invoice or invoice equivalent.

The Supreme Tax Court has now confirmed the tax office in its refusal. The legal position between merchant and separator was irrelevant to the basic requirement that the business claiming an input tax deduction may only do so on the basis of a valid voucher. Thus, the argument that the separator had a valid claim in law on the merchant and could have insisted on an identical invoice for the amount at issue did not alter the fact that the credit note had lost its validity on its rejection by the merchant. What was important was that the rejection was a proven fact, not its justification.

Supreme Tax Court judgment XI R 25/11 of January 23, 2013, published on March 20

Special duty of care on cash sales to businesses in other member states

A motor car dealer sold a Porsche for cash to a business customer in Italy. The customer sent an agent to collect the car and to pay for it in cash. She gave the agent a written authority to act on her behalf and to drive the car to Italy. The agent duly took possession of the car and paid over the agreed sum free of VAT as an intra-community supply. He signed with a signature manifestly different from that on his identity card. On investigation, the tax office refused to accept the VAT exemption, having in the meantime received information from Italy to the effect that the customer was a business in name only.

The Supreme Tax Court has upheld the tax office refusal in principle, whilst giving the German seller the chance to bolster his case with further evidence. It made the point that even in the motor trade where large cash payments are customary (payment in advance or in arrear would expose one of the parties to an unacceptable credit risk) they are still conducive to VAT fraud and thus impose a particular duty of care on the seller accepting them. Any apparent deviation should be followed up conclusively. In this case, an obviously different signature from that shown on the identity document was such a deviation requiring follow up, notwithstanding the plaintiff's claim that a person's signature tends to change over time and that the space for signature on an identity card necessarily means that the signature shown is cramped. The court emphasised that it was insufficient to demonstrate full formal adherence to the documentation requirements if no attempt was made to reconcile discrepancies. An apparently different signature was one example. Others were the absence of an on-going business relationship with the customer (she was otherwise unknown to the supplier and the two had never met personally), the entire contact throughout the deal having been through the agent, the customer appearing only on paper, and apparent discrepancies in the correspondence, such as a foreign business customer sending faxes from a German address.

Supreme Tax Court judgment XI R 17/12 of November 14, 2012 published on April 10, 2013

From Europe

No immediate tax on move to another member state

Spain provides for immediate taxation of the inherent gain (the difference between book and market value) in business assets transferred abroad. The transfer can be direct in the form of a physical movement to an establishment of the taxpayer in the other country, or indirect through a change in the taxpayer's residence. There is no similar charge to taxation in the event of a corresponding move within Spain, and the effect of a change of residence is reduced by an exemption in respect of assets remaining attached to a Spanish permanent establishment. The European Commission sees this distinction between moves within the country and within the EU as discrimination amounting to a restriction on the freedom of establishment brought an infringement case against Spain before the ECJ.

The ECJ has now held in favour of the Commission. Charging an inherent gain to immediate taxation goes beyond what is necessary to protect Spain's legitimate interest in taxing the gain accruing during the Spanish period of residence when ultimately realised. The gain can be established at the time of the move, but settlement of the liability should be deferred until realisation puts the taxpayer in funds to meet it. The court did not accept the Spanish provisions for payment deferral as sufficient protection for the taxpayer, as they were not automatic. It did, however, seek to allay Spanish concerns as to collectability of the debt by pointing to the Mutual Assistance Directive for the Collection of Tax Debts. In taking this position, the court followed its earlier case law, in particular, the *National Grid Indus* judgment of November 29, 2011, case C-371/10.

The ECJ case reference is C-64/11 *Commission v. Spain*, judgment of April 25, 2013.

Interest on tax in breach of community law to run from date of tax payment

Under Romanian law, repayments of taxes wrongly levied bear interest from the receipt of the repayment claim by the tax office. Consequently, no interest is due for the period between the original payment and the taxpayer's request for refund. A Romanian resident is contesting this exclusion on the assertion of a conflict with community law following repayment of a motor vehicle "pollution tax" levied as a registration charge on a second-hand car bought in Germany. She requested repayment a year later on the grounds that the tax was discriminatory insofar as it was only levied on vehicles first registered in Romania on or after July 1, 2008. In the meantime, the ECJ has held this tax to be indeed in breach of community law as a discrimination in favour of older vehicles purchased on the home market (case C-402/09, judgment of November 7, 2011).

The EJC has now held that the refund of a tax collected in breach of community law must hold the aggrieved taxpayer harmless from all damage resulting from the undue charge. This includes not only the amount at issue, but also adequate compensation for deprivation of the use of the funds in the meantime. Accordingly, the interest period must run from the date of the original payment if the taxpayer is to be fully compensated for the loss suffered, that is, for the remedy to be effective.

The ECJ case reference is C-565/11 *Irimie*, judgment of April 18, 2013.

N.b. Whilst there is no similar German tax on motor vehicle registration, the case is relevant in view of the German provision excluding tax payment and refund claims from interest unless specifically provided by statute. Even where there is such a statutory provision, the interest period does not necessarily coincide with the actual period of the outstanding.

Non-business entity may be member of a VAT group

On April 9, the ECJ held in favour of an Irish provision accepting a non-business entity as a VAT group member. The example cited in the judgment was that of a non-managerial holding company that did not pursue an active business of its own. However, it would suffer input tax on its expenses incurred on behalf of the group.

Later that month, the ECJ followed up with a further six judgments in the same vein in favour of member states seen by the Commission as having failed to properly transpose the VAT Directive. The example of a minor subsidiary with only occasional outside turnover as a non-business member of a group was added to that of the holding company, and the advantages of bringing non-business, but controlled, entities into VAT groups in the struggle against evasion and fraud were reiterated.

The Commission took the opportunity to add a further objection to its case against Finland – that Finland restricts her VAT groups to the financial services and insurance industries. This left the Commission arguing both for and against a widely drawn group in the same case. It lost both arguments. It objected to the Finnish restriction to the financial services industry on the assertion of a breach of fiscal neutrality. The ECJ pointed out, though, that fiscal neutrality referred to relationships between competitors, and this was not relevant to the present question of a special rule for a particular industry or activity. The restriction did breach the general principle of equal treatment throughout the business sphere, though that breach could be accepted as the Commission did not refute the assertion that it was justified in the struggle against evasion and fraud.

The ECJ also decided on the same day an earlier case brought against Sweden, this time solely concerned with the Swedish restriction of VAT groups to businesses in financial services and in insurance. As in the Finnish case, it accepted the Swedish contention that the financial supervision to which such businesses were subject offered additional safeguards against evasion and fraud, and found this to be sufficient justification of the unequal treatment experienced by other businesses denied the privilege of forming a VAT group. It reached this finding in the absence of any convincing counter-argument by the Commission.

The ECJ case references are C-480/10 (*Commission v. Sweden*), C-65/11 (*Commission v. Netherlands*), C-74/11 (*Commission v. Finland*), C-86/11 (*Commission v. UK*), C-95/11 (*Commission v. Denmark*) and C-109/11 (*Commission v. Czech Republic*), judgments of April 25, 2013. The previous case was C-85/11 (*Commission v. Ireland*) judgment of April 9.

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Details and a download of the new publication (*Tax strategy and corporate reputation*) can be found here.

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