Important legal changes

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Act Transposing the Mutual Assistance Directive and Amending Tax Provisions Passed

Bundestag and Bundesrat have passed the Act Transposing the Mutual Assistance Directive and Amending Tax Provisions in the text agreed by the resolution committee between the two houses on June 5, 2013. This text goes beyond the original version transposing revisions to the EU Mutual Assistance Directive into national law and to make the necessary adjustments to conform to various ECJ judgments to include much of content of the failed Annual Tax Bill 2013. Unfortunately, the reconciliation committee was unable to agree on a reduction of document retention periods and on a number of other proposed tax changes. It plans to resume its discussions at its next meeting on June 26, 2013.

The amendments now enacted are:

Transposition of EU law: information exchange

The EU Mutual Assistance Directive is incorporated in national law as the EU Official Assistance Act. This has now been brought into line with the amended directive on the mutual cooperation between the tax authorities of member states in the interests of ensuring proper taxation of cross-border transactions. Provision is made for joint or co-ordinated audits and for other standards of co-operation. The amendments reflect the recently tightened OECD standards of transparency and information exchange. All member states are thus now obliged to respond faithfully to information requests from other member states in respect of taxation and tax-penal matters. However, the information exchange is not yet automatic, and random searches are also not allowed. The amended EU Official Assistance Act takes effect as of January 1, 2013.

Income tax

Corresponding treatment for all dividends

The principle of corresponding treatment of shareholders in respect of their receipts of income disallowed as business expenses of the paying company (hidden distributions of profit) has been extended to all forms of dividend and dividend surrogate. Dividends from abroad are therefore no longer partially or wholly exempt if they have been deducted as business expenses of the paying company abroad. This rule is intended to curb the deliberate design of financing instruments to take advantage of qualification conflicts between the tax systems of different states in order to produce “white” income, taxable in neither state. It applies to the tax year 2014 for dividends received by individuals and to dividends received as business income to the first business year stating on or after January 1, 2014.

Tax-free drop-downs

Um die Abgeltungsteuer praktikabel auszugestalten, wird der Anwendungsbereich des § 20 Abs. 4a EStG auf Abspaltungen erweitert. Hintergrund: Durch die entsprechende Anwendung bei Abspaltungen von Körperschaften treten die den Gesellschaftern gewährten Anteile an der übernehmenden Gesellschaft anteilig an die Stelle der Anteile der übertragenden Gesellschaft. Die Anschaffungskosten der Anteile an der übertragenden Gesellschaft sind auf die Anteile an der übertragenden Gesellschaft und die gewährten Anteile an der übernehmenden Gesellschaft aufzuteilen. Ein steuerpflichtiger Gewinn und damit eine Pflicht zum Einbehalt von Kapitalertragsteuer entsteht daher nicht. Die erhaltenen Anteile übernehmen überdies den steuerlichen Status der Anteile an der übertragenden Gesellschaft. Die Vorschrift wird erstmals auf Abspaltungen angewandt, bei denen die Anmeldung zur Eintragung in das für die Wirksamkeit des jeweiligen Vorgangs maßgebende öffentliche Register nach dem 31. Dezember 2012 erfolgt ist.

Maximum trade tax relief

Trading income ranks for relief from income tax calculated on the basis of factors in the trade tax computation. The maximum relief is, however, limited to the income tax otherwise due on the trading income concerned. This amount is reduced by reliefs and allowances claimable against the tax due, including credits for foreign taxes. This foreign tax credit reduction has now been increased by that granted on investment income in respect of foreign withholding tax where the taxpayer has opted to tax the income as part of his trading income (as opposed to 25% flat rate taxation on investment income). This change applies for the 2013 year of assessment.

Taxation of earnings from services to foreign partnerships assured

The income tax act provides that income of members in foreign partnerships from services provided to their partnerships is taxable as business profits, unless the double tax treaty provides otherwise. However, the Supreme Tax Court potentially undermined this provision with a ruling restricting its application to earnings through a German permanent establishment within the meaning of the treaty. The government has now reacted to this ruling with a re-draft of the business profits attribution provision to attribute the partnership service income to the permanent establishment bearing the costs of the service provision. This also extends to income earned by the partner direct from his association with the partnership. Multi-tier partnerships, delayed earnings and income from independent personal services have also been drawn into the net. A credit will be granted against the partner’s income or corporation tax on the service income in respect of the foreign tax paid, unless the foreign payment was reduced by credit for German tax. The redrafted rule is to apply to all open cases.

No mutual exclusion of treaty override provisions

Separate treaty override provisions provide for the taxation of employment income if the foreign state does not exercise its treaty right of taxation (other than by deliberate waiver), for the taxation of income not otherwise taxable in either state due to a conflict of definition, and for the taxation of income attributable to the other state but not actually taxed there because the earner was nor regarded as resident under local law. The Supreme Tax Court held, however, that the employment income override took priority to the exclusion of the others. This led to the complete exemption of the salaries earned by German resident aircrew on Irish airlines, as the right to levy income tax fell to Ireland under the airline clause in the double tax treaty and Ireland did not (at the time) tax the employment earnings of non-residents for work done outside the country. The salary override was specific and exhaustive and thus excluded the application of the provisions on conflicts of qualification or residence. This judgment has now been countered by a change in the statute to the effect that the least favourable exemption under the treaty or treaty override provisions shall apply in any given case. This amendment is to apply in all open cases.

Electric car incentive

The act includes a provision to relieve the disadvantage felt by those taxing a benefit in kind from the private use of an electric company car. This disadvantage stems from the expensive batteries included in the list price of the car when new taken as the basis for calculating the monthly benefit (the 1% rule). The relief is to be granted in the form of a deduction from the list price of €500 for each kWh of battery capacity up to a maximum of €10,000. These figures apply to electric or hybrid vehicles purchased up to December 31, 2013. They are reduced by €50 or €500 respectively for each subsequent year of purchase. The relief expires altogether for vehicles acquired on or after January 1, 2023. A corresponding relief is available for those calculating the benefit in kind on the basis of actual cost and a mileage log distinguishing between business and private use. The "battery allowance" is to be deducted from the depreciation basis of the vehicle, or a separate payment for the battery is to be excluded from the total cost. The relief applies from the day following the promulgation of the act and may be claimed in respect of existing company vehicles used privately.

Electronic payroll withholding tax criteria ("ELStAM")
The act contains provisions for the electronic management of the employee criteria necessary for the correct deduction of payroll withholding tax from salaries. It also includes transitional provisions allowing the continued use of employee "wages tax" cards issued for 2010 and of deduction entitlement certificates issued by tax offices in hard copy for 2013. Various procedural amendments bring the provisions into line with the procedures currently followed by tax offices. These were set provisionally in December 2012 by decree in anticipation of the statutory confirmation now enacted.

Payroll withholding tax review
The act introduces the concept of an unannounced payroll withholding tax review to be carried out on the business premises of an employer during customary business hours. All relevant books and records must be shown to the inspectors on demand. The inspectors have the power to extend the review to a regular audit without the need for a formal notification should their review findings suggest such a step to be warranted. This provision shall apply from the day following the promulgation of the act.

Payroll withholding tax allowances
Employee entitlement to specific payroll withholding tax allowances will henceforth be certified by an employee's tax office for two years as opposed to the present single year. An employee must notify the tax office promptly of changes in circumstances leading to a reduced entitlement and may do so if his entitlement increases. The date for implementation of the two-year system is to be set by decree.

Hybrid vehicles – treaty relief
The act amends the treaty relief provisions in respect of payments through hybrid vehicles to provide that the relief entitlement falls to the person to whom the income is attributed under the tax law of the other state. The purpose is to prevent loss of relief through unclear taxpayer identity. Taken literally, the amendment only applies to refund claims and not to exemptions. However, the official explanation of the provision emphasises that the new rule does not restrict the right of a person entitled to refund to claim exemption. It applies to payments after the day of promulgation of the act.

Effect of foreign income on tax rate – curbing "Goldfinger" schemes
The rules for calculating the foreign business income to be taken into account when setting the tax rate to be applied to the domestic income of businesses accounting on a cash basis have been amended by a provision to the effect that foreign expenditure on current assets may only be taken into account when the assets are used, sold or withdrawn. This change has been prompted by the upsurge of "Goldfinger" schemes under which the treaty-exempt foreign-source business income was artificially reduced by purchases of easily disposable current assets (such as gold or other precious metals) through the foreign business shortly before year-end, with subsequent resale shortly afterwards. The cash accounting basis meant that the foreign source income was immediately reduced by the purchase price. The exempt foreign income to be taken into account when setting the rate on which to tax the domestic income thus became a loss. The corresponding effect the following year when the assets were sold would not be felt if the domestic income was already subject to tax at the highest rate. The new rule applies to current assets acquired by the business on or after March 1, 2013

Assuring the taxation of later gains by emigrants
In recent years, ECJ and Supreme Tax Court case law have consistently drawn the conclusion that tax on an inherent gain in assets held by a taxpayer on his change in tax residence may be established at the time of his move, but may not be levied until the gain is realised. However, the Supreme Tax Court has also held that the gain on the future sale of shares or other assets contributed to a trading (as opposed to asset management) partnership cannot be taxed for want of a domestic provision. This has now been remedied with a specific provision in the Income Tax Act. However, this treaty override

goes beyond the original intention and now catches gains accumulating over the entire holding period. The new rule applies to shares sold on or after the date of promulgation of the act and to all other cases still open.

Withholding tax exemption on a loan profit participation, and on employee shares

The list of activities ranking for exemption under the Income Tax Act has been extended to include earnings on profit participation rights and – with limitations – on shares held in trust for employees. This applies to income flowing on or after December 31, 2012.

Withholding tax relief for permanent overpayers

Those permanently overpaying income or corporation tax by virtue of the tax deducted at source from investment income may benefit from a new rule allowing an exemption for regular customers of the paying bank. The list of types of interest now includes dividends and interest on convertible bonds, and interest on profit sharing notes and similar rights. The new rule benefits, in particular, holding companies with tax-free dividends. It applies to investment income received on or after January 1, 2013.

Corporation tax

Corresponding treatment of all dividends

See Income Tax.

Further restrictions on tax exemption on shares loaned

Payaments borne by a corporation for the loan of securities are not deductible. This now also applies to payments for securities loaned from a partnership from January 1, 2014 onwards.

The provisions disallowing the costs of hiring securities do not apply where the hirer enjoys no income or other benefits from their possession. However, income in this connection also includes consideration received for not lending the securities on-. This provision applies to all open cases.

Provision for the return of insurance premiums

Insurance companies may take up a provision for the return of premiums based on profits or on the insurance surplus. However, under present law, the annual amounts taken to this provision in the five years ending on balance sheet date may not be more than 1.2 times the total of the three credits available up to the 2009 year-end. This rule applied for the periods 2010 to 2013 but has now been extended to 2015.

Trade tax

Local authority allocation for solar enery generators

Generally, the trade tax base is allocated among the communities where the business is established on the basis of the wages paid in each establishment. However, windmill farms fall under a special rule. Three-tenths of the tax base is allocated by wages total and seven-tenths by the written down value of the fixed assets employed. This special rule has now been extended to generators of electricity from solar cells (photovoltaic installations) for 2014 onwards. However, until 2023 this extension only applies to new installations.

Foreign Tax Act

Authorised OECD approach (AOA) to permanent establishment income

The present act includes a provision adopting the 2010 authorised OECD approach to allocating income between a head office and its permanent establishments, or between permanent establishments, as though each were an independent legal entity dealing at arm’s length. The new rule applies to years starting on or after January 1, 2013.

The AOA has been enshrined in the OECD model treaty and in the OECD’s official commentary. Its enactment into the Foreign Tax Act gives a legal basis in Germany for its application to head office/permanent establishment income where this has been agreed in the double tax treaty with the other state. Initially, the rule also applies to dealings with establishments in states with treaties with a business profits clause on the old, “branch” basis, or, for that matter, in states without a double tax treaty with Germany at all. However, it is open to the taxpayer to show that the other state continues to apply the old approach on the basis of an existing treaty and thus to request that the AOA rule be disapplied as necessary for the avoidance of double taxation.

The new rule simulates an arm’s length approach to international dealings between different units of the same company as though they were independent legal entities bound by contracts meeting third-party standards. The allocation of income is to be based on

1. the allocation of functions performed by company staff
2. the allocation of assets as used by company staff for their functions identified in the first step
3. analysis of the opportunities and risks faxcing the business on the basis of the allocation of functions and assetsa. This also includes setting an appropriate level of branch capital
4. identification of the exact dealings between the units of the company affected.

This allocation will then serve as this basis for setting the arm’s length transfer prices. A decree discussing in detail the issues and implications is expected.

Partnerships to follow the same arm’s length rule as companies

Parallel to the adoption of the AOA to dealings within companies, the act now provides for equal treatment of parnerships and companies in respect of their arm’s length dealings with related parties. Accordingly, partnerships (as permanent establishments of their partners) are now subject to income adjustment under the Foreign Tax Act to correct profit shifts (for 2013) and can also rank as related parties of all other group entities (for all open cases).

Exclusion of EU/EEA low tax foreign income from German attribution extended to minority holdings

The government adopted in 2008 the Cadbury Schweppes judgment of the ECJ (case reference C-196/04) with a provision in the Foreign Tax Act excluding “passive” income from a low-tax jurisdiction within the EU or EEA from the otherwise compelling German CFC rues for the attribution of foreign income, provided the company could show that the income had been earned through a properly equipped and organised local establishment. However, this exclusion only applied to the earnings of foreign companies in majority Germany ownership. It has now been extended to exclude otherwise attributable income from German taxation, even if the German interest in the ownership of the company are only a minority. This applies to the year of assessment relevant to the first business year of the foreign company starting on or after January 1, 2013.

Reconstructions Tax Act

No loss offset for acquiring entity against profits earned by merged business in the merger period

Mergers and other contributions of a sustainable business entity may be recorded tax-free under the Reconstructions Tax Act. One of the conditions is that the merger balance sheet may not be drawn up as of an earlier date than eight months prior to the trade registry filing. This means that the results of both entities are combined from the merger balance sheet date onwards, thus enabling full offset of the profits earned by the merged business during the eight month period of retrospect against losses of the survivor (acquirer). This perceived loophole has now been closed with an addition to the Reconstructions Tax Act provision governing the tax effects during the merger period. If the acquirer is an *Organschaft* subsidiary, the exclusion from offset applies to the parent. For partnerships, the exclusion applies to the partners. However, the exclusion does not apply if both entities were associated enterprises within the meaning of the Commercial Code (members of the same corporate group) at the close of business on the merger balance sheet date. The restriction applies to mergers or other reconstructions reported to the trade registry on or after June 7, 2013. If no trade registry filing is required (business units contributed to capital reserve), the date of effective transfer of the merged business is decisive.

Real estate transfer tax

RETT blocker blocked

The Real Estate Transfer Tax Act provides for a charge to RETT on the taxable value of the property held by a company or partnership if at least 95% of the shares are united in a single hand (company) or where at least 95% of the partnership capital passes to new partners over a five year period. However, the two provisions were not interlinked, so acquirers prepared to accept a very small minority interest were able to avoid a charge to RETT by acquiring, say, 94.9% of the shares in a company. The remaining 5.1% would then be acquired by a partnership in which the main shareholder held a 94.9% interest. In total, the majority shareholder then held a 99.7% beneficial interest in the company without a RETT charge. This “RETT blocker” has long been a sore point for the provinces, which are entitled to the tax. It has now been rendered ineffective with a provision basing the 95% holding on the direct or indirect economic interest in the assets or capital of the property-owning entity. The stricter definition applies to acquisitions on or after June 7, 2013.

More exemptions for group reorganisations

With the intention of giving corporate groups greater scope to reorganise themselves in the interests of a more effective reaction to the changing demands of the marketplace, the exemption provision for restructuring transactions within a group but without a change in ultimate ownership has been extended from reorganisations under the Reconstructions Act to include contributions in kind in exchange for shares and other measures taken by sharehlders acting as such. However, the government was unable to bring itself to exempt all direct and indirect transfers of property within a group *per se*. The new rule applies to acquisitions on or after June 7, 2013.

Inheritance tax

Reaction to the “cash GmbH”

The “cash GmbH” is an increasingly common vehicle for avoiding inheritance or gift tax on the transfer of private wealth. The GmbH is formed shortly before the transfer and is capitalised with the cash intended for the beneficiary. The chargeable transfer, itself, is then the transfer of the shares in the GmbH on the day of death or gift. The beneficiary as the new shareholder must continue with the GmbH for the next seven years, at which point the transfer ranks as the exempt transfer of business assets, being the shares in a wholly-owned GmbH. However, the new act has put a brake on this planning instrument by broadening the so-called “administrated assets” (which do not rank by their nature as business assets) to include cash and bank balances of material amount. A material amount is to be assumed if the cash balances net of debts account for more than 20% of the total value of the business or company. There is a let-out for banks and insurance companies and for group financing companies. This latter exempts, for example, cash pools within family-owned groups. The new rule applies to chargeable transfers on or after June 7, 2013.

VAT

Place of supply

Services falling under the general rule of supply at the place of the business customer are currently taxable at the location of the supplier (permanent establishment) when supplied to a public authority with a business operation for its non-business activity. Problems in following this rule for the supplier who does not necessarily know the purpose to which his services are to be put have now been alleviated with an amendment rendering all services to public authorities with a business activity taxable at their location, regardless of the purpose for which the supply was ordered. The only exception is services for the private needs of the customer’s staff. These are taxable at the location of the supplier. The amendment is to be applied from the day following the promulgation of the act.

Hire of a pleasure boat
The long-term hire of a pleasure boat to a non-business customer is currently subject to VAT at the place of business (permanent establishment of the supplier. In future, it will be taxable at the place where the boat is made available to the customer. The amendment is to be applied from the day following the promulgation of the act.

Hire of means of transort
The long-term hire of means of transport to a non-business customer is currently subject to VAT at the place of business (permanent establishment of the supplier. In future, it will be taxable at the home or seat of the custome. The amendment is to be applied from the day following the promulgation of the act.

No reverse charge for passenger transport by road
Road passenger transport by a foreign business – other than by taxi or by bus taxed by trip – is currently taxed by reverse charge if the customer is a business or a body corporate. A foreign customer must therefore register for VAT in Germany and submit periodic returns throughout the year, even if only a few journeys are involved. This has led to many practical difficulties and administrative effort, not least for the tax offices involved. Passenger transport by road has therefore now been excluded from the catalogue of services subject to tax by reverse charge. The taxpayer is now the carrier and only he must register in Germany. The new rule takes effect from October 1, 2013.

Foreign business
The distinction between a domestic and a foreign business operator has been conformed to recent ECJ case law (case C-421/10 *Stoppelkamp*). Henceforth a person will be seen as a foreign business operator if his business activity, place of management or fixed establishment is located abroad and he merely lives in Germany. If, however, he lives in Germany, but does not have a foreign business location or place of management, he will be regarded as operating a German business. The amendment is to be applied from the day following the promulgation of the act.

Invoicing
Basically, invoices must be issued as prescribed by the law of the EU member state where the turnover was carried out. This has now changed to the member state where the supplier is resident. Invoices issued by the customer must be labelled as credit notes – "*Gutschrift*". There have been various other changes to transpose the EU Invoicing Directive into national law. The amendment is to be applied from the day following the promulgation of the act.

Gas and electricity
Supplies of gas and electricity by a German business to a business customer will be taxed by reverse charge if the customer also offers such supplies. The purpose of this amendment is to prevent revenue losses – particularly through fraud. The risk lies in the inability to demonstrate that the supplier has fully reported his turnover and in doubts as to whether the tax due can actually be collected. This extension of taxation by reverse charge requires the authorisation of the European Council. The authorisation has been applied for but has not yet been granted.

Trade in works of art and collectors' items
Under EU law, member states may tax turnover in works of art and collectors' items at a reduced rate under certain conditions. However, the present rule in Germany goes beyond the relief granted by community law in that it applies to all sales and hires of these items, including in particular trade sales. The German rule has now been brought into line with the VAT Directive, in particular with an amendment to tax the supply and intra-community acquisition between dealers in works of art at the standard rate. The amendment applies as of January 1, 2014.

Margin taxation for works of art
Under certain circumstances art dealers may tax their turnover on the basis of the gross margin between the purchase and selling prices. However, the European Commision and Council have declared that member states may set the margin at a fixed rate of not less

than 30% for specified cases. This fixed margin has now been enacted into German law, to be applied in all cases where the individual purchase price cannot be specifically determined (e.g. house clearances) or where it is insignificant. This change is intended to compensate the trade for the future standard rate taxation on trade sales. It applies from January 1, 2014.

VAT on import

VAT on import will henceforth be deductible as input tax from the date it arises as opposed to the present rule delaying the deduction until the tax is paid. The amendment is to be applied from the day following the promulgation of the act.

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