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PwC Reports

OECD publishes new standard on automatic information exchange

At the request of the G20 leaders, the OECD has drafted a new standard for the automatic exchange of information between states on accounts held by financial institutions in the one state on behalf of residents of the other. The standard is complemented with a model text for a bilateral agreement between the two competent authorities (competent authority agreement – CAA). The guiding principles are that the competent authority of each state should gather all relevant information during a calendar year and then pass it to the competent authority of the other state by the following September 30. The information to be gathered includes investment income of all types, account balances and sale proceeds. Banks and other financial institutions affected (such as brokers and insurance companies) must observe due diligence procedures with respect to their customers. These include satisfying themselves as to the country of residence of each customer. If a customer has homes in more than one country the information is to be passed to all competent authorities potentially interested. Financial institutions must also identify the beneficial owners of income or assets passed through trusts or similar vehicles, in particular, with taxpayers in view who are prepared to tax the income, but seek to hide the principal.

Some forty countries have already undertaken to adopt the new standard. These include most of the EU countries, Liechtenstein, Cyprus and the generally known British tax havens, but not Switzerland or Austria.

Official Pronouncements

Employer contributions to social security schemes in other member states tax-free benefit

In January 2011, the Supreme Tax Court held that a German employer could not pay the employer's contribution to the French social security system as a tax free benefit for the employee, as there was no statutory obligation on him to do so. However, the finance ministry has now reconsidered the position in the light of community law and has issued a decree to the effect that this judgment should not be followed as a precedent in other cases involving contributions to the official social security systems in other EU/EEA countries and in Switzerland. In this it follows the lead taken by the ministries for health and for labour and social affairs which have taken the position that EU provisions stipulate that the contributions paid into the social security system of another member state on behalf of a voluntary member shall be treated no less favourably than those paid into the German scheme on behalf of an employee opting in.

VAT on motor vehicle leasing

Motor vehicle leasing fees are subject to VAT. However compensation for damage is not. The finance ministry has issued a decree on the distinction in respect of payments from or to the lessor when the vehicle is returned at the end of the lease. If the charge is made to compensate the loss in value of the vehicle from damage caused by use other than as contractually agreed, it is for damage caused by breach of contract and VAT-free. If, however, it is for excessive use of the vehicle as specified by the lease agreement, it is an additional rental charge and subject to VAT. Examples are charges for excessive mileage or for late return of the vehicle.

VAT on services for wind farms

The ECJ held in June 2013 that services deemed for VAT to be carried out where a property lies must depend in essence on a specific site (judgment C-155/12 Donnelley in a case on warehousing facilities for foreigners in which the court held that the service was only property-related if the customer had unfettered access to a specific section of the warehouse). The ministry of finance has now drawn upon this case as the basis for a decree on services for wind farms, particularly those located off-shore. Planning and engineering work, including technical evaluations in respect of a specific project are deemed to be carried out on the farm. This includes work on the wiring within the farm, the power cables to the shore station and on the transformers and converters on shore and at sea. By contrast, the transfer of rights to a project or its know-how, and project management, documentation or control are not services directly linked to a property and are thus subject to VAT under normal rules at the establishment of the business customer.

VAT on travel agents' charges to airlines

Commissions paid to travel agents by airlines for international ticket sales are free of VAT. Charges by travel agents to travellers are not. Since airlines do not usually offer travel agents commission on their ticket sales, the agent is forced to charge the customer a service fee. However airlines have taken to offering travel agents incentives or other benefits for promoting their flights as opposed to those of their competitors. The finance ministry has now revised its VAT Implementation Decree to take account of the various different arrangements currently being offered by airlines. If the benefit to the agent is specifically tied to particular flight sales, it will be a VAT-free commission. This still applies if the agent also charges a VAT-able service fee to the traveller for the same flight. If the charge is for the services of the agent in promoting the flights of that particular airline generally, e.g. to offer those flights to customers as the first choice, it will usually be a service charge for sales promotion subject to VAT.

Input tax from fraudulent supplier

In principle, the input tax charged by a supplier is deductible if the supply was for the customer's business. However, the deduction will be rigorously scrutinised if the sale was made with intent to defraud. Under a new decree of the finance ministry, the purchasing business must show that it did not and could not have known of the fraud when the goods were delivered. This decree is in reaction to a court case allowing the deduction for a genuinely innocent purchaser. The particular fraud at issue involved the sale of the same goods to different buyers, but with delivery only to one. The due care to be expected of a purchaser in such a case requires at least that the purchaser document his efforts to establish that the supplier was a VAT-registered business and that he record the serial or other identifying numbers of equipment items purchased.

Impairment of value of assets

In September 2011 the Supreme Tax Court held that a fall in the stock market price of shares at balance sheet without a subsequent recovery by the time the accounts were drawn up represented a permanent fall in value allowing a write-down under the rules for the permanent impairment of value of assets. Its reasoning was that stock market movements are unforeseeable; thus the current market price at any one date is as accurate an indication of the permanent value of the investment as any other price, unless there are specific pointers to the contrary. However, it did exclude short term fluctuations by providing that the fall in value must have been at least 5% of the balance brought forward from the previous year or of the acquisition cost during the current year. The finance ministry intends to react to this judgment with a decree on extraordinary write-downs generally, and has published a discussion draft. Industrial and professional associations were invited to comment by February 28.

In general, the draft follows the Supreme Tax Court's reasoning for quoted shares held as fixed or current assets (with an exception for the trading stocks of banks and restricting the 5% limitation to fixed assets), but ignores it in other cases in favour of the approach that the fall in value must be permanent and that more must speak for permanency than against it in any given case. Subsequent events are to be taken into account if they are relevant as value indicators at balance sheet date. Thus, a stock market price recovery at any time before the accounts are drawn up is to be taken into account. Redeemable securities can never be written-down below the redemption price (default risks apart), as any lower value is not permanent. A contaminated site can be written-down to its current market value if the contamination will have to be rectified at some point in the future, even if the responsible authority is not insisting on action currently. However, if the site is cleaned up, the market value will rise and the write-down should be written back. Unrealised exchange losses should only be taken into account if the relevant rate appears to have fallen permanently. The draft emphasises that the write-back requirement follows from every value increase independently of the original reason for the write-down.

Decree on private use of electric-powered company cars

The monthly taxable benefit to an employee of his private use of a company car can be taken at 1% of the list price when new. However, electrically powered vehicles are generally sold complete with batteries. The Income Tax Act provides that the list price of such vehicles be reduced by the amount attributable to the batteries. For vehicles first registered in 2013 and earlier this is to be taken at €500/KWH of battery capacity with a maximum limit if €10,000. For vehicles registered in 2014 and later years these figures are to be reduced by €50/€500 for each year. The same reduction is to be made to the depreciation base of the car for those calculating their taxable benefit at its actual cost. The finance ministry has published the discussion draft of a decree illustrating the principle with sample calculations. Industrial and professional associations were given until February 14 to comment.

Supreme Tax Court Cases

No deduction for EC fine for cartel offence

A company was fined by the European Commission for its membership of an illegal cartel. The fine was based on the nature and gravity of the offence and on the Commission's estimate of the effects on the market. The company's market share was also taken into account. The fine was uplifted by 10% for each year of the offence. The uplifted amount was then reduced to 10% of the worldwide turnover of the company in the previous year. All measures of size or importance were based on turnover. The Commission followed its own (published) guidelines throughout. These emphasise the deterrent purpose of cartel fines. The company lost its appeal against the fine before the ECJ, but then claimed a tax deduction for its legal costs and for the fine itself. The basis for the latter was an Income Tax Act provision that allows a deduction for penalties if these are levied to absorb the illicit benefits (before tax) from an offence, rather than to penalise it. The tax office allowed a deduction for the legal costs, but refused one for the fine, saying that the fine was a non-deductible penalty. The lower tax court, and now the Supreme Tax Court, confirmed this stance.

The Supreme Tax Court based its position on the fact that none of the documents relevant to the Commission's fine referred at any stage to an intention of confiscating illicit benefits. Turnover-based measures of size were intended as a test of the gravity of the offence. The Commission had also confirmed to the tax office in reply to a query that it had not taken the illicit benefit for the company into account when setting the fine and was unable to measure what that benefit might have been. The court drew the conclusion that the primary purpose of the fine was penal and deterrent, rather than confiscatory. It accepted the taxpayer's statement that the deterrent would fail if the benefit were less than fully absorbed, but found the thought to be too general as a measure of a specific element of a fine. It could only be relevant to an increase in the base fine to take account of exacerbating circumstances. Even then it would have to be looked at carefully. In the event, there had been no particular exacerbating or extenuating circumstances; the reduction of the fine to 10% of annual turnover followed from a different provision, to keep fines to a level that did not endanger the offending company's existence.

Supreme Tax Court judgment IV R 4/12 of November 7, 2013 published on February 19, 2014

Fine payment for employee is taxable benefit

A haulage company regularly paid the fines levied on its drivers for exceeding the permitted period at the wheel and for failing to take the prescribed rest breaks. The tax office saw the payments as employee benefits and demanded payment of the payroll withholding tax. The company protested that it had paid the fines in its own business interest and referred to a Supreme Tax Court judgment in 2004 (case reference VI R 29/00 judgment of July 7, 2004) allowing an employer to reimburse employees for their parking fines necessarily incurred in the course of their business duties.

The Supreme Tax Court has now confirmed the tax office in its view. An employer may reimburse an employee tax-free for outlays incurred in the business interest. However, that business interest must significantly outweigh any private interest of the employee. That can never be the case when compensating an employee for an illegal act, since a legitimate business activity must remain within the law. The court added that in response to public criticism it no longer held to its 2004 judgment.

Supreme Tax Court judgment VI R 36/12 of November 14, 2013 published on January 22, 2014

No treaty override for German-resident aircrew of Irish airline

An Irish airline paid out the salary of a German resident pilot under deduction of full Irish income tax. This was in accordance with the airline clause in the double tax treaty ascribing the right to tax the employment income of flight crew to the home state of the airline. The pilot then requested and received a refund from the Irish tax office on the basis that, as a non-resident, his Irish obligation was restricted to the income actually earned in Ireland. As a result his total annual Irish liability was a very small sum. The German tax office sought to tax the exempt portion of his Irish salary under a "fall-back" provision in the Income Tax Act. The Supreme Tax Court has now confirmed that the lower court was right to refuse this claim, as the provision referred to, taken literally, only applied to cases of income items fully exempt in the other state. The salary had, however, been taxed even if only in part; thus there was no legal basis for taxing the remainder in Germany in the face of the double tax treaty provision.

It should be noted that this provision of the Income Tax Act has been laid before the Constitutional Court for a ruling on a possible clash with international law, at least where the relevant tax treaty does not contain the same fall-back provision allowing one state to exercise the taxing right of the other where the other state does not do so. It should also be noted that Irish law has since changed to fully tax the salaries of the aircrew of Irish airlines regardless of where they are resident.

Supreme Tax Court resolution (refusing the tax office leave to appeal against the lower court's judgment) I B 109/13 of December 19, 2013 published on February 12, 2014

Interest on tax refunds taxable

Interest on income tax outstandings runs at 6% p.a. simple interest for each month from the second following 1st April after the relevant tax year. This applies equally to refunds and to liabilities. Interest paid is explicitly a non-deductible expense, whilst at the time the Income Tax Act was silent on the tax position of an interest receipt. In practice, the tax authorities generally saw it as taxable, if only under the general principle of taxing all income other than specifically exempted items. In this they were originally supported by a Supreme Tax Court case, although that court subsequently modified its position. In 2010, the tax liability of interest received on refund claims was explicitly enacted into the statute with application to all cases still open. A taxpayer with a large refund claim settled in 2007 challenged the tax office position on the grounds that interest on tax debts due to and from the tax office was similar and the treatment of receipts should parallel that of payments. He also challenged the application of the 2010 statute to a 2007 assessment as being an unconstitutional, retrospective change to the disadvantage of the taxpayer.

The Supreme Tax Court has now upheld the position of the tax office. Tax liabilities were fundamentally different from refund claims due, so there was no reason for comparable treatment of interest income and expense resulting from outstandings. Accordingly, there was no reason to disapply the 2010 change in the law as being inconsistent with other provisions. Its retroactive effects were – exceptionally – not unconstitutional, as it merely restored the previous position as generally understood on the basis of the previously valid case law.

Supreme Tax Court judgment VIII R 36/10 of November 12, 2013 published on February 12, 2014

Loss on sale of variable interest bond can only be offset against capital gains

A natural person taxpayer sold a "hybrid" bond at a loss in 2008. He sought to treat the loss as "negative interest income" under a provision equating assured gains and losses on the redemption of a bond with interest adjustments. His object under the law as it then stood was to deduct the loss currently from his other income. The tax office, however, saw the loss as only deductible against capital gains on the sale of investments in the current or in future years. Under the then law, this deduction was often something of an illusion, given that portfolio gains were not taxable unless the investment had been held for less than a year.

The Supreme Tax Court sided with the tax office. The "hybrid" bond was, in effect, a variable interest bond, that is, a floater. Initially, it carried a fixed rate of interest – 8.625%% p.a. The issuer had a redemption option exercisable on January 30, 2013. If he chose not to exercise the option, the bond continued at a variable interest rate of 3-month EURIBOR plus a risk premium of 7.3%. There was no further provision for redemption, although the bond was quoted on the capital market. It was therefore something of a speculative instrument. In particular there was no fixed yield for the term of the bond established at the time of its issue. There was thus no application of the provision to spread assured redemption gains or losses over the term of the bond as interest substitutes. The purpose of that provision was to counter attempts to build a yield into a redemption price, thus converting taxable interest income into an exempt redemption gain.

In the meantime, this case has lost much of its relevance. For 2009 the Income Tax Act was amended to treat capital gains as elements of investment income. Income on private investments is now taxed at a flat rate of 25% and there is no mingling with income from other sources. On the other hand, the provision restricting the offset of capital losses to capital gains now only applies to the sale of shares and profit sharing rights.

Supreme Tax Court judgment VIII R 42/12 of December 17, 2013 published on February 26

Shortest distance to work independent of road type

The cost of travelling to work may be offset as an employment expense at a flat rate of €0.30 for each km distance. Distance is measured by reference to the shortest available road connection unless a different, longer road is obviously more favourable from the traffic point of view. A taxpayer claimed a longer route of 27 km as the only route available to him, since the shortest route by road – 9 km – was closed to his vehicle (a moped) by virtue of a bar on all vehicles with a rated maximum speed of less than 60 km/h. Also, the shorter road passed through a tunnel subject to a toll charge.

The Supreme Tax Court has now rejected the taxpayer's claim. The provisions were general and applicable to all taxpayers, regardless of their actual means of transport. The only exception was the provision for a longer route if this was more favourable from the traffic point of view and actually taken by the taxpayer. No exception was available to exclude toll roads or roads barred to the taxpayer's vehicle from the definition of shortest available route. The actual route taken by the taxpayer was longer in terms of both distance and time, and was thus not "obviously more favourable from the traffic point of view". The fact that it was the only road available to him on his moped was not relevant in the face of the general application of the provision without regard to the actual means of transport.

Supreme Tax Court judgment VI R 20/13 of September 24, 2013 published on February 5, 2014

No liability for tax on benefits granted privately

The majority shareholder and managing director of an important local company invited important customers, business partners, influential local worthies and, as hosts, high performing employees to a lavish jubilee celebration. The tax offices involved disallowed the costs of the event as a business expense on the grounds that it was the managing director's private affair – he did not charge the cost to the company – but insisted on income tax for the guests under a 30% flat rate rule for final settlement of the income tax liability on benefits in kind received in a business connection by a group of people. The tax office also requested that the lower court require the guests to attend the hearing on the grounds that their interests might be affected by the outcome. The lower court refused both applications.

The Supreme Tax Court has now confirmed the decision of the lower court and, in so doing, sided with the taxpayer. It accepted his argument, that some of the guests were from abroad, with the consequence that, for them, the benefit was not taxable in Germany. However, it also added that the flat rate rule could not be applied *per se*, as it was restricted to benefits received in a business connection. The invitations had, though, been sent by the managing director in his private capacity, and he had borne the cost of the event from his private estate. That cost had been disallowed as a business expense. It was therefore up to the tax authorities to collect for themselves any income tax due from the guests of the event as benefit recipients.

The court also upheld the refusal to order the guests to attend the hearing. Several thousand people were involved and the tax office had not supplied the full contact details. The tax office had failed in its duty to support the court and this released it from its own duty to fully investigate the facts.

Supreme Tax Court judgment VI R 47/12 of December 12, 2013 published on February 12, 2014

No insurance tax for warranty risks on construction work abroad insured within EU/EEA

A German building contractor constructed an industrial plant in Norway. One of the conditions imposed by the customer was a two year warranty on defective construction, assembly, design or manufacture. This warranty included bought-in components and sub-assemblies. The contractor insured the risk with one German and two Swiss insurance companies. He treated the insurance premiums as costs of the Norwegian construction site permanent establishment and thus as being free of German insurance tax. The tax office disagreed; the contractor had covered risks arising after project completion to be borne by the main German undertaking. The insurance therefore covered a German risk and the premiums were subject to 19% insurance tax.

The Supreme Tax Court has now exempted the insurance taken out in Germany, but not the two policies taken out in Switzerland. In doing so it followed strictly the letter of the law. The Insurance Tax Act exempts policies taken out with EU/EEA insurers for risks arising "by reference to" immoveable property outside Germany. The insurance tax obligation on policies taken out with non-EU/EEA insurers arises by contrast in all cases where the insured person is a German resident individual or German registered corporation. The insured risks arose by reference to the Norwegian construction site even if the actual defect had been caused in Germany (such as faulty components or design). Similarly, the purpose of the policies – to protect the German undertaking from future risks – was irrelevant, given the precise wording of the statute. Thus the premiums paid on the German policy were not chargeable to German insurance tax, whereas those paid on the two Swiss ones were.

Supreme Tax Court judgment II R 53/11 of December 11, 2013 published on February 26, 2014

Project consideration in a public/private partnership split for VAT between interest and principal

A builder contracted with a public authority to rebuild a student hostel. Because the authority did not wish to take out its own finance or to appear as the principal of the builder, the two agreed to finance the project through a so-called public/private partnership. The agreement gave the full right of usage to the builder for the next twenty years, but with the proviso that he should rebuild the hostel as agreed and then let it to the operator. The rent should allow the builder to fully recover his costs over the twenty-year period and should be divided into consideration for the financing – interest free of VAT – and payment by instalments for the investment. The figures were to be fixed later, once the exact investment and interest rates were known. The tax office saw the entire "rent" as payment by instalments for the investment and thus as subject to VAT in total. It based this attitude on a provision in the VAT Guidelines (now the VAT Implementation Decree) excluding separation of the financing cost from the overall cost of the project, if the former was not fixed when the contract was signed. The builder took the view that the provision in the VAT Guidelines had no basis in law and should be disregarded.

The Supreme Tax Court confirmed the judgment of the lower court to the effect that the parties had clearly agreed two separate supplies, of finance and of the building work. They had also agreed the basis for calculating each – based on agreed building budgets – even if the details had not yet been worked out. In any case, it was immediately obvious that no business operator would accept payment deferral over twenty years without cover for the financing cost involved. However, the court's judgment was confined to confirming that of the lower court and thus did not give guidance on the principles of segregation.

Supreme Tax Court judgment XI R 24/11 of November 13, 2013 published on January 15, 2014

Partnerships to join VAT groups?

The Supreme Tax Court has suspended two cases of shipping groups disputing the amount of input tax currently accepted by the tax office as deductible pending an decision from the ECJ. One group is led by an AG and the other by a limited partnership (GmbH & Co. KG). The AG holds and effectively manages four subsidiaries with a 99% share in each. The GmbH & Co. KG holds and effectively manages two subsidiaries with a 98% share in each. Each subsidiary is a limited partnership (KG) and operates its own cargo vessel. Each parent has incurred input tax on its costs of raising capital to finance its partnerships and each receives its income from management fees charged to the partnerships, from interest on its loans to the partnerships, on profit shares from the partnerships and from interest from banks on amounts temporarily deposited pending their investment in business operations. In both cases, the dispute with the tax office centres on two points, the method of allocating expense between asset and business management of a holding, and the acceptability under community law of the narrower German requirements for membership of a VAT group.

The first area of uncertainty derives from the lack of a precise formula in either the VAT Directive or the VAT Act. Various methods of determining the portion of deductible input tax can be found in practice, but, ultimately, they are all based on one of two alternative principles – allocation in proportion to gross receipts and allocation by assets employed. The gross receipts basis is geared to the concept of the holding entity as primarily a service provider, whilst the assets employed basis see it mainly as an investor. Unfortunately, both taxpayers and tax offices tend to see the only acceptable method in the circumstances as that suiting their own best interests in the particular case.

The VAT group provision in the VAT Directive permits member states to allow VAT groups between entities with close financial, business and organisational connections. The German VAT Act requires financial, business and organisational integration onto the parent and also requires that the subsidiaries be corporations. The German provision is therefore more restrictive and thus might be acceptable as partial exercise of an option. However, it might also be objectionable as a discrimination against partnerships without a valid justification. Similarly, the demand for integration as opposed to close connections might be seen as introducing an unnecessary and unreal restriction to the detriment of groups without a strong, or consistent, hierarchy. In both cases at issue, subsidiary membership of a VAT group would force input tax deduction on the basis of group third party turnover, leaving, if any, only a minor irrecoverable amount.

Supreme Tax Court decisions XI R 38/12 and XI R 17/11 of December 11, 2013 published on March 5, 2014

No damages for excessive court delay leading to favourable result

A taxpayer filed a suit in November 2005 against his income tax assessment 2004. The point at issue was the tax office' refusal to recognise court costs as having been necessarily incurred and therefore deductible. At the time, the Supreme Tax Court's case law supported the position of the tax office. The tax court took the first concrete step towards opening proceedings in August 2010 with the appointment of a judge to try the case. The first result was a rejection of the taxpayer's plea in October 2010 on the basis of existing case law of the Supreme Tax Court. Later, though, the taxpayer was successful – Supreme Tax Court decision in February 2012 accepting that deduction of the costs at issue could not be excluded *a priori*. The basis for this decision was a Supreme Tax Court case decided in May 2011 in which the court reversed its previous attitude and held that court costs were necessarily incurred in defence of a taxpayer's rights, unless his case was hopeless from the start. The taxpayer then sued for damages for the aggravation caused by the long delay of the lower court in opening proceedings, claiming an amount of at least €4,200. The amount of tax in dispute was €169.

The Supreme Tax Court has now rejected the claim for damages, as the taxpayer had, all things considered, suffered no loss. It did not therefore go into the question of whether a delay of over four-and-a-half years before opening proceedings might have been unreasonable. Rather, it took the position that had the case been tried earlier, the lower court would have followed the earlier case law and the taxpayer would have lost. To this, the taxpayer objected that had he lost he would have appealed to the Supreme Tax Court with the same arguments that persuaded the court to change its attitude in 2011. The court, however, rejected this contention as hypothetical. Consequently, unreasonable or not, the delay had been to the taxpayer's advantage. He had therefore suffered no loss and had no claim for damages.

Supreme Tax Court judgment X K 2/12 of November 20, 2013 published on January 29, 2014

From Europe

German rule on taxation of hidden reserves on contribution of business for shares upheld

The Reconstructions Tax Act allows the owner of a self-contained business unit, or of a partnership share, to transfer the asset to a corporation at its book value as a contribution in kind in exchange for newly issued shares. One of the conditions is that Germany should retain the right to tax a capital gain on any subsequent sale of the newly issued shares. If she does not, the asset is transferred at market value and the transferor is required to tax the deemed gain without waiting for realisation. However, at the time of the case, this tax liability could be spread interest-free over the following five years, provided collection was assured. Two Austrian companies jointly owning a German partnership contributed their partnership shares to a German company as a contribution in kind. They objected to taxation, even on deferred payment terms, as discriminatory, given that German partners could have made the same contribution tax-free and would not have been concerned with any form of taxation on a capital gain, until the gain was actually made.

The ECJ has now agreed that the German provisions are a discriminatory hindrance on the free movement of capital (they apply regardless of size or proportion of the partnership holding), but sees them as justified in the overriding public interest. Under the German/Austrian double tax treaty, gains on the sale of shares in a corporation are taxable in the country of residence of the seller. However, sales of partnership shares are taxable as business income of the partners in the country of the partnership. Thus the contribution effectively removed the taxation right from Germany. Since Germany had no other way of protecting her tax interest, the immediate taxation requirement was legitimate. The five-year spread option was adequate to relieve the hardship of immediate taxation. The only proviso made by the court was that the condition for the spread, that collection be assured, should not be applied in an unduly burdensome manner, without regard to the actual risk (or lack of it) of default.

n.b. The Reconstructions Tax Act was revised in 2006 and the five-year spread option is no longer available. However, there are other provisions to alleviate hardship or apparently unfair taxation, and these might be sufficient for a court to hold that the German rules continued to be within the limits necessary to achieve a legitimate object.

The ECJ case reference is C-164/12 *DMC* judgment of January 23, 2014.

SME definition not purely formal

An SME (small or medium-sized enterprise) placed its entire marketing and many of its technical and managerial functions in the hands of another. The same two individuals were joint managing directors of both companies. The first company was owned by three shareholders, the two managing directors and – as the majority shareholder – one of their wives. The second company was held in equal shares by the wife's husband and his mother. The first company claimed an East German investment grant (no longer available in 2014) at the higher level available to SMEs. The tax office only allowed the lower benefit available to larger companies on the grounds that the two businesses effectively acted as a single unit and should be treated as one, even though they were not formally joined by shareholding or contract. The dispute came before the ECJ because the investment grant rules refer to the EU SME definition.

The ECJ has now held that a business should only be entitled to SME privileges if it remained an SME after taking all other businesses into account with which it regularly acted in concert. Acting in concert was not just a matter of shareholdings or contract; it was a question of fact and could stem from family or other ties. The court pointed out that most SME privileges were exemptions from more onerous requirements on business as a whole and definitions should therefore be followed strictly. However the court also said that although acting in concert was not necessarily dependent upon a contract, a deliberate intent to abuse the SME rules did not of itself suffice for the denial of SME privileges.

The ECJ case reference is C-110/13 *HaTeFo* judgment of February 27, 2014.

Lower taxi VAT rate only justified if noticeable difference in the service

The VAT Directive allows member states to charge VAT at a reduced rate for the "transport of passengers and their accompanying baggage". German law partially transposes this with a reduced rate provision for public transport within a local community or over distances of up to 50 km. It defines public transport as trains, busses, ferries and taxis. Taxis are the vehicles registered as such and subject to local and federal rules. Two cases came before the ECJ on the privilege for taxis over other arrangements for the transport of passengers by car. Both were brought by non-taxi providers claiming an unfair, competition distorting advantage for taxis to their own detriment. The taxi reply was to call upon the obligations on taxi drivers as a condition for their licence, in particular, the obligation to accept all fares and the requirement for a standard charge as shown by the metre. As against this they also had the privilege of picking up fares off the street and of accepting orders through the city net. They also enjoyed certain privileges on the road, such as the right to use the bus lane at intersections, thus enhancing the value of their service to the rush-hour customer.

The first taxpayer operated a transport service for the unwell, essentially paid for by the health service under a negotiated contract. Taxi firms were also invited to tender for the same agreement. The rates payable were well below the standard fares, whilst ordering was always in advance. The transport service company claimed the lower, taxi rate of VAT to place it at an unfair disadvantage, since this was in the circumstances the only distinction between the two service providers that mattered to the consumer or health service. The second case was brought by a local transport operator claiming that for standardised customer services (such as school children) there was no difference in service level, whilst for callers the only noticeable difference was the phone number. Fares "off the street" were a rarity in modern times. Both plaintiffs lost their cases before the German regional tax courts on the basis of the clear wording of the VAT Act. However, the Supreme Tax Court harbours doubts as to whether the apparent taxi drivers' privilege is in accordance with community law, particularly with the principle of tax neutrality.

The ECJ has now held that a taxi privilege can only be justified where there is a – for the customer – noticeable difference in service level. This was fairly obviously not the case with respect to the medical transport service, and may well have been not the case for the local transport company. In both instances it was for the national courts to examine the circumstances.

The ECJ joined case references are C-454/12 *Pro Med* (medical transport) and c-455/12 *Pongratz* (transport operator) judgment of February 27, 2014.

No deduction from travel agent's turnover for discounts given to travelers

A German travel agent sold travel services to the public on behalf of tour operators in return for a commission chargeable to standard rate VAT as a domestic service. Some of the services provided by the tour operators were subject to margin taxation (the tour operators' margin scheme – TOMS), whilst others were exempt. On its own initiative, the agent offered customers a discount off the published price which it claimed as a deduction from its taxable turnover, citing the ECJ judgment *Elida Gibbs* (case C-317/99, judgment of October 24, 1996). *Elida Gibbs* allowed a manufacturer a deduction for rebates granted by retailers to customers which they charged to the manufacturer direct even though their contractual relationship was with the wholesaler. The tax office granted the claim only in respect of those services falling under the margin scheme in the hands of the tour operators, refusing it in respect of services exempt from VAT altogether.

The ECJ has now held that *Elida Gibbs* is not relevant to the present situation. In *Elida Gibbs*, the discount given ultimately reduced the turnover of the manufacturer and it was therefore appropriate to reduce his VAT basis accordingly. In the present case, the discount remained a cost for the travel agent and had no effect on the results of the tour operators. Rather, these received the catalogue price from the agent and paid him the agreed commission. Any discount paid by the agent had no effect on his taxable turnover, his commission charges to the tour operators.

The ECJ case reference is C-300/12 *Ibero Tours* judgment of January 16, 2014.

Exclusion of domestic sub-subsidiaries from tax group conflicts with freedom of establishment?

Under Dutch law a domestic parent may form a tax group with its domestic subsidiaries or with a domestic permanent establishment of a foreign subsidiary. However, sub-subsidiaries may not join a tax group without their parent. In consequence, neither the Dutch sub-subsidiary of the German subsidiary of a Dutch parent could join the tax group of the latter, nor could three Dutch subsidiaries of a German parent pool their results in their own Dutch tax group. These two questions have been combined in three joined cases before the ECJ. Both have parallels in German law. The advocate general has now issued her opinion.

In all three cases the Dutch domestic units of the group were prevented from joining a Dutch tax group simply by virtue of their foreign parents. This contrasted with the position that would have obtained, had their parents themselves been subject to Dutch taxation through a permanent establishment. It also contrasted with the position of purely domestic groups, since the group would have had a free choice as to the inclusion of each subsidiary with its own sub-subsidiaries. These contrasts were a restriction on the freedom of establishment of all concerned. The restriction could not be justified by the need to prevent a double deduction of losses (once directly and once through the write-down of the investment in the books of the foreign parent), since that "danger" existed regardless of the existence of the Dutch tax group. In any case, it was primarily a matter for the foreign state to allow or disallow the write-down of its own taxpayer. It could also not be justified by the need to preserve the coherence of the tax system, since only domestic companies were at issue. If

Dutch permanent establishments of foreign companies could be included successfully in a Dutch tax grouping, then so could the Dutch sub-subsidiaries of foreign parents. The advocate general also dismissed Dutch (and German) government objections to the grouping of three subsidiaries without their (foreign) parent. Arguments that this led to a group without a taxpayer were purely technical or administrative and could easily be resolved.

The ECJ case references are C-39/13 *SCA* and C-41/13 *MSA* (sub-subsidiaries) and C-40/13 *X AG* (subsidiaries of foreign parent) opinion of February 27, 2014.

From PwC

Doing Business and Investing in Germany

We have revised our Guide to Doing Business and Investing in Germany to reflect the position as of January 1, 2014. A pdf version of the new edition can be downloaded from
http://www.pwc.de/en/internationale-maerkte/doing-business-and-investing-in-germany.jhtml

The printed edition will be available shortly. At that time, an ordering button will be added to the download page.

Breaking news

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

BEPS – The state of play

The following link leads to a recent interview (video and transcript) with Pascal Saint-Amans, director of the OECD Centre for Tax Policy and Administration on the OECD's BEPS (base erosion and profit shifting) and associated projects.
http://www.pwc.com/gx/en/tax/tax-policy-administration/beps/OECD-BEPS-video.jhtmlhttp://

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