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Constitutional Court refuses case against double charge to income and inheritance tax on interest claims

An heir to an estate objected to the unrelieved inclusion of the nominal amount of interest earned by the testator up to the date of death in the inheritance tax computation. His objection was based on the double charge to inheritance tax on the estate and to income tax in his own hands once the interest was duly paid. The tax courts refused the objection as being without foundation in law and the Constitutional Court has now refused to try a case based on the principles of equality of taxation for lack of prospects of success. The court's main point was that the legislature was within its rights not to permit a deduction for future income tax payable from the accrued interest included in the gross estate in the interests of simplicity. Simplicity would be lost if the estate duty computation were to be subject to a future income tax charge to be based on factors unknowable at the date of death and, in any case, beyond the ambit of the testator or the estate. Also the amount involved – €16,000 on a gross estate of some €7.5 m – was not so significant as to be manifestly unfair or to render acceptance of the inheritance uneconomic.

Constitutional Court resolution 1 BvR 1432/10 of April 7, 2015 published on May 13

Official Pronouncements

LIFO – open questions clarified

All businesses with a double-entry accounting system may opt to value their inventories under the assumption of LIFO (last in first out) "provided this conforms to the commercial law principles of proper bookkeeping". Once exercised, the LIFO valuation must be continued with in subsequent years unless the tax office allows a departure. The finance ministry has now issued a decree outlining the conditions to be met for initial application of LIFO.

The basic condition of conformity to the principles of proper bookkeeping is met if LIFO is not obviously at variance with the nature of the business and leads to a simplified inventory valuation over the basic rule of valuing each individual item separately. The option is therefore open in respect of all stocks with (if perishable) a shelf-life of more than one year. With this limitation, it can be exercised regardless of the treatment in the legal accounts, of the actual store-keeping practices of the company, or of any legal or other requirements to which it may be subject (e.g. food hygiene rules). The option need not be exercised uniformly for the entire inventory, but rather the individual items can be grouped. However, it is not available – as not meeting the principles of proper bookkeeping – if the stocks are not physically counted at least once a year.

Bank interest

Some banks make a charge – referred to as "negative interest" – when accepting deposits on certain types of account. The finance ministry has now announced in a decree that it regards "negative interest" of this nature as a deposit or custodial charge deemed to be covered by the savers' allowance (€801 p.a.). Accordingly, such charges are not specifically deductible from taxable income.

In the same decree the ministry also states that it regards interest on bank refunds of loan handling fees (in response to Supreme Court judgments in 2004 holding standard text agreements for service fees for reviewing loan applications to be invalid) as interest income of the borrower subject to withholding tax to be accounted for by the paying bank.

VAT invoiced in error can be settled with that on main supply

VAT billed in error is due on issue of the incorrect invoice. However, the ministry of finance has now recognised that a supplier issuing an incorrect invoice will generally not be aware of his error at the time. Accordingly, it has now announced that "for reasons of practicability" no exception will be taken to a supplier's recording and accounting for the incorrect VAT in the same reporting period as for the VAT correctly due on the main supply. The VAT Implementation Decree has been altered accordingly.

Land – taxable value notifications provisional

Land tax among other dues is assessed on the owner of property on the basis of the taxable value attributed to the site. The taxable values of the land are ultimately based on the current market values as assessed by the tax authorities when the system was first introduced in 1934. They have little relevance to the present day market values and a case is pending before the Constitutional Court claiming that they can no longer be used as a basis for taxation. The finance ministries of the provinces have now issued a joint decree (with the approval of the federal ministry) instructing tax offices to issue all notifications of taxable land values and all notifications of the basis of assessment to land tax (assessed and collected by the local authority) on a provisional basis. This keeps the assessments open until the Constitutional Court reaches a decision. If that decision is favourable, all assessments affected will be revised or withdrawn as appropriate without the need for further action by taxpayers.

Supreme Tax Court Cases

No foreign passive income attribution for trade tax

A German company held a subsidiary in Singapore. This subsidiary earned passive income – interest and exchange gains – to be attributed to the parent under the CFC rules. The tax office maintained that this attribution applied to all taxes on income and thus to trade tax as well as to corporation tax. The Supreme Tax Court, though, has now agreed with the taxpayer that the income attribution falls to a foreign permanent establishment and is thus to be deducted from the trade tax base. The court argued primarily from the wording of the Trade Tax Act, eliminating profits from "a" foreign business establishment. The "a" business establishment did not restrict the elimination to profits from an establishment of the taxpayer. The court added that if that interpretation was felt to be too abstruse, an income attribution from profits arising in a business establishment abroad presupposed the attribution of the establishment itself. In effect, the elimination of the income in question reflected the spirit of the Trade Tax Act of taxing income earned through German business establishments.

Supreme Tax Court judgment I R 10/14 of March 11, 2015 published on May 6

Minimum taxation not a reason for provisional assessment

A GmbH subsidiary of a French group brought forward losses from prior periods. Its loss offset in the year under review was restricted by the "minimum taxation" provisions to the first €1 m of the annual profit plus 60% of the remainder. The amount of the restriction (the "minimum" taxable income) increased the amount of the loss carry forward and thus potentially lengthened the carry forward period. However, some four years later the group was considering a reorganisation that might have the effect of invalidating any remaining loss carry forward rights. Accordingly, the GmbH requested the tax office to allow it to keep its options open by issuing tax audit assessments provisionally. The tax office refused as the tax audit had been closed out and there was no reason not to issue final assessments.

The Supreme Tax Court has now confirmed the tax office in its stance. A taxpayer may request provisional assessment where there is doubt as to the facts, or where court cases are pending that could lead to a different interpretation of the law. However, there was no doubt here as to the facts or as to the law; the doubt was on the nature of a future transaction. This was not a ground for issuing a provisional assessment.

Supreme Tax Court judgment IR 32/13 of December 17, 2014 published on April 15, 2015

Hedging gain not taxable with main transaction

A privately held asset management business held a number of properties for letting. These properties were primarily financed from bank loans at fixed or variable interest rates. The business hedged its interest rate risks with a series of interest swaps. These swaps were set to coincide with the individual risks. However, at one point, the management reassessed its view of the market situation and concluded that the hedges were no longer necessary. It thus took advantage of early break clauses in the contracts to wind up the hedging transactions. A series of gains resulted. The tax office saw these gains as part of the rental activities and taxable as such. The business saw them as short term gains from speculation in other assets that were only taxable if wound up within one year of opening. However, the one-year period had already passed in each case.

The Supreme Tax Court has now held that the gains from the release of the hedges are to be taxed as short-term gains from speculation. They were achieved from the sale of the asset – the claim to an interest swap – and were thus not, or no longer, linked to the property or the income therefrom. This applied even if one took the view that the hedge had been made for the sole purpose of protecting the income from the property. Winding up the hedge destroyed the link to its original purpose and thus to the property income.

Note: following a change in the law, these gains would now rank as investment income and be taxable regardless of the holding period of the security.

Supreme Tax Court judgment IX R 13/14 of January 13, 2015

Capital gain holding period runs to date of binding agreement to sell

Capital gains from the sale of privately held property are exempt from income tax if the property was held for more than ten years when sold. A taxpayer purchased a property from a disused railway site on April 1, 1998 and sold it by contract of January 30, 2008. The tax office included the gain in the individual's income tax assessment for 2008 on the grounds that the property had been held for less than ten years. He protested that the sale was not final until December 10, 2008, the date the railway authority confirmed formally that there was no longer any railway interest in the site. The sale was conditional on this confirmation and would have been reversed, had the confirmation not been forthcoming. The Supreme Tax Court has now held, though, that the date of sale was the date the sale became binding on both parties, that is, in this case on January 30, 2008. From that date on, neither party had any choice but to follow the terms of the contract, including the obligation to reverse the sale should the railway authority elect to maintain its interest in the site.

Supreme Tax Court judgment IX R 23/13 of February 10, 2015 published on April 1

EEA donations must be supported

A German couple made a donation to an otherwise unnamed Spanish "foundation" apparently operating from a villa on Majorca. The foundation's purpose was charitable in support for "learning, education, the arts and culture, as well as all forms of support for youth and for the aged" and medical assistance for the needy. It confirmed receipt of the donation from a GmbH but did not disclose the use to which the funds had been put or offer any details as to its actual activity. The tax office refused a donation deduction for lack of evidence of entitlement. The foundation later issued a second confirmation of receipt of the donation, this time naming the taxpaying couple as donors, but again without confirming the use to which the funds had been put. It did, though, emphasise that it had been recognised as a charity under Spanish law and, as such, submitted a yearly activity report to the Spanish authorities. Tax office requests for a copy of this report went unanswered.

The Supreme Tax Court has now confirmed that the tax office was right not to grant a deduction for the donation as claimed. Donations to bodies in other EEA countries were deductible if the recipient supplied the same evidence of charitable intent and purpose as would be expected of a German counterpart. A foreign foundation could not be expected to meet the German forms, although any deficiencies in substance had to be met by the German taxpayers claiming the deduction. This they could do with all the documentation at their disposal or which they could obtain from the foundation itself. In particular it included documentation, such as an official activity report, which was in any case known to exist. The documentation submitted, including a balance sheet showing assets of €25,000 (which presumably did not include the villa) and an income and expense statement showing running costs of €18,000 (the donation at issue was €15,000) offered no indication of the actual charitable activity. Accordingly, the taxpayers' claim was rejected as unvouchered.

Supreme Tax court judgment X R 7/13 of January 21, 2015 published on May 6

No spread of tax-free employee share benefit over all employees

Employees receiving shares in their employer's company gratis or at a discount off the market price receive a taxable benefit in kind. However the first (now) €360 is tax-free under a special provision of the Income Tax Act. An employer operated an employee ownership scheme under which staff were encouraged to buy packets of ten shares at market value following the annual general meeting of the company. The employee then received an additional bonus share free-of-charge at stated intervals throughout the following ten years, provided he had not left the company or sold his shares. New employees could also participate in an additional scheme under which they were granted five shares free-of-charge, but blocked for 10 years and forfeit if the holder left the company in the meantime. The company calculated the taxable benefit in a lump-sum for all employees taking a tax-free allowance for each employee into account. The tax office, and now the Supreme Tax Court, saw the tax-free allowance as specific to each employee. Thus it could only be taken into account in a lump-sum calculation in respect of those employees specifically entitled to it in the year in question – i.e. those who had actually received bonus shares in that year and only up to the market value of those shares on receipt.

Supreme Tax Court judgment VI R 16/12 NV of January 15, 2015 published on April 1

Internet trade in pharmaceuticals: no deduction for payments to health fund customers

A Dutch internet pharmacy accepted German orders from private patients as well as from members of the health funds within the social security system. As a pharmacy it was required by German law to give medicinal advice in person to all its customers. As an internet supplier from outside the country, it was unable to do this and compensated its customers with a cash payment. In its VAT return, it treated these payments as a reduction of taxable turnover. It saw its deliveries to private patients as taxable turnover as intra-community supplies to non-business customers. Its sales to health fund patients were tax-free as sales to the health funds.

The supreme Tax Court has now confirmed the lower court in its decision not to allow the pharmacy to deduct its payments to health fund customers (patients) from its taxable turnover to private patients. There was no direct connection between the tax-exempt supplies to health funds and the taxable sales of goods to private patients. Even if one followed the logic of the argument that the sales to health fund patients were effectively sales to those people, with the health fund merely acting as a payment intermediary, the conclusion would be unfavourable for the pharmacy as its entire sales would then be subject to VAT.

Supreme Tax Court resolution V B 174/14 of February 24, 2015 published on April 1

Mail order attempt to avoid VAT fails

A mail order business sold books and CDs to German consumers. The goods were delivered from a store run by an associated company in Switzerland. Delivery was by post. The postal service cleared the shipments through customs under an arrangement with the seller. Customs clearance was "for the account" of the customer. However, customers were assured that no taxes or duties would be payable, or, if they were, would be borne by the seller. VAT on import was not due under a small shipment exemption for packages worth up to €22. However, the tax office maintained the seller had sold the goods in Germany to German consumers and should have paid the VAT on sale.

The Supreme Tax Court has now agreed with the tax office. Customs clearance was made by the seller acting in his own interests. Under no circumstances could any charge be passed on to the customer. Similarly, the arrangements with the postal service had been agreed by the seller. He was therefore the importer of the goods. Their subsequent sale to the customer was thus a German domestic sale subject to VAT.

Supreme Tax Court judgment V R 5/14 of January 29, 2015 published on April 29

From Europe

Roll-over relief provision infringes EU freedom of establishment

Under a long-standing, though periodically modified, provision in the Income Tax Act, businesses may defer the tax charge on the capital gain from the sale of certain business assets (mostly land and buildings) by deducting the gain from the cost of a replacement asset. This reduces the amortisation basis of the replacement or, alternatively, its base cost for computing any future gain on sale. The replacement must be acquired within a set time limit (basically four years for the purchase or commencement of construction) and must be held as a fixed asset of a domestic permanent establishment. The European Commission took issue with this latter condition which appears to discourage German businesses from moving to another member state of the EEA.

The ECJ has now held in favour of the Commission. The German right to taxation on the gain on sale of a German fixed asset is undisputed. However, immediate taxation on the gain reinvested in another member state is discriminatory in comparison to the roll-over relief – effectively a long-term deferral – available on reinvestment in Germany. Neither the Commission nor the court accepted the correlation between the initial gain and the subsequent gain on sale, or annual write-down, of the replacement asset. The ECJ has now insisted that the German business reinvesting the gain on the sale of a German asset in a replacement asset in another member state at least be allowed the option of deferring payment of the tax liability. It would then be for the business to claim the deferral and accept the additional administrative burden as a necessary consequence, or to accept immediate taxation for the sake of administrative simplicity. If, however, a business felt able to accept the administration, the tax authority would have no grounds for claiming that its own additional administrative effort was unreasonable. Time will show the import of this latter remark.

The ECJ case reference is C-591/13 *Commission v. Germany* judgment of April 16, 2015

10-year tax deferral on gain on transfer of assets to other member state not disproportionate

A German partnership transferred a set of patents to a permanent establishment in Holland. The tax office insisted on recording the transfer at market value, but (relying on the then case law) allowed the partnership to spread the gain over the next ten years. The partnership objected that any taxation charge before the gain was ultimately realised was a hindrance on its freedom of establishment. The ECJ has now confirmed that charging a gain to tax before realisation is indeed a hindrance on the partnership's freedom of establishment, but has also held that that hindrance is justified by the need to preserve the balance of taxing rights between member states. The ten-year deferral of the burden is sufficient to alleviate undue hardship, particularly in view of the increasing risk of taxpayer default with the passage of time. In this connection, the court drew attention to an earlier judgment accepting a five-year capital gain deferral as sufficient – C-164/12 *DMC* judgment of January 23, 2014 – which would seem to suggest that the 2006 reduction of the deferral to five years should be acceptable under community law.

The ECJ case reference is C-657/13 *Verder Lab Tec* Judgment of May 21, 2015.

Estimated taxation on deemed income from non-transparent third country investment funds upheld

German law taxes unit holders in foreign investment funds that do not fully comply with the German disclosure requirements on the total of the actual distribution received and (now) 70% of the increase in the unit price over the year. This total shall not be less than 6% of the closing value at year end. A German taxpayer investing in Cayman Island funds through an account held with a Liechtenstein bank objected to this taxation on deemed income as a restriction on her freedom of capital movement. However, the ECJ has now held that investment funds essentially provide financial services and that the German legislation falls under the "grandfather" provisions of Art 64 of the TFEU, allowing continued application of restrictions on the free movement of capital in force on December 31, 1993. The present German legislation is substantially unchanged since that date.

The ECJ case reference is C-560/13 *Wagner-Raith* judgment of May 21, 2015.

Continued German tax liability under DTT does not conflict with Swiss free movement agreement?

A German resident worked for a Swiss subsidiary in Germany. Later, he moved to Switzerland, but retained his job in Germany. As a cross-border commuter he was no longer a German tax resident. However, the German/Swiss double tax treaty allows Germany to continue to tax the German source income of former long-term residents (other than Swiss nationals) for the next five full years after their move to Switzerland. German national law contains a corresponding (but more extensive) provision – Sec. 2 of the Foreign Tax Act – whilst the EU/Swiss free movement agreement basically requires each side to treat nationals from the other side as its own citizens in substantially all respects. The taxpayer protested against continued German taxation of his salary, claiming that it conflicted with the spirit of free movement between Switzerland and the EU.

The ECJ advocate general on the case has now suggested the court accept that there is no conflict in letter or spirit between the two agreements, or with the general principles of EU law. The free movement agreement explicitly reserves bilateral double tax treaty provisions, and the provision here at issue follows a legitimate aim of preserving a German taxing right for a limited period. Swiss tax on the German income is credited against the German charge, so the taxpayer suffered no additional burden from his move. The discrimination prohibitions of the free movement agreement do not apply to citizens in their own country, so the German taxpayer cannot claim in Germany that a Swiss national would have been in a more favourable position.

The ECJ case reference is C-241/14 *Bukovansky* opinion of April 30, 2015.

Partnerships to be eligible for VAT groups?

Two German partnerships held shipping partnership subsidiaries to which they provided management services for a fee. Because the VAT Act does not allow partnerships to join a VAT group as subsidiaries and also restricts membership of VAT groups to financially, managerially and economically integrated subsidiaries, the respective tax offices refused to allow them more than a minimal input tax deduction in respect of their expenses incurred in raising capital and acquiring investments. The official argument was that the main activity of the holding partnerships was to hold investments in other partnerships, that is, a "non-economic" activity per se.

The ECJ advocate general has now published his opinion on the joined cases brought by the two partnerships with their claims that the German rules were more restrictive than those of the Sixth (VAT) Directive and should therefore be disapplied. More precisely, he addressed three questions. Firstly, to the effect that a managing partnership's costs of raising capital and to acquire investments were incurred in connection with its economic activity as a whole. There was thus no relevant "non-economic" activity, so that the input tax at issue should be deductible in full, unless the partnership also achieved VAT-free turnover alongside the VAT-able management fees. He then suggested that the Sixth Directive precluded the exclusion of a subsidiary from a VAT group solely on the basis of its legal form (partnership), unless that exclusion were justified by the need to prevent abuse. However, he also made the point that he could not see how the prevention of abuse could possibly be affected by the legal form of an enterprise, although that question would be a matter for the national court. His third point was that national legislation requiring the formal integrational links of the German provisions went beyond the requirements of the Sixth Directive, although the national court might, in these cases, be able to justify the additional restriction with the need to protect the VAT system from criminal activity.

The ECJ case references are C-108/14 *Laurentia* and C-109/14 *Marenave* joint opinion of March 26, 2015.

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