German Tax News

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1. Federal German Tax Court: Liability of the recipient of an invoice if the issuer does not pay the VAT – burden of proof on the tax authorities

In 2003 a provision was added to the German VAT Code (Umsatzsteuergesetz, hereinafter "UStG") with the purpose of limiting VAT fraud, particularly in regard to so-called "carousel transactions" (Karussellgeschäfte), in which the sellers and buyers are the same but cannot be identified because a third party initiates the transaction. In order to avoid this type of fraudulent transaction, Section 25d UStG specifies that the recipient of an invoice is liable for VAT in the case of non-payment by the invoice issuer who showed the VAT on the invoice but upon issuing the invoice intended not to pay the VAT or deliberately brought about a financial situation which prevented him from being able to pay it.

The case decided by the German Federal Tax Court on February 28, 2008 did not involve such a case of fraudulent trade, but rather an invoice issuer who entered into a transaction even though insolvency proceedings had already been started against his company. The preliminary insolvency administrator did not allow the seller to pay the VAT on the invoice in order to protect the insolvency assets.

The lower tax court held that it should be regarded as a general principle that a seller whose business is confronted with insolvency, will not pay VAT on an invoice issued under such a situation. The Federal German Tax Court, however, overruled the lower tax

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court stating that even in such situations the tax authorities bear the burden of proving that the seller intended not to pay or deliberately accepted that he would not be able to pay the VAT at the time of entering into a transaction.

Additionally the Federal German Tax Court referred to a discussion under German tax experts as to whether Section 25d UStG is even consistent with EU-law. The Court noted that while the German provision is based on EU-Directive 77/388/EWG and has the intent of avoiding fraudulent transactions, the wording is so much broader than the Directive's language that even non-fraudulent cases might lead to the liability of a third, uninvolved person. In the case presented above, the Court did not need to decide this question, but the fact that it cited the discussion at length could hint to the Court's intent to bring this issue to the European Court of Justice (ECJ) in the near future.

2. **Federal German Tax Court: Profits from the sale of options on new stocks by a corporation is not free from corporate tax**

A Federal German Tax Court decision, issued on January 23, 2008, involved a corporation K which held shares of another corporation G-AG. When G-AG decided to increase its capital stock, K did not participate in the increase but did receive options to participate in the new shares which it then decided to sell. K did not declare taxable income from the sale of the options because it believed that the option sale was equivalent to the sale of shares in the corporation and therefore fell within the scope of Section 8b(2) KStG, which exempts from taxation a corporation's profit arising on the sale of shares in another corporation.

The lower tax court agreed with K, citing a decision of the ninth senate of the Federal Tax Court from October 2005, and held that the profits were free from corporate taxation. Upon appeal to the German Federal Tax Court, however, the case came before the first senate which ruled that the profits had to be taxed since, in its view, Section 8b(2) Corporate Tax Code (Körperschaftsteuergesetz; hereinafter "KStG") only allows exemption from taxation in regard to the sale of interests which would create capital gains for the holder within the meaning of Section 20 Income Tax Code (Einkommensteuergesetz; hereinafter "EStG"). According to the first senate, dividends fall under this income category, but options on new stock do not because they do not produce capital gain income.

The first senate was further of the opinion that the situation addressed by Section 8b KStG is not comparable to that of Section 3(40) EStG which addresses profits in terms of Section 23

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EStG to which the profits from the sale of options has never been attributed. The Court further noted that Section 8b(2) KStG has a different purpose than Section 3 (40) EStG since the former is intended to avoid the cascading effect of the repeated taxation of a transaction at different levels of a company group, whereas the purpose of the latter is only to avoid simple double taxation of business profits. Therefore, in regard to the sale of options, the question of whether profits are free from taxation or not depends on the concrete situation of the seller. If the seller is a corporation, the profit is taxable, but if the seller is an individual, the profit from the same transaction is exempted from taxation.

The decision issued by the first senate of the Court is very surprising given that the ninth senate of the same court in October 2005 issued a contrary opinion on the taxation of profits from the sale of options held by an individual as private assets. While the wording of Section 3(40) EStG, which is applicable to profits from sales by individuals and the wording of Section 8b (2) KStG which is applicable to sales by a corporation, is nearly identical, the first senate believes that the different treatment is necessary and does not present a contradiction.

3. Federal German Tax Court: Management fees paid by one Dutch corporation to an affiliated Dutch corporation may be qualified as hidden profit distributions and increase the taxable income of a German permanent establishment

The most interesting aspect of the Federal German Tax Court decision from March 5, 2008 is the fact that payments from a Dutch corporation to another Dutch corporation may have an influence on the determination of German taxation.

In the case decided, the shares of the Dutch company X-BV were held by C-BV, the shares of which were, in turn, held by A-BV and B-BV. All of the companies were domiciled in the Netherlands. X-BV, which had a permanent establishment in Germany, concluded a contract with A and B (the individual, Netherlands-resident shareholders of A-BV and B-BV, respectively) in which A and B were named as managing directors of X-BV.

Within the context of the corporate tax assessment of the German permanent establishment, the German tax authorities determined that the management fees paid to A and B were higher than those paid by German corporations in comparable situations and qualified them as hidden profit distributions. X-BV demonstrated that the fees were in accordance with Dutch tax law in support of its opinion that

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they were therefore deductible expenses and not hidden profit distributions.

The Federal German Tax Court supported the view of the German tax authority. The Court noted that the income determination of a German permanent establishment must begin with a review of the total income of the foreign corporation and must be calculated in accordance with German provisions even if it is only partly earned by the permanent establishment. As a second step, that part of the income which can be allocated to the permanent establishment must be calculated. Therefore, the Court noted, applying German tax principles would lead to the assumption that a hidden profit distribution had been made since the management fees exceeded those which would normally be paid by comparable German companies under similar circumstances. The Court further noted, however, that only the excess part of the income could be attributed to the permanent establishment with the resulting increase in its taxable income.

4. European Court of Justice: German provisions which prevent taxpayers from deducting exchange rate losses in connection with the capital endowment of a foreign permanent establishment violate EU-law

On February 28, 2008, the ECJ ruled that Germany must allow the deduction of exchange rate losses resulting from the repayment of capital which has served as the capital endowment of an Italian permanent establishment for many years.

In the case decided, the German Shell GmbH had integrated an Italian permanent establishment into an Italian subsidiary and sold the shares of the latter. A part of the gain realized on the sale was used to repay the former capital endowment of the permanent establishment. Since the Italian Lira had suffered massive losses within the relevant twenty-year period, Shell GmbH received around € 60 million less than it had invested in the permanent establishment. The losses could not be deducted in Italy, because the Italian bookkeeping was in Lira and therefore showed no exchange loss. In Germany, the deduction was not possible because of the double taxation treaty between Germany and Italy which exempts all types of income from a permanent establishment from taxation in the other state regardless of whether the income is positive or negative.

The ECJ found that this situation leads to a violation of the freedom of establishment granted to all business entities within the EU and rejected the so-called symmetry theory of the German Federal Tax Court

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which states that the treaty exclusion of a certain type of positive income necessarily requires the exclusion of the same type of negative income. The ECJ noted that, in regard to the type of income involved, only Germany was in the position to grant relief since the negative income only arose in Germany and would therefore not give rise to a double exclusion of income.

Since not every member state of the EU joined the currency union at the same time, this decision will likely be of great relevance in the future. Furthermore, the strict ruling in this case gives hope to many investors who are awaiting decisions in another pending case concerning losses from permanent establishments. In the case of Lidl vs. Finanzamt Heilbronn, the EU Advocate General delivered his final opinion on February 14, 2008. In this opinion, he stated that the freedom of establishment is violated when a member state precludes a company, when calculating its taxable income, from deducting the losses of a permanent establishment in another member state on the ground that the corresponding income from such a permanent establishment is not subject to taxation in the first member state under a double taxation convention. If the ECJ follows this opinion, the German system of the taxation of permanent establishments would need to be completely revised.

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