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Final Judgment of the BFH in the Columbus Container Services Case

With its final judgment in the Columbus Container Services case dated 21 October 2009 (ref. no. I R 114/08), the Federal Tax Court (BFH) has decided that German statutory rules on controlled foreign companies (CFC) in the version of 21 December 1993, which were in principle applicable until 31 December 2007, are in violation of the freedom of establishment. The rules at issue in the case provide for a switch-over from the exemption method to the credit method for income from a foreign permanent establishment where such income would be taxable as CFC income if such foreign permanent establishment was a foreign subsidiary.

Columbus Container Services (Columbus) is a Belgian limited partnership with partners resident and subject to unlimited tax liability in Germany. Columbus' commercial business income was treated as passive income and was subject to a low rate of taxation in Belgium. The German tax authorities therefore denied the German partners the exemption provided by Art. 7 (1) Double Tax Treaty Germany/Belgium

and taxed the commercial business income allowing for a credit for tax levied in Belgium. The case was brought to the Münster Tax Court and referred to the ECJ by the Court for doubts about compatibility with Community law.

The ECJ (Columbus Container Services – C-298/05, see February 2008 edition of German Tax Monthly, p. 1) did not find the switch-over provision to be in violation of the freedom of establishment or the free movement of capital, since the application of the credit method ultimately resulted in the equal tax treatment of foreign and German companies. The case was then continued before the Münster Tax Court which dismissed it as unfounded on 11 November 2008 (ref. no. 15 K 1114/99 F, EW); Columbus filed an appeal with the BFH.

In its final judgment the BFH for the first time shed light on the relation between the ECJ's decision in the Cadbury Schweppes case (C-196/04, see October 2006 edition of German Tax Monthly, p. 3) and the Columbus case. In the Court's view, German CFC rules in the version applicable in the year in question are in breach of Community

law since they lack the possibility of producing evidence in rebuttal, i.e. a so-called motive test. Under the motive test, a taxpayer may prove that he has participated in the foreign state's economy in an active, permanent and sustained manner for the purpose of the company's business, employed appropriately qualified staff and operated appropriate business premises and therefore possessed sufficient economic substance and generated income from its own activities. Columbus would have passed such a motive test and therefore its income would not have been regarded as CFC income. The German CFC rules are therefore not applicable to Columbus so that a switch-over from the exemption to the credit method is precluded. Finally, as the BFH regards Community law as it stands as unequivocal, it does not consider it necessary to refer the case to the ECJ again.

As a consequence of the ECJ judgment in the Cadbury Schweppes case, the German legislator had amended the CFC rules to include a motive test from the year 2008 onwards. However, the switch-over clause for passive income from foreign permanent establishments remains applicable regardless of the new motive test. In fact the BFH did not explicitly decide whether such a specific exception to the applicability of the motive test constituted itself again a breach of Community law or not, but the judgment contains good reasons for applying the motive test also to income from foreign permanent establishments in future and thus to avoid the legal consequence of the switch-

over clause for lack of applicability of the CFC rules.

Relocation of a Sole Proprietorship to another EU Member State does not Constitute a Fictitious Business Discontinuation

In its judgment dated 28 October 2009 (ref. no. I R 99/08) the Federal Tax Court (BFH) issued its view on whether or not the relocation of a domestic business to another EU Member State leads to the immediate taxation of hidden reserves because the relocation is to be considered as a business discontinuation, although, in fact, the business is continued in the other Member State ("fictitious business discontinuation").

In the case at issue, a taxpayer transferred his domicile and business, a sole proprietorship, from Germany to Belgium in 1995. He continued the business in Belgium in an unchanged manner. The tax authorities were of the opinion that the business relocation was a taxable, fictitious business discontinuation of the sole proprietorship and assessed a capital gain from business discontinuation. The tax authorities based their opinion on the BFH's case law on what is referred to as the "theory of final business discontinuation". According to this theory, a relocation constitutes a business discontinuation if it leads to a situation where hidden reserves can no longer be taxed in Germany.

In the case at hand, the BFH abandoned the settled case law on the theory of final business discontinuation. The Court held that in the year in question no legal basis or need for regula-

tion had existed and that it was therefore not justified to assume that the relocation implied a taxable realization of the business's hidden reserves. If the taxpayer is no longer subject to tax liability in Germany, because the owner of the business not only transfers the business but also his domicile to the foreign state, Germany's right of taxation of the hidden reserves created in Germany is not precluded in the Court's view.

According to national tax law, the business owner's gains on the sale remain subject to non-resident tax liability to the extent that such gains are based on the realization of hidden reserves created in Germany. Even subsequent income is subject to non-resident tax liability to the extent that it is derived from activities pursued in Germany. Subsequent taxation of hidden reserves created in Germany is not precluded by tax treaty law, either. According to the principle of causation, tax treaty law allocates to Germany the right to tax any hidden reserves created before relocation. The fact that there is no permanent establishment and/or fixed place of business at the time of realization is irrelevant.

The abandonment of the theory of the final business discontinuation is based on a changed interpretation of tax treaty law. The BFH already applied the interpretation principles in a judgment dated 17 July 2008 (see November 2008 edition of German Tax Monthly, p. 2) on the recognition and taxation of hidden reserves where assets are transferred to a foreign permanent establishment. The conclusion from both BFH judgments is that the

BFH recognizes the split of the gains on the sale between Germany and the country of immigration according to the principle of causation. Germany's right to tax the hidden reserves created in Germany is therefore not restricted.

Point in Time of Recognition of Losses from a Foreign Permanent Establishment

In the Lidl Belgium case (ref. no. C-414/06) the ECJ issued its view on whether the non-recognition of losses from foreign permanent establishments at the level of the German head office in cases where double tax treaty exemption applies is compatible with Community law. According to this judgment the non-recognition of losses in determining the German head office's income does not constitute a violation of the freedom of establishment, unless the possibility to use them in the state where the foreign permanent establishment is located has been exhausted (so-called final losses). The judgment was covered in the June 2008 edition of German Tax Monthly. Following the ECJ judgment, the Federal Tax Court in its judgment of 17 July 2008 (ref. no. I R 84/04) adopted the ECJ's statements regarding the finality requirement, but did not consider consequential issues such as in which accounting period such permanent establishment losses are to be recognized.

In the meantime, two first-instance judgments have been handed down on the assessment period in which such permanent establishment losses are to be considered in determining the head

office's income for German tax purposes.

According to the Düsseldorf Tax Court's judgment dated 8 August 2009 (ref. no. 6 K 308/04 K), permanent establishment losses may not be recognized when determining income for German tax purposes in the year in which the losses were incurred. The permanent establishment losses may only be recognized at this time if it is concluded to be impossible already in the year in which the losses are incurred that such losses may be offset in the state where the permanent establishment is located at any future point in time. If, however, from the perspective of the year in which the losses are incurred, it cannot be ruled out that the losses may be used at a later point in time, such losses cannot be deducted until the year in which such losses become final.

As opposed to that, according to a judgment of the Hamburg Tax Court dated 18 November 2009 (ref. no. 6 K 147/08) losses are to be deducted in retrospect in the year in which they were incurred. In the view of the Court this also applies where it is not yet clear at the end of the year in which the losses are incurred that such losses can definitely no longer be used in the state where the permanent establishment is located, and they do not become final until a later period. It is the Court's opinion that once such losses have become final in a subsequent year, it is definite that such losses are to be deducted in Germany in the year in which the losses were incurred. To that extent, the finality of the losses is an event with retroactive effect within

the meaning of Tax Procedure Law, so that the tax assessment notice of the year in which the losses were incurred may be amended retroactively.

Both judgments are not final, and given the controversial nature of this matter, it remains to be seen how the Federal Tax Court will decide.

Definition of the Term "Enterprise" in Double Tax Treaties in the Context of Commercial Partnerships

Some recent judgments passed by German Tax Courts dealt with the extent to which the re-qualification of pure passive asset management partnerships as deemed commercial partnerships under German tax law (§ 15 (3) no. 2 EStG (Income Tax Act)) affects tax treaty law.

In its judgment dated 13 August 2009, the Cologne Tax Court (ref. no. 15 K 2900/05) ruled that the above fiction has no impact on tax treaty law. Thus, a deemed commercial partnership under German tax law may not be qualified as an enterprise for tax treaty purposes by the single fact of its legal form and while said partnership is not engaged in a trade or business.

In the case at issue, the plaintiff, who is resident in Switzerland, was a limited partner of a German GmbH & Co KG (KG) (inbound case). The KG was a pure passive asset management business and deemed to be commercial solely due to the fiction of § 15 (3) no. 2 EStG.

In the context of the Double Tax Treaty between Germany and Switzerland (Double Tax Treaty Switzerland) the question was raised as to whether the

KG was an enterprise within the meaning of Art. 3 (1) f of said Double Tax Treaty. As the wording of the Double Tax Treaty Switzerland is not unequivocal, the law of the state applying the Tax Treaty applies for the interpretation.

This issue is a controversial and much discussed topic in German law. The tax authorities stated in the so-called Permanent Establishment Decree (Federal Ministry of Finance guidance issued on 24 December 1999, Federal Tax Law Gazette I 1999, p. 1076) that even a partnership exclusively engaged in passive asset management activities had to be considered a commercial business under tax treaty law, too, when such partnership were to be deemed commercial due to its legal form under German tax law.

However, this opinion differs from the view that prevails in literature according to which it is not appropriate under tax treaty law to deem a business to be commercial by virtue of its legal form.

The Cologne Tax Court follows the prevailing opinion as expressed in literature. According to said Tax Court even the single term "operate" implies that the business pursues an activity on the market, which is precisely not the case with a pure passive asset management business (Art. 3 (2) Double Tax Treaty Switzerland). The partnership's actual activity alone determined whether the partnership could be assumed to be an enterprise within the meaning of the Double Tax Treaty. Under tax treaty law the principle of the priority of the more special income category is to be applied. This means

that, as a general rule, double tax treaties provide for special income categories have priority over general income categories. The principle of subsidiarity which is enshrined in German tax law would dismiss the speciality principle at the level of treaty law. After all it is the aim of the Double Tax Treaty to divide the existing right to levy tax between two Contracting States so that it would run counter to tax treaty law to adopt the biased view of one Contracting State and allocate the right to tax to that State (to the other Contracting State's detriment). The fact that § 15 (3) no. 2 EStG was incorporated into the German Income Tax Act as an anti-abuse rule after conclusion of said Double Tax Treaty is another factor speaking against a re-qualification at the level of the Double Tax Treaty Switzerland.

This is also in line with previous decisions of other Tax Courts in outbound cases. For instance, in their judgments dated 14 July 2009 (ref. no. 5 K 210/07) and 28 April 2009 (ref. no. 17 K 1070/07 F) respectively, the Schleswig-Holstein Tax Court and the Düsseldorf Tax Court ruled that § 15 (3) no. 2 EStG does not constitute a basis for re-qualifying income from asset management into commercial income at Double Tax Treaty level because the principle of the priority of more special income categories as established under tax treaty law run counter such re-qualification. Against both decisions an appeal has been filed (ref. no. I R 81/09, I R 49/09). In its non-appealable judgment pronounced as early as on 22 August 2006 (ref. no. 7 K 255/04), the Hamburg Tax Court, too, had reasoned

that the fact of a deemed commercial business alone did not constitute sufficient grounds for business profits within the meaning of the Double Tax Treaty.

Appeal has been filed against the Cologne Tax Court and submitted to the II. Senate of the German Federal Tax Court for judgment (ref. no. II R 51/09).

German Act to Combat Tax Evasion – No Immediate Plans for a "Blacklist" of Tax Havens

In September 2009, the German Act to Combat Tax Evasion entered into force, requiring taxpayers who have business relationships with persons resident in uncooperative jurisdictions to meet additional obligations to cooperate, provide evidence or clarifications (see September 2009 edition of German Tax Monthly, p. 5). As from 2010, a so-called "blacklist" is to be maintained, listing uncooperative jurisdictions that do not provide to foreign tax authorities upon specific request, and in accordance with the standards established by the Organisation for Economic Co-operation and Development (OECD), information that is relevant to a taxation proceeding, thus facilitating tax evasion for citizens of other jurisdictions. According to a Federal Ministry of Finance (BMF) guidance issued on 5 January 2010, as at 1 January 2010 no jurisdiction was listed on the blacklist.

Shortly before the turn of the year, i.e. shortly before the Act to Combat Tax Evasion became applicable, Germany and Luxembourg signed an amending protocol to adapt the existing Double Tax Treaty to the current OECD standard of exchange of information.

Pending its ratification by the legislator, the protocol will be applicable as from the assessment period 2010. This means that currently all jurisdictions are considered cooperative. When the occasion arises, the Federal Ministry of Finance will provide information about jurisdictions that no longer qualify as cooperative in the future. No additional obligations to cooperate, provide evidence or clarifications exist for taxpayers until that point in time.

BMF Guidance on the Interpretation of the Term "Business Relationships"

Where related persons maintain cross-border business relationships, German tax law has an independent statutory basis that governs any income adjust-

ments required. According to the statutory basis, the taxpayer's income from foreign business relationships must be increased notwithstanding any other rules, if the terms agreed do not meet the requirements of the arm's length principle.

According to several Federal Tax Court (BFH) judgments, the business relationship between a domestic parent company and its foreign subsidiary does not qualify as a business relationship for the purposes of the above provision if the parent company supports the subsidiary without receiving payment (e.g. unlimited letters of comfort, interest-free loans) instead of providing appropriate equity. The BFH holds that in such case the parent company acts

in its capacity as shareholder and that no business relationship is entered into.

In a recent guidance and by way of contrast to the opinion previously held by the tax authorities, the Federal Ministry of Finance has declared the ruling to be applicable to all open assessment periods prior to 2003. However, as from the 2003 assessment period, support measures for which no remuneration is received are to be regarded as business relationships that can trigger an income adjustment due to an extension of the legal definition of business relationship which covers all types of legal relationships under the law of obligations.

Imprint

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