

Contents

- ECJ Decision in Columbus Container Services
- ECJ Judgment in Grønfeldt
- Compatibility of Withholding Tax on Artists and Athletes with EU Law Not in Doubt According to Federal Tax Court
- Tax Court of Baden-Württemberg: Pharmaceutical Companies May Reduce VAT
- Federal Tax Court Clarifies Application of Corporate Loss Limitation Rules
- Right of Representation as Intangible Fixed Asset
- Protocol to Tax Treaty Between Germany and U.S. in Force
- Promulgation of the 2008 Tax Act in the Federal Tax Gazette

ECJ Decision in Columbus Container Services

In a judgment dated 6 December 2007 (*Columbus Container Services – C-298/05*), the European Court of Justice (ECJ) upholds an important provision in Germany's controlled foreign corporation (CFC) legislation. Specifically, the court finds that the principles of freedom of establishment and free movement of capital are not infringed by a provision that mandates switching from the exemption to the credit method for income of a foreign permanent establishment where such income would constitute CFC income if derived by a foreign corporation. The case involved a Belgian limited partnership (Columbus) that was owned by individuals resident in Germany. Columbus was subject in its country of residence to a low rate of taxation on its commercial business income. The German tax authorities denied the German partners the exemption for permanent establishment income that was provided for under the applicable tax treaty. The German partners' distributive shares of partnership income were instead treated as taxable in Germany subject to a credit for foreign

tax paid (switchover from exemption to credit method).

The ECJ noted in its decision that the income of the foreign partnership was subject to the same rate of taxation as the income of a German partnership. The court reasoned that the foreign partnership was therefore not subject to discriminatory treatment. The adverse consequences of the credit method compared with the exemption method resulted, in the court's view, from the exercise in parallel by two EU member countries of their fiscal sovereignty. The court indicates that Community law does not require the member countries to tax comparable economic dealings in an identical fashion and that adverse consequences resulting from the exercise of tax autonomy by different member countries are permissible under the current state of harmonization of Community tax law.

Contrary to the opinion of the advocate general, the court declined to comment on the linkage of the switchover provision to Germany's CFC tax regime, although the ECJ had held in *Cadbury Schweppes* (case C-196/04 – see *German Tax Monthly* Oct. 2006, p.3) that

CFC regimes can violate European law in certain cases. This does not mean that the ECJ regards Germany's CFC regime as compatible with EU law. The court merely saw no reason to comment on this aspect of the switch-over clause.

While Germany recently modified its CFC regime in response to *Cadbury Schweppes*, no changes were made in the switchover clause at issue in *Columbus Container Services*. In as much, the double taxation with respect to income earned through permanent establishments in other EU/EEA countries will continue to be avoided by the credit method instead of the exemption method where such income would constitute CFC income if earned through a corporation.

ECJ Decision in Grønfeldt

At issue in the ECJ's *Grønfeldt* decision (case 436/06 – 18 December 2007) is whether, in the year 2001, taxation of gains on the sale of shares under § 17 EStG (Income Tax Law) infringed the free movement of capital guaranteed by Article 56 EC because, in 2001, the ownership threshold triggering such taxation was lower for shares in foreign companies than for shares in domestic companies.

Under § 17 EStG, certain gains on the sale of shares held as private assets are taxable. The percentage ownership threshold triggering such treatment has been repeatedly lowered over the years. The most recent reduction applied to sales of shares in domestic corporations from 2002 onwards, but to sales of shares in foreign corpora-

tions beginning in 2001. Consequently, in the year 2001 gains on the sale of shares in a foreign corporation were taxable if the seller held a stake of 1% or more in the corporation, but gains on the sale of shares in a German corporation were taxable only if the seller owned a stake of 10% or more.

The ECJ held that this difference in treatment was not compatible with the free movement of capital under Article 56 EC. The court reasoned that a difference in treatment based on the place of investment discourages shareholders from investing in the shares of companies resident in other countries and also has a restrictive effect on such companies by impeding their efforts to raise capital in Germany. Neither the fact that the restriction existed only for a limited period of time nor the fact that it arose in connection with the transition from one system of corporation tax to another constitutes an overriding reason of public interest sufficient to justify the restriction.

Compatibility of Withholding Tax on Artists and Athletes with EU Law Not in Doubt According to Federal Tax Court

Artists and athletes resident in foreign countries are subject to German non-resident tax liability with respect to fees for performances and events in Germany. The fees are subject to a withholding tax of up to 20%, which a domestic event organizer must withhold at the source. The withholding tax is based on gross earnings. Taxpayer can recover overpayments by filing tax returns. The application requires that expenses related to the

domestic activity exceed half of the domestic gross income.

There is a long-standing discussion as to whether the withholding procedure may violate Community law. In two decisions on point (*Gerritse*, case C-234/01 of 16 June 2003, and *Scorpio*, case C-290/04 of 3 October 2006) the ECJ has treated the withholding procedure as an efficient means of tax collection that is compatible with EU law provided the event organizer takes account of business expenses of which it is notified and provided artists and athletes can recover any overpayments by filing tax returns without any requirements. The ECJ notes that the state of the law may have changed after the entry into force in 2003 of the EC directive on the recovery of claims. The member countries may now have an alternative means at their disposal that is comparable in efficiency to a flat rate withholding tax.

In its ruling of 29 November 2007 (I B 181/07), the Federal Tax Court states that the compatibility of the withholding procedure with Community law is not presently subject to serious doubt. The entry into force of the EC directive on the recovery of claims does not change this assessment, in the court's opinion. Despite their international mutual assistance agreement, the EU member countries remain unable to ensure the efficient collection of taxes due to different administrative procedures, language problems, and other deficiencies.

The ruling was handed down in a response to a motion seeking a stay of execution. A decision on the merits is still pending.

Tax Court of Baden-Württemberg: Pharmaceutical Companies May Reduce VAT

The extent to which a pharmaceutical company may amend its return to deduct the so-called manufacturer's discount from the basis on which VAT is calculated is the subject of a judgment dated 6 November 2007 by the Tax Court of Baden-Württemberg.

The legal context of the case is as follows: Under the Code of Social Law, health insurance funds receive a discount from pharmacies for medications dispensed. The discount is equal to 6% of the manufacturer's selling price. Pharmaceutical companies are, however, required to reimburse pharmacies for the discount (so-called manufacturer's discount or compulsory discount).

The plaintiff pharmaceutical company argued that the manufacturer's rebate constituted a net discount. It therefore calculated the rebate based on the net sales price and reduced the base on which VAT is calculated accordingly.

The tax authorities challenged this treatment. Taking the position that the statutory manufacturer's discount represented a gross amount, just like other discounts granted by a manufacturer with respect to its merchandise, they increased the assessment base again.

The Tax Court of Baden-Württemberg held that the statutory manufacturer's discount is properly calculated from the net sale price (sales price net of VAT). The court stated that this approach accorded with the views of the Federal Ministry of Health and Social Security and the wording of the relevant provision in the Code of Social Law (§ 130a (1) SGB V). The court stated that an agreement after the fact that reduces the amount of the agreed consideration also results in a reduction in the amount of VAT. However, if the discount is calculated based on the value of the supply net of VAT, then, for purposes of determining the VAT assessment base, the discount has to be treated as reducing the net consideration. The judgment is not yet final.

Federal Tax Court Clarifies Application of Corporate Loss Limitation Rules

A corporation is permitted to deduct losses under § 8 (4) KStG (Corporation Tax Law) only if it is legally and economically identical to the corporation that incurred the loss (loss limitation rules, change-of-control rules). A transfer of more than 50 % of a corporation's shares coupled with an injection of predominantly new business assets causes the corporation to lose its economic identity and hence forfeit its loss carryforwards. Please note that from 1 January 2008 new § 8c Corporation Tax Law applies tightening the loss limitation rules significantly. § 8 (4) KStG Corporation Tax Law may however still apply in certain cases (see *German Tax Monthly* June 2007, p.1).

In a judgment dated 5 June 2007 (I R 9/06), the Federal Tax Court rejects the positions taken by the tax administration on several issues of material importance.

The court states that new business assets predominate when newly acquired assets exceed the assets that are already present. Under the specific-asset approach developed by the court, each new business asset is counted individually. It is not permissible to net acquisitions against disposals and treat merely the quantitative excess of acquisitions over disposals as newly injected assets. The court thus reaffirms its prior holding (decision of 5 June 2007, I R 106/05; see *German Tax Monthly* November 2007, p. 1) and again rejects the net asset approach advocated by the tax administration.

In its latest judgment, the court also addresses the question whether one looks solely to fixed assets or also counts current assets in order to determine whether new assets predominate. While the tax administration bases the determination on total assets, the lower courts have split on the issue of including current assets. In the judgment here reported on, the Federal Tax Court states that current assets must be counted at least when the injection of new business assets is associated with a change in nature of the corporation's business (*B Branchenwechsel*, change in industry sector or trade).

The Federal Tax Court also comments for the first time on when and to what extent loss carryforwards are forfeited. The court's position is that loss carry-

forwards in existence at the time of the detrimental share transfer are forfeited upon fulfillment of the conditions of § 8 (4) KStG (Corporation Tax Law). The tax administration contends that the taxpayer also forfeits the losses that arise between the time of the share transfer and the time of injection of predominantly new business assets (interim period). The court's decision on this point is both positive and negative from the taxpayer's perspective. The fact that losses sustained in the interim period remain available for offset against future profits is positive. However, income earned in this period may no longer be offset against losses incurred prior to the share transfer.

Right of Representation as Intangible Fixed Asset

At issue in the Federal Tax Court judgment of 22 August 2007 (X R 2/04) was whether a right of representation could be capitalized as an intangible asset. A commercial agent had obtained the exclusive right to represent a publishing company within a certain territory. Under the relevant contract, the commercial agent acquired the exclusive right in return for a payment, the amount of which was treated as an interest-free loan from the publishing company. Repayment of the loan was to be by way of offset against the settlement payment due to the commercial agent under § 89b HGB (Commercial Code) upon termination of the agency relationship. In the event the settlement payment was less than the loan principal owing, the publishing company waived its right to repayment of the difference.

The tax authorities and the Lower Tax Court refused to permit the right of exclusive representation to be capitalized as an intangible asset acquired for consideration and then amortized over a three year period. The Federal Tax Court reversed the Lower Tax Court and permitted both the capitalization and the amortization.

Under § 5 (2) EStG, an intangible asset may only be capitalized for tax purposes if it was acquired for consideration from a third party. The Federal Tax Court held that the disputed capitalization of the right of exclusive representation as an intangible asset was not barred by a lack of consideration. The court stated that the payment to acquire the right of representation need not be made immediately. Rather, the court considered it sufficient for the accrual basis taxpayer to incur a liability that was repayable only through set-off against future receivables. The court likened the arrangement to the purchase of goods on deferred payment terms, which indisputably results in cost of acquisition to be capitalized at the time of purchase.

The lower court had also refused to permit capitalization of the asset because of the waiver of loan repayment to the extent the loan amount exceeded the future offsetting claim under § 89b HGB. The lower court argued that, because of the waiver, the requisite certainty as to the justification and amount of the cost of acquisition was lacking. In the lower court's view, the waiver meant that the commercial agent's payment obligation was in effect subject to a condition precedent, with the result that acquisition cost

could not arise until the condition had been fulfilled. Only at the time of the waiver – so the lower court – would it be clear whether and in what amount costs were actually incurred to acquire the right of representation.

The Federal Tax Court found that no condition precedent existed because the payment owing to acquire the right of representation would be waived in full only if no settlement claim whatsoever arose under § 89b HGB, hence that otherwise there would be cost of acquisition in some amount at least.

The Federal Tax Court also clarifies that the period over which a capitalizable intangible asset such as a right of representation is amortized depends on the anticipated useful life of the specific asset in question.

Protocol to Tax Treaty Between Germany and U.S. in Force

The protocol signed by Germany and the United States on 1 June 2006 amending their tax treaty (see *German Tax Monthly* July/August 2006, pp. 1 - 2) entered into force upon exchange of the instruments of ratification on 28 December 2007. The major changes include the following:

- Complete elimination of taxation at the source on dividends paid by subsidiaries to parent corporations
- Revisions to the provisions of the treaty that pertain to income derived through fiscally transparent entities (above all partnerships) and income arising in permanent establishments subject to a low rate of taxation

- Mutual recognition for tax purposes of pension plans by the treaty states in order to facilitate the exchange of personnel between the treaty countries
- Planned establishment of an arbitration body to help settle differences of opinion between the U.S. and German tax authorities on application of the treaty

The amendment of the tax treaty completely eliminates taxation at the source on cross-border dividend distributions, provided the recipient com-

pany holds at least 80% of the voting rights in the distributing company and meets one of the requirements listed in treaty Article 28. This is the case e.g. where the recipient company's shares are regularly traded on a stock exchange, where at least half of these shares are owned directly or indirectly by a company whose shares are traded on a stock exchange, or where at least 95% of the shares are held by shareholders resident in EU, EEA, or NAFTA countries. Taxation at the source is eliminated retroactively for withholding taxes on amounts distributed or cred-

ited on or after 1 January 2007. Withholding taxes already remitted for this period are refundable.

Promulgation of the 2008 Tax Act in the Federal Tax Gazette

The 2008 Tax Act was promulgated by publication in the Federal Tax Gazette on 28 December 2007 and hence entered into force on this date. The principal changes made by this legislation are the subject of an article in the December 2007 / January 2008 edition of *German Tax Monthly*.

Imprint

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