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The war in Ukraine

Its implications from a German tax and law perspective

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The war in Ukraine has led to a profound international crisis which impacts the European economy. As prices for consumer and non-durable goods, especially fossil fuels, are increasing, economists predict a significant cooling of global economic growth. In response to the invasion of Ukraine by Russian troops, the EU, together with its international partners, has adopted substantial sanction packages. Amongst others, these directly target numerous individuals and institutions in Russia and abroad that support the war against Ukraine. This also affects members of the Russian government, five other members of the RUS National Security Council, all Duma deputies, representatives of the military, and numerous oligarchs. The sanctions lead to the exclusion of several Russian banks from the SWIFT system and prohibit transactions with the Russian central bank, which will leave 70% of the Russian banking market and important state-owned enterprises cut off from the main capital markets. In addition, the sanctions ban the import of Russian coal and oil.

Spotlight

The war in Ukraine

As Russia depends on the revenues generated by its exports of refined oil to the EU, it is expected that these measures will have a major impact on the Russian economy. Moreover, imports of timber, cement and other products that are important sources of income for Russia will also be banned. Furthermore, Russia will not be able to access key technologies (e.g., semi-conductors or software) as those may no longer be exported to Russia. This ban also covers dual-use goods (e.g., goods on the EU export list) and related services from the EU to Russia.

To ensure that the sanctions enacted by the EU can be enforced in Germany, the German Parliament (Bundestag) and Federal Council (Bundesrat) passed the so-called Sanctions Enforcement Act I (Sanktionsdurchsetzungsgesetz I) at the end of May and plan to present the draft for the Sanctions Enforcement Act II (Sanktionsdurchsetzungsgesetz II) before the parliamentary summer recess.

To mitigate the economic consequences of the crisis, the German government has already initiated several legislative measures to provide relief to German citizens and businesses. These include an increase in the basic tax-free allowance and the employee lump-sum allowance, as well as an advanced increase in the commuter allowance and the mobility bonus, the lump-sum energy allowance, and the so-called children's benefit.

In its decree dated 17 March 2022, the Ministry of Finance (BMF) also comments on various executive measures. In this letter, the BMF eases the requirements for proof of benefits for donations paid into special accounts as well as for fundraising activities in support of the aggrieved parties of tax-privileged corporations. Donations of wages in favor of tax-exempt aid to aggrieved other employees or in favor of a donation account should not result in taxable wages. In the area of sales tax, the BMF explains, among other things, that sales-taxable transfers of material resources, personnel and premises are treated as closely related transactions and as tax exempt from sales tax, insofar as these are made between beneficiary entities whose transactions are each exempt under the same provision. ▸

Spotlight

For companies affected by the economic repercussions of the war or the sanctions lists, the question arises as to when the conflict impacts accounting and how to deal with the loss of receivables or assets in general. In this regard, the Institute of Public Auditors in Germany (IDW) issued an initial statement on 8 March 2022, in which it classified the illegal border crossing by the Russian military on 24 February 2022 as a non-adjusting event for annual accounts with an earlier year-end. Therefore, the evaluation of financial statements with closing date before the event will not be affected as long as the company is able to operate as a going concern (according to Section 252 para. 1 no. 2 Commercial Code). If a company fails to do so, the principle of material balance sheet continuity can no longer be guaranteed, and the assets have to be examined at their individual disposal values (liquidation values). Even if the company expects to stay operational during the crisis, management still has the obligation to report any discernible effects of the crisis and to disclose those in the notes to the financial statements and the management report and, if possible, quantified.

German companies with shareholdings in Ukraine or Russia will have to examine how their fair market value has been impaired on a sustained basis due to an expected permanent reduction in value as a result of the war. The destruction of operating facilities and infrastructure or impaired supply chains for example will presumably lead in many cases to a need for a balance sheet write-off for the affected companies. However, for tax purposes the use of write-offs is only an option. Depending on the tax status of the German parent entity, off-balance sheet adjustments must also be considered, which lead to the full or partial "reversal" of balance sheet write-offs of shares in corporations. This particularly affects corporations with regard to the off-balance sheet deduction prohibition of Sec. 8b para. 3 Corporate Income Tax Act as well as the partial deduction prohibition of 40% for affected partnerships due to Sec. 3c para 2 Income Tax Act. Such a legal result is certainly problematic from the point of view of economic performance because real losses arise that are not deductible at all or only to a limited extent. To avoid this outcome, German business representatives have been demanding a force majeure rule that would allow for an increased deduction of such losses.

Also qualified shareholder loans of the German parent entities against Ukrainian or Russian shareholdings will have to be tested for their recoverability. It will presumably be even more important in the future than it has been to date to prove that a full deduction can be recognized as an expense by means of a third-party comparison test. This also applies within the scope of application of the partial deduction prohibition for individuals as partners in a partnership. The difficulty to fulfill this requirement in the current situation has already been recognized by the BMF. Yet, the German financial authorities have not published a (draft for a) statutory exception.

Without commitment of the German financial authorities, companies might be best advised to look into possibilities to readjust their entity structure. As the impairment losses cannot be claimed directly for tax purposes, tax-advantaged restructuring to be able to offset the losses at least partially against profits, e.g. in the context of a tax group, may be considered.

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Latest German tax legislation driven by low interest rates and attempts to mitigate effects of pandemic

To minimize the economic consequences of the pandemic-related restrictions and to provide additional investment incentives, the German Bundestag (lower house of parliament) passed the Fourth Act on the Implementation of Tax Relief Measures in Response to the Corona Crisis (4th Corona Tax Relief Act) on 19 May 2022.

An unexpected addition was made to the 4th Corona Tax Relief Act in the parliamentary procedure with the abolition of the mandatory discounting of non-interest-bearing liabilities in the tax balance sheet. To date, non-interest-bearing liabilities with a remaining term of more than 12 months are to be discounted in the tax balance sheet at 5.5%.

According to the new regulation, the liabilities concerned will generally be recognized at the settlement amount. This will avoid an additional tax burden from discounting income in the year in which liabilities are initially recognized.

However, the deduction of additional interest that results from discontinuing the requirement to discount liabilities for tax purposes may have an effect on the interest barrier, which needs to be considered. The corresponding tax discounting requirement for provisions remains unchanged.

The new regulation is to be applied for fiscal years ending after 31 December 2022. On request, the regulation can also be applied uniformly in fiscal years ending before 1 January 2023, provided that the assessments concerned are not final. According to the explanatory memorandum to the law, the option is deemed to have been exercised by the corresponding entries in the tax profit calculations.

Furthermore, the final bill stipulates an extension of the extended loss carryback amount of EUR 10m until the end of 2023 as well as a permanent extension of the loss carryback period to two years and the retention of declining balance depreciation for 2022. In addition, several extensions of the tax return deadlines for advised and non-advised cases and corresponding adjustments to other relevant deadlines for the assessment periods 2020 to 2024 are implemented. Please refer to *German Tax & Legal Quarterly 2022 issue 1* for more details.

The Bundesrat (upper house of parliament) approved the bill on 10 June 2022. This means that the law can probably enter into force before the parliamentary summer recess in July.

In a further legislative procedure, the government draft bill of the Second Act to Amend the Fiscal Code and the Introductory Act to the Fiscal Code has been initiated, in particular for the retroactive constitutional structuring of the interest rate for interest on arrears and refunds for interest periods from 1 January 2019.

Compared to the draft bill, one specific change in the evaluation clause should be highlighted. In order to avoid all too frequent and at the same time minor adjustments of the interest rate, a change in the context of an evaluation taking place every three years was originally to be mandatory if the base interest rate applicable on 1 January of the evaluation year deviates by more than one percentage point from the base interest rate applicable at the time of the last determination or adjustment. This restriction no longer appears in the text of the law but is merely part of the explanatory memorandum. The legislator is apparently to be given more leeway in this regard.

Furthermore, the tax authorities reserve the option of further "temporary" suspension of interest assessments for interest periods from 1 January 2019. Thus, interest assessments may continue to be "provisionally" suspended from the entry into force of the new regulations if and as long as the technical and organizational prerequisites for the application of the new law are not yet in place. In due course, the suspended interest assessments are to be made up for.

The bill is to be passed by the Bundestag on 24 June 2022.

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Implementation of the EU Directive regarding cross-border conversions, mergers and demergers into German Law

With the Directive (EU) 2019/2121 of the European Parliament and of the Council of 27 November 2019 (so called Mobility Directive) amending the Directive (EU) 2017/1132 as regards cross-border conversions, mergers and demergers, the EU legislator has established the basis for a uniform legal framework for certain cross-border legal reorganization transactions. The provisions of the regulation are to be implemented in national law by 31 January 2023.

On 20 April 2022, the Federal Ministry of Justice (BMJ) presented the long-awaited draft bill on the implementation of the Directive (EU) 2019/2121. This draft is intended to supplement as well as optimize the rules on cross-border transformation transactions already set out and thus create a reliable legal framework for cross-border legal reorganization transactions. In addition, the draft also contains some innovations for domestic conversions. The implementation of the labour law provisions on employee participation in cross-border conversions, mergers and demergers of the Directive were implemented by a separate draft bill of the Federal Ministry of Labour and Social Affairs dated 19 April 2022.

The draft bill of the BMJ essentially includes the following main aspects:

For cross-border mergers, demergers and changes of legal form (grenzüberschreitender Formwechsel) of stock corporations (Aktiengesellschaften), partnerships limited by shares (Kommanditgesellschaften auf Aktien) and limited liability companies (GmbH), a legally secure procedure compatible throughout Europe will be introduced in which the commercial registers involved communicate digitally with each other.

In addition, the rights of minority shareholders in cross-border and domestic legal reorganization transactions are harmonized. The unequal treatment of minority shareholders of transferring and acquiring companies in the case of mergers will be ended. In this respect, the so-called appraisal proceedings (Spruchverfahren) will be available to both groups of minority shareholders in the future. At the same time, a timely execution of such conversions is ensured by the exclusion of so-called execution-suspended actions (vollzugssuspendierende Klagen) by minority shareholders who invoke an exchange ratio that is unfavorable from their point of view.

It is likely to be of significant relevance in practice that stock corporations will now be given the opportunity to compensate for necessary adjustments in the value ratios of transferring and acquiring companies by means of additional shares instead of cash payments only (Barleistung). This should preserve the liquidity of the companies concerned and facilitate investments in the course of restructuring.

The protection of company creditors in conversion proceedings is also strengthened and their legal protection is efficiently structured. This is to be achieved, among other things, by the fact that, in principle, registration of the measure in question may not be carried out if creditors claim that they have not been sufficiently secured.

Also, the rights of employees are strengthened: Employees are given their own rights to early and comprehensive information about any conversion project in the case of cross-border conversions by their employers, in order to be able to effectively exercise their rights.

The draft bills thus address some challenges of cross-border conversions. It now remains to be seen to what extent the draft laws will be amended in the course of the legislative process.

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BMF issues draft guidance on the withholding tax treatment of remuneration for software contract development

The German Ministry of Finance (BMF) recently published draft guidance on the withholding tax treatment of remuneration for software development abroad. The draft was eagerly awaited — following a change in the copyright rules for software last year — and is relevant for all German-resident or German-nexus companies that have software programmed by foreign contractors (and foreign contractors offering these types of services).

The withholding tax treatment of remuneration in connection with software purchases or software development — even after the BMF clarified the tax treatment of a number of cases in guidance published in 2017 — is a recurring cause for discussion between remuneration creditors and remuneration debtors with regard to the obligation to withhold tax in accordance with Section 50a (1) No. 3 German Income Tax Act (EStG) and the economic burden arising from such withholding tax deduction.

The withholding tax treatment of transfers of rights (for software, among other things) depends crucially on the underlying copyright provisions. In particular, the provisions setting forth a non-transferability of copyright, an author's right to subsequent remuneration and a right to recall the right in the event of non-exercise are of great importance in the withholding tax analysis, as they have been interpreted — in the area of personal copyrights — by the Federal Tax Court in such a way that because of these rights even a complete acquisition of all rights must be qualified as a license (subject to withholding tax) from a tax perspective (and not as a purchase of rights, which would not be subject to withholding tax).

The copyright provisions for computer programs have now been amended as of 7 June 2021 in such a way that the author's right to subsequent remuneration and the right of recall in the event of non-exercise no longer apply to computer programs. The draft BMF guidance now comments on the tax implications of these changes in the German Copyright Act (UrhG).

In the opinion of the BMF, an economic purchase of rights by the German payment debtor (not subject to withholding tax) should now be possible in principle — even if the copyright cannot be legally transferred — since it is now possible in principle to transfer the legal position in computer programs in such a way that no further economic benefit remains with the developer. However, the analysis critically depends on the details of the contractual provisions as to whether they provide for the granting of comprehensive, exclusive and irrevocable rights of use and exploitation to the computer program for an unlimited period of time. The BMF also comments on multi-tier contractual relationships and clarifies that it must be examined at each tier whether an economic purchase of rights exists. If this is not the case at one level, an economic purchase of rights is ruled out for the subsequent levels, even if the party assigns all rights that it has received itself.

The guidance is of high relevance in practice and generally beneficial for taxpayers as it provides criteria for classifying existing contracts and aligning future contracts accordingly. From a practical point of view, the (still) strict requirements for the economic purchase of rights are nevertheless subject to criticism, as they mean increased administrative work and lengthy discussions between contracting parties even in DTA situations (which often provide for a reduction of the withholding tax to zero), as such a strict standard is not known in many other countries and the procedure for obtaining an exemption certificate before the Federal Tax Office often leads to long delays. The guidance will certainly mean more focus on these types of development contracts, so non-resident taxpayers may still consider applying for a withholding tax exemption certificate (at least in cases where the residual rate under the treaty is zero) as this may shorten discussions with their customers.

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Trade tax add-back of rental and lease interest

With decree of 6 April 2022, the German tax authorities have adopted Federal Tax Court (BFH) case law on the trade tax add-back of rental and lease interest. Thus, expenses are not subject to the trade tax add-back pursuant to Section 8 No. 1 of the German Trade Tax Act (GewStG) if they are capitalized as acquisition or production costs of fixed or current assets on the balance sheet date. Due to the balance sheet capitalization, there is no actual profit deduction to add back (not affecting net income). According to the BFH, this also applies to expenses leading to production costs of fixed or current assets which are capitalized in the balance sheet, even if the corresponding assets are removed or sold during the year and are therefore not recognized in the balance sheet on the balance sheet date (cf. inter alia BFH ruling of 30 July 2020, III R 24/18). In contrast, expenses incurred in connection with the production of a self-created intangible (fixed) asset have to be added back due to a statutory capitalization prohibition, which leads to an actual profit deduction (cf. BFH ruling of 12 November 2020, III R 38/17).

The tax authorities also incorporate BFH rulings on the existence of so-called fictitious fixed assets. According to these rulings, only rental and lease payments for rented assets which – assuming the tenant or lessee would be the owner – would belong to his fixed assets are subject to the trade tax add-back. According to the BFH, this fiction must be based on the respective specific business object (cf. inter alia BFH ruling of 8 December 2016, IV R 24/11). In addition, the BFH rulings issued on specific industries (film producer, III R 38/17; concert promoter, IV R 24/11; trade fair organizer company, I R 57/15; package tour operator, III R 22/16) are now applicable beyond the individual case decided and to be applied in all open cases.

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BMF issues updated guidance on notification obligations in case of foreign relations

Pursuant to Section 138 para 2 of the German Fiscal Code (Abgabenordnung, AO), taxpayers with residence in Germany must report certain foreign matters to the tax office. The legal norm obliges domestic taxpayers to inform the German tax authorities of the commencement or change of a foreign engagement or a foreign relationship. Since these engagements are always subject to structural changes, the provision must be observed, not least because of potential penalties. The notifications must be submitted together with the income tax, corporate income tax or tax assessment return for the taxable period in which the facts to be notified were realized, but no later than 14 months after the end of this taxable period. This deadline cannot be extended, as it is neither an official deadline nor a tax return deadline.

On 26 April 2022, the German Ministry of Finance (BMF) issued an updated guidance. In this context the BMF replaced its previously published statements regarding the notification obligations and further specifies its opinion on several points. For example, in case of the acquisition of participations in foreign corporations or partnerships, the BMF states that an indirect participation which is acquired at the same time as the direct participation must always be reported. Regarding the EUR 150,000 limit relevant for triggering the notification obligation (sum of the acquisition costs of all participations within the meaning of Sec. 138 AO), the BMF states that the limit must be determined on a company-specific basis.

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BMF accepts case law regarding the tax treatment of return of capital transactions by non-EU corporations

With a letter ruling dated 21 April 2022 (case reference IV C 2 – S 2836/20/10001 :002), the BMF has commented on the tax treatment of return of capital transactions by non-EU corporations. This had been a controversial topic in the past, as for German-owned EU corporations, strict legal requirements exist which must be met to classify a payment from such EU corporation as (non-taxable) return of capital rather than (taxable, but in a corporate context typically effectively 95% exempt) dividend. Inter alia, the existence and quantum of shareholder contributions available for repayment would have to be certified by the German Federal Tax Office upon application by the payor EU entity.

No such legal requirements existed at all for non-EU entities, which initially led the tax authorities to claim that for non-EU entities, a non-taxable return of capital transaction was not possible at all, and that as a consequence, all payments to shareholders would have to be classified as dividends. This view had repeatedly been rejected by the Federal Tax Court (BFH), and with the new guidance, the tax authorities accept these judgments. Hence, based on the guidance, the requirements for non-EU companies to have their payments to German shareholders qualify as non-taxable return of capital rather than dividend transactions continue to be – somewhat surprisingly – less strict than in EU cases, as the proof of availability of shareholder contributions (and the absence of retained earnings, which would always be deemed to be distributed first) can be based on the last balance sheet of the foreign entity, as set up under foreign law. There is – contrary to the EU cases – no specific certification procedure to go through. The guidance also clarifies that there is no requirement to recalculate the foreign entity's earnings under German tax principles. Special rules apply to the repayment of stated share capital that was created through the conversion of reserves in the last five years.

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Property tax reform – tax return submission required

Property tax is an important tax for owners of real estate located in Germany. Nevertheless, little attention was paid to this tax type in the past decades. In 2018, the Federal Constitutional Court declared the tax base for property tax purposes to be unconstitutional, forcing the German government to create a new law to redetermine the tax basis. The new legal regulations have now been implemented.

Due to the new regulations, the Federal Ministry of Finance (BMF) issued a general order dated 30 March 2022 requesting the submission of tax returns. Furthermore and as the individual federal states were not able to agree on a uniform model, the federal states which have implemented their own valuation procedures also issued their own general orders requesting the submission of tax returns. In addition, some of the federal states send out individual letters to the taxpayers.

In short, each owner of real estate located in Germany is obligated to file an electronic property tax return by 31 October 2022, whereby the electronic declarations can only be submitted from 1 July 2022.

The tax authorities informed us that extensions of the deadline will be granted only in very limited and individual cases. Thus, it is of utmost importance for taxpayers to meet the deadline to avoid any kind of late payment surcharges.

For more information regarding the individual valuation models and the challenges each taxpayer is facing, please refer to *German Tax & Legal Quarterly 2022 issue 1*.

Our property tax specialists at EY will be happy to provide individual support and assist with data gathering and preparation of tax returns. With PropEY, we have developed our own software to digitally prepare and submit tax returns. We can assist clients regardless of location, size or number of real estate properties.

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BMF issues final letter on the income tax treatment of virtual currencies and tokens

The German Federal Ministry of Finance (BMF) issued its final statement on the income tax treatment of virtual currencies and tokens with its letter dated 10 May 2022 after initially issuing a controversially discussed draft in June 2021. So far, German tax authorities had not taken a clear view on this topic, which has gained increased practical relevance over the last years.

From a tax point of view, it was always questionable to what extent the disposal of currencies or activities in the context of virtual currencies such as mining, lending etc. constitute commercial activities or are qualified as private asset management and whether a tax-free disposal is possible after a holding period of one / ten years.

The key aspects of the BMF letter are summarized in the following:

- The BMF applies general German tax principles to distinguish private asset management from commercial activities such as the criteria for commercial securities trading developed by German tax case law.

- Units of a virtual currency held as business assets are considered non-depreciable assets. The acquisition costs are determined by the market price (e.g. stock exchange price) at the time of acquisition of the virtual currency/token. Mining is generally classified as a commercial activity. However, the taxpayer can prove the opposite. Allocation and valuation are based on general (tax) accounting principles. Hidden reserves upon disposal must always be disclosed.

- Regarding virtual currencies held as private assets, the minimum holding period for a tax-free disposal of the currency is one year. After one year, a disposal is tax free. The use of the currency as a source of income (e.g. for lending/staking) does not extend the holding period. The holding period is generally determined according to the first in first out method. Optionally, the average method can be used.

- The BMF states that the exchange of a virtual currency into another virtual currency or into a state currency such as the Euro is considered a (taxable) disposal. However, the minimum holding period applies if the currency is held as private asset.

- Staking and lending, if they do not qualify as commercial activities, lead to other (taxable) income.

- Further, the BMF comments on other activities in the context of virtual currencies such as ICO, Forks etc.

The final BMF letter provides some clarity from a tax perspective in a field that has been poorly regulated so far – especially the clear statement concerning the holding period for currencies held as private assets is welcome. However, questions remain unanswered. For example, the BMF does not include any statements with regard to the taxpayers' recording and cooperation obligations as well as Non Fungible Tokens (NFTs). It can be assumed that the BMF will comment on these topics separately at a later stage.

Investors should review whether they are obliged to correct their tax returns, especially if they have treated capital gains from disposals as tax-free so far.

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Write-down to the going-concern value in the case of securities loans with effect on income

If, in the case of a securities loan, the borrower bears the opportunities and risks of the securities provided, the Federal Tax Court (BFH) states that economic ownership and thus the obligation to account for the securities is attributable to the borrower. In this case, the lender capitalizes a retransfer claim with no effect on profit or loss such that possible write-downs to the going-concern value are not subject to the prohibition on deduction under Section 8b (3) sentence 3 of the German Corporation Tax Act (KStG).

In its decision of 29 September 2021 (case reference I R 40/17), the BFH had to decide on several factual scenarios. A significant topic was the issue of partial value write-downs on the re-transfer claims from securities loans. In this respect, the BFH had to clarify in advance the question of whether, in the context of the loans in dispute, only the "empty shell" of the ownership of the securities under civil law had been transferred to the borrowers or also the (tax) beneficial ownership within the meaning of Sec. 39 (2) No. 1 Sentence 1 German Fiscal Code (AO). The latter was to be affirmed in the underlying case as the borrowers bore the chances and risks of the transferred securities completely. It was irrelevant in this respect that no voting rights were exercised by the borrowers or that any compensation payments (interest, profits and other distributions paid on the securities during the term of the loan were to be reimbursed to the lender) had to be made. Rather, the decisive factor was that the possibility for the borrower to make economic use of price changes was not contractually limited by the fact that the securities were issued to the borrower at a certain price and had to be returned at the same price after expiry of the loan term.

With regard to accounting and valuation at the lender level, the BFH decided – in line with the view of the tax authorities (Ministry of Finance letter of 9 July 2021, para. 11) and the prevailing opinion in the literature – that the re-transfer claim replacing the shares was to be capitalized with the carrying amount of the re-transfer claims issued, i.e. with the carrying amount of the securities, without affecting profit or loss. Furthermore, the consequence of this is that partial write-downs on the receivables in the event of a probable permanent reduction in value (in principle, if the price loss exceeds the de minimis limit of 5% of the quotation at the time of acquisition) are not to be neutralized off-balance sheet. This is because the relevant provisions only apply to profit reductions in connection with shares that are attributable to the taxpayer for tax purposes, and thus not to profit reductions on claims that are based on the future acquisition of shares (retransfer of securities). In this respect, the balance sheet item "retransfer claim" to be valued is therefore a claim for delivery under the law of obligations which is to be distinguished from the share. In the case in dispute, the BFH also ruled out an abuse of law, in particular because the plaintiff had also granted securities loans on shares to a considerable extent in the years in dispute, which were not reduced in their partial value and with regard to which there were consequently no comparable tax advantages.

Taxpayers entering into securities loan agreements should pay close attention to the economic ownership allocation criteria of the BFH when structuring the transaction.

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New VAT challenges for gaming operators

In its decision V R 38/19, the Federal Tax Court (BFH) had to deal with the question whether in-game renting services qualify as a supply of service within the scope of German VAT.

In the case at hand, the plaintiff (a "gamer") acquired virtual land in an online game from the gaming operator established and operating in the US, parceled out this land and "rented" it to other players ("gamers") in the online game against remuneration in the form of in-game currency. Later, the plaintiff exchanged the rent on the exchange platform managed by the gaming operator from the in-game currency into US dollars. The gaming operator itself sold the in-game currency to another player in its own name but for the account of the plaintiff.

The BFH decided that such an in-game "renting" of virtual land to other players does not fall within the scope of German VAT while the exchange of virtual money into real money qualifies as a supply of service in the form of a transfer of rights. As the gaming operator acted as commission agent for the sale of the virtual money, the gaming operator was considered the recipient of the service of the plaintiff.

Gaming operators now face new challenges from a VAT point of view as they have to determine if a player is a taxable person by his interactions in a game to be able to determine the correct VAT treatment of their payments to and from the players. In this regard, proper procedures (e.g. onboarding process where the players must attest their entrepreneurial status, routine checks of player status when payments are received and made) need to be implemented by the gaming operator.

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Identification of the economic employer in the case of intra-group international assignments

In its ruling of 4 November 2021, the Federal Tax Court (BFH) commented on the concept of economic employer in connection with a case on wage tax liability. According to this ruling, the (economic) bearing of costs in cases of international employee secondments within the group merely replaces the employment or service contract relationship between employer and employee that is necessary for the concept of employer under civil law. Irrespective of this, the company must also be regarded as the economic employer of the posted person in accordance with general principles.

An AG domiciled in Switzerland was the sole shareholder of a GmbH domiciled in Germany (plaintiff). In 2009, the companies concluded a service agreement under which the AG provided the GmbH with a managing director (B). This managing director was domiciled in Switzerland and was also a member of the AG's board of directors and CEO of the group of companies. According to the service agreement, the monthly remuneration to be paid by the plaintiff to the AG corresponded to the amount that would also have been payable to an independent third party, with the salary of the predecessor serving as a basis for comparison.

An external wage tax audit took place for the period from July 2012 to October 2015. The auditor was of the opinion that the payments were subject to wage tax deduction because the plaintiff qualified as economic employer of the individual. As a result, the managing director had limited tax liability in Germany and, according to Art. 15 (4) of the double taxation agreement with Switzerland, Germany had the right of taxation. The competent tax office then issued an assessment of liability, and the tax court dismissed the action brought against this. The BFH reversed the previous ruling and referred the case back to the lower court.

As a rule, the employer is the contractual partner under the employment contract. In cases of employee secondment, the receiving company based in Germany, which economically bears the wages for the work performed for it, is also the domestic employer. ▸

Since 1 January 2020, it is sufficient if the receiving company would have had to bear the wages according to the arm's length principle. Since the costs were passed on in the case of the judgment, the assessment by the BFH is not likely to have been (significantly) different. However, not every passing on of costs automatically leads to an obligation to withhold wage tax. A prerequisite for this is that the receiving company also fulfills the other criteria so that it can be regarded as an economic employer. In order to be considered an economic employer, the employee must also be employed by the receiving company in its interest and must be integrated into the work process of the receiving company and be subject to its instructions.

The BFH objected to the fact that the lower tax court had not determined the content of the employment contract with the AG. Neither the nature and scope of the work performed nor the amount of the remuneration received for this work were known. Therefore, it was not clear whether or to what extent the monthly lump sum paid to the AG replaced the part of the remuneration that was attributable to the plaintiff's activities as managing director. The fact that the monthly lump sum was based on the salary of the predecessor was not sufficient. The service agreement did not establish a link between these amounts and the remuneration which the managing director received from the AG. The service agreement could also be interpreted as a service agreement according to which the AG owed the assumption of management by B and received the monthly lump sum in return.

When examining whether an employee is integrated into the work process of a company and subject to its instructions, the general criteria for distinguishing between self-employed and non-self-employed activities also apply to managing directors. There are no findings, for example, on specific working hours, on personal dependency and on being bound by instructions vis-à-vis the plaintiff.

Should the lower tax court come to the conclusion that the GmbH is to be regarded as the economic employer and that the monthly payments are to be regarded (in part) as a substitute for wages, it will have to be clarified whether the division of wages holds up to an arm's length comparison. If it turns out that the monthly payment agreed in the service agreement was higher than the amount to which the AG would have been entitled, the difference would have to be regarded as a hidden profit distribution. No decision has been made as to which taxation right is to be assigned, as it must first be clarified whether the plaintiff was obliged to deduct income tax.

This case shows that the flawed design or implementation of an international assignment can have considerable unintended consequences. Companies are therefore well advised to have (tax) legal consequences examined at an early stage and to weigh the possible courses of action before facts are created.

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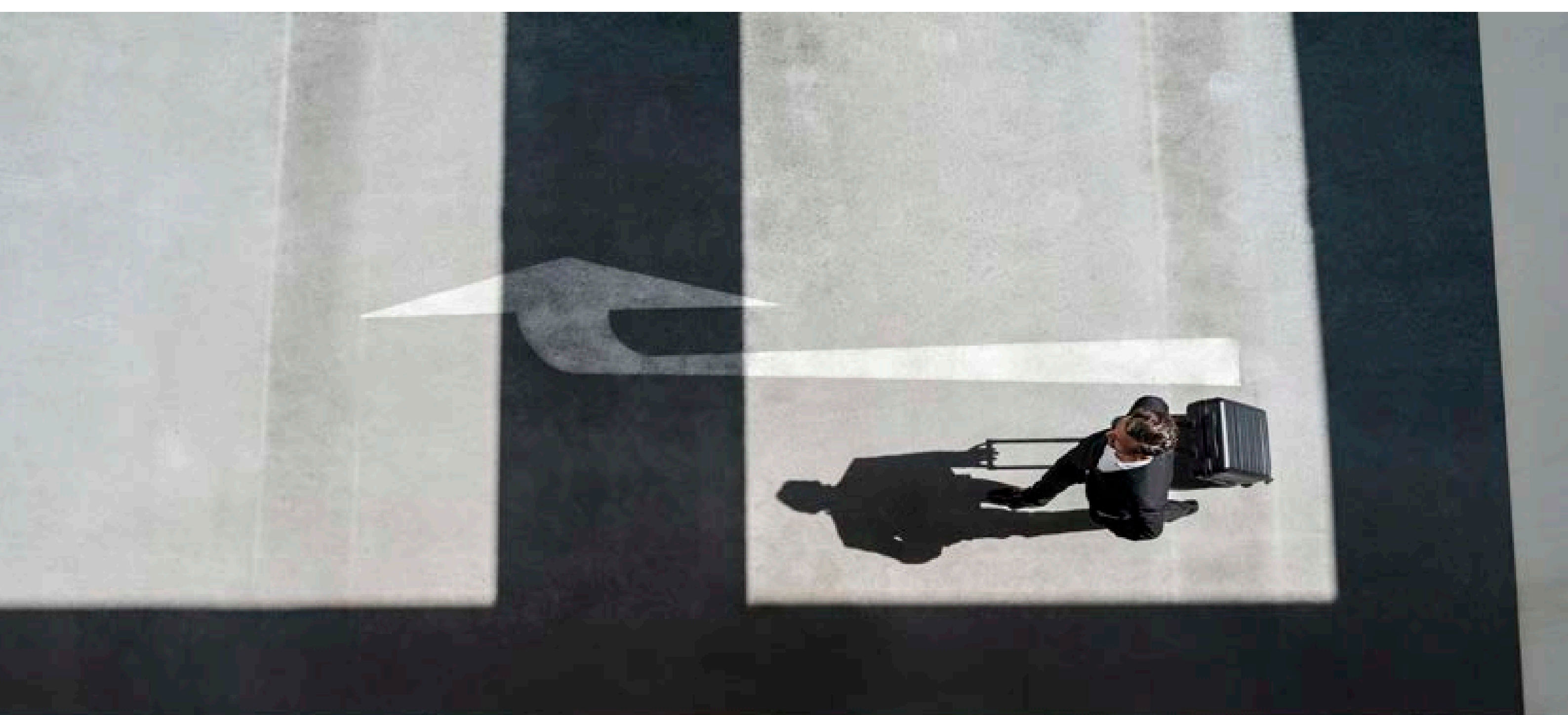

Distributions from common law trusts to German beneficiaries

The German civil law system does not acknowledge the trust as a legal form since Germany has not signed The Hague Trust Convention of 1985. For German tax purposes, any trust must be classified based on a comparison with German types of legal entities or principles. Consequently, a trust can be treated in particular as an independent property fund similar to a corporate entity ("opaque") or as a partnership or fiduciary arrangement ("transparent"). Specific legal regulations for the classification of a trust do not exist, only case law is available and therefore a case-by-case review is necessary. A trust is generally considered opaque if the assets held in trust are economically independent and neither settlor nor beneficiary have a (substantial) influence on the management of the assets in trust and distributions. Assets and income are attributed to the opaque trust itself (and not the settlor or beneficiary). If a trust can be revoked at any time without any objective reasons, or the settlor and/or beneficiary has the right to instruct the trustee, the trust is generally considered as transparent.

For opaque trusts, there was a risk that any distribution to a beneficiary tax-resident in Germany ("German beneficiary") could be subject to both gift tax and income tax. This risk has now been reduced regarding discretionary distributions by a recent judgment of the German Federal Tax Court (BFH) dated 25 June 2021, case reference II R 31/19.

Gift tax applies to distributions during the existence of a trust to an "interim beneficiary" (Zwischen-berechtigter). Under prior case law, anyone who received distributions could be considered "interim beneficiary". In the recent judgment, however, the BFH generally applies the rules as set out for foreign foundations in a 2019 judgment also to trusts. Applying these rules, such distributions should not be gift-taxable in case (i) the distribution is in accordance with the trust deed and (ii) the beneficiary has no legal right to distributions during the existence of the trust in rem or based on an obligation, since in this case the beneficiary could not be considered "interim beneficiary". According to the BFH, such a legal right could be established both in the trust deed or under the law governing the trust in general. The beneficiary has the burden of proof. In case that under these rules gift tax is triggered, the BFH stated in a non-binding comment that double taxation with income tax and gift tax may have to be accepted under German constitutional law. The BFH referred the case back to the lower court in Munich for a final decision.

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Know-how transfer to German recipient triggers German withholding tax

In the case I R 18/18 dated 13 October 2021, the German Federal Tax Court (BFH) had to decide on the withholding tax (WHT) liability of a German company which in 2007 had paid a foreign (Hungarian) company a lump-sum amount for the transfer of certain production process know-how without deducting such WHT. The German company later claimed that the transferred know-how was worthless and demanded its money back, but the Hungarian company went into insolvency in the meantime.

The BFH decided in favor of the tax office and held the German company liable for the WHT. In its judgement, the court made a few comments that have broader implications:

- The statute of limitations had not expired for the case, as – in cases where no WHT returns were filed at all – the normal 4-year period only starts after a 3-year delay (this was – and still is, even after the judgement – disputed in literature);
- The full disposal of the know-how would not have been subject to German WHT, but the court agreed that in the given case, the parties did not undertake a full disposal, but rather an indefinite transfer of the know-how use right;
- The question whether the know-how was or could actually be used in the German production and as such was valuable to the German payor was irrelevant; it is only the intent of using it in a German p.e. (which did not even have to be a p.e. of the payor) that was decisive to create German taxation nexus;
- The payor cannot directly rely on the recipient's treaty protection; the legally mandated process (royalty/payment recipient has to obtain treaty exemption certificate from German Federal Tax Office prior to receiving the payment) has to be followed and was not carried out in the given case, which gives the tax office the right to demand the WHT from the payor;
- The fact that in the given case the net outcome of the case (WHT liability at payor level, no possibility of obtaining treaty-based refund for licensor/recipient anymore as the entity was liquidated) appears unfair and not in line with the spirit of the relevant tax treaty could be claimed in a separate procedure (decision based on equity).

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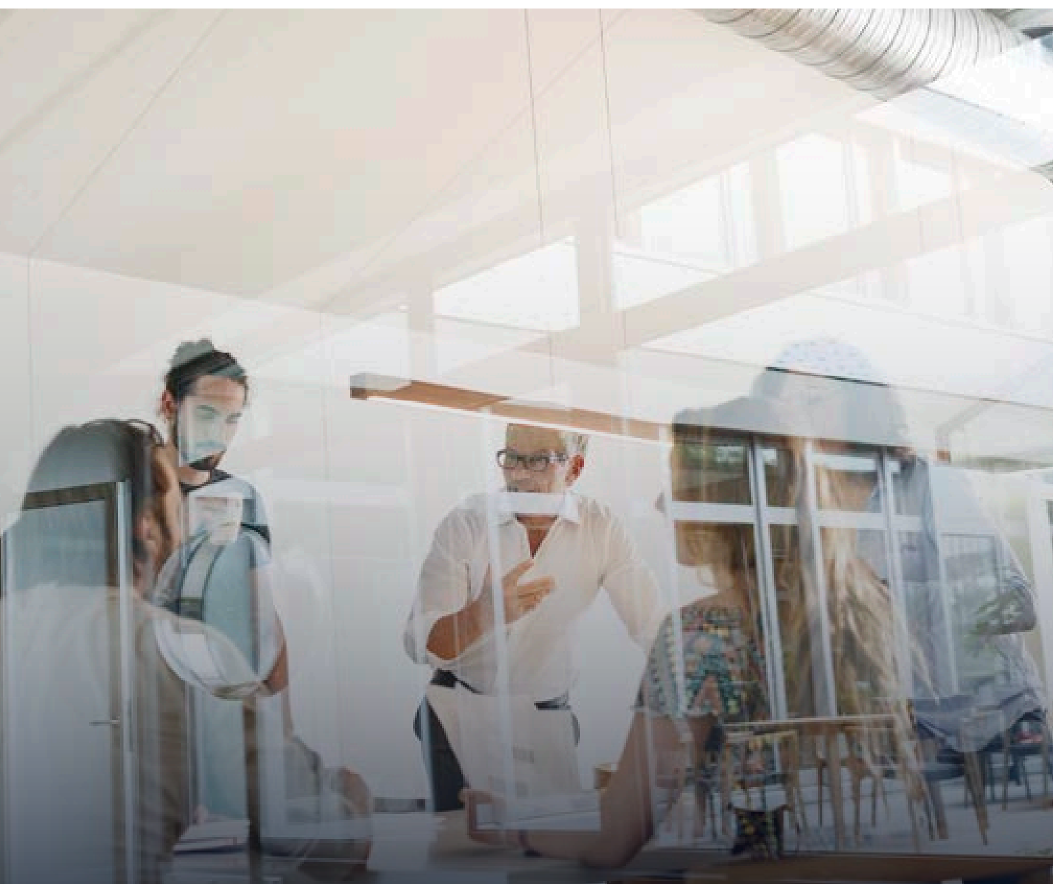

New court decision on repatriation of distressed shareholder loan ("cash round-trip")

The unwinding of distressed shareholder loans bears challenges from an income tax perspective. A waiver or contribution of the loan receivable by the shareholder typically results in taxable income at the level of the subsidiary (the debtor) to the extent that the shareholder loan receivable is not fully valuable. Several structural options exist to mitigate such risk. One of them is the so-called "cash round-trip": The shareholder contributes cash to its subsidiary (e.g., through an informal capital contribution), and the subsidiary uses such cash to repay its outstanding debt to its shareholder. The question regularly arises whether such cash round-trip can be considered an abusive circumvention of the tax consequences that would otherwise result from a waiver of the loan receivable and, thus, would be corrected under German anti-abuse rules.

In its decision dated 22 December 2021 (7 K 101/18, K,G,F), the local fiscal court in Düsseldorf had to deal with a fact pattern where the shareholder, a German stock corporation, had an outstanding receivable from its wholly owned subsidiary (a Panamanian S.A. with place of management and tax residency in Germany). Due to the distressed financial situation of the subsidiary, the receivables were considered worthless and had been written off at the level of the shareholder. To remove the debt, the shareholder decided and documented in its shareholder meeting minutes that the subsidiary required liquidity to pay off its obligations vis-à-vis the shareholder, and that the shareholder therefore authorized the contribution of cash as additional paid-in capital to the subsidiary to enable the subsidiary to repay its debt obligations to the shareholder.

The court ruled that the case at hand was to be considered abusive under the general anti-abuse rules and, thus, was to be requalified into a deemed debt waiver. The decision was driven by the fact that no actual cash payments were made; instead, the contribution and the subsequent repayment of the shareholder loan were only credited in respective intercompany accounts and, subsequently, offset (similar as under a cash pool arrangement). Moreover, the contribution and the repayment were agreed in one single document, neutralized each other in their respective amounts, and the repayment was booked only a few minutes after the contribution. In the view of the court, all of this evidenced that the cash was not intended to remain at the free disposal of the subsidiary and, hence, economically equivalent to a debt waiver. The case is now pending at the Federal Tax Court (I R 11/22).

Taking these aspects into consideration, implicit guidance is provided on how the cash round-trip could be structured not to be re-qualified into an abusive transaction. Besides that, additional risk mitigation strategies (such as, e.g., a binding ruling or insurance protection) should be evaluated to manage the remaining tax risk if the amounts are material. Moreover, in cross-border situations, it should be noted that a cash round-trip may be a reportable arrangement under the mandatory disclosure rules (DAC6).

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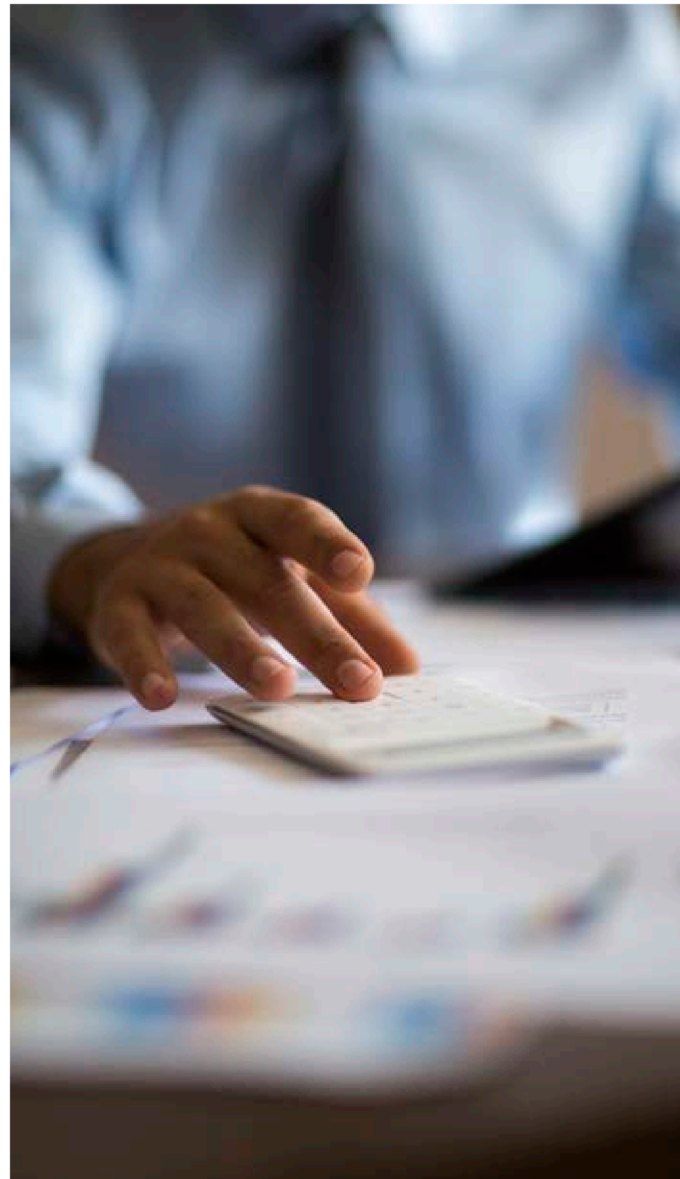
Commission requests Germany to bring its rules on taxation of dividends and interest paid to charities in line with EU law

On 6 April 2022, the European Commission sent a letter of formal notice to Germany, requesting it to amend its legislation regarding taxation of dividends and interest paid to charitable organizations. The Commission outlines that under German tax law, dividends and interest paid to charities having their legal seat or place of management in Germany are either exempt from withholding tax, or withholding tax is refunded. However, dividends and interest paid to comparable charities established in other EU and EEA Member States and third countries are taxed at a rate of 25% (plus applicable solidarity surcharge) unless a relevant double tax treaty provides for a reduced rate. In the view of the Commission, this difference in treatment of domestic and cross-border dividend and interest deductions to charities seems to constitute a restriction on the free movement of capital, guaranteed in Article 63 of the Treaty on the Functioning of the European Union (TFEU). If Germany does not provide a satisfactory response, the Commission has announced they may decide to send a reasoned opinion.

The European Court of Justice (ECJ) decided already in 2006 in the Stauffer case (C-386/04) that the German rules for taxation of dividends for charities are incompatible with the free movement of capital (Art. 63 TFEU). As a reaction, the German legislator partly amended the German Corporate Income Tax Act, generally granting a tax-exempt status to charities within the EU. However, to date there is no efficient refund procedure for non-German resident charities to claim back withholding tax on dividends or interest. After the Commission vs. Germany case (C-284/09), Germany has partly implemented refund procedures, however, these benefit mainly non-German corporations and not charity organizations, which in practice means that the discrimination under the free movement of capital persists. Moreover, the advocate general has recently issued their opinion in the request for a preliminary ruling of the Cologne tax court in the case ACC Silicones Ltd (C-572/20), stating that the evidence requirements under Germanys refund procedure rules for non-German resident entities are overly excessive and therefore discriminatory.



The development is in line with numerous cases that the ECJ has made on taxation of dividends, only to mention the Fokus Bank case (E1/04) and the following decision of the ECJ in, e.g., Denkavit Internationaal (C-170/05), Amurta (C-379/05), Aberdeen Property Fininvest Alpha Oy (C-303/07), Commission vs. Italy (C-487/07), Commission vs. Spain (C-487/08), Commission vs. Germany (C-284/09) or Fidelity Funds (C-480/16). The German Federal Tax Office currently keeps claims filed by taxpayers in the past on hold and refunds have been granted in only very limited cases so far. However, long-term investors who could be eligible under the above mentioned case law and do not benefit from a reduction under the relevant double tax treaty or the EU Parent-Subsidiary Directive may consider filing protective claims for refund of withholding tax on dividends received to keep the mandatory timelines. Also, following the decision of the ECJ in Emerging Markets (C-190/12) and College Pension Plan of British Columbia (C-641/17), third-country investors (from outside the EU) should also consider filing protective claims.

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ECJ ruling on a fixed establishment

The European Court of Justice (ECJ) decided in the Berlin-Chemie case C-333/20 on 7 April 2022 that an EU established subsidiary of a parent company established in another EU Member State does not constitute a VAT fixed establishment of the parent company by using the subsidiary's human and technical resources to exclusively provide marketing, regulatory, advertising and representation services to the parent and thus, impacting the sales volume of the latter.

From an EU VAT perspective, the place of supply of services to a taxable person is where the latter has established its business (Art. 44 EU VAT Directive). However, if such services are provided to a fixed establishment, i.e., any establishment which has a sufficient degree of permanence and a suitable structure in terms of human and technical resources to enable it to receive and use the services supplied to it for its own needs, the place of supply is where the fixed establishment is located.

In the case at hand, the German parent company Berlin-Chemie supplied goods to customers in Romania. The Romanian subsidiary provided marketing, regulatory, advertising and representation services to its parent based on a contractual relationship. The question came up if the contract gave rise to a fixed establishment of the German parent company in Romania. If this had been the case, the Romanian subsidiary would have had to account for Romanian VAT on its services.

The ECJ concluded that the economic and commercial circumstances need to be considered on a case-by-case basis and that the fact that there is a subsidiary of a parent company in another EU Member State does not automatically constitute a fixed establishment of the parent company established in the other EU Member State. The ECJ referred back to the Romanian Court to verify if the German parent company had immediate and permanent access to human and technical resources of the subsidiary, even if those were not owned by the parent but could be used based on contractual grounds and could have a sufficient degree of permanence and structure to receive and use the services supplied to it for its own business needs. However, since in the present case the subsidiary in Romania provided the aforementioned services to the German parent company, the ECJ concluded that the human and technical resources of the Romanian subsidiary could not be used at the same time to also receive the same services.

Even though in the case C-333/20 the ECJ saw no fixed establishment of the parent, it should always be reviewed in what particular circumstances technical and personal resources of a subsidiary can constitute a fixed establishment of the parent.

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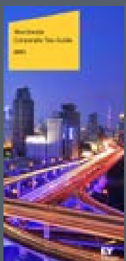

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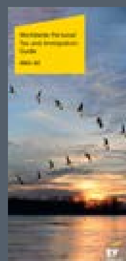

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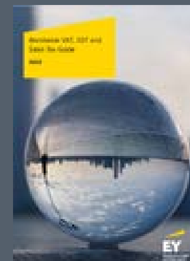

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