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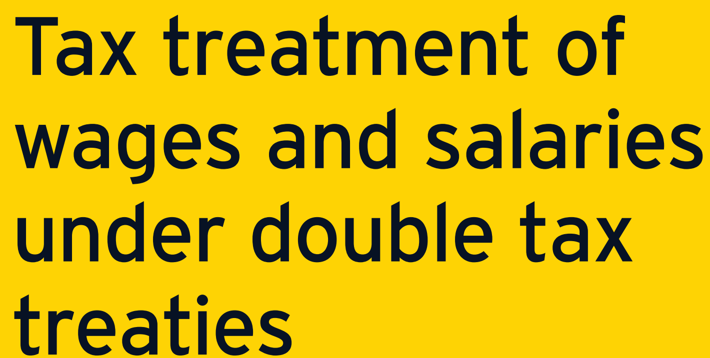


Tax treatment of wages and salaries under double tax treaties

Revised interpretative letter of the Federal Ministry of Finance and action points for employers

On 12 December 2023, the revised interpretative letter of the Federal Ministry of Finance on the tax treatment of wages and salaries under double tax treaties (DTTs) was published. Comprising 427 paragraphs (previously 372), the letter is now significantly more extensive and contains numerous editorial changes in addition to new content. It also integrates explanations from other Federal Ministry of Finance interpretative letters. Some of the material changes are likely to pose significant challenges for affected employers and all other parties involved.

Significance and effective date

In the letter, the Finance Ministry explains its view of the tax treatment of income from employment in accordance with the OECD Model Tax Convention. In places, it also deals specifically with DTTs concluded by Germany. The new interpretative letter of the Federal Ministry of Finance supersedes the letters dated 3 May 2018 and 22 April 2020 (tax advisory fees assumed by the employer). It applies to all open cases, i.e., also to matters from 2023 for example.

Major changes

Some of the new guidance already reflects current administrative practice and interpretations. However, a number of points also show new tendencies and in some places an about-face in the guidance (e.g., due to recent rulings by the Federal Finance Court). The following changes are particularly worthy of mention:

- The letter contains additional comments on the determination of residence, including new examples which indicate that the German tax authorities will assume a change of residence less frequently than is customary in an international context (marginal no. 7 et seq.). This will lead to double taxation in many constellations. In addition, the new examples are far removed from the usual real-life cases and therefore offer little assistance for the required case-by-case assessment for the determination of residence.

- The Federal Ministry of Finance clarifies that the "subject-to-tax" clauses in the DTTs and pursuant to Sec. 50d (8) and (9) EStG ["Einkommensteuergesetz": German Income Tax Act] also apply if the exemption of the income results from the allocation rule and not the relief method article (marginal nos. 37, 60 and 84).

- There are extensive new comments on the economic employer with an exemplary list of suitable evidence (marginal no. 151 et seq.). There is a partial overlap with the explanations in the Federal Ministry of Finance's interpretative letter dated 9 November 2001 (Administrative Rules – Secondment of Employees).

- The criteria for profit allocation (transfer pricing) were broadly adopted (marginal no. 160 et seq.). This suggests significantly increased documentation requirements down to the employee level.

- Explanations have been added concerning the required breakdown and allocation of the cross-charged salary components in secondment cases and the obligation to provide the individual employees with the corresponding documentation (marginal no. 165 et seq.).

- The scope of wage tax withholding obligations in cross-border cases is clarified (marginal no. 168 et seq.).

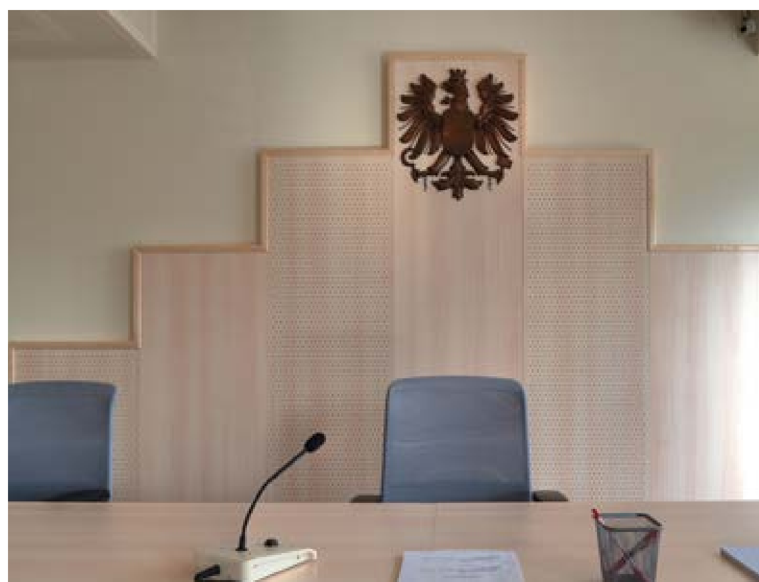
- Explanations have been added concerning the employer status of general managers, management board members and authorized signatories in special cases (marginal no. 178 et seq.).

- It stresses that for the criterion of residence (Art. 4 OECD MTC), the date on which the income is received is always relevant (Federal Finance Court's judgment of 21 December 2022, I R 11/20 on determining which country has the right to levy tax on income from stock options in the event of a change of residence) (marginal no. 223).

- It explains
  - that a signing bonus must be allocated over the expected actual working days during the term of the contract or until it becomes vested (Federal Finance Court's judgment of 11 April 2018, I R 5/16, marginal no. 250 of the interpretative letter) and
  - that the country of residence generally has the right to tax if the signing bonus is not repayable in the event of premature termination of the employment relationship (marginal no. 251).

- The comments on share-based payment models have been supplemented in particular by comments on virtual share-based remuneration (phantom stock) and a note to clarify that, depending on the circumstances of the individual case, there may initially be no receipt of income when restricted shares are granted.

- The Federal Ministry of Finance has added an example whereby the subject-to-tax clause of the DTT with the Netherlands (Art. 22 (1) (a) Sentence 1) should be applied insofar as the Netherlands' 30% ruling applies.



Conclusion

Change of residence will be assumed less frequently
According to the principles explained in the Federal Ministry of Finance's interpretative letter, in many cases, the German tax authorities will not assume a change of residence while the other contracting state will. In the case of secondments to Germany, none of the contracting states would then tax the pro-rata income for working days in third countries. However, in this case, Sec. 50d (9) Sentence 1 No. 1 EStG applies and Germany taxes it. In the case of secondments from Germany, on the other hand, there is pro-rata double taxation.

Relevant residence for stock options
The same double taxation issue arises when, for example, in the case of stock options, Germany bases the assessment of residence on the date of receipt while the foreign country bases it on residence during the vesting period and a change of residence occurs during this time. According to the feedback we have received from our local tax specialists, a significant proportion of the other countries (including some of the most populous ones) do not agree with and are unable to follow this approach, meaning that some degree of double taxation will be unavoidable or will only be able to be resolved in lengthy mutual agreement procedures.

Increased documentation requirements
Another (potential) challenge for employers is the evident increase in documentation requirements imposed by the tax authorities in connection with the determination of the economic employer and the assumption of costs. Currently, employers and employees do not normally provide the relevant information and evidence in such detail.

Date of receipt when shares with restricted transferability are granted
As before, restrictions on disposal under the law of obligations do not prevent receipt. It remains to be seen how the tax authorities will treat this if the company is required to consent to the sale of the shares by the employee. The date of receipt for shares with restricted transferability has already been hotly debated (Federal Finance Court's judgments of 30 June 2011, VI R 37/09 and of 1 September 2016, VI R 16/15). Under civil law, ownership including ownership rights is generally transferred to the employee upon acquisition. In addition, the company's consent to the transfer to the employee is implied, which in our opinion indicates that the income is received when the shares are granted. If the German tax authorities do not deem the income to have been received or consider the date of receipt to be later, this could lead to international distortions and render the provisions of treaty law for the avoidance of double taxation ineffective.

Netherlands expat tax regime
The Netherlands expat tax regime (30% ruling) is intended to make the Netherlands a more attractive country to work in. However, the legal opinion set out in the interpretative letter of the Federal Ministry of Finance of 12 December 2023 largely renders this rule ineffective if the employee retains their residence in Germany.

Overall, the specifications of the Federal Ministry of Finance lead to a considerable additional workload for employers and all other parties involved (including the tax authorities) and increase the likelihood of certain remuneration components being taxed twice in some cases.

Practical guidance
Employers who send their employees on international assignments should check what adjustments are required in light of the new interpretative letter and implement these as soon as possible. This concerns, for example, the tax treatment of severance payments and share-based payments, but also the implementation of the extended documentation requirements for the determination of the economic employer, if applicable. It is also advisable to clarify the extent to which the risk of double taxation can be reduced in cases where it can be assumed that the other contracting state will treat the employee as resident abroad and Germany will treat them as resident in Germany.

If the tax authorities levy tax on remuneration components in Germany on the strength of the Netherlands expat tax regime, we recommend reviewing whether an appeal can be filed. The Federal Finance Court has yet to clarify whether the right of taxation actually reverts to Germany in this case. Corresponding proceedings are pending before this court under ref. I R 51/22. As a possible alternative, we recommend considering whether the actual income-related expenses can be deducted, as this does not trigger any subsequent taxation in Germany. However, the employer must decide by April 30 whether to make use of the 30% ruling for the respective employee in the calendar year in question.

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