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FISCAL AND TAX LAW

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1. GENERAL FISCAL CLIMATE

In terms of fiscal policy – and thus also in terms of fiscal and tax law – the year 2013 is characterized by a degree of uncertainty. European politics remain to be dominated by the economic and financial crisis with fiscal consequences that are still completely unforeseeable. At the same time, the financial conditions within Germany are more positive than they have been for a long time. Considerable additional tax revenues are expected to allow for a federal budget surplus in 2014. The federal Länder are also benefitting from the solid tax revenues and historic low interests.

Yet, elections are being held this year. In September 2013, a new Bundestag will be elected. Some parties hold out the "prospect" of tax increases, others make unaffordable promises – at any rate, the upcoming Bundestag elections are currently leading to a certain slow-down of legislation in the field of taxation.

2. DEVELOPMENTS IN FISCAL AND TAX CONSTITUTIONAL LAW

2.1 Debt ceiling and reorganization of federal fiscal equalization

German fiscal constitutional law is going through a period of reorganisation. The focus is on the year 2020, which will involve major changes to the federal fiscal rules.

In the context of the so-called Federalism Reform II, a new credit limit rule ("Schuldenbremse" – "debt ceiling") was already introduced into the German Constitution - GG in 2009. This rule also served as a model for the European Fiscal Compact[1], which entered into force on January 1, 2013. The provisions contained in Art. 109 para. 3, 115

1 Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) signed on March 2, 2012, http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

para. 2 clause 2 and 143d para. 1 clause 3 and clause 5 GG provide that, from the budget year 2016 onwards, the German federal government (Bund) may only include credit receipts up to an amount of 0.35% of the nominal gross domestic product in its budget. After December 31, 2019, the Länder have to manage without a structural new net indebtedness[2]. This is in line with the requirements of the European Fiscal Compact, which generally limits the national structural deficit to 0.5 % of the gross domestic product[3].

At the same time, the statutory rules of fiscal equalization on the Länder level will cease to be in force as per the end of 2019. These provisions are aimed at a system of public finance under which the federation, the states and the municipalities participate in the total revenue (mainly from taxes) in accordance with their needs. It also comprises the equalization of revenue between financially weak and financially strong public law entities (federal government, states and communities)[4]. Preparations for reorganizing this federal transfer system have already begun and will in particular have to take into account the then applicable debt ban for the Länder. The previously applicable provisions are often considered to be in need of reform in terms of their content as well[5], the Länder Bavaria and Hesse filed an abstract judicial review with the Federal Constitutional Court (BVerfG) in March of 2013 (2 BvR 1/13) claiming inter alia unconstitutionality on grounds of a no longer appropriate equalization of fiscal capacity. The decision of the BVerfG is not expected before the end of 2014.

2 On this aspect Tappe, DÖV 2009, 881 et seq.

3 The Stability and Growth Pact previously provided for a maximum structural deficit of merely 1 % of the gross domestic product, the Maastricht criteria set the limit for new indebtedness at 3 % of the GDP.

4 Englisch/Tappe, in: Bizioli/Sacchetto, Tax Aspects of Fiscal Federalism, Chapter 7, p. 273 (282 et seq.).

5 On the reform proposals Tappe, DVBl 2013, 1069 et seq.

2.2 Invention of new taxes

In recent years, several “new” taxes were invented both on the federal and mostly on the municipal level, which have been and are currently under judicial review. For instance, the Bund introduced an excise duty on fuel assemblies in nuclear power plants (tax on nuclear fuel)[6] and a tax on flight tickets (air traffic tax)[7]. Following several deviating court rulings on interim judicial relief[8], the Fiscal Court of Hamburg in early 2013 submitted the tax on nuclear fuel to the BVerfG for review[9]. Regarding the air traffic tax, proceedings before the BVerfG are also pending[10]. A number of Fiscal and Administrative Courts have also been called on to review the constitutionality of municipal accommodation taxes (levied on hotel accommodation)[11].

2.3 Inheritance Tax – permanent work in progress

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6 Act of Dec. 8, 2010, BGBl. I, 1804.

7 Act of Dec. 9, 2010, BGBl. I, 1885

8 Unconstitutional: Fiscal Court of Hamburg, 4 V 133/11, DStRE 2012, 53 (Suspension of Operation reversed by BFH, VII B 171/11, BStBl. II 2012, 418); Fiscal Court of Munich, 14 V 2155/11, DStRE 2012, 49 (reversed by BFH, VII B 185/11, BFH/NV 2012, 999). – Constitutional: FG Bad.-Württ., 11 V 2661/11, EFG 2012, 537; 11 V 4024/11, BB 2012, 222.

9 Fiscal Court of Hamburg, 4 K 270/11, BB 2013, 277.

10 Federal Constitutional Court, BVerfG, 1 BvF 3/11.

11 Fiscal Court of Hamburg, 2 V 26/13, EFG 2013, 961; OVG SH, 4 KN 1/12, NordÖR 2013, 206; Higher Administrative Court for the Land North Rhine Westphalia, OVG NRW 14 A 1860/11, juris; Administrative Court of Gelsenkirchen, 19 K 2007/11, Städte- und Gemeinderat 2013, Nr 1-2, 29; BVerwG, 9 CN 1/11, BVerwGE 143, 301 et seq.; cf. Selmer, JuS 2013, 187 et seq.

The inheritance tax is a permanent topic of constitutional law and fiscal politics. By resolution of November 7, 2006[12], the BVerfG held the then applicable inheritance tax law to be inconsistent with Art. 3 para. 1 GG and thus unconstitutional. Subsequently, the legislator proceeded to redraft the Inheritance Tax Act – ErbStG – by adopting the Inheritance Tax Reform Act[13] with effect from January 1, 2009.

An unequal determination of value in relation to several asset classes had led to the BVerfG decision of 2006. This determination of value had already been criticized in a first BVerfG resolution on the inheritance tax, which was passed on June 22, 1995[14]. According to the former ErbStG, the tax basis was determined using non-realistic values for a multitude of assets. In part, this was due to a missing adjustment. Partially, the aim was to protect certain assets from taxation at the stage of valuation[15]. Following the more recent decision of the BVerfG, it is no longer permitted to protect assets from taxation at the stage of value determination. Rather, this may only be done in a step following the value determination at the stage of determining the tax basis [16].

Whether the law as it has been in place since 2009 now meets the requirements of constitutional law is highly doubtful, and the Federal Fiscal Court (BFH) has also submitted the revised version of the ErbStG of 2009 to the BVerfG for review[17]. Although a uniform

12 Federal Constitutional Court, BVerfG, 1 BvL 10/02, BVerfGE 117, 1 et seq.

13 BGBl. I 2008, 3018 et seq.; BStBl. I 2009, 140 et seq.

14 Federal Constitutional Court, BVerfG, 2 BvR 522/91, BVerfGE 93, 165.

15 Cf. Federal Constitutional Court, BVerfG, 1 BvL 10/02, BVerfGE 117, 1 (38 et seq.); 2 BvR 552/91, BVerfGE 93, 165 (175 et seq.).

16 In this regard, cf. Birk/Desens/Tappe, Steuerrecht, 16th ed. 2013, note 1551 et seq.

17 Federal Fiscal Court, BFH, II R 9/11, BStBl. II 2012, 899.

standard is applied at the stage of valuation, the tax exemptions on the following protection level are extensive to the point where equality in tax burden is missed to a greater extent than was the case with the previous law.

2.4 Equal tax treatment of registered domestic partnerships and marriage implemented

Since 2001, same-sex couples in Germany have the opportunity to register as a domestic partnership. However, domestic partners were not intended to receive the tax benefits that are linked to the traditional marriage between men and women. By gradually treating marriage and domestic partnerships as equivalent, the BVerfG later achieved what the legislator initially left undone. The BVerfG held the tax disadvantages of a domestic partnership to constitute indirect discrimination on grounds of sexual orientation and, therefore, an infringement of the general principle of equality (Art. 3 para. 1 GG). The BVerfG held the same to be true of the disadvantages contained in inheritance tax law (with regard to tax classes, tax allowances and tax rates) as early as 2010[18], of the disadvantages contained in real estate transfer law in 2012 (with regard to tax exemptions)[19] and finally of the disadvantages contained in income tax law in 2013 (with regard to the special tariff for married couples, so-called income splitting for married couples)[20].

3. INCOME TAX

18 Federal Constitutional Court, BVerfG, 1 BvR 611/07, BVerfGE 126, 400.

19 Federal Constitutional Court, BVerfG, 1 BvL 16/11, NJW 2012, 2719.

20 Federal Constitutional Court, BVerfG, 2 BvR 909/06, DStR 2013, 1228.

3.1 Big Brother prize moneys subject to income tax

In Germany, lottery winnings are not taxable. Other prize monies are subject to income tax only if they qualify as income from (other) services (sec. 22 no. 3 Income Tax Act – EStG). This has been confirmed by the BFH with regard to prize monies paid to winners of the television show "Big Brother"[21]. The reasoning of the BFH was that the prize money – in accordance with and upon performance of the (participation) agreement – was paid in consideration of the service provided by the participant through his active and passive conduct during his stay in the "Big-Brother house".

3.2 Self-employed prostitutes generate income from trade or business

In spring of 2013, the Grand Senate of the BFH revised its previous legal interpretation by qualifying the income of a self-employed prostitute as income from a trade of business (sec. 15 para. 1 no. 1 EStG)[22]. In 1964, the Grand Senate of the BFH had still rejected classification of this income as trade or business income on grounds of immorality and merely considered it to constitute "other income" as such term is defined in sec. 22 no. 3 EStG[23]. In this way, the change in case law also reflects the shift in values and moral standards during the past fifty years.

3.3 So-called subjective concept of accounting errors discontinued

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21 Federal Fiscal Court, BFH, XI R 6/10, BStBl. II 2012, 581.

22 Federal Fiscal Court, BFH, GrS 1/12, BFH/NV 2013, 1029; in depth on grounds oft he order for reference Federal Fiscal Court, BFH, III R 30/10, BStBl. II 2012, 661.

23 Federal Fiscal Court, BFH, GrS 1/64, BStBl. III 1964, 500.

In tax accounting law, the issue whether the legal determinations by the taxpayer are binding on the tax authorities in instances where such determinations were acceptable from the perspective of prudent and conscientious merchant (so-called subjective concept of accounting error) has been given up. In early 2013, this concept was explicitly rejected by the Grand Senate of the BFH[24]. It follows from this judgment that the tax authorities have the right and the obligation to base the tax assessment on their own independent determination of profits if the accounting items do not comply with the legal requirements from an objective point of view. According to the BFH, the tax authorities have this obligation irrespective of whether or not the corrections made have positive or adverse effects on the taxpayer.

3.4 Debate on the deductibility of private expenses in income taxation

In German income tax law, private expenses are inter alia deductible from taxes if they constitute an "extraordinary burden" (sec. 33 para. 1 EStG). This requires that expenses are necessarily incurred and inevitable. In a much discussed decision, the BFH had judged that even the costs incurred in civil proceedings may qualify as an extraordinary burden if the intended prosecution of the action or the legal defence has sufficient prospects of success and does not appear to constitute an act of bad faith[25]. The tax authorities have applied this ruling only to specific cases[26]. Since 2013, a statutory provision has been in force that explicitly excludes the costs of legal proceedings from deductibility unless these constitute expenses without which the taxpayer would risk losing his basis of existence and

24 Federal Fiscal Court, BFH, GrS 1/10, BStBl. II 2013, 317.

25 Federal Fiscal Court, BFH, VI R 42/10, BStBl. II 2011, 1015.

26 Federal Ministry of Finance, BMF, BStBl. I 2011, 1286.

no longer be able to satisfy his essential needs in an appropriate extent (sec. 33 para. 2 clause 4 EStG).

4. Corporate Tax

4.1 Full tax liability concerning so-called free floating dividends (sec. 8b para. 4 KStG)

Since March 2013, so-called free floating dividends (shareholdings of less than 10 %) received by a resident corporation are no longer 95% tax-exempt pursuant to sec. 8b para. 1 and 5 Corporate Tax Act – KStG (sec. 8b para. 4 KStG)[27]. This tax liability is the result of the implementation of a decision of the ECJ[28]. The ECJ held that the previous legal provisions constituted an infringement of the free movement of capital (Art. 63 TFEU), because Germany taxed free floating dividends distributed to a corporation established in another Member State of the EU more heavily than free floating dividends distributed to a corporation established on national territory. In the EU case, the effective tax burden amounted to at least 15 %. In the non-EU case, the burden was limited to a maximum of 0.75%. The German legislator, therefore, had the option to either avoid discrimination by reducing the burden in the cross-border case to the German level of taxation or by increasing the tax burden in the non-EU case to the level of the cross-border case. With the introduction of the revised provisions, the legislator decided in favour of the second option.

In our view, the revised provisions still constitute an infringement of the free movement of capital (Art. 63 TFEU) because EU-foreign shareholders are again put in a

27 Act on Implementation of the ECJ decision of October 10, 2011 in Case C-284/09 (Fee Floating Dividends) of March 21, 2013, BGBl I, 561.

28 ECJ, C-284/09, DStR 2011, 2038 (Com./Germany).

worse tax position than domestic shareholders[29]. After all, residents of another Member State of the EU cannot claim deduction of investment expenses. This means that their effective burden remains at least at 15 %, whereas domestic shareholders are entitled to the full amount of deduction for such expenses. Their maximum effective tax burden is at 15 %, though it will generally be lower.

4.2 The "small" reform of the fiscal unity concept

The German fiscal unity concept (sec. 14 et seq KStG) enables corporate groups to net the profits and losses from their various subsidiaries on the level of the parent company. However, until now, this concept was largely limited to national cases. This was why it was intensely debated in 2012 whether the fiscal unity concept should be replaced by a group taxation which would allow for a cross-border consolidation of profits and losses also in internationally structured groups.

With the so-called "small reform of the fiscal unity concept"[30], the German legislator did not – unlike, for instance, Austria – take this step. The largest concern was that the import of foreign losses would lead to tax losses. A general deduction of foreign losses is – except in the case of so-called final losses – [31] not currently a requirement under the case law of the ECJ nor does it follow from the EU fundamental freedoms.

29 Regarding non-compliance with Union law cf. Desens, DStR 2013, Supplement to Issue 4, 13 (15); Rust, DStR 2009, 2568 (2572) each with a reference to ECJ, C-234/01, ECR 2003, I-5933 (Gerritse).

30 Summary in Dötsch/Pung, DB 2013, 305; Keller, DStZ 2013, 60.

31 ECJ, C-446/03, ECR. 2005, I-10837 (Marks & Spencer); C-337/08, ECR 2010, I-1215 (X-Holding BV) on group taxation restricted to national case; recently ECJ, C-123/11, DStR 2013, 392 (A Oy) on forfeiture of losses following cross-border upstream merger.

Nevertheless, the German provisions on the concept of fiscal unity have become a bit more international since 2013:

It is no longer required that the controlled company (subsidiary) whose profits or losses are attributed to the controlling company (parent) has to have its executive management and its registered office in Germany. It is now sufficient that the executive management is in Germany and the registered office is located in an EU/EEA State (sec. 14 para. 1 clause 1, sec. 17 clause 1 KStG). A double residency (executive management and registered office) is no longer necessary either. Accordingly, a Limited company established under UK law that has moved its executive management to Germany may generally serve as a controlled company for purposes of the German fiscal unity concept. With these changes, the legislator prevented an EU infringement proceeding[32], since it is not permitted to impose stricter requirements on corporations moving into Germany only because the company was established in another Member State[33].

In contrast, a GmbH – company with limited liability – established under German law (with registered offices in Germany) that moves its executive management to an EU/EEA State, just as well as a (foreign) corporation subject to limited tax liability, cannot qualify as a controlled company for purposes of the German fiscal unity concept. In our opinion, this restriction is an infringement of the right of establishment (Art. 49 TFEU) to the extent that it also denies the netting of profits and losses from a domestic permanent establishment of the controlled company for which Germany (also under DTC) has the right of taxation[34].

32 BT-Drs. 17/10774, p. 18.

33 Cf. ECJ, C-212/97, ECR 1999, I-1459 (Centros); C-208/00, ECR 2002, I-9919 (Überseering); ECR 2003, I-10155 (Inspire Art).

34 Cf. ECJ, C-18/11, IStR 2012, 847 (Philips Electronics); likewise Schwenke, ISR 2013, 41 (43).

Another novelty is that the controlling company (parent company) no longer has to be resident in Germany (sec. 14 para. 1 no. 1 KStG). It is merely required that the controlled company is attributed to a resident permanent establishment of the controlling company for which Germany (also under DTC) has the right of taxation. As a result, the revised provisions are in line with the principle of non-discrimination of shareholders under DTC law (Art. 24 para. 5 OECD-MA)[35].

However, the scope of a revised version of an anti-abuse rule (sec. 14 para. 1 clause 1 no. 5 KStG) remains controversial from an EU law perspective[36]. This rule is aimed at preventing the inclusion of losses into the extended loss netting possibilities offered by the concept of fiscal unity where such losses are also taken into account in another country.

35 The legislative amendment was a reaction to Federal Fiscal Court, BFH, I R 54, 55/10, BStBl. II 2012, 106 (cf. BT-Drs. 17/10774, 18).

36 Cf. ECJ, C-18/11, IStR 2012, 847 (Philips Electronics); Schneipers/Linn, IStR 2013, 139; Schwenke, ISR 2013, 41 (43).