EU tax harmonisation of direct taxes from a German perspective

by Dr. Hanno Berger and Dr. Peter Happe, Dewey Ballantine LLP

As is the case for many other Member States of the EU, Germany was suddenly hit by recent European Court of Justice decisions on direct taxes. These decisions urge Germany to reconsider its current tax laws in many respects. Other driving factors for an EU direct[1] tax harmonisation are EU directives and competing tax regimes with lower tax rates especially in EU accession countries. The authors give an overview over the effects of these factors on German direct taxation.

Harmonisation through European Court of Justice decisions for fundamental freedoms

The decisions of the European Court of Justice (ECJ) refer primarily to the fundamental freedoms as stipulated in the Treaty establishing the European Community[2] ("Treaty"). The relevant fundamental freedoms comprise free movement of capital (Art. 56 Para. 1 Treaty)[3], freedom of establishment (Art. 43 Treaty) and freedom of services (Art. 49 Treaty) and are based on the idea of one single market within the EU in which the workforce, capital, services and goods can freely float to the benefit of ideal allocation of resources.

These fundamental freedoms have emerged to a strong weapon and most effective source of legal protection against national tax acts and regulations that intervene on cross-border transactions. Whenever an EU citizen can establish that it is discriminated against other EU citizens by national (tax) law, this constitutes a potential violation of the fundamental freedoms and a potential violation of the Treaty.

The European law obtains its power from the fact that whenever national law conflicts with EU law, EU law prevails in principle over national law unless the national law is justified on grounds of public morality, public policy, public security or public health[4]. The free movement of capital principle may be limited by a Member State, e.g., by referring to the tax law and the prudential supervision of financial institutions[5].

Persons qualifying for the benefits of EU law

Whereas only EU persons may refer to the freedom of establishment and freedom of services, the free movement of capital applies also to non-EU Member States[6]. Thus, even persons from third countries could refer to European law in order to achieve legal protection. The applicability of EU law has been further extended by the German Federal Tax Court (BFH): It was decided that a US corporation having its management located in Germany qualifies as an eligible parent company in a fiscal unity. The court held for the first time that under the nondiscrimination clause of Art. 24 Double Taxation Treaty between Germany and the US, US persons might claim to be treated like persons in the EU[7]. Similar nondiscrimination clauses can be found in Art. 24 of the OECD-Master Agreement and in the American German Treaty of Friendship, Commerce, and Navigation[8].

This German court decision is rather disputed, and German authorities have rejected the general assumption that persons which are resident in a non-Member State could refer to the Double Taxation Treaty antidiscrimination clause in order to be protected by the Treaty[9]. The ECJ has recently held that a person which is resident in one Member State cannot refer to a most-favoured nation clause in order to benefit from that bilateral tax treaty between Member States in which such person is not resident[10].

Unlawful German tax provisions with respect to EU law

Taking into account the fundamental freedoms, more than 130 provisions in the German Income Tax Act and the Corporation Income Tax Act as well as in other German tax acts including tax treaties are potentially unlawful from an EU law perspective[11]. In the following a selection of German tax law provisions are described that are deemed to be in conflict with the fundamental freedoms of the Treaty[12]:

- Under Sec. 49-50a German Income Tax Law (*Einkommensteuergesetz* - EStG) non resident income taxpayers are treated differently from German resident taxpayers with respect to tax assessment and deduction of expenses. This is deemed to be a discrimination of inbound investments.

- Under Sec. 2a EStG losses from certain passive activities cannot be set off against German taxable income; this is discrimination against foreign (outbound) investments.
- Under Sec. 8a German Corporation Income Tax Act (*Körperschaftsteuergesetz* - KStG) which was already recently changed due to a ECJ decision[13] and deals with German thin capitalisation rules, interest on capital that exceeds a safe haven is treated as non-deductible and is qualified as dividend income. Dividend income of individual shareholders is tax-exempt by half and by 95% in the case of corporate shareholders, whereas in principle it qualifies as taxable interest income abroad. This could trigger a double taxation in case of interest payments to foreign shareholders: Once in Germany since the interest is not deductible, and once in the country where the creditor is located due to its qualification as interest income.
- Under Sec. 12 German Corporation Income Tax Act, in the case of a German corporation that transfers its place of management or its statutory seat to a foreign country, the built-in gains are taxed as in a full liquidation of the corporation. This prevents corporations from moving between Member States and hampers the free movement of capital.
- Under Sec. 1 German Foreign Tax Act (*Außensteuergesetz* - AStG) contributions from a German entity to an associated foreign entity that are not in-kind – like the utilisation of assets (e.g., loans) and services – which are not hidden contributions and which were granted for an unreasonable low consideration need to be corrected under the arm's length principle. Such corrections are not required in the case of a German entity receiving such utilisations or services from German entities. The different treatment may be regarded as a discrimination of foreign investments.
- Under Sec. 6 AStG, the change of residence of an individual taxpayer may trigger an expatriation or exit taxation. The European Commission has already requested Germany to abolish these tax provisions.

An in-depth knowledge of the decisions of the ECJ as well as of the underlying fundamental freedoms and the tax provisions deemed unlawful is extremely helpful in assuming a defence position towards the German tax authorities, but less helpful in the structuring phase of a transaction since the fundamental freedoms are rather abstract. Therefore, it seems to be rather risky to ignore adverse unlawful national tax provisions by referring to fundamental freedoms when structuring a transaction.

Harmonisation through EU directives

Besides the decision of ECJ, the EU directives have a great impact on direct German taxation[14]. The impact of the EU directives is less forceful than the impact of the ECJ since an EU directive is already a compromise between the governments of the EU Member States. The EU directives bind the national government that is obliged to adopt its tax law to the requirements of the EU directive if the tax law deviates from the EU directive. The EU directives on direct taxes that need to be taken into consideration include the following:

Council Directive (2003/48/EC) of June 3, 2003 on Taxation of Savings Income in the Form of Interest

It is the ultimate goal of the Directive on Taxation of Savings Income in the Form of Interest[15] enabling interest on debt instruments (excluding pensions and insurance benefits) received in one Member State by individuals who are resident in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State.

This directive was mainly issued in order to combat "harmful" tax competition within the EU. This goal is achieved by exchanging banking information on interest payments to individuals between the Member States. Exempted from this information exchange are Belgium, Luxembourg and Austria for a transitional period, in which the EU tries to enter into an agreement with certain non-EU Member States (e.g., Switzerland, Liechtenstein, and the US) on the exchange of information. During the transitional period, paying agents residing in Belgium, Luxembourg or Austria are obliged to withhold tax (15% at the beginning, increasing up to 35% starting in 2011) on interest payments to individuals residing in other EU Member States.

The Directive came into effect on July 1, 2005 after Switzerland and certain other non-Member States have agreed that paying agents located in these countries will withhold taxes on interest payments made to individuals in the EU as well. Switzerland, Andorra, Liechtenstein, Monaco, San Marino, the British Channel Islands (Jersey and Guernsey), the Isle of Man, the Caribbean Islands, British Virgin Islands and the Netherlands Antilles were among those non-EU Member States that agreed to apply the withholding tax rules but without taking part in the exchange of information and informing the respective Member State where the individual recipient of the payment is resident.

To avoid withholding tax on interest or providing information to the resident state individual taxpayers are advised to interpose either a corporation or a

similar entity or to underwrite synthetic financial instruments that have the same performance as debt instruments.

Council Directive (2003/49/EC) of June 3, 2003 on a common System of Taxation applicable to Interest and Royalty Payments made between associated Companies of different Member States

The Directive on a common System of Taxation applicable to Interest and Royalty Payments made between associated Companies of different Member States[16] has been adopted by the Council of the EU with the following reasoning: In a single market having the characteristics of a domestic market, transactions between companies of different Member States are subject to less favourable tax conditions than those applicable to the same transactions carried out between companies in one of the Member States. Therefore it needs to be ensured that, interest and licence payments shall only be taxed once. Until the release of this Directive, national tax laws coupled with bilateral or multilateral agreements, if applicable, have not always ensured that double taxation is eliminated, or the application often required burdensome administrative formalities and cash-flow leakage for the companies concerned.

Under this Directive, interest payments or licence payments made by one company in one state (source state) to a company in another state are tax exempt at the source state if the receiving company is associated with the company that makes these payments. Association is given if one company holds a stake in the other company of 25% or more or if a third company has a stake of 25% or more in both companies. In certain cases also a permanent establishment may be payer or recipient of these tax exempt payments[17].

The Directive is in principle applicable to all interest payments on debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits and, in particular, to income from securities and income from bonds or debentures including premiums and prizes attached to such securities, bonds or debentures. Payments on participation rights or payments which are treated as distribution of profits or repayment of capital under the law of the source state and payments from debt claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profit may be excluded by the source state though. The term "royalty" means payments of any kind received as attached consideration for the use of or the right to use any copyright of literary, artistic or scientific work, including films, software, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; moreover, payments for the use of or the right to use industrial, commercial or scientific equipment as royalties.

The EU and Switzerland have entered into an agreement that the provisions of the Directive are also applicable to interest and royalty payments to and from Switzerland[18].

Directive 90/435/EEC of July 23, 1990 on the common System of Taxation applicable in the Case of Parent Companies and Subsidiaries of different Member States as amended by Council Directive 2003/123/EC of December 22, 2003

Under the Council Directive 90/435/EEC on the common System of Taxation applicable in the Case of Parent Companies and Subsidiaries of different Member States[19], dividends and other profit distributions paid by subsidiary companies to their parent companies in another Member State are exempt from withholding taxes in order to eliminate double taxation of such income at the level of the parent company.

Compared to the Directive 90/435/EEC[20], the Council Directive 2003/123/EC brought the following improvements: The threshold of the shareholding of one company to be considered a parent and the other as its subsidiary will be gradually reduced from 20% in 2005 (25% under the amended Directive) to 10% in 2009. The payment of profit distributions to a permanent establishment of a parent company in another state may be made and received free of tax. Numerous legal forms of companies that fall under the Directive were added to the Annex of the amended Directive 90/435/EEC, inter alia the European Company (SE) and cooperatives, mutual companies and saving institutions.

Directive 90/434/EEC of July 23, 1990 on the common System of Taxation applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares concerning Companies of different Member States as amended by Council Directive 2005/19/EC of February 17, 2005

The Directive 90/434/EEC[21] addresses the taxation of cross-border mergers, divisions, transfer of assets and exchanges of shares of companies that are located in different Member States. This Directive aims at deferring and safeguarding the taxation of the income, profits and capital gains from business reorganisations, and avoiding double taxation in two Member States but does not provide means to avoid taxation completely.

The Directive 90/434/EEC was amended by the Directive 2005/19/EC[22] in some respects. In general, the Directive 2005/19/EC is supposed to extend the reorganisation possibilities and the legal forms that can be used in a cross-border reorganisation (e.g., cooperatives, a European Cooperative and the European Company). The value of the shares and assets exchanged under the rules of the 2005 Directive are

now calculated under the same rules in the Member States involved in the reorganisation. Even though the application of the 1990 Directive has been extended by the 2005 amendment to more legal forms and ways of reorganisations, it has not overcome certain disadvantages like the inapplicability to some legal forms (partnerships) and the inapplicability of some reorganisations due to national corporation law restrictions.

The selected enumeration of Council Directives related to direct taxes shows that the harmonisation ambitions in the EU are not fairly advanced. It took decades after the predecessor of the EU was formed by the Treaty in Rome 1957 to issue directives on direct taxation that regulate only parts of international relationships. In addition, the directives have not even been implemented in full and on time into national law by the Member States. Tax harmonisation within the EU is certainly gaining more momentum by means of competition in the single market than by EU directives.

Harmonisation by tax competition inside and outside the EU: A highly competitive situation

In the past Germany has always been competing with tax havens like Liechtenstein, Switzerland and off-shore tax havens like the Channel Islands, Bermudas etc. By the expansion of the EU to Eastern Europe, some of the accession countries are now competing with Germany not only with respect to lower wages and social security contributions, but also by using investor-friendly low flat tax rates. This is, e.g., the case in Slovakia which has a flat tax rate of 19% for all taxes and in Estonia which has a flat tax rate of 24% on income of individuals and on distributed income of corporations. The average corporation income tax rate of the accession Member States amounts to 23%[23] (compared to almost 38% in Germany taking into account corporation income tax, trade tax and solidarity surcharge). Initiatives by some European countries to force these low-tax countries to higher tax rates and by this to reduce the competition within the EU have not been successful so far. In contrast, even Greece is now planning to implement a low flat tax rate of 25% by 2010[24]. Due to such competition, the average corporation income tax has been reduced from 47% to 32% within the EU in the last 15 years[25].

Discussion in Germany on further reductions of tax rates

This increasing competition has led German politicians to discuss fiercely on a tax reform implying even lower taxes. A recent effort to cut German corporation income tax from 25% to 19% (excluding solidarity surcharge and trade tax) was stopped due to the political stalemate in Berlin which ultimately led to elections on September 18, 2005.

One concept currently discussed is based on a modified flat income tax rate of 25% for individuals. In a further concept the reduction of the highest individual tax rate from 42% to 39% (excluding solidarity surcharge) and of the corporation tax rate to 22% is envisaged; the taxation of businesses should be neutral with respect to their legal form and their financing. The tax rate reductions shall be counter financed by the abolishment of so-called tax loopholes.

Moreover, it is discussed to radically simplify the tax law. Even though there seems to be an extensive unity amongst experts and economists that Germany has to reduce its tax rate in order to compete with other countries, it is still doubtful how much the effective reduction will be in the end and when it will be implemented. Since the German budget cannot bear tax money losses, the overall effective tax burden will almost certainly not be reduced by the decrease in the income tax rate but will be compensated by the cancellation of the deductibility of certain expenses and losses. Nevertheless, the nominal tax rates are the main tax factor perceived and taken into account by domestic and foreign investors; the real tax burden which takes into consideration the deductibility of expenses cannot as easily be compared between different countries.

Summary and outlook

Germany suddenly finds itself in hard competition with other EU Member States with regards to direct taxes and is more and more forced by the ECJ to adapt its tax law to the requirements of the EU treaty. The number of German tax law provisions that are deemed to be illegal with respect to EU law exceed the number of 100. Moreover, the EU has taken small steps to harmonise the direct taxes in the EU. On the whole, in the long run these factors will have the effect that Germany will almost certainly have a more comprehensible, transparent and more EU-consistent tax system in which foreign and German investors will be treated alike.

The comparatively high tax rates of up to 44% (income tax plus solidarity surcharge) in the case of individuals and around 38% (trade tax, corporation income tax and solidarity surcharge) in the case of corporations will most likely be reduced to the lower tax levels applicable in other countries in the future, since these tax rates – not the effective tax burden – is perceived by investors and compared to the tax rates in other countries. Foreign investors – irrespective of whether they are located in the EU or in third countries - will benefit from this development in many ways. Coupled with the other necessary reforms (social security, public health care, pensions etc.) that have

already been undertaken or are envisaged, Germany is evolving to a more attractive location for foreign investors[26]. It is at least worthwhile to keep track of the reforms in Germany.

Notes:

1 The harmonisation of the indirect tax (e.g., turnover tax) is accomplished by directives and decisions issued by the European Court of Justice as far as possible. The first important harmonisation directive had been issued already in 1967 (Council Directive 67/227/EEC) and has developed to a rather tight network of provisions.

2 As amended by the Treaty of Nice of December 24, 2002 - effective as of February 1, 2003 - Off. J. Eur. Communities 2002, C 325, pp. 33 et seqq.

3 Other important fundamental freedoms are free movement of goods (Arts. 28, 29 Treaty), freedom of movement for workers (Art. 39 Treaty), prohibition of discrimination on grounds of nationality (Art. 12 Treaty).

4 Art. 30, Art. 39 Para. 3, Art. 46 Para. 1 Treaty.

5 Art. 58 Para. 1 Treaty.

6 Art. 57 Treaty. EU persons are individuals that are citizens of a Member State, Art. 17 Treaty. Companies and firms formed in accordance with the public or private law of a Member State having their registered office, central administration or principal place of business, Art. 48 and Art. 55 Treaty, are eligible to the freedom of services principle and freedom of establishment principle. Cordewener, DStR 2004, pp. 7 et seq.

7 BFH decision of January 29, 2003, I R 6/99, BFH/NV 2003, pp. 969 et seqq.

8 Art. XXV para. 5 of such treaty (which also has been referred to by BFH/NV 2003, pp. 969 et seqq.) stipulates that companies constituted under the laws of one party to that treaty shall have their juridical status recognised within the territories of the other party – which, in fact, leads to the results as the well-known *"Überseering"*- decision of the ECJ. Moreover, Art. III Para. 1 of such treaty includes a most-favored nation clause setting forth that the treatment of nationals of either party shall in no case be less favourable than the treatment of nationals from any third country. Therefore, in any case, American citizens or legal entities should be entitled to the benefits provided for by EU law in Germany.

9 German Minister of Finance (BMF) decree of December 8, 2004, IV B 4 - S 1301 USA -12/04, Para. 3.

10 ECJ decision of July 5, 2005, C-376/03 (D).

11 See Kessler/Spengel, DB 2004, Supplement No. 6.

12 See Cordewener, DStR 2004, pp. 6 et seqq.; Rödder, DStR 2004, pp. 1631 et seqq.; Kessler/Spengel, DB 2004, Supplement No. 6; Schießl, NJW 2005, pp. 849 et seqq.; Bergemann/Schönherr/Stäblein, BB 2005, pp. 1706 et seqq.

13 ECJ decision of December 12, 2002, C-324/00 (Lankhorst-Hohorst).

14 Moreover, EU-regulations such as the Council Regulation (EC) No 2157/2001 of October 8, 2001 on the Statute for a European Company (SE) require changes of the national tax law in order to implement effectively the provisions of the Regulation. Otherwise the EU-regulation would be ineffective in Germany, since the German tax law bars the tax-neutral conversion to a SE so far.

15 See Off. J. Eur. Communities 2003, L 157, pp. 38 et seqq.

16 See Off. J. Eur. Communities 2003, L 157, pp. 49 et seqq.

17 A transitional period is granted to Portugal, Greece and Spain, as well as to some accession states in Eastern Europe.

18 Agreement between the European Community and the Swiss Confederation providing measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, Off. J. Eur. Communities 2004, L 385, pp. 30 et seqq.

19 See Off. J. Eur. Communities 2004, L 7, pp. 41 et seqq.

20 See Off. J. Eur. Communities 1990, L 225, pp. 6 et seqq.

21 See Off. J. Eur. Communities 1990, L 225, pp. 1 et seqq.

22 See Off. J. Eur. Communities 2005, L 58, pp. 19 et seqq.

23 Schießl, NJW 2005, pp. 849 et seq.

24 Handelsblatt, August 24, 2005.

25 Schießl, NJW 2005, pp. 849 et seq.

26 The Economist, August 18, 2005.

Authors:
Dr. Hanno Berger, Attorney, Tax Advisor and Managing Partner
Dr. Peter Happe, Tax Advisor and Certified Public Accountant
Dewey Ballantine LLP
Frankfurter Welle
Reuterweg 16
60323 Frankfurt, Germany
Tel: +49 69 3639 30
Fax: +49 69 3639 3333
Email: hberger@deweyballantine.com,
phappe@deweyballantine.com