

Corresponding adjustments between Italy and Germany:

domestic tax law, relevant treaties and
mutual agreement procedures

The German Perspective

Christoph LANGE, Frank LEGNER

International Tax Institute, University of Hamburg



Universität Hamburg

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Outline

- A. German perspective with regard to German national/ domestic rules
- B. Art. 9 OECD- Model Treaty- Adjustments on income/ tax base, based on the Double Tax Treaty
- C. Mutual Agreements
- D. Mutual agreement and Arbitration procedures under the EU Arbitration Convention

Overview- domestic law

- A German perspective with regard to German national/ domestic rules
 - I „Hidden profit distributions“
 - II „Hidden or concealed equity contribution“
 - III Arm´s length principle
 - IV Other miscellaneous rules
 - V Legal consequences

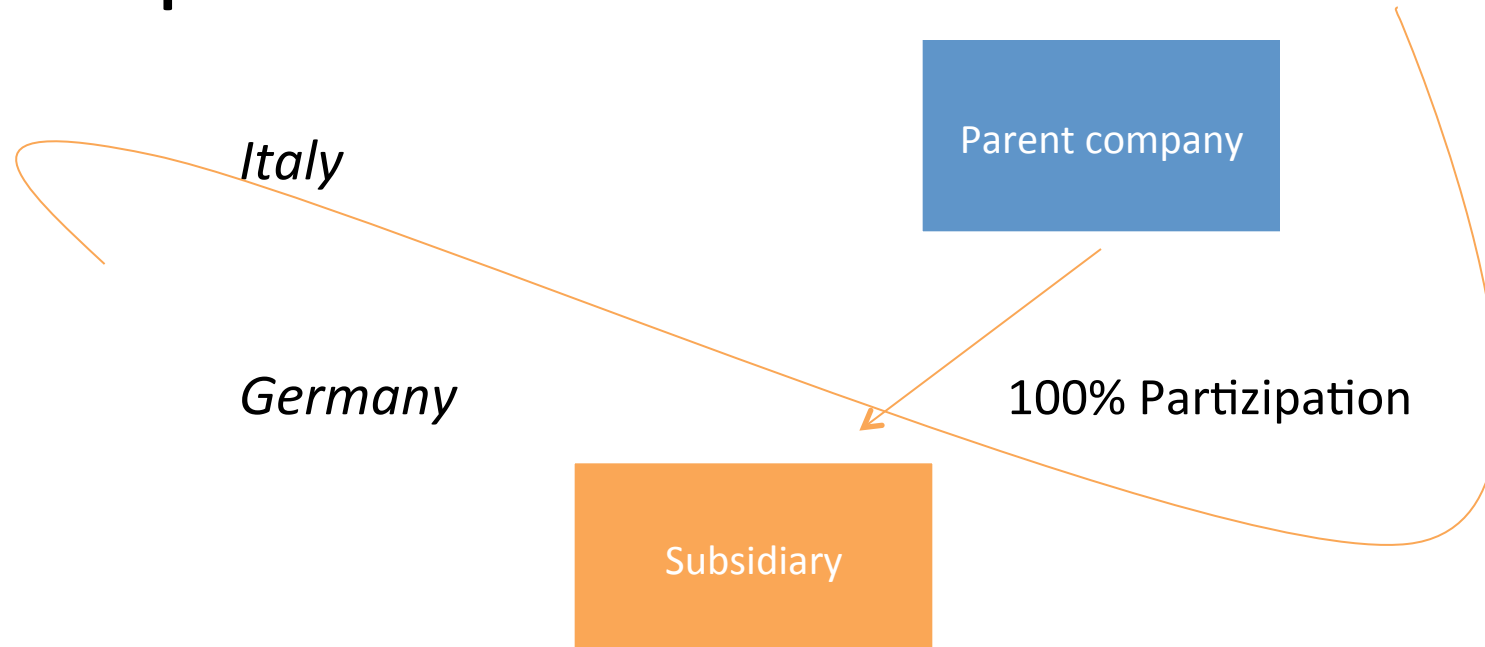
Hidden profit distribution

- I. Key clause for profit or other income correction in German corporate tax code
- II. A person related to the taxable person acquires a benefit, that a third party would not obtain
- III. HPD is provided although no contract/ agreement is in place
- IV. No formal shareholder's resolution is in place
- V. "Add on" income, or rather increase tax base

Hidden equity contribution

- I. Opposite rule to the hidden profit distribution is the hidden equity contribution
- II. A benefit granted by the shareholder to the entity in consideration of his interest, which a third party under arm's length perspective would not provide
- III. HEC is provided even no contract/ agreement is in place
- IV. "Reduce" income, or rather decrease tax base

Example “HIDDEN PROFIT DISTRIBUTION”



Assumptions: Italian parent grants a loan of € 1.000.000
Market interest rate p.a. 3,5%
German subsidiary pays 8,0% p.a. in interest,
the accounts show an equivalent cost of € 80.000

Arm's length principle

- I. From fiscal year 2008 on, first been codified in German Foreign Tax Act
- II. Presumes a “cross border situation” between
- III. “Related (taxable) persons”
- IV. Relationship between related parties must be based on agreements, etc. pursuant to civil law
- V. To ascertain arm's length prices...

Other miscellaneous rules for partnerships

- I. (capital) withdrawal
 - II. (capital) contribution
- } both codified in sec. 4
of income tax code
- III. Minor relevance of these rules in the context of international situations
 - IV. However these rules are of importance as far as they deliver the basic ruling to evaluate assets or utilizations taken out of the business for private or non-business-related purposes

Legal consequences

- I. Once a legally effective agreement to be considered formally inadequate the total of the amount treated as a hidden profit distribution
- II. Once a legally effective agreement to be considered inappropriate only in terms of the portion of the amount the tax base has to be increased
- III. Arm's length price is the standard of valuation that leads to the value adjustment

Overview- relevant treaty rules

- B Art. 9 OECD- Model Tax Treaty-
Adjustments on income/ tax base,
based on the Double Tax Treaty
 - I Basic rule, Factual Findings
 - II Art. 9 II correlative clause to Art. 9 I
 - III Legal consequences
 - IV National administrative Guidelines

Art. 9 OECD- Basic rule

- I. In case Art. 9 of a Double Tax Treaty is applicable, the national German rules to adjust income are limited
- II. Applicable, if the following conditions are met:
 - affiliated companies in
 - two different states have
 - business relationships that
 - third parties would not have performed
- III. Consequence: tax base of company to be adjusted by “Arm’s length principle”



Art. 9 II correlative clause to Art. 9 I

- I. Germany negotiated Art. 9 II only with eight states, i.e. Denmark, UK, Poland, etc., not effective in the Italian- German Treaty
- II. In case of profit adjustments, enterprises i.e. as part of one group run the risk of double taxation
- III. For this reason the Model Tax Convention puts Art. 9 II in place to correlative adjust tax base of other company in the other state

C. Mutual Agreements

Mutual agreement procedures under double taxation agreements

Art. 26 Tax Treaty Italy-Germany

- 1.) Where a person considers that the action of one or both of the Contracting States (Italy/Germany) results or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided of the domestic law of those states, present his case to the competent authority of the Contracting State of which he is a resident, if his case comes under Art. 25 (1). The case must be presented within two years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

- 2.) The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.
- 3.) The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

4.) The competent authorities of the Contracting States may communicate with each other directly. For the purpose of reaching an agreement in the sense of the preceding paragraphs, the Contracting States may communicate through a joint commission, consisting of their representatives.

§ 175a General German Fiscal Code: Implementation of mutual agreements

- 5.) A tax assessment notice shall be issued, annulled, or amended to the extent it is required for the implementation of mutual agreement or an arbitration verdict pursuant to a treaty within the meaning of § 2. In this respect, the assessment period shall not end prior to the expiration of one year after the mutual agreement or arbitration verdict has come into effect.

Summary:

- Application of the party entitled to treaty benefits
- Application by a 3rd party if affected by a taxation contrary to the agreement (liability)
- Making clear, that the application is based on double taxation agreement
- Application deadline 2 years
- Application to be filed with local tax office, in some cases Federal Central Tax Office
- Claiming, that taxation is contrary to the treaty

- Initiation of mutual agreement procedure only, if German national measures not successful (both possible)
- Direct communication with the competent authority of the other State
- All information that the German tax authority obtains in the course of a mutual agreement is subject to tax secrecy (data exchange with other State)

- Clarification of facts: ex officio applying to the provision of the General Fiscal Code
- If clarification of facts reveals contradictions: resolving by coordinated investigation
- The party entitled to treaty benefits may only file applications, comment on the facts and legal questions relevant to the agreement, and authorize an agent to be represented by (only the competent authorities of the contracting States are parties to the mutual agreement procedure)

- Mutual agreement shall be in writing (final correspondence)
- Implementation of the mutual agreement in German tax assessment notice by § 175a General German Fiscal Code
- Failure of mutual agreement procedure: The Federal Central Tax Office will immediately notify the party entitled to treaty benefits and the competent State Tax authority of the decision

- In Germany double taxation may still be avoided by § 163 General German Fiscal Code (substantive inequity)
- If the taxpayer does not comply with his tax duties in the domestic territory or abroad or gave false statements, the authorities will not enter the administrative procedure
- The Federal Central Tax Office will suggest the initiation of an arbitration procedure (the Tax Treaty Italy-Germany does not have any rules for the

initiation of an arbitration procedure, such as Art. 25 (5) OECD model Tax Treaty has)

- Costs: The contracting States will bear the expenses incurred by the mutual agreement procedure by themselves; the expenses incurred by the party entitled to treaty benefits will not be reimbursed
- Disadvantages of mutual agreement procedure: no guarantee for taxpayer, that procedure is successful and very long time until tax authorities come to an agreement

D. Mutual agreement and Arbitration procedures under the EU Arbitration Convention

- Intergovernmental procedure
- Legal basis Art. 6 EU Arbitration Convention (binding law)
- Only refers to the profit allocation between affiliated companies and the allocation in case of permanent establishments
- Arbitration Convention applies in relationships with Italy and Germany (and other EU-member-states)

- The tax authority will inform a company, as it intends to adjust the profit as to Art. 4 EU Arbitration Convention (if tax authorities and companies in both States agree to the adjustment and the corresponding adjustment, an arbitration procedure remains out of consideration)
- Application by the affected company
- Making clear, that the application is based on the Arbitration Convention

- Application is usually filed in the state of the higher-ranking taxpayer (if the application is submitted in the domestic territory, the mutual agreement procedure has to be filed with the Federal Central Tax Office)
- Application deadline: 3 years after the first notification (first assessment notice) that results or may result into double taxation
- Claiming, that taxation is contrary to the principles set out in Art. 4 Arbitration Convention

- Application shall include important information: name, address, tax number, locally responsible tax office, detailed information on the relevant facts and circumstances, tax period affected, copies of tax assessment notices, tax audit report, description of potential out-of-court or court appeals proceedings, explanation by the company of the extent to which, in its opinion, the principles set out in Art. 4 Arbitration Convention have not been observed

- Written application should be submitted (to avoid delays)
- Confirming the receipt of the application to the company and the competent tax authority of the other contracting State within one month
- Initiation of mutual agreement procedure only, if German national measures not successful (ex officio)

- If the examination reveals that the application is submissive and German tax authorities are unable to find a satisfying solution, the Federal Central Tax Office will initiate the mutual agreement procedure
- General procedural principles: notification of the company by the Federal Central Tax Office (domestic case) about significant developments, Contracting States are bound by the arm's-length-principle
- Adjustment of profits by the domestic and foreign tax authorities

- If no agreement within two years, an advisory commission is to be established
- Appointment of the advisory commission
- Composition of the advisory commission: one chairman, two representatives of each of the competent authorities and an even number of independent persons

- Opinion of the advisory commission within six months
- The cost of the advisory commission procedure are shared equally by the contracting States involved

Thank you very much for your attention!



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