tax notes international
Volume 55, Number 1 ■ July 6, 2009

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Reprinted from *Tax Notes Int'l*, July 6, 2009, p. 51

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FEATURED PERSPECTIVES

Promoting Peer Pressure — Germany's Anti-Tax-Evasion Act

by Wolfgang Kessler and Rolf Eicke

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The fight against tax havens has caused some major distortions in the relationship between Germany and Switzerland. Similar to the approach used in the United States in the Stop Tax Haven Abuse Act, Germany intensified its measures to prevent tax evasion by its own citizens starting with a German intelligence agency's purchase of data on Liechtenstein bank accounts. (See Kessler and Eicke, ''Germany's Fruit From Liechtenstein's Poisonous Tree,'' *Tax Notes Int'l*, Mar. 10, 2008, p. 871, *Doc 2008-3969,* or *2008 WTD 52-9.*) As a result of that purchase, there were some verbal battles not only between Germany and Liechtenstein but also between Germany and Switzerland. The peak was reached when the German Minister of Finance, Peer Steinbrück, let loose with his much-cited Wild West rhetoric. Reportedly, Steinbrück said at the April G-20 meeting in London that the OECD gray list of tax havens is like the 7th Cavalry at Yuma in that it need not necessarily go into battle, but it is important that ''the Indians know that it is there.''

Steinbrück's statements caused much anger in Switzerland. Later, Steinbrück rehabilitated the Indians in a speech in the Bundestag, saying that the ''tax evasion phenomenon was not widespread with the Indians.'' The reason for this speech was a debate on a legal initiative against tax havens (the Anti-Tax-Evasion Act) that was approved by the government on April 22, 2009, and is scheduled to pass the Bundestag before summer break.

Marketing Against Tax Havens

The term ''Anti-Tax-Evasion Act'' (*Steuerhinterziehungsbekämpfungsgesetz*) was chosen wisely. The drafters can always be sure to receive applause for fighting tax evasion. However, a closer look reveals that the measure is intended to give the foreign tax authorities more information on cross-border transactions.

The starting point for the act is that German revenue offices encounter difficulties in gathering information from foreign countries in tax evasion cases. The German authorities depend on the cooperation of foreign authorities in case they have to investigate German investments abroad. Basically, the authority to gather relevant information is restricted by international public law to the territory of Germany. The OECD has developed standards of information requests regarding tax matters in article 26 of the OECD model treaty. These standards require that tax-relevant information, such as bank account statements and ownership structures, is open to access by foreign tax authorities. However, many German treaties (for example, Germany's treaties with China, Japan, Austria,

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Belgium, Luxembourg, and Switzerland) do not comply with the OECD standards. Hence, from the standpoint of the German tax authorities, the refusal of foreign tax authorities to provide information promotes tax evasion.

This is what sparked the idea of an Anti-Tax-Evasion Act. Even though the naming is wise, the proposed act is fighting the wrong target. Instead of targeting uncooperative countries, it targets its own citizens and taxpayers by forcing them to provide information regarding their international activities. The measures can be divided into three groups:

- Denial of the usage of beneficial tax provisions in the case of business relationships to countries and territories that do not comply with the OECD exchange of information standards in article 26 of the OECD model treaty.
- Extended investigation rights of the German tax authorities, including:
  - — extended cooperation and documentation duties of the taxpayers;
  - — extended obligation to preserve statements;
  - — extended rights for the tax authorities to claim affidavits; and
  - — permission of the tax authorities to enforce information rights against foreign financial institutions on behalf of the taxpayer in and out of court.
- Creation of a list of countries that do not comply with the OECD standards by way of statutory regulation.

Related Parties

The cooperation and documentation duties were tightened in the last few years. Some of the already existing rules are:

- section 90 paragraph 2 AO (*Abgabenordnung*, or General Tax Code), which provides for a qualified cooperation duty in cross-border tax cases;
- section 90 paragraph 3 AO and section 162 paragraphs 2 and 3 AO in connection with a special profit-splitting documentation regulation (*Gewinnabgrenzungsaufzeichnungsverordnung*) provide for an extensive transfer pricing documentation;
- section 162 paragraph 3 sentence 3 AO allows the tax authorities to penalize insufficient cooperation of involved foreign parties; and
- section 1 AStG (*Aussensteuergesetz*, or Foreign Tax Act) in connection with the function shifting regulation (*Funktionsverlagerungsverordnung*), which provides for extensive taxation rights in case of the shifting of functions abroad. (See Kessler and Eicke, ''Out of Germany: The New Function Shifting Regime,'' *Tax Notes Int'l*, Oct. 1, 2007, p. 53, *Doc 2007-21017*, or *2007 WTD 195-6*.)

Moreover, the provision of tax-relevant information from abroad can only be rejected in case they are irrelevant for purposes of transfer pricing.

Thus, even more extensive cooperation and documentation rights are barely imaginable; but the German government attempts to accomplish this by authorizing the tax authorities to determine special cooperation and documentation rights regarding the reasonableness of business transactions between related parties and between dependent businesses operations.

Nonrelated Parties

Moreover, the draft version even extends the cooperation and documentation rights to nonrelated parties. This proposal infringes on the spirit of the arm's-length principle that sets the standard for the relationship between related parties by analyzing the conditions between nonrelated parties. The fundamental notion of the arm's-length principle is that business relationships between nonrelated parties follow a strict business-driven exchange of goods principle, in which the parties try to maximize their profit and position. In this situation, there is no such thing as a free lunch; however, the German government figures there is, and therefore doubts that even business relationships with nonrelated foreign parties are manipulated.

Denial of Beneficial Tax Provisions

Even more astonishing is the set of measures that restricts or denies the application of beneficial tax provisions in case of an infringement on the cooperation and documentation duties. The denial or restriction covers the following:

- The tax deductibility of business for business expenses or the tax allowable expenses paid to individuals or corporations that reside in so-called ''gray list countries'' that do not comply with the OECD standards.
- The tax exemption on dividends or capital gains (section 8b KStG (*Körperschaftsteuergesetz*, or Corporate Tax Law), if these payments came directly or indirectly from a ''gray list country.''
- The withholding tax exemption or reimbursement if the shareholder resides in a ''gray list country.'' The new rule applies together with the recently tightened anti-treaty-shopping rule, which is already hard to handle and highly disputed. (See Kessler and Eicke, ''Treaty Shop Until You Drop,'' *Tax Notes Int'l*, Apr. 23, 2007, p. 377, *Doc 2007-8765*, or *2007 WTD 83-10*.)
- The flat and final tax on capital income of individuals (*Abgeltungsteuer*) paid from a ''gray list country.'' (See Kessler and Eicke, ''Welcome to the German Dual Income Tax,'' *Tax Notes Int'l*, Aug. 27, 2007, p. 837, *Doc 2007-17722*, or *2007 WTD 169-7*.)

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Discharge From the Banking Secrecy

Taxpayers must inform the tax authorities about business relationships with foreign financial institutions and discharge these institutions from the banking secrecy. In the case of noncompliance, there is a presumption that nondeclared foreign capital income exists or that the actual foreign capital income is higher than reported. In that case, tax audits are permitted without further requirements.

Also, the draft of the Anti-Tax-Evasion Act contains provisions that target wealthy German citizens. If a taxpayer generates income of more than €500,000, comprehensive obligations to preserve statements apply for the income and the expenses for more than six years. Moreover, the draft permits a general tax audit for these persons.

Constitutional Critics

The draft version infringes on several constitutional principles. The legality of taxation is violated because several detrimental provisions will be in a mere statutory order that is drafted by the tax authorities (executive branch). This constitutes a violation of the principle of separation of power, because detrimental tax provisions must be passed by legislation as formal statute.

Moreover, the constitutional demands that the content, extent, and purpose of such a statutory order must be clearly determined. In any case, a statutory order must not substitute a formal statute. Also, many terms in the draft version are unclear and not defined anywhere in German law (for example, ''fight against harmful tax practices'').

Further, the measure is to a large extent inappropriate because it does not give the taxpayer the opportunity to provide for counterevidence. Instead, it grants a right to the tax authorities to perform fishing expeditions without a given suspicion.

Most importantly, the measure goes far beyond what is necessary to reach the legitimate goal of preventing tax evasion. This is because all taxpayers are held under a general presumption of evading taxes, without defining the objective or subjective elements of tax evasion. The measure shoots the wrong target. The targeted taxpayers have no influence to change the exchange of information provision in the bilateral tax treaties, which is the ultimate and underlying main goal of the lawmaker. Instead of a direct peer pressure against uncooperative countries, the peer pressure is performed indirectly, holding the taxpayers in custody to achieve this goal.

EC Law Critics

The measure also infringes on European Community law because it violates the principle of the freedom of establishment and the freedom of capital movement. Moreover, it is widely inappropriate because it does not fight ''merely artificial arrangement'' and does not provide for the opportunity to give counterevidence as required by the European Court of Justice in *Cadbury Schweppes* (C-196/04). Case law suggests that exchange of information within the European Union is exclusively governed by the EC mutual assistance directive (77/799/EEC), even in cases in which national law prohibits the exchange of information (ECJ in *Elisa*, C-451/05). Only in third country cases can a lack of information be justified by a discriminating measure (ECJ in *Skatteverket*, C-101/05).

Outlook

It remains to be seen whether this draft will be passed into law before the summer break or if the drafting process is just another measure to promote the peer pressure against uncooperative countries. Germany has concluded several exchange of information agreements that comply with the OECD standards, even with Guernsey and the Isle of Man, and more are scheduled to be concluded soon. As many German double taxation agreements already contain OECD-compliant exchange of information agreements, the need for the Anti-Tax-Evasion Act is highly questionable and should be scrutinized considering the large amount of damages it would cause. ◆

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