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by Wolfgang Kessler and Rolf Eicke

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Featured Perspectives

Legal but Unwanted: The German Tax Planning Disclosure Draft

by Wolfgang Kessler and Rolf Eicke

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Even if a tax planning structure is legal, it can still be "unwanted." However, those structures might soon be wanted — for disclosure. "Unwanted" structures do not violate the letter of the law, but still might infringe on the spirit of the law.

To fight tax avoidance, German tax authorities and lawmakers are placing all "legal but unwanted" tax planning schemes under special review. The review will take place in advance to reduce the gap before the tax benefits materialize. To do so, the authorities and lawmakers are using their favorite weapon: retroactivity. Retroactive laws are more frequent in Germany than in common-law jurisdictions, which is one reason why the disclosure draft poses such a danger to legal certainty. Also, the proposal comes at a time when the German tax authorities are on an antiavoidance roll.

First, both the anti-treaty-shopping provision[1] and the thin capitalization rules[2] were dramatically tightened. Then, a draft was intended to severely broaden the scope of the statutory general antiabuse rule, followed by Minister of Finance Peer Steinbrück's announcement that all German double tax treaties would be reviewed for loopholes and potential revenue loss risk; those double tax treaties that do not comply with German treaty policy could be terminated. Among the potential victims is the double tax treaty with the Netherlands because of the murky status of the Netherlands Antilles.

The next logical step in the mind of the lawmakers and the tax authorities is to establish an advance alert system to collect enough information to spark an administrative or legislative process to close any potential loopholes. The lawmakers address international tax arbitrage. Even though the legislation concedes that international tax arbitrage is not evil per se, as long as it constitutes the legal use of opportunities enabled by a fair international tax competition between countries, it is dangerous when it leads to double nontaxation. The proposal is

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[1]Wolfgang Kessler and Rolf Eicke, "Germany: Treaty Shop Until You Drop," *Tax Notes Int'l*, Apr. 23, 2007, p. 377.

[2]Wolfgang Kessler and Rolf Eicke, "New German Thin Cap Rules — Too Thin the Cap," *Tax Notes Int'l*, July 16, 2007, p. 263.

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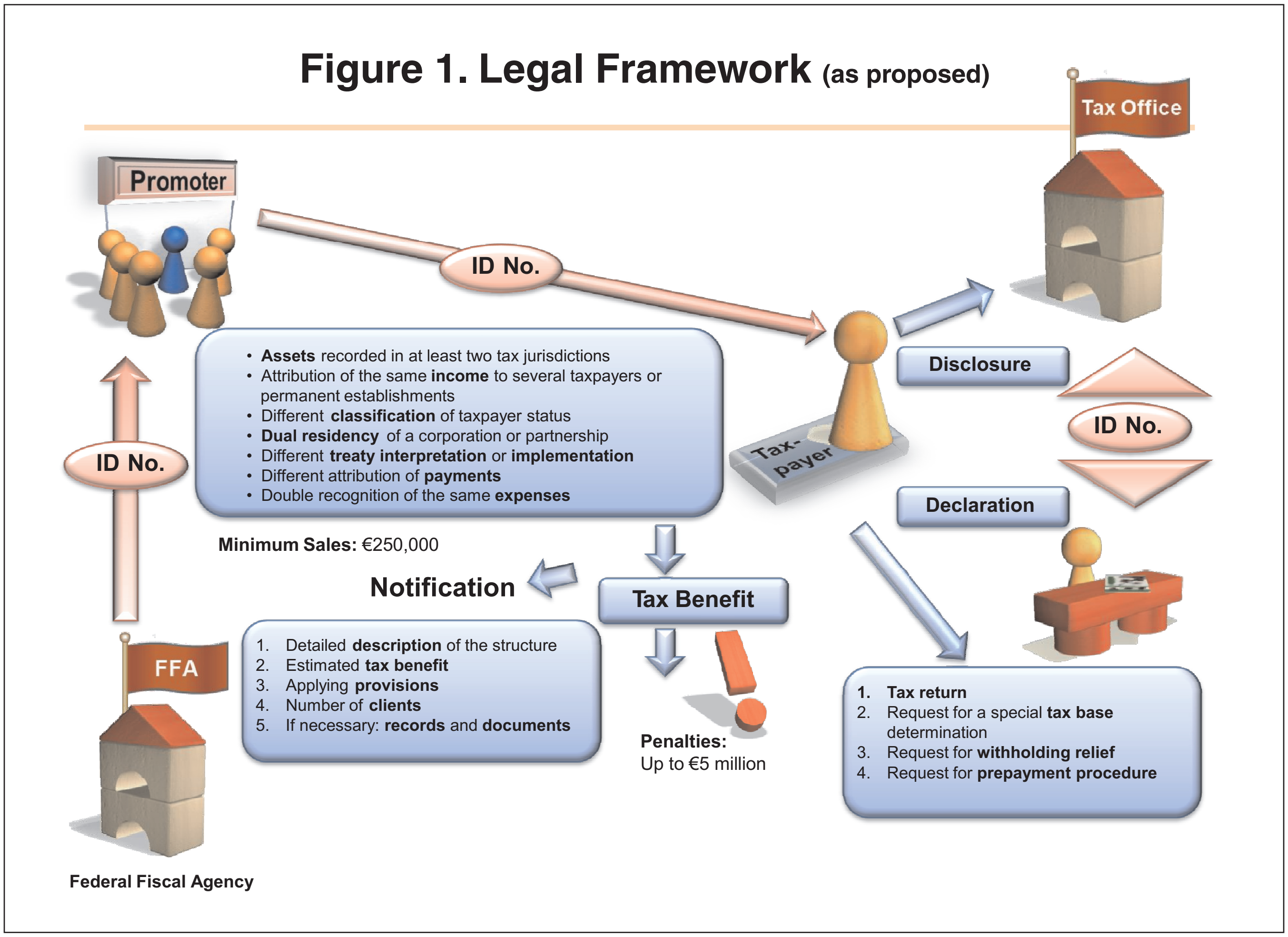

wrapped up with worldwide unprecedented high penalties for promoters in case of nondisclosure of a tax structure. However, it is unclear if and when the rule will be introduced because of the amount of criticism the rule has received.

The Rule

The new disclosure rule is supposed to be embedded in section 138(a) GTC (General Tax Code, or *Abgabenordnung*). The center of interest is not the taxpayer but the promoter. (See Figure 1.) The term "promoter" describes all professionals like lawyers, tax advisers, accountants, banking consultants, and investment firms promoting tax structures. The rule will apply to both domestic and foreign promoters if the tax structure causes revenue loss for the government, creates a tax benefit for the taxpayer, and involves one of the following cases:

- *assets* recorded in at least two tax jurisdictions;
- attribution of the same *income* to several taxpayers or permanent establishments;
- different *classification* of taxpayer status;
- *dual residency* of a corporation or partnership;
- different *treaty interpretation* or *implementation*;
- different attribution of *payments*; or
- double recognition of the same *expenses* in two or more jurisdictions.

The promoter of any tax planning involving one of the categories listed above must notify the Federal Fiscal Agency (FFA) within 10 days after the month ended in which the structure or scheme was recommended to the client. Thereby, the promoter must provide the FFA with information such as a detailed description of the structure, the estimated tax benefits, the underlying legal provisions that apply, the number of clients, and — on specific request by the FFA — all records and documents related to this subject matter. On initial notification, the promoter must provide monthly updates for two years. However, the entire disclosure regime does not apply to several exceptions:

- if the promoter makes less than €250,000 in sales on the recommended structure;

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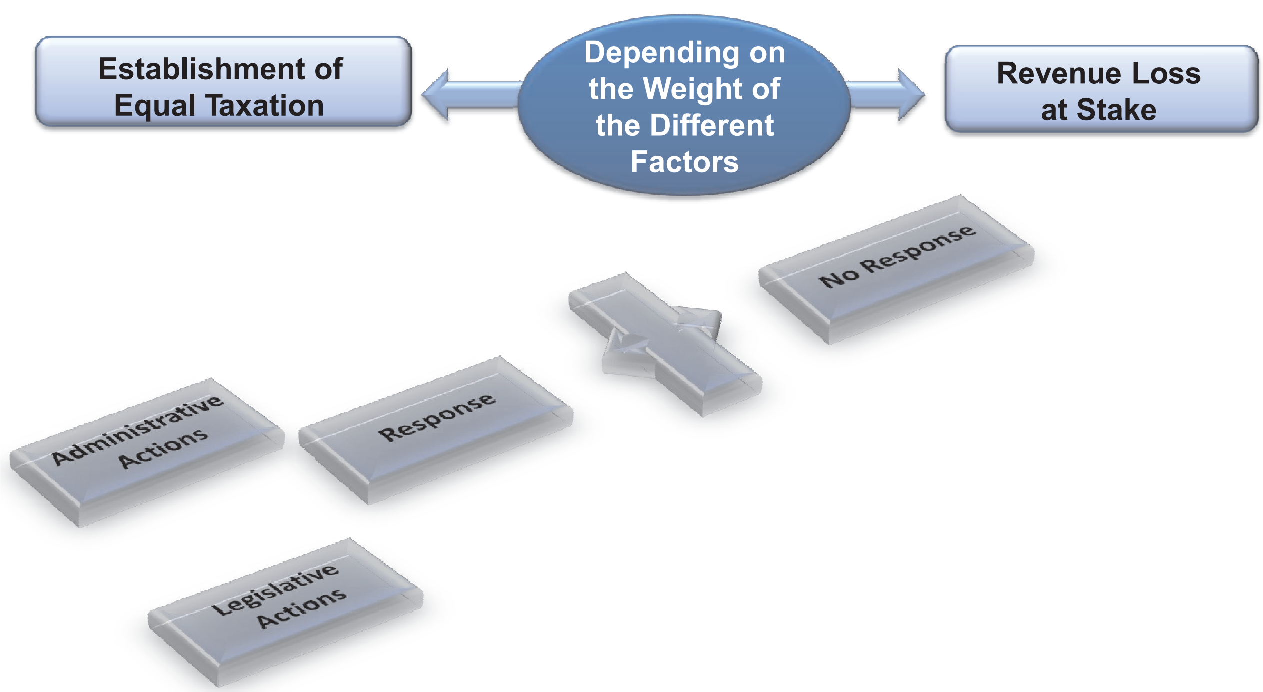
Figure 2. Reaction to Tax Arbitrage



- all *in-house* schemes, meaning structures developed for a company's own purposes and not sold elsewhere;
- oral recommendations;
- mere tax *rate* arbitrage within the European Union, when only taking advantage of the different corporate or income tax rates within the European Union; and
- any advice given in articles or lectures (fortunately for us, the authors).

After the first notification, the promoter will receive an identification number, which he must pass on to the client. Once the taxpayer has received the ID number from the promoter, the ID number must be disclosed to the local tax office in the following cases:

- filing of a *tax return*;
- request for a special *tax base* determination;
- request for *withholding relief*; and
- request for *prepayment procedure*.

Data's Destiny

On disclosure, the data is supposed to enter into a promising future (at least from the tax authorities' point of view). The FFA will analyze and evaluate the tax structures and will report some examples to the Ministry of Finance. In due time, officials from the MOF will meet with representatives from the German states (*länder*) to deliberate on further measures. Depending on how much revenue loss is at stake and whether it is necessary to establish equal taxation in a specific subject matter, this council will decide whether there will be any administrative or legislative actions. (See Figure 2.)

On request, the local tax offices will receive all details on concrete tax planning structures from the FFA. In the case of abusive schemes, the local tax offices are entitled to enforce immediate measures. (See Figure 3.)

Moreover, the gathered material is supposed to receive even more attention on a higher level. The German tax authorities are planning to submit the data to the European Commission to improve tax coordination between the member states. The data

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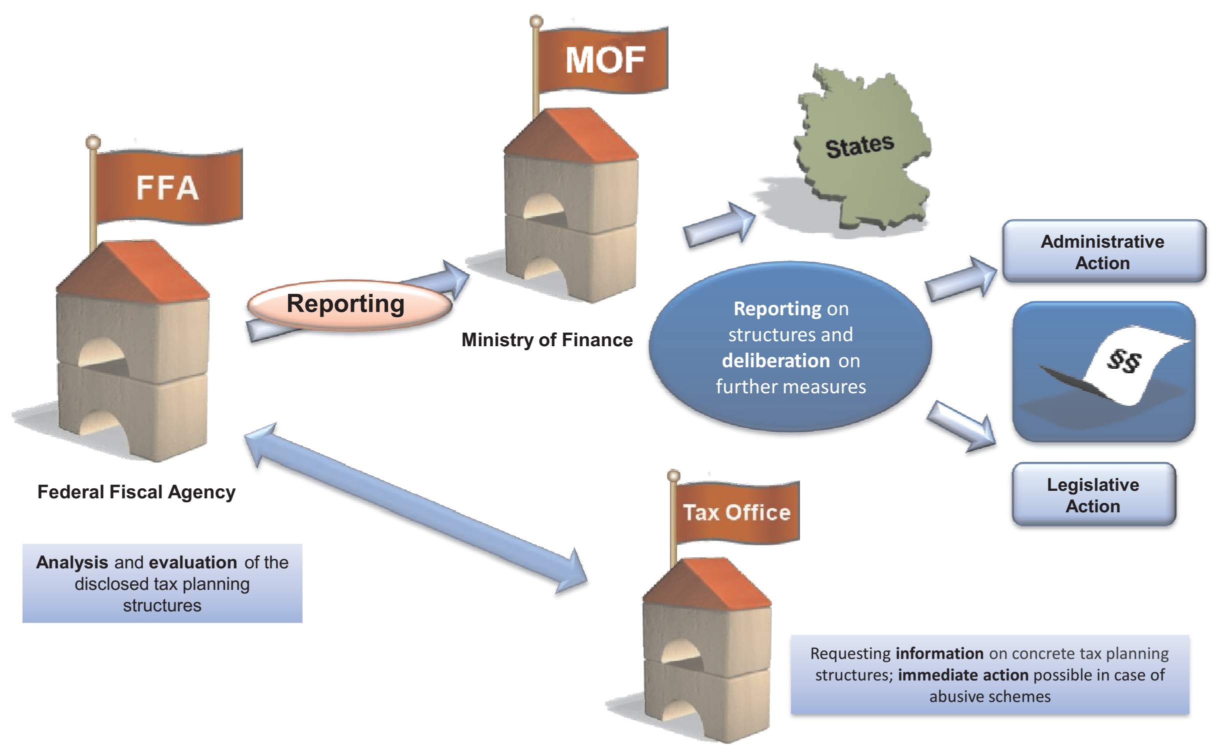
Figure 3. Analysis of Disclosed Tax Planning Structures



will also be submitted to other member states involved in the respective tax case.

Comparative Regimes

A few common-law countries — namely, the United States, the United Kingdom, and Australia — have incorporated antiavoidance disclosure rules into their tax system. Germany would be the first civil-law country to introduce such rules after France withdrew its proposals in 2005. The reason why civil-law countries have not yet implemented such a set of rules is not arbitrary but the consequence of two major factors. First, the interaction between taxpayers and the tax authorities differs. Common-law tax jurisdictions feature the self-assessment system. Second, neither the United States nor the United Kingdom have implemented a statutory general antiabuse rule. In these two countries, the disclosure rules partially fill this gap. The table on the following page depicts all the major differences between the U.S., the U.K., and the proposed German regime.

The main differences between the German proposal and the existing U.S. and U.K. disclosure rules are that the scope of application would be much wider in Germany than elsewhere. Moreover, the designated penalties with a maximum of €5 million for each promoted structure will force insurance providers to recalculate their premium. Yet, contrary to the U.K. rules, *in-house* schemes are excluded, and unlike in the U.S. and the U.K., the proposed German rules do not focus on classical tax shelter schemes, which are dealt with in Germany in a separate regime. Also, unlike the U.S. rules, the German rules focus much more on the promoter rather than on the taxpayer and are therefore closer to the U.K. rules.

International Implications

It is likely that the tax authorities will resort to the collected data when attempting to convince lawmakers to enact legislation against the legal (at the time of disclosure) tax planning. In almost all cases, lawmakers will take the shortcut, by either

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Table. Comparison of German, U.S., and U.K. Disclosure Rules

	Germany	United States	United Kingdom
Section	Proposed (section 138a AO-E in connection with section 379a AO-E)	Documentation: IRC sections 6111, 6112 6707A(c); penalties: IRC sections 6700, 6707, 6707A, 6708, 6662	Section 306-319 of the Finance Act 2004; tightened in 2006 by section 108 of the Finance Act 2007
Term	Notifiable tax planning (anzeigepflichtige Steuergestaltungen)	Reportable Transaction Disclosure Rules	Disclosure Rules for Tax Avoidance Schemes
Prime Addresser	Promoter	Taxpayer	Promoter
Promoter	Lawyers, tax advisers, accountants, banks, investment firms	*Material adviser*	Like in Germany, plus *in-house schemes* of large companies
Externally/Internally Developed Schemes	Only external schemes	In general, only external schemes	Both external and internal schemes
Targets	International tax arbitrage; not: classical loss allocation tax shelters (own regime: section 15b and section 20 para. 2b EStG)	In particular listed, confidential, loss transactions; plus classical tax shelter	*Hallmarks* typify “dangerous” schemes, *e.g.*, tax shelters, loss allocation schemes
Goal	Advance information to control international tax arbitrage	Detection of potentially or identified (listed) abusive schemes	Advance detection of tax loopholes and tax shelters
Statutory GAAR	Section 42 AO (General Tax Code)	No	No
Scope of Documentation	Description of structure, goal and tax benefits; on request comprehensive reports and documents	Details on transaction, tax benefits, names of participants	Details on scheme, tax benefits (including time frame), underlying provisions
Initial Disclosure Period	Taxpayer: tax return or other declarations; promoter: up to 10th day of month following the recommendation	Taxpayer: 90 days (until August 3, 2007: tax return); *material adviser*: 20 days	Taxpayer: tax return; promoter: 5 working days; *in-house*: 30 days
Exceptions	*In-house*, oral advice, articles, lectures	*E.g.*, *in-house*; published guidance, RICs, private letter rulings, lease transactions	Benign tax advice test, non-tax-adviser test, ignorance test
Linkage	Identification number	Identification number	Identification number (scheme reference number)
Exemptions	Sales < €250,000 (≈ $350,000)	Sales < $250,000 if client a company; others < $ 50,000; for loss transactions, special minimum loss usage amounts	Small or medium-size enterprises
Max. Penalties Per Tax Structure	€5 million (≈ $7,000,000)	Among others: for taxpayers: *listed transaction* (between $100,000 for individuals $200,000 for others); other transactions (between $10,000 for individuals and $50,000 for others) (IRC section 6707A(b)); *material adviser*: higher of $200,000 or 50 percent of sales for a *listed transaction*; $50,000 for others	£5,000 (≈ €6.800; ≈$10,000)
Max. Penalties Per Day of Nonnotification	€500 (≈ $700)	*Material adviser*: upon request $10,000 from the 20th day (IRC section 6708)	£600 (≈ €850; ≈$1,300)

conducting literary piracy by borrowing ideas from the MOF or by having MOF officials ghostwrite the entire bill.[3]

> ***Applying the rule to foreign promoters is legally possible but factually inconceivable. It would result in a tremendous amount of avoidance.***

One of the major downsides is that lawmakers intend to apply this rule to both domestic and foreign promoters. Applying the rule to foreign promoters is legally possible but factually inconceivable because the scope of enforcement of the *Abgabenordnung* is limited to the territory of Germany. As a consequence, the rule would result in a tremendous amount of avoidance; taxpayers will consult with foreign advisers, rendering the underlying purpose of the rule meaningless. This problem has been solved in the U.K. because the duty to notify is automatically transferred to the taxpayer if there is no promoter, if the promoter resides abroad, or if a notification would violate the professional secrecy of lawyers and tax advisers.

Critical Review

Speaking of professional secrecy, it is almost certain that it will be severely endangered. As a result, clients might withhold important information to prevent the disclosure of sensitive data.

The German rule violates EU law since no grounds for justification will apply; recent European Court of Justice case law demands that the anti-abuse provision must only target wholly artificial tax planning structures whose sole purpose is to avoid taxes.

The desire of the tax authorities to have information flow like milk and honey is understandable. Yet the price of the current version is too high. If lawmakers still want to uphold the proposal, the rule must include the following features to comply with both the German constitution and EU law:

- the rule must exclusively target artificial tax planning;
- the rule must have notification solely to prevent nontaxed income;
- the concrete tax planning must be unknown to the tax authorities;
- the rule must include right of rebuttal for the promoter that the structure is not abusive even if the rule is triggered;
- the rule must not apply to structures within the European Union;
- the rule must include a transfer of the duty of notification in case the promoter resides abroad or if the notification would violate professional secrecy;
- the rule must include reasonable penalties; and
- the rule must contain assurances that legal tax planning will not be targeted by retroactive laws.

Conclusion

Instead of targeting “legal but unwanted” tax planning structures, lawmakers should focus on the diligent drafting and enactment of tax laws that are consistent with the tax system and that do not create legal gaps. Rather than crying about international tax arbitrage, the tax authorities should conduct some trust-building measures ensuring legal certainty for legal tax planners. Furthermore, the tax authorities should conduct prompt tax audits more frequently instead of resorting to a disclosure rule. That way, all desired information is obtainable without infringing on legal certainty.

Moreover, a lack of taxation in the international arena is often the result of one jurisdiction exercising its freedom to tax or not to tax. Any unilateral counteraction infringes on that sovereignty. Also, the record-high penalties are detrimental to Germany, and the rule will be highly ineffective because the rule will not be enforceable against foreign advisers.

Even though the German tax authorities and lawmakers use the U.S. and the U.K. as justification for the rule, any transfer of ideas from common-law countries to civil-law countries runs the risk of creating yet another alien element in the German tax system. Not only is the relationship between taxpayers and tax authorities different, but most importantly the risk of retroactivity in lawmaking is different. Thus, closing the legal gap with the help of advance information and retroactivity will be much easier in Germany than elsewhere. Also, the disclosure rules in the U.S. and the U.K. substitute for the lack of a GAAR.

When *Tax Notes International* columnist Trevor Johnson headlined his article on the U.K. disclosure rules “Defining the Elephant” (*Tax Notes Int’l*, Aug. 7, 2006, p. 497), he could not possibly have known that German lawmakers might create a regime that someday would be as sensitive to legal certainty as an elephant in a china shop. ◆

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[3]For similar conduct in the United States, see James J. Freeland, Daniel J. Lathrope, Stephen A. Lind, and Richard B. Stephens, *Fundamentals of Federal Taxation (University Casebook Series),* (14th ed., 2006).

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