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# *flash* Alert

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**Germany – New Circular Updates Tax Principles to Align with OECD Model**

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An 86-page German government circular, in effect since January 1, 2015, provides insight into the German tax authorities' opinion on the tax treatment of employment income according to article 15 of the OECD Model Tax Convention.

This circular, issued by Germany's Ministry of Finance,[1] fully replaces the previous circular of 2006. It provides an update on the tax authorities' opinion concerning the taxation of employment income in light of double taxation treaties. Where the German tax authorities have revoked some previous interpretations, others were confirmed or even announced for the first time.

## Why This Matters

For some time to come, the new circular will serve as a basis for all German tax offices for the purpose of tax assessments, as well as tax audits. Employers with cross-border employees, as well as tax practitioners advising them, should review these new positions and principles to be followed by the German tax authorities as they could impact tax-related compliance and international assignment costs and planning.

We highlight some of the main changes and areas of focus below.

## 183-Day Ruling – Change of Residence

The Ministry of Finance has confirmed that if the individual's tax residence has changed during the year[2], the working days in that new country of residence are not taken into account to determine if the threshold of 183 days has been exceeded. In this, the German tax authorities follow the OECD approach to counting days of presence in the event of a change of residence.

## Tradeable vs. Non-tradeable Stock Options

As opposed to the previous circular, there is no longer a difference in the taxation of tradeable and non-tradeable stock options. In both cases, the benefit-in-kind occurs at the moment the underlying stock options are exercised. It is deemed compensation for the work performed during the "vesting period." In the event of cross-border activities during the vesting period, the underlying taxable value needs to be pro-rated accordingly between the contracting states.

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[1] Soon to be published in *Bundesgesetzblatt*, the German federal tax gazette, but already available (in German) at the Ministry's official Web site –please follow this link: http://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF_Schreiben/Internationales_Steuerrecht/Allgemeine_Informationen/2014-11-12-steuerliche-behandlung-arbeitslohn-doppelbesteuerungsabkommen.pdf?__blob=publicationFile&v=1 .

[2] Twelve-month period, fiscal year or calendar year, depending on the specific double taxation treaty.

Note that in the exceptional case of a sale of tradeable stock options, the sale is regarded as a tax triggering event.

## Acknowledgement of Hypothetical Taxes

The German Ministry of Finance now officially acknowledges the deductibility of hypothetical taxes when determining the assignee's net salary during an assignment (net salary agreement). Several examples of the treatment in cases of net salary agreements are provided.

## Director's Compensation

There is a new special provision dealing with the taxation of remuneration of board members or managing directors of German legal entities. In the German tax authorities' view, a German tax liability could be triggered even if the executive is living and working outside of Germany and is not separately compensated for his "director" position in Germany. The circular requests investigation as to whether – in accordance with the arm's-length principle – a part of the executive's overall compensation paid outside Germany should be regarded as compensation for the management position in Germany; if so, a German tax liability might arise.

## Economic Employer Approach

The importance of the economic employer approach has been strengthened, meaning that a German tax liability on employment income could be triggered even if there is no formal employment contract between an employee and a German firm. In fact, a German company can be considered to be an economic employer if:

1) the employee – although formally employed with a non-German affiliated company – works for the benefit of the German firm; and

2) the employee is embedded in the German firm's organization (e.g., chain of command); and

3) the German firm either actually absorbs the underlying employment costs (e.g., inter-company cross-charge) or should have been charged with the these costs according to the arm's-length principle.

The tax authorities explicitly stressed that if salary costs are arbitrarily not absorbed by a German firm, this firm could still be regarded as an "economic employer" if other criteria[3] are fulfilled. In any case, no separate agreement with the German firm (either concluded with the employee or with the non-German affiliated company) is required in order to be regarded as an economic employer. It is therefore recommended that all facts and circumstances should be taken into account up-front to determine if a tax liability arises.

[3] It is not a straightforward approach as other facts and circumstances have to be considered, such as: participation in the company's equity or pension schemes, responsibility in case of sickness or poor performance, place of work, etc.

### Severance Payment (Special Treaties)

The authorities' recent view of the taxation of severance payments remains unchanged. The term "severance payment" requires that the compensation be made for the loss of employment (future related). It must therefore not be a remuneration for the employee's work already performed in the past (e.g., bonuses or vacation days not taken). The severance payment is taxable in the country of residence at the moment the payment is made by the (former) employer.

It should be noted that Germany has concluded several special "agreements of understanding" on the right of taxation of severance payments which differ from the above-mentioned general rule. In these cases, the taxable portion of the severance payment is determined by the extent of taxability of the employee's remuneration in the contracting states in the past. These special agreements, which vary, exist *inter alia* with Belgium, the United Kingdom, Luxembourg, the Netherlands, Austria, and Switzerland.

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If you think it's become easier to deploy talent in the global economy, it's time to reconsider. The trend toward stricter immigration regulation defies the borderless economy. Taxes present significant hurdles to the free movement of employees across geographies. The diversity of labor laws complicates decisions with respect to benefit plan offerings and participation in the cross-border environment. The cost of compliance has never been higher . . . and it's rising.

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Dates: Tuesday, 6 October through Thursday, 8 October, 2015

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