KPMG

GMS Flash Alert

2018-087 | June 19, 2018

Germany - New Circular Updates Tax Opinion to Align with OECD Model

On May 3, 2018, the German Ministry of Finance issued an updated 95-page circular[1] ("the Circular") on the treatment of employment income according to the Organization for Economic Cooperation and Development's (OECD) Model Tax Convention.

The new Circular, which fully replaces the previous circular of 2014,[2] provides an update on the German tax authorities' interpretations on the taxation of employment income in light of double taxation treaties. It not only reflects the newest German legislation and case law, but also confirms and clarifies previous interpretations.

In this GMS *Flash Alert*, we highlight some of the main topics: tax residence, tax exemption, severance payments, and economic employer, amongst others.

WHY THIS MATTERS

The new Circular can be regarded as the most important update on the taxation of employment income in light of double taxation treaties from a German tax authorities' perspective. It will serve as a foundation not only for German tax offices for tax assessment purposes, but also for tax audits. It is recommended that employers with cross-border employees, and tax professionals advising them, review the positions to be followed by the German tax authorities since they could have an influence on international assignment costs and planning, as well as tax-related compliance.

Tax Residence – Applicability of a Double Taxation Treaty

In order to be able to apply a double taxation treaty ("DTT"), an individual must be resident in either of the contracting states. The Ministry of Finance highlights the importance of the correct determination of tax residence according to article 4 of the OECD Model Convention. It points out that the individual must be subject to unlimited income taxation in one state by reason of his/her domicile, habitual abode, or criteria of similar nature[3] to be deemed as treaty resident in one state. Therefore, from a German perspective an individual cannot be regarded as treaty resident in the other state – even by having a family's domicile there – without being subject to unlimited taxation according to its domestic law.[4] Consequently, the individual is either regarded as treaty resident in Germany (by having an unlimited tax liability in Germany) or the relevant DTT is not applicable at all.

Subject to Tax Clauses

Where Germany is the state of residence in cross-border scenarios, a potential double taxation of employment income is often prevented by the "tax exemption method" should the other state have – as the state of source – the primary right of taxation.

The German tax exemption, however, is only granted if the individual provides evidence that:

a) the employment income was actually subject to income tax in the contracting state (state of source); or

b) the other contracting state has actually waived its right of taxation (e.g., general tax relief in that state).

Should the aforementioned conditions not be met, Germany imposes income tax on foreign income, going against the rulings of the DTT. This so-called "treaty override"[5] also applies if the employment income is either fully or even only partly tax exempt in the other state because:

a) the individual is only subject to limited taxation according to domestic law, or

b) the other state applies the rulings of the DTT differently (qualification conflict).[6]

In the future, it can therefore be assumed there will be increased administrative work (i.e., translating and explaining non-German tax returns and tax assessment notice) in order to qualify for a tax exemption on employment income.

Severance Payments

The taxation of severance payments in cross-border scenarios has changed. The Circular reflects a new approach to the taxation of severance payments taking into account new German legislation to be applied for all severance payments made after January 1, 2017.[7] The term "severance payments" requires that the compensation only be made for the loss of employment.[8]

According to the new legislation, severance payments are regarded as an additional payment for the past employment with the employer (so, these payments will no longer be regarded as future related). For this reason, severance payments need to be sourced to the state where the work was actively performed before (state of source). The former state of source has the primary right for taxation to the extent of taxability of the individual's remuneration in that state in the past.

Only in exceptional cases, where no facts and circumstances are available to allocate the redundancy payment appropriately, will such a payment be considered to be compensation for the work performed for the last 12 months of employment, i.e., to be sourced on a pro-rated basis where the employment was exercised during the aforementioned period.

The general ruling only applies if a specific double taxation treaty does not explicitly determine another approach of taxation. Germany has concluded a special agreement on the allocation of taxation rights of redundancy payments with the following states: Austria, Belgium, France, Liechtenstein, Luxembourg, United Kingdom, and Switzerland.

To the extent that the redundancy payment cannot be taxed (or only with a reduced income tax rate) in the other state because this state applies the rulings of the double taxation treaty differently than Germany, then Germany imposes income tax on the redundancy payment regardless of the rulings of the treaty as well (treaty override). A potential double taxation would then be avoided by crediting the foreign income taxes (if any) against the German tax liability.

No Impact of Authorized OECD Approach (AOA)

Remuneration derived by a resident of a contracting state for work performed in the other contracting state is taxable in the other contracting state (state of source) if the remuneration is borne by a permanent establishment (PE). This result neither depends on whether the remuneration is paid by the PE or by the head office nor on a separate cost-sharing agreement between the PE and the head office.

The German Ministry of Finance has taken the position that the aforementioned taxation principles do not change by adopting the "Authorized OECD Approach (AOA)" in double taxation treaties with Germany. Although a PE is deemed to be a separate and independent enterprise (in particular in its dealings with other parts of the enterprise), it has no impact on how the remuneration is taxed. A PE still cannot be regarded as an employer for double taxation treaty purposes.

Hence, from a German perspective, the remuneration received by a German nonresident related to work days performed for a PE that is located in Germany remains subject to tax in Germany regardless of the threshold of 183 presence/or work days in Germany or a cost-sharing agreement.[9] The same applies when employees are employed by a PE located outside Germany and have work days in the German head office (e.g., business trips). The remuneration relating to German work days is (partly) subject to German income tax.[10]

Economic Employer Approach

The authorities' general acknowledgment of the economic employer approach remains unchanged. This means that German tax liability on employment income can be triggered even if there is no formal employment contract with an employee and a German firm. It has been confirmed that a German firm can be regarded as an economic employer if:

1) an 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; and

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

If an employee's assignment between affiliated companies does not exceed three months, there is a general presumption that the employee is not "embedded" and the receiving company should not be regarded as the economic employer. However, the German Ministry of Finance has pointed out that in each case all individual facts and circumstances[11] must be taken into account in order to determine an economic employer. Hence, even if the duration of an assignment is less than three months, the receiving company could still be regarded as the economic employer in certain cases.

FOOTNOTES:

1 Soon to be published in *Bundessteuerblatt*, the German Federal Tax Gazette but already available (in German) at the Ministry's official Web Site – to access it, click here.

2 See GMS *Flash Alert* 2015-035 (6 March 2015).

3 E.g., an unlimited tax liability due to mere citizenship of the other contracting state would not be sufficient.

4 The German Ministry of Finance explicitly mentions China and South Africa in the Circular. However, a limited tax liability in other states that rules out being treaty resident there, potentially also applies to states with a special tax regime for expatriates (i.e., Belgium, Denmark, Finland, Spain).

5 This "treaty override" was found permissible under the German constitution by the German Constitutional Court; see GMS *Flash Alert* 2016-039 (17 March 2016).

6 From the German tax authorities' perspective, this could be, for example, if the other state does not apply the "economic employer approach."

7 § 50d sec. 12 German Income Tax Act (*Bundesgesetzblatt* (Federal Law Gazette), December 20, 2016, page 3011 (in German)).

8 For example, this does not apply for bonus payments granted for a specific performance period of time.

9 A German wage tax withholding obligation for the German PE exists (shadow payroll).

10 A German wage tax withholding obligation for the German head office exists (shadow payroll).

11 The Circular provides several indications and criteria about when the receiving company can be regarded as the economic employer.

* * * *

Contact us

For additional information or assistance, please contact your local GMS or People Services professional or the following professional with the KPMG International member firm in Germany:

André Eifler
Tel. +49 30 2068-4175
aeifler@kpmg.com

The information contained in this newsletter was submitted by the KPMG International member firm in Germany.

www.kpmg.com

kpmg.com/socialmedia

Flash Alert is a GMS publication of KPMG LLP's Washington National Tax practice. To view this publication or recent prior issues online, please click here. To learn more about our GMS practice, please visit us on the Internet: click here or go to http://www.kpmg.com.