

# GMS Flash Alert

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

On 12 December 2023, the German Ministry of Finance (*Bundesfinanzministerium*) issued an updated 154-page circular<sup>1</sup> (“the Circular”) on the treatment of employment income according to the Organisation for Economic Cooperation and Development’s (OECD) Model Tax Convention.

The updated Circular fully replaces the previous circular of 2018.<sup>2</sup> It provides an update on the German tax authorities’ opinion 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 changes and areas of focus.

### WHY THIS MATTERS

This updated Circular can be viewed as the most important update on the German taxation of employment income in double taxation treaty scenarios. It reflects the German tax authorities’ perspective and will serve as a basis for all German tax offices for the purposes of tax assessments as well as tax audits. Employers with cross-border employees and tax consultants advising them may find it in their interest to review the principles to be followed by the German tax authorities as they could have an impact on international assignment costs and planning as well as tax-related compliance.

## Determination of Tax Residency

Where cross-border employees (e.g., expats) have a tax domicile in the home country as well as in the host country, it is necessary to determine the tax residency for double taxation treaty purposes. In order to determine the centre of vital interest, personal as well as economic ties need to be taken into account. The German tax authorities explain in more detail which criteria are to be used for the treaty residence test, and how they are to be applied. The authorities state more clearly than in the past that personal and economic interests are to be given equal weight, i.e., the relocation of the family alone is not the only decisive factor for assuming a treaty residence abroad.

### KPMG INSIGHTS

Through the illustration of their approach of the treaty residence test with several examples, it can be expected that the German tax authorities will more closely scrutinise (or challenge) a shift of the treaty tax residence to the host country. Hence, it is becoming more and more necessary to confirm the individual's tax position in the home country and the host country in the future to avoid conflicts of treaty interpretation.

## Economic Employer Approach / New Documentation Obligations for Employers

The German tax authorities continue applying the economic employer approach. As a result of this approach, a German tax liability on employment income can arise although there is no formal employment contract between an employee and a company. For example, a German company 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 organisation; and
- 3) the German firm either actually bears 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."

In the updated Circular, the German tax authorities provide more guidance on the assessments of the company's interest in an assignment and on the allocation of costs in accordance with the arm's-length-principle. In doing so, the authorities are strongly leaning on existing circulars on the income allocation between affiliated companies under transfer pricing regulations, i.e., the reference to corporate income tax aspects is increasing significantly.

Furthermore, the tax authorities now impose an increased documentation obligation on employers. The employer must certify to the employee the amount of costs that have been recharged to the other (non-German) company (economic employer). Also, the employer must certify any costs not recharged but still being borne by the home employer (civil employer).

### KPMG INSIGHTS

In future, it can therefore be assumed that there will be increased administrative work for employers that companies should prepare for. Cooperation between the HR and tax departments of companies is therefore becoming even more important.

## Taxation of Trailing Income after Shift of Tax Residency

The Circular contains an opinion of the German tax authorities on the taxation of trailing income (such as bonus payments or stock options). According to the general rulings of double taxation treaties, this trailing income is taxable in the current state of treaty residency *when* the payments are actually made to the individual. If the individual was tax resident in the other state before, then the portion of income relating to working days in the past performance period (in the previous state of tax residency) should be primarily taxable in this previous state and be tax exempt in the new state of treaty residency.

Following most recent case law,<sup>3</sup> the Circular now points out that the portion of trailing income that relates to working days performed during the performance period outside the previous state of residency is primarily taxable in the new state of tax residency. In other words, if Germany becomes the new state of tax residency, then the German tax authorities will tax the portion of trailing income relating to working days in third countries during the past performance period (bonus) or vesting period (stock options). Hence, this can result in double taxation if the previous state of tax residency is not willing to grant a tax-exemption for this portion of trailing income. Furthermore, this new approach requires higher administration and documentation efforts even for pre-assignment periods (i.e., complete travel tracker for entire performance/vesting periods in the past is required).

## Subject to Tax Clauses

In general, where Germany is to be regarded as the state of residence, the potential for double taxation is avoided by the method of tax-exemption. This relates to cross-border scenarios where the other state (i.e., the state of source) has the primary right of taxation. However, if this state of source deliberately waives its right of taxation of the employment income – or even only on parts of salary (!) – then the right for taxation potentially falls back to Germany depending on the respective double taxation treaty. The Circular officially provides a list of German double taxation treaties<sup>4</sup> containing these “subject to tax clauses.”<sup>5</sup>

### KPMG INSIGHTS

Employers should anticipate that implementation of the Circular will result in increased administrative work for employers. Cooperation between the HR and tax departments of companies is therefore becoming even more important.

## Impact of Tax Haven Defence Act

If a specific double taxation treaty provides for a primary right of taxation in the other contracting state, then a German tax liability will not be limited by the treaty if the other state is to be regarded as a non-cooperative state for tax purposes according to the German Tax Haven Defence Act<sup>6</sup>. A “blacklist” of these non-cooperative jurisdictions is annually provided by the German government and currently consists of 16 jurisdictions<sup>7</sup>. The German tax authorities have confirmed that a German tax-exemption for employment income according to a double taxation treaty will not be granted if the other state is officially regarded as a non-cooperative jurisdiction (“treaty override”<sup>8</sup>).

## FOOTNOTES:

1 Published in *Bundessteuerblatt I* 2023, page 2179 (the German federal tax gazette), available at the Ministry’s official web site (in German) – please follow this link:

[Steuerliche Behandlung des Arbeitslohns nach den Doppelbesteuerungsabkommen \(bundesfinanzministerium.de\).](https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/2023/07/23-07-2023-01.html)

2 See [GMS Flash Alert 2018-087](#) (19 June 2018).

3 Decision by the Federal Fiscal Court on 21 December 2022 (file number I R 11/20); for further information see [GMS Flash Alert 2024-037](#) (13 February 2024).

4 The following German double taxation treaties currently provide a “subject to tax clause”: Armenia, Australia, Bulgaria, Finland, the United Kingdom, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Sweden, Spain, Tunisia, Hungary, and the United States.

5 The Circular explicitly mentions the Dutch “30%-ruling,” a deliberate beneficial tax treatment on employment income in the Netherlands where Germany would then be entitled to levy German income taxes on this “untaxed” Dutch income; however, there is currently a case pending at the Federal Fiscal Court (file number VI R 29/22), for further information on the “30%-ruling” see [GMS Flash Alert 2023-186](#) (29 September 2023).

6 So-called “Steuerparadiesabwehrgesetz” came into force on 1 January 2022.

7 According to the most recent German Federal Law Gazette (*Bundesgesetzblatt*) please follow this [link](#), the blacklist is composed of the following states: American Samoa, Anguilla, Antigua and Barbuda, Bahamas, Belize, Fiji, Guam, Palau, Panama, Russia, Samoa, Seychelles, Trinidad and Tobago, Turks and Caicos Islands, U.S. Virgin Islands, and Vanuatu. At the time of writing, Germany has concluded a double taxation treaty with Russia as well as with Trinidad and Tobago of the aforementioned blacklist.

8 A German “treaty override” was recognised and found constitutional by the German Constitutional Court (*Bundesverfassungsgericht*), see [GMS Flash Alert 2016-039](#) (17 March 2016).

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