Translation

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10 September 2010

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Register ID number: 0764199368-97
Consultation on double tax conventions and the internal market: factual examples of double taxation cases

- Comment -

Dear Sir/Madam,

The Association of German Banks has learned that the European Commission's Directorate-General for Taxation and Customs continues to welcome submissions after the official deadline of 30 June 2010 to its public consultation "Double tax conventions and the internal market: factual examples of double taxation cases".

We welcome the opportunity to comment on behalf of the German private banks and apologise for the delay in submitting our response.

Our association supports the European Commission's initiative. It hopes that coordinating arrangements can be established to ensure that taxes are consistently levied once only and looks forward – at least in the medium-term – to a substantial reduction of tax obstacles in the internal market in the area of direct taxation.

In our view, the double or multiple taxation of earnings or income generated across borders violates the prohibition of discrimination and restrictions in the Treaty on the Functioning of the European Union (TFEU) – especially the right of establishment (Article 49), the right to provide services (Article 56) and the free movement of capital (Article 63ff.).

To comply with the fundamental freedoms of the European Union, income should be taxed once only. The fundamental freedoms limit the autonomy of member states to tax earnings and require them to coordinate their taxation practices so that cross-border activities in the internal market are taxed once only. The protection of fundamental freedoms is not suspended until member states take coordinating action to avoid double taxation. This has continued to hold true, in our view, even after the TFEU removed Article 293 of the EC Treaty, which required member states to enter into negotiations with each other where necessary with a view to abolishing double taxation within the Community. The principle that income should be taxed once only obliges member states to take coordinated remedial action.

The Association of German Banks wishes the European Union every success in its endeavours to eliminate the double or multiple taxation of companies operating across borders in the internal market – not least in the interests of the private banks in Germany.

Areas where problems occur

We would like to highlight the following areas where problems frequently occur and where, in our view, solutions need to be found as quickly as possible:

- cross-border business activity, especially with respect to
    - the taxation of permanent establishments;
        - attribution of profits to a permanent establishment in the EU (dotation capital, allocation of funding costs, losses arising from currency fluctuations, aggregate performance, global trading – transfer pricing, adjustments – counter-adjustments resulting from adjustments by external tax audits);
        - cross-border loss set-off between EU permanent establishments and German parent firms;
    - withholding tax on dividend payments to non-residents; reimbursement of dividend taxes in Italy, the Netherlands, Belgium, Spain and Portugal; also in France, Spain and the Netherlands with respect to German special investment funds; procedures for claiming withholding tax relief, especially for German banks and fund assets;
    - withholding tax on interest payments on mortgage loans to non-residents;
- national anti-abuse measures;
    - “add-back taxation” under the German Foreign Tax Act (*Außensteuergesetz*, AStG), also in EU cases;
- avoidance of double taxation, especially

  - restrictions on double taxation exemptions by way of
    - bilateral subject to tax and switch-over clauses
    - unilateral switch-over clauses
      - Section 20 (2) AStG
      - Section 50d (9), sentence 1, no. 2 of the German Income Tax Act (*Einkommensteuergesetz*, EStG);
- trade tax
  - trade tax treatment of the add-back amount pursuant to Section 10 AStG;
  - no crediting of EU foreign income tax against German trade tax – over-taxation as a result of excess credit positions;
  - double taxation of subsequent profit distributions by the foreign company due to taxation of the add-back amount and taxation of the distribution of income underlying the add-back amount;
- short-term cross-border employee assignments at the parent firm or a permanent establishment ("commuter taxation").

1. Cross-border business activity – taxation of permanent establishments

1.1. Attribution of profits to a permanent establishment in the EU (dotation capital, allocation of funding costs, losses arising from currency fluctuations, aggregate performance, global trading – transfer pricing, adjustments – counter-adjustments resulting from adjustments by external tax audits)

1.1.1. Dotation capital

In a decree issued on 29 September 2004 (Federal Fiscal Gazette I 2004, 917), Germany's Federal Ministry of Finance (BMF) set out "Principles for determining the dotation capital attributable to permanent establishments of multinational financial institutions" (*Grundsätze der Verwaltung zur Bestimmung des Dotationskapitals bei Betriebsstätten international tätiger Kreditinstitute*). Under these Principles, interest payments on debt which have been used to fund the business of a cross-border permanent establishment are not deducted from its income if they are attributed to the permanent establishment's so-called dotation capital. "Dotation capital" is understood to be the capital resources a cross-border permanent establishment would have at its disposal if it were independent of its German parent firm. Under the arm's length principle, this is deemed to be the amount of equity capital a comparable company would need to operate in the market of the permanent establishment's host country. For this reason, German case-law and the German fiscal authorities require the

dotation capital of a cross-border permanent establishment to be determined with the help of an external comparison under the direct method.

This reclassification of debt capital as equity appears appropriate at first sight because the permanent establishment has to have an adequate share in the equity capital of its parent firm.

On closer inspection, however, and irrespective of contractual reality, the reclassification raises concerns about conformity with Community law owing to unequal treatment with respect to the allocation of total profit between a German parent firm and its EU permanent establishment on the one hand and that between a German parent firm and another domestic permanent establishment on the other without examining whether using this method rather than the indirect method places a disproportionate burden on the German parent firm.

In view of the judgement by the European Court of Justice (ECJ) in the Eurowings case (C-294/97), we believe that this difference in treatment illegitimately restricts the fundamental freedoms. This is because, under paras 2.3 and 3 of the BMF's Principles, the direct method has to be used for allocating total profit between a German parent firm and a permanent establishment in another member state. By contrast, the much more straightforward indirect method is used to allocate the trade tax base between a German parent firm and a permanent establishment located in another part of Germany.

That the direct method's primacy is incompatible with Community law is also shown by the fact that a debt-based reclassification of debt capital as equity capital often fails to reflect economic reality. It is difficult to explain why interest payments for a permanent establishment funded solely by debt may not be deducted from its associated income. Admittedly, the German Federal Fiscal Court has ruled that dotation capital must be capped at the amount of equity capital at the disposal of the company as a whole. In some cases, however, this can lead to no equity whatsoever remaining to the German parent firm although the cross-border permanent establishment has demonstrably been funded by debt capital.

In any event, therefore, strict reclassification in the form currently required is incompatible with the Community principle of proportionality.

The domestic parent firm must be allowed an opportunity to disprove the assumption based on the concept that the permanent establishment is independent. Under Sections 28ff. of the German Trade Tax Act (*Gewerbesteuergesetz*, GewStG), moreover, interest on debt capital for a domestic permanent establishment located elsewhere in Germany may be deducted without examining the appropriateness of the permanent establishment's dotation capital.

But even if the **application of the direct method** is retained, we believe the practice of determining funding costs and dotation capital for tax purposes at the level of the cross-border permanent establishment raises **concerns** about its conformity with Community law.

Under OECD principles and the BMF's Principles (para 2), banking permanent establishments must, for the purposes of determining taxable profit, have sufficient dotation capital to adequately reflect the type and risk-level of their business. This involves categorising the permanent establishment's business operations and risk-weighting its assets.

The BMF's Principles (paras 2.1.2, 2.1.3, 3) require dotation capital to be determined for tax purposes using the capital allocation or minimum capital adequacy method. These **methods are largely based on EU minimum capital requirements** for cross-border permanent establishments. These requirements are **now outdated**, however, and since 1 January 2008 a new regime has been in force to implement Basel II – the German Act implementing the recast Banking Consolidation Directive and Banking Adequacy Directive of 17 November 2006 (so-called Act amending the German Banking Act, Federal Law Gazette I 2006, 2606) and the Regulation on appropriate capital adequacy for institutions, groups of institutions and financial holding groups of 14 December 2006 (so-called German Solvency Regulation, Federal Law Gazette I 2006, 2926). Under these new rules, **regulatory solvency ratios no longer need to be calculated at solo, but only at group level** (cf. Section 2a of the German Banking Act; so-called waiver option).

Banks have consequently started to make use of the waiver option and no longer calculate risk positions at solo level in the absence of the need to do so under Basel II.

Since 2008, therefore, the figures required under the BMF's Principles to determine the risk key for calculating the maximum permissible dotation capital of cross-border permanent establishments have no longer always been available. There is no tax arrangement in place which takes adequate account of this change in regulatory requirements.

We understand that France, in particular, faces the same problem. There too, regulatory requirements only require the *ratio international de solvabilité* to be calculated at group level.

We firmly reject the idea of calculating risk assets and security at solo level purely for tax purposes. This would not only fly in the face of regulatory developments and their greater focus on the group. A separate calculation for tax purposes would also place an unjustifiable and disproportionate bureaucratic burden on banks.

In our opinion, a permanent establishment's capital resources should either

- be determined using solvency ratios which may be available locally or centrally or,
- in view of the regulatory waiver option,
  - calculations of risk-weighted assets should be dispensed with at the level of cross-border permanent establishments and
  - the Community principle of mutual recognition should be applied. The home country of the parent firm should recognise the dotation capital and funding costs calculated for a cross-border permanent establishment on the basis of its host country rules as long as, first, the principles of this member state are OECD compliant and, second, the aggregate dotation capital of all cross-border permanent establishments leaves the parent firm with sufficient equity calculated under its home country rules to cover its risk-weighted assets.

1.1.2. Losses arising from currency fluctuations

When taxing cross-border permanent establishments the question arises as to whether losses arising from currency fluctuations should be attributed to the parent firm or the cross-border permanent establishment. Currency losses can be caused, for example, by fluctuations in the rate of exchange between the currencies of the parent firm's home state and the host state of the permanent establishment if the permanent establishment's operating results are used for the purposes of taxing the parent firm and assets reported in the accounts of the permanent establishment have to be written up or down. Currency losses can also arise when converting the dotation capital attributed to a foreign permanent establishment which has been wound up.

In its judgement of 28 February 2008 in the Deutsche Shell case (C-293/06), the European Court of Justice ruled that the exclusion of a currency loss suffered when repatriating the

dotation capital of a liquidated foreign permanent establishment in the EU or EEA was an illegitimate restriction on the freedom of establishment.

The German fiscal authorities apply the ECJ's decision and take account of a demonstrated currency loss when determining the tax base of the German company at the time when the permanent establishment is actually liquidated (BMF circular of 23 November 2009, IV B 5 – S2118-a/07/10011).

We believe it would be consistent with Community law to allocate currency losses to the parent firm not only if a foreign permanent establishment is wound up, but in other cases as well.

In our view, it follows from the ECJ judgement that Community law requires currency losses to be attributed to the parent firm as a general principle. This view is based on the fundamentals of income allocation set out in double taxation conventions (DTCs).

Under Article 7(1), sentence 2 of the OECD Model Tax Convention, on which German DTCs are normally based, business profits may only be taxed in the permanent establishment's country if they are "attributable to the permanent establishment". The criterion for attribution is the concept of what the permanent establishment might earn if it were an independent enterprise and the application of the arm's length principle under Article 7(2) of the OECD Convention. On this basis, losses arising from currency fluctuations must be attributed to the parent firm, not the permanent establishment. Nor, in consequence, can the losses appear on the permanent establishment's books.

Bearing in mind that the intention of the OECD's "functionally separate entity" approach is to apply in full the fiction that the permanent establishment is a separate and independent enterprise and thus to align income allocation to permanent establishments with income allocation between internationally connected companies (e.g. groups), it is clear that the permanent establishment would not generate currency losses if it were a separate, independent entity. In a parent company/foreign subsidiary relationship, moreover, there would be no doubt whatsoever that currency losses (resulting, for instance, from the valuation of the holding) should be attributed to the parent.

Further, bearing in mind that there is a causal link between currency losses and the parent firm, the question of converting currency would not arise if the permanent establishment

were an independent enterprise. The need to convert currency only occurs because of the rules governing the determination of income in the country of the parent firm, so the losses are caused by the parent firm alone. Article 7(1), sentence 2 of the OECD Convention states that profits (or losses) are only to be allocated to a foreign permanent establishment if they were unequivocally generated by the permanent establishment. If there is any doubt, the right of taxation lies solely with the country of the parent firm.

European law and double taxation conventions require losses arising from currency fluctuations to be attributed to the parent firm and deducted when determining taxable income. The ECJ judgement shows that the deduction of currency losses attributed to the parent firm cannot, moreover, be denied on the basis of the restriction on deductions in Section 3c (1) EStG.

1.1.3. Aggregate performance, global trading – transfer pricing

In global trading in the broader sense, customers are offered a package of products and services or a product made up of various elements (such as a structured security) instead of a single product or service. Resources in permanent establishments in a number of countries are used to provide and integrate the individual components. In global trading in a narrower sense, trading units working in different trading jurisdictions with their own decision-making authority contribute simultaneously or consecutively to the same "global" book. A trade may be initiated by one cross-border permanent establishment and closed by another.

To develop an appropriate method of dividing income between the parent firm and its foreign permanent establishments, it is first necessary to evaluate the various functions involved and their contribution to the bank's aggregate performance. The involved tax authorities may come to different conclusions in this respect, which may in turn result in double or multiple taxation for the bank.

It is the structures of global trading which cause problems when taxing permanent establishments, especially problems in identifying the transactions of the units contributing to the global book. The question also arises as to whether payments can be made on an arm's length basis or whether it is permissible merely to pass on or divide up charges. If arm's length prices are used, further questions arise as to comparability with transactions executed by third parties (fair market prices) and the existence of ranges. If charges are divided among units, the further question arises as to an appropriate, uncontroversial allocation key.

Double taxation therefore primarily results because the tax authorities involved are unable to agree on a residual profit split but each claim a taxable amount which they judge to correspond to the functions (front office, middle office, back office) of the cross-border permanent establishments that they have identified.

European law should consequently provide for suitable methods and procedures to ensure that profits generated across borders are taxed once only in a consistent manner and not taxed twice or more, which violates the TFEU's prohibition of discrimination and restrictions.

1.1.4. Adjustments – counter-adjustments resulting from adjustments by external tax audits

If an involved tax authority claims to be able to make a more accurate assessment of taxable income than that declared by a bank under the obligation to tell the truth, it should only be permitted to override the bank's declaration for important reasons. The burden of proof is on the tax authority to demonstrate that a declaration made under the obligation to be truthful and to the best of the bank's knowledge is in fact inadequate (Federal Fiscal Court judgement of 17.10.2001, I R 103/00, Federal Fiscal Gazette II 2004, 171; of 6.4.2005, I R 22/04, IStR 2005, 598).

The fundamental freedoms require income to be taxed once only in a consistent manner and therefore **permit only coordinated adjustments**.

If a member state wishes to make adjustments to the taxable income of a cross-border permanent establishment or the parent firm, there must first be agreement on the amounts involved and any adjustments must be coordinated in such a way as to ensure one-time taxation. **Adjustments and counter-adjustments must be coordinated and synchronised with one another**.

If member states delay in fulfilling their obligation under Community law to coordinate their taxation of income in a way which ensures income is taxed only once and in a consistent manner, the taxpayer must not be disproportionately burdened, i.e. discriminated against, hindered or restricted. Taxpayers making declarations to the best of their knowledge must not be disadvantaged by interest payments or additional charges.

If a member state's tax authority seeks an adjustment but cannot even convince the authority which would have to make the corresponding counter-adjustment, the adjustment should normally not be made. Arbitration between tax authorities such as that provided for under Convention 90/436/EEC may be used to clear up differences of opinion. But taxpayers should not be disproportionately burdened by double or multiple taxation until the matter is resolved.

1.2. Cross-border loss set-off of permanent establishments at German parent firms

The numerous bans on deducting expenses from taxable income which exist in member states for reasons of budget and planning security, together with loss set-off restrictions – the division into object-related, periodic, territorial and subject-related partial results – hamper the ability to tax companies in the area of direct tax, namely tax on persons, on the basis of economic performance.

A call for total, and thus also cross-border, loss set-off with this in mind and so as not to distort investment decisions goes beyond Community fundamental freedoms, however. This is because the Community bans on discrimination and restrictions are geared only to ensuring equal treatment of circumstances which may be judged comparable under national tax law. Minimum requirements for a system of EU cross-border loss set-off can nevertheless be derived from this aspect.

According to European Court of Justice case-law (ECJ judgement of 15.5.1997, C-250/95 [Futura]), the country of the permanent establishment is not obliged to take account of losses which are not economically linked to income earned by the company in that country. By contrast, the state of the parent firm is obliged to permit the deduction of losses incurred by a foreign permanent establishment despite application of the exemption method without loss deduction if the company has exhausted all possibilities of taking the losses into account in the source state and if there is no possibility that the company's "final" losses can be taken into account in this state in future tax periods (ECJ judgement of 15.5.2008, C-414/06 [Lidl Belgium]; N.B.: this exemption also applies to losses incurred by permanent establishments in EEA states on the basis of Article 31 EEA). This does not apply to permanent establishments located in a third country, however (ECJ judgement of 6.11.2007, C-451/06 [Stahlwerke Ergste Westig]). If a double taxation convention has been concluded between the state of the parent firm and that of the EU permanent establishment and if the permanent establishment is liquidated, currency losses arising when its dotation capital is repatriated have to be taken

into account in the country of the parent firm (ECJ judgement of 28.2.2008, C-293/06 [Deutsche Shell]); see comments on dotation capital above). If the parent firm's home country applies the exemption method with loss deduction and subsequent taxation instead of the exemption method without loss deduction, the taxation of subsequent profits does not violate Community fundamental freedoms if the country of the permanent establishment excludes the possibility of offsetting losses between taxable periods for persons with limited tax liability in a way which is contrary to Community law. (ECJ judgement of 23.10.2008, C-157/07 [Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt]). However, the country of the parent firm may not prohibit even a domestic loss deduction on the grounds that a company incurred losses at home yet in another member state in the same year made a profit which is tax exempt under the relevant double taxation convention (ECJ judgement of 14.12.2000, C-141/99 [AMID]).

In the appeal proceedings continued after the ECJ judgement on Lidl Belgium, the Federal Fiscal Court came to the conclusion (ruling of 17.7.2008, I R 84/04) that foreign losses may not be deducted in Germany unless the "losses cannot under any circumstances be made use of for tax purposes in the source country." The question has not yet been definitively resolved as to when these losses may be considered "final" and during what period they are to be deducted.

In a further ruling, however (3.2.2010, I R 23/09), the Federal Fiscal Court recently made it clear that that there is no "general" ban on deducting losses within the meaning of Section 2 (1), sentence 1 of the German Foreign Investment Act (*Auslandsinvestmentsgesetz*, AuslInvG) if the ban is ruled out merely on the grounds of a temporary deduction of losses in the country of the permanent establishment – in this case Luxembourg – and thus on the grounds of circumstances in an isolated instance. Hamburg's Fiscal Court decided (ruling of 18.11.2009, 6 K 147/08; appeal to Federal Fiscal Court: I R 107/09): "losses from an EU permanent establishment incurred by a taxpayer with unlimited tax liability in Germany which may be definitively deducted in the country of the permanent establishment must be taken into account as reducing taxable earnings in the same period at the domestic parent firm." By contrast, Düsseldorf's Fiscal Court reached the opposite conclusion (ruling of 8 September 2009, 6 K 308/04 K; appeal to Federal Fiscal Court: IX R 51/09) and denied that it was possible to deduct "in the same period" "final" losses from an EU permanent establishment in the year they were incurred. The view of Hamburg's Fiscal Court was thus also contrary to that of the German tax authority (BMF circular of 13 July 2009, IV B 5-S 2118-a/07/10004 [non-application

decree]), which decided that the determining factor should be the legal, and not the actual, use of the losses in the country of the permanent establishment.

In the German Annual Tax Act 2009 (*Jahressteuergesetz 2009*), German lawmakers endeavoured to make cross-border loss off-setting compatible with European law after the European Court of Justice concluded that the distinction between passive and active activities under Section 2a EStG (former version) was incompatible with EU law because it exceeded that which was necessary to combat tax avoidance (ECJ judgement of 29.3.2007, C-347/04 [Rewe Zentralfinanz]; confirmed by Federal Fiscal Court ruling of 29.1.2008, I R 85/06). Section 2a EStG was amended so that the restrictions now apply only to third countries. Further amendments were made to the progression proviso under Section 32b EStG. No changes were made to granting the negative progression proviso, however, which continues to require an active activity within the meaning of Section 2a (2) EStG. In our view, this failure to permit the progression proviso with respect to passive commercial permanent establishments in the EU and EEA raises significant concerns about compatibility with Community law. The decision to permit or deny the progression proviso, like the ability to offset losses directly across borders, is based on the active/passive classification under Section 2a (2) EStG, which continues to be contrary to European law. Section 2a (2) EStG thus contaminates the rules governing the progression proviso for passive commercial permanent establishments in the EU and EEA under Section 32b (1), sentence 2 EStG. As a result, Section 32b (1), sentence 2, no. 2 EStG is not, in our opinion, consistent with the freedom of establishment. In this respect, permanent establishments in third countries actually receive more favourable treatment than do those in the EU and EEA because they are not subject to the restrictions in Section 2a (2) EStG.

Even if the European Court of Justice and Federal Fiscal Court take the view that the parent firm's state is not obliged by current Community law to take account of disadvantageous effects of a rule in the state of the permanent establishment, the European Commission should nevertheless continue to launch initiatives aimed at achieving political agreement among member states. Uniform EU rules on offsetting losses should be developed which take adequate account both of member states' budget security and of the need for taxation on the basis of economic performance and without distorting companies' investment decisions. Above all, these rules should permit effective offsetting of losses.

In our view, effective offsetting of losses in the context of determining taxable income on the basis of the periodicity principle could be achieved by

- member states allowing either unlimited loss carryback with interest-earning loss carryforward or an anticipation of losses by means of partial write-offs and provisions for contingent losses through extending the recognition of loss principle;
- requiring the parent firm's state to take account when determining the income of the parent firm of losses incurred by a cross-border permanent establishment which have not been set off in the host state. In the event of the permanent establishment subsequently making a profit , this should be taxed at a later date in the home state in by imposing additional taxation on the parent firm.

It should, moreover, be ensured that there are no cases where (passive) commercial permanent establishments in the EU and EEA receive less favourable treatment than their counterparts in third countries.

2. Withholding tax on dividends to non-residents; reimbursement of dividend taxes in Italy, the Netherlands, Belgium, Spain and Portugal; and in France, Spain and the Netherlands with respect to German special investment funds; withholding tax relief procedures, especially for German banks and fund assets

Withholding tax on dividends to non-residents

EU member states have created a whole series of unilateral and bilateral arrangements on the basis of established international tax law standards to avoid the double taxation of cross-border dividend payments. If the holdings threshold in the Mergers Directive (90/434/EEC) is exceeded, investors can apply for withholding tax not to be levied from the outset. If holdings are below the threshold, withholding tax is partially refunded. Above all, there are also agreements concluded in double tax conventions based on the OECD Model Tax Convention.

European Court of Justice case-law is based on established international tax law standards. Member states may introduce mechanisms to avoid double taxation unilaterally or through agreements with other member states. These mechanisms are not permitted to infringe the fundamental freedoms, however (c.f. ECJ judgements of 12.122006, C-374/04 [Test Claimants in Class IV of the Act Group Litigation]; of 8.11.2007, C-379/05 [Amurta]; of 18.6.2009, C-303/07 [Aberdeen Property Fininvest Alpha]; of 1.10.2009, C-247/08 [Gaz de France]).

Provided that the situations of non-resident and resident companies are comparable, an infringement of the fundamental freedoms is not deemed to exist as long as pressing reasons of public interest are upheld, especially the principle of a balanced division of taxation authority between member states (c.f. ECJ judgements of 12.5.1998, C-336/96 [Gilly]; of 7.9.2006, C-470/04 [N]; of 16.7.2009, C-128/08 [Damseaux; taxation of dividends]).

The conclusions of the European Court of Justice on the comparability of non-resident and resident companies appear to differ, however, according to which of the two systems of two-step, one-time full taxation is used: the credit method (c.f. ECJ judgements of 12.12.2006, C-374/04 [Test Claimants in Class IV of the ACT Group Litigation]; of 26.6.2008, C-284/06 [Burda GmbH]) **or the partial income method** (c.f. ECJ judgements of 14.12.29006, C-170/05 [Denkavit]; of 8.11.2007, C-379/05 [Amurta]; of 18.6.2009, C-303/07 [Aberdeen Property Fininvest Alpha Oy]; of 22.12.2008, C-282/07 [Truck Center SA]).

If the partial income method is used, the ECJ assumes that the non-resident company receiving dividend payments is itself the object of tax claim which could result in economic double taxation. If the credit method is used, by contrast, it merely denies relief from up-front taxation if the company itself is not subject to any further tax claim.

In our opinion, this distinction according to whether or not the non-resident company is formally subject to a taxation claim is unsound and should not play a material role in evaluating the compatibility of the taxation with the fundamental freedoms. This is shown by the fact that the legislative objective of member states' mechanisms to avoid economic double taxation, which the ECJ requires them to extend to cross-border cases if the partial income method is applied, is only to prevent excessive taxation going beyond a two-step, one-time full taxation. The objective is not to achieve one-time full taxation as such. We consequently take the view that the European Commission was **incorrect to initiate Treaty infringement proceedings against Germany because of the effects of Section 8b (1) of the German Corporate Income Tax Act** (*Körperschaftsteuergesetz*, KStG) (holdings in other corporations and partnerships).

We believe the formal unequal treatment of domestic and cross-border dividend payments should be viewed in an overall factual and legal context, especially if the partial income method is used. This is the only way find an appropriate answer to the question of comparability and, as a result, determine whether there is discrimination in

cross-border cases. The European Court of Justice has itself stressed the need for a holistic, and thus ultimately economic, perspective in its decisions on taxing dividends both when member states use the partial income method and when the credit method is used (see above).

As to the question of the **admissibility under Community law of restricting fundamental freedoms for pressing reasons of public interest**, especially so as to preserve a balanced division of taxation powers, we consider it **debatable whether the fundamental freedoms**

- **merely require member states to put in place agreements and DTC-compatible tax credit clauses based on traditional and recognised international law, or**
- **require them to go further and effect an actual tax credit or even refrain from imposing withholding tax.**

The most recent ECJ case-law appears to argue in favour of the latter (ECJ judgement of 19.11.2009, C-540/07 [Commission v. Italy]). It could also be argued, however, that the ECJ leaves the choice between the credit and exemption methods to member states (ECJ judgements of 6.12.2007, C-298/05 [Columbus Container Services BVBA& Co]; of 12.12.2006, C-446/04 [Test Claimants in the FII Group Litigation]; in connection with the Mergers Directive 90/435/EEC of 12.2.2009, C-138/07 [Cobelfret NV], of 4.6.2009, related to C-439/07 [KBC Bank NV] and C-499/07 [Beleggen Risicokapitaal Beheer NV]).

Given the lack of an unequivocal line in ECJ case-law on the cross-border taxation of dividends in the event of dispersed holdings, we believe there is a need for a coherent procedure for taxing dispersed dividends in a way which is compatible with Community law and adequately considers how various systems interact with one another. The aim should be to eliminate existing cases of double taxation either

- in the form of a withholding tax credit or
- by refraining from levying the withholding tax and thus providing for an exemption.

The Association of German Banks calls on the Commission to extend the scope of its Recommendation C (2009)7924 on withholding tax relief for securities income earned by foreign investors (see below) **to cover the corporate sector for dividends on dispersed holdings. EU member states should be encouraged to create, with the help of DTCs and domestic law, withholding tax relief on securities income at source and not by means of tax refunds.**

Reimbursement of withholding tax in Italy, the Netherlands, Belgium, Spain and Portugal

In view of the Treaty infringement proceedings initiated by the Commission against Italy (as well as the Netherlands, Belgium, Spain and Portugal) and recent ECJ case-law on this issue (ECJ judgement of 19.11.2009, C-540/07 [Commission v. Italy]), it is clear that Italy may not tax dividend payments to companies in other member states, including Germany, at a higher rate than that for payments to Italian companies. German companies, including banks, are therefore now entitled to the reimbursement of withholding tax deducted by the Italian tax authorities.

It has admittedly not yet been clarified whether and, if so, to what extent the ability for foreign shareholders to offset withholding tax retained in Italy against domestic tax liability stands in the way of this claim to reimbursement. But this question is normally irrelevant for German corporations, especially banks, with holdings in Italian companies since foreign dividends are tax exempt in Germany under Section 8b (1) KStG in conjunction with Section 20 (1) EStG, thus precluding any offsetting under Section 26 (1) KStG.

Past experience suggests it is **doubtful**, however, **whether a claim for reimbursement** submitted to the Italian tax authority's operations centre in Pescara **will result in an actual reimbursement within a reasonable period of time**.

It has been the unfortunate experience of German companies, particularly banks, that **processing times for the reimbursement of Italian withholding tax are excessively long**. The reason, as we understand it, is that the Italian tax authority's annual budget for reimbursing withholding tax is extremely limited and consequently swiftly exhausted. As a result, the tax authority will not normally respond to claims or grant reimbursements voluntarily until a high court decision has been made or lawmakers have changed the rules. If claims for reimbursement are left in standby mode – which is usually the case – an authorised reimbursement will be paid only when the budget situation allows.

Reimbursement of withholding tax in France, Spain and the Netherlands with respect to German special investment funds

In France and Spain, and currently in the Netherlands too, **withholding tax** is deducted from **dividends** paid **to German special investment funds**, especially those with tax exempt institutional investors. The French, Spanish and Dutch **tax authorities refuse to reimburse**

this withholding tax on dividends. Comparable funds with domestic French, Spanish or Dutch investors are not, by contrast, subject to the withholding tax deduction.

In our view, the action of these member states infringes European fundamental freedoms – in this case the right to free movement of capital.

In a comparable case concerning Norwegian dividends, the **EFTA Court of Justice** (for the EEA states) reached a positive decision in its **ruling of 23.11.2004 on case E-1/04 (Fokus-Bank)**. We would also draw attention to the **ECJ's conclusions in case C-170/05 (Denkavit).**

Since the French, Spanish and Dutch tax authorities refuse to reimburse withholding tax on dividends if they relate to shares held in or through investment funds, especially German special investment funds with tax exempt institutional investors, the **only option for those affected is to go through the courts**.

Owing to the specialised nature of the procedures involved, bringing a court action in these member states requires much legal consultation and is not feasible without employing the services of a local lawyer. Cases of this kind are extremely costly and time-consuming. It is estimated that potential reimbursements of less than €50,000 and €75,000 in France and Spain respectively would probably be totally eaten up by the cost of bringing legal action, particularly since the case would have to go through at least three courts. The length of such proceedings is put at between four and thirteen years.

We have heard about similar problems with cases in the **Netherlands**, though we understand that the Dutch tax authorities wish to **take corrective action in future**.

Procedures for claiming withholding tax relief

Against this backdrop, the Association of German Banks warmly welcomes the European Commission's Recommendation of 19 October 2009 (C (2009)7924 final) on withholding tax relief procedures for securities income earned by foreign investors. According to the recommendation,

- current procedures for claiming withholding tax relief on dividend and interest income are sometimes so complicated and time-consuming that investors do not take advantage of the relief they are entitled to or are even discouraged from investing in another member state in the first place;

- the procedures often fail to take account of the present multi-tiered financial environment, where there is often a chain of intermediaries in several countries between the issuer and the investor;
- member states should apply relief from withholding tax on securities at source by means of DTCs or domestic law instead of by refund.

Our association supports the Commission's recommendations to member states for simplifying current procedures, especially by

- allowing financial intermediaries to make claims on behalf of investors and, in particular, investigating how procedures might function if there is a chain of intermediaries in different member states between the issuer and beneficiary;
- providing the relief at source when the securities income is paid out;
- standardising procedures;
- establishing standardised electronic formats;
- establishing a single point of contact for foreign investors;
- eliminating tax obstacles to securities investments by financial institutions while at the same time protecting tax revenue from errors and fraud; this could be achieved by
    - member states conducting single, joint or even external audits to investigate whether financial intermediaries comply with the obligations introduced in the recommendation and
    - making greater use of existing channels for the exchange of information between member states and exploring new channels.

3. Withholding tax on interest payments on mortgage loans to non-residents

Unlike dividend or interest payments to private individuals or between affiliated companies, interest payments to banks in another member state are not currently governed by European secondary legislation.

As with withholding tax on dividend payments to another member states, international double taxation of cross-border interest payments is avoided in line with established international tax law standards by means of agreements in DTCs, which are normally based on the OECD Model Tax Convention, by reducing the rate of withholding tax on the loan interest paid to another member state.

As with withholding tax on dividend payments, there is, in principle, no evidence of an infringement of fundamental freedoms.

But withholding tax on interest payments on mortgage loans to non-residents in some member states may result in interest payments to another member state being taxed at a higher rate than payments to residents. This would infringe fundamental freedoms.

Portugal, Italy, Greece and Lithuania levy withholding tax on interest on loans granted by non-resident EU banks if the loans are secured by real estate in the respective member states.

In Portugal, for instance, the withholding tax is up to 20% of the gross income, while the figure in Greece is 40% and in Italy 12.5%. The DTC with Portugal provides for a reduction of the rate to 10%, 12% or 15%; the DTCs with Greece, Italy and Lithuania limit withholding tax to 10%.

There is evidence of an infringement of EU fundamental freedoms because for non-resident banks, unlike resident banks, the funding costs associated with the loans are not tax deductible since the non-resident bank's refinancing expenses cannot be regarded as directly linked to economic activity in the borrower's member state. This difference in the tax treatment of loan interest paid to resident and non-resident banks makes it more difficult for banks headquartered in another member state to access the Greek, Italian, Portuguese and Lithuanian markets.

In **Treaty infringement proceedings** brought **against Portugal**, the **European Commission** took the view that that the imposition of withholding tax on loan interest by a member state infringes fundamental freedoms if differing tax bases result in the refinancing costs associated with granting the loan being unable to be deducted in that member state and interest income payable to non-resident lenders ultimately being taxed more highly than income payable to resident lenders.

The **ECJ recently dismissed this action** (ECJ judgement of 17.06.2010, C-105/08 [Commission v. Portugal]) **on the grounds that the Commission had provided no evidence of the Treaty infringement and had failed to support its hypothetical calculations of refinancing costs with any facts**.

Nevertheless, **Advocate General Kokott** showed in her **final opinion of 25.3.2010** that the assertion of a **Treaty infringement could have been based on other arguments**. Since these were not put forward by the Commission, however, they **could not be considered by the court**. She pointed out that, irrespective of the precise level of refinancing costs, withholding tax may prove obstructive if a non-resident bank reduces its interest rates even though refinancing costs remain unchanged and accepts a smaller profit in order to attract customers in Portugal. The amount of tax payable in Portugal will then fall not in accordance with the reduced profit margin but only in accordance with the reduced gross amount of interest income. **As a result, the relative tax burden on the non-resident bank rises in proportion to the fall in profit**. If the profit margin falls below a certain level, there is heavier taxation of cross-border interest payments. Domestic banks are in a different position. If their profits fall, their tax burden decreases correspondingly. The relative tax burden of the profit does not change.

This means that a domestic bank can undercut the minimum margin of a non-resident bank – i.e. that equal to the level of withholding tax – and still make a profit. By contrast, a non-resident bank wishing to avoid making a loss is forced to either refrain from the funding or make a profit at least equal to the amount of withholding tax payable.

It consequently only makes good business sense to lend to customers in these countries if the bank has a branch in the country concerned and withholding tax can be deducted from the tax payable by the permanent establishment. For banks without a branch office, withholding tax is unavoidable if they wish to provide mortgage services. As a result, such banks normally refrain from doing such business in these countries. It is extremely costly and time-consuming to set up a branch office and acquiring an interest in a local bank would not be a viable option for a German Pfandbriefbank, for instance, because the foreign bank would bear the insolvency risk of the local bank. Funding of this kind could therefore not be refinanced through Pfandbriefe.

The **enclosed** figures compiled by the German Pfandbriefbanken showing funding of commercial property abroad in 2009 demonstrate that loan commitments and loan portfolios of German Pfandbriefbanken, which finance commercial property in many European countries, are **disproportionately low in the countries in question**.

Even if the Treaty infringement proceedings against Portugal were terminated in the absence of sufficient factual information to back up the assertion that non-residents face

a higher tax burden with respect to withholding tax on interest payments on mortgage loans, the European Commission should take up the matter again and pursue the line of argument set out by the Advocate General.

Procedures for claiming withholding tax relief on interest income

Reference is made to the above comments on withholding tax relief on securities income for foreign investors and to the Commission's Recommendation of 19 October 2009 (C (2009)7924 final).

4. National measures to prevent abusive practices

4.1. "Add-back" taxation under the German Foreign Tax Act (AStG) also in EU cases

Germany fights the (improper) transfer of designated passive income to German-controlled companies domiciled in low-tax foreign countries by means of national CFC legislation, so-called "add-back" taxation (Sections 7-14 AStG). "Add-back" taxation is understood as standardised legislation to combat abusive practices that is restricted to foreign transactions.

Income is added back if parties with unlimited liability to tax

- directly (Section 7 (1) AStG) or indirectly (Section 7 (1) in conjunction with Section 14 AStG) hold more than half of the shares or voting rights in the foreign company
- the foreign company generates passive income as defined in Section 8 (1) AStG and
- the foreign company is taxed at a rate of less than 25% (Section 8 (3) AStG).

If these conditions are fulfilled, the foreign company is classified as a foreign controlled corporation (CFC). If the income of the controlled foreign corporation (designated passive CFC income) exceeds the exemption limit of €89,000 (Section 9 AStG), it is attributed pro-rata to the CFC shareholders with unlimited liability to tax as a so-called "add-back" amount (Section 10 (1) AStG). The add-back amount is included in taxable income (Section 20 (1), no. 1 EStG) and is deemed to have accrued one logical second after expiry of the business year of the CFC. Should the foreign company actually distribute profits in later business years, a full tax exemption (Section 3, no. 41a EStG in conjunction with Section 8 (1), sentence 1 KStG) applies correspondingly; there is no taxation of 5% as non-deductible operating expenses. The add-back amount is also subject to trade tax.

Tighter add-back taxation rules (Section 7 (6), 6a AStG) apply where German parties liable to tax hold a stake in a low-taxed foreign company which generates designated passive CFC income. The minimum stake in the foreign company is in such cases only 1%; if the company

earns more than 90% of its gross income in the form of designated passive CFC income, the minimum investment threshold does not apply. Designated passive CFC income is, in particular, income derived from holding and administering payment media, securities and investments, with income derived from dividends and sales of shares in companies being harmless (Section 7 (6a) in conjunction with Section 8 (1), no. 6 and 7 AStG).

The add-back rules are restricted to controlled foreign entities in the form of corporations. In the case of foreign permanent establishments and investments in foreign unincorporated businesses, the general add-back rules are tied to a switch-over clause in Section 20 (2) AStG.

In the view of the European Court of Justice (see ECJ judgment of 12.9.2006, C-196/04 [Cadbury Schweppes]), add-back taxation may only cover wholly artificial arrangements aimed primarily at evading tax which is normally payable. In contrast, standardised legal provisions designed to prevent abusive practices are incompatible with freedom of establishment if

- they allow the inclusion in the tax base of a company resident in an EU Member State of profits made by a controlled company in another Member State because those profits are subject to a lower level of taxation than that applicable in the first Member State, and
- the party liable to tax has no general means of producing evidence to the contrary, i.e. there is no way of proving, on the basis of objective factors which are ascertainable by third parties, that the controlled foreign corporation is actually established in the host Member State and carries on genuine economic activities there (so-called motives test).

In response to the ECJ judgment, German legislators created the possibility in Article 8 (2) AStG, in the version of the Annual Tax Act 2008 effective since 1.1.2008, to prove that certain income is the result of genuine economic activities carried out by an EU/EEA company. Where this can be proved, the company concerned is not considered to be a controlled foreign corporation for such income. Section 18 (3), sentence 1, second half-sentence AStG stipulates that the possibility to produce contrary evidence pursuant to Section 8 (2) AStG does not in any way affect the obligation to submit a tax assessment statement. Moreover, the phrase "*notwithstanding Section 8 (2) AStG*" was inserted in Section 20 (2) AStG.

With the **Annual Tax Act 2010**, legislators plan the inclusion in **Section 8 (3), sentence 2 (draft) AStG** of shareholders' refund and offset claims in calculation of the "low taxation" of the foreign company or permanent establishment in EU/EEA cases in order to combat specific

foreign tax regimes – such as Malta's, according to the reasons given for the legislation – which provide for higher taxation of income at the level of the foreign company although such taxation is not imposed in individual cases as a result of tax refunds granted at shareholder level (**so-called Malta model**).

The rules continue to give rise to numerous cases of doubt, particularly as regards conformity with EU law, i.e. adequate compliance with the letter of ECJ rulings.

Attention is drawn to the following:
With regard to the condition set out in **Article 8 (1), no. 3 AStG (draft),** i.e. the operation of **credit institutions** and insurance firms, there are reservations under Community law about the criterion "commercially organised business establishment". In the opinion of the Lower-Saxony Fiscal Court (judgment of 13.5.2009, 6 K 476/06), a commercially organised business establishment need not be run by the foreign company generating the designated passive income itself. Instead, it suffices if such a business establishment is in the hands of a group management company which performs its activity vis-à-vis the foreign company generating the designated passive income on the basis of a service contract. In this case, the activity of the management company and thus its (partial) business establishment must be attributed to the foreign company earning the designated passive income. This follows from EU-compliant interpretation of the condition "commercially organised business establishment", since, according to the ECJ (ECJ judgment of 12.9.2006, C-196/04 [Cadbury Schweppes]), only wholly artificial arrangements which do not reflect economic reality are exempted from the freedom of establishment rule. A ruling on 17.11.2004 (I R 55/03) by the German Federal Fiscal Court (*Bundesfinanzhof* – BFH) also states that the interposition on a permanent basis of a (passively operating) company must be recognised, so that the absence of staff and the absence of own business premises do not, in themselves, preclude the assumption of a commercially organised business establishment. In our view, the material requirements must not overstep the mark in terms of EU law as long as so-called add-back taxation is to be understood as standardised anti-abuse legislation that is restricted to foreign transactions.

We believe that **Section 8 (2) AStG (new version)** violates fundamental freedoms: there is no possibility to produce contrary evidence in the case of **designated passive CFC income** if parties with unlimited liability to tax do not own more than 50% of the controlled foreign corporation because Section 8 (2) AStG (new version) allows contrary evidence in the case of investments as defined in Section 7 (2) AStG and does not cover those as defined in Section 7 (6) AStG.

The **low tax** threshold in **Section 8 (3), sentence 1 AStG** of **25% in view of the reduction in the corporation tax rate** from 25% **to 15%** thanks to the 2008 business tax reform is also **cause for concern under EU law** in our view, as retention of the 25% low tax rate can only be justified by the imposition of trade tax. However, since the 2008 assessment period in Germany, an effective tax burden – also taking into account trade tax – of less than 25% is possible. For example, companies resident in an area with a 200% "multiplier" have an effective tax burden of 22.825% (cf. comments of the *Zentraler Kreditauschuss* on the government's draft Annual Tax Act 2008, p. 14). Moreover, not all income is subject to trade tax (e.g. Section 9, no. 1 GewStG) [reduction in the case of income derived from immovable property].

The following must be added: in line with the wording of Section 8 (3) AStG, only the income tax levied by the parties themselves for the account of an investment vehicle is (are) used for the purposes of the 25% tax burden test. Foreign income tax incurred at the level between the foreign investment vehicle (sub-subsidiary) and the German parent company is not taken into account although economically – in distribution of dividends by a foreign sub-subsidiary to a foreign subsidiary or because of other taxation mechanisms abroad applying to the foreign subsidiary – the same profit(s) originally earned by the sub-subsidiary/subsidiaries is(are) involved. Due to taxation of dividends effected abroad or marking-to-market at the foreign subsidiary, this may lead to considerable multiple taxation in the case of lower-tiered structures.

The reason for this is

- the non-recognition of indirect prior subjection of one and the same profit of a sub-subsidiary to income tax that is incurred by upstream foreign subsidiaries for tax burden test purposes (Section 8 (3) AStG);
- the non-recognition of operating expenses in connection with one and the same profit of a sub-subsidiary that are incurred by upstream foreign subsidiaries for the purpose of determining the assessment basis or for the tax burden test.

Considerable dislocation is caused by low net margin transactions, e.g. in certificates business: here, the foreign subsidiary has operating expenses of (virtually) the same size as the profit of the sub-subsidiary because it owes its bank clients the performance of the shares in the investment vehicle (sub-subsidiary) acquired solely for hedging purposes (derivates/swap

costs). It is conceivable that the assessment basis for add-back purposes at the German parent company, i.e. in principle the full profit of the investment vehicle (sub-subsidiary), is not to be reduced by the amount of such subsidiary operating expenses (derivatives/swap costs).

The planned new provision of **Section 8 (3), sentence 2 AStG (draft)** against the **Malta Model** breaches European law in that it also covers tax systems which (at any rate) the European Commission currently considers to be in conformity with European law – in this case, the Maltese tax refund scheme. The Maltese tax refund system was the outcome of several years of negotiations with the Commission after the Commission conducted Treaty infringement proceedings against the earlier arrangement as it was deemed to constitute unlawful state aid (see IP/06/608 and IP/06/363). In view of the aforementioned agreement, the Commission has not opened infringement proceedings against the new Maltese taxation regime applying as of 2007, so that in our view it can be assumed until further notice that Malta's income tax refund scheme is in conformity with European law.

Section **18 (3), sentence 1, second half AStG (new version)** is cause for concern under European law in our view since there is no declaration duty if proof pursuant to Section 8 (2) AStG can be provided because the company concerned is not a controlled foreign corporation for certain income.

The Association of German Banks believes that there is an urgent need for action by the European Commission to monitor EU Member States' national CFC legislation – in Germany, particularly the so-called "add-back legislation" under the Foreign Tax Act (AStG) – for infringements of fundamental freedoms and the requirements set by the ECJ in this respect (as explained above) and also to draft proposals on how national CFC legislation, as legislation designed purely to prevent abusive practices, should be adapted in EU Member States to take account of ECJ guidance.

5. Avoidance of double taxation, particularly

5.1. Restrictions on the DTC exemption method by way of

- **bilateral subject-to-tax clauses and switch-over clauses**

In most double taxation conventions (DTCs) signed by Germany – exceptions: United Arab Emirates, Singapore – double taxation is generally avoided through application of the exemption method, though often only if the foreign permanent establishment does not perform any "active" activities within the meaning of the respective DTC (so-called "activities clause"; exceptions: DTC Austria, Belgium, Denmark, France, Ireland, Japan, Luxembourg, Netherlands, New Zealand, Norway, Russia, Sweden, Turkey (USSR; to be applied also to Armenia, Moldavia, Turkmenistan), United Kingdom (UK 1964/70), USA). Under the activities clause, Germany switches from the exemption method to the credit method if the party liable to tax fails to prove that at least 90% of the foreign permanent establishment's gross income is derived from precisely defined "active" activities. The wording of many DTCs is virtually identical in this respect.

In more recent DTCs, income stemming from foreign sources can, however, only be exempted (subject to a progression proviso) from German tax if this income was actually taxed (so-called subject-to-tax clause; cf. Article 23 (1) DTC UK 2010; entry into force scheduled for 1.1.2011). Under older DTCs, exemption from tax is possible already if the income can be taxed in the foreign country (see, for example, DTC UK 2010 v. 1964/70). **More recent DTCs contain, in addition, some so-called switch-over conditions, according to which e.g.**

- **business profits,**
- **dividends derived from passive activities,**
- **qualification and attribution conflicts and**
- **so-called notified income**

are not exempted but set off against German tax (e.g. Article 23 (1) DTC UK 2010; Article 23 (4), Article 24 (4) DTC USA 2006).

For example, in DTC UK 2010 exemption of **business profits and dividends** is subject to an activities proviso and the company resident in Germany must prove that the British permanent establishment or subsidiary derives income exclusively or almost exclusively from

“non-passive” (i.e. “active”) activities as defined in Section 8 (1) AStG (Article 23 (1) (c) DTC UK 2010). The criterion “almost exclusively” is regarded as fulfilled by the German tax authorities if the gross income derived from active activities makes up at least 90% of aggregate gross income (cf. BMF circular of 14 May 2004, Federal Fiscal Gazette I 2004, special issue I; so-called AStG application decree, para 7.6.1, p. 7)

The provision also covers the regular income – captured under the DTC outside the “permanent establishment” article – from immovable property or from the alienation of immovable property which is attributable to the British “passive” permanent establishment (Article 23 (1) (c), second half-sentence in conjunction with Article 5 (4) and Article 13 (1) DTC UK 2010). The gains from the alienation of movable property forming part of the business property of the permanent establishment, covered separately in Article 13 (3) DTC UK 2010, accordingly fall under the switch-over clause if a “passive” permanent establishment is involved. It should be noted that reference to exemption of the income of a permanent establishment under Article 23 (1) (a) in conjunction with Article 7 DTC UK 2010 requires the party liable to tax to prove that such income is not “passive”.

The credit method is prescribed instead of the exemption method also for intra-group dividends from British companies with passive income. This provision is likely to be of little importance in general, however, because the 95% dividend exemption under Section 8b (1) and (5) KStG overrides the corresponding DTC provisions unless a case of add-back taxation as a result of low taxation within the meaning of Section 8 (3) AStG exists at the same time without fulfilling the exemption criteria set out in Section 8 (2) AStG.

The DTC regulation of dividend income from passive British companies exceptionally assumes importance in its own right if the shares form part of the trading book of a credit institution or the current assets of a financial enterprise as defined in Section 1 (3) KWG and thus the dividends – contrary to the basic rule in Section 8b (1) KStG (exemption) – are subject in full to corporation tax. However, in these cases too, under the reverse exception in Section 8b (9) in conjunction with the Parent-Subsidiary Directive (PSD), the “exemption” of British dividends usually is (will be) ensured.

The switch-over clause is therefore only applied in those cases in which the exemption pursuant to Section 8b (1) KStG is not granted because of Section 8b (7) KStG and the reverse exception in Section 8b (9) KStG established for these cases does not apply either because the PSD criteria laid down as a condition therein are not fulfilled.

This may be the case in the banking sector if

- the minimum two-year holding period (see Article 3 (2) PSD) is not fulfilled, which may be of relevance particularly in the case of newly created investment portfolios, or
- the subsidiary is resident for tax purposes in the United Kingdom (see Article 4 DTC UK 2010) because it is “UK managed and controlled”, but is not a “company of a Member State” as defined in Article 2 (1) PSD, e.g. because it was established under Cayman Islands law.

In more recent DTCs a switch-over from the exemption method to the credit method for German taxation purposes is also stipulated in the case of certain **qualification or attribution conflicts** that cannot be resolved under the mutual agreement procedure (see, for example, Article 23 (1) (e) (aa) DTC UK 2010; Article 23 (4) (a) DTC USA 2006).

For example, in DTC UK 2010 the following conditions are fulfilled cumulatively :

- **Qualification conflict**, i.e. in the UK and Germany items of income or capital are placed under different provisions of the DTC, or
  Attribution conflict, i.e. under UK and German tax law, fulfilment of tax criteria is attributed to different persons;
- **Consequence** of the qualification or attribution conflict is **non-taxation or lower taxation in the country of source** (e.g. UK; USA).
  In the event that non-taxation results from the application of intrastate law, i.e. not from a qualification or attribution conflict, it is **debatable whether the switch-over clause is applicable** (seemingly pro: German tax authorities; contra: literature, see Prokisch, in Vogel/Lehner, DBA (DTC), 5th edition 2008, Article 1, paragraph 136c; see also Vliegen, IWB, Fach 8, Gruppe 2, p.1483).

There is a further switch-over clause for **income or capital notified by Germany after due consultation** (e.g. with the UK, USA). The credit method, not the exemption method, therefore applies for all tax years following the year in which the notification was made (see Article 23 (1) (e) (bb) DTC UK 2010; Article 24 (4) (c) DTC USA 2006).

In practice, application of subject-to-tax and switch-over clauses causes considerable problems in terms of DTC abuse in cases where certain items of income are not taxed in

the country of source due to (special) legal provisions (e.g. UK, USA) although the national tax authorities of the country of residence of the cross-border company intend to tax these items of income. This applies both in cases where the national tax authorities, when applying the "method" article, functionally attribute these items of income under the method article to a foreign permanent establishment and in cases where they do not.

The above remarks show that

- **the subject-to-tax and switch-over clauses contained in more recent DTCs have become much more complex;**
- **double taxation of foreign income, particularly income stemming from other EU countries, cannot be avoided due to the complexity of the provisions;**
- **in terms of DTC abuse and anti-treaty shopping, the new provisions display a tendency to overshoot the mark in regard to double non-taxation;**
- **actual non-taxation by the country of source, which has the right to tax, does not give the country of residence any material justification for taxing these items of income.**

We believe that it is necessary under European law for the European Commission to make a clear and unambiguous proposal for avoiding double taxation in conventions between EU Member States without causing any system dislocation, i.e. to stipulate

- **which measures against DTC abuse are to be considered admissible or inadmissible under European law;**
- **when subject-to-tax and switch-over clauses may be applied in EU cases;**
- **particularly how national legislators are to handle, in compliance with EU law, exemptible income from other EU Member States which may be taxed there but which is actually not taxed in full or part (for eligible reasons) .**

In our view, strict EU-wide application of the exemption method would be desirable. Foreign items of income should at any rate be completely exempted where they are attributed functionally to an EU permanent establishment in the country of the parent firm.

5.1.1. Unilateral switch-over clauses

- **Section 20 (2) AStG**

A **foreign permanent establishment** which derives **designated passive CFC income** (as defined in Sections 7-14 AStG) is **not allowed to apply the DTC-guaranteed exemption**

method (Section 20 (2) AStG; switch-over clause). Instead, double taxation is avoided in these cases by applying the **credit method**.

According to a ruling by the **Federal Fiscal Court (BFH)** (BFH ruling of 21.10.2009, I R 114/08; final ruling on ECJ judgment of 6.12.2007, C-298/05 [Columbus Container Services], **Section 20 (2) AStG**, also in the version applying since 1.1.2008, is **inconsistent with European law** if the motives test is passed **because Section 8 (2) AstG (new version) itself violates fundamental freedoms: contrary evidence is not possible for designated passive CFC income** if parties with unlimited liability do not own more than 50% of the controlled foreign corporation because Section 8 (2) AStG (new version) allows contrary evidence in the case of investments as defined in Section 7 (2) AStG and does not cover those as defined in Section 7 (6) AStG.

The phrase "*notwithstanding Section 8 (2) AStG*" inserted in Section 20 (2) AStG needs to be removed under European law in our view to allow the possibility to produce contrary evidence also in cases covered by Section 20 (2) AStG.

- **Section 50d (9) EstG**

Because of a unilateral provision in Section 50d (9) AStG, there may be a switch-over from the exemption method to the credit method in the cases specified therein. The switch-over clause in Section 50d (9) EStG prohibits the exemption under a DTC of income accruing to a party with unlimited liability to tax if the system of foreign limited tax liability displays undesirable gaps from the German perspective.

  - **Relationship with DTCs**

Section 50d (9) EStG is overridden by the DTC provision if this provision prohibits exemption to a greater extent. **If, on the other hand, Section 50d (9) EStG restricts exemption to a greater extent than the DTC provision, Section 50d (9) EStG must be applied.**

What is problematic in this context is that, for example, the DTC UK 2010 requires a mutual agreement procedure to be conducted, whereas Section 50d (9) EStG does not. If a case is covered by both provisions, it may be assumed in practice that the tax authorities will not allow exemption unless an attempt to resolve the case by mutual agreement has been made without any success.

In our view, the switch-over clause in **Section 50d (9) EStG meets with reservations under European law. If a mutual agreement procedure has to be conducted under the provisions of the DTC, this must also apply in application of Section 50d (9) EStG.**

- **Relationship with Section 20 (2) AStG**

Like Section 20 (2) AStG, Section 50d (9), sentence 1, no. 2 EStG states that the legal consequence is the switch-over from the exemption method to the credit method. In contrast to Section 20 (2) AStG, which serves to prevent abuse of tax arrangements through the interposition of passive permanent establishments in low-tax DTC contracting states, Section 50d (9), sentence 1, no. 2 EStG sanctions non-taxation of an activity in a DTC contracting state due to a "gap" in the system of foreign limited tax liability. **The scope of both provisions may overlap.** Following the wording of the act, the non-taxation or zero taxation in Section 50d (9), sentence 1, no. 2 EStG fulfils at the same time the requirements of Section 8 (3) AStG. Section 50d (9), sentence 3 EStG stipulates with regard to the examination sequence that application of Section 20 (2) AStG should always be given precedence.

In our view, **Section 50d (9), sentence 1, no. 2 meets with reservations under European law**. **If the provisions of the AStG accept a case as non-abusive on the basis of objective and subjective criteria, it cannot be the case that something else applies for the purposes of Section 50d (9) EStG** merely because non-taxation due to the absence of a taxable event for non-resident taxpayers is involved. **The so-called motives test should be adopted also for the purposes of Section 50d (9), sentence 1, no. 2 EStG.** Subordinate examination of Section 50d (9), sentence 1, no. 2 EStG is inappropriate for cases which initially fall under Section 20 (2) AStG if it results in harder legal consequences. Subordinate examination of Section 50d (9), sentence 1, no. 2 EStG must not be allowed to lead to a contrary assessment of the case or to legal consequences going beyond those produced earlier by examination of Section 20 (2) AStG: subordinate examination of Section 50d (9), sentence 1, no. 2 must be ruled out in the case of active activities as defined in Section 8 (1) AStG. Passive, but economically meaningful activities should no longer be conducive to a different assessment under Section 50d (9), sentence 1, no. 2.

We do not see any evident justification for the divergent assessments by reference to the argument of avoiding non-taxation or unfair tax competition. We also fail to understand why the sovereign taxation decision of an EU Member State should be taken as the basis for

generally lifting a DTC-guaranteed exemption of profits made by permanent establishment. **Under ECJ rulings, the company liable to tax must be granted the possibility to produce contrary evidence, something which is missing in Section 50d (9) EStG.**

6. Trade tax

Add-back taxation also has implications for German trade tax.

6.1. Trade tax treatment of the add-back amount pursuant to Section 10 AStG

Under Section 10 AStG, the income subject to add-back taxation minus foreign tax already levied on it must be attributed to the party with unlimited liability to tax. This add-back amount is included in the income derived from capital (Section 20 (1), no.1 EStG) or business activities (Section 15 EStG) if the shares in the foreign company form part of business assets. **As Section 10 (2), sentence 2 AStG specifies an increase in the profit of a business, this means that, because the income of the business is linked to the profit from business activities pursuant to Section 7 (1), sentence 1 GewStG, the add-back amount also increases the income from the business and thus generally triggers trade tax. If, however, any of the reduction provisions of Section 9 GewStG must be applied to the add-back amount, this amount is then removed from business income and ultimately trade tax is not imposed. Such a reduction with regard to the add-back amount could be made on the basis of Section 9, no. 7 GewStG – reduction of business income for gains on shares in a corporation.**

For companies as defined in Section 9, no. 7, first half-sentence GewStG whose management and registered office lie outside the scope of the German Trade Tax Act and which do not fall under the Parent-Subsidiary Directive, such a reduction may not be made as such companies will usually derive their gross income not exclusively or almost exclusively from activities covered by Section 8 (1), no. 1-6 AStG. For corporations as defined in Section 9, no. 7, second half-sentence GewStG which fall under the Parent-Subsidiary Directive, the reduction must on the other hand be made regardless of whether the foreign corporation concerned derives its gross income from "passive" activities as defined in the AStG. A point of controversy in this respect is whether the reduction provision of Section 9, no. 7, sentence 1, second half-sentence GewStG may be interpreted (more broadly) to apply also to EU companies which do not fall under the Parent-Subsidiary Directive.

In practice, the German tax authorities assume that the reduction provision of Section 9, no. 7, sentence 1, second half-sentence GewStG is not applicable to the add-back amount for gains on shares in EU companies which do no fall under the Parent-Subsidiary Directive.

The above applies also if the reported add-back amount is based on designated passive CFC income.

In our view, inclusion of trade tax in add-back taxation is problematic under European law because no trade tax would be payable if the German corporation were to earn the income in a foreign (EU) permanent establishment. As non-application of the reduction provision for gains on shares in EU companies with a dispersed shareholder structure in Section 9, no. 7, sentence 1, second half-sentence GewStG to the add-back amount leads to imposition of trade tax, the practice adopted by the German tax authorities with regard to banks in particular meets with serious reservations under European law.

The inclusion of the add-back amount in German trade tax leads in itself to anti-systemic taxation. This results from the fact that, as a business-related property and municipal tax, trade tax follows the territoriality principle and, as an equivalence tax, is designed to offset the additional costs incurred by a municipality due to heavier use of public goods through business activities (cf. German Federal Constitutional Court – *Bundesverfassungsgericht* (BVerfG), decision of 15.1.2008, 1 BvL 2/04). This material justification for trade tax would be contradicted in our view by including foreign items of income for whose generation a foreign municipality made the decisive public contribution. In this case, a reduction of the add-back is also called for, as this is not business income earned in Germany.

In addition, in the case of corporations as defined in Section 9, no. 7, sentence 1, second half-sentence GewStG which fall under the Parent-Subsidiary Directive, the reduction must be made regardless of whether the foreign corporation concerned derives its gross income from "passive" activities within the meaning of the AStG.

The add-back amount can, in our view, also be captured (by way of interpretation) under the term "gains on shares in a corporation". The term "gains on shares" corresponds in this respect to the term "profit shares" in Section 20 (1), no. 1 EStG. Section 10 (1), sentence 1 AStG regards the add-back amount itself as covered by Section 20 (1), no. 1 EStG. This is confirmed in our opinion by a BFH ruling (BFH judgment of 11.2.2009, I R 40/08), according to which this interpretation is corroborated not least by Section 10 (2), sentence 3 AStG, since "this

exclusion of regulation" would – by implication – not be necessary if the add-back amount were not in any case (by virtue of legal fiction) part of the income as defined in Section 20 (1), no. 1 EStG".

Against this background, the reduction provision for gains on shares in EU companies with a dispersed shareholder structure in Section 9 (7), sentence 1, second half-sentence should be applied to the add-back amount in order to avoid the imposition, contrary to European law, of German trade tax on gains on shares in EU companies. In our view, the European Commission could help by submitting a proposal to this effect.

6.2. No crediting of foreign (EU) income tax against German trade tax – over-taxation due to excess credit positions

Where foreign income tax is charged at a rate of between 15 and 24.99%, there may be sizeable excess credit positions because the add-back amount is subject not only to German corporation tax but also to German trade tax, whereas foreign tax may only be credited against the (lower) German corporation tax of 15%.

> *Example (according to Wassermeyer/Schönfeld, International Tax Law 2008, 496ff.): A German corporation wholly owns a foreign corporation. The controlled foreign corporation earns passive income of 100 in 2008 which is subject to foreign corporation tax of 20% = 20. The add-back pursuant to Section 10 (2) AStG triggers corporation tax of 15% of 100 = 15, against which the foreign corporation tax of 20 can be credited (excess credit position). There remains, however, trade tax of an estimated 14% of 100 = 14 (multiplier: 400%). The total tax load is therefore 14% + 20% = 34% (excluding a "solidarity surcharge" (Solidaritätszuschlag- SolZ); including SolZ of +0.77% = 34.77%), although in Germany, with a multiplier of 400%, a tax load of only 29.83% (excluding SolZ; including SolZ of +0.77 = 30.6%) is intended.*

In relation to direct income-earning by the German corporation, add-back taxation triggers over-taxation (equivalent to the difference between 34% (or 34.77%) and 29.83% (or 30.6%) = 4.17%, applying foreign corporation tax of 20%, German corporation tax of 15%, German trade tax of 14% (multiplier: 400%) and a German solidarity surcharge of 5.5%).

There is no recognisable material justification for this. The reason for the over-taxation is that, on the one hand, foreign corporation tax is not credited against German trade tax and, on the other hand, that taxation in Germany is not capped.

In our view, inclusion of trade tax in add-back taxation is problematic under European law because no trade tax would be payable if the German corporation were to earn the income in a foreign (EU) permanent establishment. If foreign EU taxation of income produces sizeable excess credit positions, which is the case with foreign taxation of between 15 and 24.99%, the resulting over-taxation must be eliminated in conformity with European law.

To this end, the European Commission should propose that German trade tax should not be included in add-back taxation under European law.

6.3. Double taxation of subsequent profit distributions by the foreign company due to taxation of the add-back amount and taxation of the distribution of income underlying the add-back amount

Although the income of a controlled foreign corporation has already been subjected to German tax under add-back taxation, distribution of this income may lead to renewed taxation if the party liable to tax has to pay income tax as a result of the profit shares accruing to him.

Because of the German "partial income system", a distinction must be made in this respect between parties liable to income tax (natural persons) and parties liable to corporation tax (particularly companies) as shareholders.

For **parties liable to income tax as shareholders**, Section 3, no. 41a EStG exempts the distribution of profits from taxation if, in the year of distribution or the seven preceding years, add-back amounts were subjected to income tax. This exemption also applies for trade tax purposes as Section 8, no. 5, sentence 2 GewStG stipulates that there must be no add-back for trade tax purposes for profit distributions exempted from tax under Section 3, no. 41a EStG. However, this exemption applies only within a period of seven years. If profits already subjected to add-back taxation are distributed later, these will again be subjected to German income tax and German trade tax under the partial income system (Section 3, no. 40d EStG). **If the company making the distribution does not meet the requirements of Section 9, no. 7**

GewStG, the profit distributions are subjected in full to trade tax under Section 8 (1), no. 5 GewStG in conjunction with Section 9, no. 7 GewStG, with the result that in this case designated passive income is taxed twice: firstly, on taxation of the add-back amount and, secondly, on taxation of distribution of the income underlying the add-back amount.

In the case of **corporations as shareholders**, Section 8b (1) KStG stipulates that profit distributions are tax-exempt. This provision only applies to credit institutions and financial services enterprises if the shares are not to be attributed to the trading book but to the banking book or the liquidity reserves, and to financial enterprises if the shares are not acquired for the purpose of making a short-term proprietary trading profit. In this case, designated passive CFC income is again subjected to corporation tax when distributed because the exemption – unlike in the case of Section 3, no. 41 EStG – is not limited in time. The exemption is, however, capped at 95% of dividends (see Section 8b (3), (5) KStG). If the corporation refers to Section 3, no. 41 EStG – which is admissible according to the German tax authorities (cf. R 42 (1), no. 1 Corporation Tax Directive – full exemption from corporation tax can be obtained in cases in which distribution of profits takes place within the seven-year period specified in Section 3, no. 41 EStG. Section 8, no. 5, sentence GewStG may lead to add-back of distributions for trade tax purposes if the company making the distribution does not meet the requirements of Section 9, no. 7 GewStG. The reason for this is that Section 8, no. 5, sentence 2 GewStG avoids such add-back only for profit distributions which fall under Section 3, no. 41 EStG and thus only if the seven-year period is adhered to. **When designated passive CFC income already subjected to add-back taxation is distributed, trade tax may be additionally imposed if distribution takes place after expiry of the seven-year period pursuant to Section 3, no. 41 EStG. As a result, the designated passive CFC income is subjected in this case** – like with parties liable to income tax as shareholders – **to double taxation which, because of the exemption under Section 8b (1) KStG, is, however, limited to trade tax.**

In our view, the above-mentioned double burden on later profit distributions by the foreign company through taxation of the add-back amount and taxation of distribution of the income underlying the add-back amount meets with serious reservations under European law.

To this end, the European Commission should propose that German trade tax should not be included in add-back taxation under European law.

7. Short-term cross-border employee assignments at the parent firm or permanent establishment ("commuter taxation")

Short-term cross-border employee assignments at the parent firm or permanent establishment may also give rise to double taxation even where double taxation conventions (DTCs) between EU Member States apply. This is contrary to fundamental freedoms.

Double taxation concerns above all the income tax liability and deduction of wage tax for employees of foreign EU permanent establishments

- who have their place of residence in the EU country of the permanent establishment,
- who are generally employed at the foreign EU permanent establishment of a German company,
- whose salary is paid in full by the foreign EU permanent establishment and
- who are employed overall for less than 90 days per year or often only for a few days per year (in the same function)
  - at the German parent firm or
  - at German customers of the foreign EU permanent establishment

and thus reside in Germany for not more than 183 days in any calendar year.

If employees of the permanent establishment (commuters) visit the German parent firm or German customers of the foreign EU permanent establishment on official business, they have limited income tax liability and are, in addition, liable for deduction of wage tax during their stay in Germany, irrespective of the duration of their stay. Often such visits are day trips and total less than 90 days' travel in a year. The obligation to deduct wage tax is based, on the one hand, on the national right of taxation pursuant to Section 38 (1), no. 1 in conjunction with Section 49 (1), no. 4a EStG and, on the other hand, on the pertinent section in the relevant DTC, which is as a rule modelled on Article 15 (2) (b) of the OECD Tax Model Convention and according to which the employer in such cases is the German company, not the foreign EU permanent establishment because the latter is not an independent legal entity under civil law.

The German understanding is that a permanent establishment cannot be regarded as an employer under civil law (cf. BFH rulings of 29 January 1986, Federal Fiscal Gazette II 1986, 442 and 513; Federal Ministry of Finance (BMF) letter of 14.9.2006 on the tax treatment of employee remuneration under the DTCs, Federal Fiscal Gazette I 2006, 532, par. 60). If employees resident in another EU country work for their employer under civil law in Germany, it can as a rule be assumed that the employer under civil law is also the employer

within the meaning of the DTC (cf. BMF letter of 14.9.2006 on the tax treatment of remuneration under the DTCs, Federal Fiscal Gazette I 2006, 532, par. 62f.).

By way of differentiation: this means that the question concerning the employer in cases of short-term assignments of an employee of an EU permanent establishment who is resident abroad is answered differently according to the German understanding than in cases of staff secondment (see BMF circular on the "Principles for examination of the income delimitation between internationally related companies in cases of staff secondment [Administrative principles – staff secondment] (*Grundsätze für die Prüfung der Einkunftsabgrenzung zwischen international verbundenen Unternehmen in Fällen der Arbeitnehmerentsendung [Verwaltungsgrundsätze – Arbeitnehmerentsendung*] of 9.11.2001, Federal Fiscal Gazette I 2001, 796, par. 2.2), in which the economic definition of employer is declared applicable also to permanent establishments and integration into the host entity is in principle assumed from a secondment period of 90 days and more.

According to the German interpretation outlined above, in the case of short-term assignments every single day worked by an employee of a foreign EU permanent establishment in Germany is therefore taxable and the parent firm – in line with its obligations as an employer pursuant to Section 38 (1) EStG – is required to deduct wage tax for the days worked in Germany.

Irrespective of the deduction of German wage tax, foreign wage tax continues to be withheld and deducted for the employees of the permanent establishment also during their trips to Germany. This is because in most cases an exemption procedure cannot be conducted in practice mainly for time reasons.

The necessity for the German parent firm to withhold wage tax on a daily or even hourly basis on the strength of detailed travel documentation and time-consuming inquiries (made difficult by, among other things, differing legal regimes, possible currency conversion, subsequent attribution of extra payments) imposes a considerable internal administrative workload and causes external advisor costs which are in no proportion to the relatively low wage tax amounts collected. In petty cases in which foreign tax refunds are relatively small compared with the administrative workload involved, the crediting option available abroad is usually waived.

The result is ***de facto* double taxation**.

The same problem exists in principle in the reverse case in which an employee of the German parent firm carries out an assignment at a foreign EU permanent establishment.

The problem does not exist in cases where EU Member States have made different arrangements for short-term assignments or where, in derogation from the OECD Tax Model Convention, the applicable DTC restricts the right of taxation of the country in which the assignment is carried out.

Attention is therefore drawn, by way of example, to

- the short-term business visitors rule in the UK,
- the Dutch tax authorities' 60-days rule for certain short-term work
- the special provisions of Article 15 (3) DTC Germany-Austria for short-term employee transfers ("The provisions of the preceding paragraph 2 (b) shall not apply to remuneration for work in connection with employee transfers if the employee does not reside in the other state for a total of more than 183 days during the relevant calendar year.").

The problem would not exist either, however, if short-term cross-border assignments were regulated for tax purposes in line with the new social security legislation in force since 1 May 2010 (Article 13 (1) of Regulation (EC) 883/2004 in conjunction with Article 14 (7) of Regulation 987/2009). While this would mean a clear change compared with current practice under social security law, it would at the same time considerably simplify the current rules and procedures: accordingly, in the case of multistate activities (covering both separate activities pursued simultaneously and alternating activities), it must be examined whether the employee

- pursues an activity in two or more Member States (determination of multistate activity; step 1);
- pursues a substantial part of his activity in the Member State in which he is resident. In this case, the employee is subject to the legal provisions of the Member State of residence (step 2).

If the employee does not pursue a substantial part of his activity in the Member State of residence, the activity is subject to the legislation of the state in which the registered office of his employer (under civil law) is situated (Article 13 (1) of Regulation (EC) 883/2004). "Substantial part" means a "quantitatively substantial part", not the "major part" of the activity (Article 14 (8) of Regulation (EC) 987/2009). It must in particular be determined by

reference to the share of working time and remuneration whether the employee pursues at least 25% of his activity in the Member State of residence. If a share of less than 25% is assessed, this is an indicator that a substantial part of the activity is not being pursued there.

In order to avoid tax obstacles in the case of short-term multistate activities within a cross-border EU company, the Association of German Banks recommends that the European Commission draft proposals for facilitating short-term EU employee assignments, whether by applying at EU level a regulation equivalent to

- the regulations simplifying short-term assignments in force vis-à-vis Austria (Article 15 (3) DTC Germany-Austria), in the UK and in the Netherlands, or
- by applying the provisions simplifying multistate activities in EU Regulation 987/2009 coordinating social security systems and thus establishing a *de minimis* rule exempting business trips by foreign permanent establishment employees which do not exceed a certain number of days per year from deduction of wage tax and right of taxation in the Member State in which the parent firm is situated.

Yours sincerely,

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