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I. General aspects of the domestic tax situation

1. The notion of “tax competition” in domestic legal and economic science

a. Shortfall of well-founded legal analysis

For a long while, even when already surrounded by neighbour states lowering their corporate income tax rates\(^1\), Germany ignored the emerging international tax competition. Nevertheless, in the meanwhile the situation changed a lot. Starting in the mid-90ties of the last century tax competition developed to an important factor of German tax politics and had some significant impact on recent tax reforms.

In comparison, the scientific analysis seems to fall short of the political development. Certainly, tax competition is mentioned in many scientific articles. Specially articles on business taxation occasionally start with some phrases about international tax competition, but this has more the function of embellishment. Even in articles dealing primarily with tax competition, most authors just recall the definitions given by the OECD and the European Commission. What is missing are proposals for a more precise definition of tax competition\(^2\), a more detailed evaluation under which circumstances tax competition has to be considered as unfair and proposals how to deal with – fair and unfair – tax competition. With some exceptions\(^3\), this shortfall in particular is true for the legal literature. Tax competition is left to the economic and political science\(^4\). One reason might be that the

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topic involves many economic assumptions, which are still in discussion. Secondly, measures against unfair tax competition are mainly considered as matters of fiscal politics, because *legal* instruments to tackle tax competition hardly exist.

b. Controversial approach to the phenomenon of tax competition in the German literature

In the existing German literature the attitude towards tax competition diverges a lot. However, there is strong consensus about the necessity to combat unfair tax competition. Therefore, the practice of the Commission and the European Court of Justice\(^5\) to apply the State aid provisions to tax expenditures\(^6\) is widely accepted in the fiscal literature. Even authors indifferent to the general effects of tax competition appreciate a strict application of the State aid provisions to tax incentives\(^7\).

But then, the question, if and under which circumstances tax competition is harmful or unfair and how Germany should respond to international tax competition in general, divides the academic tax world into at least three groups:

Some authors welcome tax competition forcing politicians to lower tax rates and to curb the leviathan state. Especially representatives of the economic sector never tire of insisting in the positive effects of tax competition and the necessity for Germany to keep pace with the worldwide trend of falling taxes on business and capital income\(^8\), even if the impact of tax competition might interfere with the structure of the national tax system.

Just the opposite, other authors fear a loss of fiscal autonomy of the national legislator and therefore emphasize how tax competition jeopardizes national economy, tax revenue and the legal structure of the tax system\(^9\).

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\(^{5}\) Federal Republic of Germany v. Commission ECJ 156/98 from September 19, 2000 (sec. 6b, 52 Abs. 8 EStG – Personal Income Tax).

\(^{6}\) An overview on this practice is given by Frans Vanistendael, Fiscal support measures and harmful tax competition, EC Tax Review 2000, p. 152 (153-155).

\(^{7}\) Volkmar Götz, Tax Incentives subject to the European State Aid Control (Steuervergünstigungen als Gegenstand der europäischen Beihilfenaufsicht), in “States and Taxes”(Staaten und Steuern), Essays in honor of Klaus Vogel, Heidelberg 2000, p. 579 (581).

\(^{8}\) E. g. Wolfgang Ritter, Perspectives for further development of the German international taxation (Perspektiven für die Fortentwicklung des deutschen internationalen Steuerrechts, Internationales Steuerrecht 2001, p. 430.

\(^{9}\) E.g. Paul Kirchhof, in DSiG-Sonderband Unternehmenssteuerreform (2001), p. 150; Paul Kirchhof, The constitutional point of view (Standortbestimmung aus verfassungsrechtlicher Sicht), in Kirchhof/Neumann (ed.), Freiheit, Gleichheit, Effizienz, Bad Homburg 2001, p. 13 (17); Scientific Advisory Board of the German Ministry of Finance, Study on the Reform of International Capital Income Taxation,
Furthermore they seem to be of the opinion that Germany can do very well without entering into the international tax competition because the tax level is only one factor in the choice of site and corresponds with the quality of other public goods like infrastructure, internal security, education, social rights. Especially the former judge of the German Constitutional Court (Bundesverfassungsgericht) Professor Paul Kirchhof takes a very critical position towards tax competition. He claims for a legal solution of the problem. The European Union going to adopt a Charter of Fundamental Rights should be able to solve the problem of tax competition according to the principles of freedom and equality in harmony of all member states.

A third group – that also Professor Joachim Lang from Cologne University belongs to \(^{10}\) – takes international tax competition as irrevocable fact, which nevertheless shall not just be taken as given but requires intelligent solutions of the domestic law in an attempt to prevent investors from investing abroad through the attractiveness of the domestic tax system rather than through disincentives. In their opinion the answer to international tax competition lays in a shift to a consumption-based income taxation \(^{11}\). A consequently consumption-based income taxation would enable the legislator to lower and apply the competition-relevant tax rate on capital income uniformly to all kinds of capital income. An understanding of the ability-to-pay-principle as ability to consume would allow to postpone the taxable event until capital is withdrawn and consumed. Advocates of consumption-based income taxation argue that this model is the only chance to join the international tax competition without violating the constitutional fundamental right of equality \(^{12}\). This is the position of many economists as well \(^{13}\).

2. The political attitude of the government towards tax competition

As indicated already, the political attitude towards tax competition changed a lot over the last decade. Until the mid-90ties Germany stuck to a high tax policy. The unquestioned dogma that the corporate tax rate has to equal the top rate of the personal income tax hindered Germany for a long time to
follow up the worldwide trend of dropping corporation income tax rates. The first humble beginnings to take up the challenge were made in 1994 with the Standortsicherungsgesetz (Act to sustain Germany’s attractiveness as business location). However, only very recently the German tax legislator actually realized the inevitability of a competitive tax system with the introduction of the Tax Reduction Act (Steuersenkungsgesetz), which is enactive since January 1, 2001. In the meanwhile, it seems that the legislator tries to make up for former omission. The last major tax law reforms were mainly devoted to raise the attractiveness of Germany for foreign investors. That is at least what the legislative intents say.

The role Germany wants to play on the European and supranational level is ambivalent. On one hand, Germany is definitely not one of the most fervent advocates of harmonising proposals. Already its reaction to the Ruding Report was quite restrained. Germany is not willing to give up its autonomy in tax matters. On the other hand, German government fears tax dumping jeopardizing the national tax revenue. Therefore, during the German presidency of the European Council in 1999 one of the major plans featured was aimed against unfair and harmful tax competition. The German government attaches great hope to the Code of Conduct. Nevertheless the latest significant rate cuts, Germany will never be among the low-tax countries. Thus, its only chance to survive international tax competition is to keep other countries from uncontrolled beggar-my-neighbour-policies. In this context, the German Ministry of Finance does not care so much, whether the effort to eliminate harmful tax competition is based on the Code of Conduct or on the State aid rules, however favours the broader approach of the Code of Conduct, which might lead to more comprehensive and consistent solutions.

Furthermore, in the meanwhile German tax legislator recognised the CFC legislations, enactive since the early 70ties of the last century, as a suitable instrument not only to shelter its own revenue from tax competition but – as one could say spitefully – even to take advantage of low taxes abroad by a very strict application, which allows to override treaty commitments given in the past, even in cases that cannot be considered as an abuse by the single

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17 Proceedings of the German Parliament (Bundestagsdrucksache) 14/2863, p. 92 et seq., 120 et seq.
20 Governmental Report on further Development of Business Taxation (Bericht der Bundesregierung zur Fortentwicklung des Unternehmenssteuerrechts), Finanzrundschau 2001, supplement to issue 11, p. 28.
21 See the statement of Barbara Hendricks, Parliamentary Under-Minister in the German Ministry of Finance, ET 2000, p. 400.
taxpayer\textsuperscript{22}. This practice might end up in a “reverse beggar-my-neighbour-policy”.

Summarizing, the strategy of the German government to deal with tax competition can be characterised as follows: in principal, official bodies accept fair tax competition as positive outcome of an open economy\textsuperscript{23}. Unfair tax competition, however, is considered as serious threat. Since there are no legally enforceable means to deter other Member States from offering tax privileges other than the state aid provisions of the EC-Treaty\textsuperscript{24}, the government feels justified to counteract tax competition\textsuperscript{25} by application and even tightening of its CFC-legislation\textsuperscript{26}. At the same time German government tries to bring to bear its influence in the European and OECD-efforts to tackle harmful tax competition by political pressure. Besides these defensive measures Germany is willing to play an active role in the international tax competition by lowering its relevant taxes, of course, only up to a certain extent, because Germany will never become a low-tax country\textsuperscript{27}.

3. The distinction between “fair” and “unfair” tax competition

As already mentioned, up to now in German literature there has been made only very little effort to scrutinize the EU and OECD-definition of unfair tax competition and to come up with a different or more detailed definition. There is neither a very precise understanding of tax competition nor of the question of unfairness. Unfair tax competition is understood as an open typological term causing a forming of concepts without clear-cut dividing lines. Therefore it is not possible to create a distinctive definition\textsuperscript{28}.

In 1999, the Scientific Advisory Board of the German Ministry of Finance made an attempt of a distinction between fair and unfair competition. The

\textsuperscript{22} See the criticism by Endres/Thies, Intertax 1998, p. 293 (300).
\textsuperscript{24} See Edwin van den Bruggen, State Responsibility under Customary International Law in Matters of Taxation and Tax Competition, Intertax 2001, pp. 115 (137), who emphasizes that the problem of unfair tax competition can especially not be solved by application of international public law, because offering preferential tax conditions to foreign taxpayers is – even in cases of ring-fencing – part of the unrestricted fiscal sovereignty. As so far state responsibility for tax competition is not a general principle of international law.
\textsuperscript{25} Ulrich Wolff, Internationales Steuerrecht 2001, p. 440
\textsuperscript{26} Governmental Report on further Development of Business Taxation (Bericht der Bundesregierung zur Fortentwicklung des Unternehmenssteuerrechts), Finanzrundschau 2001, supplement to issue 11, p. 28.
\textsuperscript{27} Berndt Runge (see note 23), p. 559 (574).
\textsuperscript{28} Scientific Advisory Board of the German Ministry of Finance (see note 9), p. 28 et seq.; Lucas Wartenburger (see note 2), Internationales Steuerrecht 2001, p. 397 (397, 402).
board sees the purpose of this distinction in preventing distortions of the allocation of capital. Nevertheless, general tax cuts in principal were regarded as an outcome of fair tax competition, even so they might result in a distortion of international allocation of capital. A measure will only be considered as unfair, if in the first place it aims at a distortion and is part of a beggar-my-neighbour-policy instead of a general improvement of the domestic tax situation. It is unfair, if its target is to attract additional tax base from other member states without negative effects to the domestic tax revenue. Hence, the decisive criteria is the intention of the legislator, which has to be discovered by a list of indicatory features. Such are:

- Foreign investors enjoy a lower tax level than the average tax level, which in general applies to internal investments.
- Retained profits of foreign corporations are taxed preferentially in comparison to the tax levied on domestic corporations.
- A country allows tax planning structures, difficult to discover for foreign fiscal authorities and makes open offers for international tax defraud.

Off-shore clauses and ring-fencing features are an important sign indicating that a measure is the product of unfair tax competition.

In the Scientific Advisory Board’s opinion one of the major difficulties of a definition of unfair tax competition is that the question of distortion often cannot be answered until the interaction of both involved tax system – the tax system of the source country and of the investors home country – is taken into consideration. The question, whether an investor is able to keep advantages granted by the source country mainly depends on whether his home country applies the imputation or exemption method to foreign income. And even deferral effects due to the use of a corporation in the source country might be minimized by a CFC-legislation in the home country.

Other authors try to draw a line between fair and unfair tax competition according to the State aid provisions, an approach discussed in the Code of Conduct and in the Commission’s notice on the application of State aid rules to measures relating to direct business taxation as well. They say that prohibited support measures are the outcome of unfair tax competition and therefore usually meet the requirements of unfair tax competition, which at the same time, would mean, that the Commission has already an effective

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29 Scientific Advisory Board of the German Ministry of Finance (see note 9), p. 28.
tool against unfair tax competition just by consequent application Art. 87 of the EC-Treaty.

However, in my opinion Art. 87, para. 1 of the EC Treaty is not sufficient to tackle all manifestations of unfair tax competition. The measure has to be specific in terms of offering preferential treatment only to enterprises in certain industrial sectors or regions. Tax incentives offered to foreign investors in general hardly fulfil the selective criteria. On the other side, I disagree with the conclusion that prohibited support measures under Art. 87, para. 1 of the EC Treaty always represent unfair tax competition. Prohibited fiscal support measures may be offered both to foreign and domestic products or investments. If we agree on a definition of unfair tax competition mainly directed at tax incentives exclusively granted to foreign taxpayers a measure applying to national and foreign taxpayers might be an unlawful support measure without being a measure of harmful tax competition in terms of the Code of Conduct. Thus, for example eco tax relieves granted to certain branches of producing industries are considered as measures which have to be notified by the Commission under Art. 87, para. 1 of the EC Treaty, but can hardly be considered as unfair tax competition, at least as long as not all member states levy eco-taxes. Therefore in my understanding the intersection of state aid provisions and the problem of tax competition is quite small.

Though never applied to a tax provision as so far, Art. 96 and 97 of the EC-Treaty were also mentioned in the German discussion. Application of these provisions could accomplish control in cases, which cannot be subsumed under the State aid provisions. If a member state grants general tax relief, as Ireland intends to do by lowering its general corporate income tax rate to 12.5 percent this could be considered as a distortion of the conditions of competition. In this case, the principle of unanimity which in the past made progress in the field of direct taxes almost impossible would not apply.

4. Economic effects of tax competition in Germany

Tax competition in general results in changes of the whole tax system shifting the tax burden from mobile to immobile factors, from capital to labour or consumption. In Germany the ratio between direct and indirect

31 See Volkmar Götz (see note 7), p. 579 (586).
33 See Walter Frenz, Interaction of domestic Tax Law and European State Aid Provisions, discussed on the example of the partial exemption from tax on oil (Das ineinandergreifen von nationalem Steuerrecht und gemeinschaftsrechtlichem Beihilfeverbot am Beispiel einer partiellen Befreiung von der Mineralölsteuer), Deutsches Steuerrecht 2000, pp. 137.
34 Volkmar Götz (see note 7), p. 579 (588/89)
taxes has changed over the last fifteen years. Due to the dramatic reduction of the corporation income tax rate and the further reduction of the personal income tax rates until 2005 it is very likely that this trend will even accelerate. Already today, especially short-term public financial requirements – for instance expenses for internal security after the 11th of September 2001 – is answered by an increase of indirect taxes to keep the direct tax rates low.

Furthermore, statistic figures show that Germany in terms of its balance of direct investment remains significantly behind the European average. It has been argued, that the reason why foreign capital avoids Germany and domestic capital goes abroad is because other European neighbour states offer a more attractive tax environment. However, in my opinion it is hard to attribute such movements unilateral to tax competition. A proof might be given, if the situation will change with the tax reform 2000.

II. Elements of tax competition in the domestic tax system

1. Overview

In the past, whenever the discussion got onto the subject of Germany’s high nominal tax rates it was referred to the generous deductions in tax base, therefore the effective tax burden would be substantially lower than the nominal tax rate might indicate. However, the strategy changed in the last few years, when Germany joined the world-wide trend of base broadening, which finances a cut of tax rates. The last two big tax reforms, the Tax Relief Act 1999/2000/2002 (Steuerentlastungsgesetz) and the Act on the Reduction of Tax Rates and on the Reform of Corporate Taxation (Tax Reduction Act – Steuersenkungsgesetz), both resulted in substantial tax rate cuts.

35 In 1986 the ratio was 60 percent direct taxes to 40 percent indirect taxes. In 2001 it is 49 percent direct taxes and 51 percent indirect taxes. For statistic figures see www.bundesfinanzministerium.de/Steuerschaetzung-aufkommen-.457.2326/.htm.
36 In this example the taxes on tabacco and on insurances.
The Tax Relief Act 1999/2000/2002 was aimed at a determination of taxable income closer to international standards. This base broadening paved the way for a fundamental corporate tax reform and a substantial cut of tax rates. The Tax Reduction Act contained a change of the corporation income tax system from the former full imputation system to a shareholder relief system with a 50 percent personal income tax exemption for dividend income and capital gains from the disposal of shares (so-called half-income-system). As the base broadening by the Tax Relief Act 1999/2000/2002 the change of the corporation income tax system facilitated the financing of a significant reduction of the corporate income tax rate from 40 percent in the financial years 1999 and 2000 to 25 percent since 2001. Personal tax rates have been lowered as well. The highest bracket will drop in three successive steps from 48.5 percent to 42 percent in the year 2005. The abolishment of the full imputation tax system was not only motivated by the need to finance the tax rate cut but also to overcome the uncertainty of its compatibility with the EC-Treaty. Since one of the major failures of the former imputation system was the discriminatory limitation to dividends paid by domestic companies to domestic shareholders, the new half-income-system applies to dividends from foreign companies as well.

These roughly described changes can be regarded as positive effects of fair tax competition resulting in an improvement of the German tax climate for investments in general.

2. The constitutional framework for Germany entering into international tax competition

However, the recently released Commission Staff Working Paper on Company Taxation in the Internal Market\(^40\) indicates that even after the recent tax cuts, Germany still ranks among the Member States with the highest taxes on business income. This is because adding the local business tax (Gewerbesteuer)\(^41\) and the solidarity surcharge (Solidaritätszuschlag) to the corporation income tax rate, investments in Germany made through a corporation are still taxed at rates between 38 and 40 percent as long as the income is retained, and up to around 55 percent if distributed to resident shareholder in the highest bracket of personal income tax. So it is very likely that with the tax reform 2000 the reduction of the corporation income tax rate did not reach the bottom yet. But even if international tax competition might call for further reduction, the structure of German business taxation limits the margin within the legislator can act. German business tax law is characterised by the dualism of corporate and personal income tax as the tax systems of most OECD-countries, but with the peculiarity, that 85 percent of German enterprises are either sole proprietors

\(^{40}\) See COM (2001) 582 final, p. 77 et seq. and 90 et seq.

\(^{41}\) The effective tax rate of the local business tax varies in average amounts around 12 percent.
or partnerships. Therefore, one major issue in the German scientific debate is, whether constitutional law allows the legislator to lower unilaterally only the corporation income tax rate. On the other hand, the reduction of the top personal income tax rate to 42 percent in the year 2005 probably is already the maximum concession the legislator could make to the pressure of the tax competition. Further reduction of the personal income tax rate to accompany a further reduction of the corporation income tax rate is unlikely. This dilemma results in a new argument for the old demand for a neutral general business tax. Such a business tax would mean a significant gain of flexibility, because a low business tax could not longer be accused to discriminate against partnership and sole proprietors. However, the gap between tax rates would be just shifted to the borderline between business and labour income if not at the same the whole income tax rationale would be changed to a consumption-based understanding of the ability-to-pay-principle. That is at least what the advocates of a consumption-based income tax say.

German constitutional law as well limits the possibility to enter unfair tax competition. Measures of unfair tax competition excluding nationals could conflict as “reverse discrimination” with the principle right of equal treatment. According to Art. 3, para. 1 of the German constitution the exclusion of resident taxpayers from a favourable rule only applicable to non-resident taxpayers must be justified. As so far the issue whether reverse discrimination violates the equal protection clause of German constitutional law is an item of lively discussion in legal science but not decided yet by the German Constitutional Court. However, even if the non-discrimination clause would be applied the unequal treatment might be justified by good reasons of economic policy.

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Hubert Weis, Reverse discrimination between constitutional and European law (Inländerdiskriminierung zwischen Gemeinschaftsrecht und nationalem Verfassungsrecht), Neue Juristische Wochenschrift 1983, pp. 2721; Ulrich Fastenrath, Reverse Discrimination (Inländerdiskriminierung), Juristenzeitung 1987, p. 170; Doris König, The problem of reverse discrimination (Das Problem der Inländerdiskriminierung), Archiv des öffentlichen Rechts 118 (1993), p. 591; Sabine Wesser, Restrictions to reverse discrimination (Grenzen zulässiger Inländerdiskriminierung), Bonn 1995; Christoph Hammerl, Reverse discrimination (Inländerdiskriminierung), Berlin 1997.
3. Single measures

a. Measures considered as harmful by the Primarolo Group

Only one feature of the German tax law, the application of the cost-plus-method with a mark-up rate of 5-10 percent to Control and Coordination Offices\(^\text{43}\), was listed by the Primarolo Group as potentially harmful.

b. Tax rates

As already described, due to the pressure of international tax competition Germany lowered its general corporate tax rate within 10 years from 56 percent to 25 percent since 2001\(^\text{44}\).

German federal tax law provides neither in the corporation income tax nor in the personal income tax preferential tax rates. Tax rate differentials can occur from the local business tax (Gewerbesteuer). Tax competition among the German municipalities encouraged some small and rural local authorities to lower the tax rate of the local business tax substantially, in some cases even to zero. However, these tax rate incentives apply equally to domestic and foreign investment.

c. Tax accounting

Due to the reunification, German tax law was interspersed with preferential provisions for investment in East Germany. Those indirect subsidies were aimed to draw foreign capital to Germany and therefore can be considered as an appearance of tax competition as well. However, most of these measures were notified by the Commission under Art. 87 of the EC-Treaty. But even tax expenditure not notified by the Commission\(^\text{45}\) can hardly be considered as unfair tax competition, because, first of all, they apply to resident taxpayers as well. And secondly, they were not mainly designed to distract capital from other countries but to speed up the economy in Eastern Germany getting past the economic problems of the socialistic era. Moreover, 12 years after the reunification most of the tax incentives in favour of investments in Eastern Germany are abolished.

\(^{43}\) Administrative order from August 24, 1984 IV C V – S 1300 – 244/84, Bundessteuerblatt I 1984, p. 458; now No. 4.4 of the Permanent Establishment Circular, from December 24, 1999, Bundessteuerblatt I 1999, p. 1076.


\(^{45}\) See for example sec. 6b EStG (Personal Income Tax Act), which in general allows a carry forward of hidden reserves. In financial years 1996, 1997 and 1998, the concession was broadened for reinvestments in Eastern Germany. The European Court of Justice considered this tax expenditure as incompatible with the common market pursuant to Article 92(1) of the EC Treaty (ECJ 156/98, see note 6).
A very significant outcome of tax competition is the taxation of shipping enterprises not by income but by tonnage invented in 1998 as direct answer to similar tax privileges in other European countries. However, since Sec 5a EStG (Personal Income Tax Act) applies only to German-flagged ships registered in the German ship register it might be discriminatory, but cannot be considered as unfair tax competition. Actually sec. 5a EStG has to be understood as an endeavour to protect the national tax base from (unfair) tax competition of other Member States by granting the same privileges to prevent national enterprises from settling abroad.

d. Holding schemes (participation exemption)

Under the new corporation income tax system dividends received by a domestic corporation or a permanent establishment of a foreign corporation are fully tax exempt (sec. 8b (1) KStG). According to sec. 8b (2) KStG the participation exemption is applicable also to income from the disposal of shares in another corporation. Before the tax reform 2000 sec. 8b (2) KStG, introduced by the Standortsicherungsgesetz of 1994, used to exempt capital gains only derived from shares in non-resident companies, whilst capital gains from shares in domestic companies were fully taxable. Since January 1, 2002 the capital gains privilege applies to capital gains from the disposal of shares in domestic companies, too. The dividend and capital gains exemption applies no matter where the affiliated corporation is located and without any minimum-interest requirement.

The rationale of sec. 8b (2) KStG changed. The tax exemption became part of the corporation income tax system with the function to avoid economic double taxation. Therefore criticism of the new sec. 8b KStG by some Member States, who argued, Germany would violate the stand-still-agreement of the Code of Conduct and who brought the Commission to ask the Primarolo Group for further examination in my opinion is not justified. The dividend and capital gain exemption of the new corporation tax system may increase Germany’s attractiveness as a holding location. Nevertheless, neither the new tax exemption for dividends nor the extended exemption for capital gains can be considered as preferential holding regimes. Also the Primarolo Group’s findings seem to indicate something

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46 See the legislative intent Proceedings of the German Federal Parliament (Bundestagsdrucksache) 13/10271 of 25.3.1998, p. 8: Germany wanted to follow up the trend of tonnage taxation in the Netherlands, Norway, Greace, Great Britain and Finland.

47 In its interplay with sec. 10 (5) Foreign Tax Act (see under III 2 a).

48 Reported by Ottmar Thömmes, Sec. 8b KStG and EC-Law (§ 8b KStG und EG-Recht), Der Betrieb 2001, pp. 775.

different\textsuperscript{50}, EC law, especially the Code of Conduct, cannot force Germany to deny this part of its general corporation income tax system to foreign dividends and capital gains, even if the foreign corporation is low-taxed\textsuperscript{51}. The Code of Conduct may – not legally binding – oblige member states to abstain from preferential rules to attract foreign capital and business, but it is open to discussion, if it obliges them to apply a CFC-legislation with the target to take away tax advantages granted by other Member States\textsuperscript{52}. Another question discussed later on is, if Germany, if not obliged to CFC-legislation, is at least allowed to deny the exemption by CFC-legislation as it does in particular cases under the German Foreign Tax Act (Außensteuergesetz).

Backside to the participation exemption capital losses and expenses related to participation income are non-deductible (see sec. 8b (3) KStG). In the case of resident recipients of dividend income expenses are attributed actually to the part of the overall income derived from shares. However, in case of dividends or capital gains from non-resident companies sec. 8b (5) KStG deems 5 percent of the gross income of the parent corporation as related to the tax exempt dividend income treated as non-deductible expenses. Usually sec. 8b (5) KStG is discussed only as a discriminatory rule, but can turn to a measure facilitating unfair tax competition, if expenses related to the tax exempt foreign dividends actually are higher than 5 percent. Whilst expenses related to dividends from domestic companies cannot be deducted to the actual amount, expenses above 5 percent of the dividend related to foreign dividends may well be deducted.

e. Double taxation relief of dividends

According to the new participation exemption of sec. 8b (1), (2) KStG international double taxation between affiliated companies is avoided without the restrictions provided for in the most double tax treaties. Dividends received by a German corporation or a permanent establishment are tax exempt no matter of which origin they are. But as already mentioned, the participation exemption is just the consequence from the new corporation income tax system. At least form the point of view of European Law, there was no alternative to a broad scope of sec. 8b KStG applying to foreign dividends and capital gains from foreign shares, too.

\textsuperscript{50}See the criticism by Ottmar Thömmes (see note Fehler! Textmarke nicht definiert.), Der Betrieb 2001, p. 775 (778). He argues, that the state of residence cannot be blamed of unfair tax competition, because of a lack of sufficient protection measures against unfair tax competition at least as long as the question, which measures of the source country is harmful, hasn’t been answered.

\textsuperscript{51}Ottmar Thömmes (see note Fehler! Textmarke nicht definiert.), Der Betrieb 2001, p. 775 (776).

\textsuperscript{52}Ottmar Thömmes, Remarks to Ritter from the European point of View (EG-rechtliche Anmerkungen zu Ritter, S. 430), Internationales Steuerrecht 2001, 441, 442; Ottmar Thömmes (see note Fehler! Textmarke nicht definiert.), Der Betrieb 2001, p. 775 (779).
f. Double taxation relief of other capital income

Although Germany has no strict banking secret, from the point of view of non-resident taxpayers considering the taxation of interest income Germany is a tax haven not lagging behind Luxembourg, Austria or Switzerland. The 30 percent withholding tax on interest paid by banks and on interest paid on certain bonds (so-called Zinsabschlagsteuer) is imposed only on payments to residents.

III. Measures against “unfair” competition in the domestic tax system

1. Discussion of a general strategy of the domestic law to tackle unfair tax competition

Since Germany’s strategy in the international tax competition is concentrated not on attracting foreign capital but on avoiding tax evasion there is quite an extensive discussion of possible measures to counteract unfair tax competition.

One possible bilateral approach to tackle unfair tax competition is to exert pressure on states offering tax incentives to foreign investors in the negotiation of double tax treaties, may be as an ultima ratio even to cancel double tax treaties. On the other hand, negotiation of double tax treaties is a wearisome procedure. Moreover, Germany did not conclude tax treaties with tax haven countries anyway.

Therefore it is widely accepted that Germany has to undertake unilateral measures against unfair tax competition. One of the elementary questions in this context is, whether Germany should continue its tradition of tax

Heinz-Jürgen Selling (see note 12), Internationales Steuerrecht 2000, p. 225 (226).


Berndt Runge (see note 23), p. 559 (577).


exemption as common method to avoid international double taxation or whether it should turn to the imputation method – in general or only for purposes of CFC-legislation. Up to now, in German literature, the exemption method has been favoured. Especially Klaus Vogel, one of the most important writers in international tax law, and following his scholar Moris Lehner argued that the competition concept of the Treaty of Rome relies on the source principle and capital import neutrality. On the other hand, it has been stressed as well, that taxation of world-wide income in accordance to the ability-to-pay-principle is possible only by applying the imputation method. The imputation method might win new advocates since it is able to tackle tax competition efficiently to the extent earnings are not retained.

2. CFC-legislation

a. CFC-legislation in force

As a high-tax country measures against tax evasion have a long tradition in Germany. In order to defend its own high-tax policy, already in 1972 the Foreign Tax Act (Außensteuergesetz) was released implementing a departure tax and a CFC-regime.

When implemented the target of the Foreign Tax Act was to avoid abusive strategies of single taxpayers deterring them from moving to tax havens or using non-resident corporations to shelter income from the higher German tax. Today, conception and general intention of the Foreign Tax Act is no longer clear. The Foreign Tax Act has been subject to two major and contrary amendments in the last two year. With the first amendment by the Tax Reduction Act 2000, the legislator tried to establish the Foreign Tax Act as a tool to accomplish a sufficient tax burden on corporate level, which he considered as a precondition for applying the new corporation income tax system. But this change of conception has been at least partly rescinded by

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58 See the proposal by the Land Baden-Württemberg, Bundesratsdrucksache 12/98; also Heinz-Jürgen Selling (see note 12), Internationales Steuerrecht 2000, p. 225 (230); discussed by Gero Burwitz, The Draft for a Reform of the Foreign Tax Act (Der Entwurf eines Gesetzes zur Änderung des Austeuergesetzes und anderer gesetze), Finanzrundschau 1998, p. 299-304.


62 Heinz-Jürgen Selling (see note 12), Internationales Steuerrecht 2000, p. 225 (230); Berndt Runge (see note 23), p. 559 (578)
the Act of Further Development of Business Taxation, released at 28\textsuperscript{th} of December 2001. In the latest amendment the legislator mainly turned back to the former idea of preventing domestic taxpayers from tax evasion. Besides that he continued broadening the concept of (abusive) tax evasion as he did already several times in the past.

The momentary concept, laid down in sec. 7 et seq. Foreign tax Act, can be roughly described as follows: as an exemption of the general rule, that tax law respects corporations as separate entities, under German CFC-legislation the foreign corporation’s income is included in the tax basis of the German shareholder no matter if it is retained or distributed (so-called Hinzurechnungsbesteuerung). Application of the inclusion of foreign retained income requires the foreign corporation generating so-called passive income and being controlled by domestic shareholders, which means that more than 50 percent of the shares are owned by German tax residents\textsuperscript{63}. The taxation is restricted to low-taxed passive income\textsuperscript{64}. The lower rate threshold used to be 30 percent. But with Germany lowering its own corporation income tax rate to 25 percent the threshold was adapted and lowered to less than 25 percent, which means at first sight that sec. 8 (3) Foreign Tax Act considers every effective tax burden lower than the nominal German corporation income tax rate as a tax advantage justifying the application of anti-tax-avoidance rules. However, this impression changes considering the local business tax adding to the corporation income tax burden, so the total tax burden of domestic income ends up to around 37 percent.

Stricter measures apply to passive income from capital investment. It is apportioned to any German shareholder, even when the corporation is not controlled by German residents, if the shareholder owns at least 1 percent of the shares of the foreign corporation (sec. 7 [6] sentence 1 Foreign Tax Act)\textsuperscript{65}. Without any minimum interest requirement CFC-legislation applies, if all or almost all intermediary income of the foreign corporation consists of passive investment income (sec. 7 [6] sentence 2 Foreign Tax Act).

The inclusion amount is fully taxed in the hands of the German corporate or individual shareholder. Neither the participation exemption applies nor the shareholder relief system (half-income-method). Foreign taxes will be deductible (sec. 10 (1) Foreign Tax Act).

Even though, according to sec. 10 (5) Foreign Tax Act the inclusion amount may be tax exempt because of the application of a double tax treaty, which provides for an exemption of inter-company dividends. However, sec. 10 (5) Foreign Tax Act applies not to passive income from capital investment (see

\textsuperscript{63} Sec. 7 (1) Foreign Tax Act.

\textsuperscript{64} Sec. 8 Foreign Tax Act.

sec. 10 [6] Foreign Tax Act\textsuperscript{66}. Although not officially listed by the Primarolo Group, this provision giving priority to the double tax treaty over the CFC-regime was subject to criticism. Whilst the German Government took this criticism serious and plans to abolish sec. 10 (5) Foreign Tax Act\textsuperscript{67}, in German literature it was rejected for good reasons\textsuperscript{68}. First of all, if we do not consider Member States being obliged to tackle unfair tax competition unilaterally by employment of CFC-legislation, then it cannot be forbidden to restrict the application of the CFC-legislation under certain conditions. It would turn the facts upside down, if a Member State trying to defend its tax base from unfair tax competition by another State itself would be blamed to act unfair, if it loosens up its defence measures. Secondly, if at all it is not sec. 10 (5) Foreign Tax Act, which might be blamed unfair tax competition, but the double tax treaty, which does not contain an activity clause. The abolishment of sec. 10 (5) Foreign Tax Act would result in a treaty override\textsuperscript{69}. Anyway, the impact of sec. 10 (5) Foreign Tax Treaty should not be overestimated. At the moment only 11 German double tax treaties – most of them concluded with other Member States – provide for no or a more generous activity clause\textsuperscript{70}, so sec. 10 (5) Foreign Tax Act can become effective.

If in following years the retained income is actually distributed, it is tax exempt under the condition that the distribution happens within seven years (sec. 3 No. 41 ES\textsuperscript{T}G [Personal Income Tax Act]). Due to the described mechanism of the CFC-legislation dividends taxed under the Foreign Taxation Act will never be taxed in the same way neither as dividends of

\textsuperscript{66} This seems to be the reason, why the Primarolo Group – at least at the moment – did not classify sec. 8b KStG as potentially unfair as it did with holding provisions of other Member States, e.g. the Danish holding scheme, which applies to low-taxed foreign financial investments, too.

\textsuperscript{67} Governmental Report on further Development of Business Taxation (Bericht der Bundesregierung zur Fortentwicklung des Unternehmenssteuerrechts), Finanzrundschau 2001, supplement to issue 11, part D.IV.1.a.b.

\textsuperscript{68} Matthias Werra (see note 54), Internationales Steuerrecht 2001, p. 438 et seq.; Ottmar Thömmes (see note Fehler! Textmarke nicht definiert.), Der Betrieb 2001, p. 775 (777); different Berndt Runge (see note 23), p. 559 (575).

\textsuperscript{69} Different Governmental Report on further Development of Business Taxation (Bericht der Bundesregierung zur Fortentwicklung des Unternehmenssteuerrechts), Finanzrundschau 2001, supplement to issue 11, part D.IV.1b. Sec. 20 (1) Foreign Tax Act says, that the provisions of the Foreign Tax Act have priority to the double tax conventions, which means a general treaty override, see hereto Roman Seer, Acceptance of treaty overrides, discussed on the example of the Switch-over-clause of sec. 20 Foreign Tax Act (Grenzen der Zulässigkeit eines treaty overridings am Beispiel der Switch-over Klausel des § 20 AStG), Internationales Steuerrecht 1997, p. 481 (part I), 520 (part II).

shareholders resident in the source country nor as regular dividend income of resident shareholders.

b. Proposals for a reform of CFC-legislation

The future of the Foreign Tax Act is insecure. The government announced a further revision. Moreover, further changes may be pushed by the Federal Tax Court considering parts of the Foreign Tax Act as incompatible with the Common Market.

The problem with CFC-legislation employed against unfair tax competition is, that it may be object to the accusation of discrimination at the same time. The single tax payer cannot be made responsible for the revenue erosion by tax competition, but the involved countries. The question then is, whether the target to prevent taxpayers from taking advantage of favourable measures offered by other Member States justifies the application of measures of the domestic law, which limit the market freedoms, or if the Member States have to take action on the Commission level. So far no case law exists dealing with the question whether CFC-legislation contravenes the treaty freedoms, especially the right of free establishment. Probably this question cannot be answered by a general conclusion, but has to be analysed in a way differentiating between purely tax-driven investments, which might already not fall within the scope of the treaty freedoms, and activities undertaken in a foreign member state for good economic reasons.

In the Report of Further Development of Business Taxation the German government considers to broaden the concept of CFC-legislation specially by giving up or at least revising the distinction between active and passive income, because the Code of Conduct is not limited to passive income. A draft of a reform bill has not been submitted yet, but is expected for the next legislative session.

The arising questions, most of them not yet discussed thoroughly and far from being answered, can be addressed as follows:

71 See Governmental Report on further Development of Business Taxation (Bericht der Bundesregierung zur Fortentwicklung des Unternehmenssteuerrechts), Finanzrundschau 2001, supplement to issue 11, part D.
72 See Wolfgang Schön, CFC-legislation and European Law (Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht), Der Betrieb 2001, 940 (941); Thomas Menck, The (un)concealed crisis of Foreign Tax Law (Die [un]verboregen Krise des Außensteuerrechts), Internationales Steuerrecht 2001, 279, who argues, that the Foreign Tax Act can not be considered as violation the EC-Treaty as far as its object is to tackle harmful tax competition.
73 Edwin van den Bruggen, Intertax 2001, pp. 115 (137).
74 See Manfred Mössner, Internationales Steuerrecht, issue 14/2001, p. II.
75 Bejaht von Franz Wassermeyer (see note 54), Internationales Steuerrecht 2001, p. 113 (114).
[1] Is unfair tax competition just a justification for CFC-legislation or does the EC-treaty oblige Member States to tackle unfair tax competition within the European Union by an effective CFC-legislation?\(^76\)

[2] Is the target to counteract unfair tax competition a sufficient justification of unequal treatment of foreign investments in potential conflict with the treaty freedoms? And if not, how would CFC-legislation have to be changed to efficiently tackle unfair tax competition on one hand, and to be compatible with EC-Law on the other hand? One of the underlying questions is, whether passive investment, undertaken just for tax purposes, can claim the treaty freedoms.\(^77\)

[3] Shall we keep the distinction between passive and active income? This distinction might be consequential from the point of view to deter the single taxpayer from an abusive shift of tax basis, whilst still taking advantage of the domestic infrastructure. On the other hand, measures of unfair tax competition do not necessarily privilege only passive investment.

[4] If we agree, that at least in the European Union application of CFC-legislation is not justified in cases, when lower taxation is the outcome of fair tax competition,\(^78\) how can CFC-legislation be designed, that it will only cover unfair tax competition? The threshold of a low effective tax rate, as provided for by sec. 8 (3) Foreign Tax Act, does not distinguish between the reason for the low tax burden. It might be quite difficult to design CFC-legislation in a way allowing a decisive distinction between low taxation from fair and from unfair tax competition, since neither an exact definition of tax competition nor of unfair tax competition does exist.

[5] If an investment abroad enjoys preferential treatment only granted to foreigners, in accordance to the concept of the treaty freedoms what should be the benchmark for additional taxation by CFC-legislation? The regular tax level in the source country or in the investors home country? At present taxation under the Foreign Tax Act in many cases results in a tax burden much higher than for comparable domestic investments,\(^79\) a result definitely not in line with the EC-Treaty because it is not necessary to tackle unfair tax competition.

\(^{76}\) So Berndt Runge (see note 23), p. 559 (563)
\(^{77}\) See Wolfgang Schön, Der Betrieb 2001, 940 (942) with reference of the case law by the European Court of Justice.
\(^{79}\) See Birgit Hadenfeldt, CFC-legislation according to the Foreign Tax Act applied to income from German sources (Die Hinzurechnungsbesteuerung nach dem Außensteuergesetz von Einkünften aus deutschen Quellen), Baden-Baden 2001.
[6] And finally, do we need two different regimes of CFC-legislation? One applicable to EC-cases designed in accordance to the anti-discrimination clauses of the EC-treaty, and one to investments in third countries?

3. **Anti-avoidance rules and German double tax conventions**

The more recently concluded German double tax treaties usually contain activity clauses, restricting tax exemption of income from permanent establishments and inter-company dividends by a reservation clause for active income. Besides that, beneficiary clauses limit reduction of withholding taxes on dividends, interest or royalties to the beneficial owners. Some double tax treaties comprise also switch over-clauses, enabling the treaty partners to switch from the exemption to the imputation method to avoid white income or treaty shopping.

Besides that, sec. 50d (1a) EStG unilaterally denies tax relief of the German transformation of the Parent-Subsidiary-Directive or of double tax treaties to foreign entities, if their owners would not be entitled to the tax exemption, if they received the income directly. Further requirement is, that there is no good economic reason for the involvement of the corporation and the foreign entity has no own economic activities. Sec. 50d (1a) EStG aims to counteract directive- and treaty-shopping in general and supplements special provisions in double tax treaties.

4. **General anti-avoidance rule**

Sec. 42 AO (General Tax Act – Abgabenordnung) provides for a general anti-avoidance rule. The provision is directed against an abuse of law. If there are no economic reasons at all for the settlement of a foreign corporation and if it has no function other than sheltering income from the German taxation, not sec. 7 et seq. Foreign Tax Act applies, but sec. 42 AO.

In the past it has been subject to intense discussion whether sec. 42 AO applies to International Financial Services Centres (IFC) located in the Dublin Docks, and more over, if EC Law restricts the application of the German general anti-avoidance rule. The topic is closely related to the

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83 See *Stephan Eilers*, Restrictions to the application of sec. 42 General Tax Code by EC-Law (Gemeinschaftsrechtliche Anwendungsrestriktionen für § 42 AO), Der
question, what kind of means Member States are allowed to apply to counteract beggar-my-neighbour policies. In this context one issue is the relationship between the general anti-avoidance rule and the specific anti-avoidance rules of the Foreign Tax Act. Whilst the German CFC-legislation does not neglect the foreign corporation, but deems its income as distributed in the moment it is earned by the foreign corporation, due to sec. 42 AO the taxpayer is treated as if he would have earned the income directly. The Federal Fiscal Court (Bundesfinanzhof) said that sec. 42 AO because of its further reaching legal consequences supersedes the CFC-legislation, but has to be interpreted in the light of the anti-deferral-provisions of the Foreign Tax Act. Without additional circumstances a tax construction, which falls within the scope of the CFC-legislation, can not be considered as abusive in terms of sec. 42 AO. In reaction to this judgment the German tax legislator added a new and highly discussed sub-section to sec. 42 AO, which is supposed to guarantee a broader application.

Not only the relation of the general anti-avoidance-rules to the CFC-legislation, but also to Art. 87 of the EC Treaty has been questioned. Some argue that application of sec. 42 AO to measures notified by the Commission as compatible with the common market would interfere with the decision of the Commission and be in conflict with Art. 10 EC Treaty.

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84 Bundesfinanzhof, January 19, 2000, Bundessteuerblatt part II 2001 p. 222, also available at www.bundesfinanzhof.de.
Others say, that sec. 42 AO does not conflict with the freedom of establishment, because the freedoms of Art. 43 and 48 EC Treaty are granted only under reservation of abusive behaviour and do not protect purely tax-driven investments\(^87\). On the other hand, if a foreign tax measure violates Art. 87 of the EC-Treaty or has to be considered as unfair tax competition according to the Code of Conduct the application of sec. 42 AO is in particular justified and welcomed\(^88\).

5. **Restrictions of deduction of payments to tax-haven-entities**

There exists no material restriction of the deduction of payments to tax-haven-entities. However, sec. 16 Foreign Tax Act imposes a reversal of the onus of proof in cases of payments, made in a business relation with companies or individuals abroad\(^89\), that are not or not significantly taxed. The payment may be deducted only if all relations, direct and indirect, between the taxpayer and the non-resident recipient are disclosed. The aim of the provision is to prevent from conduit arrangements and enables the tax authorities to ensure the arm’s-length-principle, laid down as a general rule applicable to all international business relations in sec. 1 Foreign Tax Act\(^90\). If the circumstances of a payment are disclosed and the remuneration is adequate, no further restrictions apply no matter if the recipient of the payment is a tax-haven-entity or not.

6. **Departure taxation**

Sec. 2 et seq. of the Foreign Tax Act aim to prevent natural persons from setting up residence in low-tax jurisdictions. These provisions preserve a special tax regime for German citizens moving to a tax haven country, while still having substantial economic interest in Germany. In this case limited tax liability will be substantially extended for a period of 10 years following the move.

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1997, p. 486 (489); different *Horst-Dieter Höppner*, German anti-avoidance provisions and EC-law (Deutsche steuerliche Mißbrauchsvorschriften und das Gemeinschaftsrecht) in Rädler FS, p. 305 (314-317).

\(^{87}\) *Lucas Wartenburger* (see note 2), Internationales Steuerrecht 2001, p 397 (400); *Horst-Dieter Höppner* (see note 86), p. 305 (322).

\(^{88}\) *Uwe Paschen* (see note 83), p. 220.

\(^{89}\) Sec. 160 General Tax Code (Abgabenordnung) obliges the taxpayer to disclose the recipient in general, but does not apply to payments to non-residents.

\(^{90}\) For general restriction of the deduction of payments to tax haven see *Berndt Runge* (see note 23), p. 559 (576/77).
7. **Other**

In general sec. 1 Foreign Tax Act counteracts the shift of income due to cross-border transactions by application of the dealing-at-arm’s-length-principle. According to this provision the income of a German party to a cross-border transaction with a related party will be increased, if the parties have agreed to prices which unrelated third parties in the same situation would not have agreed on.

Sec. 8a KStG provides a special rule for thin capitalisation, which also applies only to cross-border corporations. Under sec. 8a KStG interest payments to non-resident shareholders are deemed as dividends, if the corporation is mainly debt financed. The provision contains several save haven. The ratio between permissible debt and equity in general used to be 3 (debt) : 1 (equity) and 9 : 1 in case of a holding corporation, but was significantly reduced in the latest business tax reform of 2000 to 1.5 : 1 and 3 : 1 with effect from January 1, 2001.

Sec. 8a KStG may be justified as a special provision to deter taxpayers from shifting tax base by debt instead of equity financing to low-tax jurisdictions. However, since sec. 8a KStG contravenes excessive debt financing without respect of the tax level in the shareholders residence country, it is not specifically designed to counteract unfair tax competition. Moreover in the year 2000, the Tax Court of Münster requested the European Court of Justice to give a ruling on the question, whether sec. 8a KStG is violating EU non-discrimination provisions.

8. **Conclusion**

Germany employs a lot of provisions to shelter its tax base. None of them is explicitly designed to tackle unfair tax competition. Some of them are directed against the shift of tax base to low-tax jurisdictions, some of them are directed just against the shift of income to foreign tax jurisdictions in general, no matter if the income abroad will be low- or regular-taxed.

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91 Gerken/Märkt/Schick (see note 4), p. 126.
92 Berndt Runge (see note 23), p. 559 (576).
93 Fiscal Court Münster from January 24, 2000, Entscheidungen der Finanzgerichte 2000, p. 397.