NATIONAL REPORT GERMANY

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1. General aspects of the domestic tax situation

1.1. The notion of "tax competition" in domestic legal and economic science

1.1.1. Shortfall of well-founded legal analysis

For a long time Germany ignored the emergence of international tax competition, even when neighbouring states were lowering their corporate income tax rates.[1]. Nevertheless, Germany's position has now changed. Beginning in the 1990s tax competition developed as an important factor in German tax politics and this has had some significant impact on recent tax reforms.

Scientific analysis seems to fall short of the political development when the two are compared. Precise definitions of tax competition are missing,[2] as is a more detailed evaluation of the circumstances under which tax competition has to be considered as unfair, and proposals on how to deal with – fair and unfair – tax competition. With some exceptions,[3] this shortfall in particular applies to legal literature. Tax competition is left to economic and political science.[4] One reason might be that the topic involves many

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1. See for the development of corporate income tax rates in OECD countries *Johanna Hey*, in: Hermann/Heuer/Raupach, Commentary on Personal and Corporation Income Tax, Introduction KStG (September 1999), paragraph 448.

2. *Lucas Wartenburger*, "The Impact of the Community Law on Tax Havens within the European Union", Internationales Steuerrecht 2001, p. 397.

3. Namely, a lecture of *Wolfgang Schön* held in front of the German Tax Law Association; see proceedings of the *Deutsche Steuerjuristische Gesellschaft* (DStJG) 23 (2000), p. 191, published also in English in EC Tax Review 2000, p. 90; further *Moris Lehner*, "Tax Competition in the Mirror of European and American Tax Politics", *Steuer und Wirtschaft* 1998, p. 159.

4. For example *Wolfgang Eggert*, "National Taxation and Economic Integration" (Tübingen, 2002); *Gerker/Märkt/Schick*, "International Tax Competition" (Tübingen, 2000); *Hans-Werner Sinn*, "Tax Harmonization and Tax Competition in Europe", European Economic Review, vol. 34 (1990), p. 489; *Volker Arnold*, "Equity and international tax competition", in: Schriften des Vereins für Socialpolitik, vol. 228/V, Wirtschaftsethische Perspektiven V (Berlin, 2000), p. 93; *Ulrich Schreiber*, "International mobility of tax basis – Is National Tax Policy Still Possible?",

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

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

In the existing German literature on the subject attitudes towards tax competition diverge widely. However, there is a strong consensus about the necessity to combat unfair tax competition. Therefore, the practice of the Commission and the European Court of Justice[5] in applying the State aid provisions to tax expenditures[6] is widely accepted in German fiscal literature. Even authors indifferent to the general effects of tax competition tend to agree with this approach.[7]

Nonetheless, the question of if, and under which circumstances, tax competition is harmful or unfair and of 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, claiming that it forces politicians to lower tax rates and to curb the leviathan state. Representatives of the economic sector especially never tire of insisting upon 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

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in: Schriften des Vereins für Socialpolitik, vol. 256, Jahrestagung 1996: Steuersysteme der Zukunft (Berlin, 1998), p. 29; *Bernd Genser*, "The Problem of Tax Harmonisation from the Point of View of Allocation", in: Gahlen (ed.), Europäische Integrationsprobleme aus wirtschaftswissenschaftlicher Sicht (Tübingen, 1994), p. 65; *Otto H. Jacobs*, "International Business Taxation", 4th ed. (München, 1999), p. 233-239.

5. ECJ, 19 September 2000, Case C-156/98, *Federal Republic of Germany v. Commission* [2000] ECR I-6857, concerning Section 6b and Section 52, paragraph 8 of the Personal Income Tax Act (EStG). .

6. An overview on this practice is given by *Frans Vanistendael*, "Fiscal Support Measures and Harmful Tax Competition", EC Tax Review 2000, p. 152 at 153-155.

7. *Volkmar Götz*, "Tax Incentives Subject to the European State Aid Control", in: States and Taxes (Staaten und Steuern), Essays in honour of Klaus Vogel (Heidelberg, 2000), p. 579 at 581.

8. E.g., *Wolfgang Ritter*, "Perspectives for Further Development of German International Taxation", Internationales Steuerrecht 2001, p. 430.

the impact of tax competition might interfere with the structure of the national tax system.

On the opposing side, other authors fear a loss of fiscal autonomy at the level of the national legislator and therefore emphasize how tax competition jeopardizes the national economy, tax revenue and the legal structure of the tax system.[9] 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 has a direct correlation with the quality of other public goods like infrastructure, internal security, education and social rights. The former judge of the German Constitutional Court (*Bundesverfassungsgericht*) Professor Paul Kirchhof takes an especially critical position towards tax competition. Kirchhof has called for a legal solution to the problem. The European Union's adoption of a Charter of Fundamental Rights should be able to solve the problem of tax competition whilst protecting the principles of freedom and equality in all Member States.

A third group – to which Professor Joachim Lang from Cologne University belongs[10] – views international tax competition as an irrevocable fact, which nevertheless should not just be taken as given. Intelligent solutions at the level of domestic law are required, to prevent investors from investing abroad through the attractiveness of the domestic tax system rather than through disincentives. In this group's opinion the answer to international tax competition would be a shift to consumption-based income taxation.[11] 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 postponement

9. E.g. *Paul Kirchhof*, in DStJG-Sonderband Unternehmenssteuerreform (2001), p. 150; *Paul Kirchhof*, "The constitutional point of view", in: Kirchhof/Neumann (ed.), Freiheit, Gleichheit, Effizienz, Bad Homburg 2001, p. 13 at 17; Scientific Advisory Board of the German Ministry of Finance, Study on the Reform of International Capital Income Taxation, Schriftenreihe des Bundesfinanzministeriums, vol. 65 (Bonn, 1999), p. 31 et seq.

10. *Joachim Lang* in Tipke/Lang, Tax Law, 17th edition (Cologne, 2002), § 8 Rz. 75; *Joachim Lang*, "Principles and Systems of the Taxation of Income", proceedings of the Deutsche Steuerjuristische Gesellschaft 24 (2001), p. 49 at 68-72; *Joachim Lang*, "Taxation in Europe between Harmonising and Differentiating", Besteuerung in Europa zwischen Harmonisierung und Differenzierung, in: Essays in honour of Hans Flick (Köln, 1997), p. 873 at 892.

11. *Joachim Lang*, Proceedings of the Deutsche Steuerjuristische Gesellschaft 24 (2001), note 10, p. 49 at 73; *Joachim Lang* in Tipke/Lang, note 10, § 8 Rz. 75.

of the taxable event until capital is withdrawn and consumed. Advocates of consumption-based income taxation argue that this model would be a way to participate in international tax competition without violating the fundamental constitutional right of equality.[12] Many economists share the opinion of this third group.[13]

1.2. The political attitude of the government towards tax competition

As indicated above, the political attitude towards tax competition changed a lot over the last decade. Until the mid-1990s Germany stuck to a high tax policy. The unquestioned dogma that the corporate tax rate had to equal the top rate of personal income tax held Germany back from following the worldwide trend towards reducing corporation income tax rates. The first humble beginnings in taking up the challenge were made in 1994 with the *Standortsicherungsgesetz* (Act to sustain Germany's attractiveness as business location).[14] However, it was only very recently that the German tax legislator actually acknowledged the inevitability of a competitive tax system, with the introduction of the Tax Reduction Act (*Steuersenkungsgesetz*),[15] which has been in force since 1 January 2001. In the meanwhile, it seems that the legislator has tried to make up for former omissions. The most recent major tax reforms were principally devoted to enhancing the attractiveness of Germany for foreign investors[16] – at least in terms of legislative intent.[17]

The role Germany wants to play on the European and supranational level is ambivalent.[18] On the one hand, Germany is definitely not one of the most fervent advocates of harmonization proposals. Its reaction to the Ruding Report was quite restrained. Germany is not willing to give up its

12. *Joachim Lang* in Tipke/Lang, note 10, § 8 Rz. 78 f.; similar *Heinz-Jürgen Selling*, "Germany's Role in International Tax Competition", Internationales Steuerrecht 2000, p. 225 at 226.
13. For example *Volker Arnold*, note 4, p. 93 at 111-112.
14. Federal Law Gazette (Bundesgesetzblatt) 1993, Part I, p. 1569.
15. Federal Law Gazette 2000, Part I, p. 1433.
16. *Heinz-Jürgen Selling*, note 12, p. 225 at 300; *Herzig/Dautzenberg*, "The German Tax Reform Since 1999 and its Effects on the Foreign Tax Act and International Tax Law", Der Betrieb 2000, p. 12.
17. Proceedings of the German Parliament (Bundestagsdrucksache) 14/2863, p. 92 et seq., at 120 et seq.
18. *Manfred Mössner*, Internationales Steuerrecht, issue 14/2001, editorial, p. II et seq.

autonomy in tax matters. On the other hand, the German government fears that tax dumping jeopardizes national tax revenue. Therefore, during the German presidency of the European Council in 1999 one of the major proposals put forward was targeted against unfair and harmful tax competition.[19] The German government attaches great importance to the Code of Conduct.[20] Notwithstanding 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 supports efforts to eliminate harmful tax competition based on both the Code of Conduct and on the State aid rules, although it favours the broader approach of the Code of Conduct, which might lead to more comprehensive and consistent solutions.[21]

Meanwhile, the German tax legislator has recognized that CFC legislation, in force since the early 1970s, is a suitable instrument not only to shelter own revenue from tax competition but also to take advantage of low taxes abroad. A very strict application of the legislation allows for treaty commitments given in the past to be overridden, even in cases that cannot be considered as an abuse by the single taxpayer.[22] This practice might end up in a reverse beggar-my-neighbour policy.

In summary, the strategy of the German government in dealing with tax competition can be characterized as follows: in principal, official bodies accept fair tax competition as a positive outcome of an open economy.[23] Unfair tax competition, however, is considered to be a 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

19. See Parliamentary Under-Minister in the German Ministry of Finance *Barbara Hendricks*, EC Tax Review 1999, Editorial, p. 96.
20. Governmental Report on Further Development of Business Taxation, 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.
22. See the criticism by *Endres/Thies*, Intertax 1998, p. 293 at 300.
23. See *Berndt Runge*, "Harmful Tax Competition in the European Union and OECD Countries", in: Tax Law and European Integration, Essays in honour of Albert Rädler (1999), p. 559, 563 and 567.

Treaty,[24] the government feels justified in counteracting tax competition[25] by the application and even the tightening of its CFC legislation.[26] At the same time the German government tries to bring its influence to bear in the European and OECD efforts to tackle harmful tax competition by political pressure. In addition to taking these defensive measures Germany is willing to play an active role in international tax competition by lowering its relevant taxes. However, this latter approach has limits, because Germany will never become a low-tax country.[27]

1.3. The distinction between "fair" and "unfair" tax competition

Until now very little effort has been made in German literature to scrutinize the European Union and OECD definitions 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 formation of concepts without clear-cut dividing lines. Therefore it is not possible to create a distinctive definition.[28]

In 1999, the Scientific Advisory Board of the German Ministry of Finance attempted to make a distinction between fair and unfair competition. The purpose of this distinction is to prevent distortions in the allocation of capital. Nevertheless, general tax cuts were, in principle, regarded as an outcome of fair tax competition,[29] even though they might distort the international allocation of capital. A measure will only be considered as unfair, if *in the first place* it aims to distort the allocation of capital and is part of a

24. See *Edwin van den Bruggen*, "State Responsibility under Customary International Law in Matters of Taxation and Tax Competition", Intertax 2001, p. 115 at 137, who emphasizes that the problem of unfair tax competition cannot 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 unrestricted fiscal sovereignty. So far state responsibility for tax competition is not a general principle of international law.

25. *Ulrich Wolff*, "Reflections of the Ministry of Finance on the Medium-term Development of the Foreign Tax Act", Internationales Steuerrecht 2001, p. 440.

26. Governmental Report on Further Development of Business Taxation, Finanzrundschau 2001, supplement to issue 11, p. 28.

27. *Berndt Runge*, note 23, p. 559 at 574.

28. Scientific Advisory Board of the German Ministry of Finance, note 9, p. 28 et seq.; *Lucas Wartenburger,* note 2, p. 397 at 397, 402.

29. Scientific Advisory Board of the German Ministry of Finance, note 9, p. 28.

beggar-my-neighbour policy instead of a general improvement of the domestic tax situation. It is unfair if it sets out to attract additional tax base from other Member States without negative effects on domestic tax revenue. Hence, the decisive criterion is the *intention of the legislator*, which has to be discovered by a list of indicatory features:

- 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 with the tax levied on domestic corporations; and
- a country allows tax-planning structures that are difficult for foreign fiscal authorities to discover, and makes open offers for international tax defraud.

Offshore clauses and ring-fencing features are important indicators that a measure is the product of unfair tax competition.

In the Scientific Advisory Board's opinion one of the major difficulties in defining unfair tax competition is that distortion often cannot be identified until the interaction of both tax systems – the tax system of the source country *and* of the investor's home country – is taken into consideration. The question of 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. Even deferral effects due to the use of a corporation in the source country might be minimized by 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,[30] 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. According to these authors, prohibited support measures are the outcome of unfair tax competition and therefore usually meet the requirements of unfair tax competition. This means that the Commission already has an effective tool against unfair tax competition, via the application of Article 87 of the EC Treaty.

Although never applied to a tax provision to date, Articles 96 and 97 of the EC Treaty were also mentioned in the German discussion. Application of

30. See especially *Koschyk*, "Tax Incentives as State Aid Measures According to Art. 92 of the Treaty of Rome" (Baden-Baden, 1999), p. 190 et seq.; *Norbert Dautzenberg*, "European Commission Rejects Tax Incentives as Prohibited State Aid Measures", Steuern und Bilanzen 2001, p. 443.

these provisions could accomplish control in cases that cannot be regulated under the State aid provisions.[31] If a Member State grants general tax relief, as Ireland intends to do by lowering its general corporate income tax rate to 12.5%, 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.

1.4. Economic effects of tax competition in Germany

Tax competition in general changes the entire tax system by shifting the tax burden from mobile to immobile factors, and from capital to labour or consumption. In Germany the ratio of direct to indirect taxes has changed over the last 15 years.[32] 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 accelerate. Short-term public financial requirements – for instance expenses for internal security after the 11 September 2001 terrorist attacks – are already covered by increases in indirect taxes,[33] which keep the direct tax rates low.

Furthermore, statistics show that Germany, in terms of its balance of direct investment, remains significantly behind the European average.[34] It has been argued that the reason why foreign capital avoids Germany and domestic capital goes abroad is because neighbouring European states offer a more attractive tax environment.[35] However, in the author's opinion it is hard to attribute such unilateral movements to tax competition. Proof may arise if the situation changes with the tax reform 2000.

31. *Volkmar Götz*, note 7, p. 579 at 588, 589.
32. In 1986 the ratio was 60% direct taxes to 40% indirect taxes. In 2001 it is 49% direct taxes and 51% indirect taxes. For statistics see www.bundesfinanzmini sterium.de/Steuerschaetzung-aufkommen-.457.2326/.htm.
33. In this example the taxes on tobacco and on insurances.
34. See Statistical Yearbook 2001 (Wiesbaden, 2001), p. 180, 185: 1992.
35. E.g. *Helmut Becker*, "Business Taxation as Problem of Location from the German Perspective", Proceedings of the Deutsche Steuerjuristische Gesellschaft 17 (1994), p. 195 at 217-219.

2. Elements of tax competition in the domestic tax system

2.1. Overview

In the past, whenever the discussion reached the subject of Germany's high nominal tax rates, reference was made to the generous deductions in tax base. Therefore, it was argued, 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 worldwide trend of base broadening, which finances lower tax rates.[36]

The Tax Relief Act 1999/2000/2002 (*Steuerentlastungsgesetz* 1999/2000/2002) of 24 March 1999 aimed to introduce a determination of taxable income that was closer to international standards. This base broadening paved the way for a fundamental corporate tax reform and a substantial cut in tax rates by the Tax Reduction Act (*Steuersenkungsgesetz*) of 23 October 2000. The Tax Reduction Act changed the corporation income tax system from the former full imputation system to a shareholder relief system with a 50% personal income tax exemption for dividend income and capital gains from the disposal of shares (so-called half-income system). With the base broadening effected by the Tax Relief Act 1999/2000/2002 the change of the corporation income tax system facilitated the financing of a significant reduction in the corporate income tax rate, from 40% in the financial years 1999 and 2000 to 25% from 2001 onwards. Personal tax rates have been lowered as well. The highest bracket will drop in three successive steps from 48.5% to 42% 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.

36. Especially the Tax Reduction Act 2000, Federal Law Gazette 2000, Part 1, p. 1433, is recognized as a result of tax competition; see *Jakobs/Spengel/Vituschek*, "Recht der Internationalen Wirtschaft 2000", p. 653; *Florian Kutt*, "Taxation of Cross-border Companies in German Coporation Income Tax Law" (Regensburg, 2001), p. 162; *Arndt Raupach*, "Perspectives for Germany as Business Location", Steuer und Wirtschaft 2000, p. 341 at 346; *Heinz-Jürgen Selling*, note 12, p. 225.

These briefly 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.

2.2. 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[37] indicates that even after recent tax cuts, Germany still ranks among the Member States with the highest taxes on business income. When the local business tax (*Gewerbesteuer*)[38] and the solidarity surcharge (*Solidaritätszuschlag*) are added to the corporation income tax rate, investments in Germany made through a corporation are still taxed at rates of between 38% and 40%, as long as the income is retained, and up to around 55% if distributed to resident shareholders in the highest bracket of personal income tax. So it is very likely that tax reform 2000 does not represent final tax reductions. But even if international tax competition calls for further reductions, the structure of German business taxation limits the margin within which the legislator can act. German business tax law is characterized by the dualism of corporate and personal income tax, as are the tax systems of most OECD countries, but with the peculiarity that 85% of the German enterprises are either sole proprietorships 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% in the year 2005 is probably 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 supporting the old demand for a neutral general business tax. Such a business tax would mean increased flexibility, because a low business tax could no longer be accused of discrimination against partnerships and sole proprietors.

Constitutional law also limits the scope for Germany to enter into unfair tax competition. Measures of unfair tax competition excluding nationals could conflict, as "reverse discrimination", with the principle of equal

37. See COM (2001)582 final, p. 77 et seq. and 90 et seq.
38. The effective tax rate of the local business tax varies, in average amounting to around 12%.

treatment. According to Article 3, paragraph 1 of the German Constitution the exclusion of resident taxpayers from a favourable rule only applicable to non-resident taxpayers must be justified. To date the issue of whether reverse discrimination violates the equal protection clause of German constitutional law has been an item of lively discussion in legal science[39] but has not yet been decided upon by the German Constitutional Court. However, even if the non-discrimination clause was applied the unequal treatment might be justified by good reasons of economic policy.

2.3. Single measures

2.3.1. Measures considered as harmful by the Primarolo Group

Only one feature of German tax law, the application of the cost-plus method with a mark-up rate of 5%-10% to Control and Coordination Offices,[40] was listed by the Primarolo Group as potentially harmful.

2.3.2. Tax rates

As described above,[41] due to the pressure of international tax competition Germany lowered its general corporate tax rate within a ten-year period from 56% to 25% in 2001.[42]

German federal tax law does not provide preferential tax rates for either corporation or personal income tax. Tax rate differentials can occur as a result of the local business tax (*Gewerbesteuer*). Tax competition among the German municipalities encouraged some small and rural local authorities to lower the rate of the local business tax substantially, in some cases

39. *Hubert Weis*, "Reverse Discrimination between Constitiutional and European Law", Neue Juristische Wochenschrift 1983, p. 2721; *Ulrich Fastenrath*, "Reverse Discrimination", Juristenzeitung 1987, p. 170; *Doris König*, "The Problem of Reverse Discrimination", Archiv des öffentlichen Rechts 118 (1993), p. 591; *Sabine Wesser*, "Restrictions to reverse discrimination" (Bonn, 1995); *Christoph Hammerl*, "Reverse Discrimination" (Berlin, 1997).

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

41. See 2.1.

42. Fifty per cent in financial years 1990-1993, 45% in 1994-1998, 40% in 1999 and 2000.

even to zero. However, these tax rate incentives apply equally to domestic and foreign investment.

2.3.3. Tax accounting

In the aftermath of reunification, German tax law was interspersed with preferential provisions for investment in East Germany. Those indirect subsidies were designed to draw foreign capital to Germany and therefore can be viewed as tax competition measures. However, most of these measures were notified by the Commission under Article 87 of the EC Treaty. But even tax expenditure not notified by the Commission[43] can hardly be considered as unfair tax competition, because they apply to resident taxpayers as well. Secondly, they were not mainly designed to distract capital from other countries but to speed up East Germany's recovery from the economic problems of the socialist era. Moreover, 12 years after reunification most of the tax incentives in favour of investments in Eastern Germany have been abolished.

A significant outcome of tax competition is the taxation of shipping enterprises not by income but by tonnage, invented in 1998 as a direct answer to similar tax privileges in other European countries.[44] However, since Section 5a of the EStG (Personal Income Tax Act) applies only to German-flagged ships registered in the German shipping register it might be discriminatory, but cannot be considered as unfair tax competition. Actually, Section 5a of the 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.

43. See, for example, Section 6b of the 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, Case C-156/98, note 5).

44. See the legislative intent Proceedings of the German Federal Parliament (Bundestagsdrucksache) 13/10271 of 25 March1998, p. 8: Germany wanted to follow up the trend of tonnage taxation in the Netherlands, Norway, Greece, Great Britain and Finland.

2.3.4. 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 (Section 8b(1) of the KStG). According to Section 8b(2) of the KStG the participation exemption is also applicable to income from the disposal of shares in another corporation. Before the tax reform 2000, Section 8b(2) of the KStG, introduced by the *Standortsicherungsgesetz* of 1994, used to exempt only capital gains derived from shares in non-resident companies, whilst capital gains from shares in domestic companies were fully taxable. Since 1 January 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 regardless of where the affiliated corporation is located and without any minimum-interest requirement.

The rationale of Section 8b(2) of the KStG changed. The tax exemption became part of the corporation income tax system, with the purpose of preventing economic double taxation. Section 8b of the KStG[45] has been criticized by some Member States,[46] who argued that Germany would violate the standstill agreement of the Code of Conduct and on whose behalf the Commission asked the Primarolo Group to investigate further. In the author's opinion this criticism is not justified. The dividend and capital gain exemption of the new corporation tax system may increase Germany's attractiveness as a holding location.[47] 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 different.[48] EC law, especially the Code of Conduct, cannot force Germany to deny to foreign dividends and capital gains this part of its general corporation income tax system, even if the foreign corporation is low taxed.[49] The Code of Conduct may – in a non-legally binding way – oblige Member States to

45. In its interplay with Section 10(5) of the Foreign Tax Act (see 3.2.1.).
46. Reported by *Ottmar Thömmes*, "Sec. 8b KStG and EC-Law" (§ 8b KStG und EG-Recht), Der Betrieb 2001, p. 775.
47. *Krawitz/Büttgen*, "The Impact of the Business Tax Reform on Germany as Holding Location from the Point of View of a Foreign Investor", Internationales Steuerrecht 2001, p. 658 at 662.
48. See the criticism by *Ottmar Thömmes*, note 46, p. 775 at 778. He argues, that the state of residence cannot be blamed for unfair tax competition, because of a lack of sufficient protection measures against unfair tax competition – at least as long as the question of which measures of the source country are harmful has not been answered.
49. *Ottmar Thömmes*, note 46, p. 775 at 776.

abstain from preferential rules to attract foreign capital and business. However, it is questionable if it can oblige them to apply CFC legislation with the aim of denying tax advantages granted by other Member States.[50] Another question discussed later on is whether Germany, if not obliged to implement CFC legislation, is at least allowed to deny the CFC legislation exemption, as it does in particular cases under the German Foreign Tax Act (*Außensteuergesetz*).

It should be noted, however, that under the participation exemption capital losses and expenses related to participation income are non-deductible (see Section 8b(3) of the 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 the case of dividends or capital gains from non-resident companies Section 8b(5) of the KStG deems 5% of the gross income of the parent corporation to be related to the tax-exempt dividend income treated as non-deductible expenses.

2.3.5. Double taxation relief of dividends

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

2.3.6. Double taxation relief of other capital income

Although Germany has no strict bank secrecy, from the point of view of non-resident taxpayers considering the taxation of interest income, Germany as a tax haven does not lag behind Luxembourg, Austria or Switzerland.[51] The 30% withholding tax on interest paid by banks and on

50. *Ottmar Thömmes*, "Remarks to Ritter from the European Point of View" (EG-rechtliche Anmerkungen zu Ritter, S. 430), Internationales Steuerrecht 2001, p. 441 at 442; *Ottmar Thömmes*, note 46, p. 775 at 779.
51. *Heinz-Jürgen Selling*, note 12, p. 225 at 226.

interest paid on certain bonds (so-called *Zinsabschlagsteuer*) is imposed only on payments to residents.

3. Measures against "unfair" competition in the domestic tax system

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

Since Germany's strategy in the area of international tax competition concentrates not on attracting foreign capital but on avoiding tax evasion, there is quite an extensive discussion of possible measures to counteract unfair tax competition.[52]

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. As an ultimate resource double tax treaties may even be cancelled.[53] On the other hand, negotiation of double tax treaties is a wearisome procedure. Moreover, Germany has not in any case concluded tax treaties with tax haven countries.[54]

Therefore, it is widely accepted that Germany has to undertake unilateral measures against unfair tax competition.[55] One of the elementary questions raised in this context is whether Germany should maintain its traditional use of tax exemptions to avoid international double taxation or whether it should turn to the imputation method – in general or only for the purposes of CFC legislation.[56] Up to now, in German literature, the exemption

52. E.g. *Andreas Reuß*, "'Reformstau' in international tax law?", Internationales Steuerrecht 1997, p. 673; Governmental Report on further Development of Business Taxation, Finanzrundschau 2001, supplement to issue 11, part D; *Matthias Werra*, "The Necessity of a Reform of the Foreign Tax Act with Special Regard to the Code of Conduct", Internationales Steuerrecht 2001, p. 438; *Franz Wassermeyer*, "Further Development of the Taxation of International Relations", Internationales Steuerrecht 2001, p. 113.

53. *Berndt Runge*, note 23, p. 559 at 577.

54. See *Joachim Lang* in Tipke/Lang, note 10, § 8 paragraph 76.

55. *Joachim Lang* in Tipke/Lang, note 10 , § 8 paragraph 76; *Heinz-Jürgen Selling*, note 12, p. 225; *Gerd Morgenthaler*, "Tax Haven and German CFC-legislation", Internationales Steuerrecht 2000, p. 289 at 294, 295.

56. See the proposal by the Land Baden-Württemberg, Bundesratsdrucksache 12/98; also *Heinz-Jürgen Selling* note 12, p. 225 at 230; discussed by *Gero Burwitz*, "The Draft for a Reform of the Foreign Tax Act", Finanzrundschau 1998, p. 299-304.

method has been favoured. Klaus Vogel,[57] one of the most respected figures in international tax law, and fellow scholar Moris Lehner[58] have argued that the competition concept of the Treaty of Rome relies on the source principle and capital import neutrality[59]. But the imputation method might win new advocates since it is able to tackle tax competition efficiently, to the extent that earnings are not retained.[60]

3.2. CFC legislation

3.2.1. CFC legislation in force

As a high-tax country, measures against tax evasion have a long tradition in Germany. Already in 1972 the Foreign Tax Act (*Außensteuergesetz*) had implemented a departure tax and a CFC regime.

When implemented, the target of the Foreign Tax Act was to avoid abusive strategies of single taxpayers by deterring them from moving to tax havens or using non-resident corporations to shelter income from the heavier German tax burden. Today, the 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 years. With the first amendment, via the Tax Reduction Act 2000, the legislator tried to use the Foreign Tax Act as a tool to ensure a sufficient tax burden at the corporate level, which was considered to be a precondition for applying the new corporation income tax system. But this conception was at least partly rescinded by the Act of Further Development of Business Taxation, released on 28 December 2001. In the latest amendment the legislator reverted to the former idea of preventing domestic taxpayers from evading taxes, while continuing to broaden the concept of (abusive) tax evasion.

57. See *Klaus Vogel*, "Worldwide vs. Source Taxation of Income", Intertax 1988, p. 216 at 310 et seq.; "Taxation of Cross-Border Income, Harmonization and Tax Neutrality under European Community Law" (1994); see also *Gerd Morgenthaler*, note 55, p. 289 at 292, 293.

58. *Moris Lehner*, note 3, p. 159 at 169-173.

59. See *Moris Lehner*, note 3, p. 159 at 172-173; principally also *Norbert Dautzenberg*, "Double Taxation and the EC-Treaty: Imputation Method as Minimum Standard in the Common Market?", Der Betrieb 1994, p. 1542.

60. *Heinz-Jürgen Selling*, note 12, p. 225 at 230; *Berndt Runge*, note 23, p. 559 at 578.

The momentary concept, laid down in Sections 7 et seq. of the Foreign Tax Act, can be broadly described as follows: as an exception to 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, regardless of whether the income is retained or distributed (so-called *Hinzurechnungsbesteuerung*).

For the inclusion of foreign retained income to apply, the foreign corporation must generate so-called passive income and be controlled by domestic shareholders, which means that German residents own more than 50% of the shares.[61] The taxation is restricted to low-taxed passive income.[62] The lower rate threshold used to be 30%, but with Germany lowering its own corporation income tax rate to 25% the threshold was adapted and lowered to less than 25%. At first it would appear that Section 8(3) of the Foreign Tax Act views every effective tax burden lower than the nominal German corporation income tax rate as a tax advantage, justifying the application of anti-avoidance tax rules. However, when the local business tax is added to the corporation income tax burden the total tax burden on domestic income is approximately 37%.

Stricter measures apply to passive income from capital investment. It is apportioned to any German shareholder owning at least 1% of the shares of the foreign corporation (Section 7[6], sentence 1 of the Foreign Tax Act),[63] even when the corporation is not controlled by German residents. Without any minimum interest requirement CFC legislation applies if all or almost all intermediary income of the foreign corporation comprises passive investment income (Section 7[6], sentence 2 of the Foreign Tax Act).

The inclusion amount is fully taxed in the hands of the German corporate or individual shareholder. Neither the participation exemption nor the shareholder relief system (half-income method) applies. Foreign taxes will be deductible (Section 10(1) of the Foreign Tax Act). According to Section 10(5) of the 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 intercompany dividends. However, Section 10(5) of the Foreign Tax Act does not apply to passive income from capital investment

61. Section 7(1) of the Foreign Tax Act.
62. Section 8 of the Foreign Tax Act.
63. Since 1 January 2002, tightened by the Act of Further Development of Business Taxation, Federal Law Gazette Part I 2001, p. 3858. Before: At least 10%.

(see Section 10[6] of the Foreign Tax Act).[64] Although not officially listed by the Primarolo Group as a harmful measure, this provision giving priority to the double tax treaty over the CFC regime was subject to criticism. Whilst the German government took this criticism seriously and plans to abolish Section 10(5) of the Foreign Tax Act,[65] German literature on the subject has for good reasons rejected the criticism as unfounded.[66] First of all, if we do not consider that Member States are obliged to tackle unfair tax competition unilaterally, by employment of CFC legislation, then restrictions upon the application of the CFC legislation under certain conditions should not be forbidden. It would turn the facts upside down if a Member State, trying to defend its tax base from unfair tax competition by another state, would itself be blamed for acting unfairly in loosening its defence measures. Secondly, it is not Section 10(5) of the Foreign Tax Act that should be blamed for unfair tax competition, but eventually the double tax treaty, which does not contain an activity clause. The abolishment of Section 10(5) of the Foreign Tax Act would result in a treaty override.[67] In any case, the impact of Section 10(5) of the Foreign Tax Act should not be overestimated. At the moment only 11 German double tax treaties – most of them concluded with other Member States – do not have, or have a more generous, activity clause,[68] which renders Section 10(5) of the Foreign Tax Act effective.

If the retained income is actually distributed in the following years, it is tax exempt under the condition that the distribution happens within seven years (Section 3, No. 41 of the EStG (Personal Income Tax Act)). Due to the described mechanism of the CFC legislation, dividends under the

64. This seems to be the reason why the Primarolo Group – at least at the moment – did not classify Section 8b of the 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.

65. Government Report on Further Development of Business Taxation, Finanzrundschau 2001, supplement to issue 11, part D.IV.1a,b.

66. *Matthias Werra*, note 52, p. 438 et seq.; *Ottmar Thömmes*, note 46, p. 775 at 777; different *Berndt Runge*, note 23, p. 559 at 575.

67. Different Government Report on Further Development of Business Taxation, Finanzrundschau 2001, supplement to issue 11, part D.IV.1b. Section 20(1) of the Foreign Tax Act says, that the provisions of the Foreign Tax Act have priority over 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", Internationales Steuerrecht 1997, p. 481 (part I), 520 (part II).

68. *Ulrich Wolff*, note 25, p. 440 at 441. The Government Report on Further Development of Business Taxation, Finanzrundschau 2001, supplement to issue 11, part D.II.2b)cc)bbb speaks of ten double tax conventions without activity clauses.

Foreign Taxation Act will never be taxed in the same way as either dividends of shareholders resident in the source country or regular dividend income of resident shareholders.

3.2.2. Proposals for a reform of CFC legislation

The future of the Foreign Tax Act is insecure. The government has announced a further revision.[69] Moreover, further changes may be brought about by the Federal Tax Court considering parts of the Foreign Tax Act to be incompatible with the Common Market.

The problem with CFC legislation employed against unfair tax competition is that it may be subject to the accusation of discrimination at the same time.[70] The single taxpayer cannot be held responsible for the revenue erosion caused by tax competition, but the involved countries can.[71] The question then is, whether the target of preventing 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.[72] Alternatively should Member States have to take action at the Commission level? So far no case law exists dealing with the question of whether CFC legislation contravenes the treaty freedoms, especially the right of free establishment.[73] Probably this question cannot be answered in general terms, but has to be analysed in a way which differentiates between purely tax-driven investments, which already may not fall within the scope of the treaty freedoms, and activities undertaken in a foreign Member State for good economic reasons.

In its Report on Further Development of Business Taxation, the German government considers broadening the concept of CFC legislation, in particular by giving up or at least revising the distinction between active and passive income, because the Code of Conduct is not limited to passive

69. See Government Report on Further Development of Business Taxation, Finanzrundschau 2001, supplement to issue 11, part D.
70. See *Wolfgang Schön*, "CFC Legislation and European Law", Der Betrieb 2001, p. 940 at 941; *Thomas Menck*, "The (Un)concealed Crisis of Foreign Tax Law", Internationales Steuerrecht 2001, p. 279, who argues that the Foreign Tax Act cannot be considered as violation of the EC Treaty as far as its objective is to tackle harmful tax competition.
71. *Edwin van den Bruggen*, note 24, p. 115 at 137.
72. See *Manfred Mössner*, note 18, p. II.
73. This question has been answered in the affirmative by *Franz Wassermeyer*, note 52, p. 113 at 114.

income. A draft of a reform bill has not been submitted yet, but is expected in time for the next legislative session.

The moot questions, most of which have not yet been discussed thoroughly and are far from being answered, can be set out as follows:

(1) Is unfair tax competition only 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?[74]

(2) Is the goal of counteracting unfair tax competition a sufficient justification for the unequal treatment of foreign investments, in potential conflict with the treaty freedoms? And if not, how would CFC legislation have to be changed to tackle efficiently unfair tax competition on the 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 right to treaty freedoms.[75]

(3) Should we maintain the distinction between passive and active income? This distinction might 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 relate only to passive investment.

(4) If we agree that at least in the European Union application of CFC legislation is not justified when lower taxation is the outcome of *fair* tax competition,[76] how can CFC legislation be designed so that it will only cover unfair tax competition? The threshold of a low effective tax rate, as provided for by Section 8(3) of the Foreign Tax Act, does not consider the reason for the low tax burden. It might be quite difficult to design CFC legislation in a way that allows for a decisive distinction to be drawn between low taxation from fair and from unfair tax competition, since neither an exact definition of tax competition nor of unfair tax competition exists.

(5) If an investment abroad enjoys preferential treatment granted only to foreigners, in accordance with the concept of the treaty freedoms what

74. See *Berndt Runge,* note 23, p. 559 at 563.
75. See *Wolfgang Schön*, note 70, p. 940 at 942, with reference of the case law of the European Court of Justice.
76. *Joachim Lang* in Tipke/Lang, note 10, § 8 paragraph 77.

should be the benchmark for additional taxation by CFC legislation? The regular tax level in the source country or in the investor's home country? At present, taxation under the Foreign Tax Act in many cases results in a much heavier tax burden than for comparable domestic investments,[77] a result which is definitely not in line with the EC Treaty because it is not necessary to tackle unfair tax competition.

(6) And finally, do we need two different regimes of CFC legislation? One applicable to EC cases designed in accordance with the anti-discrimination clauses of the EC Treaty, and one applicable to investments in third countries?

3.3. Anti-avoidance rules and German double tax conventions

The more recently concluded German double tax treaties usually contain activity clauses, restricting the exemption of income from permanent establishments and intercompany dividends by a reservation clause for active income.[78] In addition, beneficiary clauses limit the reduction of withholding taxes on dividends, interest or royalties for the beneficial owners.[79] Some double tax treaties also include switch-over clauses, enabling the treaty partners to switch from the exemption to the imputation method to avoid white income or treaty shopping.

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

77. See *Birgit Hadenfeldt*, "CFC-legislation according to the Foreign Tax Act Applied to Income from German Sources" (Baden-Baden, 2001).
78. See the overview in *Klaus Vogel*, Double Tax Treaties, 3rd ed. (München, 1996), Article 23, paragraphs 88 and 110 et seq.
79. See for more detailed information *Klaus Vogel* (1996), note 78, before Article 10-12, paragraph 5.

3.4. General anti-avoidance rule

Section 42 of the AO (General Tax Act – *Abgabenordnung*) provides for a general anti-avoidance rule. The provision is directed against an abuse of law. In the past there has been intense discussion of whether Section 42 of the AO applies to International Financial Services Centres (IFC) located in the Dublin Docks[80] and, moreover, whether EC law restricts the application of the German general anti-avoidance rule.[81] The topic is closely related to the question of what kind of means Member States are allowed to employ in counteracting 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 to have been distributed in the moment it is earned by the foreign corporation, due to Section 42 of the AO the taxpayer is treated as if he had earned the income directly. The Federal Fiscal Court (*Bundesfinanzhof*) said that Section 42 of the 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.[82] Without additional circumstances, a tax construction that falls within the scope of the CFC legislation cannot be considered as abusive in terms of Section 42 of the AO. In reaction to this judgment the German tax legislator added a new and highly discussed subsection to Section 42 of the AO,[83] which is supposed to guarantee a broader application.

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80. See Fiscal Court of Baden-Württemberg, 17 July 1997, Entscheidungen der Finanzgerichte 1997, p. 1442.

81. See *Stephan Eilers*, "Restrictions to the Application of Sec. 42 General Tax Code by EC-Law", Der Betrieb 1993, p. 1156; *Wolfgang Schön*, "Abuse of Law in European Tax Law", Internationales Steuerrecht 1996, Supp. 2; *Rädler/Lausterer/Blumenberg*, "Tax Avoidance and EC-Law", Der Betrieb 1999, Supp. 3; *Peter Fischer*, "Theoretical Remarks to Counteracting the Abuse of Law in International Tax Law", Steuer & Wirtschaft International (SWI) 1999, p. 104; *Florenz Hundt*, "Development of the German Understanding of Tax Avoidance in the Field of Cross-border Investments", in: Essays in honour of Helmut Debatin (1997), p. 174; *Gert Saß*, "To the Leur-Bloem Case and to the Relationship between Anti-avoidance Rules and the Freedoms of the EC-Treaty", Der Betrieb 1997, p. 2250; *Horst-Dieter Höppner*, "German Anti-avoidance Rules and EC-Law", in: Essays in honour of Albert Rädler (1999), p. 305; *Uwe Paschen*, "Tax Avoidance in National and International Tax Law" (Wiesbaden, 2001), p. 195-220.

82. Bundesfinanzhof, 19 January 2000, Bundessteuerblatt part II 2001 p. 222, also available at www.bundesfinanzhof.de.

83. Critical *Georg Crezelius*, "Revision of Sec. 42 General Tax Code?", Der Betrieb 2001, p. 2214; Federal Fiscal Court of 20 March 2002, Finanzrundschau 2002, p. 1077 at 1079, 1080.

The relationship of the general anti-avoidance rules to not only the CFC legislation but also to Article 87 of the EC Treaty has been questioned. Some argue that application of Section 42 of the 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 Article 10 of the EC Treaty.[84] Others claim that Section 42 of the AO does not conflict with the freedom of establishment, because the freedoms of Articles 43 and 48 of the EC Treaty are granted only upon the condition of non-abusive behaviour and do not protect purely tax-driven investments.[85] On the other hand, if a foreign tax measure violates Article 87 of the EC Treaty or has to be considered as unfair tax competition according to the Code of Conduct the application of Section 42 of the AO is in particular justified and welcomed.[86]

3.5. Restrictions of deduction of payments to tax haven entities

No material restriction of the deduction of payments to tax haven entities exists. However, Section 16 of the Foreign Tax Act imposes a reversal of the onus of proof in cases of payments made in a business relationship with companies or individuals abroad[87] 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 conduit arrangements and to enable tax authorities to ensure application of the arm's length principle, laid down as a general rule applicable to all international business relations in Section 1 of the Foreign Tax Act.[88] If the circumstances of a payment are disclosed and the remuneration is adequate, no further restrictions apply whether the recipient of the payment is a tax haven entity or not.

84. *Rädler/Lausterer/Blumenberg*, Der Betrieb 1996, supplement 3, p. 11 et seq.; *Koschyk* (1999), note 30, p. 263; *Jan de Weerth*, "EC-Law and Direct Taxes", Recht der Internationalen Wirtschaft 1996, p. 499 at 503; *Lausterer*, "EC-Tax Policy between Harmonisation and Tax Competition", Internationales Steuerrecht 1997, p. 486 at 489; different *Horst-Dieter Höppner*, "German Anti-avoidance Provisions and EC-Law", in: Essays in honour of Albert Rädler, p. 305 at 314-317.

85. *Lucas Wartenburger*, note 2, p. 397 at 400; *Horst-Dieter Höppner*, note 84, p. 305 at 322.

86. *Uwe Paschen*, note 81, p. 220.

87. Section 160 of the General Tax Code (*Abgabenordnung*) obliges the taxpayer to disclose the recipient in general, but does not apply to payments to non-residents.

88. For general restriction of the deduction of payments to tax havens, see *Berndt Runge*, note 23, p. 559 at 576, 577.

3.6. Departure taxation

Sections 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 ten years following the move.

3.7. Other

In general, Section 1 of the 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 from a cross-border transaction with a related party will be increased if the parties have agreed on prices to which unrelated third parties in the same situation would not have agreed.

Section 8a of the KStG provides a special rule for thin capitalization, which also applies only to cross-border corporations. Under Section 8a of the KStG interest payments to non-resident shareholders are deemed as dividends if the corporation is mainly debt financed. The provision contains several safe havens. The ratio between permissible debt/equity in general used to be 3:1 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 1 January 2001.

Section 8a of the KStG may be justified as a special provision to deter taxpayers from shifting their tax base by debt instead of equity financing to low-tax jurisdictions.[89] However, since Section 8a of the KStG counteracts excessive debt financing without respect to the tax level in the shareholder's residence country, it is not specifically designed to counteract *unfair* tax competition.[90] Moreover, in the year 2000, the Tax Court of Münster requested from the European Court of Justice a ruling on the question of whether Section 8a of the KStG is in violation of EU non-discrimination provisions.[91]

89. *Gerken/Märkt/Schick*, note 4, p. 126.
90. *Berndt Runge*, note 23, p. 559, 576.
91. Fiscal Court Münster from 24 January 2000, Entscheidungen der Finanzgerichte 2000, p. 397.

3.8. Conclusion

Germany employs many 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, regardless of whether the income abroad will be low or regular-taxed.

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