Spoiling Oktoberfest – expat´s hosts in the wage-tax-crosshair

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Abstract

When sending employees to work in Germany, international operating enterprises face various challenges. Articles about the taxation of the employees on that score are rife. Since January 2020 an amendment to the German Income Tax Act (EStG) effectively extends the scope of withholding obligations on companies operating on German soil by adding an "arm´s length factor" on supposed wage-payments. In this paper I will outline the rules for wage tax-withholding of secondments to Germany and take a closer look at the effects caused by the amendment.

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1 Wage tax withholding in Germany

Due to increased world-wide mobility, it has been common practice for international operating companies to dispatch expatriate employees to its affiliated enterprises in other countries to hold senior management, specialist key or training positions. Apart from practical issues, such secondment arrangements generally pose multiple legal challenges in light of the tripartite nature of the contracts, which involve the transferring company, the domestic hosting organisation and the secondee. Special consideration should be taken to the contractual relationships when it comes to possible unanticipated tax liabilities. Against this contractual backdrop, experience shows the importance of a detailed secondment agreement to avoid tricky pitfalls, when sending employees to Germany. Despite, being only of middling attractiveness according to the "OECD Indicators of Talent Attractiveness", published in 2019,[1] the influx of "expats" into Germany, is still unrivalled on the European continent. However, German based subsidiaries of multinational enterprises should always be aware of the German tax authorities lurking to get a slice of the pie. Apart from corporation tax, trade tax or VAT, tax field audits are regularly uncovering wage tax withholding obligations of employers.

Pursuant to *Einkommensteuergesetz* [Income Tax Act] (Germany) (*'EStG'*) § 38 (1) in conjunction with *EStG* § 39b, income from employment is collected by way of wage tax withholding. The amount withheld by the employer has to be calculated in accordance with the wage tax tables and wage tax classes (from I to VI) which take into account the employees´ personal circumstances, such as family status, church,[2] children and certain allowances. The wage tax constitutes a pre-payment of the personal income tax liability of the employee. If the paid amount exceeds the total amount of income tax due to the assessed tax year (which correlates with the calendar year) the excess amount will be refunded if the employee submits an income tax return.[3]

Beginning in 2020, an amendment of the German Income Tax Act comes into effect, which affects assignments to German-based companies. The amendment expanded the scope of *EStG* § 38 (1) 2, which constitutes the German employer´s obligation to withhold wage tax for their employees. Until 2019 employers had to withhold wage tax (together with a 5.5 % solidarity surcharge, an average 9% church tax plus social security contributions) for factual or effectual salary payments to their employees. Now, affiliated entities located in Germany are bound to withhold a monthly wage tax, even if it does not pay the salary to the secondee or any reimbursements to the transferring entity at all. In cases where costs have not been passed on to the German entity but should have been as per the arm´s length principle, the wage tax is based on a notional "arm´s length" remuneration amount. The additional costs can be substantial: The tax wedge for the average single employee in Germany is 49.5% and hence the second highest tax wedge among the 36

1 OECD, Talent Attractiveness (Web Page, 27 July 2020) <https://www.oecd.org/migration/talent-attractiveness/>.

2 In Germany the catholic and protestant – according to the German constitution - churches have the legal right to raise taxes.

3 Usually this is voluntary and sometimes forgotten and/or an area of disputes between employees and the finance offices concerning statutory limitations. Only in some certain cases submitting an income tax return is mandatory for employees, *EStG* § 46 (2) Nr 1 – 7 , if the amount withheld is suspected to be too low or there are other sources of income.

OECD members,[4] and it has to be taken into account that the wage tax is then due at the most unfavourable tax class VI (no allowances are granted).[5]

In short: when assigning an employee to a German host, it is of importance to recognize the gravity of the extension of *EStG* § 38 (1) 2.

1.1 Inbound Cross-Border-Secondments until 2019

German employers have to withhold and deduct wage tax. As the assessment basis for taxation is the gross salary paid by the employer, withholding obligations were easy to avoid by multinational enterprises as the payee just had to be a foreign entity; basically, by just changing the bank account numbers companies could be saved from a substantial cash flow drain. To counter this fiscal sleight-of-hand, in 2003 German legislation expanded the scope of withholding obligations and took a less formal but more economic approach.

Until the end of 2019, *EStG* § 38 (1) 2 had the following wording: "In cases of international posting of workers, the receiving company established in Germany (…) shall be a domestic employer if it bears the remuneration for the work performed."

By this addition the legislator ensured that the source state in which the employment is exercised retains its wage taxation right if the German company effectively bears the remuneration by paying the salary directly to the employee or by a cost-recharge-payment to the transferring entity.

Example: A Melbourne-based company assigns a specialist worker to its Berlin-based subsidiary. The employee works there for two months before returning to Australia. During this time the Australian company continues paying his salary on a monthly basis.

Case 1: The Australian company charges a fee for the services to the German entity. The fee includes employment costs for the employee and other administration costs.

The German subsidiary has to "withhold" and deduct German wage tax as it economically takes over the costs for the transferring company. The remuneration does not necessarily have to be paid in the name or explicitly "on behalf" of the German entity.

Withholding the wage tax: According to the German provisions, the hosting company has to withhold and deduct wage tax.

- The amount to be withheld is based on the fee the German subsidiary has to pay, as it is treated as wage paid to the employee. The actual income of the employee, paid by the transferring entity - is considered as irrelevant.
- However, concerning the income tax registration, the obligation to "deduct" the wage tax correlates with the inflow coming from the Australian company and is independent from the timetable of the charged reimbursements.

Case 2: As Case 1, however, due to the contract between the two entities and accounting of both companies, the whole operation is not rechargeable and no fee has to be paid.

Although the employee might be subject to German Income Tax (which is a question of his residency and/or Art 15 Model Treaty) the German subsidiary does not have the obligation

4 OECD, *Waging Taxes 2019* (Web Page) < https://www.oecd.org/tax/taxing-wages-20725124.htm>.

5 In calculating the wage tax, the employer usually considers different tax allowances such as the basic tax free amount (about 9,000 Euro) and the employee tax allowance (1,000 Euro), according to tax classes I, II, III or IV.

to withhold wage tax as no costs were recharged. Since the hosting company does not bear the renumeration it is not the "economic employer".

1.2 Introduction of the arm´s length principle in 2020

With the omnibus bill "Law on the further taxation of electromobility and the amendment of further tax regulations", here – following the German tax law tradition and somewhat less unwieldly titled - called "*Annual Tax Act 2019*" from 2020 on the scope of *EStG* § 38 (1) 2 was expanded. The law now incorporates the attached half sentence: "(…) if it bears the remuneration for the work performed *or should have borne it in accordance with the arm´s length principle*". According to the Explanatory Memorandum of the law[6] this amendment is a "clarification" and should close a taxation-gap, where multinational enterprises assign employees to German entities without charging the costs for these assignments.

Going forward, there will also be an obligation to withhold wage tax in cases where employment costs have not been passed on to the German entity, but should have been as per the arm´s length principle.

2 Requirements for wage tax withholding in Germany in detail

Starting in 2020 the German host has to withhold wage tax if the following conditions are fulfilled (*EStG* § 38 (1) 2):

- the German entity is the "economic employer" of the assignee, and
- the German entity bears the remuneration, or
- should have borne the remuneration, according to the arm´s length principle

To define an "economic employer" two criteria have to be considered:

- The obligation to withhold wage taxes requires an employer-employee-relationship in the first place.
- If there is an "employee", it is essential to identify either the hosting or the transferring company as "real employer".

Part 2.1 reviews the nature of employment relationship in comparison to an independent contractual relationship under of German domestic law. Thus, this part analyses the new rules determining which entity the employee has to be economically allocated and the practical issues involved.

2.1 Definition of "employment-relationship" in German law and Australian point of view

As in most countries, German law differentiates between dependent and independent work. The income tax of employees – not of independent contractors - is based on *EStG* § 19 and is subject to the withholding rules in *EStG* § 38-42g. In Germany no statute exists which explicitly defines the meanings of "employer" or "employee" for the different legal purposes, although in practice this is of utmost importance as it is an issue not only for

6 Explanatory Memorandum, Gesetz zur weiteren steuerlichen Foerderung der Elektromobilität und zur Aenderung weiterer steuerlicher Vorschriften 2019 (BT) 129.

taxation reasons but for social security contributions and labour law-protection rules as well.[7]

Hence, the question is: What makes an employer-employee relationship?

Without statutory rules the German authorities rely heavily on case law. Therefore, a vast array of decisions from three federal courts exists trying to establish a borderline between an employee and an independent contractor. According to their specific task situations the courts assess the status of a person independently and use slightly different approaches when ruling whether a person is an employee or an independent contractor. In each case the determination is fact specific, and requires an examination of the nature of the relationship between both parties. The wording of any contract between the parties may serve as an indicator, however it will not take precedence over the factual reality. When defining an employer-employee-relationship for tax reasons the German authorities and courts have partly adapted the leading rulings of the labour courts.

The **Bundesarbeitsgericht** (German Federal Labour Court) decides between an employee and an independent contractor by the degree of personal dependence.[8] Therefore, it weighs meaningful indicators: the scope of instructions which the principal may give concerning the content of the performance, the kind of performance, the time and duration of the performance and the place of performance.[9] The more the assignee is bound by these instructions, the more likely he will be regarded as an employee by the Federal Labour Court.[10]

The **Bundesfinanzhof** (German Federal Finance Court) generally accepted this definition. In a leading case the Bundesfinanzhof has stated several criteria which are mainly to be considered, when deciding about the nature of the relationship.[11] The judges found that an independent contractor has to fulfil two important criteria: entrepreneurial risk and entrepreneur initiative. This means that a contractor has (or could have) influence over his income and has to carry his own losses.[12] Furthermore an independent contractor participates on business decisions and has at least a certain degree of control. As these two criteria are rather vague, additional aspects have to be taken into account:[13]

- Is there a duty to comply with instructions?
- Does the person have to report to employees in addition to the managing director?
- Is the person integrated within an existing hierarchy?
- Does the person have to observe fixed working hours or a working schedule?
- Is there a particular place of work?

7 Exceptions may apply if a foreign worker is only temporarily seconded to Germany; for the pensions covered for German or Australian citizens see the Australian-German Social Security Treaty from 13 December 2000 and the Supplementary Agreement between Australia and Germany from 8 December 2007.

8 Bundesarbeitsgericht [Federal Labour Court], 5 AZR 33/00, 24 October 2001 reported in 2002 Neue Zeitschrift fuer Arbeit 527.

9 Reversing circuity derived from the statutory regulation in s 84 para 1 Commercial Code [Handelsgesetzbuch] in which a commercial agent is deemed to be independent.

10 By contrast, the social security authorities and the Bundessozialgericht (Federal Social Court) rely more on the economic dependence of a contractor. An important criterion would be therefore the financial dependency of a single principal.

11 Bundesfinanzhof [Federal Finance Court], VI R 150-152/82, 14 May 1985 reported in (1985) 144 BFHE 225.

12 Bundesfinanzhof [Federal Finance Court], VIII R 52/77, 20 February 1979 reported in (1979) 127 BFHE 144.

13 Bundesfinanzhof [Federal Finance Court], I R 46/03, 23 February 2005 reported in 2005 BStBl II, 547; Klaus Vogel and Moris Lehner (eds), Doppelbesteuerungsabkommen, Art 15 Model Treaty 49a (Beck 2015).

- Who provides the equipment for the work performance?
- Is there an entitlement to vacation?
- Does the supposed contractor receive a fixed monthly remuneration or is he or she paid only for the services he actually provided?
- How far does he use his own capital?
- Are sick leave or holidays covered?
- How sophisticated are the working tasks given to the contractor?
- *The length of a term of employment may also be regarded as important in certain cases*.[14]

The tax courts and the tax authorities consider that the relevance of weighting given to a particular factor may vary according to the circumstances. Hence, no single factor is determinative.[15]

To summarize the rulings of the German Federal Fiscal Court: the contractual employer has the right to issue directives on the place and time as well as details of the work of the employee. Typically, employees are also integrated in the organization of the employer by being assigned a certain workplace and being integrated into workplace hierarchies.

Australian point of view: According to Australian law, a check list is also important for answering the question whether or not a person performs work as an employee. The relationship of the relevant parties is determined by a characterisation of the arrangements. In ascertaining this, Australian courts nowadays consider the totality of the relationship by reference to a list of criteria or indicia.[16] This approach is commonly described as a "multifactor test" and includes all the indices as stated above. Most importantly – identical to the German approach - the existence of "control", whilst significant, is not considered as the sole (absolute) criterion.[17]

Considering the individual cases, the differences between the German and the Australian approach seem to be small as the tests are almost identical as shown in ATO´s questionaire from 11 November 2019.[18] In both countries the task of examining the relationship is not a mechanistic one by ticking boxes but a job which requires – at least to some extent – intuition of the deciding person(s).[19]

14 Bundesfinanzhof [Federal Finance Court], VI R 56/67, 2 October 1968 reported in (1969) 94 BFHE 17.

15 As the criteria stated above are open to interpretation the law opens for insurance-reasons a way to eliminate possible uncertainties. Employers or employees can apply for a "status determination procedure". S 7a SGB IV (Code of Social Law, Book IV) stipulates a process by which such questions can be resolved. A decision of the German Pension Insurance (Deutsche Rentenversicherung) provides legal certainty for all parties involved and serves to determine the insurance requirement or otherwise. However, a binding decision on the status of the employee in the form of an official communication only applies to the question if an employment relationship requires the payment of social security contributions in all social security schemes. Though not officially binding it has in practice a certain impact on the (independent) assessments of the tax offices.

16 *Stevens v Brodribb Sawmilling Company Pty Ltd* (1986) 160 CLR 16.

17 In contrast British courts may apply an alternative "organisation or integration test" with the criterion of control as an obligatory element, *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497.

18 ATO: *How to work it out contractor or employee?* (Web Page, 27 July 2020) < https://www.ato.gov.au/Business/Employee-or-contractor/How-to-work-it-out--employee-or-contractor/>.

19 For example, see: *On Call Interpreters and Translators Agency Pty Ltd v Commissioner of Taxation* (No 3) [2011] FCA 366.

2.2 Who is a real domestic employer?

Following the rule in *EStG* § 38 (1) 2, the "employer" is responsible for withholding the wage tax. In case of short-term employee assignments to Germany, the German subsidiary has to withhold tax instead of the foreign based holding, if the German entity is deemed to be the "real" employer of the employee, who (or somebody else on behalf of it) pays the salary of the employee. Hence, the meaning of "employer" under domestic law has to be determined. In this respect it is general consensus of the German tax authorities and courts, that German domestic law respects and accepts the definition of "employer" in double taxation agreements, which has the advantage of minimizing the number of potential conflicts surrounding this area.[20] In a decision from Finance Court Thuringia from 2018[21] the judges decided, that the term "economic employer" in international and domestic context should have the same meaning.

2.2.1 Following the beaten track of OECD Model Art 15

As described, German law lacks a domestic definition of the term "economic employer." Hence, it seems natural to look into the international context. Art 15 Model Treaty describes which state has the taxation right when employees work abroad. However, this right of "income taxation" is not to be confused with the right to impose tax withholding obligations on the employer (which are purely defined by domestic law). These two provisions mesh as the deducted wage tax is effectively a prepayment of the employee´s income tax. When trying to find a definition of the "economic employer" in the sense of *EStG* § 38, the German courts and fiscal authorities regularly refer to the OECD Model Treaty (Model Treaty).

Overview of Art 15 Model treaty: The question of whether or not an employee from an outside country has an obligation to pay taxes in Germany largely depends on Art 15 (1) Model Treaty, which allocates this right to the country where the work is exercised, if the residency of the employee and the hosting country differ.

An exception of this rule is established by Art 15 (2) Model Treaty. A right of taxation reverts to the country of residence if all of the following three criteria are met:[22]

a) The employee does not spend more than aggregated 183 days in the host country within a given 12-month period commencing or ending in the fiscal year concerned; and

b) remuneration is paid by, or on the behalf of, an employer that is not a resident of the host country; and

c) The remuneration is not borne by a Permanent Establishment of the employer in the host country.

It is generally assumed that (b) and (c) serve the common purpose of ensuring that the source state in which the employee works retains its taxation right if the remuneration is recognized as a deduction from profits taxable in the source state and, therefore, that (b) and (c) represent compensation for the source state for its reduced tax revenue.[23]

20 Bundesfinanzhof [Federal Finance Court], IV R 29/02, 12 February 2002 reported in (2004) 205 BFHE 94; Ludwig Schmidt (ed), Einkommensteuergesetz, 38 n 3 (Beck 2019).

21 Finanzgericht Thueringen [Finance Court Thuringia], 3 K 795/16, 13 December 2018.

22 The position of directors, sportsmen, entertainers. teachers, Civil servants are determined by different rules, see Art 15 et sqq. of the treaty.

23 Volker Kluge, Das Internationale Steuerrecht, 889 (Beck 2000); Harald Schaumburg (ed), Internationales Steuerrecht, 16.437 (Otto Schmidt 2011).

Following the OECD-commentary, (b) and (c) "… can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given state may be considered to constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that state."[24]

As a matter of fact, the first test ("183-day-rule") can be usually determined by checking the presence of the employee in the host state within any 12-month period, which may be tricky under certain circumstances but is generally tested in a visible and traceable way.

The economic employer: However, the terms of the second criterion ("…remuneration is paid by, or on the behalf of, an employer that is not a resident of the host country…") are not as pronounced and the criteria of an "economic employer" less obvious. First, the effective employer must not have his residency in the hosting country, hence "abroad" from a German perspective.

Second, the economic employer has to bear the costs of the assignment. Accordingly, the question is, if the remuneration paid to the employee is being paid by an employer who is not resident in the host country. In other words, Germany has the exclusive taxing right of the employee if these two criteria are fulfilled:

- the "employer" is not a resident of the host country (here: Germany), and
- the remuneration is paid by or on behalf of this employer.

The last condition, mentioned in Art 15 (2) (c) Model Treaty, requires that the remuneration is not borne by a Permanent Establishment of the employer in the host country and looks at who bears the salary cost of the employee. Passing the wage onto an entity based in the host country will usually cause the exemption from host country tax to be lost. Hence, it must be asked how and why the remuneration is attributable to the Permanent Establishment in the hosting country. If it is attributable as part of a fee for goods delivered or services provided, it is not borne by the Permanent Establishment.

2.2.2 Applying the international "economic employer" concept in domestic tax law

Regarding the criteria of Art 15 (2) b) Model Treaty, in Germany the details about the definition of the "economic employer" in the international context and the domestic interpretations are still controversial within a broad range. A more formal approach considers the legal relationship between the parties as decisive for tax purposes. This means, theoretically an oral contract could be sufficient to create an obligation for withholding wage tax. In contrast, the more economic approach applies different tests to establish the facts of the relationship in looking for the "economic employer".

a) Interpretation by the Federal Court of Finance (Bundesfinanzhof, BFH)

According to the Federal Court of Finance (Bundesfinanzhof) the OECD Commentary proposes guidelines to determine which company should be considered the economic employer. However, stressing the independence of judicial decisions, the rules and examples given in the commentary shall not be applied on German law unless in cases of abuse. [25]

24 Paragraph 6.2 OECD-Commentary on Art 15 (2000-2010).
25 Bundesfinanzhof [Federal Finance Court], I R 96/01, 18 December 2002.

Contractual relationship: To determine the "right" employer, German courts predominantly rely on the actual contractual relationship, and argue that "they should not be questioned for tax purposes easily". According to the substance-over-form principle the contractual relationship is not be confused with the formal contract. In finding the actual contractual relationships the factual circumstances are decisive and all factors, which are typical for an employer-employee relationship are to be considered.

In an earlier case the Federal Court made clear that, if there is any doubt regarding the identity of employer, the entity shall be considered as the employer that finally bears the costs of the employment. In that case, a German company assigned an employee to work for a Spanish company of the same group for almost five months.[26]

- During this time, the employee was released from his duties in Germany.
- His work was subject to instructions of the Spanish host.
- He received his salary from the German company, but these costs were charged to the Spanish company.

The judges found, for tax purposes, the Spanish company became the economic employer. According to the Federal Court of Finance, the integration into the hosting entity and the fact that the Spanish company had to bear the economic burden were decisive to determine the contractual relationship. Accordingly, there was effectively a labour contract between the Spanish company and the employee, which supersedes the formal contract between the employee and the German company.[27]

Integration: Later on, the courts gave some details about the criterion of integration. The assignee's activity will be seen as integrated into the organization of the host company if it is the host company which assumes responsibility for, or the risks related to, the assignee's work performance, i.e. it is the degree and manner of integration of the worker´s activity into the host company's work processes (chain of command) and organization which bears significance here. The Federal Court stated in a case from 23 February 2005[28] that for an employer "switchover" the employee does not only have to work "within" the hosting company, but also "for" the hosting entity. According to the judges one question may lead to the right direction: which entity mainly benefits from the work of the employee? An indication can be derived from the fact who ordered the assignment.

In another case – also concerning the German-Spanish Treaty – a member of the executive board of a German corporation was delegated to a Spanish subsidiary, while the German holding continued paying him.[29] As the employee exercised management duties, there was some concern of whether he should be considered as an employee of the Spanish or the German company as he was delegated from a German holding company into the Spanish´s company management, and actually, therefore, he was working for the interests of the German company. The court found that the status of the employee was irrelevant and even a managing director of the holding entity can be "integrated" in the hosting subsidiary, when he not only works within the hosting company but also "for" this entity.[30] However, since the Spanish company did not have to bear the costs in any way, the German company remained his employer. A recent decision of the Finance Court Thuringia, dealing with a

26 Bundesfinanzhof [Federal Finance Court], I R 63/80, 21 August1985 reported in (1985) 144 BFHE 428.
27 Franz Wassermeyer, Doppelbesteuerungsabkommen, 15, 114 (Beck 2019).
28 I R 46/03, reported in (2005) 209 BFHE 241.
29 Bundesfinanzhof [Federal Finance Court], I B 114/99, 27 April2000 reported in [2000] IStR 568, 570.
30 Bundesfinanzhof [Federal Finance Court], I R 46/03, 23 February 2005 reported in [2005] BFH/NV 1191.

director of a hosting company, confirmed that for an integration test, the employee does not necessarily have to be "under command" of the entity in question.[31]

Bearing the remuneration: The Federal Court of Finance ruled that it is a prerequisite for an economic employer to bear the financial burden of the assignment.[32] According to Art 15 (2) b) Model Treaty the salary has to be paid "by, or on behalf of, an employer". The same applies to the explicit definition in *EStG* § 38 (1) 2 when it comes to the obligation of withholding taxes. If the economic employer does not pay the salary of the employee himself, the charged costs of the assignment must be clearly identifiable within the contract between the affiliated entities and have to be treated as transitory items, plus possible surcharges.

In one case a German resident working for an Indonesian entity for five months referred himself to a German Finance Court.[33] He was of the view that his salary earned abroad should be exempted from German taxation. His application was denied as it turned out that his remuneration was borne by a German employer. One argument was that the inter-company invoices for the services were flat-rate agreements not reflecting the actual salary and overtime pay of the employee in question, therefore, it was not proved that the Indonesian host became his employer.

According to the Finance Court Munich[34] the rules (until 2019) provided that an obligation to withhold only exists if the German company was charged the costs of the assignment. However, where the costs were not charged, but should have been on the arm´s length principle, the judges found no obligation to withhold taxes as the clear wording of *EStG* § 38 (1) 2 was until 2019: " (…) shall be a domestic employer if it bears the remuneration for the work", which left no room for a different interpretation in terms of the arm´s length principle. Accordingly, any tax due is reflected in the employee´s German income tax return.

With the *Annual Tax Act 2019* these decisions are rendered obsolete, when considering the withholding obligations according *EStG* § 38 (1) 2. Since January 2020 hosting entities are obliged to withhold wage tax in cases where employment costs have not been passed on to the German company but should have been as per the arm´s length principle. This means that in future decisions the courts - unless the hosting company bears the remuneration - have to apply a new test: *Would an independent employer hosting the employee pay him wages?*

b) German Tax authorities: A bird in hand is worth two in the bush

In identifying the economic employer German tax authorities follow a less "contract"-oriented approach. The latest ruling by the German government, which came into effect on May 3, 2018 deals with the tax treatment of employment income according to Art 15 Model Treaty.[35] The circular not only provides an update on the tax authorities' opinion concerning the taxation of employment income but also – expressly[36] – for the purpose of establishing the obligation of withholding wage tax in cases of secondments.

31 Finanzgericht Thueringen [Finance Court Thuringia], 3 K 795/16, 13 December 2018.
32 Bundesfinanzhof [Federal Finance Court], I R 28/99, 15 March 2000 reported in (2000) 191 BFHE 325; Finanzgericht Muenchen [Finance Court Munich], 13 K 4198/03, 23 October 2007.
33 Finanzgericht Kassel [Finance Court Kassel], 1 K 1877/01, 28 September 2005 reported in (2005) NWB SAAAB-74412.
34 Finanzgericht Muenchen [Finance Court Munich], 13 K 4198/03, 23 October 2007.
35 Bundesministerium der Finanzen [Ministry of Finance], IV B 2 – S 1300/08/10027, 3 May 2018.
36 Ministry of Finance [2018] (n 35) 129.

The importance of the economic employer approach has been stressed, meaning that a German withholding-liability could be triggered even if there is no formal employment contract between an employee and a German entity. In fact, a German company can be considered to be an economic employer if:[37]

- the employee is embedded in the affiliated German firm's organization, and
- the German entity either actually absorbs the underlying employment costs or should have been charged with these costs according to the arm's length principle.

The tax authorities explicitly stress that for the integration-test, it is essential that the hosting entity bears the risk of the performance of the work of the employee. Furthermore, for a positive result the hosting company should be able to effectively control the employee so it can give him instructions concerning how the work is done.

"3-months-rule": There is no de minimus number of days before the local taxation authorities will apply the economic employer approach. However, the ruling contains an important presumption. If the employee´s assignment between affiliated companies is no longer than 3 months, the tax offices are generally bound to deny an integration into the hosting´s company structure.[38] Still, this presumption may be rebuttable, depending on the individual case. On the other hand, in the case of an assignment to Germany of more than three months, the German tax authorities use the 3-months-rule vice-versa to work on the rebuttable presumption that the assigned employee is integrated into the organisation of the hosting entity and that the latter thus qualifies as economic employer. Consequently, if no documentation exists to prove otherwise, the employer often becomes liable to withholding wage tax from the first day of employment in Germany onwards, even if the employee is there for less than 183 days.

Managing Directors and proxy holders: If a non-resident employee is appointed as a statutory director or a proxy holder of a German entity (not members of a Supervisory Board[39]) and is found to be sufficiently "integrated" in the German hosting company it will trigger a personal tax liability and wage tax withholding obligation of the German entity. However, the details of a proper integration are not clarified by the ruling, only that it makes no difference where the executive actually performs his duty physically (e.g. board meetings).

Training or rotational mode: The fiscal authorities assume that in case of assignments for training reasons or within a rotational mode scheme, such set-ups are always connected with benefits for the transferring company.[40] That means that according to the arm´s length principle the transferring company has to bear all the costs connected with the assignment.

Unlike "individual" assignments the rotational mode encompasses transfers that result from personnel concepts decided by the parent company. Essentially the hosting company cannot autonomously fill a certain position with its own employee of choice.

37 Ministry of Finance [2018] (n 35) 132.
38 Ministry of Finance [2018] (n 35) 142.
39 As they are no employees under German law, members of a supervisory board are taxed differently: If they are non-resident, they are subject to German 30 % withholding-tax (plus 5.5 % solidarity surcharge) according to *EStG* § 50a (1) Nr 4 and (2). Assessment basis of the tax are all types of remuneration paid, including travel expenses.
40 Bundesministerium der Finanzen [Ministry of Finance], IV B 4 - S 1341 - 20/01, 9 November 2001, 3.4.2 and 3.4.3.

According to the Ministry of Finance,[41] the rotational mode can be identified by certain criteria:

- The transfer unilaterally decided by the parent company,
- The expatriation period is of a typical length,
- Key positions are regularly filled with employees of the parent company, and
- Hosting company does not actively try to fill the position with local people.

Reimbursement of costs: Regarding the reimbursements of costs the opinion of the fiscal authorities, laid down by a ruling of the Ministry of Finance,[42] remains unclear. According to the new version of the ruling,[43] they take a different view than the courts did when it comes to the issue of non-charged assignment costs. If salary costs are arbitrarily not absorbed by a German firm, the hosting company could still be regarded as an "economic employer" if the other criteria – especially the integration test - are fulfilled. It is noteworthy that this passage came out before the legal introduction of the arm´s length principle and regular seemed to be an issue during payroll tax audits.[44]

Interestingly, the Ruling does not mention the diverging court decisions, which – at this time – still demanded actual reimbursements. A clarification for pre-2020-periods would have had been helpful. On one hand, the authorities seem to be satisfied, when the hosting company "should have" paid the employee according to the arm´s length principle. However, the illustrating examples - rather confusingly – show that the tax authorities are following the courts and presuppose actual reimbursement to establish an obligation for the hosting company to withhold wage taxes. The situation changed in 2020 with the amendment of *EStG* § 38 (1) 2. Now, the "arm´s length principle" is adapted by law, so No. 132 of the Ruling is applicable. However, the (still) contradicting examples provided are now obsolete regarding the requirement of actual reimbursement.

2.2.3 "Clarification" by the Annual Tax Act 2019

Is there a major impact of the *Annual Tax Act 2019* on companies seconding their employees to German entities? Nothing will change, if the hosting entity has to bear the costs of the assignment. However, all other cases are affected by the extension "(…) if it bears the remuneration for the work performed *or should have borne it in accordance with the arms-length principle*". From the position of the German fiscal authorities, the amendment of *EStG* § 38 (1) 2 might resolve an issue of alleged misuse by international operating enterprises. Apart from this unproven claim, it certainly helps adding some coins to the German fiscus. However, under the new regime new disputes between taxpayers and fiscal authorities are provoked as it is does not come with any clarification. Probable issues to be considered are the questions:

- Is the employee working "for" the hosting company, and
- What is his notional salary?

As there is no further explanation one might only speculate about the urgency of the amendment. The explanatory memorandum just gives the estimated number of affected cases by 45,000.

41 Ministry of Finance [2001] (n 40) 3.4.2.
42 Ministry of Finance [2018] (n 35).
43 Ministry of Finance [2018] (n 35) 132.
44 Lukas Hilbert et Uwe Nowotnick, ´Deutscher Lohnsteuereinbehalt in Fällen der Arbeitnehmerentsendung´, [2018] IStR 936.

a) "New" economic employer

In allocating the "economic employer", the relevance of actual reimbursements completely vanished. The contractual terms have to be reviewed in the light of the arm´s length principle, which is not only applied when the hosting company does not reimburse anything or less than expected but also vice versa. That means if salary costs are arbitrarily absorbed by a hosting company, the resident company could still be regarded as an "economic employer". In this context the definitions (no 132 et sqq) of an economic employer according to the Ruling 2018 are misleading (and were before 2020).[45] In fact, the tax authorities only rely on the integration test. If an employee is embedded in the host´s organization, as there is an automatic assumption that his performance should be remunerated by the hosting company.

In short: *The integration test is the only relevant test left for determining the economic employer*.

b) Advancing the transfer pricing issues

Starting 2020, questions concerning the "arm´s length principle" have to be answered, if there is no obligation for reimbursement of the costs. As there are no specific domestic statutory regulations dealing with this specific question, one has to look at the existing rules. The tax authorities published 2001 an administrative regulation[46] that addresses the allocation of secondment-related expenses among internationally associated companies for purposes of German trade and corporate income taxes on business profits. Although they do not deal with the employee´s personal income tax or with wage tax obligations, the content is most likely to applied on these cases at least in a similar manner applicable for tax-withholding-cases.[47]

According to German law the assignment has to be documented by the German hosting company. The rules are qualified in (Tax Code [Abgabenordnung] § 90 (3), 'AO') and supporting guidelines. The law stipulates the obligation of the employing entity to clarify transactions that occurred outside Germany and to deliver supporting evidence. Since the burden of proof is on the German entity, it means that it must clarify the facts and provide evidence when asked for. It has to use all existing options to achieve this. AO § 90 (3) also stipulates that the German entity in a cross-border transaction is obliged to record the type and content of the business transaction to affiliated companies.

Such evidence includes

- the relevant contracts,
- descriptions of the host company's business activities and the employee's activities therein,
- correspondence with respect to the transfer,
- analyses of the local labour market,
- profit calculations and cost benefit analyses with respect to the transfer,
- time sheets and track records,
- travel expense reports,

45 Ministry of Finance [2018] (n 35) 132.
46 Ministry of Finance [2001] (n 40).
47 Ministry of Finance [2018] (n 35) 130.

- other recorded proof of activities, and an
- economic and legal basis of arm's-length principle with respect to pricing.

Apart from adequate cost accounting for the expenses created by the assignment, the hosting company (and the transferring entity as well) should be able to provide information about its and the transferring company´s interest in the transfer. The documentation has to be provided to the tax authorities within 60 days, whenever requested.

c) Considering the numbers

The tax authorities require that the recharges of the seconding company to the hosting entity have to apply the comparable uncontrolled price method in the first instance. Therefore, it has to be determined what expenses would have been incurred if the employer had hired a person with the same knowledge and capabilities in Germany. It is obvious that in most cases the numbers cannot be identified with legal certainty in advance and are most likely open for discussion during field tax audits. It has to be noted that by law the tax authorities are permitted to estimate the income at the upper level within the bandwidths of likely incomes (AO § 162). Considering this administrative burden, it is quite astonishing, that – according to the Explanatory Memorandum to the *Annual Tax Act 2019* - the legislature estimates the average additional time expense for each case to be as much as 20 min for the employee and 5 min (sic!) for the German entity.[48]

Problems regarding the withholding administration may arise if the German entity is obliged to calculate and transfer the appropriate shadow payroll-tax to the tax office on a monthly basis. Ideally, the salary paid to the employee by the transferring company should be the basis for withholding-purposes. However, additional costs, surcharges and other extras must also be taken into account. Like in cases of third-party payments, even getting the amount of the salary might pose a problem for the hosting entity in the light of strict data protection policies.

Additionally, even if the fictional remuneration is accordingly calculated, it is not assured that the hosting entity has sufficient liquidity to cope with the cash-flow affecting costs. Until 2019 this was actually no real problem as the "economic employer" was to be able to reimburse the costs of the assignment. However, when applying the arm´s length principle it is far from being certain that the hosting company has enough cash flow to pay the wage tax. *This is actually a major deviation from the basic principle of a "withholding" tax*.

d) The perils of liability

EStG § 42d outlines the liability for wage taxes. The hosting company is generally liable for all wage tax not properly withheld. However, there are two possible – yet somewhat shaky – last-ditch-defence lines for the economic employer to counter the liability:

- According to *EStG* § 42d (3) 3 *EStG* the liability of the employer for paying the wage tax-withholding does not expire after income tax assessment of the employee. Though, the Federal Court of Finance stated, that claiming liability from the employer may be unjust, if the actual wage tax obligations can be easily be claimed in the income tax return of the employee.[49] The decision might support the hosting company under certain circumstances. However, it

48 Bundestagsdrucksache [Parliament Printed Matter] (19/13436) 80.

49 Bundesfinanzhof [Federal Finance Court], VI R 23/66, 14 April 1967 reported in (1967) 88 BFHE 457.

is still a discretionary decision of the tax authorities which is verifiable legally only to a certain extent in evident cases.

- Following the prevailing opinion in literature[50] *EStG* § 42d does not constitute a right for damages. Hence, a liability for wage taxes withholding would require sufficient clarity about the modalities of the payments in case of third-party payments, which can be doubtful in the cases of employee-secondments as mentioned before. This opinion seems to be supported by an earlier decision of the Federal Court of Finance in a case of illegal temporary employment.[51] However it is doubtful, if this argumentation is still valid since 2004, a later amendment of *EStG* § 42d (9) *EStG* established a liability of the employer in case of third-party payments without any reference about the requirement of "clarity". In view of this concept of unconditional liability, the argumentation is questionable.

3 Consequences for Australian resident employees

If Australian resident employees working in Germany are subject to withholding taxes due to *EStG* § 38 the question arises if this tax burden has to be definite. As mentioned before, two different issues have to be considered separately:

i. The right to withhold wage tax, which is determined by domestic law of the working state, and
ii. the right to tax concerning the employee´s income which is determined (with the means of restriction) by the rules of Double Taxation Agreements (DTA).

If both rights do not coincide, Australian employees might be double-taxed, if there are no provisions preventing it.

Hence, it has to be analysed how far the German domestic withholding rules match the conditions of the DTA between Australia and Germany. Further, the question is, how the DTA is affected by the (national) amendment of *EStG* § 38.

3.1 Scope of Art 14 Australia-Germany DTA

In 2017 a revised Australian German Tax Treaty entered into force. It replaced the old 1972 treaty and reflects much of the wording in the OECD Model Convention as well as recommendations in the OECD final 2015 BEPS Reports.

Following basically Art 15 of the OECD Model Treaty, in the Australia-Germany DTA, Art 14 deals with income from employment. As a general rule para 1 of Article 14 gives exclusive taxing right to the state of the employee's residence, unless the given employee exercises the employment in the other contracting state and - according to para 2 - in addition one of three connecting factors links the employee to the host state:

(a) the employee is present in the host state for a period exceeding 183 days;

(b) the employer is resident in the host state; or

(c) the employee's remuneration is borne by a PE in the host state.

50 Ludwig Schmidt, Einkommensteuergesetz, 42d, 8 (Beck 2019).
51 Bundesfinanzhof [Federal Finance Court], VI R 34/79, 2 April 1982 reported in (1982) 135 BFHE 501.

3.1.1 Germany´s interpretation of the DTA economic employer

As shown, German courts and authorities tried to mesh the scope of *EStG* § 38 for withholding reasons with the provisions of the DTA by referring to Art 15 of the Model Treaty. However practically, due to the different purposes varying interpretations are hard to avoid.

When it comes to interpreting the treaty term "employer" Art 31 (1) of the Vienna Convention states that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose. The German Federal Court of Finance has stressed this principle several times.[52] On the other hand, the courts are still somewhat reluctant to acknowledge the OECD commentary as a general guideline unless in certain cases of abuse and use their own interpretation, which was discussed earlier.[53]

3.1.2 Australia´s interpretation of the "economic employer"

Australia takes a different approach: Since *Thiel v FCT*[54] the courts and the ATO support considerations of the OECD commentary.[55] Based on paragraphs 8.1 to 8.28 of the OECD Commentary, when defining the economic employer substance should prevail over form, which means that the term employer should be considered in a broader sense. For this purpose, the key criterion is the contractual relationship[56] which usually defines the risk and responsibility of the employer. If this is not the case, additional factors may be relevant to determine which entity will qualify as the "economic employer" under the treaty. According to ATO[57] the following criteria have to be taken into account:

- who exercises ultimate control over the worker - the right to control in terms of the ability to withdraw a worker from an assignment and/or terminate the relationship with the worker;
- who exercises day-to-day control over the worker - that is, the degree of actual control exercised in terms of, for example, how, when and what is to be done;
- integration - the nature of the services rendered by the worker and whether they are an integral part of the business activities carried on by the enterprise to which the services are provided;
- the terms of engagement - for example, entitlements to leave and who has obligations to deduct PAYG instalments, pay superannuation contributions and workers' compensation insurance;
- who is responsible for payment of remuneration for the worker's services;

52 Latest decision: Bundesfinanzhof [Federal Finance Court], I R 73/16, 27 February 2019 reported in (2019) 263 BFHE 525.

53 Bundesfinanzhof [Federal Finance Court], I R 96/01, 18 December 2002.

54 (1990) 171 CLR 338.

55 Australian Taxation Office, Income tax: the identification of 'employer' for the purposes of the short-term visit exception under the Income from Employment Article, or its equivalent, of Australia's tax treaties (TR 2013/1), 30 January 2013.

56 72 ATO (TR 2013/1) (n 55) with reference to the following cases: *Building Workers' Industrial Union of Australia and Others v. Odco Pty Ltd* (1991) 29 FCR 104; (1991) 37 IR 380; (1991) 99 ALR 735 (Odco); *Drake Personnel Ltd & Ors v. Commissioner of State Revenue* [2000] VSCA 122; 2000 ATC 4500; 44 ATR 413 (Drake); *Swift Placements Pty Limited v. Workcover Authority of New South Wales* [2000] NSWIRComm 9; (2000) 96 IR 69 (Swift Placements) and *Damevski v. Giudice* [2003] FCAFC 252 (Damevski).

57 (TR 2013/1) (55).

- who bears the responsibility or risk for the results produced by the worker;
- whether or not the contract is for the achievement of a specified result;
- who provides or maintains the necessary equipment and resources to perform the work; and
- whether or not the work can be delegated by the worker.

3.1.3 Interim result

The Australian requirements of a "economic employer" seem to be very similar to the German interpretation. However, the devil is in the detail. The examples given in paragraphs 17 to 49 ATO TR 2013/11 may be differently answered by German authorities. In that case Art 3 (2) Australia-Germany DTA provides that undefined terms used in the treaty – such as "employer" – have their meaning that they have under the domestic law of the country applying the treaty. For this purpose, a country applies a treaty when assesses income tax.[58] Ultimately, this might lead to a double taxation, if both, Australia and Germany interpret Art 14 Australia-Germany DTA differently. To prevent this, according to Art 25 Australia-Germany DTA the employer may trigger the "Mutual agreement procedure" (MAP). This procedure is a method of resolving difficulties arising out of the application of the agreement, and to provide for consultation with a view to reaching a satisfactory solution if a taxpayer is subject to taxation not in accordance with the provisions of the agreement.

3.2 Taxation of Australian residents working in Germany

Assume an Australian resident entity (AusCo) assigned an (also Australian resident) employee to a company based in Germany (GeCo) for 4 months while still paying him. The hosting entity does not reimburse the costs but should have done so by arm´s length-principle.

3.2.1 Withholding the wage tax in Germany and Australia

Germany: As already discussed, under the new regime of *EStG* § 38 (1) 2, the German hosting company has to withhold wage tax. The criteria for the withholding rules are set by domestic law. The computation base is the gross salary according to the arm´s length principle, not the actual salary paid by the Australian entity. As "withholding" is "just" an administrative act the provisions of Art 14 DTA Australia Germany cannot grant relief.

Australia: In the case mentioned above the same reasoning applies vice versa to tax withholding in Australia as an Australian based company pay wages to an employee. Payments from work and services are subject to the Pay As You Go-Withholding (PAYG) system. An Australian based entity is required to withhold an amount from salary, wages, bonus or allowances paid to an employee. The legal definition of "employee" is not prescribed in the *Tax Administration Act 1953*. For the purposes of withholding under section 12-35 the term has its ordinary meaning. Consequently, the definition derives from a range of multifactorial common law tests.[59]

58 Brian J. Arnold, International Tax Primer (Kluwer Law International 3rd ed, 2016) 8.6.3.
59 *Stevens v Brodribb Sawmilling Co Pty Ltd* (1986) 160 CLR 16 and *Hollis v Vabu Pty Ltd* (2001) 207 CLR 21.

3.2.2 Income taxation in Germany and Australia

Depending on Art 14 DTA Australia Germany income from employment performed in Germany may be taxable in Germany or in Australia.

Germany: If he is taxable in Germany, earnings derived from a contractual relationship between employer and employee are income from employment (*EStG* § 19). If he maintains a domicile or habitual place aboad (in the latter case the 183-days-rule is applied) in Germany, the employee is fully liable to income tax as set out in *EStG* § 1 (1). When assessing the income tax, the wage tax, paid by the German entity will be credited. Non-residents are customarily subject to taxation if the income originates from a German source, defined in *EStG* § 49 (1) Nr 4. This is considered to be the case, if the employee has actually "worked" in Germany. However, if the income from employment is subject to wage tax withholding, the tax obligations are fulfilled with the withholdings and no German tax return needs to be filed. In other words, the wage withholdings become final.

Australia: If the employee is taxable in Australia, the employee may claim a refund from German tax authorities, *EStG* § 50d (9). If the employer was subject to PAYG, the employee is generally entitled to a tax credit equal to the amount withheld, s 18-15 *Tax Administration Act 1953*. The ATO has to apply amounts withheld against the employees´ taxation liability.

4 Conclusion

For multinational operating enterprises, cross-border-secondments can be hampered by a number of constraints. Apart from the practical problems, assignments to affiliated companies may easily be a tax-trap. Especially after the extension of *EStG* § 38 German ground can be a minefield, which makes careful preparation essential. The employer has to be aware of the following issues:

- As the wage tax-withholding-rules are applied on "employees", possible independent contractors have to be filtered out according to German law by abstracting the key indicators.

If the test determines there is an employer-employee-relationship, two more questions have to be answered concerning the withholding of wage tax:

- Is the hosting entity an "economic employer" as stated in EStG § 38 (1) 2?
- If so, what amount has to be "deducted" from the salary? This is a quite manageable task when the salary is paid by the hosting company itself or if there are equivalent reimbursements. However, if there are no payments or reimbursements the numbers have to be determined by the arm´s length principle.

To counter the classification as an "economic employee" according to German law, the hosting company basically has to a show that the employee is not integrated in the hosting company´s structure and that the German enterprise has no personal economic interest in the secondment. It is advisable to document why, or why not, the receiving entity should be regarded as an "economic employer" with reference to transfer pricing policy.

The following important criteria are to be considered in a balancing way (integration-test):

Criteria	Comment
Formal contract?	German and Australian rules are corresponding ("substance over form").[60]
Salary paid in own name and/or own account of hosting company?	Before 2020: Mandatory for withholding obligations according to courts; however, tax authorities unclear.[61] Since 2020: not important according to s 38 *EStG*: However, according to Federal Court of Finance indicator for integration-test, Bundesfinanzhof [Federal Finance Court], I R 46/03 (might be an obsolete argument by now).
Employee works up to three months for hosting company?	Presumption that he is *not* integrated in hosting company´s organization, but rebuttable.[62]
Secondment for training purpose?	Strong indication that no integration into hosting company´s organisation.[63]
Rotation-process secondments?	Strong indication that no integration into hosting company´s organisation.[64]
Appointed director, board member or proxy holder?	Full integration-test (without the control-test), entry in the commercial register has strong indication.[65]
In whose interest is the employee working? Who provided the initial impetus of the assignment?	Bundesfinanzhof [Federal Finance Court], I R 46/03, 23 February 2005
Which company has the right to supervise and control?	Supposedly a relevant criterion.[66]
Who decides about vacation of the employee?	No relevant court cases until now.[67]
Where is the work performed?	However, no strong indication for appointed directors, board members or proxyholders.[68]

Special care has to be taken with the issue of "interest". To express the interests in the assignment of either the hosting or the transferring company convincingly, the documentation provided to the German tax authorities should regard following aspects:

- functions performed and activities undertaken by the assignee,
- skills, knowledge and contacts,
- contribution to the hosting company's results in relation to the costs,
- specific projects the employee works on,
- costs and availability of comparable employees in the local labour market,

60 For Germany: Ministry of Finance [2018] (n 35) 136; for Australia: ATO (TR 2013/1) (Fn 55), 11.
61 Ministry of Finance [2018] (n 35) 138.
62 Ministry of Finance [2018] (n 35) 142.
63 Ministry of Finance [2001] (n 40) 3.4.3.
64 Ministry of Finance [2001] (n 40) 3.4.2.
65 Ministry of Finance [2018] (n 35) 147, 148.
66 Ministry of Finance [2018] (n 35) 133; "important" according to Sabine Ziesecke et al, ´Steuerliche Behandlung des Arbeitslohns nach den Doppelbesteuerungsabkommen´ [2018] Deutsches Steuerrecht 1889.
67 Ministry of Finance [2018] (n 35) 134.
68 Ministry of Finance [2018] (n 35) 134.

- special conditions of the transfer arrangements, and
- which party took the initiative for the transfer.

Final thoughts: Indeed, the amendment of *EStG* § 38 (1) 2 has closed a gap. However, considering the potential fall-out damage inflicted, it comes with a price for employer, employees and tax authorities. Until 2019 at least it was rather clear when it came to defining the obligation of withholding taxes.

When deciding about future secondments employers have to take a probable tax- and wage tax-withholding-liability into account, which makes assignments potentially more expensive and – consequently – less likely. To minimize the risk, comprehensive documentation is essential, producing extra work for all parties, thus provoking disputes on audits. With these uncertainties it may be advisable to act beforehand to avoid unanticipated liability and costs. A way to legally bind the German revenue authorities is the "advance income tax ruling" (Lohnsteueranrufungsauskunft), *EStG* § 42e. The employer (or even the employee) can get advance-information from tax authority whether and to what extent the provisions related to German wage tax law apply. The tax authority confirms whether a withholding obligation exists and to what extent. This confirmation is legally binding and could make compliance easier. Without this, secondments can be costly if the employer cannot provide a solid documentation.