March 26, 2010

A Comparison of the Income Tax Systems in the United States and Germany: The Rugged Individualist Meets the Social Activist

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A COMPARISON OF THE INCOME TAX SYSTEMS IN

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THE RUGGED INDIVIDUALIST MEETS THE SOCIAL ACTIVIST

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I. INTRODUCTION

There is more than one road up the mountain. Different countries find different solutions to raising revenues and taxing their citizens. The United States tends to be a bit inbred about tax policy decisions, rarely looking outside of its own borders for answers. Yet other countries may have looked at a given issue and come up with intelligent answers that could helpfully inform U.S. decisions. The converse is, of course, also the case. One of the striking things about doing comparative tax analysis is how differently, but legitimately, different countries can answer the same question. There also times when one country's answer is demonstrably superior to that of another country.

In this paper we will compare German and U.S. income taxation of individuals. A comprehensive review of the two systems would require a multi-volume treatise, not an article. Instead we will primarily concentrate on noteworthy topics involving the taxation of individuals who are employees or self-employed professionals. Our focus is civil, not criminal law.

Tongue in check, part of the title is "The Rugged Individualist (i.e. the U.S.) Meets the Social Activist (i.e. Germany)." To say that the U.S. tax code is that of the rugged individualist is far from true; a social agenda can be found in many code sections. But the U.S. tax code does not go nearly as far as the German tax code in this regard, which is often dominated by efforts at social

engineering. As we will discuss, to a great extent the difference in the two tax codes reflects the difference in the two cultures.

Part II of our article provides some relevant background information on the German and U.S. legal systems. Part III discusses the relevant constitutional issues, including the impact of decisions of the European Court of Justice on German tax law. Part IV reviews overarching doctrines that apply to the two tax systems. Part V, which in some ways forms the heart of the article, explains and analyzes how the two countries get to taxable income. Part VI addresses how Germany and the U.S. tax foreign income. Part VII looks at each country's loss limitation rules. Part VIII discusses how each country taxes capital gains and losses. Part IX focuses on dividend and interest income. Part X does a brief flyover of the U.S. alternative minimum tax rules. Germany is unburdened by this complex parallel tax system. We provide our conclusion in Part XI. Throughout these may parts, we pay particular attention to the ways Germany and the U.S. can learn from each other.

The German income tax rates discussed in this article are currently increased by the "solidarity surcharge" of 5.5% of the tax that would otherwise apply. This tax is meant to fund the costs of German reunification.[1] As

[1] See Solidaritätszuschlaggesetz. Interestingly, Germans do not usually use the term reunification. It is more common to use the term "die Wende," which in this context could be translated as "turning point," or simply "die Deutsche Einheit," "German Unity." The latter term is more commonly used by officialdom and in the treaty of unification itself: "Vertrag zwischen der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik über die Herstellung der Einheit Deutschlands (Einigungsvertrag)."

reunification took place 1990, 20 years ago, it is increasingly questionable whether this tax can be fairly said to have that same focus, and indeed its constitutionality has recently been questioned.[2]

II. BACKGROUND

A. Some Basics

Technically, Germany does not have a constitution. After World War II, "West Germany" did not want to adopt a formal constitution, fearing it might inhibit a hoped for reunification with "East Germany."[3] Instead Germany adopted a "Basic Law" which is indistinguishable from a constitution in everything but name. The German Basic Law ("Grundgesetz") contemplates that Germany will adopt a constitution to replace it.[4] After reunification finally happened in 1990, Germany still did not want to adopt a new constitution, this time fearful that negotiations could be time consuming and inhibit the reunification process.[5] The

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[2] A lower court has questioned the constitutionality of this tax and requested a ruling from the German Constitutional Court. See http://www.faz.net/s/RubA5A53ED802AB47C6AFC5F33A9E1AA71F/Doc~E6BC33895B1084012B5DF6A0831FDA8D3~ATpl~Ecommon~Scontent.html; also see infra notes 75 to 130 and accompanying text.

[3] See David E. Weiss, Striking a Difficult Balance: Combating the Threat of Neonazism in Germany While Preserving Individual Liberties, 27 VAND. J. TRANSNATN'L L. 899, 901 n.3 (1994). See also Gregory S. McCurdy, Note, German Reunification: Historical and Legal Roots of Germany's Rapid Progress Towards Unity, 22 N.Y.U. J. INT'L L. & POL. 253, 257 (1990).

[4] See Basic Law Art. 146.

[5] See Mathias Reimann, Takeover: German Reunification Under a Magnifying Glass, 96 MICH. L. REV. 1988, 1996 (1998); the Basic Law has been amended over 50 times since its adoption in 1949. See http://www.tagesschau.de/inland/grundgesetz160.html. It requires a two thirds vote of the Bundestag and Bundesrat to amend the Basic Law. Art. 79(2).

Basic Law thus remains the underpinnings of the German legal system. The German Basic law protects a wider array of rights than the U.S. constitution, some of which are detailed below.[6]

Like the U.S., Germany uses the federal system of government. Germany is divided into 16 states or "Länder." While the Basic Law was intended to strengthen the hand of the Länder,[7] they have limited influence on most important tax matters. Unlike the U.S., where the states have broad taxing authority,[8] the federal government in Germany possesses the bulk of the taxing jurisdiction.[9] The Länder may not enact tax legislation in areas where the federal government has exercised its authority,[10] which leaves the Länder with decidedly limited room in which to operate. The Länder's tax legislation tends to focus on local taxes on consumption and expenditures that are not substantially similar to taxes imposed by a federal law.[11] The federal government is, however, required to share tax revenues with the Länder, which in turn are required to share their revenues with the municipalities and communal governments.[12] Currently, the general income tax is allocated 42.5% to the federal government,

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[6] See Henry Ordower, Horizontal and Vertical Equity in Taxation as Constitutional Principles: German and the United States Contrasted, 7 Fla. Tax Rev. 259, 264-265 (2006) (hereinafter Ordower); in this article Prof. Ordower does an excellent job of contrasting the German and U.S. constitutional review of tax cases.

[7] See Hugh J. Ault and Brian J. Arnold, Comparative Income Taxation, A Structural Analysis, 2nd Edition, at 53 (hereinafter "Ault and Arnold").

[8] See David Schultz, State Taxation of Interstate Commuters: Constitutional Doctrine in Search of Empirical Analysis, 16 TOURO L. REV. 435, 444 (2000).

[9] Basic Law Art. 105; also see Ordower supra note 6 at 266-267 and Thomas Stobbe, Steuern kompakt, 7th edition, p. 33 (hereinafter "Stobbe").

[10] Basic Law Art's. 72(1), 105(2).

[11] Basic Law Art. 105.

[12] Basic Law Art. 106.

42.5% to the state government, and 15% to municipal and communal governments.[13] The corporate income tax is allocated 50% to the federal government and 50% to the state governments.[14]

B. Tax Authorities

Of course, Germany has tax statutes. It also has what the U.S. would call legislative regulations.[15] It does not have interpretive regulations, at least not in the U.S. sense of that term. Germany does have "Richtlinien" which provide guidance similar to the U.S. interpretive regulations,[16] but are only binding on the tax administrative authorities, not on the taxpayers or the courts.[17] In the U.S., both legislative regulations and interpretive regulations are binding on taxpayers as well as the government, and are almost never overturned by the courts. The "jaw-boning" effect of Richtlinien is doubtless significant, however. Germany also has a close analog to the U.S. revenue rulings/revenue procedures conflated into a single governmental issuance ("Steuererlass").[18] Finally, the courts interpret the law. As Germany is a civil law country, the courts, aside from the Constitutional Court, do not see themselves as having as free a hand as U.S.

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[13] Stobbe supra note 9 at p.33.

[14] Id.

[15] Legislative regulations are regulations issued by the Treasury Department that are specifically authorized by a statute. See IRS PRAC. & PROC. REV. 2nd ED., (Thomson & Reuters) ¶ 3.02[3][a] 2002, *available at* Westlaw IRSPRAC 3.02 at p. 5.

[16] Interpretive regulations are regulations that the Treasure Department issues under its general administrative authority without being specifically authorized by statute. See 2009 Cumulative Supplement No. 2, IRS PRAC. & PROC. REV. 2nd ED., (Thomson & Reuters) ¶ 3.02[3][b] 2009, *available at* Westlaw IRSPRAC 3.02 at p. 6.

[17] See Tipke and Lang, Steuerrecht, 19th Edition at 142-143 (hereinafter Tipke and Lang).

[18] Id.

courts would, though their interpretive function gives them ample influence.[19] But tax administrative authorities generally limit the effect of a lower court rulings to the case in question, the so-called "Non-Application Ruling" ("Nichtanwendugnserlass"). Thus, it may take a decision of the 'Bundesfinanzhof,' The Supreme Court for Financial Matters (the highest authority for nonconstitutional tax questions) to get the tax administrative authorities to change their position.[20]

C. Tax Code Structure

The U.S. Supreme Court held the early efforts at an income tax to be unconstitutional.[21] Congress and the states responded with the 16th Amendment specifically authorizing an income tax. The predecessors to the current "Internal Revenue Code" followed. Almost all federal tax statutes, including the income tax statutes, are contained within this code.

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[19] See Robert F. Utter & David C. Lundsgaard, Judicial Review in the New Nations of Central and Eastern Europe: Some Thoughts From a Comparative Perspective, 54 OHIO ST. L.J. 559, 567-71 (1993).

[20] See infra notes 52-55 and accompanying text.

[21] At the time of the early enactments, the U.S. Constitution required indirect taxes to be uniform and direct taxes to be apportioned among the states. U.S. Constitution Art. 1, Sections 8 and 9. In Pollock v. Farmers' Loan & Trust Co., 157 US 429 (1895) and Pollock v. Farmers' Loan & Trust Co., 158 US 601 (1895), the Supreme Court held that a tax on income from real estate was a direct tax that needed to be apportioned. Apportionment requires that aggregate amount paid by each state be proportional to its population instead, for example, to the value of the taxable income earned within that state. As apportionment had not occurred for the income taxes under discussion in Pollock (and indeed is highly impractical to do in any event), the Supreme Court held them to be invalid. Congress and the states responded with the 16th Amendment, specifically authorizing an income tax. See Bittker, McMahon & Zelenak: Federal Income Taxation of Individuals at ¶ 1.01 (hereinafter "BM&Z").

The German tax law is broken into separate codes. It contains an overarching "General Tax Code" ("Abgabenordnung" or "AO") that contains rules of general application and are thus relevant to more specialized tax statutes, including the income tax provisions. The Abgabenordnung governs the terms and definitions relevant for all tax laws. In § 1 Abs. 1 AO it states:

> "This law is relevant for all taxes, including tax benefits that are governed by federal law or the law of the European Community, as far as they are administered by federal or state tax authorities. It is subject to the law of the European Community ."

For example, the Abgabenordnung defines the terms residence,[22] permanent establishment[23] and place of management.[24] The Abgabenordnung contains the entire tax law of obligations and procedural issues dealing with the relationship between tax authorities on the one side and citizens and corporations on the other side. Furthermore, the Abgabenordnung contains criminal tax law provisions, including the rules on criminal tax evasion. We discuss the importance of European Community law on German tax law below.[25]

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[22] § 8 AO.
[23] § 12 AO.
[24] § 10 AO.
[25] See infra notes 56 to 74 and accompanying text.

In the U.S., the individual and corporate tax regimens are contained within a single taxing structure.[26] In Germany, on the other hand, the individual and corporate income tax provisions are contained in separate taxing codes, the Einkommensteuergesetz (literally, the income tax law--hereinafter "EStG") and the Körperschaftsteuergesetz (literally, the corporate tax law).[27] To observe this difference in organization is to observe little, however, as the U.S. income tax provisions contain numerous differences between the way individuals and corporations are taxed and could be thought of as two taxing structure collapsed into one. The reality is that both the U.S. and Germany tax individuals and corporations quite differently.

Both the U.S. and Germany have progressive income tax structures, with those with higher incomes taxed at high rates than those with lower incomes. The tax rates range from about 11.5% to 45%[28] in Germany and from 15% to 35% in the U.S.,[29] with both countries excluding very low incomes from any tax. The U.S. adds progressivity by phasing out the certain tax benefits for higher income taxpayers.[30]

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[26] See Chapter 1 of the Internal Revenue Code (hereinafter "Code").
[27] Germany has yet another income tax, the "Gewerbesteuer," a type of trade or business income tax, the proceeds of which go to municipal governments. We do not discuss it in this article.
[28] § 32a EStG.
[29] I.R.C. § 1. Taxes on net capital gains can be as low as 0%, but more typically range from 15% to 28%. See I.R.C. § 1(h).
[30] See infra notes 149 to 150 and accompanying text.

In 2009, for single taxpayers, Germany's maximum marginal tax rate of 45% applies to taxable incomes of over 250,401 Euros,[31] but its second highest marginal rate of 42% applies to taxable incomes of over only about 52,552 Euros.[32] Conversely, for single taxpayers, in 2009 the U.S. marginal tax rate on a taxable income of $78,000 (close to 52,000 Euros) is 25% and the maximum tax rate of 35% applies to incomes over $372,950 (just under 250,000 Euros).[33] Germany's rate structure is thus significantly less progressive than that of the U.S. The higher German tax rates can be a bit deceiving, as the German tax system effectively permits a deduction for some living expenses and additional state and local income taxes do not greatly increase the income tax burden for individuals.[34] State and local income taxes on individuals in the U.S., on the other hand, can be substantial. In California, for example, the marginal income tax rate can be as high as 9.3%.[35] The median state income tax rate in the U.S. is about 5%.[36] Thus, at least in some states, the cumulative marginal rate of tax

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[31] We have decided not to convert Euros to dollars as the rate of exchange fluctuates. As a rule of thumb, 1 Euro equals $1.50. In the experience of the authors, however, a comparison of the buying power of a dollar in the U.S. and a Euro in Germany results in closer to a 1:1 relationship.

[32] See § 32a EStG. We reference single taxpayers, though in the German tax system its relevance differs from that of the U.S. system. See infra notes 273 to 285 and accompanying text. For certain extraordinary income, where income from multiple years is bunched together into a single year, Germany sometimes provides a reduced rate of tax. See § 34 EStG, Stobbe supra 9 note at 203-204. The U.S. used to do something similar with "income averaging," which the Tax Reform Act of 1986 mostly repealed. See BM&Z supra note 21 at ¶ 39:08.

[33] I.R.C. § 1; Rev. Proc. 2008-66.

[34] See supra notes 7 to 14 and infra notes 99 to 100 and accompanying text.

[35] This rate applies when income exceeds $23,950. CAL. REV. & TAX. CODE § 17041(a)(1) (2009).

[36] 5.00% based on the average of median tax rates of all states which have a state income tax (thus, this excludes Alaska, Florida, Nevada, South Dakota, Texas, and Washington). Source for tax rates: TAX FOUNDATION, STATE INDIVIDUAL INCOME TAX RATES, 2009, available at http://www.taxfoundation.org/taxdata/show/228.html.

for high income taxpayers can be comparable to that of Germany's, but for middle income taxpayers, it will be uniformly lower.

The overall tax burden on the German citizenry is heavier than that for the U.S. In 2006, Germany's total taxes were about 35% of gross domestic product ("GDP") , whereas in the U.S. it was about 28%[37] A major component of German taxes is the 19% value added tax.[38] The value added tax also reduces the progressivity of the German tax system as it poses a heavier burden for lower income taxpayers than higher income taxpayers. Lower income taxpayers tend to spend virtually all of their income on necessities, almost all of which is subject to the value added tax. Rent is exempt from the German value added tax, and certain necessities such as food not consumed in restaurants and public transportation are subject to a lower 7% rate.[39] While wealthier taxpayers may buy more goods subject to the value added tax, and thus pay greater value added taxes in absolute terms than poorer taxpayers, the value added taxes they pay tend to represent a smaller percentage of their incomes. Savings and investments of wealthier taxpayers are not subject to the value added tax. The value added tax is thus a regressive tax which reduces the overall progressivity of the German tax system.[40]

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[37] See http://www.oecd.org/document/4/0,3343,en_2649_34533_41407428_1_1_1_1,00.html.
[38] Umsatzsteuergesetz (hereinafter „UStG") § 12(1); it is reduced to 7% in limited circumstances. UStG § 12(2).
[39] UStG § 12(2) and Anlage. Food consumed in restaurants remains subject to the regular 19% value added tax as is clothing. UStG § 12.
[40] See Der Zusammenhang zwischen Steuerlast-und Einkommensverteilung, Forschungsprojekt für das Bundesministerium für Arbeit und Soziales, Endbericht, Dezember 2007; Andreas Peichl and Thilo Schaefer, Wie Progressiv ist Deutschland? Das Steuer- und Tranfersystem im

A fairly low rate of progressivity is unavoidable when a government, such as that of Germany, wants to raise a large amount of revenue for an extensive array of social programs.[41] As is the case in most developed countries, few taxpayers earn large incomes; the vast majority earn moderate incomes. Therefore it is necessary to heavily tax the middle class to raise large amounts of revenue.[42]

Most states in the U.S. impose sales taxes in addition to income taxes. Sales taxes, for the same reason as German value added taxes, tend to be regressive, but the U.S. sales tax rates tends to be much lower than that of the

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Europäischen Vergleich, SOEPpapers on Multidisciplinary Panel Data Research, Deutsche Institut Für Wirtschaftsforschung; also see Ordower 6 note at 275-277.

[41] In 2009, German total governmental spending equaled 44.2% of GDP, see http://www.heritage.org/Index/Country/Germany. In 2009, in the U.S., by contrast, it was 37.4%, see http://www.heritage.org/Index/Country/UnitedStates.

[42] In 2005, Germany's income distribution was as follows:

Singles:

47,1% earned from 1 euro up to 20.459 Euros
47,4% earned from 20.459 Euros up to 52.293 Euros
4,6% earned from 52.293 Euros up to 122.724 Euros
0,5% earned from 122.724 Euros up to 245.423 Euros
0,3% earned from 245.423 or more Euros

Married couples:

57,8% earned from 1 Euro up to 40.918 Euros
38,0% earned 20.459 Euros up to 104.586 Euros
3,3% earned from 52.293 Euros up to 245.449 Euros
0,5% earned from 122.724 Euros up to 490.846 Euros
0,3% earned 490.846 or more Euros

Frankfurt Allgemeinen Sonntagszeitung, November 13, 2005 as shown on http://blog.seibert-media.net/2005/11/trends/einkommensverteilung-in-deutschland/.

German value added tax. The median sales tax rate in the U.S. is under 6%.[43] Also, unlike the German value added tax, most states do not apply the sales tax to services.[44]

Both countries impose other regressive taxes. In the U.S. these includes Social Security taxes, Medicare taxes, and self-employment taxes.[45] In Germany these include mandatory contributions to the national pension program and health care insurance system. Higher income taxpayers pay smaller portion of their incomes for these items than lower income taxpayers.[46]

In analyzing the regressivity of a tax system, it is important to analyze who receives benefits from the public trough and the amount of those benefits. If, for example, a tax system imposes a regressive tax such as the value added tax, but the persons most burdened by the tax are also most benefited by its proceeds, there may be little net regressive effect, if any. We are not aware of any studies that calculate this net effect, but as we will discuss, the German system is often more generous than that of the U.S. in providing those in need with exclusions and deductions. Of course, the higher overall rate of German taxation permits a greater amount of governmental largesse.

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[43] See http://www.usa-sales-use-tax-e-commerce.com/table_sales_rates.asp.
[44] See Ordower supra note 6 at 277-279.
[45] See I.R.C. §§ 3101(a) and (b), 3111(a) and (b), 1401(a) and (b).
[46] See Ordower supra note 6 at 280. Note that the U.S. Social Security and comparable self-employment taxes apply only up to a set of amount of wages or comparable self-employment income, $102,000 in 2008. See 2007-92, 2007-47 I.R.B. 1036. Medicare taxes apply without limit to wages or comparable self-employment income, but neither tax applies to investment income, which typically is a larger component of the total income of wealthier taxpayers. See I.R.C. §§ 3101(b), 3111(b) and 1401(b)

In both countries, the income tax is the largest source of revenues, though in Germany the value added tax runs a close second. In Germany, total income taxes in 2006 were 159,700 million Euros.[47] In 2006, the value added tax added 146,688 million Euros to the government's coffers. The numbers are much larger in the U.S. given its larger population and larger economy. In 2006, corporate Federal income tax revenues were about $381 billion; individual Federal income tax revenues were about $2,051 billion.[48] The U.S. has no value added tax, though most states impose a sales tax and/or an income tax. In 2006 total state income tax revenues were about $332 billion; total state sales tax revenues were about $293 billion.[49]

D. Judicial System

In the U.S., the tax system is administered by the Internal Revenue Service ("IRS") and in Germany by the Ministry of Finance. In the U.S., if a taxpayer has a dispute with the IRS, he takes his case to a federal trial court. He may take it to the Tax Court without paying the taxes first.[50] If he wants to litigate the case in the Court of Federal Claims or a Federal Circuit Court (in the latter

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[47] See Stobbe supra note 9 at p. 29; also see Tipke and Lang supra note 17 at 200.

[48] Internal Revenue Service, Internal Revenue Gross Collections, by Type of Tax and State, Fiscal Year 2006, available at http://www.irs.gov/taxstats/compliancestats/article/0,,id=97168,00.html.

[49] United States Census Bureau, State Government Tax Collections, 2006, available at http://www.census.gov/govs/statetax/0600usstax.html.

[50] See I.R.C. § 6213(a).

case a jury trial is available), he must first pay the tax and apply for a refund.[51] The judgment of any of these courts may be appealed to a Circuit Court of Appeals and from there to the U.S. Supreme Court. In Germany, on the other hand, trial courts are almost always state courts, even for federal tax matters. A taxpayer first takes her case to the "Finanzgericht,' literally "Financial Court."[52] Most of the German "Länder" or states have one such court, though Berlin and Brandenburg share one.[53] An appeal from the Finanzgericht goes to the Bundesfinanzhof in Munich.[54] As noted above, it is the highest court to which an appeal of a tax case can be made, unless a constitutional issue is raised, in which case an appeal to the Constitutional Court ("Bundesverfassungsgericht" in Karlsruhe) may be allowed or mandated.[55]

III. CONSTITUTIONAL ISSUES

A. The Impact of the European Court of Justice on the German Tax Law

We next discuss how the constitutions of Germany and the United States influence their tax systems. We should first note, however, that Germany's constitution is to some extent trumped by the rules of the European Union. By

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[51] See I.R.C. § 7422.
[52] Victor Williams, A Constitutional Charge and a Comparative Vision to Substantially Expand and Subject Matter Specialize the Federal Judiciary: A Preliminary Blueprint for Remodeling Our National Houses of Justice and Establishing a Separate System of Federal Criminal Courts, 37 WM. & MARY L. REV. 535, 602 (1996) (hereinafter "Williams").
[53] Daniel J. Meador, Appellate Subject Matter Organization: The German Design From an American Perspective, 5 HASTINGS INT'L & COM. L. REV. 27, 29 (1983).
[54] Williams, *supra* note 52.
[55] Williams, supra note 52. See also Erhard Denninger, Judicial Review Revisited: The German Experience, 59 TUL. L. REV. 1013, 1024-25 (1985).

U.S. standards, the European Union is a very powerful organization, much more so, for example, than the OECD[56] or the World Trade Organization. While the European Union may not create tax laws in the first instance,[57] it has the legal authority to require its Member States to harmonize[58] their national tax systems.[59] While "Member States are free to design their direct tax systems so as to meet their domestic policy objectives and requirements, they must exercise that competence consistently with Community Law".[60] They may not enact laws that discriminate against the residents of other Member States.[61] Thus, in joining the European Union, the Member States did not give up the right to self-governance, including the right to tax, but they did cede substantial authority to the European Union.[62]

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[56] Organization for Economic Cooperation and Development. For a brief comparison between the EU and the OECD initiatives see *Degrève/Molitor,* Tax Notes International 2006, Vol. 41, 299, 305, 306.

[57] *Pistone,* Expected and Unexpected Developments of European Integration in the Field of Direct Taxes, Intertax 2007, Vol. 35, 70-74.

[58] On the status of the harmonization of EU company taxation see the table in *Spengel,* Common corporate consolidated tax base - don't forget the tax rates!, EC Tax Review 2007, Vol. 16, 118, 119.

[59] See Gosch, Steuerrecht im Spanungsfeld, Deutsches Steuerrecht 2007, 1553, 1554; *O'Shea,* Tax Harmonization vs. Tax Coordination in Europe: Different Views, Tax Notes International 2007, Vol. 46, 811-814; *Schön*, Tax Competition in Europe - General Report, in: Schön, Tax Competition in Europe, 2003, 1, p. 3; *Hrehorovska,* Tax Harmonization in the European Union, Intertax 2006, 158; Terra/Wattel, European Tax Law, 2005, pp. 164 et seq. and Chapter 4; *Merks,* Corporate Tax and the Global Village, Intertax 2006, Vol. 34, 26, 30, 31; Niznik, EU Corporate Tax Harmonization: Road to Nowhere?, Tax Notes International 2006, Vol. 44, 975 et seq.; *Hey*, Wettbewerb der Rechtsordnungen oder Europäisierung des Steuerrechts?, in: Reimer, Europäisches Gesellschafts- und Steuerrecht, 2007, 295, 305; Hey, Harmonisierung der Unternehmensbesteuerung in Europa, 1997, pp. 77 et seq.; Lammel/Reimer, Europäisches Unternehmenssteuerrecht, in: Reimer, Europäisches Gesellschafts- und Steuerrecht, 2007, 165-191; Kube, EuGH und Steuerrecht, in: Reimer, Europäisches Gesellschafts- und Steuerrecht, 2007, 225.

[60] Council Conclusions on Co-ordinating Member States' direct tax systems in the Internal Market, 2792nd Economic and Financial Affairs Council Meeting,27/3/2007. Further, *Hey*, Wettbewerb der Rechtsordnungen oder Europäisierung des Steuerrechts?, in: Reimer, Europäisches Gesellschafts- und Steuerrecht, 2007, 295, 296.

[61] Douma, The Three Ds of Direct Tax Jurisdiction, European Taxation 2006, Vol. 46, 522-523.

[62] In depth, Weber, In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC, Intertax 2006, 585-616; Kofler, Wer hat das Sagen im Steuerrecht -

The European Court of Justice ("ECJ") plays an influential role in assuring that German tax law conforms with the European Community ("EC") Treaty's principles of non-discrimination.[63] Indeed, the ECJ has relentlessly chipped away at the tax laws of the Member States.[64] In this respect, the court's holdings have been described as "indirect harmonization", "negative integration", or "harmonization by the back door".[65] The impact of the ECJ on the German tax

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EuGH (Teil 1), Österreichische Steuerzeitung 2006, 106, 107. On the scope of the Member State's direct tax jurisdiction, Douma, The Three Ds of Direct Tax Jurisdiction, European Taxation 2006, Vol. 46, 522, 523; See also Panayi, Treaty Shopping and Other Tax Arbitrage - Part 1, European Taxation 2006, Vol. 46, 104; Lehner, Das Territorialitätsprinzip im Licht des Europarechts, in: Gocke/Gosch/Lang, Festschrift für Franz Wassermeyer, 2005, 241, 245.

[63] See Douma, The Three Ds of Direct Tax Jurisdiction, European Taxation 2006, Vol. 46, 522, 526; Gosch, Steuerrecht im Spannungsfeld, Deutsches Steuerrecht 2007, 1553, 1557, 1558; de Hosson, On the Controversial Role of the European Court in Corporate Tax Cases, Intertax 2006, Vol. 34, 294, 296; O'Shea, From Avoir Fiscal to Marks & Spencer, Tax Notes International 2006, Vol. 42, 587, 589 et seq.; O'Shea, Dividend Taxation Post-Manninen, Tax Notes International 2007, Vol. 45, 887-918; Kofler, Wer hat das Sagen im Steuerrecht - EuGH (Teil 1), Österreichische Steuerzeitung 2006, 106-114; Kofler, Wer hat das Sagen im Steuerrecht - EuGH (Teil 2), Österreichische Steuerzeitung 2006, 154-165; Eicker/Obser, Highlights 2006 der EuGH-Rechtsprechung im Bereich der direkten Steuern, Internationale Wirtschaftsbriefe 2007, Gruppe 2, Fach 11, 761-768; Cordewener/Schnitger, Steuer und Wirtschaft 2006, 50, 377; Seer/Thulfaut/Müller, Die Rechtsprechung des EuGH auf dem Gebiet der direkten Besteuerung in den Jahren 2005 und 2006, Europäisches Wirtschafts- und Steuerrecht 2007, 289, 290; Saß, Zur Begrenzung der nationalen Ausgestaltung der Körperschaftsteuersysteme durch den EuGH, Der Betrieb 2007, 1327-1331; Alber, Auswirkungen des europäischen Rechts auf das mitgliedsstaatliche Steuerecht, in: Ernst & Young, EuGH-Rechtsprechung Ertragsteuerrecht, 2005, 35, 38, 39; Rödder, Deutsche Unternehmensbesteuerung im Visier des EuGH, in: Gocke/Gosch/Lang, Festschrift für Franz Wassermeyer, 2005, 163, 165; Borgsmidt, EuGH-Rechtsprechung zu den Grundfreiheiten in Steuerfällen, Internationales Steuerrecht 2007, 802-809. Critical in regard implementation of EC law by the ECJ, Forsthoff, EuGH versus Europäischer Gesetzgeber - oder Freiheiten über alles?, Internationales Steuerrecht 2006, 222, 224. Further, the taxation of dividends from an Austrian point of view, Haslinger, Die Besteuerung von Dividenden - EuGH bestätigt Kritik an geltender Rechtslage, Steuer und Wirtschaft International 2007, 175-186; Kube, EuGH und Steuerrecht, in: Reimer, Europäisches Gesellschafts- und Steuerrecht, 2007, 225, 226.

[64] See Hey, German Tax Court Revamps Treaty Shopping Law, Tax Notes International 2005, Vol. 40, 122. Further in regard to the Irish tax law, *O'Connor,* The Current Tax Environment: Impact for Irish Business, Tax Planning International Review 2006, Vol. 33, June, 17, 19, 20.

[65] See Soler *Roch,* Corporate tax in the EU: a never-ending story ?, EC Tax Review 2005, Vol. 14, 116, 117. Nonetheless, she doubts that the harmonizing effect of the decisions of the ECJ is so obvious. Further, *Kokott/Henze,* Ist der EuGH -noch- ein Motor für die Konvergenz der Steuersysteme?, Betriebs-Berater 2007, 913-918; Seer/Kahler/Rüing, Die Rechtsprechung des

law should thus not be underestimated. The rate of success for plaintiffs claiming that a national tax law violates EC law is quite high.[66] Currently, there are many provisions in the German domestic law that may violate EC law. In fact, "Kessler and Spengel" receive a great deal of attention for their annually updated list of German tax law provisions that potentially violate EC law.[67]

Among the three ECJ procedures, the infringement procedures (Art. 226 EC Treaty) and the preliminary ruling procedure (Art. 234 EC Treaty) are the most relevant for tax purposes. The most common way to submit tax issues to the ECJ is the preliminary ruling procedure. The national courts certify questions to the ECJ on the interpretation or validity of a provision of national law. The ECJ, by invalidating and modifying national laws, serves as a "harmonization engine" and works to coordinate tax policy among the Member States. Once the ECJ declares that a country's law does not conform with EC law, the country has two options. The country must either extend a beneficial law to all EC citizens and/or companies or repeal the law.[68]

EuGH 2003 und 2004, Europäisches Wirtschafts- und Steuerrecht 2005, 289, 10; Hey, Wettbewerb der Rechtsordnungen oder Europäisierung des Steuerrechts?, in: Reimer, Europäisches Gesellschafts- und Steuerrecht, 2007, 295, 309, 309; Kofler, Wer hat das Sagen im Steuerrecht - EuGH (Teil 2), Österreichische Steuerzeitung 2006, 154-158.

[66] In 2003 and 2004, the ECJ decided in 18 cases against the participating tax authority and only in 2 cases in favor of them. See Seer/Kahler/Rüing, Die Rechtsprechung des EuGH 2003 und 2004, Europäisches Wirtschafts- und Steuerrecht 2005, 289.

[67] Kessler/Spengel, Checkliste potenziell EG-rechtswidriger Normen des deutschen direkten Steuerrechts - Update 2008, Der Betrieb 2008, Supp. 2, 1 et seq. See also Cordewener/Schnitger, Steuer und Wirtschaft 2006, 50, 64 et seq.

[68] See Griffith/Klemm, Tax Competition Experience of the Last 20 Years, Tax Notes International 2004, Vol. 34, 1299, 1310.

The ECJ at times significantly undermines the authority of the German government. As a practical matter, the ECJ has the last word and can render any legislative action void, if it is held to violate EC law. Interestingly, citizens and corporations frequently do not bring a proceeding in the German Constitutional Court to challenge a tax statute, but instead go to the ECJ where their success rate is higher. Each year, significantly more tax cases are decided by the ECJ than by the German Constitutional Court.[69]

Recently, an issue has arisen as to whether there is any limitation of the effects of an ECJ decision.[70] This dispute was raised in the ECJ cases Test Claimants in the FII Group Litigation[71] and Meilicke[72]. On the one hand, in FII Group Litigation and Melicke, the ECJ denied a temporal limitation.[73] On the other hand, in Meilicke the ECJ also explained ways for the Member States to restrict the effect of an interpretation. In brief, the ECJ ruled that a Member State

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[69] Gosch, Steuerrecht im Spannugsfeld, Deutsches Steuerrecht 2007, 1553, et.seq.

[70] Kofler, Wer hat das Sagen im Steuerrecht - EuGH (Teil 1), Österreichische Steuerzeitung 2006, 106, 113-114; Kofler, Überlegungen zur steuerlichen Kohärenz, Österreichische Steuerzeitung 2005, 26-30.

[71] ECJ of 12 December 2006 – C-446/04 (Test Claimants). See, Denys, The ECJ Case Law on Cross-Border Dividends Revisited, European Taxation 2007, Vol. 47, 221, 223-226; Vanistendael, Denkavit Internationaal, European Taxation 2007, Vol. 47, 210, 212-213.

[72] ECJ of 6 March 2007 – C-292/04 (Meilicke). See further, Lang, Die Beschränkung der zeitlichen Wirkung von EuGH-Urteilen im Lichte des Urteils Meilicke, Internationales Steuerrecht 2007, 235-244; Meilicke, Nachlese zum EuGH-Urteil vom 6.3.2007 - Rs. C-292/04, Meilicke, Der Betrieb 2007, 650, 651; Thömmes, Verpflichtung zur Anrechnung ausländischer Körperschaftsteuer, Internationale Wirtschaftsbriefe 2007, Fach 11A, 1131-1136. See also ECJ of 7 September 2004, C-319/02 (Manninen); O'Shea, Dividend Taxation Post-Manninen, Tax Notes International 2007, Vol. 45, 887-918; Kofler, Manninen, Österreichische Steuerzeitung 2004, 582-586; Hintsanen/Pettersson, The implications of the ECJ holding the denial of Finnish imputation credits in cross-border situations to be incompatible with the EC Treaty in the Manninen case, European Taxation 2007, 130-137.

[73] ECJ of 12 December 2006 – C-446/04 (Test Claimants in the FII Group Litigation), para 129-133; ECJ of 6 March 2007 – C-292/04 (Meilicke), para 32-38.

may seek to limit the application of an ECJ judgment if it may cause "grave financial consequences."[74]

B. National Level

Under the Basic Law, Germany's Constitutional Court (note it was never called a Basic Law court) has primary jurisdiction over constitutional questions outside the scope of the EC.[75] Unlike in the U.S., lower courts in Germany normally do not have the power to decide constitutional issues and are required to suspend proceedings and refer such questions to the Constitutional Court if they are critical to the case being heard.[76] As a consequence, the German Constitutional court is required to hear more cases than the U.S. Supreme Court, which usually has discretion as to which cases it wants to hear.[77]

The U.S. Supreme Court uses different standards of review, depending on the matter before it. It only asks if the legislation has a rational basis when challenged legislation does not discriminate against suspect classes or groups, or target fundamental interests. Under this highly deferential rational-basis

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[74] ECJ of 6 March 2007 – C-292/04 (*Meilicke*), para 37: "Indeed, there must necessarily be a single occasion when a decision is made on the temporal effects of the requested interpretation, which the Court gives of a provision of Community law. In that regard, the principle that a restriction may be allowed only in the actual judgment ruling upon that interpretation guarantees the equal treatment of the Member States and of other persons subject to Community law, under that law, fulfilling, at the same time, the requirements arising from the principle of legal certainty."

[75] Basic Law Art. 93.

[76] Basic Law Art. 100.

[77] The U.S. Supreme Court has original jurisdiction in some cases, see U.S. Const. Art. III, § 2.

review, legislation is presumed valid and will be upheld as long as it is rationally related to a legitimate state interest.[78] The U.S. Supreme Court employs "intermediate scrutiny" when the challenged legislation is not facially discriminatory, but when its effect is discriminatory. Intermediate scrutiny is also applied when the legislation applies specifically to certain groups which have historically been subject to discrimination. To pass intermediate scrutiny, the challenged classification must further a substantial state interest.[79] The U.S. Supreme Court employs its highest level of review, "strict scrutiny," when legislation infringes on a constitutionally protected right. Strict scrutiny is an intensified review that applies to suspect classifications (such as those based on race) and classifications aimed at fundamental interests. To pass strict scrutiny, the state must demonstrate a compelling interest and that the law is as narrowly tailored as possible.[80]

It is very unusual for the U.S. Supreme Court to find that a federal U.S. tax law violates the constitution. It consistently applies the rational basis test.[81] For example, the Supreme Court rejected a 1st Amendment free exercise of religion claim and refused to exempt the Amish from the Social Security tax, even though

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[78] 16B AM. JUR. 2D Constitutional Law § 813; Minn. State Bd. for Cmty. Colls. v. Knight, 465 U.S. 271 (1984).

[79] 16B AM. JUR. 2D Constitutional Law § 814; State v. Post, 541 N.W.2d 115 (Wis. 1995).

[80] 16B AM. JUR. 2D Constitutional Law § 815; Att'y Gen. of N.Y. v. Soto-Lopez, 476 U.S. 898 (1986).

[81] See Ordower supra note 6 at 262-263.

their religious beliefs prevented them from participating in Social Security.[82] While at one time the Supreme Court was receptive to due process arguments against the retroactive application of taxes,[83] it has been much less so of late.[84] The government wins the constitutional arguments about 90% of the time in tax cases that reach the Supreme Court,[85] and most of the taxpayers' wins that involve meaty constitutional issues under the Bill of Rights or the Due Process Clause predate 1940.[86]

Germany, on the other hand, employs a more exacting standard of review than the U.S. and has invalidated or modified many German tax statutes on constitutional grounds.[87] The Constitutional Court can, by U.S. standards, be quite intrusive in resolving tax cases, sometimes giving the German legislature very specific guidance on what the content of a tax statute must be to pass muster. The Constitutional Court has played an important role in shaping the German income tax system and has caused the legislature to abolish wealth taxes.[88] Much emphasis is placed on treating like taxpayers alike, 'horizontal

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[82] United States v. Lee, 455 U.S. 252 (1982).

[83] See Nicols v.Coolidge, 274 U.S. 531 (1927) and Untermyer v. Anderson, 276 U.S. 440 (1928).

[84] See Darusmont v. United States, 449 U.S. 292 (1981), where taxpayers claimed that 1976 amendments of the alternative minimum tax provisions could not be applied to a transaction that had taken place in 1976, prior to enactment of the amendments. The Supreme Court held that the amendments did not violate due process. Similarly, see United Staes v. Carlton, 512 U.S. 26 (1994). Also See Charels B. Hochman, The Supreme Court and the Constitutionality of Retroactive Legislation, 73 Harv. Law Review 692 (1960).

[85] See Ordower surpa note 6 at 281-282.

[86] See Ordower supra note 6 at 281-301; also see Karen Beck, Zur Abzugsfähigkeit von Farhtkosten zwischen Wohnung und Erwerbsstätte im amerikanischen Einkommensteuerrecht, Steuer und Wissenschaft, (Febuary 2007), 78-90, at 78-79.

[87] See Ordower supra note 6 at 263-264.

[88] See BverfGE 93, 121 (June 22, 1995 2d Senat) which held that the valuation rules of the wealth tax violated equal rights under Art. 3 of the Basic Law; it also held that the tax was

equity,'[89] as well as "Leistungsfähigkeit," the ability to bear the burden of a tax. While horizontal equity receives significant attention in U.S. tax literature,[90] Leistungsfähigkeit, as such, does not. But in the German system, Leistungsfähigkeit strongly influences the decisions of the Constitutional Court, even though there is a debate as to whether it actually qualifies as a constitutional principle.[91] The principle of Leistungsfähigkeit is not specifically guaranteed by the Basic Law, but was derived by the Constitutional Court from other guarantees within the Basic Law.[92]

A few examples of the Constitutional Court's approach:

In an early Leistungsfähigkeit case, the Constitutional Court indicated that a proportional income tax would violate the equality principle. Art. 3(1) of the Basic Law contains an equality principle (reminiscent of the U.S. Equal Protection Clause) which provides that all "persons shall be equal before the law."[93] The Constitutional Court stated that justice requires that those with the

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confiscatory in violation Art. 14's provisions on property rights. Note that German cases, unlike those in the U.S., do not have "name." The cases, as available to me, do not contain page numbers either. In BVerfGE 93, 165 (June 22, 1995 2d Senat) the Constitutional Court held that the valuation rules of inheritance and gift tax laws violated Art. 3 as they did not fairly represent the actual values. Also see Ordower supra note 6 at 301-302.

[89] See Ordower supra 6 note at 302.

[90] See David Elkins, Horizontal Equity As a Principle of Tax Theory, 24 YALE L. & POL'Y REV. 43 (2006); Richard J. Wood, Supreme Court Jurisprudence of Tax Fairness, 36 SETON HALL L. REV. 421, 425 (2006); also see Ordower supra note 6 at 267-281.

[91] See Tipke and Lang supra note 17 at 73.

[92] The term is used in the Basic Law in other contexts, see e.g. Basic Law Art. 29.

[93] Basic Law Art. 3(1).

greater Leistungsfähigkeit should pay a higher percentage of their income in taxes.[94]

A perhaps more important case with regard to Leistungsfähigkeit involved the Constitutional Court's review of Germany's complex approach for aiding parents with children, which involves both the equivalent of a tax deduction as well as direct payments to the parents.[95] Some of the Constitutional Court's preliminary remarks are noteworthy. The Constitutional Court pointed out, for example, that childless couples do little to financially support the next generation that will in large part pay the pensions of the prior generation.[96] To treat childless couples the same as couples with children, in addition to violating the principle of horizontal equity, breaks the "contract between generations."[97] The U.S. Supreme Court, in contrast, has never made note of such a contract.

The most striking part of the case, however, was the Constitutional Court's conclusion that the State may not tax the minimum amount of income that is needed to live with "human dignity."[98] The Constitutional Court based its holding on three provisions of the Basic Law. One was Art. 1(1) which provides that: "Human dignity shall be inviolable. To respect and protect it shall be the duty of all state authority." The second was Art. 20(1). It provides that "The Federal

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[94] BVerfGE 8, 51, 68 f.
[95] BVerfGE 82, 60; see infra notes 119 to 121and accompanying text.
[96] BVerfGE 82, 60 at A.II.
[97] The Court did note that problems with the German Pension System did not, in and of themselves, constitute a reason to invalidate the child support provisions.
[98] BVerfGE 82, 60 at C.III.

Republic of Germany is a democratic and social federal state." The term "social" is a rendering of the German word "sozial." Sozial in German has a much broader meaning than social has in English, and Art. 20(1) might be better translated as: "The Federal Republic of Germany is a democratic and *socially just* federal state."[99] The term "social justice" is not common to American political parlance, and when heard, it is typically heard from the left, but it is a mainstream term used by almost all of the political parties in Germany.[100] While the contrast with U.S. constitutional jurisprudence is striking, it should be noted that the U.S. Constitution does not contain articles similar to the noted articles of the Basic Law nor to the third article cited by the Constitutional Court, which was Art. 6(1). It provides that: "Marriage and the family shall enjoy the special protection of the state." The Constitutional Court stated that a society that elevates the status of marriage and family cannot place expenditures for children on the same level as more optional expenses. Further, horizontal equity required that parents with children not be taxed the same as childless couples. This remains true even for those with higher incomes.[101]

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[99] The Court noted that the law in question for support of children did not, in and of themselves, violate Art. 20(1); the Court noted that the state has significant leeway in constructing a socially just state. At a minimum, the court said, the state is charged with creating a society with a standard of living for its citizens not below the minimum needed for human dignity. BVerfGE 82, 60 at C.II.

[100] In fact, the center-right CDU, currently the largest party in Germany, takes pride in the fact that they invented the "social market economy" ("soziale Marktwirtschaft") that endeavors to reconcile the forces of free competition and entrepreneurship with higher levels of economic security for German citizens. During the current financial crisis, the support for a social market economy is stronger than ever and likely will fuel tax changes.

[101] BVerfGE 82, 60 at C.III.

The Constitutional Court is quite rigorous in its application of horizontal equity as it showed in a case involving the living expenses of a spouse who lived and worked in a different city than that in which his family lived. In the U.S., a taxpayer may deduct living expenses "while away from home."[102] One must have a home to be away from.[103] An employee temporarily assigned to a post away from his home can thus deduct his living expenses while at the temporary post. There is, however, a one year limit. If the taxpayer is away from home for over one year, or from the outset anticipates being away from home over one year, the living expenses are not deductible.[104] The presumption here is that if a taxpayer is away from home for over one year, it is reasonable to expect him to make a permanent move to the new location.

Germany has a similar rule, but without a time limit.[105] At one point, Germany tried to provide a time limit, making the duplicated living expenses nondeductible after two years.[106] A married professor challenged the new law. He and his self-employed wife had lived in Frankfurt. The professor moved to Berlin to take a new position at a university and sought to deduct the expenses of the second home in Berlin.[107] The Constitutional Court took a detailed look at the

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[102] I.R.C. § 162(a).
[103] See Rosenspan v. United States, 438 F.2d 905 (2nd Cir. 1971).
[104] I.R.C. § 162(a); Treas. Reg. § 1.162-2(e); If the taxpayer anticipates being away from home one year or less, but while away discovers that he will be away from home for over one year, the living expenses are deductible up to the time his expectations change. Rev. Rul. 99-7, 1999-1 C.B. 361.
[105] § 9(5) EStG.
[106] § 9(5) EStG (1995).
[107] See BverfGE 107, 27; the decision actually involved two different taxpayers;we only address the facts of one. Under the German system, a taxpayer first takes her case to the Finanzgericht, literally "Financial Court." See Williams supra note 52 at 602. Most of the German "Länder" or

available statistics of German taxpayers that have duplicated living expenses. It was clear from this review that many married couples were forced to live apart for job-related reasons, often lasting longer than two years. The Constitutional Court noted that under the equality principle, a law cannot be upheld if a reasonable person cannot find a good reason for the differentiation that is made between different taxpayers. In addition to the focus on horizontal equity, and the Court emphasized the need to be attentive to the Leistungsfähigkeit. In this latter regard, the Constitutional Court pointed out that the costs of earning income—up to an average level-- are fundamentally deductible, and taxpayers are normally to be taxed on their net income.[108] In contrast, U.S. courts have seen deductions as a matter of legislative grace.[109] The Constitutional Court, while acknowledging that the legislature needs some flexibility in implementing its laws, stressed that exceptions from taxing taxpayers on their net income requires special justification. Further, expenses such as child care, while within the private sphere, are nondiscretionary and must be taken into account in computing taxable income. The Constitutional Court concluded that there was no special justification for the two-year limit, as legitimate reasons might exist for incurring

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states have one such court, though Berlin and Brandenburg share one. See Daniel J. Meador, *Appellate Subject Matter Organization: The German Design From an American Perspective*, 5 HASTINGS INT'L & COM. L. REV. 27, 29 (1983). An appeal from the Finanzgericht goes to the Bundesfinanzhof, literally the "Federal Financial Court." See Williams supra note 52. It is the highest court to which an appeal of a tax case can be made, unless a constitutional issue is raised, in which case an appeal to the Constitutional Court may be allowed or mandated. See Williams, also see Erhard Denninger, *Judicial Review Revisited: The German Experience*, 59 TUL. L. REV. 1013, 1024-25 (1985).

[108] BverfGE 107, 27.

[109] See First Nat. Bank & Trust Co. v. United States, 115 F.2d 194 (5th Cir. 1940); also see Erwin N. Griswold, An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943).

duplicative living expenses for more than two years, such as where two spouses carry on their professions in different locales.

In considering duplicated expenses, the Constitutional Court also addressed Art. 6 of the Basic Law which, as noted above, provides that "marriage and the family shall enjoy the special protection of the state."[110] The Constitutional Court observed that the legislature may not interfere with the decisions married couples make over the division of labor. In particular, the legislature should not encourage a wife to be a stay-at-home mother as opposed to entering the workplace. Similarly, a husband cannot be limited in his career decisions by his wife's choice to have her own career. Under the reviewed statute, income used for duplicated living expenses of spouses who lived apart for career reasons was, once the two year limit had passed, put on the same footing as the income of spouses that was freely disposable. This, the Constitutional Court concluded, violates both Art.'s 3 and 6. Why the couple might choose careers in different cities is not a relevant consideration; it makes no difference if those are the only jobs available or if they simply represented superior career opportunities. Art. 6 protects spouses trying to unite career and marriage. Further, to allow the two-year limit would place one-earner marriages on the same footing as two-earner marriages, even though they find themselves in different circumstance, a violation of horizontal equity and, as a consequence, Art.'s 3 and 6. As breath-taking as these holdings are from a U.S. perspective, the Constitutional Court did not stop there, insisting that the amount of the

[110] Basic Law, Art. 6 (1).

incomes earned by the spouses, and thus there ability to absorb the duplicated expenses, was not an appropriate consideration for the legislature to take into account. In invalidating the two-year limit, the Constitutional Court was thus taking something close to an absolutist approach in protecting the ability of spouses to unite career and marriage, though a single-earner family could be prohibited from deducting duplicated living expenses, where the duplicated expenses would not be necessary to produce the income. [111]

It is difficult to imagine the U.S. Supreme Court delving in such detail into the impact of a taxing statute on families, though the U.S. Constitution has no equivalent to Basic Law Art. 6. In the 14th Amendment[112] it effectively has an analog to Art. 3. The difference does not seem, however, to result primarily from a difference in the constitutional language as a difference in constitutional philosophy. The U.S. Supreme Court with its rational basis test is, for the most part, taking a "hands off" approach. The German Constitutional Court is unmistakably "hands on."

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[111] BverfGE 107, 27. We have accurately related the substance of the Constitutional Court's arguments. A literal translation of the German would sound stilted in English, so we have been somewhat liberal in our translation.

[112] The 14th Amendment, Section 1: All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

The U.S., in contrast to Germany, specifically says personal living expenses are *not* deductible.[113] The U.S., however, permits certain deductions that effectively take living expenses into account. A deduction is allowed for "personal exemptions."[114] Generally, the code permits a taxpayer to take a personal exemption for herself, each spouse if a couple is married and filing jointly, and for each dependent.[115] In 2009, the amount of each personal exemption, which is adjusted for inflation, was $3,650.[116] Additionally, taxpayers are generally allowed to deduct the greater of the "standard deduction" or itemize deductions. Itemized deductions are commonly living-related expenses, such as the interest expense of a mortgage on a home, but cover unrelated expenses as well, such as charitable contributions.[117] For 2009, the standard deduction, which is adjusted for inflation, was $11,400 for married taxpayers and $5,700 for single taxpayers.[118] While these deductions offset living costs, unlike in Germany there is no fundamental right to such deductions in the U.S., and the amount of the allowed deductions typically falls far short of actual living expenses.

Germany, on the other hand, to comply with the Constitutional Court's mandate, has a "basic exemption amount," currently 7664 Euros, and a basic exemption amount for dependent children, currently 1904 Euros per child, per

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[113] I.R.C. § 262.
[114] See I.R.C. §§ 151.
[115] I.R.C. § 151; a dependent is typically a family member from whom the taxpayer provides over 50% of the support, see I.R.C. § 152.
[116] See http://www.irs.gov/newsroom/article/0,,id=177992,00.html.
[117] See I.R.C. § 63(d), I.R.C. §§ 163(h), 163(h)(2)(D), 170(a)(1).
[118] See I.R.C. § 63(c) and http://www.irs.gov/newsroom/article/0,,id=187825,00.html

parent (or a total of 3808 Euros per child for a married couple).[119] Germany also makes a direct payment to parents of a subsidy for the expenses of raising children.[120] The exemption amounts under the Constitutional Court's mandate would necessarily need to be adjusted for inflation, but there are no inflation adjustments comparable to the U.S. ones built into the German tax code. Further the exemption amounts apply to all taxpayers, and their benefit is thus not phased out for high-income taxpayers, as is sometimes the case in the U.S..[121]

Perhaps the best example of the aggressiveness of the Constitutional Court is a 1995 case.[122] The Constitutional Court took note of Basic Law Art. 14(1), which provides that "Property carries with it obligations. It shall simultaneously serve the public good." From the word "simultaneously" the Constitutional Court inferred that in addition to serving the public good, there must also be a private benefit. Given the need for a private benefit, the Constitutional Court concluded that the maximum constitutionally allowed rate of tax was approximately 50%.[123] While the case involved a wealth tax matter, the Constitutional Court used broad language suggesting that the total tax burden,

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[119] § 32a EStG contains the "Grundfreibetrag," i.e. the basic exemption amount; EStG 32 Abs. 6 contains the exemption amount for children. Generally the exemption for children applies to those under the age of 18, but that age limit can be increased to 25 if, for example, the children are in college. § 32 Abs. 4 EStG; also see note 303.

[120] See §31 EStG and

[121] See I.R.C. § 151(d)(3)(E) and 68, currently scheduled to expire at the end of 2009. Personal exemptions are phased out by 2% for each $2500 by which a taxpayer's adjusted gross income exceeds a threshold amount. That amount in 2009 is $250,200 for joint returns and surviving spouses and $166,800 for single taxpayers. http://www.irs.gov/newsroom/article/0,,id=177992,00.html I.R.C. § 68 phases out most itemized deductions, but is repealed as of 2010.

[122] BVerfGE 93, 121 (1995)

[123] BVerfGE 93, 121 (1995) at C.I.

including the application of the income tax, could not meaningfully exceed this 50% threshold (the so-called "Halbteilungsgrundsatz," literally the "Principle of Half Division").[124] The case was criticized as being beyond the pale even for judicial activists.[125] In 2006, the Constitutional Court, glossing its earlier holding, concluded that it only applied in the wealth tax context, and refused to find an effective income tax rate of about 57% unconstitutional.[126] As the German wealth tax has been repealed,[127] the 1995 case is of limited direct relevance, but still dramatically contrasts the German judicial tax philosophy with that of the U.S..

What might encourage the Constitutional Court's aggressive stances is that fact that it is much easier to amend the German Basic Law than it is the U.S. Constitution. Art. 79(2) of the Basic Law requires a two-thirds vote of each of the two German legislative branches, the Bundestag and the Bundesrat, to amend the Basic Law.[128] On the other hand, Art. 5 of the U.S. Constitution requires a constitutional amendment to be approved by a two-thirds vote of the House of Representatives and the Senate followed by a ratifying vote of three-quarters of the states.[129] In a sense, the Constitutional Court has a freer hand to be activist,

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[124] Id.
[125] See Tipke and Lang supra note 17 at 129; also see Ault and Arnold supra 7 note at 54.
[126] BVerfGE 115, 114 (2006) at C.I. and II..
[127] The case required its repeal; see Tipke and Lang supra note 17 at 95.
[128] Art. 79(3) prohibits amendments which would change the federal structure of the country, and the rights specified in Art. 1 (on human dignity) and Art. 20 (establishing basic institutional principles, such as the principle that Germany is to be a democratic and socially just state). It would seem, possible, however to amend Art. 79(3), thus end-running the prohibition.
[129] In the alternative to approval by the Senate and House of Representatives, two-thirds of the state legislatures can ask Congress to call a national convention to propose amendments. This has never occurred. In the alternative to approval by the state legislatures, an amendment can

because it is not exceptionally difficult for the legislative bodies to overrule it, should its decisions be deemed to be too radical. As it is exceptionally difficult to overturn a U.S. Supreme Court decision, on the other hand, its judges may feel more restrained in the decisions they make.

IV. OVERARCHING DOCTRINES

Both the U.S. and Germany frown on efforts to avoid taxes by using structures the have little economic substance and are created primarily for tax avoidance purposes. In the U.S., this has been primarily the province of the courts, whereas in Germany it has been (unsurprisingly, for a civil law jurisdiction) more the province of the legislature.

During the earliest days of the 16th Amendment, the Supreme Court held that substance controls form:

> We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases...we have under varying conditions followed the rule.[130]

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be approved by ratifying conventions in three-quarters of the states. This has only occurred once, the repeal of Prohibition.

[130] US v. Phellis, 257 US 156, 168 (1921).

Actually applying the substance over form doctrine is the hard part. In some cases, form will control. If a taxpayer has shares of stock in a corporation with different tax bases, she can choose which to sell based on the tax consequence she prefers. On the other hand, if there is self-dealing, the doctrine is much more likely to find its footing. Thus, if a parent lends money to a child under circumstances where it is better classified as a gift, the substance likely will control the form.[131]

Given that the regulation came from the courts in the U.S., not all courts used the same names for doctrines to cover a given set of transactions. Some related doctrines developed that largely have the same purpose as the substance over form doctrine, but different names. Thus, structures used by taxpayers have also been held to fail if they lacked a "business purpose."[132] Similarly, the "step transaction doctrine" requires that related steps taken by a taxpayer be viewed as a whole rather than taken separately.[133]

Germany's general antiabuse rule ("GAAR") is contained in Section 42 of the Abgabeordnung.[134] It generally provides that a taxpayer cannot avoid taxes

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[131] See BM&Z supra note 21 at ¶ 1.03[3].

[132] See Gregory v. Helvering, 293 US 465 (1935) and CIR v. Transport Trading & Terminal Corp., 176 F2d 570 (2d Cir. 1949), cert. denied, 338 US 955 (1950); also see BM&Z supra note 21 at ¶ 1.03[4].

[133] See Warner Co. v. CIR, 26 BTA 1225 and Carter Publications, Inc. v. CIR, 28 BTA 160 (1933) (acq.); also see BM&Z supra note 21 at ¶ 1.03[5].

[134] § 42 AO; see Kessler/Eicke, Germany's New GAAR - "Generally Accepted Antiabuse Rule"?, Tax Notes International 2008, Vol. 49, 151-153; Ehlermann/Nakhai, Germany Launches Attack On Tax Planning Structures, Tax Notes International 2007, Vol. 47, 316, 317; Eckhardt, Germany to Strengthen Avoidance Rules, Tax Notes International 2007, Vol. 47, 709, 710.

by using an “inappropriate legal structure” that gives rise to a tax benefit that was not contemplated. The statute does not define “inappropriate.” The Bundesfinanzhof determined that a legal structure is “inappropriate” if two unrelated and reasonable parties would not have chosen it to achieve a specific business goal. Inappropriate structures are in the view of the Bundesfinanzhof “complex, complicated, and artificial.”[135] In contrast to the U.S.,[136] the burden of proof of whether or not a structure is “inappropriate” rests with the government. The tax administrative authorities compare the tax consequences of an appropriate structure with the one of an inappropriate structure. If the latter results in a tax advantage for the taxpayer or a third party, the tax administrative authorities must further examine whether or not this tax advantage is contemplated by the tax law or not. Even if the tax administrative authorities make a showing that an inappropriate legal structure was used, the taxpayer has the right to rebut and demonstrate that there were nontax reasons for using the structure.[137] As in the U.S., if the taxpayer loses, the tax payable is computed based on the substance of the transaction.[138]

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[135] Cf. Bundesfinanzhof (“BFH”) decision of 19 August 1999 – I R 77/96, BStBl. II 2001, p. 43; BFH decision of 1 February 2001 – IV R 3/00, BStBl. II 2001, 520.

[136] See, e.g., Tax Court Rule 142(a), 26 U.S.C.A. (I.R.C.1954) § 7453; Bull v. U.S., 295 U.S. 247 (1935).

[137] Kessler/Eicke, Germany's New GAAR - "Generally Accepted Antiabuse Rule"?, Tax Notes International 2008, Vol. 49, 151, 152.

[138] Kessler/Eicke, Germany's New GAAR - "Generally Accepted Antiabuse Rule"?, Tax Notes International 2008, Vol. 49, 151.

In the U.S., there is nothing in the judicial holdings to prevent one of the discussed "general" anti-abuse rules from applying even if a more specific anti-abuse statute also applies, though often the more specific statutes makes the judicial doctrines superfluous. In Germany, by contrast, there has been a long-standing dispute as to whether GAAR takes priority over the other, more specific anti-abuse rules.[139] The position of the German tax authorities was that even when a more specific anti-abuse rule (e.g., the Anti-Treaty-Shopping Rule) applies, GAAR could apply as well. In the German legal context, though, there was a good argument that the general rule of GAAR should be superseded by a special rule as provided by the *lex specialis principle*. This argument has now been accepted, the *lex specialis principle* applies, and the application and the legal consequences of the GAAR are superseded when a special anti-abuse rule applies.[140]

Unsurprisingly, there is little fundamental difference between the U.S. and German approaches. Both countries are trying to get at the bottom line, that is, what is the substance of the transaction. Germany, as a civil law country, may have the tougher time of it. It is not easy to write a statute that will, on the one hand, cover abuse and, on the other hand, not overreach. And indeed, compared to the U.S., the hurdles faced by the German government in stopping

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[139] Kessler/Eicke, Germany's New GAAR - "Generally Accepted Antiabuse Rule"?, Tax Notes International 2008, Vol. 49, 151.

[140] Kessler/Eicke, Germany's New GAAR - "Generally Accepted Antiabuse Rule"?, Tax Notes International 2008, Vol. 49, 151, 153.

abusive transactions appear to be more daunting, as they are mostly bound by the language of the relevant statutes. A U.S. (common law) court, in contrast, is typically less bound by the language of prior court holdings, and thus has more flexibility in fashioning an appropriate remedy.

V. GETTING TO TAXABLE INCOME

A. The Fundamentals

The two countries get to taxable income rather differently, radically differently for most businesses, though our focus is primarily on individuals who are employees and professionals. There are also some surprising differences in what is included as income.

The U.S. system defines income broadly. The Internal Revenue Code in I.R.C. § 61 contains a number of categories of income, but also provides that "..gross income means all income from whatever source derived…"[141] The Supreme Court in Commissioner v. Glenshaw Glass Co. underscored this point, holding that income includes "undeniable accessions to wealth."[142] Numerous

[141] I.R.C. § 61(a) provides that " Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (*but not limited to*) the following items…" (emphasis supplied).
[142] 348 U.S. 426, 431 (1955).

code sections except certain accessions to wealth from gross income,[143] but the starting premise of the income tax system is that income is to be defined broadly.

In the U.S., taxpayers start with "gross income" and make certain deductions under I.R.C. § 62 to get to "adjusted gross income" ("AGI"). By and large these deductions are for expenses that are necessary to earn the income. Thus a self-employed lawyer might have substantial I.R.C. § 62 deductions whereas a lawyer employed by a law firm may have none. While in the U.S. an employee is considered to be in the trade of business of being an employee[144] and may deduct expenses to earn the income under some circumstances, by and large these expenses are not deductible under I.R.C. § 62. I.R.C. § 62 is in large part designed to level the playing field between employees and the self-employed. Expenses that are deductible, but not listed in I.R.C. § 62, are deductible under I.R.C. § 63 in getting from AGI to taxable income.[145] Also deductible from AGI are personal exemptions.[146] I.R.C. § 62 expenses are sometimes called "above the line" deductions, and I.R.C. § 63 deductions are sometimes called "below the line" deductions or "itemized" deductions. Taxpayers are permitted to take the greater of their itemized deductions or the

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[143] There are numerous exclusions, including under some circumstances for gifts (I.R.C. § 102), interest on state and local bonds (I.R.C. § 103), compensation for injuries or sickness (I.R.C. § 104), medical insurance payments (I.R.C. § 105), employer provided medical insurance (I.R.C. § 106), and income from discharge of indebtedness (I.R.C. § 108), to name but a few.

[144] See, e.g., David J. Primuth v. Commissioner, 54 T.C. 374 (1970); United States v. Generes, 405 U.S. 93 (1972).

[145] In lieu of I.R.C. § 63 deductions, a taxpayer may take a "standard deduction." This is also adjusted for inflation. For 2008, the standard deduction is $10,900 for married couples filing a joint return and surviving spouses, $5,450 for singles and married individuals filing separately, and $8,000 for heads of household. See IR-2007-172, Oct. 18, 2007. An additional amount is deductible for taxpayers that are over 64 years old or blind (or both). See I.R.C. § 63(f). The standard deduction is limited for taxpayers who are dependents of others. See I.R.C. § 63(c)(5).

[146] I.R.C. § 151. See supra notes 114 to 116 and accompanying text.

standard deduction.[147] I.R.C. § 62 deductions are far preferable, because there are usually no limits on their deductions. There are commonly limits on I.R.C. § 63 deductions. For example, medical expenses are only deductible to the extent they are not covered by insurance and do not exceed 7.5% of AGI. Under I.R.C. § 67, many itemized deductions are only allowed to the extent they in the aggregate exceed 2% of AGI, though this rule does not apply to some of the most important deductions such as interest on the mortgage on a home, state taxes, and charitable contributions. Finally, up to 80% of most itemized deductions (now also including the more important deductions) are phased out for wealthy taxpayer, though the phase out is itself subject to being phased out (i.e. repeal) starting in 2010.[148] All of these phase outs and hurdles are dubious from a tax policy perspective. People do not incur medical expenses as a tax dodge, and the 7.5% hurdle is far greater than is needed to avoid frivolous deductions. The 2% threshold of I.R.C. § 67 and the various phase outs are ways of increasing taxes without having to formally increase income tax rates. They add a lot of complexity to the code. It would be more honest and simpler to increase income tax rates As we discuss below, the German system lackes hurdles and phase outs, and in our view in this regard takes the preferable approach.

[147] See I.R.C. § 63(B) and supra notes 116 to 118 and accompanying text.
[148] See I.R.C. § 68.

Once taxable income is calculated, I.R.C. § 1 then assesses a tax at a rate of up to 35% on the taxable income of the taxpayer.[149] While the maximum I.R.C. § 1 tax rate is the same for everyone, how quickly one gets to it depends on one's classification. The ranking, moving from most favored to least favored, is (1) married taxpayers filing jointly and surviving spouses,[150] (2) heads of household,[151] (3) individuals, and (4) married taxpayers filing separately.

The German definition of income, while hardly narrow, is more restrictive. Whereas, the U.S. system usually starts with "gross income" on its way to computing "taxable income," the German system starts with 7 categories of "revenue" (revenues in this context are not synonymous with gross receipts). While the term income in German can be used in a broad sense comparable to the way it is used in the U.S., in its formal usage, the German word for income ("Einkommen") is only used in the penultimate step in calculating taxable income. The term taxable income, unsurprisingly, is used the same way in Germany as it is in the U.S., though it is surely calculated differently.

The 7 categories of revenue in the German system are:

1. agriculture and forestry;

[149] Children under the age of 14 are sometimes taxed at their parents' tax rate. See I.R.C. § 1(g).
[150] Surviving spouses are, the main, single parents of minor children whose spouse died within the last two years. See I.R.C. § 2(a).
[151] Heads of household are, in the main, single parents with minor children who do not qualify as surviving spouses. See I.R.C. § 2(b).

2. business operations;

3. self employment earnings;

4. employment earnings;

5. income from capital and certain capital gains and losses (to use U.S. nomenclature);

6. rental and lease income.

7 "other revenue," a bit of potpourri that includes a wide variety of sources, but does not attempt to provide comprehensive coverage on a par with Glenshaw Glass; examples: annuities, under some circumstances alimony, and certain capital gains and losses.[152]

In principle, the revenues and expenses in each category are netted. A net loss in one category typically can offset net income in another category, though as we discuss in more detail below, there are exceptions.[153] Germany calls the result of this netting process, assuming it yields a positive number, the "sum of the revenues" ("Summe der Einkünfte"), the next step on the road to taxable income.[154]

As we also discuss below, Germany historically has not made the distinction that exists in the U.S. between ordinary income and capital gains. However, while the term ordinary income is still not used, it could be starting in

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[152] §2 Abs. 1 EStG.

[153] See Stobbe supra note 9 at 99-101 and infra notes 361 to 369 and accompanying text.

[154] http://www.steuerlehre-freiburg.de/fileadmin/repository/lehrstuhl/intltaxnotes/Kessler_Eicke_Welcome_to_the_German_Dual_Income_Tax.pdf;

2009 with the "Abgeltungsteuer," which could be translated as "final tax." It applies a flat 25% tax on most domestic and foreign income from investment assets as well as certain capital gains, which are thus not included in the Summe der Einkünfte.[155]

The Summe der Einkünfte are reduced by deductions allowed for the elderly and single parents as well as an exclusion provided for those engaged in agriculture and forestry.[156] This yields what Germany calls the "Gesamtbetrag der Einkünfte" which translates awkwardly into English as the "aggregate sum of the revenues."[157] It would be a mistake to think of Gesamtbetrag der Einkünfte as analogous to AGI as the deductions permitted to get from the Summe der Einkünfte to the Gesamtbetrag der Einkünfte don't primarily focus on the expenses of earning the revenues as do the expenses in the U.S. system that take the taxpayer from gross income to AGI. Actually, the Summe der Einkünfte is generally reduced by the expenses of earning them, so it would be more analogous to AGI. To say that, however, it to say little, for sum or the revenues does not go on to play the role in the German tax system that AGI does in the U.S. one. Germany does not generally treat some expenses more favorably than others, whereas the U.S. definitely favors above the line expenses over below the line expenses.

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[155] See http://www.steuerlehre-freiburg.de/fileadmin/repository/lehrstuhl/intltaxnotes/Kessler_Eicke_Welcome_to_the_German_Dual_Income_Tax.pdf; also see Stobbe supra note 9 at 99 and infra notes 407 to 427 and accompanying text.

[156] §§ 24a, 24b, 13 Abs. 3, 2 Abs. 3 EStG; see Stobbe supra note 9 at 99.

[157] See Stobbe supra note 9 at 99.

The Gesamtbetrag der Einkünfte is reduced by certain "special expenses" ("Sonderausgaben") such as the church tax,[158] certain charitable donations, possibly alimony,[159] expenses for "unusual burdens" (e.g. costs for sickness or disability),[160] and a possible loss deduction to yield what Germany now for the first time formally calls income.[161] Sonderausgaben do have a bit of the flavor of the U.S. itemized deductions, but, again, it is not that relevant a comparison as Sonderausgaben are not generally treated less favorably than other expenses. On the other hand, Sonderausgaben (exclusively) and itemized deductions (mostly) involve personal rather than business or employment related expenses. Finally, certain other items may be deducted from income, most importantly possible deductions for the support of children,[162] to now yield what Germany calls taxable income.[163] Aside from the netting process that takes place in the Summe der Einkünfte, there is no special logic to the order in which deductions are taken in the German system, and the order could be changed without changing the ultimate outcome. The same cannot be said of the U.S. where the

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[158] A voluntary tax. There is no constitutional limitation in this regard in Germany—indeed "Christian" is part of the name of two of Germany's main political parties, The "Christian Democratic Union" ("CDU") and the "Christian Social Union" ("CSU"), though these days they almost invariably only use their initials.

[159] See §§ 2 Abs. 4, 10 EStG; see Stobbe supra note 9 at 99.

[160] See §§ 2 Abs. 4, 33, 33a, 33b EStG; see Stobbe supra note 9 at 99.

[161] See Stobbe supra note 9 at 99.

[162] Germany has a highly complex system of providing for the needs of children, which can include moneys from the state in the form of a withholding tax rebate or, if it would generate a larger tax savings, certain tax deductions. See Tipke and Lang supra note 17 at 260-263; § 31 and § 32 Abs. 6 EStG; children up to the age of 25 can be covered, see § 32 Abs. 3 and 4 EStG; also see Stobbe supra note 9 at 99.

[163] § 2 Abs. 5 EStG.

computation of taxable income is very much affected by whether or not a deduction is above or below the line.

Unlike the U.S., Germany does not have a rate structure that varies by classification of the taxpayer, though different classes of taxpayers (for example parents) may receive more deductions than other classes. As noted above, the maximum 45% rate only applies to taxpayers with taxable incomes in excess of 250,000 Euros. A 42% rate applies to taxpayers with taxable incomes in excess of only 52,152 Euros.[164]

Both countries require employers to withhold income taxes from the employees' wages.[165] U.S. taxpayers have a fair amount of flexibility as to how much tax is withheld, though penalties can apply if the tax withheld is too low.[166] German taxpayers have little choice on withholding. Generally, they are assigned to one of 6 "tax classes" with Class 1 having the least tax withheld and Class 6 the most. These tax classes are reminiscent of the U.S. tax rate system, even though Germany does not vary the tax rate based on classification. As a taxpayer's status does, however, affect the deductions to which he is entitled, it makes sense to have different tax withholding classes for different taxpayers. For example, widows and widowers are in Class 1, single parents are in Class 2,

[164] § 32a EStG.
[165] I.R.C. § 3402; § 38 Abs. 1 EStG.
[166] See, e.g., I.R.C. § 6654.

married couples where only one spouse works are in Class 3; if both work, they are generally placed in Class 4.[167]

B. Differences in the Definition of Income

The Summe der Einkünfte system has some surprising consequences from a U.S. perspective. Since, for example, lottery or gambling winnings are not included on the list of revenues, they are typically not taxable under the German system,[168] though they of course would be in the U.S. Integrated into the German income tax system is the idea that for income to be taxable it must be "earned," be the result of effort.[169] Lottery or gambling winnings cannot generally be said to be earned in the usual sense of that term, hence they are normally excluded.[170] Ultimately the point of an income tax is to help pay for the cost of government, and the more important question would appear to be whether one has income, not whether it was technically earned or not. One might ask why the German courts have not taken a step similar to the U.S. Supreme Court in Glenshaw Glass. The German Constitutional Court, as we have seen, is far from bashful. On the one hand, in a civil law system the role of the courts is to

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[167] See http://www.bundesfinanzministerium.de/nn_53848/sid_0F69DC78E278DA6CAA89EFBD98FDE53B/DE/BMF__Startseite/Service/Glossar/L/004__Lohnsteuer.html?__nnn=true?__nnn=true.

[168] See Tipke and Lang supra note 17 at 274.

[169] See Tipke and Lang supra note 17 at 268-274.

[170] There are some very limited exceptions for, e.g., certain lottery winnings of a business, e.g. those of a tire distributor from a lottery conducted by the tire manufacturer; see F.G. Münster EFG 2005, 687 and Tipke and Lang supra note 17 at 274.

interpret and apply the law, not create law.[171] Of course, interpretation can be a creative process, but to add to a legislative list would ignore the principle of legislative supremacy fundamental to a civil law jurisdiction.[172] On the other hand, not taxing lottery winnings while taxing other types of income seems to violate principles of horizontal equity. Taxpayers with comparable levels of (what the U.S. would call) income may be taxed quite differently. Further, it seems inconsistent with principles of social justice to tax "earned" income by not tax lottery income. Both "earners" and lottery winners are advantaged by the income they receive; to the extent their economic gains are the same, should not their obligation to contribute to the costs of government be the same? Horizontal equity and social justice are issues on which the Constitutional Court has focused at length. It seems, therefore, that the Constitutional Court could have, and perhaps should have, insisted that lottery winnings be taxable. Even more curious is why the German legislature does not step into the breach and adopt a more comprehensive definition of income. From a tax policy perspective, it is not apparent why all income, earned or not, should not be at least potentially taxable.

As we discuss below, Germany excludes certain capital gains entirely from taxation under circumstances that raise questions similar to those for lottery winnings.[173]

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[171] See Robert F. Utter & David C. Lundsgaard, Judicial Review in the New Nations of Central and Eastern Europe: Some Thoughts From a Comparative Perspective, 54 OHIO ST. L.J. 559, 567-71 (1993).

[172] Id.

[173] See infra notes 406 to 415 and accompanying text.

C. Tax Expenditures[174]

The German system is more generous than that of the U.S. when it comes to exclusions. § 3 EStG contains a list of some 69 items that are excluded from income. Some of the exclusions are uniquely German, such as damages received on account Nazi atrocities,[175] or damages received as a consequence of having been a German prisoner of war.[176] § 3 EStG contains many other Germany-specific provisions, but there are interesting parallels and differences with the U.S. system.

Tips are income in the U.S. and at times have been a major battle ground between the Service and taxpayers.[177] In a somewhat startling contrast, they are excluded from income in the Germany, provided they are truly voluntary.[178]

Both systems exclude insurance payments for medical expenses from income.[179] The U.S., though, gets to this point rather awkwardly. If someone pays for the accident or health insurance himself, all payments received on account of personal injuries or sickness are excluded from income under I.R.C. §

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[174] A tax expenditure is simply a tax benefit a the government gives its taxpayers. Since the benefit reduces government revenues, it leaves the government in the same position as if it had collected the funds and then spent them, hence the term tax expenditure.
[175] §3 Nr. 8 EStG.
[176] § 3 Nr. 19 EStG.
[177] See BM&Z supra note 21 at ¶ 5.02[2].
[178] § 3 Nr. 51 EStG.
[179] Medical insurance payments: I.R.C. §§104(a)(3), 105(b); §3 Nr. 1a EStG; see §4 Versicherungssteuergesetz.

104(a)(3). This covers not just payments for costs of medical care, but also disability payments. On the other hand, if a taxpayer's employer pays for insurance policy, and the payment of insurance is excluded from income, then only the payments for medical expenses are excluded from income; other payments, such as those for disability, are not excluded.[180] As virtually all employer-provided accident and health insurance coverage is excluded from income under I.R.C. § 106, if the employer provides the insurance, it almost always means that only the payment of medical expenses is excluded from income. Disability payments from such insurance, on the other hand, are income. Consequently, advisors tell their clients to make sure they pay for their disability insurance themselves, as then the actual disability payments will be excluded by I.R.C. § 104(a)(3). Why so much should hinge on whether the employer does or does not provide the insurance coverage is not apparent. Disability insurance is normally not expensive. If a taxpayer—sadly—collects, he is likely to collect far more than he paid in insurance. Still, the U.S. does not tax him, doubtless out of compassion for his unfortunate situation. Why should that compassion suddenly evaporate if the employer provides the policy? The fairly small amounts that are excluded from income for employer provided disability policies would not seem to justify making the disability payments fully taxable, when they are fully excluded if the employee pays for them himself. Germany does not make this dubious distinction and provides that all such insurance payments are excluded from income.[181] The German provisions are sufficiently

[180] I.R.C. §§ 105(a),(b).
[181] §3 Nr. 1a EStG.

broadly written to exclude what the U.S. calls worker's compensation payments. The U.S. excludes them from income under I.R.C. § 104(a)(1).

Germany's exclusions demonstrate a greater level of "social generosity" than exists in the U.S. For example, payments to the unemployed are excluded from income in Germany,[182] but specifically included in income in the U.S.[183] As the unemployed already find themselves in a difficult, and indeed often financially precarious, situation, they would seem an appropriate target of government largesse. Unemployment compensation typically represents a substantial pay cut for most people, so the German approach of providing a helping hand by excluding the payments has much to be said in its favor.[184]

But that is just the beginning. Germany, in addition to other exclusions to help the un- and underemployed,[185] also has exclusions for certain aid to AIDs and hepatitis C victims,[186] various kinds of assistance for the elderly,[187] subsidies to miners and certain industry workers to ease the pain of closings and help them to adjust to new occupations,[188] aid to the handicapped,[189] what Germany calls "parent money," i.e. amounts paid to parents of new born children for the first 12-

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[182] § 3 Nr. 2 EStG.
[183] I.R.C. § 85.
[184] Actually, Germany is not as generous as it could be. While the unemployment compensation is excluded from income, it is added back in to calculate the marginal tax rate. Thus, while it is not taxed, unemployment compensation can move a taxpayer into a higher tax bracket. § 32b Nr. 1a EStG.
[185] § 3 Nrn. 2, 2a, 2b EStG.
[186] § 3 Nr. 68, 69 EStG.
[187] § 3 Nrn, 28, 55, 56, 63, 66 EStG.
[188] § 3 Nr. 60 EStG..
[189] § 3 Nr. 11 EStG.

14 months of life as well as other payments designed to help parents to help with the cost of raising children,[190] funds that promote the arts,[191] certain governmental maternity leave payments,[192] and supplemental payments for work on Sundays, holidays, and at night.[193] Further, Germany has related provisions that provide some level of deduction for care and training of adult children,[194] as well as deductions for those with disabilities that depend on the extent of the disability.[195] By and large, there are no analogs to these tax benefits in the U.S. system. Obviously, the effort of the German tax code to do what Germans perceive to be social good is great. Query whether exempting supplemental payments for work on Sunday, holidays, and at night is a social good. If the employees are receiving supplemental payments, they are already being compensated for the "extra" effort. A tax break on top of that seems excessive. Indeed, it is not obvious why income for services, supplemented or not, should be subject to a special tax break. Finally, we should note that in may ways the German tax system has taxpayers pay for services. Germans receive more services from their government than Americans receive from theirs, and Germans pay for them, usually in advance, through the tax system.

In contrast to Germany, the U.S. tax code has 34 exclusions; typically their reach is narrow, such as the exclusion for energy conservation subsidies

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190 § 3 Nrs. 24 and 67 EStG; see Stobbe supra note 9 at 195.
191 § 3 Nrn. 11, 43, 44 EStG.
192 § 3 Nr. 1d EStG.
193 § 3b EStG.
194 § 33a EStG.
195 § 33b EStG.

provided by public utilities of I.R.C. § 136 or the exclusion for adoption assistance programs provided by I.R.C. § 137. A few, though, are both broad and expensive, such as the exclusion for death benefits from a life insurance policy under I.R.C. § 101(a)(1),[196] for gifts to other than employees under I.R.C. § 102(a), or for fringe benefits under I.R.C. § 132. Gifts and life insurance payments are also excluded from income under the German system by dint of not being listed within the 7 categories of revenue.[197] Like the U.S., Germany has gift and estate taxes.[198] Unlike the U.S., Germany has a separate set of laws designed to tax the beneficiaries of various types of insurance. It is an adjunct to the value added tax system; the standard rate is the same as it is for the value added tax, 19%.[199] But recipients of life insurance are excluded from the tax (as are payments of medical or disability insurance),[200] so the tax consequence (or, actually, lack thereof) is typically the same for Germans and Americans.[201]

Both countries try to help working parents. It will not surprise the reader at this point to learn that Germany is more generous. The U.S. provides a tax credit of up to 35% of the first $3,000 for 1 "qualifying individual" or $6,000 for 2 or more "qualifying individuals" of employment related "dependent care services." This includes, for example, daycare. Most commonly the credit is 20%, however.

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[196] There is no exclusion if the taxpayer bought the policy from the original issuee. I.R.C. § 101(a)(2).
[197] See Tipke and Lang supra note 17 at 269.
[198] Germany has gift and estate taxes. See Erbschaftsteuer- und Schenkungssteuergesetz.
[199] § 6 VerStG.
[200] § 4 VersStG.
[201] Germany lacks the exception for life insurance policies transferred for consideration; see I.R.C. § 101(a)(2).

The usual cut-off age is 13.[202] For a typical taxpayer with 2 or more children under 13, the U.S. tax credit saves 20% x $6,000 or $1,200 in taxes. Germany excludes employer provided daycare from income.[203] There is no analog in the U.S. tax code. Further, Germany permits taxpayers to deduct 2/3 of the cost of employment-related child care expenses, up to 4,000 Euros per child. Unlike the U.S. system, there is no upper limit on the number of children to which this rule applies. Germany even one-ups the U.S. on the usual cut-off age, which is 14.[204] As Germany provides a deduction and not a credit, the contrast between the two systems might best be explained by an example. Assume a German taxpayer with 2 children, who pays 9,000 Euros in child care expenses, and is in a 25% marginal tax bracket. He may deduct 6,000 Euros of the expenses, which saves 1,500 Euros (about $2250) in taxes, in comparison to the typical $1,200 in the U.S. Of course, German taxpayers who have more than 2 children quickly leave U.S. taxpayers in the dust.

Both the U.S. and Germany provide that expenses incurred to earn excluded income are not deductible.[205] Unlike the U.S., however, Germany has an interesting rule designed to retain the progressivity of its tax system. If a taxpayer has taxable and excluded income, she has to add most of the excluded income (there are exceptions) to the taxable income to calculate her (now likely

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[202] See I.R.C. § 21.

[203] § 3 Nr. 33 EStG. While the U.S. does not exclude this type of income, it does provide a tax credit of up to 35% of the first $3,000 for 1 "qualifying individual" or $6,000 for 2 or more "qualifying individuals" for "dependent care services," which can include daycare. Most commonly the credit is 20%, however. See I.R.C. § 21.

[204] § 4f EStG.

[205] I.R.C. § 265 and § 3c EStG.

higher) tax rate. The higher rate applies to the income that is taxable.[206] This approach works more smoothly in the German tax system than it would in the U.S. as Germany uses linear progression. The U.S. has tax brackets, with lower brackets of income having lower rates of tax. A high income taxpayer has parts of his income taxed at the rates of the lower tax brackets, and parts taxed at the rates of the higher tax brackets. Income is thus broken into parts.[207] The German linear progression system avoids the need to break the income into parts, but requires greater math skills on the part of the taxpayer.[208] Generally, an every increasing, single rate of tax applies to all the taxable income.[209]

A progressive income tax system is grounded on the principle that those with more ability to pay, should pay a higher portion of their income in taxes. To the extent exclusions from income understate a taxpayer's true income, a

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[206] § 32b EStG.
[207] See I.R.C. § 1.
[208] Here is an excerpt from § 32a EStG which, even untranslated, conveys a sense of the complexity of the calculation:

Die tarifliche Einkommensteuer bemisst sich nach dem zu versteuernden Einkommen. Sie beträgt vorbehaltlich der §§ 32b, 32d, 34, 34a, 34b und 34c jeweils in Euro für zu versteuernde Einkommen
1. bis 7 834 Euro (Grundfreibetrag): 0;
2. von 7 835 Euro bis 13 139 Euro: (939,68 • y + 1 400) • y;
3. von 13 140 Euro bis 52 551 Euro: (228,74 • z + 2 397) • z + 1 007;
4. von 52 552 Euro bis 250 400 Euro: 0,42 • x - 8 064;
5. von 250 401 Euro an: 0,45 • x - 15 576.

"y" ist ein Zehntausendstel des 7 834 Euro übersteigenden Teils des auf einen vollen Euro-Betrag abgerundeten zu versteuernden Einkommens.
"z" ist ein Zehntausendstel des 13 139 Euro übersteigenden Teils des auf einen vollen Euro-Betrag abgerundeten zu versteuernden Einkommens.
"x" ist das auf einen vollen Euro-Betrag abgerundete zu versteuernde Einkommen.
Der sich ergebende Steuerbetrag ist auf den nächsten vollen Euro-Betrag abzurunden.

See Tipke and Lang supra note 17 at 396-399.
[209] See Stobbe supra note 9 at 104-106..

taxpayer could be paying fewer taxes than his ability to pay would justify. Further, income is often excluded in the German system on the assumption that a taxpayer is in a difficult economic position. The exclusion for unemployment compensation is an example. If, in fact, a taxpayer's economic picture is not that bleak because he has other sources of income, there is a good argument that the exclusion should be offset with the German tax rate rule. What makes even more sense, however, is to phase out the exclusion for taxpayers to whom it does not intelligently apply. That approach more precisely addresses the issue and we think its greater precision makes it preferable. While we do disagree with the U.S.'s use of phase-outs to disguise tax increases, the use of phase-outs in this context would make good sense.[210]

Neither country taxes what in the U.S. is called imputed income. Imputed income is the benefit one gets from one's own goods or from one's services performed for one's own benefit.[211] Examples are the value one derives from living in one's own house, driving one's own car, and harvesting vegetables from one's own garden.

While we have noted that Germany's tax code typically is more generous than the U.S. tax code when it comes to permitted deductions, this of course comes at a price. The price is higher, sometimes much higher, German tax rates. Many argue, with some cogency, that high tax rates create economic

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[210] See supra notes 148 to 149 and accompanying text.
[211] See Tipke and Lang supra note 17 at 269 and BMZ supra note 21 at ¶ 3.03.

inefficiency and retard economic growth.[212] On the other hand, a more socially oriented tax code may create a more socially just society. While we have seen no empirical data on this, it is conceivable that in a more socially just society taxpayers will be happier and more productive, perhaps offsetting some of the economic inefficiency of the higher tax rates—also perhaps not. Even if there is an economic disadvantage, a society may prefer the more social justice/less economic growth trade-off----or not. Within limits, we see no right or wrong in this. It is a question of each society applying its own norms—though we acknowledge that we are, unavoidably, giving short shrift to a complex topic.

D. Parallel System For Business

As noted in the above discussion, while there are differences in the way Germany and the U.S. calculate taxable income, the two systems—as described to this point-- are fundamentally similar. They start with (what the U.S. calls) income, exclude some items, deduct others, and end with taxable income. The U.S. always calculates taxable income using this schema. In Germany, that is generally only the case for employees, investors, smaller businesses, and many self-employed professionals, provided they operate through sole proprietorships or partnerships.[213] Businesses and farming and forestry enterprises who are required to keep formal books according to specified German accounting

[212] See Harvey Rosen, Public Finance, Chapter 13.
[213] See §4 Abs. 3 EStG; the self employed generally follow the same schema as employees for computing taxable income, though, of course, the self-employed may have substantial deductions for business expenses. See § 2 Abs. 2 Nr. 2.

standards[214] use a different method for calculating taxable income than the one we described above. Self-employed professionals in Germany are not seen as conducting a business, as such, and are thus not required to keep formal books, but may choose to do so and use the alternate means of calculating taxable income.[215] Taxpayers who keep formal books calculate taxable income by comparing the net value of their balance sheets at the end of the current tax year with that value at the end of the prior tax year. After making adjustments for contributions and distributions, there is a profit if the net value has gone up and that profit generally equates to taxable income. Of course, if net value has gone down, there is a loss, and generally no tax liability.[216] German financial accounting rules, like those in the U.S., look to historical value rather than market value.[217]

This system has wide-ranging implications which are mostly beyond the scope of this article, but two matters are worthy of mention. Since a fairly low amount of profit, 50,000 Euros, can trigger the obligation to keep formal books, the system of comparing balance sheets to calculate taxable income often

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[214] §4 Abs. 3 EStG. The following are required to keep formal books: (1) Businesses with revenues over 500,000 Euros per year, (2) farming and forestry enterprises (which Germany classifies separately from other business undertakings) where the owner himself conducts the enterprise and the underlying property is worth over 25,000 Euros, (3) businesses with a profit of over 50,000 Euros per year, and (4) farming and forestry enterprises with a profit of over 50,000 Euros per year. §141 AO.

[215] This is partly a matter of vocabulary. The German term we are translating as business, Gewerbebetrieb, does not include professionals such as lawyers and doctors. Also see Stobbe supra note 9 at 109 and § 18 EStG. Simply renting property is generally not seen as a business enterprise either. § 14 Abs. 3 AO.

[216] See § 2 Abs. 2 Nr. 1, § 4 - § 7k.

[217] Vockert, Tax Accounting in Germany: An Outline, European Taxation 2009, p. 442-443; Karen Kincaid Balmer, CPA, CrFA, et al, *Finding and Analyzing Financial Data,* 1465 Practicing Law Institute, January 2005, *available at* Westlaw 1465 PLI/Corp 9 at p.30.

applies to individuals who conduct business through sole proprietorships or partnerships.[218] Further, Germany looks to whether a given item of property is allocable to "business assets" ("Betriebsvermögen") or is allocable to "private assets" ("Privatvermögen").[219] Only business assets are relevant for the balance sheet comparison method for calculating taxable income. On the other hand, only private assets are eligible for capital gain preferences and are subject to certain capital gain taxes discussed below. While the U.S. often looks to whether an item of property is used in a trade or business for its tax treatment,[220] and often requires formal books to be kept,[221] because it does not use the balance sheet comparison method for calculating taxable income there is less focus on, and less discussion of, which group a given asset belongs to. It certainly does not play the dominant role it does in Germany.

E. Employee Trade or Business Expenses

In both countries, employees are considered to be in the trade or business of being an employee.[222] As a consequence, expenses of that business are deductible. In the U.S., however, employee trade or business expenses are

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[218] See Stobbe supra note 9 at 109-137; also see §141 AO.
[219] Mixed use is also possible. See Stobbe supra note 9 at 109-110.
[220] See e.g. I.R.C. § 162.
[221] The Securities and Exchange Commission requires publicly traded companies to use "Generally Accepted Accounting Principles" ("GAAP"), and GAAP is often used by other businesses as well. See Thomas Lee Hazen, The Law of Securities Regulation 340-341 (Thomson/West, Fifth Edition 2005) and 17 C.F.R. §§ 210.1-01-210.12.29. Also see http://www.legalzoom.com/legal-articles/general-accepted-accounting-principles-or.html
[222] See I.R.C. § 162 and, e.g., Rev. Rul. Rev. Rul. 82-210, 1982-2 CB 203, and § 9a EStG.

subject to the 2% AGI floor of I.R.C. § 67,[223] and thus the expenses are only actually deductible if they are unusually large. Germany has no such limitation, and it indeed seems odd that nonemployee trade or business expenses are fully deductible in the U.S. but those of employees are not. There might be an argument that employees have fewer legitimate trade or business expenses, and §67 is a way to reduce fraud, but if that is true, it is a very heavy handed approach, wiping out both legitimate and illegitimate expenses, and wiping out legitimate expenses that may be substantial. Further, it is noteworthy that Germany manages without specially restricting those type of expenses, suggesting that fraud may not be a large issue in this area. Germany also permits employees to take an automatic deduction of 920 Euros for employee trade or business expenses without providing proof of their expenses. Larger deductions are allowed with proof.[224]

F. Office in the Home

Under some circumstances the U.S. permits taxpayers to deduct the costs of an office in the home. This can include proportionate shares of utility expenses as well as depreciation deductions based on the office's percentage of the basis of the home (excluding the land).[225] To qualify, the office generally must be used exclusively and on a regular basis as (1) the principal place of

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[223] See supra notes 147 to 148 and accompanying text.
[224] §9a Abs. 1a EStG.
[225] Land is not generally depreciable. See Treas. Reg. § 1.167(a)-2. For a detailed discussion of the office in the home deduction, see BM&Z supra note 21 at ¶ 13:10.

business for any trade or business of the taxpayer or (2) a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer.[226] In the case of an employee, the use of a home office must be for the convenience of the employer, as opposed to that of the employee. As long as the employer provides the employee with an office in which he can work, the fact that the employee has an office in the home is typically of no special advantage to the employer, and the employee normally would not be allowed a deduction.[227] Further, a deduction for the home office is allowed if it is used exclusively for management and administration, if there is no other fixed location where these functions are preformed, even if the home office is not the principal place of business. This latter rule was triggered by a case involving an anesthesiologist to whom the U.S. Supreme Court denied an office in the home deduction because he did not have a principal place of business as he worked in different hospitals.[228]

Clearly the focus of the statute is to permit deductions where the use is driven by legitimate business needs, and to otherwise deny them. Potential for abuse remains and it is difficult for the IRS to verify the extent to which a home office is appropriately used.

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[226] See I.R.C. § 280A(c)(1)(A),(B). In the case of a separate structure not attached to the dwelling unit, a looser standard applies. The structure must be used "in connection with" the taxpayer's trade or business. See I.R.C. § 280(c)(1)(C).
[227] See BM&Z supra note 21 at ¶ 13:10.
[228] See I.R.C. § 280(c) flush language and Commissioner v. Soliman, 506 U.S. 168 (1993).

The tax authorities in Germany also, of course, find it difficult to determine whether a home office is being appropriately used, which may explain why in Germany the rule for deductions of an office in the home is a bit tougher. The general rule is that a deduction is only allowed if the office is the principal place of business (or, as the German statute phrases it, the office "stands at the middle of the business").[229] Generally, then, someone who has the use of an office elsewhere likely is not entitled to a deduction.[230] As in the U.S., an employee normally does not qualify for the deduction. The German rule provides a bright line, an undeniable plus, but strikes us as overly strict. Many have no choice but to have a home office, even if it is not the principal place of business (e.g. our anesthesiologist), but in Germany receive no deduction. Given the Constitutional Court's holding that the expenses incurred to earn income must be deductible,[231] there is also a question of whether Germany meets the standards set by the Constitutional Court.

Very recently, the Bundesfinanzhof has made exactly this point, and questioned the constitutionality of the existing rule as it applies to school teachers.[232] School teachers in Germany do not have their own classrooms (teachers travel to the students rather than, as in the U.S., the other way around), and schools do not normally provide teachers with any other workspace, forcing teachers to work at home. The Bundesfinanzhof has not yet issued a

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[229] §§ 4 Abs. 5 Satz 1 Nr. 6b; 9 Abs. 5 Satz 1 EstG.
[230] See Stobbe supra note 9 at 146.
[231] See supra notes 106 to 112 and accompanying text.
[232] BFH-Beschluss dated August 25, 2009, VI B 69/09.

final decision on this matter, and until it does, the Ministry of Finance (which administers the tax system) has modified the home office rule. A deduction for a home office is now allowed if the taxpayer spends more than 50% of his work time in the home office or if the taxpayer is otherwise not provided with an office and he needs one to properly perform his duties (e.g. the school teachers).[233] A decision by the court is expected in late 2010. Note that in the U.S. the home office deduction is available for a teacher for whom the school does not provide an office. The home office provides a space in which the teacher can prepare for classes and, thus is for "the convenience of the employer."

G. Business Use Of Personal Automobiles, Personal Use Of Business Automobiles

In the U.S., generally, the taxpayer is allowed to depreciate the business use of a personal car. This can be done by depreciating that percentage of the basis equal to the percentage of business use. I.R.C. § 280F limits the maximum that may be deducted as depreciation each year for cars.[234] The purpose of I.R.C. § 280F is to prevent taxpayers from buying luxury cars and getting large depreciation deductions as a consequence. In addition, a proportionate share of

[233] BMF-Schreiben dated June 10, 2009 (Az: IV A 3 – 0623/09/10001 – DOK 2009/0650100).

[234] But for I.R.C. § 280F, I.R.C. § 179 might allow the entire cost of an automobile to be expensed in the year for purchase. For 2009, I.R.C. § 179 allows a deduction of up to $250,000 of expenses that otherwise could only be recovered through depreciation. However, I.R.C. § 280F restricts the amount that can be deducted annually for most cars. These amounts are adjusted for inflation. For 2009, the amounts are $10,950 for the first year (an $8,000 increase over the normal amount due to the recession), $4,800 for the second year, $2850 for the third year, and $1775 for each succeeding year until the car is fully depreciated. IRB 2009-17.

the maintenance costs are deductible.[235] Instead, and perhaps more commonly, the taxpayer is permitted to simply deduct his costs at a "standard mileage rate," 55 cents per mile for 2009.[236] No deduction is normally allowed for commuting from home to work.[237]

If, on the other hand, a taxpayer makes personal use of an employer's car, the value of that use is typically income to the taxpayer. Generally, the value will be based on what a the employee would have to pay a third party to buy or lease the benefit, but commonly income is based on the mileage used at the standard mileage rate for 2009 of 55 cents per mile.[238]

The German rules for business use of a personal car are similar. Fundamentally, the business use of a personal car is deductible as a cost of earning income.[239] The method typically used is to deduct .30 Euros per kilometer.[240] There is no analog to I.R.C. § 280F, though one suspects the German courts would apply a reasonableness standard to restrict excessive deductions.

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[235] See Sapp v. CIR, 36 TC 852 (1961) (acq.), aff'd per curiam, 309 F2d 143 (5th Cir. 1962) (depreciation and maintenance of doctor's automobile allocated between personal and business mileage, notwithstanding the fact that the doctor was always on call); generally see I.R.C. §§ 167, 168, and 280F which can limit depreciation deductions for cars; also see See BM&Z supra note 21 at ¶ 13:10.

[236] See http://www.irs.gov/formspubs/article/0,,id=178004,00.html.

[237] There are some limited exceptions. See BM&Z supra note 21 at ¶ 11:02[2][e. Further, I.R.C. § 132(f) excludes "qualified transportation fringes" from income, which can include payments of up to $100 per month to reimburse employees for the expense of using public transportation and up to $175 per month to reimburse them for parking.

[238] See IRS Publication 15B, Employer's Tax Guide to Fringe Benefits, page 23.

[239] See § 9 EStG.

[240] See Stobbe supra note 9 at 145.

Unlike the U.S., Germany permits a deduction for the cost of commuting. The deduction is .30 Euros per kilometer of distance between home and work (one way) ("Entfernungspauschale"). The German government initially denied the deduction for the first 21 kilometers of the commute. The Constitutional Court, in yet another decision that would be inconceivable in the U.S., held the 21 kilometer limitation to be unconstitutional.[241] It violated both the principle the taxpayers should only be taxed on their net income,[242] and the equality principle (that all persons should be equal before the law).[243] Consequently, currently commuting costs are deductible for all from the first kilometer at the .30 Euro rate. Since commuting is undoubtedly an employee trade or business expense, a good argument can be made for the German approach. The limit of the .30 Euro per kilometer avoids the problem of taxpayers buying expensive cars and taking excessive deduction. A negative is that there is no upper limit (beyond a reasonableness standard). It may not adequately encourage taxpayers to live closer to work and live in a more environment-friendly way. The latter issue has been a concern in Germany in this regard.

While one might argue that the U.S. Supreme Court is too "hand off" when it comes to tax matters; here the Constitutional Court appears to be too "hand on." It does not strike us as unreasonable to limit the deduction to those with the greater commuting burden. Query whether the Constitutional Court is

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[241] BVerfG, 2 BvL 1/07, 2 BvL 2/07, 2 BvL 1/08, 2 Bvl 2/08.
[242] See supra notes 106 to 112 and accompanying text.
[243] See supra notes 93 to 98 and accompanying text.

unduly handcuffing, and showing inadequate deference to, the legislative process.

As in the U.S., if an employee uses an employer's car for personal purposes, the value of the use is income. Typically, the measure of the income is 1% of the domestic gross list price of the car for each month during which the car has been used for personal purposes.[244] Alternatively, the income can be based on the actual cost of the use. Employees using this latter approach much keep written track of the miles driven for personal and business purposes.[245]

H. Fringe Benefits

Germany has no broad statutory exclusion for fringe benefits analogous to that of I.R.C. § 132. I.R.C. § 132 is a highly detailed statute and a comprehensive review of its provisions would require a separate article, but its main exclusions include:

1. No-additional-cost service (e.g. flying stand-by for an airline employee).
2. Qualified employee discount (within limits, discounts on the cost of services and goods given by an employer to employees).
3. Working condition fringe benefits (cost free provision of items an employee could otherwise deduct, e.g. professional magazines).

[244] § 8 Abs. 2 EStG; § 6 Abs. 1 Nr. 4. Satz 2 EStG.
[245] § 8 Abs. 2 EStG.

4. De minimis fringe benefits (i.e. items too small to keep track of, such as coffee).

5. Qualified transportation fringe benefits (within limits, providing free transit passes and parking).

6. Qualified moving expenses that are job related.

7. Qualified retirement planning services.[246]

In principle, fringe benefits are income in Germany.[247] The impracticality of fully enforcing that rule has lead to numerous regulatory exclusions. Some exclusions are analogous to the U.S. de minimis rules, such as the exclusions for coffee and snacks.[248] Others go well beyond what is contemplated by I.R.C. § 132, excluding massages that may prevent work-related illness.[249] The German cases are, perhaps unsurprisingly given the lack of clear statutory guidance, all over the board,[250] but the thrust is the same as that of I.R.C. § 132. There are certain kinds of benefits employers provide employees that are either not worth the trouble, or politically imprudent, to tax. The two countries have not drawn the lines in exactly the same places, but both are pursuing the same policy objective. As one commentator has noted, it is difficult to get a "grip" on the

[246] See BM&Z supra note 21, Chapter 8.
[247] See Tipke and Lang supra note 17 at 350-351.
[248] See R 19.6 LStR 2008.
[249] BFH BStBl. 2001, 671.
[250] See Tipke and Lang supra note 17 at 350.

widely scattered German rulings on fringe benefits,[251] and Germany might do well to follow the lead of the U.S. and develop brighter statutory lines.[252]

I. Education

Traditional scholarships to pay tuition and fees at primary and secondary schools as well as at colleges and universities are excluded from income in the U.S.[253] Scholarships for living expenses are not excluded. The German rule is more liberal, excluding scholarships not just for tuition and fees, but also for living expenses.[254] Germany universities generally don't charge tuition, often reducing the need for scholarships. But, of course, German students may need assistance with living expenses and the cost of books. Germany's more liberal rule on scholarships is the more sensible one. Students cannot live from free tuition alone. If scholarships for living expenses are taxed, it makes education more expensive, often for the most needy students. While we have not seen any statistics on this, we would think the relative burden on the taxed students would be far greater than the relative benefit to the fisc. Further, as politicians are fond of repeating, education is the key to surviving in a global economy. Increasing burdens to entry hardly seems prudent.

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[251] Id.

[252] Also see R 19.3 Abs. 2 LStR holding that "conveniences" are not wages.

[253] I.R.C. § 117; see Prop. Reg. § 1.117-6(b) and BM&Z supra note 21 at ¶ 5:06; up to $5,250 of employer provided educational assistance is excluded by I.R.C. § 127.

[254] § 3 Nr. 44 EStG.

In both the U.S. and Germany, the cost of education necessary to maintain existing job skills are usually deductible as a business expense.[255] But, in the U.S., the general rule is that educational expenses are not deductible if they are incurred to meet the minimum educational requirements to enter into a profession or if they qualify the taxpayer for a new trade or business (even if they assist with an existing trade or business);[256] the educational expenses for developing a specialty within an existing profession (e.g. a dentist specializing in orthodontics) are deductible.[257]

But there is a (for the U.S. system sadly typical) hodgepodge of exceptions. Taxpayers with low to moderate incomes are allowed a limited above the line expense deduction for tuition and fees at an institution of higher education, provided they do not use the expense for a tax credit (discussed next). For taxpayers whose AGI does not exceed $65,000 ($130,000 if married filing jointly), the maximum permitted deduction is $4,000. For taxpayer whose AGI exceeds those levels but not $80,000 ($160,000 if married filing jointly) the maximum permitted deduction is $2,000. No deduction is permitted for taxpayers whose income exceed these thresholds.[258] Further, two tax credits are available. The "Hope Scholarship Credit" generally gives the taxpayer a 100% credit for the first $1,000 of tuition and fees and a 50% credit for the next $1,000 of tuition and

[255] I.R.C. § 162, Treas. Reg. § 1.162-5(a); § 9 EStG, R 34 LStR; in Germany this would be part of the "sum of the revenues" calculation. See supra notes 151 to 173 and accompanying text.
[256] Treas. Reg. § 1.162-5(b); Morton S. Taubman v. CIR, 60 T.C. 814 (1973).
[257] See Rev. Rul. 74-78, 1974-1 C.B. 44.
[258] See I.R.C. § 222.

fees for a total possible credit of $1,500.[259] It historically only has applied to the first 2 years of college.[260] Additionally, taxpayers may take the "Lifetime Learning Credit" of 20% of up to $10,000 of tuition and fees for a maximum credit of $2,000 for any year of post-secondary education.[261] The credits are phased out for taxpayers with AGI's beginning at $40,000 ($80,000 if married filing jointly) and fully phased out for AGIs of $50,000 ($100,000 if married filing jointly) or higher.[262] Only one of the credits can be used by a student in one year.[263] To complicate this complicated area further, Congress changed the rules for the Hope Credit for 2009 and 2010,[264] applying it to the first 4 years (rather than 2) of college and increasing the maximum credit to $2,500, 100% of the first $2,000 expended plus 25% of the next $2,000.[265] The phase out range is also increased to AGIs between $80,000 and $90,000 ($160,000 and $180,000 if married filing jointly).[266] Further, for both the Hope and Lifetime Learning credits, covered expenses are expanded to include course materials in addition to tuition and fees.[267] Most tax credits are not refundable, meaning that if the credit exceeds the total tax bill, the taxpayer does not receive a refund of the difference In the case of the Hope Credit, however, 40% of the credit is made refundable.[268]

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[259] I.R.C. § 25A(b)(1).
[260] I.R.C. § 25A(b)(2)(A). The student must be at least "half-time." I.R.C. § 25A(b)(2)(B).
[261] I.R.C. § 25A(c)(1).
[262] I.R.C. § 25A(d)(2). The phase outs are indexed for inflation after 2001. See I.R.C. § 25A(h)(2).
[263] I.R.C. § 25A(c)(2)(A).
[264] President Obama's 2009 Budget Message proposes to make the change permanent.
[265] I.R.C. § 25A(i)(1),(3).
[266] I.R.C. § 25A(i)(4). Just to complicate matters further, the 40% of the credit is refundable, meaning if it exceeds a taxpayer's taxes, he gets a refund of the difference. I.R.C. § 25A(i)(6). Historically, the Hope Credit was nonrefundable, but Congress made 40% of it refundable in the recent change. I.R.C. § 25A(i)(6).
[267] I.R.C. § 25A(i)(1)(A)(3).
[268] I.R.C. § 25A(i)(6).

Public protestations notwithstanding, these (and many other) rules demonstrate that simplicity is not a Congressional priority.

In Germany, the rules are more straight forward and more liberal. Like the U.S., in Germany *the first* education one receives that enables one to enter a profession is not deductible as a business expense, unless the education is part and parcel of an existing job.[269] Something of a contradiction is wired into the German statute, since if the education is part of an existing position, one arguably has already entered a profession, and thus some prior education one received (perhaps in secondary school) might be the ”first education.” The primary intent, though, seems to be to deny an education deduction for first-time university students.[270]

Once someone has entered into the workforce, however, the cost of training to enter a new profession is also deductable as employee trade or business expenses (and part of the Summe der Einkünfte calculation), in marked contrast to the U.S.[271] The German rule here seems more sensible than that of the U.S. In an era of rapidly changing job markets and globalization, no one can count on keeping the same career for a professional lifetime. The U.S. should encourage retraining for this ever changing universe and, like Germany, permit

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[269] § 12 Nr. 5 EStG.
[270] See Stobbe supra note 9 at 145.
[271] R 34 LStR.

deductions for these expenses even if (perhaps especially if) a new profession is involved.

Further, in Germany up to 4,000 Euros per year of those "first" educational expenses, though they do not qualify as employee trade or business expenses, are still deductible as Sonderausgaben.[272] This tracks the U.S. Hope credit, though in much more straight forward, and often more generous, form. The straight-forwardness of the German approach is something the U.S. would do well to emulate.

J. Married Couples

As noted above, in the U.S. married spouses filing jointly receive the most favorable tax rate. There is, however, sometimes a "marriage penalty" on two-income couples, where the tax paid when they file jointly is more than would have been paid if the couple had not been married and filed individual returns. Generally, the marriage penalty is most pronounced when the income of each of the two spouses is equal, and drops as the disparity between the incomes of the spouses increases.[273] The current U.S. marriage penalty actually is in part a reaction to what had been a marriage bonus. At a time when two-income couples were uncommon, single taxpayers complained that they were being unfairly penalized for not being married, and Congress responded by changing

[272] § 10 Abs. 1 Nr. 7.
[273] See BM&Z supra note 21 at ¶ 44.02[5].

the rates in 1969, but that rate change created a marriage penalty for two-income couples.[274] In 2001 and 2003 Congress eliminated the marriage penalty in the 15% and lower tax brackets and also eliminated it with regard to the standard deduction, making standard deduction for married couples exactly double what it is for singles.[275] But for two-income married couples whose marginal rates are above 15% and/or who itemize deductions, a decidedly large group, the marriage penalty can still occur. Giving the hew and cry over the marriage penalty over the years, it is surprising that more has not been done by Congress. Then again, it would be expensive to fix.

Germany does not have a marriage penalty. Instead, Germany has (literally translated) "spousal splitting" ("Ehegattensplitting"). The origins of the current German rule are found in decisions of the Constitutional Court which provide that the government cannot mandatorily aggregate the incomes of spouses for tax purposes.[276] The decisions rest in part on Art. 6(1) of the Basic Law which provides that marriage and the family shall enjoy the special protection of the state. The aggregation of the income of the spouses and the erstwhile marriage penalty that arose as a result was seen as a violation of this constitutional protection.[277] As a consequence, spouses in Germany have the option of filing separately and being treated, in effect, as if they were not

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[274] See BM&Z supra note 21 at ¶ 44.02[5].

[275] See BM&Z supra note 21 at ¶ 44.02[5] and I.R.C. § 63(c)(2).
[276] BVerfGE 6, 55, 67; 9, 20, 34 f.
[277] Id.

married,[278] though, as we will discuss, there is no tax advantage to doing so. Alternatively, provided they live together, they may elect to file jointly.[279]

Germany takes the view that a married couple is an economic partnership in which the joint efforts of the couple produce the couple's income.[280] It is of no import which spouse brought in the income. The tax on a married couple filing jointly is determined by taking the total income of the couple, dividing it in half, determining what the tax would be for a single person on that half, and doubling it to yield the tax on the married couple.[281] For two-income, middle class couples, this will typically reduce the marginal tax rate, which is computed on half of the couple's income. This approach also eliminates the marriage penalty for two income couples. The splitting system, and the consequent, potential reduction in the marginal tax rates, means that spouse with the greatest disparities of income receive the biggest tax benefit. This to some extent tracks the U.S. system in which the marriage penalty is highest for spouses with comparable incomes.

The German approach would seem like tax nirvana for a lot of Americans, but it is actually somewhat controversial in Germany. Some argue that a fully enlightened view of marriage would not see the couple as a single economic community.[282] Further, even under a system like Germany's that fully eliminates

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[278] § 26 EStG.
[279] Id, assuming the couple is taxable on its worldwide income, and further assuming does not separate or divorce during the year.
[280] See Tipke und Lang supra note 17 at 132-133.
[281] § 32a Abs. 5 EStG.
[282] See Tipke und Lang supra note 17 at 133.

the marriage penalty, a married couple only saves taxes if it lowers the married couple's marginal rate of tax. If, for example half the income of a couple exceeds the 42% threshold of 52,152 Euros, but the combined income is less than the 45% threshold of 250,000 Euros,[283] the German system offers the married couple no tax advantage over two single taxpayers with the same total income. On the other hand, if the combined incomes are less than 104,304 Euros (double the 42% threshold), a two-income married couple in Germany will realize a tax benefit from splitting system.

Which country has the wiser approach? Some object to a marriage penalty on grounds that it discourages marriage, an institution that for moral and religious reasons should be supported. That argument found early traction in Germany given the support of marriage in the Basic Law, and the Constitutional Court's ruling (in effect) that the marriage penalty was unconstitutional.[284] But, the German splitting system created in response to the Court's decision has generated lively debate. Supporters have argued that in addition to encouraging marriage, the splitting system protects a couple's economic base and helps secure future maintenance in marriage or after divorce.[285] Others have argued that the German splitting system is inconsistent with an emancipated vision of marriage. In this emancipated vision, a married couple's assets and income

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[283] See EStG § 32a. These are the rates for single taxpayers.

[284] BVerfGE 6, 55, 67; 9,20,34. The Court has sanctioned the current system, BVerfGE 6, 55, 80.

[285] Winhard, Das Ehegattensplitting – Ein Dauerbrenner der steuerpolitischen Diskussion, Deutsches Steuerrecht 2006, p. 1730.

should not be combined. Each spouse should be seen as an independent participant with independent and separate ownership rights to property and income.[286] Others have argued that the unit to encourage is not the couple, but the family (i.e. parent or parents and children). Thus, the splitting should happen at the family level.[287] Particularly in a country with a low birth rate like Germany, this argument has appeal. Comparable debates have taken place in the U.S.[288]

An argument in favor of the marriage penalty is yet another core German tax principle, Leistungsfähigkeit (i.e. the relative ability to bear the burden of the tax). A married couple, in fact, has economies of scale when compared to two single persons living separately. It does not cost as much, on average, for two people to live under 1 roof, than 2 roofs. Thus, the marriage penalty is consistent with Liestungsfähigkeit. The difficulty is that to get around the marriage penalty, two "significant others" are encouraged to not get married and co-habit, as happens in the U.S. A solution might be to give co-habiting couples the same penalty as married couples, though reliably identifying them would surely be a challenge.

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[286] See Tipke und Lang supra note 17 at 132-133 and articles cited in footnote 50; F. Vollmer, Das Ehegattensplittung: Eine verfassungsrechtliche Untersuchung der Einkommensbesteuerung von Eheleuten, Baden-Baden 1998, U. Sacksofsky, Steuerung der Familie durch Steuern, NJW 2000, 1896.

[287] Vogel, Ehe und Familie – Splitting, Steuer und Wirtschaft 1999, pp. 201 et seq; Pfab, Familiengerechte Besteuerung – Ein Plädoyer für ein Familiensplitting, Zeitschrift für Rechtspolitik 2006, pp. 212 et seq.

[288] See Bryan Camp, 108 Tax Notes 1307 (2005); Robert S. McIntyre and Michael J. McIntyre, Fixing the 'Marriage Penalty," 33 Valparaiso University Law Review 907 (1999); For Better Or Worse: Marriage and the Federal Income Tax, Congressional Budget Office (June 1997); James Maule, Tax and Marriage: Unhitching the Horse and Carriage, 67 Tax Notes 539 (1995); Wendy Gerzog, The Marriage Penalty: The Working Couple's Dilemma, 47 Fordham L. Rev. 27 (1978).

This is a messy area. What system one chooses is inevitably value laden, Achieving complete equity in all economic circumstances is unattainable, as is getting everyone to agree on what is equitable. Even in the German splitting system, a couple only attains a tax benefit if their combined incomes place them in a higher tax bracket than the splitting system does, which is hardly always the case. At the end of the day, countries must draw imperfect lines and live with them, perhaps making the marriage taxing systems in both countries defensible.

K. Alimony/Property Settlement

In the U.S., ordinarily alimony payments are an above the line deduction for the payor and are income to the payee.[289] As long as the payment qualifies as alimony, there is no dollar limit. The U.S. permits the spouses to opt out of this system, and for the alimony payments to neither be deductible to the payor or income to the payee.[290] No gain or loss is recognized when property is transferred between spouses during marriage or between former spouses incident to a divorce.[291]

Germany's rules for alimony payments are more restrictive than those of the U.S., at times in ways that seem overtly unfair, and indeed have been

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[289] I.R.C. §§ 71 and 215. Alimony is specifically defined in I.R.C. § 71(b) and among other requirements must be in cash and end at the death of the payee spouse. I.R.C. § 71 treats "separate maintenance payments," where the spouses live apart but do not formally divorce, the same as alimony payments. There are also "front loading rules" designed to insure that what the taxpayer calls an alimony payment is in fact not a disguised property settlement.

[290] I.R.C. § 71(b)(1)(B).

[291] I.R.C. § 1041.

criticized in the German literature.[292] The German taxpayer can choose between a deduction as a "Sonderausgabe," so-called "Realsplitting," or a deduction as an "extraordinary burden" ("auβergewöhnlicher Belastung").[293]

If the taxpayer chooses Realsplitting, the payor may deduct the alimony up to limit of 13,805 Euros, not exactly a princely ransom.[294] This limit applies even if the payor is obligated to pay more. Further, to be entitled to a deduction, the payee has to agree each year to the Realsplitting approach.[295] If Realsplitting is used, then, as in the U.S., to the extent the payor receives a deduction, the payee has income.[296] If, as one would think is more likely the case, the payee does not consent,[297] then the payor also receives a deduction for the extraordinary burden, but the maximum is now reduced to 7,680 Euros, with no income to the payee. It is hard to think of these rules as other than baffling. Why should alimony payments be limited to such a small numbers? Why should the deduction ever be dependent on the consent of the payee spouse *each year*? Divorced spouses are not known for generous inclinations to their former spouses. Why should there be two different systems? There are no obvious answers to any of these questions, and indeed, the same questions are posed in the German literature.[298] Throughout this article we note many areas where one country can learn from the other. Often it is difficult to say which

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[292] See Tipke and Lang supra note 17 at 263-265.
[293] § 33a Abs. 1 EStG.
[294] § 10 Abs. 1 Nr. 1 EStG.
[295] Id.
[296] § 22 Nr. 1, 1a EStG.
[297] The payee is required to consent to Realsplitting if the payor compensates the payee for the taxes the payee must pay. BGB §§ 1569 ff., 242: EStG 1979 §§ 1979 10 I Nr. 1, 22 Nr. 1a.
[298] See e.g. Tipke und Lang supra note 17 at 264-265.

country has taken the more intelligent approach—but not here. Given the high tax rates in Germany and the limited deduction, a German taxpayer could find himself in the position of owing more in taxes and alimony than he has in income. This exact situation existed in the U.S. before World War II and lead the U.S. to adopt the current rules.[299] Alimony shifts income from one spouse to another. It only makes sense for the payor to receive a full deduction and the payee to have the income absent a consensual contrary agreement.

Child support payments are not deductible in the U.S.[300] Usually, the dependency exemption goes to the custodial spouse, but can be given to the payor spouse.[301] As noted earlier, Germany has a complex system for the support of children which can involve a mix of exemptions, deductions, and payments to the parents by the state.[302] The child support payments could qualify the payor to a deduction in 2009 of 6,024 Euros per child.[303] Thus, the German system is much more generous with payments for children than with payments to ex-spouses. It is difficult to draw particular conclusions about the two systems in

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[299] See BM&Z supra note 21 at ¶ 36.01.

[300] See I.R.C. § 71(c); in Germany this is the case by dint of the lack of a statute permitting such a deduction.

[301] I.R.C. § 152(e) assuming both parents in the aggregate provide over half of the support.

[302] See supra notes 119 to 121 and accompanying text; also see note 303.

[303] The taxpayer is given the more favorable of the following two alternatives. Either a montly payment ("Kindergeld") of 164 Euors for the first and second, 170 Euros for the third and 195 Euros for each following child in 2009. In 2010 each figure is raised by 20 Euros. Alternatively, the tax office grants a "child allowance" ("Kinderfreibetrag") (the equaivlent of a U.S. deduction) of the noted 6024 Euros per child in 2009, 7008 Euros in 2010. For 2009, the child allowance is more beneficial than the child benefits, when the family income of both spouses exceeds taxable income of 67,000 Euros, or in the case of a single parent, 35,000 Euros. We will spare the reader the calculations, but the German system offers greater net child benefits to those with higher incomes than those with lower incomes, which seems inconsistent with Germany's social justice focus. For more details see Schmidt, EStG – Einkommensteuergesetz – Kommentar, 28. Auflage 2009, § 31 note 10 et seq.

this regard. Underlying the German system is a very much hands on, socially activist government. The U.S. system is much more hands off, more the rugged individualist perspective, as it were. Many Americans would be offended to have the government as involved in their children's lives as the German government is. Many Germans would be startled by how little involvement the U.S government has. The tax consequences for payments to children reflect these differing values.

L. Bribes, Fines, and Penalties

Here the U.S. and Germany see eye to eye. Neither permits a deduction for bribes, fines, or penalties.[304]

M. Damages

Germany has a rule for excluding damages from income that is both more liberal and more conservative that that of the U.S., and ultimately more rational. The general rule in both countries is that damages are income if they are being paid in lieu of what would have been income if the event creating the right to damages had not occurred.[305] In Germany, this is generally the only time there is income. The U.S. is less consistent, sometimes excluding income under these circumstances, and often finding income when the damages are not an income

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[304] I.R.C. § 162(c)(2), (f); § 4 Abs. 8, 10 EStG.

[305] § 24 Nr. 1 EStG; Raytheon Productions Corporation v. Commissioner, 144 F.2d 110 (1st Cir. 1944). See Tipke and Lang supra note 17 at 269.

substitute. In the U.S., damages to compensate for lost income are excluded from income if the "first cause" of the damages is a physical injury.[306] Otherwise, compensatory damages are normally income, whether they substitute for lost income or not.[307] Thus, in the U.S. damages for a psychological injury are income if unaccompanied by a physical injury. Not so in Germany, where compensatory damages are only income if they replace lost income.[308] Punitive damages are income in the U.S.,[309] but don't exist in Germany, so there is no rule. German law required that damages compensate, but not "enrich," the victim.[310] Damaged are not allowed to punish the wrongdoer.[311]

The German rule on when damages are income seems more cogent. Compensatory damages are designed to make one "even." If they only do that, there should be no income, except when they are replacing what would have been taxable income had there been no injury. If compensatory damages are otherwise taxed, the claimant falls short of being made whole by the tax imposed.

N. Deductibility of Property Taxes and State Taxes

[306] I.R.C. § 104(a)(2); There is also an exclusion for worker's compensation payments, as noted earlier, in both countries. See supra notes 181 to 183 and accompanying text.

[307] In the U.S., damages for injury to property first recover basis and thereafter cause gain to be recognized. See Raytheon Production Corporation v. Commissioner, 144 F.2d 110 (1944); also see I.R.C. § 104(a)(4) and (5) for additional technical exceptions. For a discussion of medical insurance payments see note to and accompanying text. Damages received for injury to nonbusiness property cannot generate gain in the German system.

[308] § 24 Nr. 1 EStG. See Tipke and Lang supra note 17 at 269.

[309] Commissioner v. Glenshaw Glass Co 348 U.S. 426 (1955); see I.R.C. § 104(a)(2).

[310] Oetker, in Münchener Kommentar, 5th Ed. 2006, § 249 BGB n. 8.

[311] Oetker, in Münchener Kommentar, 5th Ed. 2006, § 249 BGB n. 8

As noted above,[312] unlike in Germany, in the U.S. states may independently assess income taxes on its citizens. They are almost always a highly important source of revenues for states that assess them. In the U.S., counties rather than the states usually operate the local school systems, [313] and the counties assess property taxes to finance those operations. Germany also has a property tax, the "Grundsteuer," that is also assessed by the communal authorities, though it is not primarily dedicated to the school system. In Germany, the Länder, rather than the communal authorities, operate the school systems.[314] . The Grundsteuer is almost invariably much lower than U.S. property taxes.[315] In the U.S., both the state income and property taxes are deductible in computing federal taxable income, and often represent a taxpayer's largest deductions after the mortgage interest deduction. There are no analogs for these deductions in the German system.

One can fairly debate whether state charges should be deductible for federal income tax purposes. The federal government is, in effect, subsidizing the state and local governments, but on a patchwork basis, depending on what kind of taxes the state and local governments assesses. To the extent certain

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[312] See supra notes 11 to 14 and 34 to 36 and accompanying text.

[313] For non-U.S. readers, states are typically divided into "counties." The sizes vary and may contain a large city (rarely more than one).

[314] The Gewerbesteuer, a kind of business tax, is a more important source of revenues for the communal authorities than the Grundsteuer. In 2006, the Grundsteuer raised revenues of 10,399,000,000 Euros, whereas the Gewerbesteuer raised revenues of 38,369,000,000. See Stobbe supra note 9 at 29.

[315] See Strohm in Assmann/Schütze, Handbuch des Kapitalanlagerechts, 3. Auflage 2007, § 22 note 84-89.

state and local charges are deductible and others not, the federal government may encourage some kinds of assessments over others, with little, if any, factual basis for the preference. The German system is cleaner in this respect, though its job is made easier by the fact that Germany is many times smaller than the U.S.

O. Charitable Contributions

In the U.S., charitable contributions are itemized deductions.[316] For a donation to be deductible, it generally must either be made to a governmental entity, a church, or a charity organized for "religious, charitable, scientific, literary, or educational purposes" that has received a governmental imprimatur.[317] There are complex rules on the amount in any given year that can be deducted, but these limits are quite generous, no less, generally, than 20% of AGI and commonly as high as 50% of AGI. The limits thus do not affect most taxpayers.[318] A charitable contribution is not deductible to the extent there is a commercial quid pro quo. Thus, if one buys a ticket for a charitable event at the local symphony, or pays a membership fee to an organization, only the amount paid in excess of commercial value of the ticket or the membership rights is deductible.[319] Further, in order for a contribution to a charity to be deductible, the

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[316] They are not subject to the 2% AGI floor of I.R.C. § 67.

[317] See I.R.C. §§ 170(c) and 501(c)(3).

[318] See I.R.C. § 170(b); amounts contributed in excess of the limit may be carried forward for 5 years, see I.R.C. § 170(d).

[319] This area has a long and complex history. See Hernandez v. CIR, 490 US 680 (1989) where the Supreme Court held that any quid pro quo, even noncommercial one, disallowed the deduction. The IRS, however, has only enforced the commercial quid pro quo standard. See

charity may not attempt to influence legislation or participate in any fashion in a political campaign.[320] And, of course, a political party is not a qualifying charity under the U.S. rules. Contributions of services are not deductible in the U.S.[321] Finally, the U.S. requires appropriate documentation of the contribution.[322]

The German rules are at times broader and at times narrower than those of the U.S. Germany permits a deduction for charitable contributions defined in a way very reminiscent of the U.S. rule, though much longer-winded. Among the 25-plus qualifying contributions are those that foster science, religion, health, youth, seniors, art, culture, support for the politically and religiously oppressed, and nature.[323] There is also a provision that permits unlisted purposes to be covered if the top financial authorities of a Land authorize it.[324] Further, membership fees paid to charitable organizations are deductible.[325] The total deduction, for individuals, is limited to 20% of the Gesamtbetrags der Einkünfte per year.[326] As was the case in the U.S., the 20% limit is a very generous one and doubtless fully covers the charitable contribution of the vast majority of taxpayers.

BM&Z supra note at ¶ 25.01[2]. Also see I.R.C. § 170(f)(8) and Rev. Rul. 67-246, 1967-2 C.B. 104. Rev. Rul. 68-432, 1968-2 CB 104,

[320] I.R.C. § 170(c)(2)(D).

[321] See BM&Z supra note 21 at ¶ 25.01.

[322] See I.R.C. § 170(f)(8) requiring a receipt from the charity for contributions of $250 or more. Also see I.R.C. § 170(f)(17) generally requiring a receipt from the charity or a bank record for any contribution, even one under $250, to be deductible.

[323] See §§ 52-54 AO; § 10b EStG.

[324] See § 53 Abs. 2, Nr. 2 AO.

[325] § 10b Abs. 1 EStG; there are restrictions to insure the purpose is charitable; contributions to sporting clubs, for example, are not deductible. § 10b Abs. 1, S. 2.

[326] There is an indefinite carryforward right should that threshold be exceeded. § 10b Abs. 1, S. 3 EStG.

Very much unlike the U.S., contributions to political parties are deductible in Germany, but here the limits are much stricter. Initially Germany gives taxpayers a tax credit of 50% of their contributions to political parties, up to a maximum of 825 Euros, 1650 Euros for married couples filing jointly.[327] Given the use of a tax credit, all taxpayers are placed on the same footing; a contribution by a wealthy person is not more tax-advantaged than a contribution by someone further down the economic food chain. To the extent these contributions exceed those thresholds, a charitable deduction is permitted for the excess up to 1650 Euros per year, double that for spouses filing jointly.[328] In this latter regard, Germany deviates from the more egalitarian approach it takes with tax credits, albeit in a minor way, Further, unlike the U.S., charities are not prohibited from participating in the political process.[329] The U.S. rules restricting the participation of charities in politics have been the subject of significant debate, but permitting a charitable deduction for contributions to political parties has not.[330] As long as there are strict deduction limits, as there are in Germany,

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[327] § 34g EStG.

[328] § 10b Abs. 2 EStG.

[329] The restrictions on political activities of tax exempt "public benefit" organizations are found in the regulations interpreting the AO § 52 (Anwendungserlass zur Abgabenordnung -- AEAO 800). These regulations state quite clearly that political purposes "are fundamentally not" public benefit purposes. On the other hand, "political" is fairly narrowly defined by the regulations. Although it specifically includes trying to influence public opinion and supporting political parties, the regulations go on to say that a certain amount of "influencing public opinion" is permissible for "public benefit" organizations. In fact, it is permissible so long as the accomplishment of a public benefit purpose is linked with setting a political goal, and the actual attempts to influence the political parties and the state are not foremost in what the organization does. The regulations go on to cite a specific case, which held that an organization could take a specific political position, consistent with its public benefit purposes, so long as that was not its primary activity. Quoted from Lee Irish and Karla Simon, CASES AND MATERIALS ON COMPARATIVE LAW AFFECTING CIVIL SOCIETY ORGANIZATIONS, made available to the authors.

[330] See Johnny Buckles, Not Even a Peep? The Regulation of Political Campaign Activity By Charities Through Federal Tax Law, 75 University of Cincinnati Law Review, 1071 (2007); Oliver

to prevent the financially powerful from being given an undue deduction or credit, giving a charitable deduction for contributions to political parties (or related groups) does not seem inherently objectionable. Taxpayers who make smaller contributions to political parties, and other politically active groups, typically do so because the taxpayer they feel they are supporting a good cause, and not in anticipation of some immediate payback—that is, the same circumstances as contributions to charities generally. Further, the deductions encourage participation in the political process, and may make it easier for alternative political parties to get off the ground. In this latter regard, it is noteworthy that Germany has 5 major political parities, the U.S. only 2. Indeed, there is no other major industrialized country that has as few political parties as the U.S.

There is a criticism one could make of the German approach, which also provides an argument sometimes made in favor of the U.S approach: If charities are permitted to participate in the political process, one can end-run the rules for contributions to political parties, by making contributions to charities that supports one's political goals. The contribution to the charity may be deductible, and the

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Houck, On the Limits of Charity: Lobbying, Litigation, and Electoral Politics by Charitable Organizations Under the Internal Revenue Code and Related Laws. 69 Brook Law Review 1 (2003); Allan Samansky, Tax Consequences when Churches Participate in Political Campaigns, *Ohio State Public Law Working Paper No. 76* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=924770; Donald Tobin, Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s; Dangerous for Democracy, forthcoming in the Georgetown Law Review, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=947905 (who would not agree with us); Benjamin Leff, "Sit Down and Count The Cost: A Framework for Constitutionally Enforcing the 501(c)(3) Campaign Intervention Ban," 28 Vir. Tax rev. 673 (2009); Laura Brown Chisholm, Politics and Charity: A Proposal for Peaceful Coexistence, 58 Geo. Wash. L. Rev. 308 (1990); Elias Clark, The Limitation on Political Activities: A Discordant Note in the Law of Charities, 46 Va. L. Rev. 439 (1960).

charity can spend the money on the political party. The contribution to the political party would not be deductible in the U.S, and in Germany one might be effectively be able to exceed the limits on contributions to political parties. The concern raised is a legitimate one, but there are countervailing arguments. In neither the U.S nor Germany does a political party count as a charity, as such. Accordingly, an organization primarily organized to influence the political process would not count as a charity, and contributions to it would not be deductible in the U.S. or Germany. Further, regulations could be promulgated to insure only limited charitable resources are used for political purposes. With appropriate safeguards in place, it does not to us seem inherently offensive for the Sierra Club or a conservative church to support political parties that support its goals. While we acknowledge we are again giving a complex topic short shrift, it is at least noteworthy that Germany lives with significantly more liberal rules for charities and politics without raising many eyebrows. This is not a topic hotly debated in the German tax literature..

Germany and the U.S. see eye to eye on the charitable contribution of services. They are also not deductible in Germany.[331] Germany like the U.S. requires appropriate documentation of the contribution.[332]

Germany has a very tough, and somewhat surprising, rule on quid pro quos. An (apparently) commercial quid pro quo prevents the taxpayer from

[331] § 10b Abs. 3; see Tipke and Lang supra note 17 at 890.
[332] § 50 EStDV; see Tipke and Lang supra note 17 at 890.

taking a charitable deduction, even if the value of the contribution far exceeds the value of the quid pro quo.[333] There is no apparent reason why the net charitable deduction should not be deductible. Charities often use commercial quid pro quos (concert tickets, sometimes items of small value) to lure contributions. Charities ability to raise funds would seem to be significantly hampered by Germany's rule. Germany might argue that the rule promotes administrative efficiency, the contribution is either all in or all out, but the U.S. has been living with a different rule for many years without it posing an undue burden. For any contribution in excess of $75 where there is a non-de minimis quid pro quo, the U.S. requires the charity to inform the taxpayer that only the amount in excess of the value of the consideration received is deductible. The charity must also provide a good faith estimate of the value of the quid pro quo.[334] A similar rule would seem workable—and sensible-- in Germany.

P. Casualty and Theft Losses

In the U.S., if a taxpayer incurs a loss through theft or casualty (e.g. a hurricane), the loss can be deductible, but only if it is quite large. It is only deductible, generally, to the extent it exceeds 10% of AGI, meaning a loss deduction is usually unavailable in the presence of insurance or the absence of

[333] See Tipke und Lang supra note 17 at 889.
[334] I.R.C. § 6115,

catastrophe.[335] Germany has a rule that is both more liberal and more encompassing. It permits the deduction of unavoidable costs that are not covered by other tax rules and are extraordinary in nature, that is, costs that are uncommon for the "overwhelming majority of taxpayers of comparable income, wealth level and family status."[336] Virtually any expenditure could qualify, including, for example, casualty and theft losses, medical expenses, funeral expenses, criminal defense costs, damages payments, and support for needy parents.[337] Cost are considered to be extraordinary if they exceed certain thresholds, which depending on income level and family status can be anywhere from 1%-7% of the Gesamtbetrag der Einkünfte.[338] While the statutory thresholds insure that the costs truly have to be extraordinary, the wide-open nature of the German statute makes us worry that it might pose too great a burden on the fisc and/or be an invitation to fraud. Further, costs that can be anticipated are less worthy of tax subsidy than those than cannot be anticipated, as is typically the case for costs of theft and casualty. We would restrict the tax subsidy to costs that cannot reasonably be anticipated, but dislike the across the board 10% AGI threshold of the U.S. The variable threshold of Germany, which looks to the ability of the taxpayer to bear the burden of the expense (and at a maximum is less that the U.S. threshold), makes more sense to us.

VI. FOREIGN INCOME

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[335] See I.R.C. § 165(h).
[336] § 33 EStG. "Family status" looks to whether or not one is married and/or has children.
[337] See Stobbe supra note 9 at 192.
[338] § 33 Abs. 3 EStG.

The U.S. taxes its citizens on their worldwide income, irrespective of where they reside.[339] U.S. noncitizen residents are also taxable on their worldwide income.[340] A relative modest exclusion is contained in I.R.C. § 911. For 2009, up to of $91,400 of foreign earned income of U.S. citizens and residents is excluded from income for taxpayers primarily living outside of the U.S.[341]

Many countries only tax their citizens on income earned within the country. Germany takes something of a compromise position. Individuals who reside in Germany (citizen and noncitizen) are taxable on their worldwide income.[342] Governmental employees, such as diplomats, who are paid with public funds, are also taxable on their worldwide income even if living outside of Germany.[343] Otherwise, nonresident German citizens are only taxed on income (as Germany defines it) earned within Germany.[344]

The U.S.'s system was once challenged by a U.S. citizen as being unconstitutional and a violation of international law. The Supreme Court upheld

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[339] See Treas. Reg. § 1.1(b).
[340] Id. See I.R.C. § 7701(b) for the definition of residency.
[341] A "housing cost" amount can also be excluded. See I.R.C. § 911(a) and http://www.irs.gov/formspubs/article/0,,id=177960,00.html. Typically, the taxpayer must live outside the U.S. for 330 days out of a calendar year. See I.R.C. § 911(d)(1)(B).
[342] EStG §1(1).
[343] EStG §1(2).
[344] EStG §1(4); see EStG §49. Under some circumstances, taxpayers, whether or not they are German citizens, may elect to be taxable by Germany on their worldwide income. Among other requirements, 90% of their receipts must be subject to German taxes. See EStG §1(3). Making this election can permit the taxpayer to take advantage of certain deductions that are only available to those taxable on their worldwide income. See Stobbe supra note 9 at 97.

taxation on worldwide income, noting that the benefits of citizenship extend beyond the country's territorial boundaries.[345] While it is surely true that the benefits of citizenship extend beyond a country's borders, it is also true that a citizen or resident living outside the U.S. cannot obtain the full measure of benefits of someone living inside the U.S. Indeed his only benefit from being a U.S. citizen may be the right to return to the U.S and access to the U.S. diplomatic personnel abroad. Under these circumstances, a taxpayer may justifiably complain that he is being overtaxed by the U.S. government. Germany's solution strikes an intelligent balance. If someone has full access to the benefits of Germany society by living within its borders, he is taxed on worldwide income. But if those benefits are more limited, because the German citizen lives outside of Germany, only income earned within Germany is taxable.

Both countries permit foreign taxes to reduce domestic taxes. The U.S. usually does this under a highly complex foreign tax credit system.[346] Under the U.S. system, foreign tax credits can bring U.S. taxes to zero, but foreign taxes in excess of U.S. taxes cannot be credited.[347] Complex rule exist to prevent foreign taxes from inappropriately reducing U.S. taxes on U.S. income.[348] The German rules are comparable.[349] Both rules can be overridden by treaty.[350]

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[345] Cook v. Tait, 265 U.S. 47, 54 (1924).

[346] After mustering a lot of courage, see I.R.C. §§ 901-908 and EStG §34c. Income taxes from a political subdivision of a foreign state can qualify as creditable income taxes. See Treas. Reg. § 1.901-2(g)(2). Tax treaties between countries may significantly reduce taxes that would otherwise be assessed and/or exempt certain types of income from tax.

[347] See I.R.C. § 904.

[348] See I.R.C. § 904.

[349] § 34c EStG.

VII. LOSS LIMITATION RULES

In this section we compare the rules limiting the deduction of losses. We discuss what in the U.S. are called capital losses separately below.

A. Hobbies

An issue with which tax systems have to wrestle is whether a taxpayer is legitimately engaged in an activity for profit, or whether it is truly only a hobby. Take, as an example, someone one of us has met. He is a U.S. secret service agent with an avid interest in underwater photography. He occasionally sells photographs to the likes of National Geographic, but he lacks a bottom-line profit motive. His expenses always exceed his income. What deductions should be allowed for photography equipment and other expenses for what is in truth primarily a hobby? It is important not to allow losses from a hobby to not offset income from sources other than the hobby. To do otherwise would significantly undermine the fisc, and require offsetting, higher tax rates on other income.

Hobbies[351] are of no tax consequence in the German system. The income is not taxable as it is not listed within the 7 categories of revenue, and apparently

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[350] See Stobbe supra note 9 at 96-97; I.R.C. § 6114; U.S. treaties uniformly provide for a credit mechanism for foreign taxes, whereas German treaties sometimes provide that foreign income is exempt from taxation.

[351] The term Germans use for hobbies is Liebhaberei, literally "love having." See, e.g., Stobbe supra note 9 at 107.

it is an unwritten (and inescapable) rule that it follows that the expenses are not deductible.[352] When is an activity a hobby in Germany? Germany does not have a statute on point, nor provides a bright-line test. Whether an activity is a hobby looks to whether, based on all the facts and circumstances, the taxpayer has a legitimate profit motive. If a long-term profit motive exists, early losses are deductible, though an extended period of losses may demonstrate that the profit motive was absent in the first instance, causing the losses to be retroactively disallowed.[353] As a rule of thumb, an activity should have the potential to generate an aggregate profit within the first 10 years.[354]

Unlike Germany, the U.S. weighs in with a dedicated statute. This may partially be the result of the fact that under the U.S. system all income, including income from hobbies, is potentially taxable, making it necessary to address how hobby expenses should be handled. I.R.C. § 183, in broad outline, permits expenses of hobbies to be deducted from income from hobbies, but does not permit a net loss from a hobbies to offset nonhobby income. A hobby is defined as an activity not engaged in for profit. I.R.C. § 183(d) provides a safe harbor: An activity is not a hobby if the gross income from the activity for 3 or more years within the past 5 years exceeds associated expenses (2 of 7 years for breeding, training, showing, or racing horses). If the activity is a hobby, the U.S.

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[352] See Stobbe supra note 9 at 107; there is a somewhat related loss disallowance rule in § 22 Nr. 3 Satz 3 EStG. Essentially, losses from certain minor revenue sources within category 7 of the revenue classification rules may not offset income from other revenue sources. The constitutionality of this rule has been questioned, as it arguably violates principles of horizontal equity. See Tipke and Lang supra note 17 at 371-372 and notes to supra and accompanying text.

[353] See Tipke and Land supra note at 272-274.

[354] Selder, in Blümich, EStG-Kommentar, § 13 EStG, n. 139.

Regulations provide complex rules for prioritizing which expenses are deductible, generally preferring cash expenses over noncash expenses such as depreciation.[355] Germany has not had the need to go into this level of detail as the entire hobby activity operates, so to speak, outside the tax system.

B. Business and Investment Activities

In Germany, expenses incurred within any one of the 7 categories of revenue are deductible from revenue within that category, and if there is a loss from one category, that loss may generally be deducted from revenues from another category, with the exception of category 5 (income from capital) and category 7 (other income). [356] We discuss the limitations for categories 5 and 7 revenues below, but for now note that these are generally nonbusiness categories.[357] There are additional limitations, some quite technical or of minor significance. We discuss the more important ones that apply to individuals.

In Germany, losses incurred by a limited partner from a limited partnership may generally offset income from other sources, provided the losses do not create a negative capital account.[358] If the losses do create a negative capital account, they may still be deductible to the extent the limited partner is required to pay certain debts of the limited partnership, which could be thought of as an

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[355] See Treas. Reg. § 1.183-1(b).
[356] See Stobbe surpa note 9 at 193.
[357] See infra notes 404 to 412 and 414 to 426 and accompanying text.
[358] § 15a Abs. 1 EStG.

indirect obligation to restore the negative capital account.[359] The limited partner may carry any currently denied losses forward and deduct them from other income of the partnership, but may not deduct them from income from other sources, including income from other limited partnerships.[360]

Losses from "Steuerstundungsmodellen," may only be deducted from income from the same source.[361] Steuerstundungsmodell demonstrates the German's love for compound words and literally means "tax deferral model." It is probably best translated as tax shelter (in Germany and the U.S., tax shelters are commonly partnerships). This loss limitation only applies if "projected losses" from the tax shelter are expected to exceed 10% of invested capital during the (undefined) "beginning phase" of the investment. The relevant statute is, by U.S. standards, quite brief and short on detail given its potential impact. The same can be said for the related discussion in secondary literature, but what appears to be covered are tax shelters that give investors projections that anticipate losses in the early going.[362]

If after netting income and (to the extent allowed) losses among the 7 categories of revenue, an individual taxpayer operates at an overall loss,[363]

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[359] Id. The debts must have been registered in the "Handelregister." Note that the U.S. rules, before the application of I.R.C. §§ 465 and 469, can operate similarly. See Treas. Reg. § 1.704-1(b)(2).
[360] § 15a Abs. 2 EStG.
[361] § 15b EStG.
[362] See Tipke and Lang supra note 17 at 250 and 790.
[363] But see infra notes 404 to 412 and 414 to 426 and accompanying text.

carryback and carryforward rules apply that are reminiscent of I.R.C. § 172. Generally, up to 511,500 Euros of these losses (up to 1,023,000 Euros for married couples filing jointly) may be carried back to the immediately preceding year.[364] As in the U.S., if a return has been filed, it may be amended, and a refund received.[365] Any unused losses may be carried forward indefinitely, though there are limits on the amount that can be used. The aggregate amount that may be carried forward is 1 million Euros, plus, if income remains to be offset, 60% of the remaining income. For married couples filing jointly the amount is 2 million Euros plus 60% of the remaining income.[366] Somewhat oddly, the loss carryback or carryforward is treated as a Sonderausgabe, though it has priority over other Sonderausgaben.[367] Since it arises from the calculation of the sum of the revenues, one might have expected it to be part of that calculation, rather then come at the end of the process as a Sonderausgabe.[368]

In the U.S., net operating losses from an individual's business operations may, generally, be carried back 2 years and forward 20 years under I.R.C. § 172. The German provisions do not formally limit the carrybacks and carryforwards to business operations to the same extent I.R.C. § 172 does, but effectively the German rule is comparable. As noted below, special restrictions apply to losses

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[364] § 10d Abs. 1 EStG. In Germany this is called "Mindestbesteuerung" or "minimum taxation," not to be confused with the U.S. alternative minimum tax system. The statute contains some additional technical limitations. See Stobbe supra note 9 at 193-194.

[365] Id.

[366] § 10d Abs. 2 EStG. The statute contains some additional technical limitations. See Stobbe supra note 9 at 193-194.

[367] § 10d Abs. 1.

[368] See infra notes 404 to 412 and 414 to 426 and accompanying text.

from the nonbusiness categories 5 and 7.[369] Typically, then loss carrybacks and carryforwards will come from the other 5 categories, all of which have a business nexus.[370] I.R.C. § 172 lacks the dollar limitation of the German system. Having a monetary limitation on loss carryforwards and carrybacks indeed seems dubious. To the extent business income is fully taxable, business losses should—ultimately—be fully deductible. The U.S. permits one more year of carrybacks than the German system. The U.S. limits carryforwards to 20 years, whereas the German system has no limit, but 20 years is hardly a brief period. Aside from the dollar limitations, the differences between the 2 systems cannot be said to be significant.[371]

Germany does not have an analog to the at risk rules of I.R.C. § 465. These rules arose in the 1970's in response to the abusive use of (purported) nonrecourse debt (i.e. debt for which there is no individual liability—generally the creditor's only recourse is to foreclose on the property securing the debt). Taxpayers would, for example, buy property for inflated values, paying the seller in part with nonrecourse debt. The seller would thus act as the lender, perhaps carrying the loan at a low interest rate. The inflated values could then, for example, give the buyer a higher basis in the property and higher depreciation deductions as a consequence.[372] Before the enactment of the original issue

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[369] See I.R.C. § 172(d).

[370] Category 4, employment earnings, is, of course, also not likely to be a source of the loss, a good thing for the employee. § 2 Abs. 1 Nr. 4 EStG.

[371] While we compare the tax rules for individuals and not corporations, it is worth noting that I.R.C. § 382 provides often draconian limitations on the use of NOL carryforwards for corporations.

[372] See BM&Z supra note 21 at ¶ 19.04.

discount rules, the seller/creditor might, given the low interest rates, avoid some ordinary interest income and replace it with lower taxed long term capital gains on the sale.[373] Generally, I.R.C. § 465 stops this abuse by only permitting an individual to take deductions to the extent of the amount "at risk" in the activity.[374] The amount at risk generally only includes cash invested in, and the basis of property contributed to, an activity, as well as the taxpayer's unrestricted liability on recourse debt involved in the activity.[375] Losses disallowed under I.R.C. § 465 may be carried forward indefinitely.[376] There is an important exception for nonrecourse debt used to acquire real estate. Such "qualified nonrecourse financing" typically is included in the amount at risk if the funds are borrowed from a commercial lender.[377] Nonrecourse debt does not appear to be common in Germany, there is little discussion of it in the secondary literature, and it appears that Germany never developed a rule because it never had much of a problem.

Germany also has no clear analog to the passive activity loss rules of I.R.C. § 469 under which losses from a "passive activity" are generally only

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[373] Gains often taxed at lower rates if a capital or I.R.C. § 1231 asset is involved. See I.R.C. §§ 1(h) and 1231. Since the enactment of the original issue discount rules, , lenders are generally required to charge close to market rate interest. See I.R.C. §§ 1272-1274 and 483 if you like to suffer.

[374] I.R.C. § 465(a)(1).

[375] See I.R.C. § 465(b); also see Pritchett v. CIR, 827 F2d 644 (9th Cir. 1987) and Walter Schwidetzky, The Tax Benefits of Liabilities--Their Rise and Fall, 41 Southwestern Law Journal (now SMU Law Review) 953 (1988).

[376] I.R.C. § 465(a)(2).

[377] See I.R.C. § 465(b)(6). It can also be borrowed from a governmental authority. The debt may not be convertible. Id.

deductible from income from passive activities.[378] Generally a passive activity is a business activity in which the taxpayer does not materially participate.[379] Rental activities are automatically passive except to the extent the taxpayer is involved in real estate activities in a very substantial way.[380] Unused passive losses may be carried forward indefinitely.[381] If the taxpayer's interest in a given activity is sold or exchanged in a fully taxable transaction, any suspended passive losses attributable to that activity are freed of the passive loss rules and generally become fully deductible.[382] Germany's loss limitation rules for limited partners and for Steuerstundungsmodell can be thought of as distant cousins of the passive loss rules, but the passive loss rules are, of course, much more prophylactic. The passive loss rules create economic inefficiency and distort economic decisions, inducing taxpayer to prefer investments that do not generate passive losses, irrespective of the underlying economics. To that extent, more focused rules like those of Germany are preferable. Bona fide business and investment losses should be deductible to the same extent bona fide business and investment income is taxable. The rules for Steuerstundungsmodellen, with their focus on abusive tax shelters, are less objectionable, though legitimate investments may be unfairly tainted as well.

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[378] I.R.C. § 469(a).

[379] I.R.C. § 469(c). Royalties, dividends, and other easily earned passive types of income are excluded from the definition of passive income by I.R.C. § 469(e)(1).

[380] See I.R.C. § 469(c)(2) and (7); to be exempted, the taxpayer must be involved in a real estate trades or businesses more than half of the time and more than 750 hours per year, I.R.C. § 469(c)(7)(B). There is a special exception for taxpayers "actively" involved in real estate. They may deduct up to $25,000 of real estate activity losses, with the benefits phased out for taxpayer with adjusted gross incomes over $100,000. This exception typically applies to an individual who rents out a house or condominium. See I.R.C. § 469(i).

[381] See I.R.C. § 469(b).

[382] See I.R.C. § 469(g).

It is highly appropriate for governments to disallow the deduction of tax losses that do not correspond to economic losses, but to the extent loss disallowance rules overreach, they do economic harm. On the whole, Germany has positioned itself better than the U.S. with regard to business losses. On the other hand, its rule for stock losses, which we discuss below, is more debatable.

As noted above, both countries also have substance over rules which could also be used to deny the deduction of artificially constructed losses.[383]

VIII. CAPITAL GAINS AND LOSSES

The U.S. defines certain assets as "capital assets."[384] Most nonbusiness assets are capital assets. If capital assets are held for 1 year or less, and sold at a gain ("a short term capital gain"), the gain is taxed at ordinary income rates.[385] If capital assets are held over 1 year, favorable rates can apply to any "long term capital gains," typically 15%, 25%, or 28%, in contrast with the maximum ordinary income tax rate of 35%.[386] The 28% rate applies to collectibles; examples are stamp collections and gems.[387] The 25% rate applies to gain equal to the

[383] See supra notes 130 to 140 and accompanying text.
[384] See I.R.C. § 1221.
[385] See I.R.C. § 1, particularly 1(h); also see I.R.C. § 1222.
[386] See I.R.C. § 1(h) and 1(i)(2).
[387] See I.R.C. §§ 1(h)(1)(E) and (1)(5) and 408(m).

depreciation taken on real estate.[388] The 15% rate applies to most other long term capital gains.[389]

In the U.S., short term capital losses arise from the sale of capital assets held for 1 year or less and long term capital losses arise from capital assets held for over 1 year. Under the U.S. netting system, however, ultimately any capital loss, long or short term, can offset any capital gain, long or short term.[390] The system is also taxpayer-friendly in that net short term capital losses, as well as net long term capital losses from a lower tax category, first offset net long term capital gains from a higher tax category. For example, short term capital losses first offset 28% net long term gains and then net 25% long term gains. Further, net long term capital losses from the "15% category" again first offset net 28% long term gains and then net 25% long term gains.[391] If, on the other hand, an individual's over-all capital losses, long and short term, exceeds his over-all capital gains, long and short term, under I.R.C. § 1211(b) he may deduct only a maximum of $3,000 per year of the excess capital losses from ordinary income.[392] Any unused capital losses may be carried forward indefinitely to future years, where it may offset capital gains, and if it exceeds them, may again offset up to $3,000 of ordinary income.[393] The capital loss treatment should be distinguished from the treatment for "ordinary" (i.e. noncapital) losses, which may

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[388] See I.R.C. § 1(h)(1)(D) and (h)(6); this is also known as "unrecaptured section 1250 gain."
[389] See I.R.C. § 1(h)(C), and (h)(3). Other lower gains are sometimes available for taxpayers will lower levels of income, though it takes great effort to ferret these rates out of the code. See I.R.C. § 1(h)(1)(A), (B), and (i)(1).
[390] See I.R.C. § 1222.
[391] See I.R.C. § 1(h)(1), (4) and (6).
[392] I.R.C. § 1211(b).
[393] See I.R.C. § 1212. Due to the operation of I.R.C. § 1014, the carry-forward stops at death.

be fully deductible.[394] As the $3,000 limit of I.R.C. § 1211(b) came into the code in 1986[395] and has not been changed since, and is not indexed for inflation, one could fairly criticize the U.S. system as unfairly restricting the deduction of certain economic losses and increasingly doing so over time. This unfairness is made more striking by the fact that the capital gains are fully taxable, though often at a favored rate. When a government favors certain losses over others, it effectively prefers certain investments over others. This can lead to economic distortions and reduced economic efficiency. Germany's system, which in some ways is still tougher on losses that that of the U.S., has similar problems.[396]

The U.S. has a parallel system in I.R.C. § 1231. I.R.C. § 1231 primarily applies to depreciable property and real property used in a trade or business and held for over 1 year.[397] These assets do not qualify as capital assets.[398] I.R.C. § 1231 can apply both to sales and exchanges of these assets, but also to their damage or destruction by casualty or their taking by the government.[399] If the I.R.C. § 1231 gains exceed I.R.C. § 1231 losses, both the I.R.C. § 1231 gains and losses are treated as long term capital gains and losses (which are then analyzed within the capital gain and loss regime discussed above).[400] If the I.R.C. § 1231 losses exceed I.R.C. § 1231 gains, both the I.R.C. § 1231 gains

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[394] Subject to the limitations of the at-risk rules of I.R.C. § 465 and the passive loss rules of I.R.C. § 469. See supra notes 351 to 371 and accompanying text.
[395] Pub. L. 99-514 § 301(b)(10).
[396] See infra notes 404 to 412 and 414 to 426 and accompanying text.
[397] See I.R.C. §§ 1231(a)(3).
[398] I.R.C. § 1221(a)(2).
[399] There are still other possibilities. See I.R.C. § 1231(a)(3).
[400] I.R.C. § 1231(a)(1).

and losses are treated as ordinary gains and losses.[401] This is tax nirvana. When things are going well, a business can get the benefit of the favorable long term capital gain rates. When they are going badly (the case for almost everyone at the moment), the business may have fully deductible losses. For depreciable personal property, I.R.C. § 1231 is overridden by I.R.C. § 1245 which provides that gain from the sale of depreciable personal property is ordinary income to the extent of the depreciation taken.

I.R.C. § 1231 is perhaps the only U.S. Code section on which Germany has had a substantial, if unintended, influence. During World War II, many companies were realizing substantial, if involuntary, profits when their vessels were requisitioned for military use and purchased by the government or destroyed in action while heavily insured. The companies were able to persuade Congress that it was unfair to tax these unsolicited profits at the high, wartime rates. Accordingly, the gains were taxed at favorable long term capital gain rates. It did not seem fair, however, to provide a corresponding limit on losses for taxpayers not benefiting from wartime inflation. Accordingly, Congress continued the existing ordinary loss deduction. Congress did not stop here, and expanded § 1231 well beyond involuntary conversions; and, of course, the code section continues in effect long after its wartime impetus has vanished.[402]

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[401] I.R.C. § 1231(a)(2).
[402] See BM&Z supra note 21 at 33.01[1].

Germany does not have an analog to I.R.C. § 1231. Business income, including from asset sales, is generally fully taxable, losses fully deductible.[403] We are aware of no empirical economic data that would justify the existence of I.R.C. § 1231. Conceivably, the very favorable tax treatment that I.R.C. § 1231 provides might encourage business asset sales and promote economic activity. Equally conceivably, it might over-promote those sales. Or, and we think in the absence of hard evidence this to be the most likely, I.R.C. § 1231 has no effect on business decisions at all. Whether or not to sell business assets is likely determined less by the tax benefits of a sale, than by the exigencies of the business. As the business generated ordinary deductions for depreciation and other expenses associated with business assets, the equities would not seem to favor reduced tax rates on subsequent sale gains.[404] Further, World War II having come to an end, there is no special reason to favor the gains resulting from a casualty or condemnation of business assets, neither of which are common in any event. Thus, for us Germany has the more sensible rule.

While Germany also taxes gains from certain assets favorably (or not at all), it gets there differently than the U.S. does with its rules on capital gains and losses. Germany, rather than focusing on what the U.S. would call capital assets, generally looks at sales gains and losses. Sales gains of most assets are taxed like any other income, but all or part of the sales gains of certain assets are excluded from income. Typically, the favorably treated assets would be

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[403] See supra notes 152 to 153 and accompanying text.
[404] Recall that I.R.C. § 1245 does not apply to real property.

capital assets in the U.S. system, but historically the German system has not viewed these transactions through a capital-asset-like prism. Indeed, Germany does not have a term analogous to "ordinary income," there is just "income." Starting in 2009, this has changed to some extent. Gains on certain investment assets are subject to a special tax (as are certain types of investment income), the "Abgeltungssteuer" or "final tax," which we discuss below.[405] While Germans still do not use the term ordinary income, it would not be much of an overstatement to say that Germany now has a U.S.-like capital asset system, with the proviso that capital assets are limited to certain investment assets.

"Private sales transaction"[406] gains is an area for which Germany permits exclusions. Private sale transactions generally are sale transactions involving category 7, i.e. nonbusiness assets.[407] As such, § 22 Abs. 2 EStG includes private sale transaction revenues within category 7. § 23 EStG in turn provides for some valuable exclusions. Generally, gains from sales of category 7 assets are excluded from the Summe der Einkünfte to the extent in the aggregate they are less than 600 Euros.[408] There is a cliff-effect here. Once the 600 Euro limit is exceeded, all the gains, not just those over 600 Euros, are taxable at regular tax rates, unless covered by another exception.[409] Gains from the sale of nonbusiness real property held over 10 years are excluded from the Summe der

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[405] See infra notes 414 to 426 and accompanying text.
[406] "Private Veräußerungsgeschäfte," see § 22 Abs. 2 EStG and § 23 EStG. Changes have been made to § 23 EStG that are effective for 2009.
[407] Glenk, in Blümlich, EStG KStG GewSt Kommentar, 101 Ed. § 23 n. 22.
[408] § 23 Abs. 3 Satz 6 EStG; see Stobbe supra note at 173.
[409] Id.

Einkünfte.[410] Gains are also excluded if they are from the sale of property used from the time of acquisition (or completion of construction) as a residence or, alternatively, used as a residence during the year of the sale and for the prior two years.[411] Other gains from the sale real property are fully taxable at regular rates.[412]

The U.S. has a similar rule for gains from the sale of personal residences. Under I.R.C. § 121, gains from the sale of a home that has been used as a principal residence for 2 of the last 5 years are excluded from income to the extent they do not exceed $250,000, $500,000 for married taxpayers filing jointly.[413] Note, however, that the German system only requires the property to be used as a residence, not, in contrast to I.R.C. § 121, as a *principal* residence, and there are no dollar limits. The U.S. rules seem more cogent. Taxpayer selling second (or third or fourth) residences probably are from the wealthier segment of society, and there seems to be no reason not to tax the gain. It is curious that Germany, with its emphasis on social justice and its application of fairly high rates of tax on higher incomes, excludes from income gains from the sale of nonprincipal residences.

In Germany in the past, gains from the sale of "other" nonbusiness assets, including stock and other corporate securities, have been excluded from income

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[410] § 23 Abs. 1 Nr. 1 Satz 1 EStG.
[411] Id.
[412] § 23 Abs. 1 Nr. 1 Satz 1 EStG.
[413] A recent change can reduce the exclusion, if the home was not used primarily as a principal residence throughout the taxpayer's ownership. See I.R.C. § 121(b)(5).

if the asset was held over one year; otherwise the gains were fully taxable at regular rates.[414] This remains the rule for noninvestment assets.[415] There is a new rule for stock acquired in 2009 and thereafter. Gains and losses from the sale of stock held as an investment are netted.[416] A 25% tax (i.e. the Abgeltungssteuer) is applied to any net gains, irrespective of the holding period.[417] The lack of any holding period seems odd, from a U.S perspective. Purely speculative, short-term transactions could receive the beneficial rate. There is a backstop in the German system, however, if one perhaps not easy to enforce. Technically, net stock gains are allocated to category 5 (income from capital), notwithstanding the fact they do not participate in the usual netting process that takes place within each category. If one were, for example, in the business of buying and selling stock, the gains and losses would fall within category 2, business operations, and net gains would be subject to regular rates of taxation,[418] Finally, Losses from the sale of stock may only be offset with gains from such sales. Net losses may not reduce other income.[419] German stock losses suffer, therefore, from the same disability as U.S. capital losses, only more so, as Germany does not permit any excess losses to be deducted

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[414] § 23 Abs. 1 No. 2 EStG.
[415] Id.
[416] § 20 Abs. 2 EStG.
[417] § 43a Abs. 1 Satz 2 EStG. As in the U.S., if (what the in the U.S. would be called the) German ordinary income tax rate is under 25%, that rate can apply, though this takes a special application by the taxpayer, see § 32d Abs. 6 EStG and Stobbe supra note at 158-159. In the U.S. long term capital gains are taxed at less than the "regular rates" of 15%, 25%, or 28%, if a taxpayer's marginal ordinary income tax rate is less than the relevant long term capital gain rates. See I.R.C. § 1(h)(A) and (B). Professor Schwidetzky gives his students extra credit if they can explain to him how I.R.C. § 1(h)(1) works.
[418] See supra notes 152 to 154 and accompanying text.
[419] § 20 Abs. 6 EStG.

from other income as the U.S. does.[420] As is the case in the U.S., in Germany the excess losses may be carried forward indefinitely to offset stock gains in future years.[421]

Stock is not treated as a nonbusiness asset, however, and thus falls outside of categories 5 or 7, if the shareholder owns 1% or more of the outstanding shares.[422] Gain from the sale this stock is treated as fully taxable category 2 (i.e. business operations) income, unless the shareholder has held the stock for over 5 years, in which case the gain is fully exempt from tax.[423] Losses from the sale of over-1%-stockholdings is a fully deductible category 2 loss.[424] This stands in marked contrast to the U.S. I.R.C. § 1211(b) rules that would apply in the U.S. context.[425] The rule for stock held over 5 years is reminiscent of I.R.C. § 1231 in that the gains are favorably treated and the losses fully deductible. It is not apparent why the gains and losses should be treated differently, and even if they should, it seems odd that Germany would fully exclude the gains from tax. It would seem more socially balanced to subject the gains to the same tax as long-term stock gains generally.

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[420] See supra notes 390 to 396 and accompanying text.
[421] § 20 Abs. 6 EStG.
[422] § 17 EStG.
[423] This 1% threshold was at one time 25%, and its reduction over time effectively means that those owning percentages less that 25%, but more than 1%, saw the tax ramifications of their holdings change without a change in the holdings themselves, a type of retroactive tax consequence. This raises constitutional issues in the German system. See Tipke and Lang supra note at 373.
[424] Due to the lack of any contrary rule. See Tipke and Lang supra 17 note at 373.
[425] See supra notes 390 to 396 and accompanying text.

Finally, and highly importantly, losses from private sales (i.e. category 7) transactions, subject to the special rule for stock sales noted above, may only be deducted from gains from private sale transactions. Further, in Germany unused losses from private sale transactions only may be carried back or forward one year. The current rule, effective for 2009, is more stringent that the rule that proceeded it.[426]

IX. DIVIDEND AND INTEREST INCOME

In the U.S., most dividends received by individuals are favorably taxed at a 15% rate.[427] To prevent tax arbitrage, this low rate is only made available to individual shareholders who hold the underlying stock for more than 60 days during the 121 day period beginning 60 days before the ex-dividend date.[428] An example of the tax arbitrage the holding period is meant to avoid: Assume A has a $200,000 short term capital gain on the sale of stock (which in the U.S. is taxed at regular tax rates). The gain is taxable at ordinary income rates.[429] Assume A's marginal ordinary income tax rate is 35%. Further suppose A buys $5,000,000 of stock which pays a $200,000 dividend the day before it goes ex-dividend. A sells the stock the day after the ex-dividend date at a $200,000 short term capital loss, and subsequently receives the $200,000 dividend. The short term capital loss exactly offsets the short term capital gain. Without the holding

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[426] Among other things, the losses could have been deducted from income from capital. See § 23 Abs. 3 EStG.
[427] I.R.C. § 1(h)(11).
[428] I.R.C. § 1(h)(11)(B)(iii).
[429] See supra notes 384 to 389 and accompanying text.

period requirement, the dividend would be taxable at a 15% rate. A would effectively have swapped 35% income for 15% income without meaningfully having changed his economic position, as the stock purchase and sale breaks even on a before-tax cash flow basis.[430]

Another tax arbitrage opportunity exists for individuals if an extraordinarily large dividend is going to be paid on stock. Here the taxpayer might be willing to risk the 60 day holding period. The 15% dividend tax rate still applies, but the basis of the stock is reduced by the untaxed portion of the dividend unless the stock has been held for 2 years.[431] A common stock dividend is extraordinary if it exceeds 10% of the basis of the taxpayer's stock; the threshold is 5% in the case of a preferred stock dividend.[432] Further, any loss on the sale of stock is treated as a long term rather than short term capital loss.[433] Historically, this might have been a penalty, but now no longer is; as noted above, now effectively any capital loss can offset any capital gain.[434] The basis reduction rule provides the more effective disincentive.

The rules for Germany changed in 2009. The Abgeltungsteuer discussed above also applies to dividends, though now as a 25% withholding tax.[435] Germany does not have the dividend anti-abuse rules that the U.S. does. There

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[430] See BM&Z supra note 21 at ¶ 9.13.
[431] I.R.C. § 1059(a).
[432] I.R.C. § 1050(c).
[433] I.R.C. § 1(h)(11)(D)(ii).
[434] See supra notes 390 to 396 and accompanying text.
[435] § 32d, § 43a EStG. If (what the in the U.S. would be called the) German ordinary income tax rate is under 25%, that rate can apply, though this takes a special application by the taxpayer, see § 32d Abs. 6 EStG and Stobbe supra note 9 at 158-159.

may be less need for them given the higher German tax rate, and the fact that stock losses may only be deducted from stock gains, whereas in the U.S. stock losses may be deducted from any capital gains and possibly from ordinary income.[436]

Interest income in the U.S. is generally fully taxable as ordinary income.[437] In Germany, by contrast, the Abgeltungsteuer again generally applies a 25% withholding tax, provided the interest income arises from nonbusiness holdings.[438]

When contrasted with the top German marginal tax rate of 45%, and the common tax rate of 42%, for many taxpayers, Germany's systems encourages savings and investment by taxing interest and dividends at lower than the general rates. Further, Germany provides an automatic expense deduction of 801 Euros (1,602 Euros for married filing jointly) from "income from capital," which can include either interest or dividend income, thus providing a further incentive for savings and investment.[439] However, no additional, associated expenses are deductible even if they in fact exceed the 801/1602 Euros threshold. The U.S., where savings are often low, could take a page from Germany's books and encourage savings with lower rates of tax on interest.

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[436] See supra notes 384 to 396 and accompanying text.

[437] Interest on state and local bonds can be exempt from tax. See I.R.C. § 103.

[438] § 32d, § 43 a. If (what the in the U.S. would be called the) German ordinary income tax rate is under 25%, that rate can apply, though this takes a special application by the taxpayer, see § 32d Abs. 6 EStG and Stobbe supra note 9 at 158-159.

[439] On the assumption the savings and investment are allocated to private wealth. See § 20 Abs, 9 EStG and Stobbe supra note 9 at 158-160.

X. ALTERNATIVE MINIMUM TAX

The U.S. has an alternative minimum tax ("AMT")system which for higher income taxpayers can effectively replace the "regular" tax system. Essentially, in the AMT system, certain deductions are disallowed and others are reduced, so that the taxpayer has more income to tax.[440] Exemptions of $70,950 apply for married taxpayers filing jointly as well as surviving spouses, and $36,700 for single taxpayers, though these exemptions are phased out for higher income taxpayers.[441] The remaining income is taxed at a rate of either 26% or 28% rate.[442] Taxpayers then pay the higher of the regular tax or the AMT.

The AMT system was created to make sure that the very wealthy do not avoid paying taxes. The difficulty is that the exemptions have not kept up with inflations so that more and more taxpayers, including those in the middle class, are now subject to the AMT.[443] Further, other tax law changes make it very unlikely that the wealthy could now avoid paying significant taxes.[444] Consequently, the entire AMT regimen makes little sense and there is growing sentiment for its repeal.[445] Alas, it also generates large amounts of revenue. If it were repealed, other taxes would have to be increased to make up for the

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[440] See I.R.C. §§ 55-59.
[441] I.R.C. § 55(d).
[442] I.R.C. § 55(b)(1)(A)(i).
[443] See BM&Z supra note 21 at ¶ 45.01.
[444] For example, the periods over which real estate can be depreciated have been elongated, and normally only straight line depreciation, not accelerated, can be uses. See § 168(e)(2).
[445] See BM&Z supra note 21 at ¶ 45.01.

shortfall. The political challenges this would create had kept the AMT on the books.

Germany, to its good fortune, is unburdened by an analog to the AMT.[446] It should be noted that the problem the AMT addressed never really existed in Germany given the country's tax system and its higher tax rates.

XI. CONCLUSION

The great value of comparative scholarship is that it brings the different choices made by different countries to light, providing valuable information that can intelligently inform the decision making process in each country. One country may have an idea or come up with a solution that has not occurred to other countries. Further, one country's concerns about a given area may be allayed (or exacerbated) by another country's experience. Often, the U.S. and German tax systems simply reflect each country's differing values. At other times, they make different, but rational choices. But, as we have shown, there are many instances where one system has made, in our view, a demonstrably superior choice. Ideally, the superior choice of one system should inform the other. No country has a monopoly on wisdom or intelligence.

[446] Interestingly, Germans sometimes refer to the limitation on loss carryforwards discussed at notes to supra as effectively generating a "minimum tax." See 10d Abs. 2 EStG. While literally true, it is a far cry from the U.S. AMT system.