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Beware of bargains!
The extended liability for (unpaid) VAT under the German Turnover Tax Act, *Umsatzsteuergesetz*, *UStG*, section 25d, paragraphs 1 and 2

It is of the essence of revolutions of the more silent sort that they are unrecognized until they are far advanced.[1]

A. Introduction

In the year 2002, section 25d has been inserted in the *UStG*. The new section, part of the Act against Tax Evasion (*Steuerverkürzungsbekämpfungsgesetz - StVBG*) of December 19th, 2001 (Federal Law Gazette, part I, p. 3922, in force since January 1st, 2002), which aimed at closing loopholes and curing weaknesses of German tax law, stipulates a tax liability of the purchaser, in case:

I. his or any other[2] **supplier**
1. has declared VAT in an invoice

but

2. has not paid VAT

and

3. has acted intentionally
either right from the beginning (i.e., already when he has sent the invoice),
or when he later on has rendered himself unable to pay VAT

and

II. the **purchaser** had been informed about preconditions I, 1 - 3 at the moment he purchased the good, i.e. he must have acted **intentionally**.

Other than in the *StVBG* draft, where the liability was stipulated to already take effect in case of the purchaser's ignorance of the facts, *Kennenmüssen*, the dependence on intention, governed in the final norm, meant a high threshold. In the end, the threshold proved to be a shortcoming of the rule, because in virtually no case so far has it been possible to prove the intention of the purchaser.

B. The new regulation

In order to sharpen teeth and claws of too tame a tiger, article 5 no. 31 of the Second Act Amending the German Tax Law (*Steueränderungsgesetz* 2003 - *StÄndG* 2003) of December 19th, 2003 (Federal Law Gazette, part I, p. 3642), has altered section 25d (paragraph 1, clause 1) *UStG* with respect to the above-

[1] *Berle*, preface to Berle / Means, The Modern Corporation and Private Property, 1933.
[2] The purchaser is not only liable for the immediate transaction he entered into, but for the whole prior commerce with respect to the purchased good.

mentioned precondition II. In force since January 1st, 2004,[3] the newly shaped norm governs that tax liability is already triggered in case of "commercially negligent" unawareness of the facts of tax evasion, *Kennenmüssen*. "Commercial negligence" paraphrases the fact, that the norm refers to the diligence of an average merchant, *Sorgfalt eines ordentlichen Kaufmanns*, i.e. the diligence a merchant shall normally show.

In the new section 25d paragraph 2 *UStG* examples are given, in which cases such "commercial negligence" has to be assumed (identically published in the directive of the Ministry of Finance of March 29th, 2004 (*BMF-Schreiben* IV B 2 - S 7429 - 1/04), publishing (binding) instructions for the fiscal authorities of how to apply the new section 25d *UStG*).

Accordingly, "commercial negligence" shall especially (but not only) be assumed:
- when the **purchaser** has sold the good **below the usual market price** that has been in effect at the moment of his resale (section 25d paragraph 2, clause 1 *UStG*)[4]

or

- if the price his supplier asked for, was below the usual market price (section 25d paragraph 2, clause 2, variant 1 *UStG*)[5]

or

- if the price his supplier asked for, was below the price his supplier or other suppliers were billed for the good (section 25d paragraph 2, clause 2, variant 2 *UStG*).[6]

Market price equals an at-arms-length price.

The purchaser can offer rebuttal to the supposition of *Kennenmüssen*, resulting from the examples mentioned, section 25d paragraph 2, clause 3 *UStG*. Therefore, he has to prove that there were commercial reasons for the formation of the price.

C. Review

Whilst the 2004 norm aims at fighting tax evasion in the form of "merry-go-round deals", *Karussellgeschäfte*—i.e. the vendor declares VAT without paying it and acts together with a purchaser claiming input tax deduction, albeit no VAT has been paid—the reshaped section 25d *UStG* will probably result in an unduly burdensome pitfall for retailers and, thus, for the consumers, who will have to face the music due to ballooned price tags.

First of all, the new rule is inappropriate insofar as it defines the *Kennenmüssen* by the help of using "commercial negligence", a term stemming from section 347 paragraph 1 German Commercial Code, *Handelsgesetzbuch*, *HGB*. In general, *Kennenmüssen* in German civil law means that someone must have known the facts, or, as it is being put in other words, that someone has put a blind eye on the facts. The definition in the new section 25d *UStG*, however, waters down the requirements to a simply negligent behaviour of a merchant. Thus, section 25d *UStG* will have to be applied in virtually every situation a "merry-go-round deal" has happened and has had an, even the slightest, impact on the price of the product.

[3] The lead time of less than 2 weeks, including Christmas Holidays and New Year' s Eve, was noteworthily short, not only from the constitutional, but also from the practical point of view. That, together with the fact that the new regulation has to be applied to all purchases after January 1st, 2001 (!), gives a clue, why Switzerland and BVI are enjoying a steady inflow of monies from Germany.
[4] E.g. market price for 1,000 airbags = 500,000 Euros; the purchaser sells at 400,000 Euros.
[5] E.g. wholesale price for 1 m. screws = 100,000 Euros; the supplier bills only 80,000 Euros.
[6] E.g. one of the suppliers was charged 100,000 Euros, the purchaser pays no more than 80,000 Euros.

Corresponding misgivings are being fostered by the examples given in section 25d paragraph 2, clauses 1 and 2 *UStG*, and the directive, given by the Ministry of Finance, referred to before. Negligence, and thus liability, shall be assumed if the price has been below the normal level. Every purchaser, trying to buy at give away prices and/or to undercut the prices of his competitors will thus have to fear being treated by the tax authorities like a tax evading villain. Bargain, then, will be the acronym for "**b**arely **a r**eal **gain**".

The said directive of the Ministry of Finance, instead of simply repeating the wording of section 25d *UStG*, better should have explained, how the purchaser—without wasting too many of his resources—will be able to demonstrate to the tax authorities as well as to the fiscal courts that the (lower) price was determined by the market instead of VAT-trickery. As matters stand, one has to fear, that the aforementioned assumption will practically be unchallengeable, because every tax officer as well as every tax judge—not to mention the fact that the entrepreneur is not only the only one acting in the market, but also the only one really knowing something about market prices—will simply jump to the conclusion that the evasion—and not the market—determined the price.

As a result of the norm, all entrepreneurs are being called upon to carry the can back, because a few of them are engaged in "merry-go-round deals", a practice, by the way, made possible by the national legislator as well as an ongoing discord on the EU-level.

D. Measures to be taken

Since neither retailers nor customers want do without bargains, steps have to be taken in keeping with the precautionary principle.

1. Create haystacks

First and foremost, there should be a thorough documentation of prices, in order to have something in your hands as well as in order to show your "commercial diligence" and, not at least, in order to be able to send over a haystack to the tax authority to busy them with searching for a needle, if need be.

2. Caveat creditor

Second, and insofar the new regulation will indeed show the desired impact, purchasers have to act due to the caveat-principle, which means that they have to be wary of black sheep. Within the market, there are no donations—everything comes at a certain price. And too cheap a bargain may well prove to be too expe n-sive an experience. So, beware, and calculate—either to avoid dubious offers or to have some extra money at hand for the exchequer.

3. The You ought to have known better-approach

If possible, do not change your suppliers as often as you change your shirt. A long-lasting business relationship does not only make sense and has extra value in terms of business. It also eases Your argument to convince the authorities and the tax courts of your diligent behaviour as a proper merchant, if suppliers, who are too creative, are being exposed.

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