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No Taxation of Cryptocurrency Gains in Germany?

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The use of crypto coins and tokens is on the rise. With the perception of constant and unrestrained gains in value reaching all-time highs, most national and subnational tax laws dramatically lag behind this astonishing bull run. Simple crypto coins are already something from the past since tokens, both fungible and non-fungible, are now at the forefront of interest in the crypto world. Meanwhile, the German Regional Finance Courts – the first arbiters of German tax matters – are presently required to devote their expertise to the taxation of this new reality.

While professional literature – at least in Germany – has already found a common denominator on the taxation of cryptocurrency, jurisprudence is right at the beginning. This article will share the current German state of crypto taxation in a short overview. We assume that taxpayers may want to take their chances in front of tax courts sooner rather than later since, in the very first judgment with cryptocurrencies at the core of the case illustrated below[1], the claimant might just have found the taxpayers' sweet spot.

The German Tax System

The German tax system is embedded in a typical code law system. Everything that can be taxed, speaking from an individual's income tax perspective, must be codified in statutes. Sometimes, this is referred to as a schedular system. Income can only be taxed if it can be subsumed under one of the seven categories of income[2] exhaustively listed in the German Income Tax Act: i) income from self-employment, ii) employment, iii) capital assets, iv) business, v) agriculture and forestry, vi) rental income or vii) other income. Hence, it is possible to have income outside these seven categories that is not subject to taxation. A classic example is a lottery jackpot. Indeed, not wholly tax-free but still out of the scope of the German income tax system. This stands in contrast to income tax systems like the United States (US)' federal tax concept of taxing 'all income from whatever source derived'[3]. With a 'Gotta Catch Em All' global provision like that, gains from cryptocurrencies are, of course, taxable.

Under the German system, however, one could – theoretically – conclude that gains from the disposal of cryptocurrencies are non-taxable for individuals; certainly, the envisioned goal by a typical taxpayer, but with chances close to zero.

Out of the seven German income categories, four (i, ii, v, vi) are obviously inapplicable. By

assumption, one would also rule out the category of business income as the whole debate solely deals with private persons engaging in part-time crypto trading. Left over would be two thinkable income categories: income from capital assets and other income. Skipping some details for the category of capital income, the prevailing legal opinion sees the disposal of cryptocurrencies – just as other currencies other than legal tender – in the category of other income. Since assets must be defined broadly according to the German tax law, it includes, in addition to objects or rights also actual conditions, concrete possibilities, and operating advantages, if they are accessible to an individual valuation. This is supported by the fact that cryptocurrencies are sometimes accepted as a payment method in business operations.

Taking a step back, it also holds with the most conceptual principle of German income taxation: the ability to pay principle. Derived from the German Constitution stating that ‘[a]ll people are equal before the law’, it is a long-standing tax interpretation that whoever can pay more is – under proportionality constraints – deemed to pay higher taxes. Especially with immense gains from the disposal of cryptocurrencies in the hands of individuals, it is perfectly in line with the German understanding of income taxation to dilute these gains to the common good through taxation. Long story short – dodging material German tax law to avoid taxes on cryptocurrency gains is an illusion.

Nevertheless, in the first German courts’ hearing with cryptocurrencies in the main proceedings, the plaintiff came up with another idea. He invoked the objection of a structural deficit of enforcement in the taxation of cryptocurrencies. This objection merits a closer look.

Facts of the Case

A German resident, subject to unlimited tax liability in Germany, brought an action against his income tax assessment.^[4] This income tax assessment included gains from the disposal of cryptocurrencies. Residing in the state of Baden-Württemberg, the regional Fiscal Court of Baden-Württemberg had to deal with the case. In essence, the taxpayer based his claim on two grounds.

First, he claimed gains through the disposal of cryptocurrencies were outside of the German income tax system. Unsurprisingly, the court rejected this position, in line with the prevailing opinion on cryptocurrency taxation in Germany.

The plaintiff’s second basis for avoiding taxation of his gains deserves more attention. He claimed a structural deficit of tax enforcement: a claim not easily dismissible as it is not based on circumventing the statutes but on attacking the constitutionality of a statute. In the best outcome for the taxpayer, part of the statute could be deemed void until a new – constitutional – regulation is found.

Structural Deficit of Enforcement

If a provision of German tax law, such as the statute of other income in the Income Tax Act, is not enforced in such a way that an equal burden is placed on taxpayers, the statute may be deemed unconstitutional. In other words, if a statute only works – and hence taxes – a few individuals, all taxpayers are relieved from the resulting tax burden imposed by that statute.

Again, this interpretation of equality in taxation is derived from the very same part of the German Constitution discussed above, i.e., the statement that “[a]ll persons are equal before the law”. The requirement of equal taxation is derived from this principle, which is understood as equality in

applying the law and not in the final tax payment.

This principle is also found in the German Fiscal Code, which prescribes that no differences are made in tax enforcement in case of identical tax matters.[5] The corresponding regulation requires that the tax offices clarify the facts relevant for taxation *ex officio* and that evidence may only be requested with proportionality.[6] Even though taxpayers are obliged to declare and cooperate, the tax authorities must have opportunities to verify the relevant information. For example, this can be achieved through withholding tax at source or the obligation to transmit data electronically to the authorities. If this is not the case and the tax authorities cannot provide equality in applying the tax, a structural enforcement deficit could violate the constitution.

In tax law, the Federal Constitutional Court has already declared the taxation of interest[7] (1991) and private speculative transactions with stocks[8] (2004) unconstitutional for specific periods due to structural enforcement deficits. In both judgments, the Federal Constitutional Court tied in with whether sufficiently useful collection rules underpinned the taxation facts or whether their success depended solely on the taxpayer's willingness to declare. In the 1991 judgment, the Federal Constitutional Court reaffirmed the requirement of equality in taxation with an excursus on the long regulatory history of civic rights, which can already be found in rudiments in the French Declaration of the Rights of Man and Citizen of 1789 and the 1818 Constitutions of Baden and Bavaria, among others. Accordingly, the decisive factor is whether the enforcement of the taxation rules in mass proceedings is designed to be successful, and inadequate declarations are associated with an appropriate risk of detection. Furthermore, in this context, attempts by the tax authorities to improve the success of taxation rules must be considered.

Although cryptocurrencies have already gained attention since the emergence of Bitcoin in 2009, the verification possibilities demanded by the Federal Constitutional Court's case-law might be seriously challenged, primarily because they shall be used in the regular taxation process, not in special inquiries. The Federal Constitutional Court has explicitly stated that 'fishing expeditions' are not allowed.

No one knows for sure all of the possibilities to create a crypto wallet – worldwide – or whether all jurisdictions have 'Know-Your-Customer' (KYC) provisions and if they are applied accurately. Hence, the theoretical possibilities of the tax authorities might lead to dead ends. If the taxpayer does not declare the generated profits, there are hardly any indications or control possibilities comparable to the implementation rules for other types of income. The fact that the Federal Ministry of Finance has drafted an administrative decree regarding the taxation of cryptocurrency trading also shows the existence of a certain deficit. Whether this will be determined to be a structural deficit of enforcement is still unclear.

The Fiscal Court of Baden Württemberg has rejected a structural deficit of enforcement, and an appeal to the German Federal Fiscal Court is currently pending[9]. Furthermore, it is not yet sure whether this case will be submitted to the Federal Constitutional Court through a direct referral or a later constitutional complaint. We think the question deserves a deep dive.

The Regional Finance Court's Take on the Structural Deficit of Enforcement

The Fiscal Court of Baden-Württemberg dismissed the claim of a structural deficit of enforcement, stating that crypto exchanges, as multilateral trading systems, are subject to corresponding identification obligations under the German Banking Act. In international cases, the possibilities of

mutual administrative assistance and increased taxpayers' obligations to cooperate must also be considered. The present deficits in the taxation of cryptocurrencies cannot be attributed to the German legislature.

The court's opinion was very brief and did not reflect the inquisition into the topic as the Federal Constitutional Court had in past comparable cases.^[10] However, even though the decision of the Federal Fiscal Court may not be conclusive, as only the Federal Constitutional Court can conclusively determine the existence of structural deficit of enforcement, for now, it is unclear whether the Federal Constitutional Court will deal with the case. There are two conceivable scenarios in which this would be possible: 1) either the Federal Fiscal Court submits the case directly to the Constitutional Court; or 2) the plaintiff files a constitutional complaint after a dismissive ruling by the BFH. It must be added that the Regional Fiscal Court in Baden-Württemberg could have put the case directly to the Federal Constitutional Court. Apparently, the judges decided not to and to dismiss the plaintiff's claim.

Due to a high similarity with the matters handled by the Federal Constitutional Court in the issues addressed above (shares and interest), the Federal Fiscal Court could and should address the following points, before being sufficiently justified in handing over the case to the Federal Constitutional Court:

- Do verification possibilities truly exist – especially in mass proceedings of tax declarations? And are they be applied in practice?
- How is the taxation practice of cryptocurrencies to be classified compared to the taxation of other income categories? How is it to be classified with the category of other income?
- How can the tax authorities detect errors in tax returns? Are there external notices that do lead to investigations without initial suspicion?
- Does the current situation invite incomplete and purposefully wrong tax returns?
- Are the legislature and or the fiscal administration sufficiently working on improving the taxation practice?

Final Remarks

The decision of the Regional Fiscal Court Baden-Württemberg is perceived as insufficient – at best. Compared to other judgments, one barely dares to see the opinion as a serious attempt to test for a structural enforcement deficit. The court did not address how sound requests for mutual administrative assistance in tax proceedings contribute to the equality in taxation required by the German Constitution.

Moreover, the argumentation brought forward is not even the tip of the iceberg, it is merely some ice. The situation is more complex from a holistic point of view. Taking this into account, the argumentation of the Fiscal Court seems too superficial to falsify a structural deficit of enforcement. Indications are mounting that a situation similar to 1991 and 2004 could exist. The Federal Fiscal court is now in charge to examine the facts for the parallels to the case-law provided by the Federal Constitutional Court.

Should the Federal Constitutional Court conclude that there is a structural deficit of enforcement in the sense of its previous case-law, crypto profits would not be legally taxable and thus be de facto tax-free. Losses would also be beyond taxation and – within the framework of the statutory loss offset – could also no longer be offset against later profits of a constitutionally compliant tax.

[1] Two other decisions already dealt with cryptocurrencies, though, not on the main proceedings, see Regional Finance Court Berlin-Brandenburg (13 V 13100/19) and Regional Finance Court Nürnberg (3 V 1239/19).

[2] Sec 2 Para 1 EStG (German Income Tax Act).

[3] 26 U.S.C. § 61.

[4] Regional Finance Court Baden-Württemberg (5 K 1996/19).

[5] Sec. 85 German Fiscal Code.

[6] Sec. 88 German Fiscal Code.

[7] BvR 1493/89.

[8] 2 BVL 17/02.

[9] IX R 27/21.

[10] Currently, an appeal to the Federal Fiscal Court is pending against this judgment.

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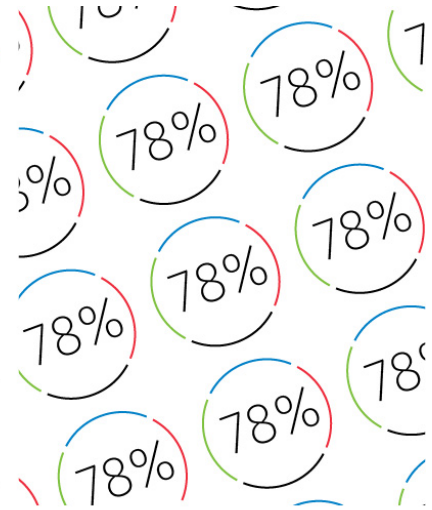
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