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Federal Tax Court (I R 92/12): Deduction of Refinancing Costs as Business Expenses in Case of an Ownership Interest Held in a Domestic Partnership

In its judgment dated 12 October 2016 the Federal Tax Court (BFH) issued its view on a deduction of refinancing costs as business expenses in the case of an ownership interest held in a domestic partnership.

In the case at issue, a Dutch corporation held an ownership interest in a German partnership (plaintiff) from which it received profit shares. These profit shares were subject to limited tax liability in Germany. In 2002, the corporation made a contribution to the plaintiff which was financed through a loan obtained in the Netherlands. The plaintiff in turn was a controlling entity in a tax group with a German corporation as controlled company. Subsequently to making the contribution, the Dutch corporation contributed its interests in the plaintiff to a Dutch partnership in return for ownership interests. As a result, the Dutch corporation held direct ownership interests in the Dutch partnership while its interests in the plaintiff became an indirect interest.

According to German Tax Law, the loan in connection with the contribution has to be regarded as so-called special partner business property (SBV II, type II of special partner business property) of the Dutch corporation at the level of the plaintiff. The term SBV II refers to business property which serves to establish or to strengthen the partner's interest in the partnership. The associated interest expense for the loan qualifies as so-called special business expenses. Based on its limited tax liability, the Dutch corporation recognized the special business expenses before and after the contribution transaction with tax-reducing effect for determining its profit share from the ownership interest in the German partnership. As a result, the loan interest was used twice, i.e. in the Netherlands and in Germany, to reduce taxable income. Assuming the interest expenses reduced the tax assessment basis in the Netherlands, negative income of a controlling entity in a tax group does not reduce the tax assessment basis in Germany according to German

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Tax Law (§ 14 (1) sent. 1 no. 5 Corporate Income Tax Law (KStG)). There has been no decision so far as to whether this provision is applicable at all in cases where controlling entities are partnerships.

The BFH therefore had to decide whether any type II special partner business property of the Dutch corporation existed at the level of the plaintiff after the contribution and whether the interest on the loan had any tax-reducing effect when determining the Dutch corporation's profit share from the ownership interest in the German partnership.

The BFH ruled that even in the case of an indirect interest, type II special partner business property can be assumed to exist (§ 15 (1) no. 2 sent. 2 German Income Tax Law (EStG)) and hence also continued to exist after the contribution transaction. Furthermore, the loan interest has a tax-reducing effect when determining the Dutch corporation's profit share from the ownership interest in the German partnership. Under the double tax treaty Netherlands the interest on the loan is allocated to the German partnership. In addition, the non-deductibility provision pursuant to § 14 (1) sent. 1 no. 5 KStG fails to apply in the case under review. According to the BFH, the controlling entity's consolidated income is relevant (income after add-back of the income of the controlled company). Despite the special business expenses, there was a positive income at the level of the plaintiff. There was no need for the BFH, therefore, to decide whether the provision referred to is applicable at all in cases where partnerships are controlling entities.

Please note that for assessment periods starting from 2017 the reduction of special business expenses is denied according to a revised legislation (§ 4i EStG; October 2016 edition of German Tax Monthly).

German CFC Rules Case Referred to CJEU by Federal Tax Court (I R 80/14)

The German Federal Tax Court (BFH) has expressed doubts as to whether the so-called CFC rules applicable to passive income with investment character in cases involving non-EU/EEA countries are compatible with the freedom of capital.

Under German tax law the CFC rules apply where foreign companies (CFCs) with shareholders who are subject to unlimited tax liability in Germany generate so-called passive income and are subject to a low rate of taxation in their country of residence. If the CFC rules apply, the income of the CFC is attributed to the shareholder and is thus subject to German taxation. In the case of EU/EEA corporations, the application of the CFC rules may be avoided if evidence can be provided that the CFC pursues a genuine and actual business activity in the Member State in which it was established ("motive test"). The motive test was introduced based on CJEU case law regarding the application of British CFC rules in the "Cadbury Schweppes" case (C-196/04). However, since there is no similar exemption option for CFCs residing in non-EU/EEA countries, this could result in a restriction of the freedom of capital.

In the case which the BFH had to decide, a domestic corporation (GmbH) held a 30 % share in a corporation resident in Switzerland (AG) which received income from transferred money claims. The local tax office regarded the AG as a CFC within the meaning of the Foreign Transactions Tax Law. Consequently, the income derived from the transferred money claims was considered passive income with investment character and thus subject to the CFC rules, to the detriment of the domestic GmbH.

In a first step, the BFH examines whether the national CFC rules are applicable and affirms their applicability. In the next step, the BFH assesses the compatibility of these rules with EU law.

Since the national CFC rules applicable in the case at issue are already applicable starting from a percentage of shareholding of one percent, their compatibility with EU law needs to be reviewed with regard to the freedom of capital. The actual percentage of shareholding of 30 % is irrelevant in this case. As a result, the scope of application of the EU freedom of capital, which also applies for non-EU/EEA countries, is concerned.

Moreover, the national CFC rules have the effect of restricting capital freedom. If the GmbH held a share in a domestic corporation comparable to the Swiss AG, no add-back of passive income with investment character would have occurred.

However, it is to be questioned whether the restriction is justifiable in the present case. The explanation of the BFH is that a restriction of the freedom of capital vis-à-vis non-EU/EEA countries can be admissible if the national rule on the movement of capital with third countries in the context of direct investments at issue already existed as at 31 December 1993 and has not been substantially amended since (so-called standstill clause). The BFH has doubts in the case at hand as to whether the rule existing as at

31 December 1993 is still covered by grandfathering given the fact that the application scope was subsequently extended. The BFH therefore has also referred this issue to the CJEU.

In addition, it is questionable in the view of the BFH whether the CJEU ruling in the Cadbury Schweppes case regarding the freedom of establishment is also transferrable to the freedom of capital on the one hand and to non-EU/EEA cases on the other.

Even if this was the case, the restriction of capital freedom is not justified in the opinion of the BFH, because an add-back is not only made in cases with purely artificial arrangements. This is due to the national CFC rules, which do not provide for the possibility of furnishing evidence to the contrary because the motive test is not applicable to companies residing in non-EU/EEA countries.

Hence, if the standstill clause is not applicable, the CJEU is also requested to decide whether the national CFC rules in the case at hand are in breach of the freedom of capital.

Discussion Draft of the Federal Ministry of Finance on the German Ordinance on the Documentation of Profit Allocations

New documentation requirements in the field of transfer pricing were introduced with the Law on the Implementation of the Amendments to the EU Administrative Assistance Directive and Further Measures against Base Erosion and Profit Shifting (Anti-BEPS-I Law) (January/February 2017 edition of German Tax Monthly). Essentially, the law provides for a three-tiered approach to transfer pricing documentation, comprising standardized information (Master File), local and entity-specific information (Local File) and documentation related to activities in a specific country (Country-by-Country Reporting (CbCR)).

At the German national level, documentation requirements for transfer pricing are detailed in the Ordinance on the Documentation of Profit Allocations (Gewinn-abgrenzungsaufzeichnungs-verordnung (GAufzV)) issued by the Federal Ministry of Finance (BMF) on 13 November 2003.

The BMF has recently published a discussion draft based on which the ordinance currently in force is to be amended taking into account the changed legal situation due to the newly introduced Anti-BEPS-I Law. Essentially, the structure of the transfer pricing documentation is to be adapted so that a differentiation is made between local, entity-specific documentation (Local File) and standardized documentation (Master File).

The discussion draft contains the following material changes compared to the ordinance of 13 November 2003:

– According to the new provisions, an analysis is now required of key functions and important risks, comprising a weighting and/or description of how such risks or functions are allocated. Quantitative evidence must be provided regarding which party in a transaction actually assumed which function and which risk. This is intended to rule out subjective and unverifiable assessments.

– Where the taxpayer uses comparables databases for determining transfer prices, he is required to make the search process fully transparent and to document the configuration of the company database. The reason is to enable the tax authorities to verify and reproduce the search process performed by the taxpayer.

– A new section regarding the Master File and an attachment specifying the scope of the Master File was included. The attachment contains the elements to be covered by the Master File such as, inter alia, the organizational structure, description of supply chains, principal service agreements, a brief functional analysis, important restructuring transactions, overall strategy for intangibles and intercompany financial activities. The individual items correspond to the recommendations expressed in the G20/OECD final report on Action 13 of the BEPS Action Plan.

The revised ordinance shall be applicable for assessment periods from 2017 onwards. The entry into force of the revised ordinance shall simultaneously abrogate the ordinance of 13.

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