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German Tax Monthly

Information on the latest tax developments in Germany

May | 2021

Government Draft Bill for the Modernisation of Corporate Taxation Law

The German Federal Government has published the draft bill for the modernisation of corporate taxation law. The essence of the draft bill is the introduction of an option for corporate taxation for commercial partnerships.

The draft bill provides among other for the following measures to modernise corporate taxation law.

- Option for corporate taxation for commercial partnerships and partnerships
- Tax deductibility of foreign exchange losses relating to shareholder loans
- Opening up the German Reorganisation Tax Act to transformations of corporations worldwide.

Option for corporate taxation

The draft bill aims to introduce an option for commercial partnerships to be taxed like a corporation. For income tax purposes, companies opting for such treatment are deemed **equivalent to corporations** (also for the purposes of trade tax). The partners are treated as not personally liable shareholders of a corporation. Under civil law, the company remains a partnership.

In order to exercise this option, an **application** must be filed to the competent tax office by the partnership. The application is irrevocable and must be made before the start of the fiscal year in which taxation as a corporation is to apply. Retroactive application is not possible.

The transition from transparent taxation as a partnership to corporate taxation is treated as **change of form** for tax purposes. To ensure that this fictitious change of form is 'tax neutral', the requirements of the German Reorganisation Tax Act must therefore be met.

The draft bill allows for a **reversion option**. On application, the company can revert to transparent taxation as partnership. This event is also treated as change of form – from a corporation to a partnership, also without retroactive tax effect. The application must be made before

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the start of the fiscal year in which taxation as partnership is to apply again.

Excluded from the option for corporate taxation are: investment funds within the meaning of the German Investment Taxation Law [InvStG] and companies that are not subject to taxation comparable to German unlimited corporate tax liability after exercising the option in the country in which their place of effective management is located. This is to prevent hybrid arrangements.

The amendments are to enter into force on **1 January 2022**.

Reduction in profits from exchange rate fluctuations relating to shareholder loans

Reductions in profits relating to loan receivables of a major shareholder (shareholding of more than **25 %**) of a corporation, from certain financially comparable receivables and related to the use of collateral for such loan receivables generally are not tax deductible.

According to the contemplated amendment in the draft bill, foreign exchange losses are not to be deemed reductions in profits and thus no longer be subject to non-deductibility. The amendment is to be applied for the first time to reductions in profits occurring **after 31 December 2021**. For reductions in profits from previous periods, the appeal proceedings at the German Federal Tax Court (file ref. I R 41/20) should be taken into account.

Opening the parts of the Reorganisation Tax Act relevant for corporations to worldwide transactions

Application of the Reorganisation Tax Act to transformations of corporations is currently limited to companies from EU/EEA countries. In addition, the Corporation Tax Act provides for beneficial treatment for certain mergers of third-country corporations. The Reorganisation Tax Act is now to be opened up for certain **transformations of corporations worldwide**. This concerns in particular spin-offs or demergers of third-country companies as well as cross-border mergers. Contributions and the exchange of shares are not covered, however.

The transformation must show the structural features of a domestic transformation. In addition, the Federal Republic of Germany's **right to tax** may not be restricted or excluded.

The opening up to worldwide application is initially for transformations with a transfer date for tax purposes **after 31 December 2021**.

The Bundestag must pass the draft bill before the end of the legislative period; that means before the constituent meeting of the new Bundestag after the federal elections on 26 September 2021, otherwise the draft bill is subject to discontinuity. The final scheduled meeting week of the Bundestag is set for the week from 21 to 25 June 2021.

Tightening of Real Estate Transfer Tax Regulations for Share Deals

On 21 April 2021, the Bundestag [lower house of the German parliament] passed measures against so-called "**share deals**". The need for reform is explained essentially by the fact that large investors can avoid **RETT** on real estate transactions through share deals, whereas a private person would not usually have this option in the context of an "asset deal".

The most important content of the passed bill is:

- Lowering the relevant investment level from **95 % to 90 %**.
- Expanding the special provision for shareholder changes in partnerships owning real estate (RE-partnerships) to include **corporations** owning real estate (RE-corporations) but with introduction of a so-called stock exchange exception clause.
- Extension of the current **holding periods** from five to ten or fifteen years.

Lowering the investment level from 95% to 90%

The Real Estate Transfer Tax Act [RETTA] contains several special provisions (so-called fictions) for share deals involving real estate. These provisions equate a direct or indirect transfer of shares in a real estate company with the transfer of a piece of real estate. It is a key feature of these fictions that the investment level currently amounts to at least 95%. Hence, whenever at least 95% of the shares are unified in one single hand, or the shares already unified in one single hand (i.e. 95% or more) are transferred to one acquirer in one go, there is a transaction that is subject to real estate transfer tax as far as real estate corporations are concerned. Currently, real estate transfer tax can therefore be avoided in the event of a share deal involving the transfer of shares in a RE-corporation if the main investor holds directly less than 95% in the real estate company and the other shares are acquired by a co-investor.

According to the draft bill, the **investment level** shall be **reduced**

from 95% to 90% for all fictitious cases. Thus, in future, a main investor would have to limit its direct holding in the RE-corporation to less than 90% for the acquisition not to be subject to real estate transfer tax.

Expanding the special provision for RE-partnerships to include RE-corporations

According to the draft bill, in addition to generally lowering the investment limit to 90%, a corresponding special provision (based on a time-period) shall also be **introduced for RE-corporations**. Thus, a RE-corporation would already incur real estate transfer tax when, for example, three new shareholders each acquire 30% in the RE-corporation at the same time.

According to the explanatory memorandum to the Act, the proposed § 1 (2b) draft RETTA does not provide for a corresponding application of personal tax exemptions and the special exemption provisions for RE-partnerships.

Due to the fact that not only the associations of the real estate industry but also the Bundesrat [upper house of the German parliament], in its comment on the original draft legislation, have proposed an exception provision for **listed stock corporations** in this context, such a "stock exchange clause" for the special provisions relating to RE-partnerships and RE-corporations was now included in the draft legislation. Hence, in the context of the special provisions for RE-partnerships and RE-corporations, transfers of shares in listed stock corporations shall not be considered for the determination of the relevant participation quota. In the case of the already existing provision of § 1 (2a) RETTA, this concerns participations of a listed stock corporation in a RE-partnership. The RE-corporation itself shall be liable for tax, by analogy with the application of the current legal system to RE-partnerships.

Finally, it must be assumed that real estate transfer tax arises upon the "**closing**" (assignment/transfer of the shares or the respective transfer of beneficial ownership). This represents a significant change as to date, in the case of forthcoming share deals in connection with RE-corporations, the "**signing**" (conclusion of the share purchase agreement) has been the key criterion.

Extension of periods from five to ten / fifteen years

The special provision currently in place for RE-partnerships includes a five-year period. In addition, there are special exemption provisions for RE-partnerships. Under certain circumstances, these allow exemptions for real estate transfers between a RE-partnership and its shareholder. The exemptions require five-year **pre- and post-holding periods**. According to the draft bill, all periods in the RETTA shall generally be extended to **ten years**. Moreover, with respect to the pre-holding period, the draft bill provides for an extension to **fifteen years**. The purpose of this provision is to counteract abuse and to make tax arrangements designed to achieve tax benefits by gradually acquiring shares in the assets of a RE-partnership significantly more difficult.

Temporal application

The draft bill provides for provisions regarding the temporal application of the amended RETTA. In general, the amended RETTA shall be applicable for the first time to acquisition transactions realized **after 30 June 2021**. However, the reduction of the investment limits and the extension of the periods basically have implications for past legal transactions.

After almost two years in the legislative process, the reform of real estate transfer tax has now entered the home stretch. Following the decision of the Bundestag, the Bundesrat must still approve the Act.

Federal Ministry of Finance Guidance on Mandatory Disclosure Rules

Since 1 July 2020, cross-border tax planning arrangements must be reported to the tax administration (DAC 6). The Federal Ministry of Finance [BMF] has now published the final BMF guidance on the application of the provisions on the mandatory disclosure rules for cross-border tax planning arrangements. This was preceded by a BMF draft guidance in March 2020. Moreover, the Federal Central Tax Office [BZSt] had published on its website a draft guidance from July 2020 which had reflected the then current state of affairs with regard to the discussions between the highest national and federal tax authorities and had already been applied by the BZSt.

In comparison with the last draft version from July 2020, there were no fundamental changes but only few rather specific adjustments. The basic statements remained unchanged.

The BMF guidance is divided into **three parts**:

I. material and personal scope of the disclosure requirements (margin nos. 6 to 104)

II. hallmarks (margin nos. 105 to 190)

III. procedure for reporting a cross-border tax arrangement (margin nos. 191 to 276)

The so-called **white list** is attached to the BMF guidance. The white list defines case groups where no tax advantage is to be assumed, in particular because the tax advantage of a cross-border tax arrangement has an effect only within the scope of the Fiscal Code and because it is, taking into account all circumstances of the tax arrangement, provided for by law. At the beginning, the BMF guidance contains an eight-step overview of how to verify the existence of a reporting obligation.

In addition, as an attachment to the BMF guidance, the BZSt published on its website a list of the **preferential tax regimes** and a list of the **non-cooperating tax jurisdictions**. These lists are relevant for the hallmarks "payments into a jurisdiction with preferential tax regimes" or "payee resident for tax purposes in a non-cooperating jurisdiction".

Cross-border tax planning arrangements must be reported electronically to the BZSt using the **officially prescribed data set** via the officially designated interface. The report on the cross-border tax arrangement must be submitted **in German**. Only here and there information may, in addition, be provided in English.

Moreover, implemented tax arrangements **must be declared in the tax return**. The first tax return on which the tax advantage shall have an effect, must provide information on the arrangement for the tax type and the tax period or the taxable moment.

Intentional or reckless violations of the reporting obligations constitute administrative offences which can be sanctioned with a **fine of up to 25.000 €**.

Successful Constitutional Complaint to Adjust Income pursuant to § 1 AStG

The German Federal Constitutional Court [BVerfG] granted the complainant's **constitutional complaint** (file ref. 2 BvR 1161/19) against the German Federal Tax Court [BFH] ruling I R 73/16. The judgment infringes upon the complainant's rights because the BFH refrained from referring the case to the European Court of Justice (ECJ) for a preliminary ruling. The BVerfG thus overturns the BFH's judgment and refers the matter back to the BFH.

In the underlying case, a German limited liability company maintained an unsecured clearing account for a Belgian subsidiary. After the Belgian subsidiary had experienced financial difficulty, the German limited liability company waived the receivable from the clearing account and derecognised it from its balance sheet, thus reducing profit. However, the tax office eliminated this reduction in profit pursuant to § 1 (1) Foreign Transactions Tax Act (AStG).

With its judgment of 27 February 2019 (file ref. I R 73/16), the **BFH has amended its settled case law** on the precluding effect of Article 9 (1) of the OECD Model Tax Convention with respect to income adjustment pursuant to § 1 (1) AStG: Article 9 (1) of the OECD MTC (here: Art. 9 of the Belgian-German DTA 1967) does not limit the scope for adjustment under § 1 (1) AStG to price adjustments; it also allows the elimination of the profit-reducing derecognition of a loan receivable or write-down to fair value. The absence of loan collateral generally falls under non-arm's length 'conditions' as defined by § 1 (1) AStG. The same applies to Article 9 (1) of the OECD MTC. Whether an adjustment pursuant to § 1 (1) AStG is contrary to the principle of proportionality of EU law will have to be determined after examining all the circumstances of the individual case. In doing so, the economic self-interest and financing responsibility on the one hand and the structural proximity to equity and the change in the lender's asset and liquidity status on the other must be taken into account. The BFH did not refer the case to the ECJ for a preliminary ruling.

The case in question concerned the **year in dispute 2005**. The non-deductibility of a loss in value relating to a loan receivable of a major investee or from the use of collateral (§ 8b (3) sent. 4 et seqq. KStG) only applies from assessment period 2008 onwards.

According to the BVerfG, the **judgment violates the complainant's right to a lawful judge**. The right to a lawful judge is violated when pertinent ECJ case law is not yet available on a decisional issue of Community law or available case law may not yet have addressed the decisional issue exhaustively. Moreover, in such cases, the court of last instance on the merits must have unjustifiably exceeded the scope of assessment to which it is necessarily entitled in such cases. This occurred in the case at hand according to the BVerfG. The correct application of Union law to the case of granting a loan not secured on an arm's length basis, which was (for the first time) subsumed by the BFH under § 1 AStG, was in any case not so obvious according to the reasons provided by the BFH and in view of the incompleteness of ECJ case law on the requirements of freedom of establishment that there was no room for reasonable doubt.

The BVerfG explains further why the BFH was required to refer the case to the European Court of

Justice for a preliminary ruling. As this did not occur, the **matter was referred back to the BFH** for a new decision.

Government Draft Bill for an Act to Combat Tax Avoidance and Unfair Tax Competition

On 31 March 2021, the Federal Cabinet passed the government draft bill for an Act to Combat Tax Avoidance and Unfair Tax Competition and to amend other laws.

In comparison with the ministerial draft bill (see German Tax Monthly issue March 2021), in particular the following changes have been made:

– **Temporal application** of certain defensive measures after a tax jurisdiction was named non-cooperative: introduction of a "**phased model**"

– **Elimination of the defensive measure** "denial of withholding tax relief"

– **Tightened CFC rules**:

  - Application only to income that is subject to a lower taxation rate (**less than 25 %**)

  - Extension to **lower tier companies** and their **foreign downstream companies** as well as to **permanent establishments** situated in a non-cooperative tax jurisdiction

– **Measures concerning dividends and sales of ownership interests**: denial of the application of the partial income method and the tax exemption of § 8b Corporation Tax Act [KStG] also with respect to income the taxpayer receives from an **affiliated person,** and this income is earned from dividends or gains on disposals that the affiliated person has directly or indirectly received from a corporation resident in a non-cooperative tax jurisdiction.

For certain defensive measures, a "**phased model**" for the temporal application was included in the government bill: the prohibition on the deduction of operating expenses shall only be applicable as from the beginning of the fourth year (or financial year) after entry into force, the measures concerning dividends and sales of shareholdings shall only be applicable as from the beginning of the third year (or financial year) after entry into force of the legislative decree.

The **denial of the withholding tax relief** pursuant to DTT or § 44a (9) Income Tax Act [EStG], provided for in the ministerial draft bill, in cases where individuals who are resident in a non-cooperative tax jurisdiction hold direct or indirect ownership interest in the foreign company of altogether more than 10% was **not included in the government draft bill**.

The government draft bill further extends the **tightened CFC rules** to lower tier companies and their foreign downstream companies who are resident in non-cooperative tax jurisdictions. Negative income of such companies is not to be attributed (prohibition on offsetting losses against income of other foreign companies). According to the government bill, the so-called switch-over rule from the exemption method to the credit method shall apply to permanent establishments of a resident taxpayer that are situated in a non-cooperative tax jurisdiction, on the proviso that the switch-over rule shall apply to the entire income of the permanent establishment. However, in the case of active income, the tightened CFC rules shall be subordinate to the aforementioned denial of deducting expenses.

According to the government bill, the application of the **partial income method** and the **tax exemption method** shall also be **denied** in the event of income that the taxpayer receives from an **affiliated person,** and this income is earned from dividends or gains on disposals that the affiliated person has directly or indirectly received from a corporation resident in a non-cooperative tax jurisdiction. The tax exemption or tax benefit shall not be denied insofar as it can be demonstrated that the dividends are derived from amounts which were subject to the denial of the deduction of operating expenses or withholding tax measures.

In principle, the Act is to be applied as of **1 January 2022**. With regard to tax jurisdictions that were not yet named on the 'blacklist' as at 1 January 2021, the Act shall only apply from **1 January 2023**.

Imprint

Published by
KPMG AG Wirtschafts-
prüfungsgesellschaft
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60549 Frankfurt/Main, Germany

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