KPMG

German Tax Monthly

Information on the latest tax developments in Germany

December | 2021

Content

Coalition Agreement for a new Federal Government

BMF Guidance on the Option of Corporate Taxation for Partnerships

Arm's Length Interest on Intercompany Loans

Write-up of Liabilities Denominated in Foreign Currency in the Tax Balance Sheet due to the Appreciation of the Swiss Franc

Regulation to apply the Act to Combat Tax Havens – Designation of Non-Cooperative Tax Jurisdictions

Coalition Agreement for a new Federal Government

Around nine weeks after the parliamentary elections, the Social Democrats (SPD), the Greens (Bündnis 90 / Die Grünen), and the Free Democrats (FDP) have agreed on a coalition agreement. The ministries, too, were distributed among the parties. The federal ministry of finance goes to the FDP.

The coalition parties emphasize that fair taxes form the basis for a state's ability to act. The tax system shall become much simpler for people and companies. Digitalization and de-bureaucratization of the tax administration shall be promoted. Tax evasion and tax avoidance shall be combatted more intensely. The coalition agreement provides for a large number of individual tax measures.

In the following, we summarize the most important fiscal proposals of the government coalition:

- Introduction of a limitation on interest rates for tax purposes to supplement the interest limitation rules.
- Expansion of withholding taxation, in particular through an adjustment of the DTTs.
- Introduction of a reporting obligation for national tax arrangements of companies with a turnover of more than €10 million.
- Introduction of a "super depreciation" for climate protection and digital assets in the years 2022 and 2023.
- Prolongation of the extended loss offset (€10m instead of €1m) until the end of 2023 and extension of the loss carryback to the two immediately preceding years.
- Closing of tax loopholes used by corporate groups in the acquisition of real estate (share deals) for reciprocal financing purposes.
- Increase of the depreciation rate for new residential buildings from 2% to 3%.

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- Combat of illegal financing of real estate through suitable measures, i. a. through proof of taxation required for commercial and private real estate buyers from abroad for any acquisition of real estate in Germany, as well as a ban on purchasing real estate with cash.
- Reallocation of the EU plastic tax to manufacturers and distributors.

BMF Guidance on the Option of Corporate Taxation for Partnerships

The German Federal Ministry of Finance [BMF] issued an application guidance on the option of corporate taxation for commercial partnerships (Section 1a of the German Corporation Tax Act [KStG]) on 10 November 2021.

Background

With the Act Updating Corporate Tax Law, an option of corporate taxation for commercial partnerships has been introduced. Commercial partnerships are thereby granted the option of being taxed like a corporation without actually changing their legal form. The option of corporate taxation can be exercised **for the first time for financial years beginning after 31 December 2021**.

Main content of the BMF guidance

The legal entities within the scope of the option are all **commercial partnerships** [Personenhandelsgesellschaften]. This applies explicitly also for partnerships pursuing purely asset management activities. Companies of comparable foreign legal forms (legal form comparison, operation of a commercial enterprise) are also entitled to apply. Companies without a registered office and management in Germany can also opt for corporate taxation; upon exercising the option these companies are subject to limited corporate tax liability. The option is also possible if the foreign company generates no German-source income.

The application to exercise the option must have been submitted to the competent tax authority **no later than one month before the start of the financial year** from which the option of corporate income taxation is to apply.

The transition to corporate taxation is considered as a **change of form** from partnership to corporation.

- To exercise the **valuation option** for German reorganisation tax purposes (change of form at book or interim value), all of the company's functionally material operating assets must be transferred to the fictious corporation. This also includes assets under the ownership of the partner and which are provided to the company for use (e.g. the business property). These must be transferred separately to the company before the fictious change of form.
- The fictious change of form due to the option being exercised can also lead to the violation of existing **lockup periods**.
- Due to the option of corporate taxation, all interests in the opting company will be subject to **lockup periods** (seven years) if the fictious change of form at book or interim values is enacted. This has the effect of an early sale of interests in the opting company triggering "taxation of contribution profit", i.e. the hidden reserves in the "transferred" assets are to be taxed retroactively at the date the option is exercised.
- Exercising the option results in any **loss carryforward** (for trade tax) of the opting partnership being forfeited. This also applies for the interest carryforward and any EBITDA carryforward in the context of the interest limitation rules [Zinsschranke].

A company that has opted for corporate taxation, is, for purposes of taxation, treated equally according to taxation of income of a corporation. The partners of the company opting for corporate taxation are treated like the not personally liable shareholders of a corporation and the ownership interest in the opting company is treated like a shareholding in a corporation.

- **EU Directives:** The opting company is not a beneficiary company of the Parent-Subsidiary Directive or the Interest and Royalties Directive.
- **Double taxation treaties (DTT):** The opting company is entitled to treaty benefits as "company" within the meaning of the DTT and is resident in Germany if its place of management is in Germany.
- **Tax group:** An opting company can be a controlling entity but not a controlled entity. Already existing tax groups between the opting company as controlling entity and its controlled entities will be continued.
- **Partners' profit shares** are deemed distributed and partners must pay tax on these profit shares only when they are withdrawn or their payment can be demanded.

Reversing the option from corporate taxation back to transparent taxation as partnership also requires an **application to be made** no later than one month before the beginning of the financial year in which the opting company is for the first time no longer to be taxed like a corporation. The termination of the option of corporate taxation

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is treated as a fictious change of form from corporation to partnership.

Reversing the option or other termination of the option of corporate taxation within seven years generally leads to a **violation of the lockup period** regarding the interests subject to the qualifying period and triggers taxation of contribution gains.

Arm's Length Interest on Intercompany Loans

In three recently published judgments, the German Federal Tax Court (BFH) laid down arm's length principles for intercompany loans.

Judgment I R 4/17: FinCo

In the first case, a Dutch finance company (FinCo) granted an interest-bearing unsecured loan to its German associated company. At the same time, the German company took out loans from banks which, although bearing lower interest than the intercompany loan, were secured by guarantees. The tax office considered the interest rate on the intercompany loan to be non-arm's length, i.e. too high, and reduced the interest payable in Germany. In the opinion of the tax office, the FinCo should not be considered a bank, but an agent. The service nature of forwarding loan funds is to be regarded the primary focus. The interest is therefore to be determined on an arm's length basis using the cost-plus method.

The BFH was of a different opinion: the basic method to be used for determining arm's length lending rates is the comparable unrelated price method (CUP). The comparison with the bank loans is to be rejected not only because the bank loans were secured (internal arm's length comparison). It should not be ruled out that the effect of the security provided on the interest rate can be quantified and eliminated. The external arm's length comparison does not fail because of the FinCo's structure, which typically has less resources than a bank. Corporate bonds could also be used for comparison. The group affiliation itself does not prevent application of the CUP method, however, could affect the credit rating and the interest rate. The credit rating of the borrower should be on a standalone basis and not a group rating. A rating agency's credit rating could be used for that purpose (in this case: S&P).

Judgment I R 62/17: Shareholder loan

In the second case, a German company acquired shares in a company. This was financed by the following loans: unsecured subordinated shareholder loan (interest rate 8%); secured bank loan (interest rate 4.78%); unsecured loan from the seller of the shares (interest rate 10%). The tax office considered the interest rate on the shareholder loan too high and only granted tax deduction of the interest payable of 5% (comparison with bank loan).

The BFH did not uphold that view. The comparison with the bank loan is flawed: the bank loan is – contrary to the shareholder loan – secured and senior. An unrelated party would not grant a subordinated and unsecured loan at the same "price" as a secured and senior loan. The statutory subordination of shareholder loans is irrelevant for arm's length determination. The "close relationship" between the shareholder and the subsidiary should be "disregarded", meaning that the lender is precisely not acting as a shareholder and thus statutory subordination does not apply or compensation would be required for "voluntary" subordination of the loan. As a result, for arm's length comparison, actual agreements with unrelated parties (in this case the secured senior bank loan) would first have to be adjusted mathematically to compensate for any special circumstances at affiliated companies (in this case: no collateral, subordinated) before they can be used.

Judgment I R 32/17: Write-down of receivables

In the third case, a domestic company granted shareholder loans to its foreign subsidiaries. Most of the loans were fixed interest; for one of the loans, annual participation in net profit was agreed as compensation in lieu of a fixed interest rate. The loans were unsecured. In the year under dispute (2005), the German company wrote off its receivables against profit. The tax office was of the opinion that the loan terms were not at arm's length and added the write-downs back to profit (pursuant to Section 1 of the German External Tax Relations Act [AStG] – profit adjustment in the case of cross-border business relationships between associated companies at non-arm's length conditions).

The BFH ruled that the lack of loan collateral falls under the "conditions" within the meaning of Section 1 AStG which, in the overall analysis, can lead to the business relationship (related party transaction) being considered non-arm's length. The same applies to Article 9 of the OECD Model Tax Convention, so that Article 9 of the OECD Model Tax Convention has no precluding effect on the unilateral adjustment of profit under Section 1 AStG. Whether an unsecured intercompany loan is considered arm's length depends on whether an unrelated party would have granted the loan under the

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same conditions – taking into account compensation for potential risks where applicable. Not only banks, but also other lenders could be considered "unrelated parties" if there is a market for the specific financing in which such lenders are active. Even the collateral itself does not always need to be "customary in banking". Moreover, full collateralisation cannot always be assumed.

When determining the market for the agreed loans, all circumstances of the individual case should be considered, i.e. in addition to the borrower's credit rating, other circumstances such as the corporate group's conduct in lending to unrelated parties, the economic benefits of potential collateralisation in the specific individual case, alternatives to non-collateralisation, loan amount and term, the purpose of the loan and the business strategy of the lender. It is therefore possible, according to the BFH, that an unrelated party on this market is willing to compensate for the increased credit risk arising from non-collateralisation, for example through agreement of an interest rate premium. Accordingly, the lack of a single "condition" (in this case: lack of collateral) does not immediately lead to the profit adjustment pursuant to Section 1 AStG being applied.

The BFH has referred the case back to the lower court to be able to expand its findings on arm's length transactions. Should the lower court come to the conclusion that arm's length "conditions" were agreed in general, a profit adjustment pursuant to Section 1 AStG is precluded. Should the examination show that the agreed conditions were not at arm's length, even when taking into account a so-called risk compensation, an adjustment of the write-down to fair value – i.e. of the loan amount – pursuant to Section 1 AStG is also precluded. However, the profit adjustment would be limited to the difference between the actually earned and the arm's length interest income if there is such a market for the agreed loans.

Write-up of Liabilities Denominated in Foreign Currency in the Tax Balance Sheet due to the Appreciation of the Swiss Franc

In three judgments on 10 June and 2 July 2021 (file ref. IV R 18/18, IV R 2/19, XI R 29/18), the BFH ruled that the write-up of a liability in foreign currency to its higher fair market value in the tax balance sheet is permissible if the value of the euro against the foreign currency has declined due to a fundamental change in the economic and monetary policy data of the currency areas involved. The BFH has affirmed such a fundamental change with respect to the appreciation of the Swiss franc against the euro in the years under dispute 2010 and 2011. This applies to all liabilities denominated in foreign currency, irrespective of whether the remaining term is at least ten years or less.

According to German tax law, liabilities must be recognised in the tax balance sheet at their repayment amount. If a liability is payable in foreign currency, the amount must be translated into euros on the date the liability is incurred. If the exchange rate of the currency increases in the subsequent period, the repayment amount and thus the fair market value of the liability also increases. A profit-reducing write-up to fair market value is permissible under tax law only when that value is higher than the original repayment amounts due to an expected permanent increase in value. It is not defined in tax law under what circumstances a change in value is "expected to be permanent".

In all three cases under dispute, the plaintiff companies had taken out bank loans in Swiss francs (CHF). While the proceedings IV R 18/18 and IV R 2/19 each referred to the year in dispute 2010 and a loan in foreign currency with a remaining term of less than 10 years, the proceedings XI R 29/18 concerned the years in dispute 2010 and 2011 and a loan in foreign currency with a remaining term of more than 10 years. The plaintiffs each sought a profit-reducing write-up of the loan liabilities to the higher fair market value as at the reporting date of the years in dispute due to the sharp rise in the CHF/euro exchange rate since the loans were taken out.

The three legal proceedings were partially successful. With regard to the loan in foreign currency with a remaining term of more than ten years, the BFH initially confirmed its previous judgment, according to which not every foreign exchange loss justifies the assumption of an expected permanent increase in fair value. This is because it can be assumed that the fluctuations in exchange rate will balance out again over the remaining term. However, an increase in value is expected to be permanent when it can be assumed that the change in exchange rates is permanent based on fundamental changes in economic and/or monetary policy data. This applies to all liabilities in foreign currency, i.e. irrespective of whether it is a loan with an indefinite or definite remaining term and whether the remaining term is at least ten years or less.

In the cases under dispute here, such a fundamental change in economic data between the euro area and Switzerland applied in 2010 according to the BFH, because extensive rescue measures were taken in response to the debt crisis in several EU member states,

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e.g. the adoption of an aid package for the member state Greece and installation of the so-called euro recovery package at a volume of 750 billion euros. A fundamental change also occurred in the subsequent year because the Swiss central bank announced its intention in September 2011 to buy foreign currencies without limitation from then on to defend the CHF exchange rate. In doing so, the Swiss central bank intervened in the market and influenced the development in exchange rates.

The BFH has clarified that – contrary to the opinion of the plaintiffs – it is not sufficient for assuming an expected permanent increase in fair market value that the exchange rate fluctuation exceeds a certain percentage, e.g. a foreign exchange loss of 20% on a single reporting date or 10% each on two successive reporting dates. Otherwise – contrary to the apparent intention of the legislator – even random fluctuations in value would also justify a write-up to a higher fair market value.

And lastly, the BFH has emphasised that the relevant date for determining the fair market value of a liability in foreign currency is the reporting date. Changes in foreign exchange rates, just like decisions of an economic or monetary policy nature, represent so-called "non-adjusting" events, not merely "adjusting events". This means they could only be taken into account when determining the fair value of a liability denominated in foreign currency if they were already objectively in existence on the relevant reporting date.

Regulation to apply the Act to Combat Tax Havens – Designation of Non-Cooperative Tax Jurisdictions

The German Federal Ministry of Finance [BMF] has published a ministerial draft for a regulation to apply the Act to Combat Tax Avoidance and Unfair Tax Competition [Steueroasenabwehrverordnung – StAbwV].

The Act to Combat Tax Avoidance and Unfair Tax Competition (Act to Combat Tax Havens – StAbwG) of 25 June 2021 provides administrative and legislative measures that apply in relation to those states and territories that are non-cooperative tax jurisdictions. This Act empowers the BMF and the German Federal Ministry for Economic Affairs and Energy [BMWi] to issue a regulation specifying the tax jurisdictions which are non-cooperative tax jurisdictions pursuant to the StAbwG, if they are on the EU list of non-cooperative countries and territories for tax purposes, as amended. The regulation is relevant for the application of Sections 3 and 4 StAbwG (defensive measures and increased duties to cooperate).

The StAbwV currently lists the following nine non-cooperative tax jurisdictions: American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, US Virgin Islands and Vanuatu.

In addition, the date is specified on which the non-cooperative tax jurisdictions were included in the StAbwV. This is relevant for the applicability of defensive measures, because the StAbwG provides for a "phased model" for the timing of certain defensive measures for new countries included:

- From the first year after inclusion, tighter CFC rules and withholding tax measures (Sections 9, 10 StAbwG) must be applied.
- From the third year after inclusion, measures concerning dividends and sales of ownership interests (Section 11 StAbwG) must be applied in addition.
- From the fourth year after inclusion, denial of tax deduction of expenses (Section 8 StAbwG) must be applied in addition.

For the regulation to enter into force, it must be promulgated in the German Federal Law Gazette after approval by the Upper House of the German Parliament (Bundesrat).

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Imprint

Published by
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60549 Frankfurt/Main, Germany

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