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Information on the latest tax developments in Germany

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## BFH (I R 14/19): Crediting of Foreign Withholding Tax

In its judgment of 17 August 2022 (I R 14/19), the German Federal Tax Court (BFH) ruled that the amount of business expenses deducted when determining the amount of creditable foreign withholding taxes is limited in substance and in time.

For an entity with unlimited tax liability in Germany that is liable to foreign tax equivalent to German corporate income tax on foreign income in the state from which the income originates, the foreign tax assessed and paid is to be credited against the German corporate income tax attributable to the foreign income from this state (Section 26 of the German Corporation Tax Act [KStG] in conjunction with Section 34c EStG). If this constitutes foreign income (e.g. licence income), then the determination of the income is to include deductions of business expenses that have an economic nexus with the proceeds underlying this income. These rules also apply for foreign income originating from a DTA state insofar as the DTA provides for the tax credit method for this income.

In the case at hand, the claimant (German GmbH) held a 100% investment in a Chinese subsidiary. The GmbH transferred development results to the foreign subsidiary for use and thereby generated licence income in the year under dispute (2011) for which withholding tax of 10% was withheld in China. The business expenses incurred in the year under dispute were connected in part to the licence income of the year under dispute and in part to ongoing development work that has not yet been completed. According to the relevant China DTA (1985), the tax credit method was applicable for licence income. The tax office was of the opinion that all business expenses of the year under dispute were to be deducted in the determination of foreign income, thereby reducing the maximum credit amount to zero euro.

The action was successful. The BFH ruled that only the portion of business expenses in the year under dispute that has an economic nexus to the licences already issued and the licence income based thereon in the year under dispute is to be deducted when determining the maximum credit amount. The other business expenses of the year under dispute, which relate to ongoing development work that has not yet been completed, have no economic nexus with the licence income of the year under dispute (but instead with any future licence income) and should therefore not be deducted.

In giving reason, the BFH first stated that the term "*economic nexus*" is not legally defined. However, by referring to "*the proceeds*

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*underlying this income*", this provision contains a specific purpose-related reference to causation which, in the view of the BFH, limits in substance and in time, the deduction of business expenses for the purposes of calculating the maximum credit amount. In terms of substance, the BFH considers that the deduction of business expenses sets as prerequisite an economic nexus with specific *"proceeds".* It is therefore deemed insufficient for the business expenses to merely have in general an economic nexus with foreign income of the entity or a specific type of income. In respect of time, the court believes it is necessary for the deduction of business expenses to follow an approach based strictly on the assessment period. According to the BFH, the applicable principle for period taxation under German income tax law can be satisfied only by taking such an approach. As a result, when calculating the maximum credit amount, only those business expenses of a specific assessment period are to be considered for deduction that have an economic nexus to specific proceeds of the same assessment period.

## BFH (I R 25/20): Real Estate Transfer Tax is not a Deductible Business Expense for Upstream Mergers

In its judgment of 23 November 2022, the German Federal Tax Court (BFH) ruled that real estate transfer tax arising based on an indirect unification of shares due to a merger cannot, in the case at hand, be deducted as business expenses, and instead that it constitutes "costs for the transfer of assets" (Section 12 (2) sentence 1 of the German Reorganization Tax Act [UmwStG]).

According to the applicable law in the year of dispute (2011), the transfer of interests in a company is also subject to real estate transfer tax if at least 95% (according to current law: 90%) of the interests in a company of a property-holding company are directly or indirectly unified in the hand of one owner. In this case, the owner must pay real estate transfer tax in relation to the property belonging to the company despite ownership of the property not having been transferred under civil law. Taxation is based on hypothetical acquisition of the property.

In the case before the BFH, the tax office, following a merger, thus determined real estate transfer tax for an indirect unification of shares under the German Real Estate Transfer Tax Act at the level of the acquiring corporation. The disputed matter concerned whether real estate transfer tax triggered was immediately deductible as a business expense or if it – as part of the takeover profit/loss – was to be disregarded for tax purposes.

The BFH ruled that real estate transfer tax is attributable to the costs for the asset transfer of the acquiring corporation and not to the immediately deductible business expenses. In the court's opinion, the object of taxation for the unification of shares is not the acquisition of ownership interests but rather a hypothetical purchase of property. However, the BFH stated that in such a case, there is no (direct) nexus to the property, which is here the object of taxation. With there being no definition for the term "costs for the transfer of assets", the BFH used as analogy the principles of costs to sell. Accordingly, the principle of causation ("Veranlassungsprinzip") applies, and it is necessary to determine in each case whether the costs are more closely related to the costs of transformation or to the company's current profits. In the case at hand, the company had an economic burden from the determined real estate transfer tax, which was linked to the merger agreement; therefore, the BFH considered that the necessary causation was satisfied.

## BFH: Non-Performance of a Profit Transfer Agreement in a Tax Group

A prerequisite for forming a tax group (*Organschaft*) for income tax purposes is the conclusion of a profit transfer agreement (PTA). The PTA must be performed throughout its entire period of validity, at least for five years (§ 14 (1) sent. 1 no. 3 sent. 1 of the German Corporate Tax Act [KStG]). Premature termination of the PTA before the end of the five-year minimum term is not detrimental if an important reason justifies the termination.

The German Federal Tax Court (BFH) has now specified in two current judgments when a PTA is actually performed.

In the first ruling (I R 37/19), the controlled company had made a current loss in 2013. The PTA requires the controlling company to absorb (or offset) this loss. In 2015, the controlling company did offset this loss through a transfer to the controlled company. However, the controlled company had not recognised a receivable from the controlling company for the loss absorption in its 2013 annual financial statements. The BFH ruled that the PTA had thus not actually been performed. The court stated that it is not sufficient merely for the profit to be paid to the controlled company or the loss to be offset by the controlling company, but that the corresponding receivables and liabilities must also be entered in the annual financial statements. It is only in this way that it is objectively possible to identify that the PTA was actually "practised" during the entire period of application.

In the case at hand, the non-performance of the PTA occurred

within the minimum contractual period of five years. This resulted in the tax group not being recognised not only in the year of interruption (in this case 2013) but for the entire time since its inception (with retroactive effect also for the years 2009 to 2012).

In the second case (ref. I R 29/19) A-Holding GmbH (hereafter 'Holding') was the sole holder and controlling entity of A-GmbH (hereafter 'GmbH') since 2006. The Holding and the GmbH were integrated into a so-called 'cash pooling' system together with A-Group. A cash pool was maintained at Bank X. The Holding was the holder of the primary target accounts. At the end of each day (midnight), the bank transferred the account balance of the GmbH account to the account of the Holding as instructed and agreed, so that the GmbH's account balance was EUR 0.00 (physical cash pool). Insolvency proceedings were initiated in 2009 regarding the Holding and GmbH assets – before the financial statements of the GmbH for 2008 could be formally adopted. The amount of the GmbH's profit transfer obligation was therefore based on preliminary and not on finalised annual financial statements. The claimant and the tax office agreed that the amount of the profit to be transferred in the final annual financial statements would have deviated from the preliminary annual financial statements. Due to restrictions under German insolvency law, it would no longer have been effectively possible to make an adjustment to the preliminary annual financial statements.

The question in dispute was to what extent early termination and non-performance of the profit transfer agreement due to insolvency during the minimum term of the PTA is detrimental to the assumption of a corporate tax group.

The BFH concluded also in this ruling that the PTA had not actually been performed. If, due to insolvency, the preliminary annual financial statements of the controlled company can no longer be adjusted and if correct application of German GAAP would require a different profit (profit to be transferred) to be presented, the PTA is deemed to not actually be performed. Although the insolvency of the controlled company is considered good cause for the early termination of the PTA within the five-year minimum period, this would result only in the early termination in itself having no detrimental effect on the recognition of the tax group up to that date. However, a lack of actual performance of the PTA in this period cannot thereby be "cured" by this.

In the second case at hand, the non-performance of the PTA also occurred within the minimum contractual period of five years. This resulted in the tax group not being recognised not only in the year of the non-performance (in 2008) but for the entire time since its inception (with retroactive effect for the years 2006 and 2007).

The decisions show how important it is to make sure that the obligations under the PTA are fulfilled. The decisive factors here are accounting and an actual settlement of the claims (e.g. through payment or offsetting). The actual settlement should take place as soon as possible.

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