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BFH (I R 45/20, I R 40/20, I R 36/20 and I R 21/20): Financial Integration and Tax Group in the Case of Conversion during the Year

In various decisions (I R 45/20, I R 40/20, I R 36/20 and I R 21/20) of 11 July 2023, the Federal Tax Court (BFH) commented on issues relating to financial integration in the case of tax groups for income tax purposes and the attribution of income in the case of conversions during the year.

According to the statutory regulation, the controlling entity must hold an uninterrupted interest in the controlled entity from the beginning of its financial year to such an extent that it is entitled to the majority of the voting rights from the shares in the controlled entity.

In the proceedings I R 45/20, I R 36/20 and I R 21/20, the main issue was whether the financial integration continues to exist in the event of a merger of the controlling entity (old) with a controlling entity (new) during the year. The tax authorities only assume an existing financial integration in the event of a merger at the beginning of the financial year of the controlled entity. At first instance, both the Lower Tax Court of Rhineland-Palatinate (1 K 1585/15 of 19 August 2020) and the Lower Tax Court of Hamburg (6 K 150/18 of 4 September 2020) ruled that the requirements for financial integration of a controlled entity into the controlling entity do not cease to apply if the controlling entity is merged on a transfer date during the year. The tax authorities had lodged an appeal against the decisions.

In the legal dispute I R 40/20, there was a contribution (exchange of shares) of the shareholding in the controlled entity to a new entity during the year. In this case, the tax authorities are of the opinion that in the event of a contribution during the year (and without a change in the financial year) a tax group can only be established in the following year. At first instance, the Lower Tax Court of Düsseldorf (6 K 2704/17 K of 29 September 2020) ruled that the existence of financial integration was possible from the start of the controlled entity's financial year. The tax authorities also lodged an appeal against this decision.

The BFH ruled that financial integration continues to exist in these cases. In the case of the mergers in question or the exchange of shares in the event of a contribution below the fair market value, the acquiring entity assumes the tax status of the transferring entity even if the conversion takes place during the year. The shareholding by the first controlling entity is attributed to the second controlling

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entity as part of the universal succession. The effect of the so-called "footstep theory" is comprehensive and also applies to the requirements of the tax group and, in particular, financial integration. This also applies to the attribution of the shareholding in the controlled entity to a domestic permanent establishment of the controlling entity.

According to the BFH, there is therefore ultimately only one controlling entity and therefore no possibility of splitting the income of the tax group between the controlling entity (old) and the controlling entity (new). The entitlement to profit transfer is based solely on who is the entitled controlling entity at the end of the financial year of the controlled entity in accordance with the profit transfer agreement.

BFH (I R 50/20): Financial Integration in the Case of a Tax Group with Qualified Majority Requirements

In its decision of 9 August 2023 (I R 50/20), the Federal Tax Court (BFH) comments on the existence of a tax group if the articles of association of the controlled entity generally provide for a qualified majority for resolutions of the shareholders' meeting. If this is the case, the controlling entity must have a corresponding qualified majority of voting rights in order to fulfil the requirement of financial integration.

In the case at hand, K1, a GmbH, held 79.8 % of the shares in K2, also a GmbH. The articles of association of K2 contained, among other things, the provision that entity resolutions require a majority of 91%. The tax office did not recognise the tax group in this case. The appeal and tax court action against this were unsuccessful.

In the opinion of the BFH, the Lower Tax Court of Düsseldorf (6 K 3291/19 F of 24 November 2020) correctly ruled that a tax group did not exist in the years in dispute due to a lack of financial integration. Financial integration is based on the "majority of voting rights". However, if the articles of association of the controlled entity provide for a (higher) qualified majority for resolutions of the shareholders' meeting, the controlling entity must not only have a simple majority, but a corresponding qualified majority of the voting rights, at least in those cases in which a qualified majority is generally required, in order to fulfil the requirement of financial integration. According to these standards, K1 lacked the qualified majority of voting rights required for financial integration. It did hold 79.8% of the shares in K2, meaning that it was entitled to a simple majority of the voting rights. However, according to the articles of association, a majority of 91% was generally required for resolutions of the shareholders' meeting. K1 did not have this qualified majority.

BVerfG (2 BvL 8/13): Book Value Transfer of Assets between Sister Partnerships

In its decision of 28 November 2023, the Federal Constitutional Court ruled that the regulation excluding the transfer of assets between partnerships with identical shareholdings at book value is not compatible with the German Constitution.

Under German tax law, when an asset is transferred from one business assets (“Betriebsvermögen”) to another business assets, the book value of the asset can be recognised in certain constellations. This means that hidden reserves are not realised. This is the case, among others, if the asset is transferred

- from one business assets to another business assets of the same taxpayer or
- from the taxpayer's own business assets to his special business assets in a business partnership and vice versa or
- between different special business assets of the same taxpayer in different business partnerships.

If, on the other hand, an asset is transferred from the business assets of a business partnership to the business assets of another business partnership with the same shareholding, the hidden reserves of the asset must be disclosed. This is because, in terms of the facts of the case, this is not one of the constellations listed exhaustively in the law.

In the case at hand, a limited partnership sold two developed properties to its sister company, also a limited partnership, for a purchase price equal to the book value. In the opinion of the tax office, the hidden reserves in the properties were to be released as a result of the transfer. In a ruling dated 10 April 2013, the BFH referred the question to the BVerfG as to whether the unequal treatment violates the general principle of equality.

The Federal Constitutional Court has now affirmed a violation of the general principle of equality. The transfer of assets between the business assets of sister partnerships with identical shareholdings is comparable to the constellations exhaustively listed in the law. No objectively plausible reasons for the unequal treatment were apparent. In particular, there is no increase in the performance of the shareholders or a shifting of hidden reserves to another taxable entity. Justification by the prevention of abusive arrangements is also out of the question. There was nothing to suggest that a tax-

neutral transfer of assets between sister partnerships would typically not be undertaken with the legitimate business purpose of restructuring, but with the aim of obtaining abusive tax advantages.

Lower Tax Court of Bremen (1 K 111/18 (6)): Inbound-Dividend Taxation in Permanent Establishment Cases

In its judgement of 29 April 2021, the Lower Tax Court of Bremen commented on the taxation of dividends in permanent establishment cases within an inbound structure.

Dividends received by a foreign corporation from a German corporation are subject to withholding tax (WHT) in the amount of maximum 26.375% in Germany. This WHT is generally final. This means that the foreign corporation does not have to submit a tax return for such dividends in Germany. The filing of a tax return (so-called assessment procedure) would only be necessary if the dividends were to accrue in a German permanent establishment (PE) of the foreign corporation. Under the assessment procedure, dividends from Germany are effectively only subject to a tax burden of 1.5 %. Another option for reducing withholding tax would be a refund - not relevant here - based on a DTT or the Parent-Subsidiary Directive.

The decision of the Lower Tax Court of Bremen was based on the following simplified facts: In the years 2007 to 2009, two corporations based in Chile (non-DTT state) held shares in a domestic, deemed commercial limited partnership ("gewerblich geprägte Kommanditgesellschaft" [KG]). The KG received dividends from a domestic corporation ("Gesellschaft mit beschränkter Haftung" [GmbH]) in which it held 50 % of the shares. The Chilean corporations were commercially active. It was questionable whether the shareholding in the GmbH and therefore also the dividends were to be allocated to the German PE (KG) or the foreign PEs (headquarters in Chile).

The Lower Tax Court of Bremen came to the conclusion that the shareholding in the GmbH was to be allocated to the foreign PEs of the shareholders in Chile and made the following key statements in this regard:

- The arbitrary allocation of the shareholding to the KG is not decisive. Rather, the actual economic affiliation is decisive (principle of causation). According to the principle of causation to be applied, the allocation is to be made according to the extent to which the asset is conducive to the business activities developed in the individual PEs.
- If there are several causal relationships, a weighting is to be applied with the result that the GmbH shareholding is to be allocated to the PE to which the strongest causal relationship exists. In this context, the causation test must be functionally oriented. In this respect, the most significant PE in organizational and economic terms must be determined based on the overall picture of the circumstances.
- In the case in dispute, all significant decisions that were made for the KG with regard to the GmbH were made at the level of the one Chilean corporation in its PE in Chile and not in the PE located in Germany. The decisive factor in this context is that the GmbH and this Chilean corporation were active in the same business area, each to a considerable extent. In addition, there were direct business relationships between the GmbH and this Chilean corporation. The KG, on the other hand, only acted as a holding entity.
- Insofar as the shareholding in the GmbH and the dividend income are attributable to the other Chilean corporation, they can also not be allocated to the domestic PE mediated by the KG, but to its Chilean PE. This is because the interests of the two Chilean corporations were aligned.

As a result, the Chilean corporations were not able to claim the reduced tax burden in the assessment procedure. An appeal to the Federal Tax Court ("Bundesfinanzhof" [BFH]) was not permitted.

The Lower Tax Court of Bremen had ruled in the second instance. This is because the BFH had ruled in its judgment of 29.11.2017 (I R 58/15) that the Lower Tax Court of Bremen, as the court of first instance, had not sufficiently assessed which PE the investment in the GmbH was attributable to. The judgment of the Lower Tax Court of Bremen in the second instance has only now been published.

BMF Guidance on the Application of the German Foreign Transactions Tax Act

On 22 December 2023, the Federal Ministry of Finance (BMF) published the final BMF guidance on the principles for the application of the Foreign Transactions Tax Act (FTTA, in particular on CFC taxation (FTTA Application Decree)). On 20 July 2023, the BMF initially published the draft of a FTTA Application Decree. Compared to the draft version, only a few significant changes were made in the final FTTA Application Decree.

The FTTA Application Decree is intended to adapt the existing BMF guidance of 14 May 2004 on

the principles for applying the FTTA to the current legal situation. The Act on the Implementation of the Anti-Tax Avoidance Directive (ATAD Implementation Act of 25 June 2021) in particular has resulted in extensive changes to CFC taxation:

- Change of the control criterion and introduction of a shareholder-related approach,
- Abolition of the concept of downstream intermediary companies (transferable CFC taxation),
- Revision of the catalogue of active income,
- Revision and extension of the motive test for certain passive income to third countries.

Selected notes on the BMF guidance

Shareholder-related approach:
Pursuant to the law, control of the foreign company also exists if the taxpayer is directly or indirectly entitled to more than half of the profits or liquidation proceeds of the intermediate company. In the opinion of the BMF, a shareholder position is not required for this. The concrete contractual agreement is decisive, so that hybrid financial instruments (e.g. profit-sharing rights, participating loans or silent partnerships) can also convey such a claim.

Closeness through concerted conduct:
Pursuant to the law, concerted behaviour between partners of a partnership is rebuttably presumed. In practice, this has considerable consequences, since in principle any participation in a fund in the legal form of a partnership could lead to "control" of any intermediate companies. Proof to the contrary should be possible in particular if the common purpose of the investors is exhausted in an asset situation where the investment object is not concretely determined and as long as investors do not know each other and only have information rights. According to marginal no. 301, which has been newly introduced compared to the draft, a rebuttal should also be possible as a rule if a calculated shareholding of five per cent in the partnership is not exceeded and no special circumstances apply.

Active/passive catalogue:
The BMF guidance explicitly clarifies that disposals of assets also belong to the income, insofar as they were used for the activity.

According to the BMF guidance, individual activities with a significant economic impact are not to be grouped together but are to be subsumed separately under the catalogue, even if they have an economic connection with other activities (modification of the previously applicable so-called functional approach).

Motive test:
According to the BMF guidance, the motive test is not to be applied to third-country companies, except in the case of non-controlled investment companies. The motive test is excluded insofar as the essential economic activity is predominantly provided by third parties. This should include, in particular, business management and management contracts. However, outsourcing to related parties in the same country should be possible (marginal no. 458). This was not yet provided for in the draft.

Procedural obligations:
Pursuant to the law, each taxpayer with a direct or indirect interest in the foreign company must submit a tax declaration. In practice, the question often arises as to whether this also applies if the result is that there is no CFC taxation (e.g. because of the exemption limits). It is also questionable who is obliged to declare in the case of participation via a partnership. According to the BMF guidance, there is a duty to declare even if the result is that there is no additional taxation. The partnership itself does not have to make a declaration.

Tightened CFC taxation:
For the first time, the BMF guidance also contains statements on the tightened CFC taxation (concerns foreign companies, that are resident in a non-cooperative tax jurisdiction), according to which not only passive income, but all low-taxed income of an intermediate company is subject to (tightened) CFC taxation.

Reduction of low tax threshold

In the Minimum Tax Directive Implementation Act, the low tax threshold (Section 8 (5) FTTA) was reduced from the current 25 per cent to 15 per cent as of 2024, which should significantly reduce the factual scope of application of CFC taxation. However, the final BMF guidance does not yet refer to the Minimum Tax Directive Implementation Act and continues to focus on a low tax threshold of 25 per cent.

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