German Tax Monthly

Information on the latest tax developments in Germany

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Bundestag passes MLI Application Act

The German Bundestag passed the "Law on the Application of the Multilateral Convention of 24 November 2016 and Further Measures" (**MLI Application Act**) on 16 May 2024.

The Act sets out the modifications to the German tax treaties covered by the Multilateral Convention of 24 November 2016 to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS Multilateral Instrument - MLI). Furthermore, the application and priority of the BEPS-MLI regulations with regard to the respective treaty are concretised.

Background and aim of the law

Due to the large number of options and reservations provided for in the BEPS-MLI, Germany had reserved the right to ensure that the modifications to the German DTTs covered only take effect after the conclusion of domestic measures. This Act is intended to implement these domestic measures. In particular, this Act is intended to specify the modifications resulting from the BEPS-MLI, considering the selection decisions of Germany and the respective other contracting state (so-called matching) for the DTTs covered. The modifications resulting from this Act will apply in addition to the existing DTTs.

Once the legislative process has been completed, Germany can inform the OECD as MLI depositary and the other contracting states of the completion of the domestic measures.

Scope of application

The selection decisions and declarations of reservation for a contracting state of the BEPS-MLI only become binding once this state has ratified the BEPS-MLI. For this reason, this Application Act only lists the modifications to those tax treaties covered by the BEPS-MLI for which the other contracting state has already ratified the BEPS-MLI. The MLI Application Act therefore extends to the DTTs with the following states:

1. **Croatia**
2. **Czech Republic**
3. **France**
4. **Greece**
5. **Hungary**
6. **Japan**
7. **Malta**
8. **Slovakia**
9. **Spain**

Content

In addition, only those DTTs that have not already been adapted through bilateral agreements are covered by this law. Therefore, the modifications to the DTTs with **Austria** and **Luxembourg** - whose adaptation to the MLI was already initiated resp. realised in 2023 - are not covered by this law.

The DTTs with **Italy** and **Turkey** covered by the BEPS-MLI are not yet included in this law, as these contracting states have not yet ratified the BEPS-MLI. As soon as this happens, the corresponding modifications are to be supplemented by amending acts.

The DTT with **Romania** covered by Germany is not modified by the BEPS-MLI, as Romania has not named the treaty between Germany and Romania in the context of the ratification.

Temporal application

The law is to enter into force on the day after promulgation.

As a result of the reservation made by Germany, the BEPS-MLI will take effect for withholding tax on amounts paid or credited to non-residents as follows:

- On or after 1 January of the calendar year beginning 30 days after receipt by the depositary of Germany's notification of the completion of the domestic procedures for the BEPS-MLI to take effect in relation to the relevant treaty.

As a result of the selection decision made by Germany and the reservation, the BEPS-MLI will take effect as follows for all other taxes levied for assessment periods:

- On or after 1 January of the calendar year beginning six months after receipt by the depositary of Germany's notification of the completion of the domestic procedures for the entry into force of the BEPS-MLI in relation to the relevant treaty.
- However, according to the explanatory memorandum, the six-month period can also be shortened if Germany and the respective contracting state notify the depositary that they intend to apply a correspondingly shorter period. The date on which the legal changes resulting from the application of the BEPS-MLI in relation to the respective treaty take effect will be announced in the Federal Law Gazette.

According to this – when using a shorter time period of e. g. four months – initial application would be possible from 2025 if the legislative process is completed by the end of July 2024 and the depositary is notified by then (31 July 2024 + 30 days = end of August 2024 + 4 months = end of December 2024). According to reports, a shortening of the time period for individual states is already being examined.

Outlook

After the Bundestag, the Act still has to be passed by the Bundesrat. Subsequently, the Act still has to be promulgated in the Federal Law Gazette.

In view of the diverse selection decisions and declarations of reservation, the legal practitioner is faced with the challenge of reading the tax treaties adapted to the MLI in the "correct" version in each case. Before this law was referred to the Finance Committee of the Bundestag, the BMF submitted a report containing so-called application aids on the DTTs covered by the BEPS-MLI. These working aids contain synopses of the DTTs covered in their respective modifications by the BEPS-MLI, prepared in accordance with the OECD's guidance. The BMF plans to publish these working aids on its website after this law comes into force.

BFH (I R 42/20): Taxation of Internationally Active Attorney Partnerships under the DTT USA

In its ruling of 5 December 2023, the Federal Tax Court (BFH) decided that the US Double Taxation Treaty 1989/2008 (DTT USA) does not result in a switch-over from the exemption method to the credit method in Germany if US domestic tax law provides for non-taxation only of a portion of the total profit share of a partner in a liberal professions partnership (here: "guaranteed payments" for partners not resident in the USA). In addition, the BFH confirmed its previous case law according to which DTTs are to be interpreted statically and not dynamically.

In dispute was the DTT treatment of remuneration from the participation in an internationally active law firm with its headquarter in the USA. In 2008 (year in dispute), the plaintiffs were equity partners (partners) of the law firm (LLP) with its registered office and management in the USA. The LLP generated the vast majority of its profits in the USA, but also maintained several permanent establishments outside the USA, including one in Germany. The plaintiffs worked predominantly in this German permanent establishment, but also in the USA for a small number of working days.

According to the internal profit distribution rules, all partners of the LLP were entitled to a share of the LLP's worldwide total profit. For tax purposes, the total profit of the LLP was allocated to the respective countries using the permanent establishment principle. Each partner was then allocated its share of the profits for each country. The partners had the option of receiving part of their profit share in the form of "guaranteed payments" (GP). The GPs were advance payments on the respective profit shares, which were to be offset against the profit shares actually generated.

Among other things, the LLP declared income that was attributable to the German partners and was to be tax-exempt under the DTT subject to progression. Of the German partners' tax-exempt income under the DTT, x Euros was attributable to the USA. Of this, y Euros was granted as net GP. This net amount resulted from the gross GP of the German partners less the GP taxed in the USA and the GP attributable to permanent establishments located outside the USA, and less the state taxes paid in the USA and proportionately attributable to the GP that were tax-deductible in Germany. The GP paid to the German partners were subject to limited tax liability in the USA in accordance with Art. 707 (c) of the Internal Revenue Code (IRC) in conjunction with Art. 61 (a) IRC only to the extent that these partners had become personally active in the USA. Otherwise, they were not taxed in the USA.

However, the German tax office was of the opinion that the shares in the GP that were attributable to the permanent establishment in the USA were also part of the German partners' taxable income in Germany.

Based on the principles outlined below, the BFH ruled that the profit shares earned by the partners (including the GP) are tax-exempt in Germany under the DTT USA to the extent that they are attributable to a US permanent establishment. The conditions for a reversion of the right of taxation to Germany due to non-taxation in the USA are not fulfilled.

From a German perspective, the partners' profit shares - including the GP - are part of the business profits in accordance with Art. 7 DTT USA. In the case of partners resident in Germany, the profits attributable to the US permanent establishment are exempt from domestic taxation pursuant to Art. 23 para. 3 sentence 1 letter a DTT USA. The disputed income (net GP) is also not covered by the switch-over clause of Art. 23 para. 4 letter b DTT USA. According to this provision, the crediting method and not the exemption method ("switch-over") applies, inter alia, "to income [...] where the United States applies the provisions of the Convention to exempt such income [...] from tax [option 1] [...] or may under the provisions of the Convention tax such income […] but is prevented from doing so under its laws [option 2]". In the case in dispute, neither the requirements of option 1 nor of option 2 were met.

Option 1: The (partial) non-taxation of the GP paid to the German partners in the USA is not based on a different understanding of the interpretation of the DTT USA or the underlying facts, but is due to the national tax law of the USA.

Option 2: The scope of application is generally open, as the USA was (at least partially) prevented from taxing the GP paid to German partners under its national tax law due to the special regulations for GP, even if it had a right to tax all profit shares attributable to the permanent establishment in the USA under treaty law. However, the application of the switch-over clause fails because the non-taxation in the USA did not affect the entire profit share of the German partners, but only the GP - and in principle only a part of it. The BFH has already ruled several times that it is particularly important whether the qualitative-conditional link "if" or the quantitative-conditional link "to the extent" or "insofar" is used in the text of a DTT. When using "where" (in the sense of "if"), the BFH has denied the application of these clauses if only parts of the income were not taxed in the other state, as in the present case. The BFH understands the wording of Art. 23 para. 4 letter b DTT USA "where" in the sense of "if" or "only if". In addition, the English version of Art. 23(4)(b) DTT USA refers to "income" and not to "items of income". This suggests that, irrespective of the use of "where", reference is made here to the entire income of a type of income under tax treaty law and not just to items of income.

The tax office had referred to a possibly different understanding in the OECD model commentary in the 2017 version. Apart from the fact that the wording of the OECD Model Tax Convention commented on is not comparable with the DTT USA to be assessed here, the argument was also to be rejected because DTTs are to be interpreted statically and not dynamically according to established case law of the BFH. Therefore, the version of the OECD Model Commentary applicable at the time of the German Approval Act for the respective DTT can, at best, be relevant. The German Approval Act for the DTT USA dates back to 2006, while the cited paragraphs of the OECD Model Commentary only date back to 2017.

The BFH ruling contradicts the official view of the tax authorities on two key points. According to the administrative opinion, the non-taxation of items of income also meets the requirements of Art. 23 para. 4 letter b option 2 (MoF guidance of 20 June 2013). Furthermore, the tax authorities interpret DTT dynamically and not statically (MoF guidance of 19 April 2023). It remains to be seen whether the tax authorities will adhere to their views.

It should be noted that the unilateral switch-over rule in German national tax law (Sec. 50d (9) Income Tax Act) changed significantly with effect from 1 January 2017. Since then, this regulation, which is designed as a treaty override, has used the link "to the extent" and also refers to "items of income". In the case in dispute, the new regulation was not yet applicable (year in dispute: 2008). The BFH's decision could therefore be different for cases from 2017 onwards. However, the BFH has not yet had to decide this.

Measures against Tax Havens – An Overview

The Act Combating Tax Avoidance and Unfair Tax Competition (Tax Haven Defence Act; THDA) governs measures against business relationships with non-cooperative tax jurisdictions. Classification as non-cooperative tax jurisdiction has effects not just on the Tax Haven Defence Act but also on the reporting requirement for cross-border tax arrangements ("DAC 6") and the public country-by-country reporting ("public CbCR").

I. Non-cooperative tax jurisdictions

The EU Council assesses countries' tax policy according to transparency, tax fairness, implementation of anti-BEPS measures and information exchange. Those not complying end up on a "black list" of non-cooperative tax jurisdictions. The EU first published the black list in December 2017. The list is updated twice each year, in February and October. After the last update in February 2024 the following tax jurisdictions are currently on the EU black list: American Samoa, Anguilla, Antigua and Barbuda, Fiji, Guam, Palau, Panama, Russia, Samoa, Trinidad and Tobago, American Virgin Islands, Vanuatu.

II. The Tax Haven Defence Act

1. Background

The EU black list does not apply immediately for purposes of the German Tax Haven Defence Act. A tax jurisdiction must first be included in a national regulation before the defensive measures related to that jurisdiction become applicable. In April 2024, sixteen non-cooperative tax jurisdictions are listed in this regulation ("listed countries"): American Samoa, Anguilla, Antigua and Barbuda, Bahamas, Belize, Fiji, Guam, Palau, Panama, Russia, Samoa, Seychelles, Trinidad and Tobago, Turks and Caicos Islands, American Virgin Islands and Vanuatu. The German regulation is only adapted to the current status of the EU black list at the end of the year - taking into account the changes in October - and therefore does not yet take into account the changes from February 2024.

2. Typical areas of application and sectors

Those affected are domestic taxpayers who have business relationships or investment/ownership relationships with persons in a listed country. The economic reasons for this are irrelevant. With a view to the countries listed in the regulation in April 2024, it is especially (but not only) tourism, aviation and shipping companies that are affected. Following the inclusion of countries such as Russia, but also Panama, on the list, association with a specific business sector will likely become a lesser factor in determining who is affected by the regulation.

3. The defensive measures

a) "Inbound" cases

The Tax Haven Defence Act provides for withholding tax measures (Section 10 THDA) or a prohibition on deducting business-related and income-related expenses for expenses arising from business relationships in or related to a non-cooperative tax jurisdiction (Section 8 THDA). For purposes of withholding tax measures, the foreign person is assumed to have limited tax liability while the domestic taxpayer is assumed liable for deduction of withholding tax. The limited tax liability of the person, association of persons or pool of assets resident in the listed country covers income from financing arrangements, insurance or reinsurance benefits, trade in goods or services and – since 1 January 2023 – income from the granting or sale of rights that are entered in a domestic public book or register ("register cases").

b) "Outbound" cases

Tighter CFC rules (Section 9 THDA) have been introduced for investments in a company in a listed country and cash flows from a listed country, while privileges and DTA exemptions for dividends and capital gains (Section 11 THDA) have been abolished.

Following the tighter CFC rules, a foreign entity with all of its income, which is subject to low taxation overall, shall be deemed a controlled foreign company (CFC), irrespective of the activity of income, whether it satisfies the motive test or the exemption threshold for mixed income.

4. Time of application of defensive measures

If a tax jurisdiction is added to the national regulation, the defensive measures and enhanced cooperation obligations related to that tax jurisdiction shall generally apply from the beginning of the following year (or financial year). A "step model" is set out for the time of application for specific defensive measures: the prohibition on deducting business and income-related expenses (Section 8 THDA) applies only from the beginning of the fourth year (or financial year) following a country's inclusion in the regulation, while the measures for dividends and sale of shares/ownership interests (Section 11 THDA) apply only from the beginning of the third year (or financial year) following inclusion in the list.

Example of the chronological sequence of defensive measures:

Year 0: Inclusion of tax jurisdiction in the regulation

From year 1: tighter CFC rules (Section 9 THDA), withholding tax measures (Section 10 THDA), enhanced cooperation obligations (Section 12 THDA)

From year 3: Measures for dividends and sale of shares/ownership interests (Section 11 THDA)

From year 4: Prohibition on deducting business expenses and income-related expenses (Section 8 THDA)

III. Further (tax) measures in relation to non-cooperative tax jurisdictions

1. Reporting requirement for cross-border tax arrangements (DAC 6)

Cross-border tax arrangements are reportable in Germany only if a hallmark is satisfied. Such a hallmark relates to specific cross-border payments between two or more affiliated entities if the payment recipient is resident in a tax jurisdiction included on the list of third countries that are classified by the EU Member States or the OECD as non-cooperative jurisdictions. In contrast to the THDA, this provision refers directly to the EU black list, which becomes valid upon being published in the EU Official Journal. Therefore, it is not necessary for the listed countries to be included in a national "German" list.

2. Public country-by-country reporting

For the implementation of Directive (EU) 2021/2101, the legislator passed the Act on the disclosure of income tax information by certain undertakings and branches (public CbCR) - entry into force on 22 June 2023. It essentially affects standalone undertakings resident in Germany and ultimate parent undertakings with global revenue or consolidated revenue of more than EUR 750 million in each of two consecutive financial years. The obligation generally applies for the first time for financial years beginning after 21 June 2024. The disclosures in the public CbCR are to be made separately for each EU/EEA Member State. For third countries, however, disclosure is presented on an aggregated basis unless the third country is e.g. on the EU black list in the reporting period on 1 March. In such cases, the disclosures are also to be made separately. The legislative process is not yet complete. Public CbCR also refers directly to the EU black list, meaning that there is again no need for the country to be included in a national "German" list.

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Editorial team

Dr. Cora Bickert (V.i.S.d.P.)
Directorin, Tax

Veronika Aschenbrenner
Manager, Tax

Julian Fey
Senior Manager, Tax

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