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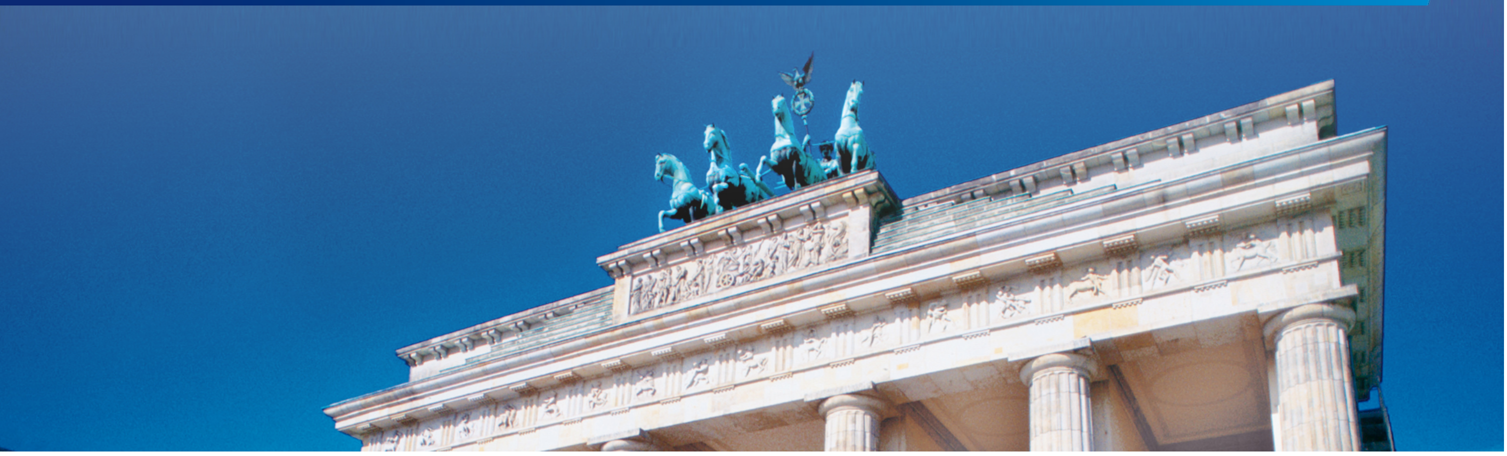

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1. BFH (I R 70/12): Trade Tax Add-Back also in Cases of Subletting

In a ruling of 4 June 2014, the Federal Tax Court (BFH) decided that leasing expenses for sublet properties are also subject to trade tax add-back. The BFH does not have any concerns regarding the constitutionality of the add-back of leasing expenses.

German trade tax law provides for several different add-backs to profit when determining trade income. These add-backs serve the purpose of determining the trade income without regard to the company's capital resources. For this reason, among others, part of the leasing expenses is added back to profit.

In the case at issue the plaintiff (GmbH) sublet shops to several retail businesses for revenue-based lease prices. The plaintiff himself rented the shops at a fixed price. When determining trade income, the local tax office added part of the plaintiff's leasing expenses back to profit. The plaintiff objected to these add-backs. According to the plaintiff, the add-back provision needs to be interpreted restrictively so that it does not cover cases of subletting. In addition, the plaintiff argues that the add-back is incompatible with the ability to pay principle and the objective net principle, and is therefore unconstitutional.

The BFH did not follow this reasoning. It did not see a possibility for a restrictive interpretation, neither in the wording nor with regard to the purpose and intent of the provision. The BFH does not see any indications of unconstitutionality, either. The fundamental structure of trade tax was already confirmed by the Federal Constitutional Court (BVerfG), and, according to the view of the BFH, the standardization of the amounts to be added back is justified, too, when taking into account earlier rulings of the BVerfG. The BFH refused to suspend the proceedings with a view to the request for a ruling by the Lower Tax Court of Hamburg pending with the BVerfG on the unconstitutionality of trade tax add-backs of interest and leasing expenses. The BFH does not see any prospects of success for the request for judicial review (reference to resolution of the Court of 16 October 2012, I B 128/12). Apart from this, the BFH refused to grant a waiver of trade tax in another subletting case in a ruling of 4 June 2014 (I R 21/13) for objective equitable grounds. Trade tax add-back corresponds to the intention of the law, also in cases of subletting, so that there is generally no scope for equitable decisions.

Content

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2. Lower Tax Court of Thuringia (3 K 43/12): Interest paid for Financing EU Fines deductible as Business Expenses

The Lower Tax Court of Thuringia ruled that interest paid for financing an EU fine may be deducted as profit-reducing business expenses.

In the case at issue, the European Commission imposed a fine on the plaintiff (GmbH) for price fixing. The plaintiff paid the fine in installments. Pursuant to German income tax legislation, fines imposed by a body of the European Union must principally not reduce the taxable income of a company, unless the economic benefit derived is absorbed by the fine. The GmbH treated the fine rightly as non-deductible business expense. Whereas the interest expenses incurred for the payment of the installments of the fine were recorded as business expenses.

The Lower Tax Court of Thuringia ruled that the interest expenses are deductible as business expenses. According to the Lower Tax Court, the wording of the non-deduction provision in the law covers only fines, procedural fines, and warning fines as well as certain other payments. In contrast, the non-deduction provision does not apply to the additional costs without punitive character related to the fine. For the same reasons the Federal Tax Court (BFH, X R 59/09) had ruled in a previous judgment that the costs of legal proceedings such as court and attorney fees may be deducted as business expenses, even if they are incurred in connection with a non-deductible fine. The judgment of the Lower Tax Court of Thuringia is final.

3. BFH (I R 2/12): Transfer of Beneficial Ownership when Shares are acquired (so-called Cum-/Ex-Trades)

In a ruling of 16 April 2014, the Federal Tax Court (BFH) dealt with the transfer of beneficial ownership when shares are acquired in the context of so-called “cum-/ex-trades”.

According to German tax law shareholders derive income from capital investment including dividends. The holder of the legal title at the moment of the decision on profit distribution (dividend record date) is the holder of the shares, or – in case someone else but the owner has actual control over the shares – the economic beneficiary of the shares on the relevant date. Generally, dividends are subject to a withholding tax rate of 26.375% (withholding tax incl. solidarity surcharge). As a rule, the recipient of the dividend may credit the withholding tax withheld against tax owed.

In the case at hand the plaintiff, a German GmbH, used a foreign Broker A to acquire shares carrying dividends (“cum dividend” shares) in a listed domestic corporation in the year at issue 2008. At the moment of their acquisition, the shares were held in custody at a French bank. The plaintiff entered into a conceptual and standardized scheme of contracts with Bank B in London. Under this scheme, the bank granted a loan to the plaintiff for the purpose of acquiring the shares. In return, the plaintiff entered into a securities lending arrangement with the bank under which it transferred the full ownership of the shares (until the return sale) on the respective dividend record date. For the dividend lost the plaintiff received a compensation payment as well as a cash deposit for the lending of the securities from Bank B. In addition, the plaintiff transferred the market price risk of the shares to the bank by way of a so-called total return swap transaction. After completion of the transaction, the plaintiff sold the shares, paid the cash deposit back to Bank B from the proceeds and delivered the shares (“ex dividend”) transferred by Bank B to Broker A.

The plaintiff claimed a withholding tax credit for the tax withheld on the dividends. The local tax office argued that, on the dividend record date, the plaintiff was neither the legal nor the beneficial owner of the shares. Crediting of the withholding tax was therefore not possible.

The BFH ruled that beneficial ownership had not passed to the plaintiff as a result of the conceptual and standardized scheme of contracts the plaintiff had concluded with the bank. The plaintiff was not in a position to force the legal owner of the shares out of its status as owner, which would have been required for taking beneficial ownership of the shares. The share acquisitions where inextricably linked to the financing, securities lending and total return swap transactions, and the instant return sale. This amounted to a kind of “pass-through purchase” where Bank B owned the shares only for a short time. As a result, there was no need for the BFH to rule on the controversial question of whether cum-/ex- trades constitute an abuse of legal structuring possibilities.

The BFH passed the ruling based on the legal situation as in force in 2012. It has to be noted that a law has been passed in the meantime (on 22 June 2011, the UCITS-IV Implementation Act) which has changed the rules on withholding tax for the purpose of preventing abuse.

4. Lower Tax Court of Munich (4 K 1304/13): No Exemption from Real Estate Transfer Tax when a Group of Companies is terminated

In a ruling of 23 July 2014 the Lower Tax Court of Munich (FG) decided that the exemption from Real Estate Transfer Tax (RETT) when real properties are acquired in the context of reorganization transactions within a group of companies does not apply if the group consisting of the companies involved in the reorganization ends as a result of the reorganization.

According to German tax law, transfers of real property are generally subject to RETT. However, where the transfer of the real property occurs in the context of the reorganization of a group of companies, an exemption is possible when certain requirements are met (§ 6a Real Estate Transfer Tax Law). The law requires, among others, that either a controlling company and one or several controlled companies, or several companies controlled by the same controlling company are involved in the reorganization. Apart from that the group of companies of the controlling company and the controlled companies must continue to exist for at least five years succeeding the reorganization transaction.

In the case at hand a sole proprietorship was to be reorganized into a GmbH. For this purpose the entire commercial business of the sole proprietorship including real property owned was transferred to a newly incorporated GmbH in a contract (dated 28 June 2011) by way of a spin-off. The transfer of ownership in the real property as a result of the spin-off initially constituted a transaction subject to RETT, which is undisputed among the parties involved. However, what is disputed is the application of the tax exemption provision for reorganization transactions within groups of companies.

According to the Lower Tax Court of Munich, the exemption can ultimately not be applied in the case at issue, because the existing group of companies ceased to exist as a result of the complete spin-off of the controlling company to the GmbH. Thus the post-transaction holding time of five years could not be fulfilled, because, as a result of the termination of the business activities of the sole proprietorship, no controlling company existed any more. After all, not only parts of the sole proprietorship were spun off to the newly incorporated GmbH but the entire assets of the business. It is irrelevant in this context that the owner of the sole proprietorship that ceased to exist with the spin-off continues to exercise the decisive (i.e. controlling) influence – now as sole shareholder of the GmbH.

The judgment is final and confirms the view of the Ministries of Finance of the German States voiced in a decree of identical content of 19 June 2012 (margin number 2.1), according to which a reorganization in a group of companies does not enjoy privileges if the group ceases to exist as a result of the reorganization.

5. Lower Tax Court of Cologne (13 K 2292/10): Substantiation “Holding-Company Privilege” of abandoned Thin Capitalization Rule

The 2008 Corporate Tax Reform fundamentally changed the tax rules for preventing excessive thin capitalization. The previously valid rule was applicable for the last time to the fiscal year equaling the calendar year 2007 or to fiscal years not equal to the calendar year 2007/2008 having commenced prior to 26 May 2007.

In its decision dated 4 September 2014 the Lower Tax Court of Cologne (FG) ruled on the so-called "holding-company privilege" of the old thin capitalization rule. The decision relates to the 2006 and 2007 version of the law. The decision of the Lower Tax Court of Cologne may be advantageous for the taxpayer and could therefore merit attention to assessment periods that are still "open".

The abandoned old thin capitalization rule was primarily intended to counteract excessive shareholder loans to a corporation by its foreign shareholders. Where the requirements of this rule were met, the payments by the corporation for debt capital loaned by the shareholders were not recognized as business expenses, but had to be added back to the profit of the corporation (treatment as "constructive dividend"). The requirements were regularly met where the payments for debt capital exceeded the total amount of € 250,000 per fiscal year, and as far as the debt capital exceeded 1.5 times the pro-rated equity of the shareholder (so-called “safe haven”: debt-equity-ratio < 1.5).

When calculating the debt-equity-ratio, the pro-rated equity had to first be modified by certain add-backs and reductions. This also involved the reduction of the book values of the shares in further subsidiaries held by the relevant corporation. However, the law contained a privilege for holding companies. In the version of the law relevant for the years at issue (2006 and 2007), the “holding-company privilege” stipulated that a holding company did not have to reduce its pro-rated equity by the carrying amount of the subsidiaries. As a result, a holding company benefited from a higher "safe haven".

A corporation qualified as a holding company, if its main activity consisted in holding shareholdings in corporations and in financing said corporations (var. 1) or if more than 75% of its total assets consisted of shareholdings in corporations (var. 2). Based on the wording of the regulation (the plural is used several times: "shareholdings", "corporations") it used to be controversial whether a corporation could be deemed a holding company if it only held one shareholding.

The FG ruled that (apart from other criteria) even only one shareholding is sufficient to enjoy the “holding-company privilege” and to benefit from an expanded "safe haven". Indeed, the plural of the terms "shareholdings" and "corporations" is used, however, in general this wording is understood to also include the singular. In this respect the FG refers to other tax rules as well as to commercial law. According to the FG, this interpretation is not in contradiction with the purpose and intent of the rule. Appeal has been allowed against this decision.

6. Application of Double Tax Treaties to Partnerships

The Ministry of Finance (BMF) amended its guidance of 16 April 2010 on the application of Double Tax Treaties (DTTs) to partnerships. It was the aim of the amendment to adapt the BMF guidance to recent developments in case law and in legislation (in particular the legislative changes following the Act on the Implementation of the Directive on Administrative Cooperation in the Field of Taxation (AmtshilfeRLUmsG), see July 2013 edition of German Tax Monthly). A draft guidance was published by the BMF in early November 2013 (see December 2013 edition of German Tax Monthly). The final version of the BMF guidance on the application of DTTs to partnerships was published on 26 September 2014.

In the first two sections the tax authorities explain the general principles of domestic tax law and tax treaty law that are relevant for domestic and foreign partnerships. Following this the BMF guidance deals with the taxation of profits of partnerships and distinguishes between Germany as the country where the permanent establishment of a business partnership is located and Germany as the state of residence of the business partners. The two last chapters discuss the tax treatment of special partner remunerations as well as some specific procedural aspects.

The following are the essential amendments compared to the draft version of November 2013:

- Detailed explanations on the legislative changes regarding the taxation of income of deemed commercial partnerships (§ 50i Income Tax Law, EStG) due to legislative amendments following Croatia's accession to the EU (see August 2014 edition of German Tax Monthly)
- References to the application of the Authorised OECD Approach (AOA) which has in the meantime been transposed into national tax law (see July 2013 edition of German Tax Monthly)
- Explanations regarding two-tier and multiple-tier partnerships
- Detailed explanations on the treatment of special partner remunerations and special partner business property under tax treaty law.

The BMF guidance as now published replaces the former BMF guidance of 16 April 2014 and is to be applied to all open cases.

7. Amendments to German Tax Treaties

New Double Tax Treaties with the Philippines, Israel, and Costa Rica

Germany signed new Double Tax Treaties (DTTs) with Israel on 21 August 2014 and with the Philippines on 9 September 2013. These Double Tax Treaties replace the DTT Israel from 1962 (last amended in 1977) and the DTT Philippines from 1983. In addition, on 13 February 2014, Germany agreed for the first time with Costa Rica on a Treaty on the avoidance of double taxation. The new DTTs correspond in the main to the OECD Model Tax Convention.

For the taxation of business profits the new DTTs do **not** implement the "Authorised OECD Approach (AOA)" according to the OECD Model Tax Convention 2010 for determining the profits attributable to a permanent establishment, but rather continue to apply the arm's length principle in the 2008 version of the OECD Model Tax Convention.

The general withholding tax rate for dividends in the DTT Israel will be reduced from previously 25% to maximally 10%. In case of direct shareholdings of a corporation of at least 10% in the distributing company the withholding tax rate shall not exceed 5% (Art. 10 DTT Israel). For the first time, the new DTT Philippines provides for a reduction of the withholding tax rate on dividends to maximally 5%, if the beneficiary holds at least 70% in the dividend distributing company (Art. 10 DTT Philippines). For shareholdings of at least 25% the maximum withholding tax rate of 10% will continue to apply unchanged; in all other cases it will amount to maximally 15% (Art. 10 DTT Philippines). In the new DTT Costa Rica the right to taxation of the source state is generally limited to 15%; in cases of substantial shareholdings of at least 20% it is limited to 5% of the gross dividend amount (Art. 10 DTT Costa Rica).

The withholding tax rate for interests in the new DTT Israel is limited to 5% of the gross interest amount (previously 15%; Art. 11 DTT Israel). The revised DTT Philippines limits the withholding tax rate for all cases of interest payments to 10% (previously 10% for specific cases only, for all other cases 15%; Art. 11 DTT Philippines). The new DTT Costa Rica provides for a withholding tax rate of maximally 5% of the gross interest amount (Art. 10 DTT Costa Rica).

According to the new DTT Israel, royalties may no longer be taxed in the source state, but principally only in the state of residence of the beneficiary (previously 5% for specific cases; Art. 12 DTT Israel). The new DTT Philippines fixes the withholding tax rate for all cases of royalty payments at 10% of the gross royalty amount (depending on the case category previously 10% or 15%; Art. 12 DTT Philippines). A withholding tax rate of a maximum of 10% of the gross royalty amount has been agreed with Costa Rica (Art. 12 DTT Costa Rica).

To the extent that there is active income, Germany generally applies the exemption method for the avoidance of double taxation. Whereas the credit method is used for passive income and certain other types of income (Art. 24 DTT Philippines, Art. 22 DTT Israel, Art. 23 DTT Costa Rica).

The rules on the exchange of information in the OECD Model Tax Convention that were updated and expanded several times will apply (Art. 27 DTT Philippines, Art. 25 DTT Israel, Art. 26 DTT Costa Rica). Only the DTT Costa Rica contains a clause on the mutual administrative cooperation for levying taxes (Art. 27 DTT Costa Rica), while the new DTTs with the Philippines and Israel do not.

The "183-days rule" for determining the right to tax income derived from employment in the new DTTs with Israel and the Philippines does no longer use the fiscal year as a reference (DTT Israel) or the calendar year as a reference (DTT Philippines), but a 12 month period commencing or ending during the relevant fiscal year (Art. 14 DTT Israel, Art. 15 DTT Philippines). The DTT Costa Rica also contains such a provision (Art. 15 DTT Costa Rica).

The new DTTs have not yet entered into force. They require the transposition into the national laws of the respective Treaty States and the subsequent exchange of the instruments of ratification in order to become effective. The legislative process for transposing the DTT Israel into national law in Germany has not yet started. The German Federal Government introduced a bill concerning the DTT Costa Rica to the Bundestag (lower house of the German parliament) on 25 September 2014. A resolution by the Bundestag and the consent by the Bundesrat (upper house) are still pending. Upon consent of the Bundesrat to the relevant bill the new DTT Philippines was transposed into national law on 19 September 2014. However, the instruments of ratification have not been exchanged yet.

Each new DTT will enter into force on the day of the exchange of the instruments of ratification and will be applicable for the first time on 1 January of the calendar year following the entry into force (Art. 32 DTT Philippines, Art. 29 DTT Israel, Art. 32 DTT Costa Rica).

Amendment to the DTT Norway

On 24 June 2013 Germany and Norway signed an amending protocol to the existing DTT Norway dating from 1991. For major changes of the contents please refer to the August 2013 edition of German Tax Monthly.

The amended DTT has not yet entered into force. It still requires the transposition into the national laws of both Treaty States and the subsequent exchange of the instruments of ratification in order to become effective.

On 25 September 2014 the German Federal Government introduced a bill to the Bundestag concerning the amending protocol to the DTT Norway. A resolution by the Bundestag and the consent by the Bundesrat are still pending.

Amendment to the DTT Georgia

On 11 March 2014 Germany and Georgia signed an amending protocol to amend the DTT Georgia from 1 June 2006.

The most important changes of the DTT Georgia relate to the exchange of information and to administrative cooperation. The amended exchange of information clause in Art. 26 DTT Georgia is geared to enhance obtaining information in tax matters to a larger extent than in the past. In addition, the inclusion of an administrative cooperation clause in Art. 26a DTT Georgia is intended to promote the cooperation in the field of tax levying.

The amended DTT has not yet entered into force. The amending protocol still requires the transposition into the national laws of both Treaty States and the subsequent exchange of the instruments of ratification in order to become effective. The German Federal Government introduced a corresponding bill to the Bundestag on 25 September 2014. A resolution by the Bundestag and the consent by the Bundesrat are still pending.

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