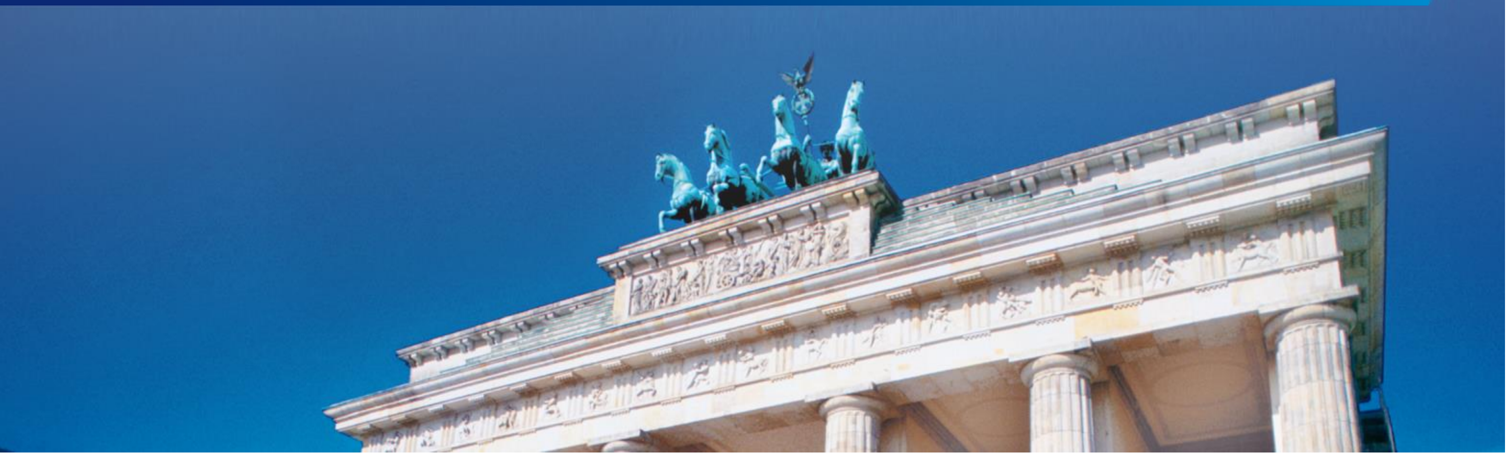
German Tax Monthly
March 2015



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1. Regional Tax Office North-Rhine Westphalia: Responsibility for Equitable Measures regarding Trade Tax

In its brief notice dated 6 February 2015 the Regional Tax Office of North-Rhine Westphalia (OFD NRW) announced that the German municipalities still have responsibility for granting equitable measures regarding trade tax in matters concerning so-called restructuring profits.

The restructuring of a business entity regularly gives rise to a so-called restructuring profit, in particular due to the cancellation of debt. In some cases this restructuring profit is subject to tax, especially because of the minimum taxation rules, although the business entity regularly carries forward significant losses and the restructuring profit does not improve liquidity.

According to the so-called Restructuring Decree (Sanierungserlass) issued in a guidance by the Federal Ministry of Finance (BMF) dated 27 March 2003 the business entity may therefore on equitable grounds seek exemption from, inter alia, the minimum taxation rules, to be able to offset at an early stage the losses carried forward in their full amount against the restructuring profit. It is undisputed that with respect to income tax and corporate income tax responsibility for processing the application lies with the tax office in the district where the company's effective place of management is located. However, regarding trade tax it is not clear whether the same tax office is in charge, or whether each individual municipality where the business entity maintains a permanent establishment is competent to decide independently on the equitable measure. Because unlike in matters of corporate income tax and income tax, the municipalities have the exclusive right to levy trade tax. In its decision of 25 April 2012 (I R 24/11), the German Federal Tax Court (BFH) ruled that for the purpose of trade tax the responsibility for processing the application lies exclusively with the municipalities. In practice, this entails difficulties whenever the application must be filed with a multitude of municipalities which, moreover, can arrive at different decisions.

Pursuant to the Customs Code Alignment Law (see January/February 2015 edition of German Tax Monthly), the Tax Procedure Law was amended and now stipulates that the local tax office responsible for the company's effective place of management shall be the competent tax office for equitable measures relating to trade tax. Where equitable measures are to be granted in the context of restructuring profits, this would facilitate the submission of applications for the purpose of trade tax

Content

Responsible
Dr. Martin Lenz
mlenz@kpmg.com

Published by
KPMG AG Wirtschaftsprüfungsgesellschaft
The Squaire, Am Flughafen
60549 Frankfurt/Main, Germany

Editorial Team
Prof. Dr. Gerrit Adrian
Alexander Hahn
Christian Selzer
Corinna Tigges
Dr. Dennis Weiler

because the business entity would only have to contact one single municipality.

However, in its brief notice of 6 February 2015 the OFD NRW expresses the view that precisely these equitable measures are not covered by the new provision. As a result, for the purpose of trade tax, responsibility would remain with the municipalities.

2. Federal Central Tax Office: Provisions on Repayment of Contributions by an EU Corporation also applicable to Share Capital

The Federal Central Tax Office (BZSt) has included a communication on its website (www.bzst.de), according to which the rules applicable to the tax treatment of repayments of contributions by an EU corporation (§ 27 (8) Corporate Income Tax Law - KStG) also apply to retransfers of an EU corporation's share capital. The federal tax authorities and the tax authorities of the Federal States are reported to have agreed on this official view.

Corporations resident in Germany maintain a "tax-specific capital contribution account" (steuerliches Einlagekonto) in order to record contributions which have not been made to the share capital. Any payment made by the corporation to its shareholders out of the tax-specific contribution account (so-called repayment of a contribution) is generally tax-exempt at the level of the shareholder. However, whether such payment is made out of the tax-specific contribution account or deemed to be a taxable profit distribution is not an arbitrary decision. The so-called appropriation sequence ("Verwendungsreihenfolge") must be applied. According to this rule, for the payments made by the corporation profits are deemed to be distributed first (taxable profit distribution) before the contribution account may be used.

A reduction of the share capital with an ensuing repayment to shareholders is also recorded in the tax-specific capital contribution account, but in this case the appropriation sequence rule does not apply. Instead, the payments are directly made out of the tax-specific contribution account, i.e. repayments of share capital are not taxable at the level of the shareholder.

According to § 27 (8) KStG, the provisions relating to the repayment of contributions are also applicable to corporations in other EU Member States, subject to additional requirements (especially. a separate assessment upon application within a set period of time and additional obligations to provide evidence).

Now the view of the tax authorities has become known, according to which a separate assessment (as provided in § 27 (8) KStG regarding the repayment of contributions) is also required for share capital repayments by EU corporations to ensure their treatment as tax-neutral repayments of share capital. For this purpose, the EU corporation must submit, within a set period of time, an application on the officially prescribed form and other documents including their German translations, e.g. a certificate issued by the competent foreign tax authority confirming the corporation's resident (unlimited) tax liability, organizational chart, statement on the development of share capital and the current share capital including relevant resolutions on changes of share capital.

The application and all relevant documentation must be filed with the BZSt by the end of the calendar year that follows the calendar year in which the repayment of the share capital takes place. If the taxpayer submits the application with a delay or fails to submit an application at all, separate assessment of the repayment amounts is no longer possible and the repayments are generally deemed to be taxable profit distributions. According to the wording of the provision, these stricter formal requirements solely affect share capital repayments made by corporations resident in another EU Member State.

3. Federal Tax Court: Offsetting of Losses not yet offset or deducted in the Case of an Asset-Managing Limited Partnership (IX R 52/13)

In a ruling of 2 September 2014, the Federal Tax Court (BFH) decided that losses incurred by a limited partner from a participation in an asset-managing limited partnership (*Kommanditgesellschaft*, "KG") which fail to qualify for offsetting or deduction must be offset with the profits generated from the interest in the limited partnership in subsequent years. This also applies where the losses result from different fields of activities (income categories) of the KG.

Losses incurred by a limited partner from an interest in a KG pursuing commercial business activities may not be offset with the limited partner's income from other sources if, as a result, said partner's capital account balance becomes negative or its negative balance increases. It is possible, however, to offset such losses with profits generated from the same limited partner's interest in subsequent years. Where the KG does not generate commercial income but income from rental and usufructory leasing, said provision applies analogously.

In the case at issue, the KG initially generated losses from the rental of real properties, which did not qualify for offsetting. In the subsequent year, the KG disposed of a property which was part of the jointly held assets and generated a gain on the sale. The local tax office refused the offsetting of losses which to that date failed to qualify for offsetting, with the profit derived from the sale. As a reason the tax office stated that in the legislation the explicit reference to the analogous application of the loss limitation rules and the subsequent offsetting of losses is restricted to income from rental and usufructory leasing. The law does not provide for an analogous application of the rules to income from gains on sales.

In contrast to the opinion of the tax authorities, the BFH decided that the losses from the rental activity had to be offset with the gain on the sale. In the view of the BFH offsetting is permitted because the law applies to all of the profits resulting from the interest in the KG without distinguishing between different categories of income. Hence, it is only the relationship of the profits with the ownership interest which is relevant here. The gain on the sale is derived from a property which was part of the jointly held assets, i.e. there is a direct relationship with the ownership interest.

The BFH's decision could also have implications for other cases where the KG initially generates losses from rental and usufructory leasing which do not qualify for offsetting or deduction, and in subsequent years generates income from capital assets.

4. Federal Tax Court: Recognition for Tax Purposes of Disproportionate Profit Distributions (IV R 28/11)

In its ruling of 4 December 2014 the German Federal Tax Court (BFH) decided that a disproportionate profit distribution must principally be recognized for tax purposes, provided that it is based on a legally valid agreement. In the case at hand the BFH thus did not follow the view held by the tax authorities according to which disproportionate profit distributions may only be recognized if non-tax-related economic reasons exist (cf. guidance of the Federal Ministry of Finance of 17 December 2013, see February 2014 edition of German Tax Monthly).

In the case at issue the plaintiff and A held a share in a GmbH. With effect from 2 January, the plaintiff transferred its share in the GmbH to A, without receiving a consideration for the transfer. At the same time, the plaintiff and A agreed on a profit distribution scheme under which the plaintiff would be the exclusive beneficiary (so-called disproportionate profit distribution). The distribution corresponded to the plaintiff's share in the GmbH's retained earnings. The local tax office considered part of the disproportionate profit distribution to be a consideration for the sale paid by A to the plaintiff. In the opinion of the tax authorities, to the extent that the plaintiff also received A's share of the profit distribution a consideration had been paid, from an economic point of view, for the transfer of the share in the GmbH.

The BFH did not agree with the tax authorities and voiced doubts as to whether the case involved a genuine disproportionate profit distribution at all. The fact that only the share of retained earnings allocable to the plaintiff was distributed and the share allocable to A was retained within the GmbH speaks against this. However, the BFH left this question unanswered because a disproportionate profit distribution based on an agreement valid under civil and company law must principally be recognized under tax law, too. It has to be noted that while the BFH denied any abuse of legal structuring possibilities, it founded this assessment mainly on the reason that in the present case the disproportionate profit distribution did not give rise to any tax benefits for the plaintiff but in fact had a negative tax effect. Hence, it is possible that in other cases the BFH would, from an economic point of view, deny recognition of disproportionate profit distributions.

5. Lower Tax Court of Munich on Real Estate Transfer Tax during Group Restructurings (4 K 37/12)

Pursuant to German tax law, real estate transfer tax may also be incurred during restructuring processes, e.g. in case of a conversion, when this involves the transfer of real estate property. However, the so-called "group exemption provision" (§ 6a GrEStG - Real Estate Transfer Tax Law) allows for an exception. In this regard the law stipulates that no real estate transfer tax is incurred, inter alia, where the restructuring involves several "controlled" companies, in both of which the "controlling" company holds shares. Concerning the question, under which conditions a company is deemed a "controlled" company, the Real Estate Transfer Tax Law requires the "controlling" company to hold no less than 95% of the shares. The shares have to have been held without interruption for five years prior to the implementation of the restructuring and have to continue to be held for five years after the implementation of the restructuring.

In the case, the Lower Tax Court of Munich decided on 22 October 2014 (4 K 37/12), a parent corporation (A) held shares in two subsidiary corporations (B and C). The shareholding in B had been at least 95% for more than five years, whereas the shareholding in C had only been increased from 16.79% to more than 95% three years ago. The company B holding real property was merged into company C. In the opinion of the plaintiff, no real estate transfer tax was due, because the minimum holding period of five years prior to the restructuring only had to be observed for the shareholdings of A in B. According to the "real estate property based interpretation" it was not detrimental that the shareholding of A in the receiving entity C had not been held for five years yet. As a result of this interpretation the requirement of having to observe a previous minimum holding period of five years would only affect the entity which owned the real property before the restructuring.

The Lower Tax Court of Munich ruled that a "real estate property based interpretation" is not possible. In its ruling it invoked the strict wording of the law. Prerequisite for the "group exemption provision" to apply would be, that both companies B and C qualify as "controlled" entities. This requires that the five year minimum holding periods prior and subsequent to the restructuring are kept by both subsidiaries.

Appeal against the ruling of the Lower Tax Court of Munich has been filed with the Federal Tax Court (BFH; II R 58/14). Please note in this connection that in the recent past the Lower Tax Court of Düsseldorf (7 K 281/14 GE) has already ruled against the strict legal wording of the group exemption provision. The question at issue in this case was, whether the requirement of a minimum holding period of five years prior to the restructuring could be waived in cases where a new company is established as a result of a conversion. The Lower Tax Court of Düsseldorf answered this in the affirmative and ruled against the strict wording of the law on the basis of the purpose and intent of the law, which is to prevent tax avoidance due to abusive tax arrangements. In this case, too, appeal has been filed with the Federal Tax Court (BFH; II R 36/14).

6. Federal Tax Court: Real Estate Transfer Tax incurred due to the Acquisition of a Partnership Interest is deductible as Business Expenses (IX R 50/13)

Pursuant to German tax law, the sale of any domestic real estate property is subject to real estate transfer tax. The real estate transfer tax paid has to be capitalized as incidental acquisition costs of the acquired real estate property. Apart from the basic case the real estate transfer tax act knows alternative cases: 1) On the one hand, real estate transfer tax is triggered where at least 95% of the interests in a partnership owning real estate property are transferred to new partners (§ 1 (2a) GrEStG - Real Estate Transfer Tax Act). 2) On the other hand, a unification of at least 95% of the interests in a partnership or the shares of a corporation holding real estate property also results in the obligation to pay real estate transfer tax (§ 1 (3) GrEStG). It has been questionable in such cases, whether the real estate transfer tax to be paid qualifies as incidental acquisition costs of the real estate property or as immediately deductible business expenses.

As decided by the Federal Tax Court (BFH) in its judgment dated 20 April 2011, real estate transfer tax triggered by a unification of at least 95% of the interests in a partnership or the shares of a corporation owning real estate property (§ 1 (3) GrEStG), which is owed by the company, can be directly deducted as business expenses at the level of the company. However, so far there had been no ruling in a case by the BFH, where at least 95% of the interests of a partnership owning real estate property were transferred to new partners (§ 1 (2a) GrEStG).

In the case at hand, 99.98% of the interests in a limited partnership were acquired. The limited partnership owned domestic real estate property. The issue under dispute was whether the real estate transfer tax to be paid by the limited partnership is to be qualified as immediately deductible business expenses or whether it should be capitalized as incidental acquisition cost of the real estate property.

In effect, the BFH confirms the decision of the Lower Tax Court of Munich, according to which real estate transfer tax is immediately deductible as business expenses. Thus the Court also disagrees with the opinion expressed by the Regional Tax Office (OFD) Rhineland in its administrative guideline dated 23 January 2012 (S 2174 – St 141, DB 2012, 486). The administrative guideline was issued with reference to the BFH judgment dated 20 April 2011 and insisted that in case of § 1 (2a) GrEStG, i.e. where at least 95% of the interests in a partnership owning real estate property are transferred, the real estate transfer tax thus triggered has to continue to be capitalized as incidental acquisition costs. In the reasoning of the recent BFH judgment the court refers to its judgment dated 20 April 2011. Also in the case in question of a transfer of at least 95% of the interests in a partnership owning real estate property, the partnership continues to be the unchanged civil-law and beneficial owner of the real estate property, even after a change in partners. In this case, too, the real estate transfer tax is based on a deemed acquisition process. Thus, while there is a causality between the expenses and the act of the acquisition, it lacks the necessary immediate (“final”) connection.

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