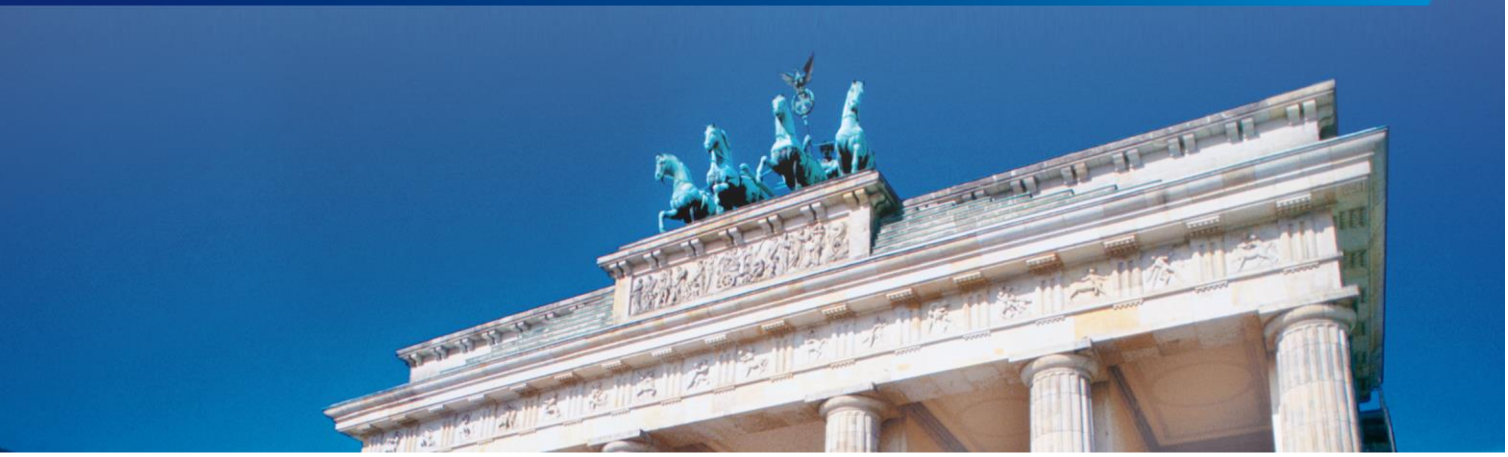
KPMG cutting through complexity

German Tax Monthly
April 2015



April 2015

German Tax Monthly

1. Draft Bill on the Implementation of the Minutes Statement on the Customs Code Alignment Law

The Federal Ministry of Finance has published the draft bill of a law on the Implementation of the Minutes Statement on the Customs Code Alignment Act.

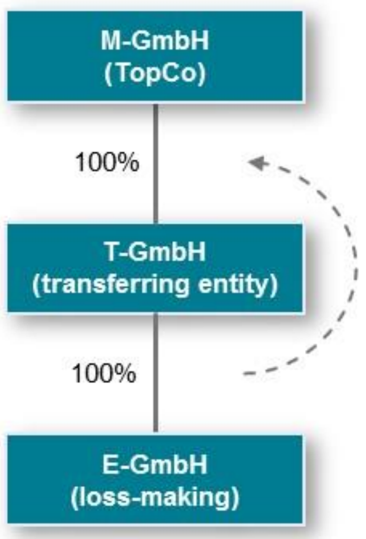
The minutes statement was issued by the Federal Government on 19 December 2014 on the occasion of the Bundesrat's (upper house of the German Parliament) approval of the Customs Code Alignment Law. Therein, the Federal Government had announced that it would address and review open proposals submitted by the Federal States in a separate legislative procedure. This as well as further need for regulation is being implemented through the present draft bill. For further information about the Bundesrat's proposals please refer to the December 2014 edition of German Tax Monthly, p. 1.

In the following we will summarize the most important contents of the draft bill.

§ 8c KStG – Extension of the Group Exemption Provision

The draft bill provides for an extension of the so-called group exemption provision of § 8c KStG (Corporate Tax Income Law) (forfeiture of loss carry-forwards in the event of a detrimental change of ownership) to group internal acquisitions with participation of the group's parent company (TopCo) (§ 8c (1) sent. 5 KStG-Draft). This is meant to benefit acquisitions by or of the TopCo of the group that have not been covered by the present wording of the group exemption provision and shall be subject to the condition that the TopCo of the group indirectly or directly holds 100% of the shares in the transferring entity (in the case of an acquisition by the TopCo of the group) or in the acquiring entity (in the case of a sale by the TopCo of the group).

Example: Acquisition by the TopCo



Content

Responsible
Dr. Martin Lenz
mlenz@kpmg.com

Published by
KPMG AG Wirtschaftsprüfungsgesellschaft
The Squaire, Am Flughafen
60459 Frankfurt/Main, Germany

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

A disposal of the shares in E-GmbH by T-GmbH to M-GmbH would fall under the provisions of the newly revised group exemption provision.

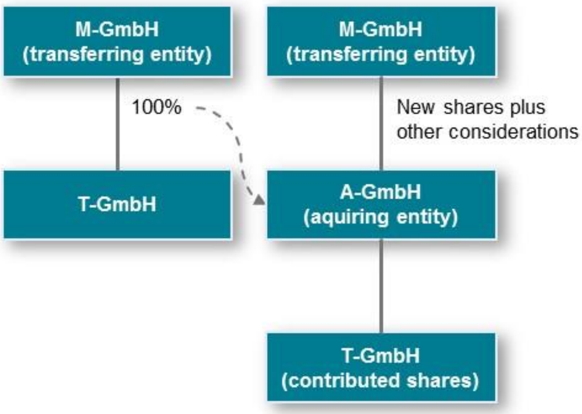
Furthermore, also commercial partnerships shall be regarded as TopCos of a group. According to the explanatory memorandum of the act, in each case, 100% of the shares must be part of the commercial partnership's joint assets.

The amendments shall be applicable to detrimental changes in ownership after 31 December 2009, and have thereby retroactive effect to the time of the first application of the group exemption provision (§ 34 (6) sent. 5 KStG-Draft).

Other Considerations in Exchange for Contributions

New shares are to be provided in exchange for the contribution of business segments to a corporation (§ 20 UmwStG – Reorganization Tax Law) and the exchange of shares (§ 21 UmwStG). Other considerations up to the amount of the book value of the contributed assets or the contributed shares are not detrimental with regard to a valuation at book value or an intermediate value.

Example: Exchange of shares



According to the draft law, the non-detrimental provision of other contributions shall be restricted. Contribution at book values or intermediate values shall henceforth only be possible insofar as the fair market value of the other considerations does not exceed (a) 25% of the book value of the contributed business assets or (b) EUR 300,000 but maximally the book value of the contributed business assets (§§ 20 (2) sent. 2 no. 4, 21 (1) sent. 2 UmwStG-Draft). To the extent the limit is exceeded, the business assets shall be stated at fair market value.

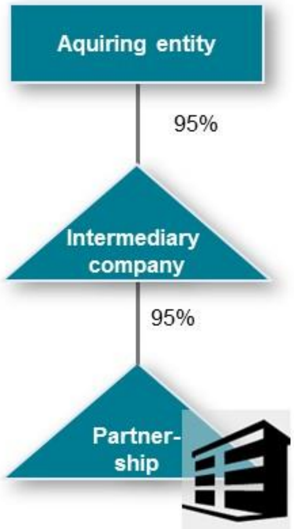
With regard to contributions of business assets to a partnership (§ 24 UmwStG), the restrictions on other contributions shall apply as well (§ 24 (2) sent. 2 UmwStG-Draft).

The revisions shall be applicable to contributions for the first time, if in cases of universal succession the decision to reorganize has been taken after 31 December 2014 or, in the other cases, the contribution agreement has been executed after 31 December 2014 (§ 27 (14) UmwStG-Draft).

Indirect Changes in the Composition of the Shareholders of a Partnership owning Real Property (§ 1 (2a) GrEStG-E – Real Estate Transfer Tax Act-Draft)

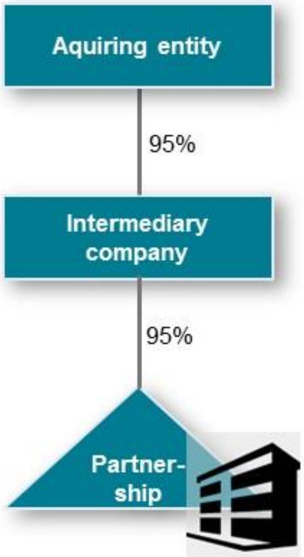
Also transfers of shares to partnerships owning real property are subject to real estate transfer tax if at least 95% of the shares are directly or indirectly transferred to new shareholders within five years (§ 1 (2a) GrEStG). The consideration of indirect changes in the composition of a partnership owning real property shall be regulated on the basis of the legal form of the intermediary company. Changes in the composition of participating partnerships shall be recorded pro rata by multiplying the ownership percentages in the partnership assets (§ 1 (2a) sent. 2 GrEStG-Draft).

Example: Partnership as intermediary company



As a result, 90.25% (= 95% x 95%) of the shares are transferred to new shareholders and real estate transfer tax is not being triggered.

Example: Corporation as intermediary company



Directly participating corporations, however, are regarded as new shareholders if at least 95% of their shares are transferred to new shareholders (§ 1 (2a) sent. 3 GrEStG-Draft).

As a result, 95% of the shares are transferred to new shareholders and real estate transfer tax is being triggered.

The revision establishes the existing administrative opinion, to which the case-law of the Federal Tax Court was in contrast (BFH II R 17/10, August 2013 edition of German Tax Monthly).

The new rules shall be applicable to acquisition transactions that are executed after the date of promulgation of the law.

Outlook

The present draft bill constitutes the beginning of the legislative procedure. The consent of both Bundestag (lower house of the German Parliament) and Bundesrat is still outstanding. The law shall enter into force on 1 January 2016, in parts on the day after its promulgation.

2. Federal Tax Court (I R 23/13): Write-Downs of Loan Receivables due from Foreign Related Companies

In a decision of 17 December 2014 the Federal Tax Court (BFH) dealt with the tax treatment of a write-down of a loan receivable and ruled that the tax treaty principle of "dealing at arm's length" has an overriding effect over the income adjustments arising from German provisions.

In the case at hand, a German limited liability company ("GmbH") had granted unsecured loans annually from 2004 to 2007 to its loss-making US subsidiary. Each time a loan was granted, the German GmbH recorded a write-down of the loan receivable in the same year. The local tax office denied recognition of expenses from the write-downs for tax purposes since the loans were granted without collateral, so that an income adjustment applying the German "dealing at arm's length" principle was triggered, which reversed the write-down. The court of first instance, the Lower Tax Court of Berlin-Brandenburg, followed this view (Lower Tax Court of Berlin-Brandenburg, decision of 30 January 2013, 12 K 12056/12).

In its decision the BFH referred to the Double Tax Treaty between Germany and the USA (DTT-USA) as authoritative in the case at hand. Art. 9 (1) DTT-USA corresponds to Art. 9 (1) OECD Model Tax Convention and represents an income adjustment provision for related companies based on the "dealing at arm's length" principle. It defines the precondition for profit adjustments and has an overriding effect to the extent that it does not allow for admissible domestic but more far-reaching adjustment possibilities.

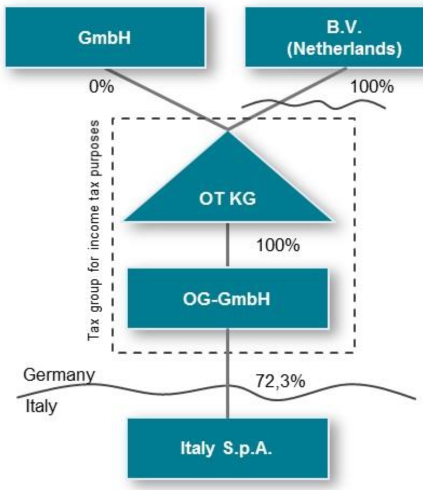
Thus the tax treaty principle of "dealing at arm's length" does not allow for an income adjustment pursuant to domestic rules of the contracting states unless the price agreed between associated enterprises (which, in the case at issue, is the interest of the loan) is inappropriate as to the amount and therefore incompatible with the "dealing at arm's length" principle. However, it does not provide for the adjustment of a write-down of a loan receivable that is required because the domestic parent has issued the loan to its foreign subsidiary in a way which would be unusual among unrelated parties, i.e. without collateral. Even if such an adjustment is possible under domestic adjustment rules, such an adjustment will be overridden by the narrower Double Tax Treaty provision.

Furthermore, the BFH opined that if an unsecured loan is tested for appropriateness as to its amount, so-called group support has to be considered, too. Group support alone can be regarded as sufficient security since the controlling shareholder guarantees the solvency of the subsidiary.

Even if the BFH has voiced its legal opinion, it still referred the case at issue back to the Lower Tax Court of Berlin-Brandenburg for further fact-findings. The Court has been asked to review whether in actual fact loans were granted to the subsidiary or whether what was granted to the subsidiary must, for purposes of taxation, be regarded as a constructive contribution. To the extent that the relationship in question was in fact a loan relationship, it would have to be established to what extent the interest rate agreed corresponded to the "dealing at arm's length" principle. Another fact to be established is whether at the point in time of the write-down the group support actually applied.

3. Federal Tax Court (I R 39/14): Ruling on the Trade Tax Treatment of Intercompany Dividends in the Case of a German Tax Group

In its ruling of 17 December 2014 (ref. no.: I R 39/14), the Federal Tax Court (BFH) decided that intercompany dividend payments received by a controlled company from a foreign company are, for trade tax purposes, not subject to the 5-percent charge pursuant to German Corporate Income Tax Law (deemed non-deductible business expenses in the amount of 5% of the dividend payment). The BFH follows the ruling of the Court of lower instance (Lower Tax Court of Muenster, ruling of 14 May 2014, K 1007/13 G, see July 2014 edition of German Tax Monthly, p. 2).



In the decided case, a German limited partnership (KG) as the controlling entity and a German limited liability company (GmbH) as the controlled company formed a tax group for income tax purposes. The GmbH held the majority of shares in a corporation resident in Italy from which it received a dividend payment in the year at issue (2006). At the level of the GmbH, the prerequisites of the trade tax participation exemption privilege were met with regard to the dividend payment. It was disputed whether at the level of the KG as the controlling entity, the disallowance of the flat-rate deduction of business expenses is to be applied for trade tax purposes.

The BFH ruled, against the opinion of the tax authorities, that intercompany dividend payments received by a controlled company from a foreign company are, for trade tax purposes, not subject to the 5-percent charge. According to the BFH in the case of a tax group for trade tax purposes, the controlled company is deemed to be a permanent establishment of the controlling entity. However, they are two independent businesses with the effect that the trade income has to be determined separately. With regard to the dividend payment collected by the controlled company, this implies the following:

First of all, the trade income of the controlled company is to be determined (first level of determination). The profit of the controlled company still includes the amount of the dividend payment (so-called gross method). The provisions regarding trade tax add-backs and deductions are to be observed at the first level by each company. Therefore, the dividend payment may be reduced by the full amount if the requirements for an intercompany participation for trade tax purposes are met. The reduced amount is not to be adjusted by the 5-percent charge since, pursuant to the gross method, it is not applicable to the controlled company.

The trade income of the controlled company is then to be attributed to the controlling entity (second level of determination). Due to the trade tax related deduction, the dividend payment is no longer included in the attributed trade income. Thereby, also an application of the 5-percent charge at the level of the controlling entity can no longer be considered for trade tax purposes.

As a result, according to the BFH, the gross method is to be observed also when determining the trade income of the controlled company and the controlling entity. Therefore, in the case of a trade tax related intercompany dividend collected by the controlled company, the 5-percent charge is neither applicable to the controlled company nor to the controlling entity for trade tax purposes.

In the decided case, the controlled company collected a dividend payment from a foreign company subsidiary. The principles on which the judgement is based should equally apply to dividends that the controlled company receives from a domestic limited partnership subsidiary.

The BFH only had to decide whether the 5-percent charge is applicable with regard to trade tax. The ruling does not include any explanations on de facto expenses of the controlled company that are directly related to the dividend payment. These lower the amount of the trade tax

It is currently open, how the tax authority is going to react to the BFH ruling.

4. Federal Tax Court (I R 31/13): Payment out of the Tax-Specific Capital Contribution Account in Cases of Repayments of Share Capital

In a decision of 21 October 2014 the Federal Tax Court (BFH) ruled that a payment made by a corporation to its shareholders qualifies as repayment of share capital if it is clear that the payment is meant as a pay-out of the capital reduction amount. Whether this is the case has to be established by reviewing the capital reduction resolution and other additional facts.

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.

In the case at issue the sole shareholder of a GmbH decided to reduce the share capital of the GmbH from € 17 million to € 1 million in October 2006 so as to avoid the requirement of preparing consolidated financial statements according to IFRS at a higher group level. Implementing the capital reduction resolution, the reduction amount of € 16 million was first allocated to additionally paid-in capital. As per a resolution of November 2007, a partial amount of € 4 million was paid out of the additionally paid-in capital to the sole shareholder. The local tax office regarded this partial repayment as a distribution of profits and assessed withholding tax. The GmbH considered the payment a tax-free repayment of a contribution.

Unlike the tax authorities and the court of lower instance, the BFH deemed the partial repayment of € 4 million as repayment of share capital and thus assumed that it was paid out directly from the tax-specific capital contribution account. According to the view of the BFH it is not necessary for a payment to constitute a repayment of share capital that the capital reduction resolution itself already provides for the pay-out of the reduction amount. Rather, a direct pay-out from the tax-specific capital contribution account is to be admissible whenever the payment may otherwise and unmistakably be qualified as pay-out of the reduction amount. According to the BFH this includes at least all those cases where the share capital reduction and the repayment to the shareholders occur in close temporal proximity and where it is unequivocally discernible that the later pay-out is related to the prior capital reduction. Both criteria were met in the case at issue, according to the view of the BFH. The share capital reduction was meant to prepare and enable a later pay-out from the additionally paid-in capital. In addition, the pay-out occurred in close temporal proximity with the reduction resolution (here: 13 months).

However, the BFH did not provide any further guidance as to how close temporal proximity between the share capital reduction and the pay-out is to be defined. Furthermore, the BFH leaves open which further circumstances in comparable cases would have to apply for a repayment of equity portions to qualify as a pay-out of a reduction amount.

5. Lower Tax Court of Düsseldorf (6 K 3339/12 K F): No Denial of Loss Deduction when Chain of Ownership is Shortened

In its decision of 9 February 2015 the Lower Tax Court of Düsseldorf ruled that the loss limitation rules of § 8c Corporate Income Tax Law (KStG) do not apply where only the chain of ownership is shortened, while the top indirect shareholder remains the same.

The loss limitation rules (§ 8c KStG) stipulate that where more than 50% of the shares of a corporation are directly or indirectly acquired within five years (detrimental change in ownership), the by then not utilized losses of the corporation are forfeited. If more than 25% but not more than 50% of the shares are acquired the losses will only be forfeited on a pro-rata basis.

In the case at issue, the parent company indirectly (via several levels) held shares in a German corporation (plaintiff), a loss corporation. Due to mergers within the chain of ownership a detrimental indirect acquisition of more than 50% of the shares in the plaintiff occurred. However, the top indirect shareholder remained the same. Following the wording of § 8c KStG the local tax office completely denied plaintiff's loss deduction.

The Lower Tax Court disagreed with the view of the local tax office. It held that § 8c KStG had to be interpreted based on its purpose in order to remain constitutional. The underlying idea of the provision is that the business identity of a company changes when a new shareholder engages in the business. In such cases, losses incurred in previous periods are not to be recognized to the extent the business identity changes due to a detrimental change in ownership.

In the opinion of the Court, in the case at issue the business identity of the plaintiff did not change, because only the chain of ownership became shorter, while the top indirect shareholder remained the same. Hence, there was no new business engagement of another shareholder.

The decision of the Lower Tax Court of Düsseldorf related to § 8c KStG in the version as amended on 14 August 2007, i.e. prior to the introduction of the so-called group exemption provision. According to the group exemption provision, § 8c KStG is not applicable to internal group restructurings if certain requirements are met. However, according to the recent wording of the law, the case at issue would have been covered by the exemptions contained in the group exemption provision.

6. German Double Tax Treaties

Current Status of Double Tax Treaties

In a communication dated 19 January 2015 the Federal Ministry of Finance informed about the current status of double tax treaties and negotiations regarding such treaties as of 1 January 2015. At present, Germany maintains double tax treaties on income and capital with more than 90 states.

On the occasion of the BMF´s communication we provide the following summary of the current status of important DTTs:

DTTs that have entered into force:

- **Georgia**: Upon consent of the Bundesrat (upper house of the German Parliament) on 7 November 2014, the revised Treaty signed by Germany and Georgia on 11 March 2014 was transposed into German law. The instruments of ratification were exchanged on 16 December 2014. Thus, the Treaty entered into force pursuant to the treaty provisions and is applicable to assessment periods starting from 1 January 2015.

  For further information on the new DTT Georgia please refer to the May 2014 edition of German Tax Monthly.

Double tax treaties which have been signed and transposed into German law but will only enter into force upon exchange of the instruments of ratification:

- **Costa Rica**: On 13 February 2014, Germany and Costa Rica signed a DTT for the first time which was transposed into domestic law upon consent of the Bundesrat on 7 November 2014. The instruments of ratification were not exchanged in 2014. Therefore, the Treaty for the Avoidance of Double Taxation will enter into force at the earliest on 1 January 2016.

  For further information on the new DTT with Costa Rica please refer to the April 2014 edition of German Tax Monthly.

- **Netherlands**: On 12 April 2012, Germany and the Netherlands signed a new DTT which was transposed into domestic law upon consent of the Bundesrat on 23 November 2012. The instruments of ratification were not exchanged in 2014. Therefore, the Treaty for the Avoidance of Double Taxation will enter into force at the earliest on 1 January 2016. A Protocol of Amendment to the DTT not yet in force was initialed by Germany and the Netherlands on 11 July 2014.

  For further information on the new DTT with the Netherlands please refer to the May 2012 edition of German Tax Monthly.

- **Norway**: On 24 June 2013, Germany and Norway signed a new DTT which was transposed into domestic law upon consent of the Bundesrat on 7 November 2014. The instruments of ratification were not exchanged in 2014. Therefore, the Treaty for the Avoidance of Double Taxation will enter into force at the earliest on 1 January 2016.

- **Philippines**: On 9 September 2013, Germany and the Philippines signed a DTT for the first time, which upon consent of the Bundesrat was transposed into domestic law on 19 September 2014. The instruments of ratification were not exchanged in 2014. Therefore, the Treaty for the Avoidance of Double Taxation will enter into force at the earliest on 1 January 2016.

DTT´s that were signed but not yet transposed into German law:

- **China**: A new DTT between Germany and China was signed on 28 March 2014. The Treaty will enter into force thirty days upon receipt of the last notification about the transposition of the Treaty into domestic law. The Treaty has not been transposed into German law yet. It is applicable for the first time on 1 January of the calendar year following the year of its entry into force.

  For further information on the new DTT with China please refer to the May 2014 edition of German Tax Monthly.

- **Ireland**: A Protocol of Amendment to the current DTT between Germany and Ireland was signed on 3 December 2014. However, the Treaty still has not been transposed into German law. The Protocol of Amendment will enter into force on the day of the exchange of the instruments of ratification. The Treaty as amended by this Protocol is applicable to periods commencing on or after 1 January of the calendar year following the year of its entry into force.

- **Israel**: A new DTT between Germany and Israel was signed on 21 August 2014. However, the Treaty still has not been transposed into German law. The Treaty will enter into force on the day of the exchange of the instruments of ratification and will be applicable for the first time starting from 1 January of the calendar year following the year of its entry into force and will apply to all taxes not levied by way of withholding.

- **Oman**: On 15 August 2012, Germany and the Sultanate of Oman signed a DTT for the first time. While the text of the Treaty was initialed more than 10 years ago, the ratification process was supposed to be completed in 2013. However, the Treaty still has not been transposed into German law.

- **United Kingdom**: A Protocol of Amendment between Germany and the UK was signed on 17 March 2014. However, the Treaty still has not been transposed into German law.

Countries with whom Germany is conducting negotiations, but with whom the DTT´s have not been signed yet:

- **France**: A Protocol of Amendment to the current DTT between Germany and France was initialed on 24 October 2014.

- **Japan**: Negotiations on the conclusion of a new DTT are ongoing. It is currently not foreseeable when it will be signed.

The negotiations with the countries Belgium, Croatia, India, Poland, and Singapore are still ongoing. There have been no reportable changes so far. For further information on those DTT`s please refer to the April 2014 edition of German Tax Monthy.

* * * *