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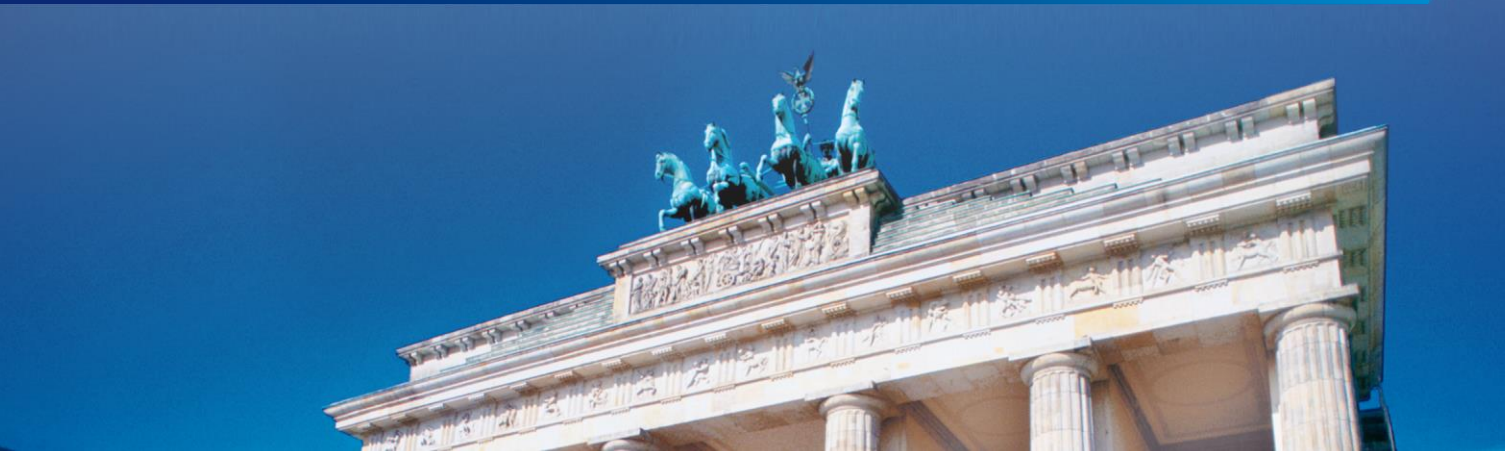

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1. Counterstatement by the German Federal Government to the Bundesrat Opinion on the Draft Bill on the Implementation of the Minutes Statement on the Customs Code Alignment Law

On 13 May 2015, the Federal Government published its counterstatement to the Bundesrat (upper house of German parliament) opinion on the draft bill on the Implementation of the Minutes Statement on the Customs Code Alignment Law (for details please refer to the April 2015 edition of German Tax Monthly, p. 1). In the following we will summarize the most important contents of the Bundesrat opinion, followed by the respective counterstatement submitted by the Federal Government:

Request for consideration of trade tax exemption for dividends received by the controlled entity of a tax group

In its judgment dated 17 December 2014 (I R 39/14) the German Federal Tax Court (BFH) expressed the view that, instead of only 95%, all of the profit distributions received by the controlled entity of a tax group from a substantial shareholding have to be exempt from trade tax (see April 2015 edition of German Tax Monthly, p. 3). The Bundesrat has put forward a request for the consideration of an amendment to Trade Tax Law in the course of the further legislative procedure. This is to ensure that the dividends distributed by a subsidiary to a controlled entity are liable to the same trade tax as the dividends received by an entity which does not belong to any tax group (95% tax exemption).

The German Federal Government intends to examine the request.

Provision on immediate deductibility of standard market discount on loans

As a rule, a standard market discount on loans is not immediately tax-deductible unless profit is determined using the cash-based accounting method. The Bundesrat opined that, given the prevailing low interest rates, a discount on a loan is currently not used to fine-tune the nominal interest rate but rather as a tax saving measure. Therefore the Bundesrat requires the deductibility rule for discounts on loans to be abandoned.

However, the Federal Government has rejected the proposal of the Bundesrat, arguing that sufficient specific provisions exist which prevent abusive tax arrangements.

Amendment proposals and requests for review regarding different rules of Value Added Tax Law

The proposals are mainly based on current BFH case law and relate,

Content

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among others, to the chain transaction (to be examined by the Federal Government), the reverse charge mechanism (to be partly examined by the Federal Government; the proposal was otherwise rejected) and the time when VAT arises (approved by the Federal Government).

Adoption of the amendments proposed in the Draft Bill for the Tax Simplification Act 2013

The Bundesrat requires the adoption of proposals already made in the Draft Bill for the Tax Simplification Act 2013 in March 2014. In particular the amendments are: Simplification of the loss deduction for limited partners of a partnership, elimination of tax-related exceptions for "carried interest" and several amendments in the fields of employee taxation. For details please refer to April 2014 edition of German Tax Monthly.

The Federal Government refers to its counterstatement of April 2014. In the counterstatement the Federal Government rejected most of the proposals.

Outlook

The next step of the legislative procedure will be a debate about the Draft Bill in the Bundestag. Bundestag and Bundesrat must approve the law before it can come into force.

2. Valuation of Inventories – LIFO Method (BMF Guidance)

The Federal Ministry of Finance (BMF) issued a new guidance on the application of the so-called LIFO (last in – first out) method. The new BMF guidance dated 12 March 2015 corresponds to the draft (see December 2014 edition of German Tax Monthly, p. 3). The application of the LIFO method is principally still admissible. However, this requires that the valuation complies with German GAAP under commercial law (HGB). This means that at the end of the fiscal year full stock has to be taken of the quantities of all business assets. Furthermore, the LIFO method has to lead to a valuation simplification. Under commercial law, the LIFO method may be applied to raw materials and supplies, work in progress, finished goods, and goods for resale.

Under tax law, the application of the LIFO method requires that it is possible to form groups of similar-type business assets. Business assets are regarded as similar if they belong to the same type of goods or have the same function. For purposes of the tax law, too, the LIFO method is required to contribute to a valuation simplification. The application of the LIFO method for tax purposes is independent of its application for commercial law purposes. The application of the LIFO method must, however, basically also be permissible under commercial law.

The BMF addresses three application cases of the LIFO method separately. The use of LIFO method is generally not permissible for perishable inventory. Neither is the use of the LIFO method permissible, where the individual acquisition costs of merchandise can be easily determined, e.g. with the help of an IT system. This does not apply, where further efforts or computation or determination steps are necessary for determining these costs. Whereas the application of the LIFO method is always permissible for processed/finish treated goods. This also applies where a clear distinction would be possible. This also includes the associated raw materials and supplies as well as work in progress.

3. CJEU (C-591/13): German Income Tax Law Provisions in § 6b EStG Infringe EU Law

In an action brought by the EU Commission, the CJEU ruled in a judgment of 16 April 2015 that the German provisions governing the transfer of hidden reserves in the case of reinvestments (§ 6b Income Tax Law [EStG]) infringe EU law.

Under current German legislation, taxpayers may, under certain conditions, transfer, tax-free, hidden reserves from business assets sold to other newly acquired replacement assets. If the replacement asset is not acquired in the current financial year, the taxpayer may create a profit-reducing reserve and transfer it to the replacement asset when acquired in the following years. However, the replacement asset must belong to the fixed assets of a German permanent establishment of the taxpayer. Consequently, the taxpayer may not transfer the hidden reserves to business assets acquired for a permanent establishment located in another EU/EEA Member State. In these cases the hidden reserves are taxed immediately, which leads to an unequal treatment when compared with domestic cases. The difference in tax treatment gives rise to a disadvantage for a taxpayer who intends to invest in another EU Member State in comparison with a taxpayer who intends to invest in Germany.

As early as in May 2009, the EU Commission sent a letter of formal notice to Germany stating that the provision might be incompatible with the free movement of capital. After Germany expressed its disagreement with the Commission's position, the Commission sent a supplementary letter of formal notice in May 2010 stating that the legislation was incompatible with the freedom of establishment. Germany expressed its disagreement also with this position, whereupon the Commission brought an action against Germany on 20 November 2013.

According to the decision of the CJEU the restriction to permanent establishments located in Germany cannot be justified by the need to guarantee the coherence of the national tax system. For an argument based on such a justification to succeed, it is necessary that a direct link be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy.

Furthermore, the objective pursued by the national legislation, namely the desire to promote investment in the same undertaking and the restructuring of that undertaking, in order to ensure its continuity, cannot be achieved only if the replacement asset also comes within the powers of taxation of Germany.

The Lower Tax Court of Lower Saxony and the Lower Tax

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Court of Munich had both affirmed an infringement of the freedom of establishment by § 6b EStG in their judgments of 1 December 2011 (6 K 435/09) and of 7 July 2014 (5 K 1206/14). Both Courts interpreted § 6b EStG in keeping with EU law by allowing a transfer of hidden reserves also to replacement assets acquired for permanent establishments located outside Germany.

4. BFH (I R 10/14): Trade Tax Treatment of Imputed Income Amounts under the CFC Rules

In a ruling of 11 March 2015 the Federal Tax Court (BFH) decided that in the context of the CFC rules the imputed income amount is – ultimately – not subject to trade tax at the level of the resident shareholder. While the imputed income amount forms part of the profit of a domestic commercial business and therefore is subject to income tax, it may be reduced for trade tax purposes. The court of lower instance, however, was of the opinion that the imputed income amount was subject to trade tax as well (see February 2014 edition of German Tax Monthly, p.2).

Generally, for the CFC rules to apply it is required that German resident taxpayers hold more than 50% of the shares in a foreign company (controlled foreign company – CFC), that the CFC generates so-called passive income, and that the foreign income is subject to a low rate of taxation abroad (less than 25%). In such cases the application of the CFC rules leads to a deemed distribution of profits of the CFC to the resident shareholder (so-called imputed income amount). At the level of the resident shareholder the imputed income amount is fully subject to German income tax.

In the case at issue the plaintiff (a German corporation) held 100% of the shares in a corporation resident in Singapore in the year at issue (2009) that only derived passive income (interests and exchange rate differences). It is undisputed that the conditions for the application of the CFC rules were met. However, it was disputed whether, apart from being subject to income tax, the imputed income amount was also subject to trade tax.

Where shares in a CFC are held as business assets, the imputed income amount forms part of the profit from commercial business activity. Thus, it generally also increases the trade income, which is the assessment base for trade tax. However, under certain conditions the trade income is reduced by certain parts of the profit. There is one provision in particular that needs to be considered for purposes of reducing trade income by the imputed income amount: The trade income is to be reduced by the amount that is attributable to a permanent establishment that is not located in Germany.

According to the BFH the requirements for this reduction provision are met. In contrast to the court of lower instance, the BFH is of the opinion that the reduction provision applies regardless of whether said permanent establishment is a permanent establishment of the German shareholder (plaintiff) or the CFC. In the case at hand passive income was generated by a permanent establishment of the CFC. Therefore, the requirements of the reduction provision are met and the imputed income amount is, in the final analysis, not subject to trade tax.

In the case of a CFC the reduction of trade income by the imputed income amount should be applicable regardless of the specific passive income. In addition, the percentage of shareholding should not matter for the trade tax reduction, and thus trade income should also be reduced by the imputed income amount if there is no majority shareholding.

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

5. BFH (IV R 22/12): "Extended Trade Income Reduction for Real Property" in Cases of a Disposal of a Partnership Interest to be Denied also for Assessment Periods before 2004

According to German tax law, companies that exclusively manage and use their own real property are relieved from trade tax. The relief is granted by means of an off-balance sheet reduction of trade income by the amount of trade income attributable to the management and use of the real property (so-called "extended trade income reduction for real property"). In addition, German tax law stipulates: Where interests in a partnership are disposed of, the gain on the sale is subject to trade tax at the level of the partnership to the extent that a corporation holds an interest in the partnership. This is to prevent corporations from transferring individual business assets, whose sale would per se be liable to trade tax, in a first step to a subsidiary partnership (tax free) and then dispose of the interests in the partnership while the latter would not be liable to trade tax.

When interests in a partnership that exclusively manages and uses its own real property and therefore is granted "extended trade income reduction for real property" are sold, the portion of trade income that is attributable to the gain on the sale does not qualify for extended trade income reduction for real property. This is explicitly stated in the wording of the law that applies for assessment periods from 2004 onwards. In a ruling of 18 December 2014, the Federal Tax Court (BFH) dealt with the question as to whether the "extended trade in-come reduction for real property" must also be denied for gains on the sale of partnership interests for assessment periods before 2004.

In the case at issue, a German limited partnership (KG) had fulfilled the requirements for being granted "extended trade income reduction for real property" since a reorganization in the year 2002. Two German limited liability companies (GmbHs) holding interests in the KG as limited partners sold their interests as of 1 January 2003. The opinion of the local tax office was that the gain on the sale of interests in partnerships managing real property does not qualify as income attributable to the management and use of real property. Therefore, the gain on sale would have to be subject to trade tax. As opposed to this, it was the view of the KG that it was entitled to an "extended trade income reduction for real property".

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In its decision of 18 December 2014 the BFH ruled that the "extended trade income reduction for real property" must be denied for gains realized on the sale of partnership interests also for assessment periods prior to 2004. According to the BFH this results from the systematic interpretation of the law and the legal purpose of the law. Granting the "extended trade income reduction for real property" is in contradiction with the legal purpose of the law if it is possible for a corporation to transfer real property to a partnership managing real property and thus circumvent trade tax – by claiming "extended trade income reduction for real property" – that would otherwise be incurred on the gain on the sale. According to the BFH the new wording was introduced for assessments periods from 2004 onwards merely for making this purpose more explicit.

6. Hessian Lower Tax Court (4 K 208/13): Use of the Tax-Specific Capital Contribution Account for Several Distributions within a Fiscal Year

The Hessian Lower Tax Court ruled that the use of the tax-specific capital contribution account for several distributions within the same fiscal year has to be allocated on a pro-rata basis according to the proportion between the individual payments and the total of the payments (thus the Court affirms the Ministry of Finance Guidance of 4 June 2003, No.12 in the text).

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.

In the case at issue, a GmbH had an assessed tax-specific capital contribution account balance of approx. EUR 1.2 million on 31 December 2008. In April 2009 it made a distribution in the amount of EUR 500,000 and in October 2009 another distribution in the amount of EUR 700,000. The distributable profit on 31 December 2008 amounted to approximately EUR 240,000. For the first distribution, the GmbH certified to its shareholders that it was appropriated from the tax-specific capital contribution account in the amount of EUR 260,000 (EUR 500,000 minus EUR 240,000). For the second distribution, the GmbH certified to its shareholders an appropriation from the tax-specific capital contribution account in the amount of EUR 700,000 and did not report withholding tax. However, with respect to the second distribution the local tax office subjected EUR 140,000 to withholding tax and issued a notice of liability to the GmbH (see table below).

The Hessian Lower Tax Court dismissed the action brought by the GmbH against the notice of liability as unfounded. In the view of the Lower Tax Court, all payments to the shareholders effected within a fiscal year must be considered in their sum total. Consequently, the resulting total appropriations from the tax-specific capital contribution account within a fiscal year must be allocated to all individual payments according to the proportion of the individual payments to the total of individual payments of the fiscal year. While this is not made explicit in the wording of the statutory provision in § 27 (1) sent. 3 Corporate Income Tax Law [KStG], it corresponds to the purpose intended by the legislator which can be determined by the interpretation of the law, as well as to the view of the tax authorities and the probably generally supported opinion expressed in the literature.

According to the conviction of the Court, the consideration of the sum total prevents corporations from freely determining which distribution and, in particular, which shareholder benefits from the tax-exemption of a repayment of a contribution simply by choosing the chronological sequence of distributions within a fiscal year. Furthermore the Lower Tax Court refers to the case law of the Federal Tax Court (BFH, ruling of 30 January 2013, I R 35/11) and emphasizes that the legislator assumes that, in total, for payments of the corporation to its shareholders the corporation will always, in economic terms, draw on the balance of the tax-specific capital contribution account as existing on the preceding balance sheet date (accounting for all additions that occurred in the fiscal year ending on this balance sheet date). If, however, all additions must be totaled for the year, then this speaks in favor of also totaling all appropriations according to the Lower Tax Court, particularly since company law does not specify a sequence for capital repayments.

According to the view of the Lower Tax Court it is not an obstacle to the consideration of the sum total that as a consequence of its application the scope of distributions effected from the tax-specific capital contribution account for a fiscal year is not finally established until the end of such fiscal year. While a report of withholding tax for the first distribution in a financial year becomes unlawful when further distributions are paid in the same fiscal year, this could easily be corrected from the point of view of procedural law.

Finally, the Lower Tax Court stresses that, due to the consideration of the sum total, the tax certificate cannot be issued to the shareholders in the appropriate amount until after the end of the fiscal year. Any disadvantages for shareholders arising from this (the GmbH alleged, for example, that its stock exchange-listed shareholder would have needed the certificate as early as in April 2009 so as to comply with accounting requirements) seemed tolerable to the Lower Tax Court. The Court stated that the shareholders would, as a rule, not suffer tax disadvantages. Only the shareholder for whom the first distribution falls into an earlier assessment period is prevented from claiming the full tax exemption for repayment of the contribution in the appropriate amount until the fiscal year of the corporation ends.

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Bearing in mind the partial tax exemption of dividends this is also tolerable in the view of the Lower Tax Court.

The decision of the Hessian Lower Tax Court is final.

Payments to shareholders in FY 2009	**April 2009**	**October 2009**
Payment amount	**€ 500,000**	**€ 700,000**
Distributable profit (a pro rata)	*€ 240,000 x 5/12* **= € 100,000**	*€ 240,000 x 7/12* **= € 140,000**
Tax-exempt re-payment of con-tribution	*€ 500K ./. € 100K* **= € 400,000**	*€ 700K ./. € 140K* **= € 560,000**
Withholding tax (26.375 %)	*26.375% of € 100K* **= € 26,375**	*26.375% of € 140K* **= € 36,925**

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