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## German Tax Monthly

### 1. BFH (I R 44/14): Accounting for Liabilities in the Case of a Subordination Agreement

In a judgment of 15 April 2015 the Federal Tax Court (BFH) ruled that a liability may not be recognized in the balance sheet if according to a subordination agreement it is to be repaid only out of a future balance sheet profit and liquidation proceeds, if any.

According to German tax law, a liability may only be recognized if the debtor is currently economically burdened by the liability. A liability which only has to be repaid when and to the extent income or profits are generated may not be carried as liability until the proceeds or profits have actually been incurred [§ 5 (2a) Income Tax Law (EStG)].

In the case at hand a subsidiary corporation received a loan from its parent corporation and recognized a corresponding liability in the balance sheet. The two corporations concluded a subordination agreement for the loan with the aim of avoiding an over-indebtedness of the subsidiary corporation under insolvency law with the following provision: "The parent corporation's right to interest and repayment of the principal is subordinated below the claims of all other creditors. Hence, the parent may not claim the interest and repayment of the loan until

future balance sheet profits or liquidation proceeds are incurred".

The dispute with regard to the liability was whether § 5 (2a) EStG was applicable with the consequence that the subsidiary corporation would have to recognize the liability to profit or loss with the resulting profit being subject to tax.

In the view of the BFH, § 5 (2a) EStG is applicable in the case at hand. Since the liability need not be repaid until a future balance sheet profit or liquidation proceeds are generated, it cannot be recognized as liability because the debtor is not currently economically burdened by it. In the view of the BFH "profits" within the meaning of § 5 (2a) EStG may principally also mean "balance sheet profits" as provided for in the agreement in the case at hand. However, § 5 (2a) EStG is not applicable where a subordination agreement is concluded which provides that the repayment may occur not only out of potential future profits or liquidation proceeds but also out of so-called "other available assets" (*sonstiges freies Vermögen*). In these cases a current economic burden exists. However, because in the case at issue the agreement lacked a reference to a repayment out of "other available assets", the subsidiary corporation had to derecognize the liability with an effect on profit.

#### Content

1. **BFH (I R 44/14): Accounting for Liabilities in the Case of a Subordination Agreement**
2. **Realization of Profits in the Case of Instalments Paid under Contracts for Work**
3. **New Double Tax Treaty (DTT) with Japan Initialed**
4. **E-Balance Sheet – Publication of Taxonomy Version 5.4**

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Please note, however, that according to the view of the BFH the subordination has to be treated as a contribution to the subsidiary by the parent corporation if the subordination is based on the shareholdership and to the extent that the liability is unimpaired. In this case the profit arising from derecognition of the liability would have to be neutralized. This legal effect does not only apply in subordination cases but also in the case of a shareholder loan for which a retro-active agreement provides for repayment only from future profits.

## 2. Realization of Profits in the Case of Instalments Paid under Contracts for Work

On 29 June 2015 the Federal Ministry of Finance (BMF) issued a guidance on the realization of profits in the case of instalments paid under contracts for work in response to a decision of the Federal Tax Court (BFH) of 14 May 2014.

In its decision the BFH ruled on the realization of profits in the case of instalments paid to architects and engineers. Architects and engineers issue invoices according to professional fee schedules. These professional fee schedules provide for instalments for services rendered as the work progresses. So far, such instalments were treated as having no impact on profit or loss and the profit was not recognized until the work was finally completed and the work is accepted by the ordering party. In its decision the BFH found fault with this practice and ruled that a profit does not arise as late as when the work is accepted or the final invoice is issued. On the contrary, a profit is realized as early as the claim for payment of an instalment arises.

In a BMF guidance the tax authorities have now stated that the principles of the judgment are not only applicable to architects and engineers but to all instalment payments. However, a distinction must be made between instalments and advances. When paying an instalment, the recipient of the work has already received some value added, because parts of the work have already been delivered. An advance is a payment made before a service is rendered. As in the past, no profit is realized in the event of an advance payment or prepayment.

The BMF requires first-time application of the principles of the BFH ruling to financial years beginning after 23 December 2014 at the latest.

Regarding the profit which results from the first-time application of the new principles, the BMF guidance provides for an equitable rule: The profit may be spread over the financial year to which the principles are applied for the first time and the following financial year, or the first year and the two subsequent financial years.

## 3. New Double Tax Treaty (DTT) with Japan Initialed

On 3 July 2015 the Federal Republic of Germany initialed a new Treaty on the avoidance of double taxation with respect to taxes on income and on capital with Japan. The new Treaty is to replace the Double Tax Treaty of the year 1966 and provides for comprehensive changes compared to the existing provisions.

The new Treaty provides for reductions in withholding taxes on dividends, interest and royalties.

Furthermore, the taxing rights of the two states with respect to commercial business income are to be defined according to the Authorized OECD Approach (AOA). In addition, the Treaty is to provide for a new binding arbitration procedure as well as for the possibility of mutual assistance in the recovery of tax claims.

Both contracting States have not yet signed the new Treaty. After an internal review and translation of the draft on both sides, the signing of the Treaty is the desired next step.

## 4. E-Balance Sheet – Publication of Taxonomy Version 5.4

Reporting companies are required to transmit their balance sheets and their income statements electronically to the German tax authorities (e-balance sheet). In case of a calendar-based fiscal year, companies are obliged to transfer an e-balance sheet for fiscal years beginning after 31 December 2012 at the earliest. Foreign companies maintaining a permanent establishment in Germany (*domestic branch*) are also required to submit an e-balance sheet for the German permanent establishment to the local tax office if they are subject to reporting obligations or have opted for voluntary reporting. However, according to a transitional rule foreign companies have to transmit the e-balance sheet for German permanent establishments obligatory for the fiscal years beginning after 31 December 2014 for the first time.

At the end of June 2015 the BMF published the updated version 5.4 of the taxonomy (predefined tax chart of accounts for the e-balance sheet to be used by the preparer).

The 5.3 taxonomy update included in particular improvements of the taxonomy for domestic permanent establishments of foreign companies. For these the above-mentioned transitional rule expired with the end of the year 2014. Update 5.4 contains mainly editorial changes. A few new taxonomy items were included, among other changes, which help users to better differentiate between individual items.

In a guidance dated 25 June 2015 the Ministry outlined that the new version 5.4 is mandatory for the preparation of an e-balance sheet for fiscal years beginning after 31 December 2015. However, there will be no objections if the new version is also used for the prior fiscal year 2015 or 2015/2016.

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