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German Tax Monthly
September 2015

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1. Discussion Draft of a Law on the Reform of Investment Taxation and on the Tax Liability of Gains on the Disposal of Portfolio Investments

On 22 July 2015, the Federal Ministry of Finance published a discussion draft of a law on the reform of investment taxation (*Investmentsteuerreform* – InvStRefG). The discussion draft includes a fundamental reform of investment taxation and a provision on the tax liability for gains on the disposal of portfolio investments.

Reform of Investment Taxation

The new Investment Tax Act is to be applied to investment funds and their investors. Investment funds are any capital investment vehicles that are subject to the supervisory provisions of the Investment Code or comparable foreign investment vehicles. Pursuant to the discussion draft, also closed-ended investment funds (investment company issuing a fixed number of shares, closed-ended investment limited partnership) or comparable foreign vehicles would be covered by the Investment Tax Act. Partnerships, however, shall only fall within the scope of application of the Investment Tax Act if their corporate purpose serves directly and exclusively the coverage of obligations in connection with the company pension scheme (so-called Pension-Asset-Pooling). The currently existing fiscal investment restrictions for investment funds shall be waived, at least for (mutual) funds.

The Investment Tax Act provides for a new, intransparent taxation system for the taxation of the investment funds and their investors. This means a separate taxation of investment funds and investors. Funds (domestic as well as foreign funds) are generally subject to corporate tax, but not to trade tax. Tax exemption may be granted, e.g. in the case of investments by tax-exempt investors. Tax liability, however, only extends to German income from dividends and real estate.

The investor pays taxes on the dividend distributions of the fund as well as on the gains on redemption, sale or withdrawal of investment shares at the final withholding tax rate or books them as business receipts (operational investor). New is also the collection of an advance flat-fee, a (fictitious) taxable income, on which the investor is to pay taxes in order to avoid an unlimited – in terms of time – possibility for deferral. On the part of the investor, a partial exemption shall be introduced.

The imposition of tax continues to be effected by deducting withholding tax on capital yields.

Content

1. Discussion Draft of a Law on the Reform of Investment Taxation and on the Tax Liability of Gains on the Disposal of Portfolio Investments
2. Federal Constitutional Court declares auxiliary basis of assessment in the Law of Property Transfer Tax unconstitutional
3. Treatment of Selling Costs and Purchase Price Changes for Purposes
4. Exchange of Information / Administrative Cooperation

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Published by
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For special investment funds, the current transparent taxation system shall continue to be in place. In accordance with this system, certain earnings can be retained tax-free (mainly gains on the sale of securities and forward/futures contracts). Special investment funds are exempt from corporate tax and trade tax. Taxation is generally performed on the part of the investor. In the future, individuals shall not be allowed to invest in special funds through interposed partnerships.

The new provisions shall generally apply from 1 January 2018, thereby allowing for time for the funds to adapt to the new legislation. In the case of private investors, the interim arrangement for shares acquired by 31 December 2008 ("old stocks") shall generally expire by 31 December 2017. If old shares under the protection of the grandfathering provisions are sold after 31 December 2017, the appreciation occurring from 1 January 2018 shall be subject to taxation only if a tax-free amount of € 100,000.00 is exceeded.

Gains on the Disposal of Portfolio Investments

Until February 2013 95 % of the dividends received from a corporation and 95 % of the gains derived from the sale of shares in corporations were generally tax-exempt for corporations, irrespective of the amount of the ownership interest (§ 8b KStG – Corporate Income Tax Act). In 2013 the legislator introduced a tax liability for portfolio dividends to meet the requirements of European Law. Along with this adjustment of law the legislator had announced a review of the taxation of the gains derived from the sale of shares in portfolio investments. The discussion draft now includes a relevant revision.

According to the revision, an investment shall be deemed a portfolio investment if the shareholding at the beginning of the calendar year amounted to less than 10 % of the share capital. An exception for a mid-year acquisition of a 10 % ownership interest is not envisaged. Shares in a corporation that are held via partnerships shall be attributed pro rata to the respective partner as a direct participation. In the case of a German tax group, the shareholdings of the controlled company and the controlling entity are to be considered separately with regard to the review of the 10 % minimum shareholding.

In correspondence to the tax liability, the flat-rate non-deductible business expenses in the amount of 5 % of the capital gains on the sale of shares shall not be applicable. Profit reductions that are linked to portfolio investments (in particular losses on the sale of shares) shall only be offsetable against capital gains and dividends derived from portfolio investments. Profit reductions that cannot be offset within an assessment period, shall be able to be carried forward to later assessment periods.

The revised provisions shall be applicable to capital gains on sales and profit reductions after 31 December 2017 for the first time. The time of acquisition of the portfolio investments shall not be relevant. Accordingly, also existing portfolio investments would become subject to taxation.

With regard to capital gains on the sale of shares in so-called "eligible businesses" a tax reduction upon application is provided for if certain requirements are met. According to the explanatory memorandum of the act, in particular start-ups, among others, can be considered eligible businesses. The tax reduction shall amount to 30 % of the acquisition cost of the share sold, maximally, however, the part of the corporate tax that is allotted to the capital gain derived from the sale. The relevant requirements particularly include that the share was held at least for three years before the sale and that the acquisition of the shares was not supported or subsidized otherwise.

The tax reduction shall be limited in terms of time and be implemented for the assessment period 2018 for the first time and for the assessment period 2027 for the last time.

Outlook

The present discussion draft has been sent to the associations for comment by 1 September 2015. In September 2015, a government draft shall be prepared. It is basically possible to finalize the legislative process before the end of this year, at the moment, however, it is not quite clear.

2. Federal Constitutional Court declares Auxiliary Basis of Assessment in the Law of Property Transfer Tax unconstitutional

In its decision published on 17 July 2015 (1 BvL 13/11, 1 BvL 14/11), the Federal Constitutional Court (*Bundesverfassungsgericht* – BverfG) declared the regulation regarding the auxiliary basis of assessment (*Ersatzbemessungsgrundlage*) provided for in the law of property transfer tax unconstitutional.

The regular basis of assessment for property transfer tax is the value of the performance exchanged for the property in question, which typically corresponds to the fair market value of the property. In exceptional cases (i.e. in particular in the case of a property transfer due to restructuring or transfers of shares) the property transfer tax, due to the fact that nothing is received in exchange for the property, is determined on the basis of an auxiliary basis of assessment, the so called real estate value. In these cases, the publicly listed land value (Bodenrichtwert) shall apply to undeveloped real estate, and for developed real estate the value is to be determined in accordance with the simplified earnings value method (simplified: 12.5 x annual rental rate less deduction from value on account of age). The BVerfG declared the regulation regarding the auxiliary basis of assessment unconstitutional from 1 January 2009 and set a deadline to the legislator to issue a revision with retroactive effect from 1 January 2009 by 30 June 2016.

The BVerfG bases its ruling of unconstitutionality on the fact that the values determined as auxiliary basis of assessment deviate significantly from the fair market value (regular basis of assessment). On average, the value of developed real estate, for example, is 50 % lower than the fair market value. If the legislator chooses to apply an auxiliary basis of as-

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sessment, it must – in order to satisfy the requirements of the principle of equal burdens – achieve results that come more or less close to those of the regular basis of assessment (*Regelbemessungsgrundlage*). The BVerfG also states that there are no sufficiently weighty reasons that could justify this considerable unequal treatment, which, therefore, is incompatible with German Basic Law (*Grundgesetz* – GG).

The legislator must revise the auxiliary basis of assessment with retroactive effect as of 1 January 2009. At the moment, it is not yet entirely clear how the revised legislation shall be designed. If the auxiliary basis of assessment is more closely geared to the fair market value, it would be to the disadvantage of the taxpayer, because of the to-be-expected higher basis of assessment for property tax.

In already assessed cases, the provisions regarding the protection of confidence are to be observed. Accordingly, the tax assessment notices must not be changed to the taxpayer's disadvantage.

If, as a result of the two orders for reference by the BFH, objections were raised in relevant cases and an application filed for adjournment of proceedings, a withdrawal of the objection should be considered.

If the circumstances triggering property tax have already been realized (transitional cases), but a property tax assessment notice not yet issued, there is generally no protection of confidence.

3. Treatment of Selling Costs and Purchase Price Changes for Purposes of Tax Exemption of Gains on the Sale of Shares in a Corporation

On 24 July 2015 the Federal Ministry of Finance (BMF) issued a guidance (IV C 2 - S 2750-a/07/10002:002) on the treatment of selling costs and purchase price changes for purposes of tax exemption of gains on the sale of shares in a corporation (§ 8b KStG – Corporate Income Tax Law). The BMF guidance essentially reflects the conclusions of several rulings of the Federal Tax Court (BFH).

In Germany, gains on the sale of shares in a corporation are in effect 95% tax-exempt for corporations. The provision governing the tax exemption contains a special rule on how to determine the gain on the sale. According to this the gain is the amount by which the selling price exceeds, after deduction of the selling costs, the book value on the date of the sale. The gain so computed is deducted in an off-balance sheet adjustment for the purpose of tax exemption.

In the guidance the BMF has now issued its opinion on the treatment of subsequent purchase price changes and selling costs incurred in fiscal years preceding or succeeding the fiscal year in which the sale was transacted. According to the BMF guidance, subsequent purchase price changes or selling costs incurred in other fiscal years must be recognized in the assessment period of the sale. Thus they have an influence on the tax-exempt amount of the gain on the sale of the shares. To the extent that the costs have been recognized in the balance sheets of other fiscal years, off-balance sheet adjustments are required for both the year of the actual recognition of the costs in the balance sheet and the year in which the sale was transacted.

Selling costs may also include losses from offsetting hedging transactions. However, expenses or income from compounding or discounting of the purchase price are not recognized in the determination of the gain on the sales of shares. The complete loss of the purchase price claim is also regarded as a subsequent change in the purchase price.

Notices of assessment of previous years can only be adjusted if the requirements for the application of an adjustment provision are met. Where subsequent purchase price changes or costs incurred in later periods are to be recognized in the year of the sale of the shares, the adjustment requires that the application criteria for an adjustment provision are met. It is the opinion of the BMF that subsequent costs and purchase price changes constitute an event with retroactive effect and that for this reason the assessment notice of the year in which the sale was transacted may be adjusted.

4. Exchange of Information / Administrative Cooperation

Automatic Exchange of Information on Financial Accounts

On 29 October 2014 the Federal Republic of Germany, together with 50 other jurisdictions, signed a Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (CRS MCAA). The CRS MCAA is intended to effectively combat cross-border tax evasion and encourage tax compliance. For this purpose particularly the exchange of information on financial accounts should be intensified. The signatories to the CRS MCAA undertake to regularly collect the required financial account information and to automatically transmit such information to the residence jurisdiction. The following information shall be reported:

- Name, address, tax identification number, date and place of birth of each reportable person,
- account number,
- year end balances of financial accounts,
- capital income credited to the account, including redemption amounts and proceeds from the sale of assets.

The automatic exchange of information is intended to apply from September 2017 onwards, beginning with data relating to the fiscal year 2016. Two national legislative processes have now been initiated to ratify the CRS MCAA and to transpose the information exchange process into German national law.

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Law on the Convention on Mutual Administrative Assistance in Tax Matters entered into Force

On 16 July 2015 the Law on the Convention on Mutual Administrative Assistance in Tax Matters and on the Amending Protocol to the Convention of 27 May 2010 were promulgated in the Federal Law Gazette. The law entered into force on 17 July 2015.

The Convention serves the intensified cooperation between the tax authorities of the signatories. In particular, its aim is to combat tax evasion and avoidance, but also to support taxpayers in exercising their rights, above all with regard to due legal process and protection against unequal treatment and double taxation. The cooperation between the tax authorities of the signatories and the mutual administrative assistance required by the Convention relate, among other things, to the exchange of information, simultaneous tax examinations, participation in tax examinations abroad, administrative assistance in the collection and recovery of tax as well as to the service of documents.

Federal Ministry of Finance Guidance on the FATCA Agreement

On 17 July 2015 the Federal Ministry of Finance (BMF) published the officially prescribed data record for the automatic exchange of information with the United States of America according to the FATCA Agreement of 31 May 2013.

The agreement between Germany and the USA serves as the bilateral basis for the aims and objectives pursued by the USA through their FATCA regulations. Germany and the USA have agreed to ensure effective taxation particularly by mutually exchanging information on financial accounts. Financial institutions in Germany may withhold 30 % tax on all US source payments. However, they are released from theobligation to conclude separate agreements with the IRS within the meaning of the FATCA regulations. The following provisions apply instead:

- Germany undertakes to collect information on accounts kept for US accountholders by financial institutions based in Germany and to automatically disclose such information to the IRS.
- In exchange, the USA will make available to Germany information obtained by the IRS from US financial institutions relating to interest and dividend income.

Taxpayers are required to transmit the reportable data to the Federal Central Tax Office according to the officially prescribed data record. The recent BMF guidance contains both a technical description and a content description of the required data record.

The data record is to be transmitted no later than on the 31st of July of the year following the year to which it relates. The data record is to be transmitted for the first time by 31 July 2015 for the year 2014.

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