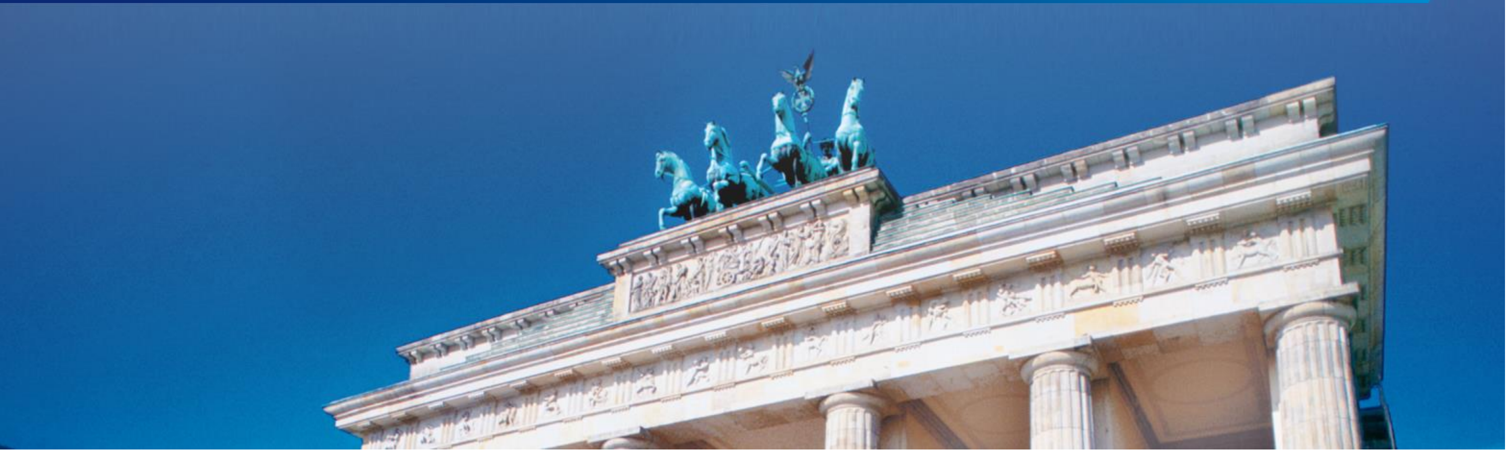
cutting through complexity

German Tax Monthly
May 2015



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1. Supplementary Treaty to Double Tax Treaty with France Signed

On 31 March 2015, Germany and France signed a supplementary treaty to the Treaty for the Avoidance of Double Taxation (DTT France). Pursuant to the supplementary treaty, significant articles of the current tax treaty are amended and new articles are added. The major changes are as follows:

In particular, the taxation of gains on the sale of property is revised in the supplementary treaty. The provisions on gains on the sale of property which were contained in several articles of the current tax treaty are abolished and replaced with the new Article 7 DTT France. While the content of the new Article 7 DTT France in substance corresponds to Article 13 of the OECD Model Tax Convention, an additional provision regarding the exit taxation of gains on sale in connection with the relocation of an individual to another country has been incorporated in the DTT.

Moreover, the supplementary treaty stipulates that the source state will have the right to tax certain dividends at the relevant domestic tax rate which are paid from a tax-exempt investment funds, provided that the beneficial owner of the dividend holds a qualifying interest and further requirements are met.

The provisions for the right to tax cross-border state pensions, retirement benefits (including social security income) and similar payments will be fundamentally revised. In the future, the amended Article 13 (8) DTT France will allocate the exclusive right to tax the above-mentioned payments to the beneficiary's country of residence. So far, the source state has had the exclusive right to tax social security income.

The new Article 13b incorporated in the DTT France, which largely follows Article 17 of the OECD Model Tax Convention, governs the taxation of income of entertainers, athletes and models, stipulating that the income derived by an entertainer, athlete or model resident in one tax treaty state from that resident's personal activities in the other treaty state may be taxed in that other state. In this context particular provisions are included which apply to income derived from the use of personal rights and income derived from the activity pursued by artists or athletes in a tax treaty state, if their abode in this treaty state is financed entirely or mainly from public funds of the other treaty state.

Finally, the provisions for the avoidance of double taxation contained in the methods article are revised regarding persons resident in France. The articles on mutual recovery assistance

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as well as on the mutual agreement and arbitration procedures are amended.

The supplementary treaty has not entered into force yet. It still requires the transposition into the national laws of both countries and the subsequent notification by both treaty states that the legislative procedures have been completed. The supplementary treaty will enter into force on the first day following the day of receipt of the last notification. It is applicable as from 1 January of the calendar year following the year of its entry into force. The Federal Ministry of Finance announced in a press release that it intends to ensure the application of the supplementary treaty from 2016 onward.

2. Federal Tax Court (VIII R 22/11): Asset Management Partnerships as Shareholders in Case of Constructive Dividends

In a decision dated 21 October 2014 the Federal Tax Court (BFH) underlined that when testing for constructive dividends the asset management partnership has to be treated as shareholder rather than its business partners.

According to German tax law a “constructive dividend” is a decrease in corporate property or a prevented increase in corporate property that is induced by the shareholder relationship. Generally, inducement by the shareholder relationship is assumed where the requirements of the arm’s length principle are not met. As a result of the constructive dividend, the decrease or prevented increase in corporate’s property is not recognized for tax purposes, with the consequence of a recapture. The financial benefits received are qualified as dividend income on the level of the shareholder.

Constructive dividends are attributable to the person to whom the shares are attributed for domestic tax law purposes. While this decision is generally based on the ownership in civil law terms, in derogation of the above the law also allows for the possibility to focus on the beneficial ownership.

In the case at issue, the plaintiff founded a corporation together with, among others, another corporation (a UK Limited) in 1997. The corporation was a so-called pre-incorporated company which was never entered into the commercial register. This pre-incorporated company in turn held 100 percent of the shares in a further subsidiary corporation. The plaintiff was, among others, appointed managing director of the pre-incorporated company. The tax field audits for the year under dispute (1997) brought about that the plaintiff arbitrarily and unlawfully had a collection agency collect payments from the subsidiary. Having passed through several foreign intermediary corporations the payments were finally credited to the plaintiff’s fixed deposit account in Prague. The balance sheets of the subsidiary always showed the payments as repayments of liabilities.

However, the local tax office treated the payments as constructive dividends distributed to the pre-incorporated company. It argued that the company had been a partnership from the start, since it had never been entered into the commercial register. For profit allocation purposes the local tax office attributed the constructive dividends at the level of the pre-incorporated company solely to the plaintiff.

The court of first instance ruled in favor of the plaintiff in the proceedings taken against this treatment. However, the BFH revoked the decision of the Lower Tax Court for formal reasons. It referred the case back to the Lower Tax Court for another trial and ruling.

The plaintiff exceptionally had the right to go to court because in the context of the profit distribution the constructive dividend was solely attributed to him as shareholder of the pre-incorporated company. In its judgement the BFH again confirmed its established case law. A pre-incorporated company that cannot be entered into a commercial register is deemed completed and will therefore have to be treated as a commercial or asset management partnership.

Furthermore, the BFH made comments without binding effect on the Lower Tax Court, regarding the position of the shareholder in case of constructive dividends, explaining that for purposes of constructive dividend tests the pre-incorporated company has to be treated as shareholder. The shareholder is either the civil law owner or the economic beneficiary of the shareholding; but not persons related to the shareholder. There is especially no fraction consideration for constructive dividends.

In addition the BFH confirmed its case law regarding constructive dividends in case of arbitrary withdrawal of funds from a subsidiary. If a company has knowledge of and does not prevent its own shareholder withdrawing the funds this is deemed a constructive dividend to the company. This was the case, as the plaintiff was both shareholder and managing director as well as representative of the pre-incorporated company; therefore his knowledge about the payments of the subsidiary to the bank account he owned is attributable to the pre-incorporated company.

In the case at hand the BFH leaves open, to whom the constructive dividend is attributable at the level of the pre-incorporated company in the context of the profit distribution. The Lower Tax Court will now have to assess again whether the property of the subsidiary had actually decreased. In its balance sheets the subsidiary had treated the payments as repayments of own liabilities to an indirect shareholder. The entire matter may be an accounting error in the balance sheet which may conflict with a constructive dividend. If this is the case, there is overall no constructive dividend.

3. Lower Tax Court of Düsseldorf (6 K 4332/12): Term of a Profit and Loss Absorption Agreement in Case of a Spin-Off with Retroactive Tax Effect

In its decision of 3 March 2015 the Lower Tax Court of Düsseldorf ruled that the retroactivity for tax purposes in cases of reorganizations does not unconditionally apply when determining the 5 year minimum term for a profit and loss absorption agreement required for a tax group for corporate income tax purposes.

In Germany, the existence of a tax group for corporate income tax purposes depends on certain conditions. In particular, the controlled entity and the controlling entity have to conclude a so-called profit and loss absorption agreement. This agreement has to be concluded and executed for a term of at least 5 years (60 months). The profit and loss absorption agreement obliges the controlled entity to transfer its profits to the controlling entity. If, however, the controlled entity generates losses, the controlling entity is obliged to absorb these losses. The total income is then taxed at the level of the controlling entity, although both the controlled entity and the controlling entity remain independent legal entities.

In the case at hand, a GmbH (GmbH 1) transferred part of its assets on 16 August 2005 in a spin-off to a GmbH (GmbH 2) which was established on 9 February 2005. At the time when the assets were transferred, GmbH 1 held all shares in GmbH 2. The spin-off was to be effective retroactively as of 1 January 2005, which is possible for tax purposes. Simultaneously, the two corporations concluded a profit and loss absorption agreement which was entered into the commercial register, in order to establish a tax group for income tax purposes. The agreement was also to be effective retroactively as of 1 January 2005 and terminable for the first time as of 31 December 2009. This was intended to meet the requirement of a minimum term of 5 years.

The issue under dispute was whether the profit and loss absorption agreement had been concluded for a minimum term of five years or whether it only became effective at the time of the establishment of GmbH 2 (9 February 2005), meaning for a term of less than five years.

The local tax office held the opinion that in the case at hand the prerequisites for a tax group for income tax purposes were not met, because GmbH 2 was only established on 9 February 2005. Consequently, the profit and loss absorption agreement could not enter into force on 1 January 2005. Hence, it had not been concluded for a term of 5 years (60 months).

The Lower Tax Court of Düsseldorf confirmed the view of the local tax office. The real circumstances have to be taken into account when determining the minimum term of the profit and loss absorption agreement. Pursuant to the wording of the profit and loss absorption agreement it was to be entered into for a term of five years because it was applicable starting from 1 January 2005 and terminable for the first time after 31 December 2009. In reality, however, the tax group was only formed by notarized agreement on 9 February 2005 (date of establishment of GmbH 2). Therefore, the prerequisite of a minimum term of five years for the profit and loss absorption agreement was not met. The retroactive tax effect of the spin-off does not apply unconditionally also to the determination of the minimum term of the agreement. The receiving legal entity definitely has to have existed at the beginning of the fiscal year in reality and not only due to the fiction of retroactivity for tax purposes.

Since appeal has been allowed, it remains to be seen how the Federal Tax Court will decide.

4. Lower Tax Court of Cologne (10 K 2892/14): Extent of Operating Expenses Connected to Tax-Exempt Foreign Income

In its decision of 11 December 2014 the Lower Tax Court of Cologne dealt with the question to what extent operating expenses are connected to tax-exempt foreign income and are therefore not deductible as business expenses in Germany.

The case at issue was about a German limited liability company ("GmbH"), whose purpose was to buy, sell, and construct buildings and to let real property. The net profit for the year 2012 also included gains on the sale of real property located in the Netherlands. Pursuant to the Double Tax Treaty between Germany and the Netherlands (DTT Netherlands) this profit had to be exempt from tax in Germany. German Tax Law stipulates: Expenses that have an "immediate economic connection" with tax-exempt income are not deductible as business expenses (§ 3c (1) Income Tax Law [EStG]). The question at issue was therefore, whether certain overhead costs of the GmbH (e.g. wages, expenses for premises, general insurance policies) had an "immediate economic connection" with the tax-exempt income. The local tax office wanted to split the overhead costs in proportion of the foreign revenues to the domestic revenues. The GmbH denied that there was an "immediate economic connection" and therefore wanted to fully deduct the expenses from the domestic tax assessment basis. It argued that the overhead costs could not be unequivocally attributed to taxable or tax-exempt income, that there was only an "indirect" economic connection with the tax-exempt income, and that splitting expenses into deductible and non-deductible portions was not admissible.

However, in its decision the Lower Tax Court of Cologne confirmed that there was an "immediate economic connection" and that consequently the overhead costs have to be split into a deductible and a non-deductible portion. According to common BFH case law an immediate economic connection exists where expenses would not have been incurred without the tax-exempt income. However, according to the decision of the Lower Tax Court of Cologne this definition is not far-reaching enough. The court opines that it has to be considered, too, that the costs would also have been incurred if the GmbH had exclusively transacted tax-exempt foreign real property business from Germany. This shows that there is not only an indirect causality, but rather an immediate economic connection between the overhead costs and the tax-exempt income.

In addition the Lower Tax Court of Cologne also addressed the BFH's case law on the recognition of expenses in withholding procedures for non-resident tax liabilities in connection with the provision of the use and enjoyment of rights (§ 50a (4) sent. 1 no. 3 EStG (old version)). This standard, too, required an "immediate connection" for the deduction of expenses. In its decision of 27 July 2011 the BFH had not allowed deduction of overhead costs, but did not give specific reasons why. In its recent decision the Lower Tax Court of Cologne therefore referred to a potential derogation from its current case law and from the previous case law of the BFH.

The decision is final, although the Lower Tax Court of Cologne had allowed appeal.

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