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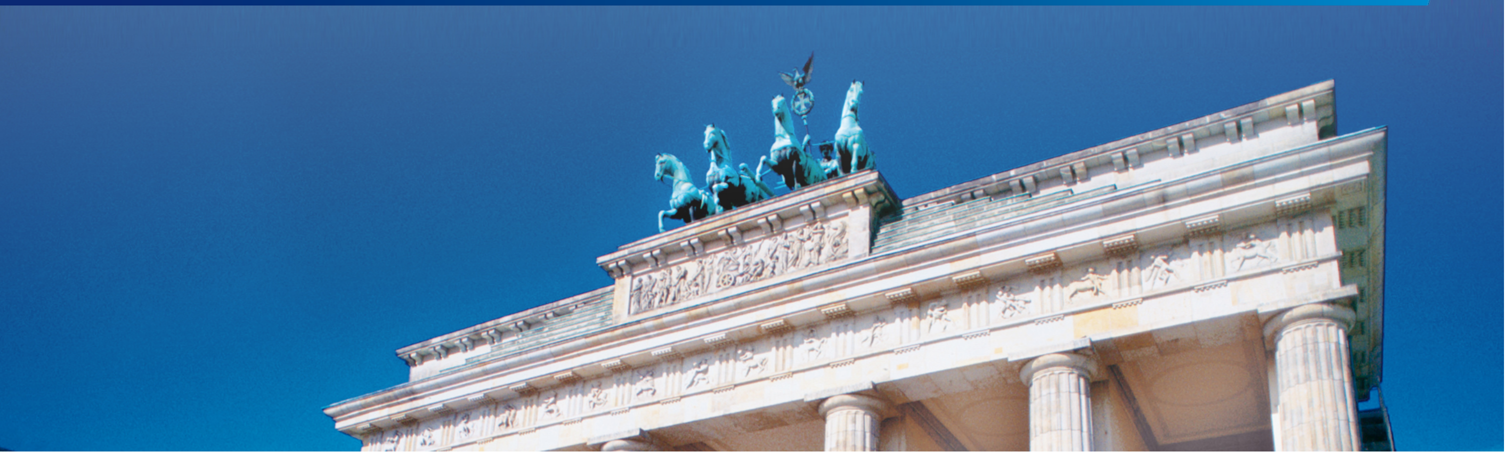

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1. BFH (I R 29/14): Write-Downs of Loan Receivables due from Foreign Related Companies

In its ruling of 24 June 2015 the Federal Tax Court (BFH) dealt with the tax treatment of a write-down of a loan receivable. The BFH confirmed its case law by ruling that the tax treaty principle of "dealing at arm's length" according to Art. 9 (1) OECD Model Tax Convention has an overriding effect over the income adjustments arising from German domestic provisions [§ 1 Foreign Transactions Tax Law (AStG) see April 2015 edition of German Tax Monthly]. Section 1 AStG governs income adjustments in cases where the arm's length principle is not complied with and related parties maintain cross-border business relationships.

In the case at issue, the plaintiff (a German limited liability company, GmbH) granted a loan to its wholly-owned foreign subsidiary in the year 2000 at an annual interest rate of 5%. No securities were agreed. Due to poor performance, the foreign subsidiary discontinued operations on 31 October 2002. Thus, in the year under dispute 2002, the plaintiff wrote down the loan to EUR 0 with effect on profit (write-down to the lower going-concern value).

In the opinion of the tax authorities a write-down to the lower going-concern value was, already as a matter of principle, not admissible in this case, because due to the so-called "group support" (Konzernrückhalt) the repayment claim could not be deemed at risk and therefore the loan receivable was recoverable, i.e. not impaired [Federal Ministry of Finance (BMF) guidance of 29 March 2011]. Group support is to be assumed as long as the controlling shareholder effectively guarantees the subsidiary's (borrower) solvency vis-à-vis unrelated third parties (externally). Apart from that, the lack of a collateral might at least allow for an income adjustment according to § 1 AStG.

The BFH referred to the Double Tax Treaty between Germany and the UK (DTT-UK) as authoritative in the case at hand. Article 9 (1) DTT-UK 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 has an overriding effect to the extent that it overrides any domestically admissible but more far-reaching adjustment possibilities.

Content

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Thus the tax treaty principle of "dealing at arm's length" would only allow for an income adjustment pursuant to domestic rules of the contracting states where the price agreed between associated enterprises (i.e., in the case at issue, the interest of the loan) is inappropriate as to the amount and therefore incompatible with the 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. Therefore it is decisive in the case at hand whether, even taking into account the lack of an effective collateral, the interest agreed was appropriate as to the amount and therefore met the requirements of the arm's length principle. The court opined that this was to be assumed in the case at hand.

Moreover, the BFH pointed out that an existing group support did not allow for the conclusion that the loan will be repaid by the subsidiary and thus that the repayment claim arising from the loan granted is unimpaired. The fact that the parent assumes liability - externally - for the subsidiary's debts vis-á-vis third parties does not necessarily allow for the conclusion that the subsidiary will repay its loan liability. On the contrary, precisely when the subsidiary is effectively in need to rely on the group support to meet its debts vis-á-vis third party creditors, it seems obvious that the debt vis-á-vis its parent will not be serviced. Therefore group support does generally not influence the write-down to the lower going-concern value of an intra-group loan receivable. According to the BFH it may, apart from that, be compatible with the arm's length principle to grant loans without collaterals between corporations within a group.

Please note that an explicit provision for these cases was included in the Corporate Income Tax Law (KStG) for assessment periods starting from 2008 onward. According to this provision, profit reductions relating to domestic and cross-border shareholder loans between corporations are, as a general rule, no longer tax deductible, and an off-balance-sheet adjustment is required.

2. Lower Tax Court of Hamburg (2 K 12/13): Retroactive Taxation of Type II Gain on Contribution after Upstream Merger

The Lower Tax Court of Hamburg ruled on 21 May 2015 that an upstream merger does not constitute a detrimental sale of shares subject to a lock-up period. Consequently, it does not trigger a type II gain on contribution.

According to German tax law, individuals can contribute shares that they hold in a corporation to another corporation (receiving legal entity) at book value and receive shares in the receiving entity as consideration (so-called exchange for shares). Where the receiving entity subsequently sells the shares, 95 percent of the resulting gain on sale is tax-exempt. If, in contrast, individuals themselves sell their shares to a corporation, the gain on sale is principally treated according to the so-called partial income system. This means that only 40 percent of the gain on sale is tax-exempt. From the perspective of the individuals, there is a so-called status improvement regarding the contributed shares.

Where the receiving entity sells the contributed shares within a period of seven years of the date of their contribution (so-called shares subject to a lock-up period), the contribution will be taxed retroactively (so-called type II gain on contribution). Pursuant to a BMF guidance dated 11 November 2011 (so-called Reorganization Tax Decree [UmwSt-Erlass]) a reorganization process, and here in particular a merger, is principally treated in the same manner as a sale. At the time of the contribution, the type II gain on contribution is subject to the partial income system. A type II gain on contribution is the amount by which the fair market value of the contributed shares at the time of the contribution exceeds the value at which the contributor recognized the shares that he received. A type II gain on contribution declines by one seventh for each calendar year that has lapsed since the time of the contribution. It is deemed an addition to the cost basis of the shares received. From a tax perspective the contributor is *de facto* treated as if he had sold the shares himself.

In the case at issue, plaintiff and A (individuals) had contributed their entire shares in a corporation (B-GmbH) at book value to another corporation (C-GmbH) in return for new shares. Consequently, C-GmbH was the sole shareholder of B-GmbH. Within seven years of the date of the contribution B-GmbH was merged into C-GmbH (so-called upstream merger). Book values were used for the merger.

The issue in the case at hand was whether the plaintiff had to tax a type II gain on contribution due to the upstream merger.

The defendant tax office treated the merger as a sale. It therefore assessed a type II gain on contribution at the level of the plaintiff.

In its decision dated 21 May 2015, in contrast, the Lower Tax Court of Hamburg dissented. It agrees that the term "sale" principally also includes reorganizations since they are comparable to swaps or exchanges. Albeit, the main characteristic of a sale, i.e. a consideration, was lacking in the case of the upstream merger into the sole shareholder. The Reorganization Tax Law is intended to prevent an abusive improvement of the tax status by contributing shares to a corporation. However, one cannot assume an abusive status improvement because of the upstream merger, because no consideration was granted in return and therefore no tax-advantaged gain on sale was generated. Furthermore, the hidden reserves contained in the shares subject to a lock-up period were not excluded from taxation.

Since appeal has been filed against the decision (I R 48/15) it remains to be seen how the BFH will decide.

3. BMF Guidance on Tax Groups for Corporate Income Tax Purposes and Atypical Silent Partnerships

In a guidance dated 20 August 2015 (IV C 2 - S 2770/12/10001) the Federal Ministry of Finance (BMF) expressed its opinion on atypical silent partnerships in connection with the recognition of tax groups for corporate income tax purposes.

German tax law distinguishes between so-called typical and atypical silent partnerships. In case of a typical silent partnership the silent partner only makes a capital contribution. Whereas in case of an atypical silent partnership the silent partner also bears part of the entrepreneurial risk (in particular by sharing in the hidden reserves and hidden liabilities) and takes entrepreneurial initiative (in particular by participating in the management). From a tax perspective, the atypical silent partnership qualifies as a deemed commercial partnership. The partners of the deemed partnership are the operator of the commercial business (in which the silent partner holds an interest) on the one hand, and the atypical silent partner on the other.

In the guidance the BMF distinguishes between the following cases:

- An atypical silent partnership itself (i.e. the deemed partnership) is intended to be the controlling entity or the controlled company in a tax group
- A corporation in which an atypical silent participation exists is intended to be the controlling entity or the controlled company in a tax group.

In the opinion of the tax authorities in none of the cases a tax group for corporate income tax purposes may be recognized.

The BMF guidance provides for an equitable approach for existing recognized tax groups. According to this, tax groups, which are currently recognized for tax purposes with controlling entities in which atypical silent participations are held will continue to be recognized.

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