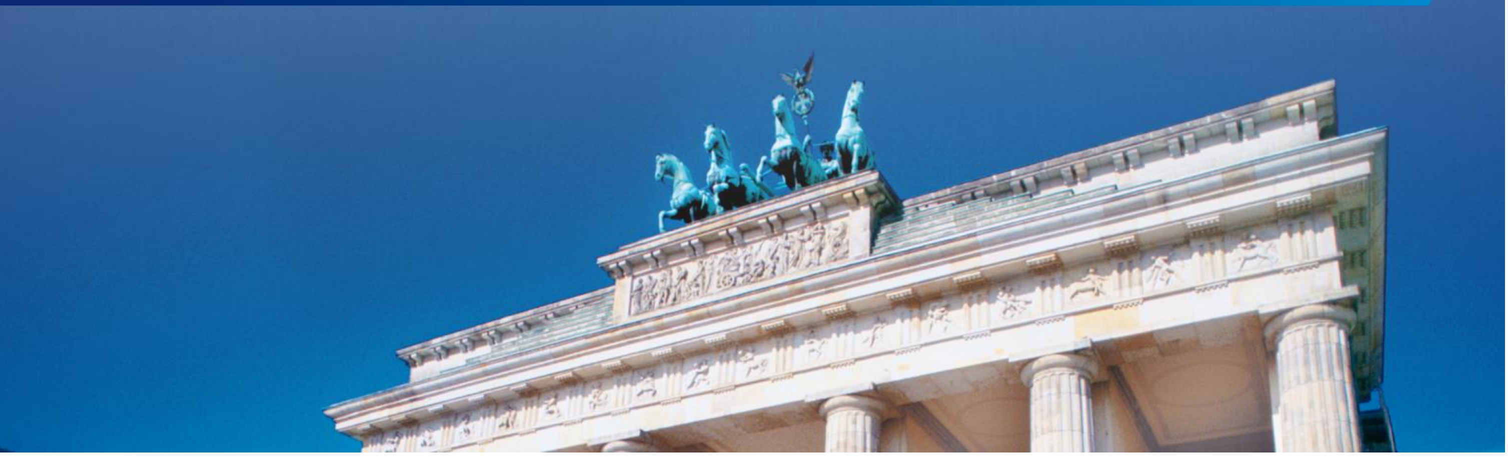
cutting through complexity

German Tax Monthly
January / February 2016



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1. Reform of investment taxation

On 18 December 2015, the Federal Ministry of Finance published the draft bill of a law on the reform of investment taxation (Investmentsteuerreformgesetz – InvStRefG). The draft bill essentially includes a fundamental reform of investment taxation.

Compared with the discussion draft which was published by the Federal Ministry of Finance on 22 July 2015 (GTM September 2015, p.1) there are significant changes:

Investment taxation

Partial exemptions of earnings and gains from shares in investment funds shall be increased on the part of the investor. As a result, in the case of property funds with a focus on domestic properties a flat-rate amount of 60% (before: 40%) of the income and in the case of property funds with a focus on foreign properties a flat-rate amount of 80% (before: 60%) of the income would be tax-exempt on the part of the investor. Income from equity funds shall be tax-exempt at the amount of 30% (before: 20 %) for individuals holding the shares in the fund among their private assets, 60% (unchanged) for individuals holding the shares in the fund among their business assets, and 80% (unchanged) for corporations (so-called equity partial exemption).

Moreover, an advance flat-fee in cases where shares in investment funds are held shall be considered (fictitious) income and as such subject to minimum taxation on the investor level in order to prevent an unlimited – in terms of time – possibility for deferral. The minimum amount of this annually accruing advance flat-fee shall be determined at a flat-rate of 70% (before: 80%) of the annual base rate of the Bundesbank, applied to the value of the share in the fund at the beginning of the year. Its amount is limited to the de facto increase in value of the shares in the fund during the calendar year. On the later disposal of the shares in the fund, the already taxed advance flat-fees can be deducted from the gain on the disposal.

The new provisions shall principally apply from 1 January 2018, thereby allowing for time for the funds to adapt to the new legislation.

Portfolio Investment

The provision on tax liability for gains on the disposal of portfolio investments (§ 8b (4) Corporate Income Tax Law-Draft (KStG-E)) contained in the dis-

Content

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cussion draft was no longer included in the draft bill. The disposal of portfolio investments, therefore, continues to be generally (at the amount of 95%) corporate tax-exempt unless the provision is readopted in the further legislative process.

New provision on the so called cum/cum-trades

Another significant addition compared with the discussion draft is a provision on the so-called cum/cum-trades, i.e. transactions where investors purchase German shares or participating certificates shortly before the dividend record date and thereafter claim credit or refund of dividend withholding tax. The new provision shall allow investors to credit withholding tax on German dividends provided that they hold the shares for at least 45 days (so-called minimum holding period around the dividend record date) as legal and economic owner and assume a substantial risk of loss in value within this period of time. The regulations to prevent abusive cum/cum-trades shall be applicable for the first time to capital yields (in particular dividends) accruing from 1 January 2016 onwards.

It has to be noted that the legislative procedure is still at an early stage. The approval of Lower House of German Parliament (Bundestag) and Bundesrat (Lower House of German Parliament) is still outstanding.

2. New Double Tax Treaty with Japan Signed

On 17 December 2015, Germany and Japan signed a new Double Tax Treaty (DTT Japan). The DTT is intended to replace the current DTT Japan dated 22 April 1966. The new DTT corresponds in the main to the OECD Model Tax Convention.

The personal scope of the DTT is supplemented by a provision covering income derived by entities that are transparent for tax purposes (Art. 1 (2)). Under the DTT Japan, entities that are transparent for tax purposes are principally not entitled to treaty benefits, because they are not deemed residents within the meaning of Art. 4. However, pursuant to the new provision in Art. 1 (2), income derived through a transparent legal entity, is deemed to be income of a resident of one of the Treaty States to the extent that the income is treated, for the purposes of taxation by that Treaty State, as income of a resident of that Treaty State. Internationally, a comparable provision is contained in Art. 1 (7) DTT USA and in Art. 1 (2) of the newly signed DTT Australia.

Regarding the taxation of business profits (Art. 7) the new DTT implements the so-called Authorised OECD Approach (AOA) in line with the OECD Model Tax Convention 2010 to determine the profits attributable to a permanent establishment. According to the AOA, profits which a permanent establishment would be expected to make if it was a separate and independent enterprise have to be attributed to the permanent establishment, taking into consideration the functions it performs, the assets it uses and the risks it assumes. The arm's length principle to be observed in this context also applies to internal transactions between head office and permanent establishments (so-called "dealings with other parts of the enterprise").

The general withholding tax rate on dividends remains unchanged at 15% of the gross amount of the dividend (Art. 10 (2) b). A reduction of the withholding tax rate to 5% amount is possible where a company (with the exception of partnerships) directly holds at least 10% of the voting rights in the dividend distributing company for a period of at least six months prior to the day on which the entitlement to the dividend is determined (Art. 10 (2) a). However, where a company (with the exception of partnerships) directly holds shares in the amount of at least 25% of the voting rights in the dividend distributing company for a period of at least 18 months prior to the day on which the entitlement to dividends is determined no withholding tax must be levied (Art. 10 (3)). In addition, the new DTT Japan does no longer contain the source country's right to tax royalties and interests (up to now 10%; Art. 11 (1) and Art. 12 (1)).

According to the new DTT, profits derived from the sale of shares in certain real estate companies may also be taxed in the Treaty State in which the real estate is located (Art. 13 (2)).

The 183-days rule for determining the right to tax income derived from employment in the new DTT Japan does no longer use the calendar year as a reference, but a 12 month period commencing or ending during the relevant taxable year (Art. 14 (2) a; the relevant taxable year in Germany is – in this context – the calendar year).

Germany generally uses the tax exemption method to avoid double taxation (Art. 22 (2) a), whereas the credit method is used for passive income and certain other types of income such as gains from the sale of shares in certain real estate companies (Art. 22 (2) c and d). In case of actual non-taxation in the source country and/or country of employment (subject-to-tax clause) as well as in case of qualification conflicts there may be a switch-over from the exemption to the credit method (Art. 22 (2) e).

In addition, the DTT contains amended provisions regarding the exchange of information (Art. 25) as well as, for the first time, a provision on arbitration proceedings (Art. 24) as well as a provision on mutual administrative assistance in tax collection (Art. 26).

It has to be noted, that the new DTT has not yet entered into force. It requires the transposition into the national law of both Treaty States as well as subsequent mutual notification thereof. The legislative process for transposing the new DTT Japan into national law in Germany has not yet started. The new DTT shall enter into force on the thirtieth day following the day on which the last notification is received and shall have effect as of 1 January of the following calendar year.

3. CJEU (C-388/14 "Timac Agro"): Final Losses of Foreign Permanent Establishments

In its ruling of 17 December 2015 (C-388/14 "Timac Agro") the Court of Justice of the European Union (CJEU) expressed its view regarding the treatment of losses of foreign permanent establishments.

In general, profits and losses of a foreign permanent establishment to which the tax exemption method pursuant to a Double Tax Treaty (DTT) applies, are not included in the domestic tax assessment basis. Until the assessment period 1998, German Income Tax Law (EStG) stipulated that losses incurred by a foreign permanent establishment may as an exception be deducted from the domestic assessment basis to the extent that they cannot be recognized in the country where the foreign permanent establishment is located (§ 2a EStG old version). Correspondingly, the amount was added back in subsequent years, insofar as the foreign permanent establishment generated profits. The deducted amounts were also added back, if the permanent establishment was reorganized, transferred or discontinued in subsequent years. In case of reorganizations, transfers or discontinuations the amounts had to be added back irrespective of the fact whether a profit was generated.

This rule ceased to exist for assessment periods from the year 1999 onwards. Following the DTT symmetry thesis, losses of a foreign permanent establishment are deductible only in the country where the foreign permanent establishment is located but not for domestic tax purposes. Nevertheless, according to CJEU case law (C-414/06 "Lidl Belgium") losses may be deducted for domestic tax purposes as an exception where the use of a loss in the country where the permanent establishment is located is definitely no longer possible, i.e. in case of so-called final losses.

In the case at issue the plaintiff, a German corporation, had operated a permanent establishment in Austria since 1997 for which the exemption method applied. In 2005 this permanent establishment was sold within the group to a sister company also resident in Austria. In the years from 1997 to 2005, with the exception of the years 2000 and 2005, the permanent establishment had continuously generated losses. Upon application, the plaintiff was first able to use the losses in 1997 and 1998 in Germany pursuant to the former legal situation (§ 2a EStG old version). However, in 2005 the tax office added back the losses due to the sale of the Austrian permanent establishment. The provision in § 2a EStG was no longer applicable in the years 1999 to 2004, so that in line with the exemption method provided for in the DTT the losses were no longer deductible in Germany.

In a preliminary ruling requested by the Lower Tax Court of Cologne (decision dated 19 February 2014, 13 K 3906/09, see October 2014 edition of German Tax Monthly) the CJEU first affirmed the admissibility of the add-back in connection with the intra-group sale under Community Law. In the opinion of the CJEU, the loss deduction and the add-back in the amount of the previously deducted losses directly mirror each other. A recapture is in particular justified in view of the principle of a balanced allocation of the right of taxation between Member States, but also in order to avoid tax evasion. However, if in such a case an add-back is denied, the group can rearrange its tax structure such as to freely choose in which Member State it uses its losses. Finally, the CJEU also stated that the denial of the exceptional tax deduction of the losses incurred in the years 1999 to 2004 were not in breach of Community Law. The CJEU explained its interpretation by stating that the domestic and the foreign permanent establishments are not in a comparable situation regarding the taxation of their income to the extent that the DTT exemption method is applied.

Regarding "final losses" of permanent establishments in the EU/EEA resulting from the intra-group sale of a permanent establishment, the CJEU ruling is contrary to the Federal Tax Court (BFH) decision (judgment dated 5 February 2014, IR 48/11, BFH/NV (collection of not officially published decisions) 2014, 963). In its decision the BFH generally deemed an intra-group sale a reason for finality in cases in which the DTT exemption method is used and therefore applied the principles of the decision in the Marks & Spencer case ("Marks & Spencer" (C-446/03); "Lidl Belgium" (C-414/06); "A Oy" (C-123/11)).

From a systematic perspective, the argument of the lacking comparability with a domestic case will apply to any situation in which the DTT exemption method is used. Whether the CJEU has thus intentionally amended its case law or whether the ruling should be regarded as an exception so that the finality principles continue to apply will have to be substantiated in future rulings.

4. BFH (I R 56/14): "Holding-Company Privilege" of abandoned Thin Capitalization Rule

In its decision of 18 August 2015 (I R 56/14), the Federal Tax Court [BFH] ruled with regard to the old thin capitalization rules pursuant to § 8a Corporate Income Tax Law old version [KStG o.v.] that the holding-company privilege shall also apply to cases where only one shareholding is held.

Pursuant to the old thin capitalization rules the compensation paid for debt capital that a corporation obtaines not only for short-term use from a shareholder with a significant holding can qualify as hidden profit distribution if the total amount of the compensation exceeds EUR 250,000 and

- if the agreed compensation is not defined as a proportion of capital or
- the agreed compensation is defined as a proportion of capital and as far as the debt capital exceeds 1.5 times the pro-rated equity of the shareholder at a point in time of the fiscal year (so-called safe haven and the arm's length test is not met.

The holding-company privilege consisted in a beneficial determination of the safe haven (i.e. the equity did not have to be reduced by the book value of the shareholding of a corporation) if the main activity of the company consisted in "holding shareholdings in corporations and in financing said corporations" (var. 1) or "if more than 75% of its total assets consisted of shareholdings in corporations" (var. 2).

In the case of issue the plaintiff was a German GmbH whose business activity was exclusively limited to the holding and financing of the 70% shareholding in the E-GmbH. In 2005, the GmbH obtained an interest-bearing loan in the amount of EUR 5.4 million from its sole shareholder, M-Ltd. domiciled in India. The GmbH, for its part, granted this amount and further EUR 600,000 to E-GmbH as an interest-bearing loan. In the opinion of the tax office, the holding-company privilege does not apply because the plaintiff only held one shareholding.

The BFH decided that the plaintiff can apply the holding-privilege pursuant to the above mentioned two variations, and the interest payments therefore were not to be reclassified as hidden profit distributions. Thus, the BFH decided against the administrative opinion (Federal Ministry of Finance letter of 15 December 1994, marginal no. 84) pursuant to which application of the holding-company regulation requires at least two shareholdings.

5. Hessian Lower Tax Court (4 K 677/14): "Good Cause" for Early Termination of a Profit and Loss Absorption Agreement

In its decision of 28 May 2015, the Hessian Lower Tax Court ruled that in a tax group the contribution of shares in the controlled company to another subsidiary of the controlling entity may constitute "good cause" for terminating the profit and loss absorption agreement and thus the associated tax group for corporate income tax purposes. However, the contribution must occur as part of a restructuring of the corporate group for business reasons and there must be serious intentions to form, from the following fiscal year onwards, new tax groups between the controlled company and the receiving corporation on the one hand and between the receiving corporation and the former controlling entity on the other.

One prerequisite for a tax group is the conclusion of a profit and loss absorption agreement for a term of at least five years and its proper execution throughout the entire term. An early termination of the agreement by notice of termination or cancellation does not adversely affect tax recognition provided the termination is justified by "good cause".

In the case at issue a tax group existed between the plaintiff and its sole shareholder (A-GmbH). A profit and loss absorption agreement was concluded in 2004 which contained a clause which provided for the possibility of extraordinary termination in case the shareholders in the plaintiff changed. In the course of a restructuring within the corporate group in 2006, the shares in the plaintiff were contributed to Y-GmbH - another subsidiary of A-GmbH. A-GmbH gave notice of termination of the profit and loss absorption agreement with effect of 31 December 2006 invoking the extraordinary termination clause. The aim of the restructuring efforts was to create intermediary holdings for the different divisions of the corporate group. Apart from that, there was an intention to continue the tax group including the plaintiff without interruption from 1 January 2007 onwards through a (two-level) tax group involving the intermediary holding (Y-GmbH). The local tax office did not recognize the intra-group change of shareholders due to the contribution as "good cause" and denied recognition of the tax group from the beginning.

The action brought before the Hessian Lower Tax Court was successful. Whether - from a tax perspective - "good cause" for termination exists must not be based on an arbitrary decision of the contracting parties. Rather, "good cause" for termination must be derived from objective reasons according to the inherent standards of tax law (see also GTM edition of May 2014, p. 3, for a similar case). While the contribution - just like the intra-group disposal - does not constitute "good cause" for termination of the tax group in each and every case, the Hessian Lower Tax Court was convinced that the business-related (not the tax-related) reasons for the contribution (creation of an intermediary holding) as well as the uninterrupted continuation (from an economic perspective) of the tax group via a chain of tax groups justified the early termination of the profit and loss absorption agreement.

Finally, the Lower Tax Court ruled that, in the case at issue, it was sufficient that the notice of termination was issued as late as two months after "good cause" (the contribution) occurred. In the view of the Court, company law only required a "timely" notice of termination, and in the case at issue the plaintiff already knew that the profit and loss absorption agreement would be terminated following the restructuring.

The decision is final. It is important to note that, according to the guidelines of the tax authorities, a contribution of the shareholding in the controlled company may, but does not necessarily have to, be regarded as "good cause". The decision depends on the circumstances in the individual case. Moreover, the Lower Tax Court emphasizes that it is not bound by regulations of authorities neither for the benefit nor to the detriment of the taxpayer.

6. BMF Guidance on the Non-Application of § 50i (2) Income Tax Law

As a consequence of a legislative amendment in 2013 certain profits of deemed commercial partnerships are taxed in Germany, even if under a DTT another state has the right of taxation (§ 50i income tax law [EStG]). A deemed commercial partnership originally derives income from rental/lease or income from capital (dividends or gains on the sale of shareholdings), but under certain circumstances the income is treated as commercial income. The legislative amendment resulted from a change in the case law of the Federal Tax Court (BFH). According to this case law the deemed commercial partnership nature (under German tax law) must not be taken into consideration for DTT purposes.

The amendment is intended to safeguard Germany's right of taxation especially in cases where partners of a deemed commercial partnership relocate to another DTT state without the hidden reserves in the assets of the partnership having been taxed. The so-called exit taxation was not applied to these cases, because pursuant to the old case lawa continuation of Germany's right of taxation was assumed.

In 2014, § 50i EStG was amended again (§ 50i (2) EStG). The adjusted version intends to prevent bypassing § 50i EStG and therefore ensures exit taxation of hidden reserves also in cases of reorganization, contribution or gratuitous transfers. The amended provision essentially focuses on the assessment of the assets that are transferred and makes it mandatory that their fair market value be used.

However, the wording of the amended provision is rather broad and thus also covers cases where Germany's right of taxation is not questioned, e.g. purely domestic cases. A guidance issued by the Federal Ministry of Finance (BMF) on 21 December 2015 now excludes these cases from the scope of application of the provision on equitable grounds. Accordingly, the taxpayer can, in deviation of the provision, continue to contribute, reorganize or gratuitously transfer at book value provided that the German right to tax hidden reserves is not excluded or restricted. The prerequisite is that the transferring and the receiving legal entity file matching applications.

7. Non-Application Decree: Reduction of Trade Income by Imputed Income Amounts under the CFC Rules for Trade Income Tax Purposes

The tax authorities will not apply the Federal Tax Court (BFH) ruling of 11 March 2015 (I R 10/14) on the reduction of trade income by the imputed income amount under the CFC rules except in the individual case on which the ruling was issued. The Ministries of Finance of the Federal States published the corresponding non-application decree on 14 December 2015.

In its decision of 11 March 2015 the BFH ruled that the imputed income amount under CFC rules formed part of the trade income of a German resident company, which is the assessment base for trade tax. It is regarded as foreign income generated by a permanent establishment that is not located in Germany. Therefore, the company's profit has to be reduced by this amount for purposes of determining trade tax (see June 2015 edition of German Tax Monthly, page 3).

The Ministries of Finance of the Federal States do not share this interpretation of the law and have issued the following explanation:

- The imputed income amount under CFC rules cannot be deemed foreign income, because foreign income would not form part of trade income.
- The purpose of CFC rules is to prevent profit shifting of passive income. Consequently, income that is subject to CFC rules cannot be qualified as foreign income but must be qualified as domestic income. Furthermore, if the imputed income amount was to be qualified as foreign income, this would result in unequal treatment when compared with the treatment of dividends. Dividends derived from passive activities are subject to trade tax.
- The taxpayer whose income is subject to CFC rules does not itself operate a foreign permanent establishment, but is merely a shareholder in a(n) (intermediary) CFC. Therefore, the imputed income amount is treated as income from a domestic permanent establishment.

According to the opinion of the tax authorities the imputed income amount under the CFC rules is therefore fully subject to trade tax. Following the non-application decree, the reduction will not be granted by the tax authorities, but has to be enforced by a court.

8. Real Estate Transfer Tax Rates

The real estate transfer tax rates levied on real property depend on the Federal State in which the real property is situated. The reason for this is that the Federal States have the right to define the tax rate autonomously.

On the occasion of the turn of the year we provide the following summary of the current real estate transfer tax rates in a descending order as of 1 January 2016. You will also find the most up-to-date information on real estate transfer tax rates in our KPMG Tax Facts App.

Federal States	as of 1 January 2016
Brandenburg	6.5 %
North Rhine-Westphalia	6.5 %
Saarland	6.5 %
Schleswig Holstein	6.5 %
Berlin	6.0 %
Hesse	6.0 %
Baden-Württemberg	5.0 %
Bremen	5.0 %
Lower Saxony	5.0 %
Mecklenburg-Vorpommern	5.0 %
Rhineland-Palatinate	5.0 %
Saxony-Anhalt	5.0 %
Thuringia	5.0 % (6.5 % as of *1 January 2017*)
Hamburg	4.5 %
Bavaria	3.5 %
Saxony	3.5 %

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