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Group exemption provision for real estate transfer tax purposes (§ 6a GrEStG): unlawful state aid?

In four decisions of 25 November 2015 (II R 36/14, 50/13, 62/14, 63/14) on the group exemption provision for real estate transfer tax purposes (6a GrEStG – Real Estate Transfer Tax Law), the Federal Tax Court (BFH) requested the Federal Ministry of Finance (BMF) to join the proceedings. Substantive-law related matters of interpretation of the norm are in the center of the proceedings. Nevertheless, according to the opinion of the BFH, it is to be examined also from a EU law perspective whether or not the tax exemption constitutes a newly introduced state aid within the meaning of article 107 (1) of the Treaty on the Functioning of the European Union (TFEU). For explanations regarding the group exemption provision for real estate transfer tax purposes please refer to November 2014 edition of German Tax Monthly.

Article 107 (1) TFEU basically prohibits Member States to grant aid from state resources to certain undertakings (selectivity) in order to avoid distortion of competition within the European Union. The notion of state aid covers all kinds of economic advantages granted without a market equivalent. Thus it also includes the waiver of tax revenues in favor of certain undertakings.

If a Member State intends to grant state aid, it generally has to notify the EU-Commission in advance about this intention and ask for authorization (preliminary investigation procedure). The state aid must not be granted before authorization has been given (stand-still clause). Hence, the undertaking itself, although directly affected, is only indirectly involved in state aid procedures.

It cannot be gathered from the legislative documents on the introduction of § 6a GrEStG that the Federal Republic of Germany had submitted the regulation to the EU Commission for authorization for state aid purposes before its entry into force. If no authorization procedure was carried out, the group exemption provision could be subjected to an investigation procedure by the EU Commission. Currently, the EU Commission has not yet initiated a formal investigation procedure.

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As a national court, the BFH is merely obliged to review whether a measure that had been introduced without consideration of the preliminary investigation procedure would have had to be subjected to the procedure. Irrespective of the result of the review conducted by the BFH, the EU Commission is not bound to it. Even if the BFH does not classify the group exemption provision as unlawful state aid in the context of its review, the EU Commission may still initiate an investigation procedure. After initiation of the investigation procedure, the EU Commission can oblige Germany to suspend the group exemption provision until the final decision of the EU Commission (suspension order). In addition, temporary recovery of the state aid, provided further conditions are met, is possible (recovery order).

Should the EU Commission upon termination of the investigation procedure classify the group exemption provision as unlawful state aid, it would order Germany to recover the state aid, including interest as of the date of granting, from the taxpayers. The EU Commission can recover state aid for a period of up to ten years from the day it was granted. This even affects cases with binding information or time-barred assessments. The decision of the EU Commission, on the other hand, is subject to judicial control by the Community Courts.

Thus, legal uncertainty arises for the undertakings until the EU Commission has reached a final decision, which has to be considered in the case of group restructurings.

Repeal of BMF Guidance on Profit Realization for 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 (see GTM August 2015, p. 2).

In its decision (VIII R 25/11) 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.

The BMF guidance dated 29 June 2015 intended to make the principles of the Federal Tax Court ruling generally applicable to any instalments paid, i.e. not only instalments paid to architects or engineers.

In its guidance dated 15 March 2016 the BMF now repeals its guidance dated 29 June 2015. The application of the principles of the BFH ruling is restricted to instalment payments received by engineers and architects for planning services invoiced according to the old professional fee schedule. The old professional fee schedule is applicable to services/work that were contractually agreed before or on 17 August 2009.

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 fiscal year to which the principles are applied for the first time and the following fiscal year, or the first year and the two subsequent fiscal years.

BFH (I R 57/13): Interpretation of the 10% Threshold in the Context of the Earnings Stripping Rules in Case of Corporations

In a ruling of 11 November 2015, the Federal Tax Court (BFH) decided that the remunerations for debt capital paid to individual substantial shareholders will not have to be added up when determining whether the 10% threshold has been reached.

According to German tax law, expenses caused by the operating activities of a taxpayer are tax-deductible and generally reduce the tax assessment base (objective net principle). In the case of interest expenses, however, the earnings stripping rules must be observed pursuant to which the deduction of interest as business expenses is limited under certain circumstances. The earnings stripping rules are not applied where the business forms part of a group of companies and the equity ratio of the business is at least as high as the equity ratio of the group (escape clause). In addition, when applying the equity escape clause, corporations have to prove that the remunerations for the debt capital of the corporation to one shareholder who either directly or indirectly holds more than 25% of the capital (substantial shareholder) do not exceed 10% of the interest expenses exceeding the interest income (net interest expenses) (§ 8a (3) Corporate Income Tax Law [KStG]).

In the case at issue, several shareholders held interests in B-GmbH in 2008. Among them were two shareholders who held more than 25% throughout the entire year at issue. The interest expense portions attributable to the substantial shareholders (EUR 398,008 and EUR 353,918 respectively) each amounted to less than 10% of the total net interest expenses (EUR 4,043,860). Initially, neither B-GmbH nor the local tax office disputed that the equity ratio of B-GmbH's business exceeded the equity ratio of the group of companies and that therefore the equity escape clause was principally applicable. However, in the opinion of the local tax office, the interest expense portions attributable to the substantial shareholders exceeded the 10% threshold when added up and therefore the application of the escape clause was ruled out.

The action brought before the Federal Tax Court (BFH) against this decision was successful. In the opinion of the BFH the wording of the rule ("to one shareholder") refers to one shareholder individually. Insofar, the wording is unequivocal. If the legislator had wanted the rule to apply to the interest expense portions of several shareholders in total, such as in case of a detrimental change in ownership pursuant to § 8c (1) sent. 3 KStG ("group of acquirers"), it would have been necessary for the wording of the rule to be unequivocal. Indeed, the BFH acknowledges that the purpose of the earnings stripping rules - prevention of financing structuring between a corporation and its shareholder - may possibly be better achieved by considering several substantial shareholders in total. Pursuant to the BFH an interpretation oriented to the normative purpose is, however, excluded, because of the far-reaching burdening effects of the earnings stripping rules and the impairment of the fundamental objective net principle.

It has to be noted that the opinion held up to now by the Federal Ministry of Finance (BMF) [BMF guidance dated 4 July 2008 (margin number 82)] conflicts with the present ruling of the BFH. It is still open whether the BMF will maintain its opinion. In addition, the earnings stripping rules are currently under review by the Federal Constitutional Court (see GTM March 2016).

BFH (IV R 37/13): Constitutionality of Non-Recognition of Loss on Acquisition when Changing Legal Form

According to the German Reorganization Tax Law, an acquisition gain or loss has to be determined when a corporation is the transferring entity and a partnership the receiving entity in a reorganization process. The acquisition gain or loss is the difference between the value at which the transferred business assets have to be recognized in the balance sheet of the partnership and the value of the shares in the transferring corporation. Where the result is a loss on acquisition, the loss is not deductible. This rule also applies to a change in legal form, whereby the newly created partnership is deemed to have held all shares in the corporation.

In the case at issue, the plaintiff acquired shares in a GmbH on 1 January 2007. In the same month the legal form was changed from a limited liability company (GmbH) to a limited partnership (KG). The change in legal form was carried out at book values. The acquisition costs of the plaintiff for the shares in the GmbH were considered when the gain/loss on acquisition was determined. The result was a loss on acquisition to which the non-deductibility of losses, as explained above, applied and which could consequently not be used by the plaintiff. In 2008, the plaintiff sold his shares in the KG that emerged from the change in legal form. When determining the gain on sales his capital account in the partnership was taken into consideration as acquisition costs. However, because the book value continued to be carried after the change in legal form, the value of the capital account was significantly lower than his original acquisition costs for the shares in the GmbH.

In its decision of 22 October 2015 (IV R 37/13) the Federal Tax Court (BFH) ruled that neither was a teleological reduction of the non-deductibility possible nor had a breach of the general principle of equality pursuant to Art. 3 (1) of the German Constitution (Grundgesetz, GG) occurred. The loss limitation serves to ensure that the hidden reserves that exist in the business assets of the corporation are taxed once. Indeed, in the case at issue the norm has an excessive effect. According to the BFH the objective net principle is breached because a deduction of the acquisition costs is definitely and finally no longer possible. However, this breach is factually justified, because it forms part of the admissible standardization and simplification procedures to which the legislator is entitled. In addition the BFH argued, that the plaintiff had several possibilities that he could have used in order to reduce his burden, such as a change in legal form at fair market value or a consideration of the deferred tax burden which would have reduced the purchase price.

Please note that in an *obiter dictum* in its decision of 24 June 2014 (VIII R 35/10; BFHE 245, 565) the eighth Senate of the BFH commented in a similar case that it has to be examined whether one should desist from a tax assessment on grounds of substantive inequity (§§ 163, 227 Tax Procedure Law [AO]). The Senate argued that a breach of the objective net principle might exist where the non-deductibility results in the fact that a tax deduction of acquisition-related expenses is definitely and finally denied without reasonable factual justification.

An application for equitable relief should therefore be filed in such cases of change in legal form. It remains to be seen what a final and binding judgement will decide regarding a deviating assessment on equitable grounds.

Lower Tax Court of Münster (10 K 1410/12 F): Requirements of the Motive Test in the Context of the CFC Rules

Under German tax law the CFC rules apply where foreign companies are controlled by German resident taxpayers and generate so-called passive income which are subject to a low rate of taxation (controlled foreign company - CFC). Where the CFC rules apply, the income of the CFC is attributed to the shareholder and is thus subject to German taxation. In the case of EU/EEA companies, the application of the CFC rules may be avoided if evidence can be provided that the controlled subsidiary pursues a genuine and actual business activity in the Member State in which it was established ("motive test").

In its judgment of 20 November 2015 the Lower Tax Court of Münster dealt with the question as to whether royalty income of a subsidiary based in Cyprus was to be qualified as passive income and, if so, whether the requirements of the motive test were met.

In the case at issue, the German parent held an indirect share in a Cyprus Limited. The Limited had rented office space in Cyprus and employed a managing director. The business activity of the Limited consisted in obtaining book licenses in order to transfer them for use by other companies belonging to the corporate group based in Russia and Ukraine against payment. The group companies used the licenses to market the books in the Russian speaking market.

According to the decision of the Court, the royalties generated by the Limited are to be considered passive income, because the licenses that were utilized were not generated internally but purchased externally. The motive test, in due consideration of CJEU case law in the "Cadbury Schweppes" case (C-196/04), could not avoid the application of the CFC rules as well. According to the view of the Lower Tax Court of Münster, the taxpayer was unable to prove that the subsidiary carried on economic activities in the country of residence because of a lack of objective factors evidencing such genuine economic activities.

In Cyprus, the Limited used the market merely for procurement purposes (renting office space etc.), not, however, for selling purposes as it did not sublicense any book rights to Cypriot customers. This in itself does not preclude the assumption of genuine economic activities. But the motive test requires that the establishment of the subsidiary occurred with the intention to use specific resources in the host state, such as particularly favorable or specifically equipped premises for the activity, machines, well qualified staff or special production conditions. This did not apply in the case at issue.

The Court held that genuine economic activities could not be assumed because the Cypriot subsidiary did not exercise its core business functions itself. The essential business decisions were not made locally in Cyprus but by the other group companies located in Russia or Ukraine. Rather, the function of the Limited was restricted to the administrative implementation of these decisions. The geographical proximity of Cyprus to Russia and its simultaneous membership in the EU did not constitute objective grounds for establishing a Limited in Cyprus as well.

It can be concluded that the Lower Tax Court of Münster assumes high barriers for proving genuine economic activities. It remains to be seen whether the judgment is confirmed by the Federal Tax Court in case the plaintiff should file appeal.

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