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Information on the latest tax developments in Germany

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Federal Constitutional Court (2 BvL 1/12): Constitutionality of the "Treaty Override"

In a ruling of 15 December 2015 the Federal Constitutional Court (BVerfG) held that the provision of § 50d (8) Sent. 1 Income Tax Law (EStG) is compatible with the German Constitution (Grundgesetz, GG) despite the fact that it has an overriding effect over tax treaty law. The Federal Tax Court (BFH) had referred the case to the BVerfG on 10 January 2012.

§ 50d (8) EStG contains a treaty override provision according to which the tax exemption, agreed under treaty law in a Double Tax Treaty (DTT), for income from dependent employment without the requirement to provide evidence is only granted (regardless of the DTT), if the taxpayer proves that the other country has waived its right of taxation or that the taxes assessed on the income in such country have been paid.

In the case on hand, the plaintiff received income from employment. Part of the income was wages earned from employment in Turkey. The plaintiff applied for tax exemption pursuant to the DTT Turkey 1985 for the part of the wages allocable to the activities pursued in Turkey. As there was no evidence regarding an exemption from or payment of taxes on the wages paid for the activities pursued in Turkey, the local tax office, contrary to the DTT, treated the entire wages as income subject to tax liability in Germany according to § 50d (8) EStG.

In its ruling of 10 January 2012 the BFH held that the treaty override of § 50d (8) EStG is unconstitutional. However, the BVerfG decided in its ruling of 15 December 2015 that the override of § 50d (8) EStG over Tax Treaty Law is neither in breach of the principle of the rule of law nor of the principle of openness to international law (Grundsatz der Völkerrechtsfreundlichkeit) enshrined in the GG.

According to the German GG, on the national level, international treaties such as DTTs take the same rank as statutory federal laws. Correspondingly, the principle of democracy requires that, within the boundaries set by the GG, later legislatures are able to revoke legal acts of previous legislatures.

Content

The BVerfG does not share the view of the BFH that treaty overrides contravene Art. 25 GG (precedence of general rules of public international law). According to the BVerfG, Art. 25 GG applies to general rules of public international law but not specific provisions of international treaties.

The ruling of the BVerfG may also be relevant for other national tax law provisions, which also provide for a treaty override. It is to be noted, however, that the purpose and intent of each treaty override may differ (e.g. avoiding abuse and double non-taxation, counteracting an erosion of the domestic tax base) and that the BVerfG might identify justifications for each kind of treaty override based on such specific purpose or intent. However, if a violation of the GG occurs without justification, the national law provision is unconstitutional.

General Court of the European Union: Decision on Turnaround Exemption Clause in § 8c Corporate Income Tax Law

In its decisions of 4 February 2016 (T-287/11 - Heitkamp Bau, T-620/11 - GFKL) the General Court of the European Union (EGC) dismissed two actions as unfounded that had been brought before it against the EU Commission's decision to qualify the turnaround exemption clause in § 8c (1a) Corporate Income Tax Law (KStG) as inadmissible state aid.

The turnaround exemption clause provides for an exception from the loss limitation rules in § 8c KStG governing cases of detrimental change in ownership. If an acquisition of shares in a company serves to turn around the company, such an acquisition is not treated as detrimental change in ownership and the losses are not forfeited. In a decision of 26 January 2011 the European Commission declared the turnaround exemption clause to be inadmissible selective state aid within the meaning of Art. 107 (1) Treaty on the Function of the European Union (TFEU). The action of the Federal Republic of Germany brought against the decision of the EU Commission had already been dismissed as inadmissible in a final and unappealable decision of 3 July 2014 (C-102/13 P) because it was not at due date. For content of the turnaround exemption clause, the decision of the EU Commission, and the dismissal of Germany's action see March 2013 edition of German Tax Monthly.

An inadmissible state aid under EU legislation may exist in the context of tax law where a tax advantage is, as an exception from general taxation rules, only granted to a specific group of persons. The plaintiff held that the applicable general taxation rule is § 10d German Income Tax Act (EStG), which explicitly allows for the loss carryforward. Accordingly, the turnaround exemption clause does not constitute a tax advantage, but is merely the return from the exception of the loss limitation rule back to the general taxation rule. According to the EGC not only § 10d EStG but also the loss limitations in § 8c KStG form part of the reference system. Both provisions together serve as the general taxation rule governing the loss deduction limitations in cases of detrimental change in ownership. Accordingly, the turnaround exemption clause grants a tax advantage.

In the opinion of the EGC this tax advantage only benefits a specific group of companies, i.e. selectively those companies threatened to become insolvent and therefore in need of a turnaround.

Finally, the tax advantage is not justified by the nature or structure of the taxation system. In particular, the turnaround exemption clause does not serve the purpose of implementing the ability-to-pay principle, since this principle basically prescribes the loss deduction for all companies and not only for companies in need of being turned around. On the contrary, the reasons why the turnaround exemption clause was established, namely to support companies in distress during a financial or economic crisis, are non-tax reasons.

Based on this assessment of the EGC, this is inadmissible state aid, so that the decision of the EU Commission was correct and the legal action therefore unfounded.

It is still open whether the plaintiff will file appeal against this decision. If this applies the CJEU would have to rule on the case.

Currently, several other actions against the decision of the EU Commission are pending with the EGC. Against the background of the general recitals one has to assume that these actions will, if admissible at all, also be dismissed as being unfounded.

BFH (I R 20/15): Constitutionality of the Earnings Stripping Rules referred to the Federal Constitutional Court

With a decision of 14 October 2015 the Federal Tax Court (BFH) referred the question to the Federal Constitutional Court (BVerfG) as to whether the earnings stripping rules are in breach of the principle of equality before the law as enshrined in Art. 3 of the German Constitution (Grundgesetz - GG) and are thus unconstitutional.

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. Interest expense that is not deductible due to the earnings stripping rules is assessed separately as so called interest carryforward and may be deducted in subsequent assessment periods in certain cases. However, there are also cases where the interest carryforward is forfeited, e.g. as a consequence of business restructurings or ownership changes.

In this context the question arises whether the limitation of the deduction of interest as business expenses constitutes an unjustified breach of the objective net principle and thus a violation of the constitutional principle of equality before the law. In Germany, the exclusive authority to decide whether a provision under tax law is unconstitutional lies with the BVerfG.

In the case at hand the deduction of interest as business expenses of a German limited liability company (GmbH) belonging to a corporate group was limited under the earnings stripping rules in the years under dispute 2008 and 2009. In addition, the interest carryforward assessed as of 31 December 2008 was forfeited because of a restructuring of the corporate group in the subsequent year. An action against the tax assessment brought before the court of lower instance (Lower Tax Court of Munich) by the GmbH requesting the assessment of corporate income tax without application of the earnings stripping rules remained unsuccessful.

However, the BFH does regard the earnings stripping rules as unconstitutional in the case at issue. The main explanation provided by the BFH for its decision is that the limitation of the deduction of interest as business expenses pursuant to the earnings stripping rules disregards the objective net principle, because then it is no longer the net income (balance of revenues and expenses) that is the basis of taxation. The taxation of net income cannot be guaranteed either by allowing for an interest carryforward, i.e. the possible utilization of non-deductible interest expenses in subsequent assessment periods. Moreover, the interest carryforward may be forfeited, like in the case at hand.

The limitation of the deduction of interest as business expenses is not justified, neither as a means to strengthen equity nor for the aim of counteracting tax base erosion or preventing abuse. The same applies to the intention of avoiding unpredictable tax losses. The German tax base suffers erosion in particularly when deductible interest expenses arising in the context of group financing activities are incurred in Germany while the corresponding interest income is recognized in a low-tax country.

It remains to be seen how the BVerfG will decide.

Draft Bill on the Fiscal Promotion of the Construction of new Rental Apartments

On 3rd February 2016, the German Federal Government published a draft bill on the fiscal promotion of the construction of new rental apartments. The draft bill provides for the introduction of a time-limited, special depreciation for the acquisition or construction of new residential rental buildings in areas with a tight housing market. The tax incentive shall be introduced with the objective of quickly creating new rental apartments in the low or mid price range in designated incentivized areas. The most important contents of the draft bill are as follows:

Tax-privileged investments

Tax-privileged investments shall be acquisition/construction of new buildings or condominiums, provided that the buildings are leased for residential purposes for a period of at least ten years after acquisition/construction. The tax incentive shall be restricted to newly constructed buildings whose tax-deductible acquisition or construction costs do not exceed 3,000 EUR per square meter living space (construction cost cap).

Special depreciation allowance

In the year of acquisition/construction as well as in the following year the special depreciation allowance shall be up to 10% and in the following third year up to 9% of the acquisition or construction costs (max. 2,000 EUR per square meter living space) in addition to the "regular" tax depreciation allowance.

Area of development

The tax privilege shall not apply nationwide, but only to residential apartments in areas with a "tight residential housing market" (so-called incentivized areas) which shall be defined by law. The relevant point in time to qualify as incentivized area shall be the application for the building permit or the building notification (so-called start of the investment).

Limitation of time

The tax incentive shall be limited to construction measures that are initiated in years 2016 to 2018. In order to claim the special depreciation allowance, the building application or the building notification shall be relevant. The special depreciation allowance shall be admissible for the last time in the assessment period 2022.

Outlook

The enactment of the government draft is an early stage of the legislative process. Now, the Bundesrat (upper house of the German parliament) is given an opportunity to comment on the draft bill.

The tax incentive is conditional on the European Commission's approval under state aid rules. Therefore, the law will not be enacted before approval has been given.

General Administrative Guidance on the Application of Corporate Income Tax Law (Corporate Income Tax Guidelines 2015)

In 2015, the Federal Ministry of Finance (BMF) published a Draft General Administrative Guidance on a Revised Version of the Corporate Income Tax Guidelines (KStR 2015) (GTM July 2015, p.1). In February 2016, the Federal Government adopted the KStR 2015 and referred them to the Bundesrat (Upper House of the German Parliament) for its consent.

The main modifications to the BMF draft are as follows, among others:

Third country merger

According to the Federal Government, the provision stipulating that a continuation to carry shares at book value is only possible where the transferor is subject to limited tax liability in Germany is to be deleted entirely.

Tax Group

The scope of the provision on the dissolving of adjustment items for tax groups is extended (R 14.8 KStR 2015-E):

- When a shareholding in a controlled company is sold, the adjustment item has to be netted with the book value of the shareholding. This is particularly relevant for the application of tax-exemptions regarding the disposal of shareholdings. The provision on netting is now intended to be applied when determining the gain or loss on acquisition within the meaning of the Reorganization Tax Law (UmwStG). In general, reorganizations are treated as exchange-like transactions for tax purposes. Their tax consequences are basically similar to a disposal.
- Furthermore, in the case of indirect shareholdings in the controlled company, adjustment items are to be dissolved when the controlling enterprise sells its shareholding in the intermediary company.

If the guidelines do not provide for anything to the contrary, the new KStR 2015 are intended to be applicable starting from the assessment period 2015.

BFH Ruling (I R 88/13) on Transfer of Beneficial Ownership in Cases of Securities Lending

The Federal Tax Court (BFH) had to decide whether in cases of securities lending the beneficial ownership of the securities lent passes to the borrower or remains with the lender. Usually, the objective of securities lending is to achieve a tax exemption of dividends [§ 8b (1) Corporate Income Tax Law (KStG)]. For this purpose, companies for whom dividends are generally not tax-exempt (in particular banks) used to lend shares to other companies for whom the dividends received were tax-exempt. In return, the borrower paid a tax-deductible compensation payment plus lending fee to the lender. The beneficial ownership of the shares was therefore essential in answering the question whether the borrower could receive the dividends tax-exempt.

Pursuant to the ruling of the BFH (I R 88/13) the beneficial ownership exceptionally remains with the lender where merely a formal legal position is created for the borrower which allows him to formally receive tax-exempt dividend payments and simultaneously generate tax-deductible business expenses (compensation payments and lending fees), in order to enjoy tax advantages.

In the case at issue, an industrial enterprise borrowed securities from its bank in 2007, each time for a period of 14 days including the dividend record date. Due to the short holding period the borrower was not able to exercise his voting rights. The industrial enterprise paid a lending fee to the bank and made a compensation payment at the same time and in the same amount as the dividends. Hence, the borrower did not enjoy a liquidity advantage. In addition, the opportunities and risks did not finally pass to the borrower since the cancellation period was only three banking days. In view of the overall picture the BFH decided that the beneficial ownership of the shares was not transferred to the borrower and that as a consequence the dividends were not tax-exempt at the level of the bank.

While pursuant to the ruling the beneficial ownership of the lent securities "exceptionally" remains with the lender, the criteria cited by the BFH at least partially apply to numerous securities lending transactions.

Please note that a statutory provision has existed starting from the assessment period 2007, according to which expenses (in particular compensation payments and lending fees) associated with securities lending transactions are no longer tax-deductible (§ 8b (10) KStG). The provision is intended to avoid tax structuring with the help of such transactions. The BFH did not have to decide whether it was constitutional to apply the provision retroactively (starting from the assessment period 2007), because the court had already denied that the beneficial ownership of the securities had passed to the borrower.

Current Developments regarding Legislation and Double Tax Treaties

Double Tax Treaties (DTT)

In the following, we would like to give an overview of the most recent developments regarding the German DTTs:

1. DTTs that have entered into force

Philippines: The new DTT Philippines dated 09 September 2013 entered into force on 18 December 2015 and has been applicable since 1 January 2016. See November 2013 edition of German Tax Monthly for the content of the new DTT.

France: The additional agreement to the DTT France, which has been signed on 31 March 2015, entered into force on 24 December 2015 and has been applicable since 1 January 2016. See May 2015 edition of German Tax Monthly for content of the additional agreement.

United Kingdom: The amending protocol to the DTT UK, which has been signed on 17 March 2014, entered into force on 29 December 2015 and has been applicable since 1 January 2016. See December 2015 edition of German Tax Monthly for content of the amending protocol.

Ireland: The amending protocol to the DTT UK, which has been signed on 03 December 2014, entered into force on 30 December 2015 and has been applicable since 1 January 2016. See December 2015 edition of German Tax Monthly for content of the amending protocol.

2. DTTs which have been signed and transposed into German law but will only enter into force upon exchange of the instruments of ratification

China: The new DTT China was published in the Federal Law Gazette on 29 December 2015. However, the instruments of ratification have not been exchanged yet. See May 2014 edition of German Tax Monthly for content of the new DTT China.

3. DTTs that were signed but not yet transposed into German law

Netherlands: On 11 January 2016 the amending protocol to the DTT Netherlands was signed. The amendments relate to the definition of property companies and the definition of gains and the right of taxation regarding seagoing vessels and aircrafts. Furthermore the purpose of the DTT is extended to the prevention of tax avoidance.

There haven't been any changes since the last communications in December 2015 edition of German Tax Monthly regarding the DTTs with Japan, Costa Rica, Israel, Jersey, Uzbekistan and Oman.

Legislation

The Law on the Automatic Exchange of Information on Financial Accounts in Tax Matters and on Amendments of Further Laws was promulgated in the Federal Law Gazette on 30 December 2015. This law will serve to transpose the Multilateral Agreement on the Automatic Exchange of Information on Financial Accounts, signed by Germany and 50 further countries on 29 October 2014, into national law. Up to now more than 60 states signed the Multilateral Agreement and undertake to exchange information. The Law on the Automatic Exchange of Information on Financial Accounts in Tax Matters (FKAustG) is a new Principal Act centrally governing the reportable data, the duties of the financial institutions, the competent authorities, and the sanctions to be imposed where the mandatory reporting requirements are not met. Information has to be reported for the first time from the financial institutions to the Federal Central Tax Office (Bundeszentralamt für Steuern - BZSt) for the assessment period 2016 by 31 July 2017 at the latest.

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