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Federal Constitutional Court (1 BvL 8/12): Referral by the Hamburg Lower Tax Court for Constitutional Review of Trade Tax Add-Back Rules Inadmissible

The Federal Constitutional Court (BVerfG) decided in a ruling of 15 February 2016 that the request of the Lower Tax Court of Hamburg of 29 February 2012 (1 K 138/10) for constitutional review of the trade tax add-back rules is inadmissible.

Any commercial business activity located and operated in Germany is principally subject to German trade tax. Trade tax is assessed based on trade income. Trade income is the profit from commercial business activity established pursuant to income tax law or corporate tax law, modified pursuant to trade tax law (GewStG) by certain add-backs and deductions. Such add-backs include, in particular, partial amounts of debt remunerations (e.g. loan interest) as well as rent and lease payments for movable or immovable fixed assets (§ 8 no. 1 lit. (a), (d) and (e) GewStG).

In the case at issue, a German limited liability company (GmbH) operated several filling stations. In 2008, the GmbH incurred expenses for debts as well as for rents and leases of which it added back partial amounts to its profits pursuant to the add-back rules of the GewStG. However, according to the opinion of the GmbH such add-backs are incompatible with the German Constitution and following an unsuccessful administrative appeal the GmbH filed a judicial appeal with the Lower Tax Court of Hamburg. The Lower Tax Court of Hamburg is convinced that the add-back rules of § 8 no. 1 lit. (a), (d) and (e) GewStG are unconstitutional.

The Lower Tax Court explained its legal opinion by arguing that the add-back rules result in an increased tax burden for and therefore unequal treatment of certain taxpayers. The Lower Tax Court compared taxpayers who, in the course of their commercial business activities, incurred expenses for debts and/or rents and leases with taxpayers who did not incur such expenses. In the opinion of the Court there are no sufficient reasons of general public interest to justify an exception from the principle of taxation equality in these cases.

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Therefore, the Lower Tax Court of Hamburg suspended the judicial appeal proceedings on 29 February 2012 and referred a request for a preliminary ruling to the BVerfG on the question as to whether the rules regarding partial add-backs of expenses for debts and/or rents and leases are in breach of the general principle of equality enshrined in the Constitution.

The BVerfG rejected the request as inadmissible. According to the BVerfG the reasoning given by the Lower Tax Court of Hamburg for the request for a preliminary ruling was insufficient. The BVerfG criticized, first of all, that the request lacked a sufficient review of the case law of the BVerfG on the constitutional legitimization of trade tax. Moreover, the BVerfG complained that the Lower Tax Court of Hamburg had not sufficiently dealt with the case law of other Tax Courts on the constitutionality of trade tax and in particular the add-back rules. Finally, the BVerfG reproved that the Lower Tax Court's review of the constitutionality of the trade tax add-back rules did not take account of the considerations of the BVerfG on the extent of tax law discretion of the legislator.

With respect to the constitutionality of the trade tax add-back rules, further proceedings are pending with the Federal Tax Court (BFH) (e.g. under ref. no. IV R 55/11 [re. lit. (e)], I R 41/15 [re. lit. (d), (e) and (f)]). Invoking these pending BFH proceedings, the suspension of the administrative appeal proceedings may be achieved (or maintained).

Regional Tax Office Karlsruhe: Treatment of Dividend Payments within Tax Groups

In its ruling of 17 December 2014 (I R 39/14), the Federal Tax Court (BFH) decided that intercompany dividend payments received by a controlled company from a foreign company are, for trade tax purposes, not subject to the 5-percent charge pursuant to German Corporate Income Tax (deemed non-deductible business expenses in the amount of 5% of the dividend payment) (see April 2015 edition of German Tax Monthly, p. 3).

The ruling has meanwhile been promulgated in the Federal Tax Gazette and must therefore be applied by the tax authorities. This was recently confirmed by the Regional Tax Office (OFD) Karlsruhe in its administrative guideline dated 17 February 2016.

In addition, the administrative guideline of the OFD Karlsruhe comments on expenses of controlled companies which are directly related to the dividend income. Consequently, when determining the trade income of the controlled company in these cases not the full dividend amount has to be deduced, but rather the deduction is reduced in the amount of the expenses. Where the controlled company receives a dividend amount of e.g. 100 k€ and bears expenses in the amount of 40 k€ the reducible amount is only 60 k€ (100 k€-40 k€). Therefore, the trade income of the controlled company attributed to the controlling company still contains the dividend on a pro-rata basis (in the example above: 100 k€-60 k€ = 40 k€). Consequently, the dividend taxation of the Corporate Income Tax Law (§ 8b KStG) can be applied to the pro-rated dividend amount.

The result is a general add-back of non-deductible business expenses in the amount of 5% of the pro-rated dividend amount when applying the OFD's administrative guideline (§ 8b KStG). In turn, the full amount of the actual expenses has to be deductible without being subject to a trade tax add-back pursuant to § 8 (1) Trade Tax Law (GewStG).

Please note that the administrative guideline of the OFD Karlsruhe was only agreed at the level of the Federal State of Baden-Württemberg. It is therefore not binding for tax authorities in other Federal States.

Draft Administrative Principles for the Attribution of Profits to Permanent Establishments

On 18 March 2016, the Federal Ministry of Finance (BMF) published the draft of the BMF guidance on the attribution of profits to permanent establishments (Administrative Principles Attribution of Profits to Permanent Establishments – VWG BsGa). In 152 pages, the draft regulates the principles of the tax administration with regard to the attribution of profits pursuant to § 1 (5) Foreign Transactions Tax Law (AStG) and the Decree on the Attribution of Profits to Permanent Establishments (BsGaV).

On the basis of the authorization pursuant to § 1 (6) AStG, the BMF has already substantiated the regulations of § 1 (5) AStG through the Decree on the Attribution of Profits to Permanent Establishments. It can be stated very briefly that the draft BMF guidance is a consistent continuation of the direction set by the BsGaV.

The draft guidance provides the tax authorities' view on various topics relating to the cross-border

allocation of profits between a permanent establishment and the rest of the enterprise. In the general part, the guidance deals, in particular, with the relationship of § 1 (5) AStG to other domestic provisions and the tax treaty regulations. The subsequent, more specific part of the guidance deals, in particular, with the definition of the relevant personnel function as well as the attribution of real property, shareholdings, dotation capital and so-called up-front costs. The draft guidance also includes statements with regard to opportunities and risks of the auxiliary and ancillary tax account and its design in cases of building and construction permanent establishments, the "zero sum theory" in cases of representative permanent establishments and the transfer of economic goods and the provision of services between permanent establishments. Furthermore, the draft guidance deals with the question of how the taxpayer can prevent or spread one-time taxation over time.

The BMF has initiated a hearing of associations. The associations are given an opportunity to comment by 13 May 2016. Publication of the VWG BsGa is planned for the second half of 2016.

Non-Application Decree for BFH Case Law on Overriding Effect of Art. 9 OECD MTC over § 1 AStG

In its decisions of 17 December 2014 (I R 23/13) and of 24 June 2015 (I R 29/14) the Federal Tax Court (BFH) dealt with the tax treatment of a write-down of an intra-group loan receivable and ruled that the tax treaty principle of "dealing at arm's length" according to Art. 9 (1) OECD Model Tax Convention (MTC) has an overriding effect over the income adjustments arising from German provisions [§ 1 Foreign Transactions Tax law (AStG) see April 2015 and October 2015 edition of GTM].

According to the BFH rulings the tax treaty principle of "dealing at arm's length" does not allow for an income adjustment pursuant to domestic rules of the contracting states unless the price agreed between associated enterprises (which, in the cases at issue, is the interest of the loan) is inappropriate as to the amount and therefore incompatible with the "dealing at 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.

Moreover, in its ruling of 24 June 2015 the BFH pointed out that an existing group support did not allow for the conclusion that the loan will be repaid by the subsidiary. Therefore, group support does generally not influence the write-down to the lower going-concern value of an intra-group loan receivable.

In a guidance dated 30 March 2016 the tax authorities responded to these rulings with a non-application decree. According to that decree, the principles of the BFH rulings are not to be applied to cases other than the specific cases decided by the court insofar as the BFH assumed an overriding effect of the Double Tax Treaty (DTT) rules over § 1 AStG. The reasoning of the Federal Ministry of Finance (BMF) is mainly based on the wording of the Law and of the DTT, the will of the parties to the DTT, the historical interpretation as well as the purpose and intent of both Art. 9 (1) of the OECD MTC and § 1 AStG.

Regarding the argumentation of the BFH on a write-down to the lower going-concern value on the intra-group loan receivable despite group support, the BMF points out that its guidance dated 29 March 2011 (application of § 1 AStG to cases of write-downs to the lower going-concern value and other impairments of loans to foreign related companies) continues to apply unchanged. According to the BMF a write-down to the lower going-concern value is principally not admissible, because the loan receivable is recoverable in the case of group support.

It cannot be ruled out that the opinion of the tax authorities will by laid down by law. However, since the non-application decree is not binding for the courts, taxpayers may continue to invoke the BFH case law until the law amendment is promulgated.

BFH (I R 13/14): Currency Losses in the Context of the Liquidation of a Lower-Tier Foreign Partnership

In a ruling of 2 December 2015, the Federal Tax Court (BFH) decided that currency losses resulting from the liquidation of a foreign lower-tier partnership may not reduce the trade income of the German upper-tier partnership taxable in Germany.

In the case at issue, a German upper-tier partnership held a 25% interest in a US lower-tier partnership (two-tier partnership). The US partnership was liquidated. The dispute was over the treatment for trade tax purposes of currency losses resulting from changes in the exchange rate between the point in time when the capital contributions were made and the date of the discontinuation of the lower-tier partnership.

For purposes of establishing trade income, each partnership that belongs to a two-tier structure (be it an upper or lower-tier partnership) and operates a business activity is subject to trade tax. Shares in the loss or profit of a (domestic or foreign) lower-tier partnership therefore have to be added to the domestic profit from commercial business activity of the upper-tier partnership, or the profit from commercial business activity has to be reduced correspondingly. The currency loss is attributable to the lower-tier partnership. These rules do not only apply to current dividend income but also to currency losses incurred in the context of a business discontinuation.

The BFH also does not see an obligation under EU law to deduct the currency losses attributable to the lower-tier partnership when establishing the domestic trade income of the upper-tier partnership. According to the trade tax system, the profit from commercial business activity is to be adjusted symmetrically for both profits and losses derived from investments in the domestic or foreign partnership.

In general, there seems to be a tendency in the context of the interpretation of EU law regarding so-called "final losses" to make the recognition of losses conditional on whether a domestic right to tax the foreign income exists at all. Where this is not the case, such as where an exemption applies under a Double Tax Treaty (DTT) for income derived from foreign permanent establishments in the state where the head office is located, the principle of symmetry seems to result in a comprehensive limitation of the loss deduction (please refer to prevailing CJEU case law in the "Timac Agro" case, among others; see GTM January/February 2016).

Lower Tax Court of Münster (9 K 1900/12 K): Repayment of Contributions by Third Country Subsidiaries

In its judgment of 19 November 2015 (9 K 1900/12 K) the Lower Tax Court of Münster ruled that payments made by a subsidiary residing in a third country may qualify as repayments of contributions.

Payments by a subsidiary may be qualified as taxable dividends or tax-exempt repayments of contributions or repayments of share capital. Pursuant to § 27 Corporate Income Tax Law (KStG) domestic companies are obliged to carry a so-called tax-specific capital contribution account and to calculate the distributable profit annually. Where a company makes payments to its shareholders, first the distributable profit is deemed appropriated. The payment will not be qualified as repayment of a contribution until the distributable profit is used completely (so-called appropriation sequence). Starting from the assessment period 2006 onward, § 27 (8) KStG has expressly stipulated that EU companies may also make repayments of contributions and has specified how supporting evidence has to be documented. The question at issue is whether § 27 (8) KStG also has an effect on payments made by third country companies.

In the case at hand, the Lower Tax Court of Münster ruled that the payment was a repayment of a contribution. However, it did not have to decide whether the appropriation sequence also had to be observed regarding third country companies, because in the case at hand there was demonstrably no distributable profit. The Lower Tax Court of Münster also underlined that from the express rule for EU companies in § 27 (8) KStG alone one cannot conclude that payments made by a third country company are always taxable. This would constitute a breach of the free movement of capital.

The Lower Tax Court of Nuremberg had already previously decided in its ruling of 12 June 2013 (5 K 1552/11) that the principles of the case law of the Federal Tax Court (BFH) continue to be applicable. According to the BFH the foreign Commercial Law or Company Law has to be taken into account. Where the country in which the subsidiary resides qualifies the payment as repayment of a contribution, the payment is also tax-exempt for the domestic parent company. Appeal has been filed against this decision and is now pending decision by the BFH (VIII R 47/13).

In a recent BMF (Federal Minstry of Finance) guidance the BMF expressed its view on the scope of application of § 27 (8) KStG (BMF guidance dated 4 April 2016, IV C 2 - S-2836 / 08 / 10002). It specifies that where EU/EEA companies are concerned the scope of application goes beyond the wording of the rule and also covers repayments of share capital. However, the BMF did not voice an opinion regarding the extent to which the rule may also have an impact on the treatment of third country companies.

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