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Regional Tax Office North Rhine-Westphalia: Treatment of Profit Participation Certificates under Corporate Income Tax Law

In an administrative guideline issued on 12 May 2016 the Regional Tax Office North Rhine-Westphalia (OFD-NRW) voiced its opinion on the treatment of profit participation certificates for corporate income tax purposes.

Profit participation certificates are contractual agreements under the law of obligations. The issuers warrant to the holders of profit participation certificates certain pecuniary rights, e.g. a participation in the profit, in return for the provision of capital. Profit participation certificate arrangements may vary widely from case to case, so that the question as to whether the profit participation certificate presents equity capital or debt capital at the level of the issuer has to be assessed on a case-by-case basis. From a tax law perspective this ties in with the question whether distributions on the profit participation certificates qualify as deductible interest expenses (in case of debt capital) or as an appropriation of income irrelevant for tax purposes (in case of equity capital).

The Corporate Income Tax Law (KStG) contains a provision in § 8 (3) stipulating that any kind of distribution on profit participation certificates associated with the right to share in the profit and the liquidation proceeds must not reduce the income of the distributing corporation. Partly, this provision was considered to be an independent definition under tax law which allows a qualification of profit participation certificates as equity capital or debt capital deviating from commercial law. The different qualifications were e.g. applied in cases of so-called debt-equity swaps used in the context of restructurings to convert existing debt capital into profit participation certificates. The profit participation certificates were structured such as to qualify as equity capital under commercial law, in order to avoid over-indebtedness in the balance sheet, while they continued to qualify as debt capital for tax purposes, in order to avoid an increase of the profit due to the elimination of the liability.

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However, the OFD-NRW does not share this understanding of an independent tax law assessment. On the contrary, it assumes that according to the so-called principle of linkage (Maßgeblichkeits-prinzip), the qualification under commercial law also has to be applied to the balance sheet treatment for tax purposes. Hence, if profit participation certificates are qualified as equity under commercial law they necessarily also have to be qualified as equity in the tax balance sheet and any distribution on the profit participation certificates is considered to be an appropriation of income. Only where debt capital is assumed under commercial law and the distributions on the profit participation certificates reduce profit it will be necessary to verify whether the non-deductibility provision pursuant to § 8 (3) KStG applies.

The administrative guideline of the OFD-NRW has been concerted with the Federal Ministry of Finance and the Ministries of Finance of the Federal States. So far, neither the Lower Tax Courts nor the Federal Tax Court (BFH) have had the possibility to decide on the controversial issue whether to qualify profit participation certificates as equity or as debt capital for tax purposes. Please note that if court proceedings are initiated in the future to decide on this question, the courts are not bound by the OFD's interpretation.

Federal Tax Court (I R 81/14, I R 66/14): Fee for Binding Ruling Charged Twice from Tax Group for Income Tax Purposes where Two Requests are Filed

In decisions with identical contents (I R 81/14, I R 66/14) the Federal Tax Court (BFH) ruled on 9 March 2016 that where binding ruling requests regarding the same matter are filed by both the controlling company and the controlled company this will trigger binding ruling fees for both requesting parties.

According to German Tax Law, local tax offices may, upon request, issue binding rulings on precisely defined but as yet unrealized matters, if a particular interest in the clarification of such matters exists on the part of the requester because of substantial tax effects. A fee is levied for processing such a request which is principally based on the value that the binding ruling will have for the requester (case value).

In the case at issue, a tax group for corporate income tax purposes exists between two corporations resident in Germany. In a letter dated 20 March 2009, the authorised representatives of the corporations filed requests for binding rulings with identical contents in the names and on behalf of both corporations. The tax office issued two separate notices with request processing fees to the two corporations.

The complaint lodged with the BFH against this was not successful. In the opinion of the BFH, the legal obligation to pay the fee is associated with the processing of a request for a binding ruling. Consequently, the requester owes the fee. The requester is deemed to be the individual or entity in whose name the request is filed. The BFH holds that in the case at issue the requests for a binding ruling were explicitly filed in the names and on behalf of both of the corporations. In addition, the special tax interest in the binding ruling had been presented for each of the two corporations. Regarding the legal obligation to pay the fee it does not matter whether multiple requesters have requested an answer to the same legal question.

The BFH not only denied the validity of the basic constitutional objections against the fee being charged twice, but also denied the objection of the plaintiff that only one request for a binding ruling is filed where the legal assessment of the matter only relates to one taxpayer. The BFH explained that the companies that form the tax group are independent, separate taxable entities.

In addition, the BFH rejected the possibility of recourse to the principles of the advance pricing agreement procedure invoked by the plaintiff which excludes a multiplication of fees in tax group cases. The BFH reasoned that both rules were introduced in 2007 and that one therefore has to assume that the legislator intentionally decided to introduce two different fee rules.

The BFH also held that the amount of the fees that were charged is lawful. The fee for the binding ruling was rightly based on the case value. In the case at hand of the tax group, it relates to the tax amount resulting from the add-back of the income of the controlled company to the controlling company. The BFH did not follow the objection of the plaintiff who argued that in the case at issue the principles of a joinder of parties are applicable by analogy. According to these principles, the case values are not added up for a joinder of parties, if and to the extent that the prayers for relief sought are "economically identical". However, the procedure for the issuance of a binding ruling does not allow for the possibility of combining different requests. A binding ruling does not relate to a "total case value" to be determined uniformly, but to the individual case values of the requesters.

Finally, the BFH also dissents with the plaintiff's opinion that filing the request twice does not lead to a duplication of tax advantages, because the income is alternatively either recognized at the level of the controlling entity for tax purposes or at the level of the controlled entity. The alternative recognition for tax purposes based on a uniform and binding assessment of the same matter is the specific intention where the companies forming the tax group file the request twice.

The law on the modernization of the taxation procedure passed by the Bundestag (lower house of the German Parliament) and the Bundesrat (upper house of the German Parliament) is intended to create the possibility that, in the future, identical binding rulings may be uniformly issued to several requesters. The new provisions allow for the fact that in such cases the fee may only be charged once. According to the explanatory memorandum to the law, the issuance of identical binding rulings should in particular be intended to apply to tax group cases.

Federal Tax Court (I R 61/14): Business Expenses and Declines in Value of Business Assets in Direct Economic Connection to Foreign Income of a Domestic Business

In a decision issued on 6 April 2016, the Federal Tax Court (BFH) ruled on the extent to which business expenses and declines in value of business assets that are directly connected to foreign income of a domestic business may be deducted when determining profit. Where the credit method is applied for purposes of avoiding double taxation in cross-border cases, the deduction of business expenses and declines in value of business assets reduce the maximum creditable amount to the extent that they are attributable to foreign income, thus also reducing the amount of foreign tax credited against the German tax burden.

The economic connection is determined based on the principle of causation. The business expenses and declines in values of business assets are attributed to domestic and foreign income based on the principle of causation. A necessity for business reasons or an exclusive connection to the income are not required.

Where a causality of the expenses exists both with domestic and foreign income, the expenses must be divided up or attributed to the income to which they are predominantly connected. According to the BFH, these principles of attribution are compatible with the German Constitution and with EU Law.

In the case at hand, a mutual insurance company (VVaG) filed appeal against the decision of the Lower Tax of Münster (17 September 2014, 10 K 1310/12 K). The plaintiff requested the reduction of its domestic tax burden arguing that the transfer to actuarial reserves cannot be attributed to foreign income. The BFH ruled that the obligation to create actuarial reserves under the German Commercial Code (HGB) must be attributed to the domestic insurance business and that a reduction of the maximum creditable amount based on an allocation to these reserves is out of the question. In the opinion of the BFH, the business expenses mentioned above are not attributable to the foreign but to the domestic income.

Lower Tax Court of Lower Saxony (6 K 386/13): Recognition of a Profit and Loss Absorption Agreement for Tax Purposes

One prerequisite for forming a tax group is the conclusion and proper execution of a profit and loss absorption agreement under which the controlled company transfers its entire profit to the controlling company (§ 14 (1) Corporate Income Tax Law (KStG)). The profit and loss absorption agreement must be concluded for a term of at least five years and must be executed properly throughout the entire term.

In a decision of the Lower Tax Court of Lower Saxony issued on 11 November 2015 it was disputed whether a profit and loss absorption agreement concluded in 2004 was to be recognized for tax purposes. The proper execution of the agreement was in question because of the specific wording of the provisions on loss absorption (§ 302 Stock Corporation Act (AktG)) and the provisions governing the compensation payment arrangements for outside shareholders (§ 304 AktG).

In the specific case at hand the profit and loss absorption agreement provided for a combination of a fixed compensation plus an additional variable component of the compensation payment to the outside shareholders. The amount of the variable component was assessed based on the net income of the controlled company before profit transfer to the controlling company.

In the opinion of the Lower Tax Court of Lower Saxony the agreement thus conforms to the stipulations of § 304 AktG for commercial law purposes. However, it is in breach of the requirement for tax purposes to transfer the entire profit to the controlling company if the variable component is assessed based on the profit of the controlled company and not based on the profit of the controlling company. In this case the outside shareholders receive a share in the profit of the controlled company rather than a compensation payment. As a consequence, the profit and loss absorption agreement was not properly executed, because not the entire profit was transferred to the controlling company.

In this case it was not the absolute amount of the variable component that was detrimental to the recognition of the agreement for tax purposes but the fact that the variable component was linked to the profit of the controlled company.

The recognition for tax purposes of the profit and loss absorption agreement also failed due to the wording of the provisions on loss absorption. The provision set out in § 302 AktG, to which the agreement referred, had changed during the term of the profit and loss absorption agreement. However, the profit and loss absorption agreement was not amended in line with the revision of the law.

The profit and loss absorption agreement would have had to be amended at the latest by 31 December 2014 by including either an explicit reference to the newly introduced paragraph (4) of § 302 AktG or by including a dynamic reference. Without these amendments, the contractual provisions are in contradiction with the legal situation and thus the profit and loss absorption agreement cannot be recognized for tax purposes.

Appeal has been filed against the decision (Federal Tax Court (BFH) I R 93/15).

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