German Tax Monthly

Information on the latest tax developments in Germany

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Lower Tax Court of Rhineland-Palatinate (1 K 1472/13): Referral to the CJEU regarding the compatibility of German transfer pricing rules with European law

On June 28, 2016, the Lower Tax Court of Rhineland-Palatinate referred a case to the Court of Justice of the European Union (CJEU) regarding German transfer pricing rules.

German transfer pricing rules mandate an adjustment to the taxable base of a German resident taxpayer, based on arm's length principles, if that taxpayer's base has been reduced as a result of a transaction / business relationship with a non-German related party on terms that would not have been agreed between independent parties in similar circumstances. For transactions between German entities such an adjustment is not required.

In the case at issue, a German parent company had given guarantees and letters of comfort to banks, in relation to loans to its foreign subsidiaries, without requiring any payment. Independent parties would not have concluded such an agreement without payment. Consequently, the income of the German corporation was based on arm's length principles.

The Lower Tax Court of Rhineland-Palatinate has doubts whether the imputation of income under the German transfer pricing rules in relation to these transactions is compatible with the freedom of establishment under EU law (Article 49 of the Treaty on the Functioning of the European Union (TFEU)). In a previous similar case (C-311/08) decided by the CJEU, involving Belgian transfer pricing rules with similar adjustment provisions, it was held that the applicable rules did amount to a restriction on the right to freedom of establishment. According to the CJEU this were justified on the grounds of preserving the allocation of taxing rights between Member States and combating tax avoidance. The CJEU also held that the Belgian rules were proportional since they allowed taxpayers the opportunity to provide evidence of any commercial justification for the arrangements.

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In this context the Lower Tax Court Rhineland-Palatinate pointed out that the German rules do not have an explicit mechanism for taxpayers to provide any exception based on commercial justifications to prevent the transfer pricing adjustment.

Therefore, the case is referred to the CJEU to clarify whether the transfer pricing legislation constitutes a restriction on the freedom of establishment, given the different treatment for cross-border arrangements to wholly domestic situations.

Federal Tax Court (I R 33/14): Impact of Negative Goodwill on the Recognition of Assets in the Case of a Contribution of a Branch of Activity to a Corporation

In a decision of 28 April 2016, the Federal Tax Court (BFH) ruled on the balance sheet recognition of business assets in the case of contributions involving negative goodwill. The measurement of the contributed assets must be based on the group of assets in its entirety and not on the individual component assets. Therefore, a step-up of the book values of the contributed assets to reflect their component values is not permitted where - due to negative goodwill - the value of the contributed group of assets (economic unit) is lower than the sum of the individual values of its components.

Similar to business combinations or acquisitions of branches of activities for consideration, the historical cost accounting principle applies to balance sheet recognition according to which acquistions have to be recognized tax neutral. Thus, negative goodwill must be accounted for by a pro-rata reduction of the values of the individual assets.

It was explicitly left open by the BFH whether a step-down of the contributed business assets below their book values due to negative goodwill could be required in individual cases.

The decision referred to cases dating back to the years 2001 and 2002. However, due to the wording of the law governing measurement and recognition of contributions as applicable at present, the decision continues to be relevant.

Lower Tax Court of Cologne (10 K 1128/15): Existence of Portfolio Dividends

Generally, 95% of the dividends that a corporation receives from another corporation are ultimately tax-exempt pursuant to § 8b Corporate Income Tax Law (KStG). However, this does not apply where the shareholding in the distributing corporation amounts to less than 10% at the beginning of the calendar year in which the dividend is received (so-called portfolio dividends). Whether this applies or not is generally determined strictly based on the effective date principle. In its decision of 9 June 2016, the Lower Tax Court of Cologne ruled that a judgment of the percentage of shareholding may exclusively be based on the actual conditions according to civil law at the registration date. The mere eligibility of a third party at the beginning of the calendar year to acquire shares to the extent that the shareholding of the taxpayer will fall below the 10% threshold ought therefore not to be taken into account when calculating the percentage of the shareholding.

In the case at hand, the plaintiff held 34% in A-GmbH in 2012. The other shareholder was P-GmbH. In December 2012, a capital increase for A-GmbH was decided, in which only P-GmbH was to participate by contributing a branch of activity. The contribution was made with effect of 31 December 2012. The capital increase was entered in the company register on 2 January 2013. Following the capital increase, the plaintiff only held 0.12% in A-GmbH. In July 2013, A-GmbH distributed a dividend to the plaintiff.

The question at issue was whether at the beginning of the calendar year the plaintiff still held more than 10% in A-GmbH and whether the dividend was therefore 95% tax-exempt. According to the Lower Tax Court of Cologne, exclusively the civil-law conditions on the registration date are relevant for the calculation of the percentage of shareholding, and therefore the 95% tax-exemption had to be granted. The reason is that the capital increase and the reduction of the percentage of shareholding of the plaintiff associated with it did not become effective under civil law until its entry in the company register.

The court reasoned that in particular no other conclusion can be derived from the provisions of the Reorganization Tax Law (UmwStG) on the tax retroactivity of the contribution process. The prerequisites for a tax-exemption of the dividend have to be met at the level of the plaintiff and not at the level of the distributing company. Since the plaintiff did not share in the contribution process the UmwStG did not apply to the plaintiff. The reduction of the percentage of shareholding was merely a reflex effect to the contribution process of P-GmbH. In addition, the retroactivity only applies to the calculation of the income and the assets of the contributing party and the receiving company, but not to the calculation of the share capital. In the opinion of the

Lower Tax Court of Cologne, the contribution of the branch of activity and the capital increase are two different transactions that have to be assessed separately, whereby the retroactive effect pursuant to the UmwStG is only applicable to the contribution process. The calculation of the percentage of shareholding of the shareholders in the share capital, in contrast, is not covered by the retroactivity fiction.

In contrast to the opinion of the local tax office it is also irrelevant that the plaintiff was able to anticipate the reduction of the percentage of shareholding at the beginning of the calendar year, since only the actual conditions on the registration date are decisive. Furthermore, focusing on the conditions under civil law does not lead to a risk of abuse.

Lower Tax Court of Schleswig-Holstein (1 K 20/13): Currency and Interest Losses in the Context of a Tax-Exempt Gain on Sale

The Lower Tax Court of Schleswig-Holstein ruled on 25 May 2016 (1 K 20/13) that currency and interest losses resulting from the sale of an interest-bearing purchase price claim from a tax-exempt sale of shares on which a deferral as well as payment in a foreign currency had been agreed, may have to be qualified as subsequent change in the gain on sale within the meaning of § 8b (2) Corporate Income Tax Law (KStG).

According to the provision on which the Lower Tax Court of Schleswig-Holstein bases its decision, § 8b (2) KStG, gains resulting in particular from the sale of shares in corporations are tax-exempt. Correspondingly, disposal losses as well as profit reductions resulting from share transactions are not deductible (§ 8b (3) KStG).

In the case at issue the plaintiff, a domestic limited liability company (GmbH), disposed of its shares in foreign corporations. A long-term deferral and interest payment on the purchase price claim was agreed. In the following years, the GmbH sold the purchase price claim in several individual steps. The GmbH expensed the currency and interest losses incurred in this context with tax effect in the respective years. However, in the opinion of the local tax office the losses mentioned above are not deductible under § 8b (2) and (3) KStG.

The Lower Tax Court of Schleswig-Holstein denies the deductibility of the currency and interest losses as current expenses. According to the Lower Tax Court, the currency and interest losses must be qualified as retroactive reduction of the tax-exempt gain on sale in the year of the sale. The explanation of the Lower Tax Court was that in the case at hand the currency and interest fluctuation risks are based on and rooted in the provisions of the purchase agreement on the tax-exempt sale of the shares. The possibility of impairments is therefore already contained in the very purchase agreement. According to the Lower Tax Court, the retroactive correction of the tax-exempt gain on sale will thus continue until the balance is € 0. Any further reductions in profit are not recognizable for tax purposes pursuant to § 8b (3) KStG.

The Lower Tax Court did not follow the plaintiff's objection that this legal opinion leads to an inadmissible extension of the application of § 8b (2) KStG to business assets which have replaced the originally sold shares. While it is true that the changes in value do not affect the business asset "share in a corporation" but the business asset "purchase price claim", the Lower Tax Court opines that such considerations that are related purely to the business assets are not compatible with the meaning and purpose of § 8b (2) KStG which is to make the final gain on the sale of shares tax-exempt.

Appeal against the ruling of the Lower Tax Court of Schleswig Holstein has been filed with the BFH (I R 43/16). The Lower Tax Court's decision does therefore not have final and binding effect yet.

Current Developments in German Tax Legislation

In the following, we would like to give you an overview of the most recent developments in German tax legislation:

- The Law on the Modernization of Taxation Procedures was promulgated in the Federal Law Gazette on 22 July 2016. Thus the legislative procedure has been concluded. Major amendments to the law relate to:
  - Automated processing of tax returns
  - Filing of tax returns, extensions of time to file tax returns and filing penalties
  - Electronic notification and electronic retrieval of administrative acts
  - Other amendments concerning binding rulings, electronic certificates regarding the payment of withholding tax and the concept of costs of production for tax purposes

  For further details on the contents of the law see June 2016 edition of German Tax Monthly.

- The Investment Taxation Reform Act was promulgated in the Federal Law Gazette on 26 July 2016. Thus the legislative procedure has been concluded. The most important contents covered by the law are:
  - Reform of investment taxation
  - Restriction on the credit or refund of dividend withholding tax (in so-called cum/cum-trades)
  - Non-resident tax liability in the event of a sale of shareholdings in real-estate partnerships

  Despite the request of the Upper House of the German Parliament (Bundesrat) to consider the inclusion of mandatory taxation of gains on the sale of portfolio investments in the law (§ 8b (4) Draft Corporate Income Tax Law [KStG-E]) this did not happen. For further details on the legislative procedures see January/February 2016 and July 2016 editions of German Tax Monthly.

  For further details on the contents of the law see June 2016 edition of German Tax Monthly.

- The law on the transposition of the new Double Tax Treaty (DTT) Japan into national law was promulgated in the Federal Law Gazette on 25 July 2016. This completed the legislative procedure in Germany. However, in order to become effective the new DTT still requires the mutual written notification about the transposition into the respective national laws.

  See January/February 2016 edition of German Tax Monthly for content of the new DTT Japan.

- The government draft for the Law on the Implementation of the Amendments to the EU Administrative Mutual Assistance Directive and further Actions against Base Erosion and Profit Shifting (BEPS-I-Act) was promulgated on 13 July 2016. As compared to the ministerial draft bill (see July 2016 German Tax Monthly for further details) the date for the first time application of the modified requirements for transfer pricing documentations (local file and master file) was deferred by one year (fiscal years commencing after 31 December 2016). There are no other major changes as compared to the ministerial draft bill.

- On 22 July 2016, the Federal States of Hesse and Lower Saxony published a draft bill on the gradual reform of real estate tax. In a first step, this draft bill is intended to revise the valuation rules for the purpose of real estate tax. The necessary amendments of the Real Estate Tax Law are to follow in a second legislative procedure. The background of the legislative initiative is to adapt the values for the assessment of real estate tax to the current value situation.

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