On 1 December 2016, the German Federal Parliament approved the Act Concerning the Implementation of Changes to the EU Administrative Cooperation Directive and of Additional Measures against BEPS (“CbCR legislation”). The bill was initially proposed by the German Federal Government on 13 July 2016. For a summary of the most relevant changes proposed in this law package, see German Tax & Legal Quarterly 2016 Issue 3.

As demanded by the German State Council in its statement of 23 September 2016, the Federal Parliament added a specific anti-hybrid regulation concerning partnerships to the bill. The new rule eliminates certain cases of double deduction for partnership special expense items.

Under the German concept of partnership taxation, expenses incurred by a partner of a partnership to acquire, finance or support the partnership interest are deductible when computing the partners’ share of the partnership’s taxable income as if they were expenses of the partnership itself (for example, financing expenses incurred to acquire or fund the partnership interest). In principle, this rule applies also to German partnership income which is allocable to a nonresident partner.

Continued on page 2
Legislation

Germany adopts CbCR legislation, creates rule against double deductions for inbound partnerships

Continued from page 1

With reference to BEPS Action 2, the State Council demanded the introduction of a new rule (Sec. 4i of the German Income Tax Act) to disallow such expenses if they also reduce the basis of the partner’s taxable income in another jurisdiction. The disallowance shall not take place if the partner’s German partnership income is also taxed in the other jurisdiction and the deduction of the expenses is, therefore, necessary in order to avoid double taxation.

According to the explanatory notes, the disallowance shall also apply if the deduction in the foreign jurisdiction is taken in a preceding or in the following fiscal year.

The law change will likely impact a number of German-inbound partnership structures where, e.g., financing expenses are deducted both in Germany as well as in the foreign jurisdiction of the nonresident partner. The new sec. 4i will become effective as of 1 January 2017.

Other changes proposed by the State Council have not found their way into final legislation. These include in particular the inclusion of capital gains on the sale of (foreign) entities owning German real property as German taxable source income as well as the deemed distribution and hence withholding taxation of earnings and profits in an outbound cross-border merger of a German company. It is unclear whether these proposals will be taken up again in a future tax bill.

Loss offsetting rules for corporations amended

On 1 December 2016, the German Federal Parliament approved a Government bill allowing more companies to be able to use tax losses following a shareholder change. The bill passed the federal parliament without significant changes. The newly introduced sec. 8d of the German Corporate Income Tax Act allows a conditional loss carry-forward, which is, however, contingent on fulfilling several business continuation criteria. Though it is widely expected that the German Federal Council (Upper House) will confirm the new legislation on 16 December 2016, it cannot be ruled out that the EU Commission will examine whether it is in line with EU state aid provisions. Details on the new regulation can be found in German Tax & Legal Quarterly 2016 Issue 3.

Germany and the Multilateral Instrument

On 24 November 2016, the Organisation for Economic Co-operation and Development (OECD) released the text of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS) under BEPS Action 15 (the multilateral instrument). The text and the related explanatory statement were formally adopted by approximately 100 countries at a ceremony hosted by the OECD following the conclusion of the negotiations during the week of 21 November 2016. The text of the multilateral instrument and explanatory notes are available on the OECD website.

The multilateral instrument under BEPS Action 15 is a key part of the OECD’s effort toward implementation of the tax treaty related BEPS measures into existing bilateral or regional tax treaties as quickly and consistently as possible.

In general, the multilateral instrument will only enter into force after five countries have ratified it and will apply for a specific tax treaty, after all parties to that treaty have ratified the instrument; and a certain period has passed to ensure clarity and legal certainty.

It is expected that the multilateral instrument will be open for signature as of 31 December 2016 and a first high-level signing ceremony will take place in the week beginning 5 June 2017.

While it is expected that Germany will be supportive and hence adopt most of the proposed changes through the Multilateral Instrument, public statements by leading members of the Ministry of Finance suggest that Germany will opt out of the proposed changes to Art. 5 para. 5 and para. 6 OECD Model Treaty (revised agency PE definition), while going along with the proposed changes to Art. 5 para. 4 (auxiliary activities). This recent development is apparently driven by concerns that the more frequent assumption of PE creation in typical distribution structures could increase controversy with source jurisdictions, and lead to German tax revenue loss given the use of the PE income exemption in German treaties.
Legislation

German Ministry of Finance (BMF) launches an initiative against letterbox entities

On 1 November 2016, as a reaction to the “Panama Papers”, the German Ministry of Finance (BMF) published a draft act to fight tax avoidance and to change further tax legislation. The intention is to restrict by increasing disclosure obligations and transparency the possibilities for German taxpayers to circumvent taxes through the use of base companies (so-called letterbox entities) incorporated outside the EU/EEA.

In particular, the draft act includes the following measures:

- The threshold to disclose the acquisition of indirect participations in foreign entities is reduced from 25% to 10%, which is also the relevant threshold for direct participations under current law.
- Irrespective of the above, taxpayers will have to report any direct or indirect dominant influence over the corporate, financial or economic activities of a corporation or partnership in a non-EU/EEA country to the German tax authorities.
- Under certain conditions, financial institutions will have to inform the tax authorities about any business relationships they have facilitated between German taxpayers and non-EU/EEA entities.
- The banking secrecy according to Sec. 30a of the German Fiscal Code shall be repealed.
- The automatic account screening procedure for tax purposes shall be extended to allow for a better identification of German taxpayers that are the beneficial owners of a bank account or brokerage account of a foreign individual or entity.
- In the course of the establishment of bank accounts, financial institutions shall record the tax identification number of the account owner and any other authorized persons and must disclose it to the tax authorities.
- A new obligation to store certain business records for a period of 6 years shall be introduced for taxpayers that are able to exercise dominant control over the corporate, financial or economic activities of a corporation or partnership in a non-EU/EEA country.
- Tax avoidance carried out through undisclosed business relations with non-EU/EEA entities that are controlled by the taxpayer shall be qualified as severe tax fraud, which allows for harsher punishment.

The draft act is currently in public consultation. It is expected that the German government will start the formal legislative process still in 2016. The process might then be completed around summer 2017.
More than 90% of public contracts are below the threshold for the application of European public procurement law (see table below). The German federal government is now working on a draft bill (UVgO-E) to subject tendering procedures below the thresholds to a uniform regulatory regime for the first time. A consultation took place in mid-October, and the Federal Ministry of Economics is currently evaluating the results. The federal government is expected to issue a regulation by the beginning of 2017, which can then be declared applicable to the public sector by the federal states.

The draft of the regulation below the thresholds is based on the regulation above the thresholds. Thus, many regulatory approaches of the public procurement law above the thresholds will apply also below the thresholds. Rules unsuitable for smaller procurement procedures have been deleted. The harmonization of those two regulations means that foreign bidders used to participating in tendering procedures above the thresholds should already be familiar with many of the new rules.

One of the most important deviations from the regulations above the thresholds is that no new legal protection for losing bidders will be introduced below the thresholds. Instead, existing legal protection possibilities apply. Therefore, a losing bidder will not have the possibility to win the bid, but will be able to recover damages.

UVgO-E is intended to replace the official contracting terms for supplies (VOL / A, 1st section), but not the official contracting terms for “construction contracts” or “works contracts” (VOB / A). The differences in regulations concerning the provision of services (deliveries / services) and the provision of construction services will thus increase with the new law, and so will regulatory density.

The scope of UVgO-E is rather vague with regard to the contracting party and is to be made more specific by national legislation. In addition, the contracting entity may choose between the “open procedure” and the “restricted procedure with call for competition”. The “competitive procedure with negotiation” remains applicable only under certain conditions. The minimum requirements and award criteria set out in the terms of reference cannot be negotiated, which is consistent with attempts to prevent manipulation.

What is new is the obligation to provide information after conclusion of the contract. The contracting authority is required to provide for three months via internet portals or via its own website information on all orders placed that have an order value of EUR 25,000 or more. The draft UVgO so far does not permit the use of “competitive dialogue”. This form of procedure, which is still rarely used in Germany compared to other European countries (e.g. France), offers certain advantages, e.g. when procuring innovative products. When a “competitive dialogue” takes place, the contracting authority does not have to determine the details of the product prior to the procurement, but can develop the solution to match its needs in dialogue with the tendering party.

**Directive 2014/24/EU on public procurement:**

<table>
<thead>
<tr>
<th>Contracting authorities</th>
<th>Types of services</th>
<th>Threshold Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Government authorities</td>
<td>Works contracts, subsidized works contracts</td>
<td>5,225,000</td>
</tr>
<tr>
<td></td>
<td>All services concerning social and other specific services listed in Annex XIV</td>
<td>750,000</td>
</tr>
<tr>
<td></td>
<td>All subsidized services</td>
<td>209,000</td>
</tr>
<tr>
<td></td>
<td>All other service contracts and all design contests</td>
<td>135,000</td>
</tr>
<tr>
<td></td>
<td>All supplies contracts awarded by contracting authorities not operating in the field of defence</td>
<td>135,000</td>
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<tr>
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<td>Supplies contracts awarded by contracting authorities operating in the field of defence</td>
<td>135,000</td>
</tr>
<tr>
<td></td>
<td>Concerning products listed in Annex III</td>
<td>209,000</td>
</tr>
<tr>
<td></td>
<td>Concerning other products</td>
<td>209,000</td>
</tr>
<tr>
<td>Sub-central contracting authorities</td>
<td>Works contracts, subsidized works contracts</td>
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<td></td>
<td>All services concerning social and other specific services listed in Annex XIV</td>
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<tr>
<td></td>
<td>All other service contracts, all design contests, subsidized service contracts, all supplies contracts</td>
<td>209,000</td>
</tr>
</tbody>
</table>
On 25 September 2016, the German Federal Government adopted a draft for a proposed Ninth Amendment of the German Act against Restraints of Competition (ARC). It shall become effective – after completion of the legislative procedure – no later than 27 December 2016. The main contents are:

- A new merger control notification threshold based on transaction value
- Specific criteria for the appraisal of market power in (digital) multi-sided markets
- Introduction of group liability and a broader successor liability for fines
- Implementation of the EU directive for cartel damages

The proposed amendment will expand the merger control for mergers and acquisitions of start-ups, particularly of internet companies. Transactions shall require notification even if the domestic turnover thresholds are not met, but the transaction value exceeds 400 million Euros. The new threshold is intended to enable the German Federal Cartel Office to review transactions in the digital economy that would otherwise not have required notification. A frequently quoted example is Facebook’s acquisition of WhatsApp, which did not meet the German merger control thresholds.

The draft clarifies that services (or goods) provided free of charge, i.e., without payment, may also be considered a market activity and therefore fall within the scope of the ARC. Specific criteria for platform markets are to be introduced, clarifying that markets with no monetary payments are relevant antitrust markets open for investigations. When assessing whether a company holds a dominant market position, the following criteria need to be considered:

- Direct and indirect network effects
- Parallel use of networks (multi-homing) by users and switching costs for users
- Economies of scale in connection with network effects
- Access to data
- Innovation-driven competitive pressure (possibility of disruptive changes)

The draft provides for a tightening of liability for companies based on the EU model. Accordingly, parent companies shall be liable for anti-competitive market behavior of their subsidiaries even if they are not directly involved in the infringements or do not violate their supervisory duties. In addition, the intended extension of company liability also covers the area of universal succession as well as economic succession in order to close loopholes since so far companies are able to escape liability by internal restructurings or transfers of assets. This intended change is particularly controversial because the introduction of such a liability without fault would mean a paradigm shift, which also raises concerns in terms of German constitutional law.

Additionally, the proposed amendment will implement the EU Directive 2014/104, which is essentially a simplification of procedures for consumers as well as other companies who have suffered damages caused by a cartel and are seeking to receive compensation.
**Update on double tax treaties**

**Australia** and Germany have both completed the domestic implementation procedures regarding their new double taxation treaty (signed on 12 November 2015). According to German officials, the exchange of the documents of ratification is planned to take place before the end of 2016. Given a successful ratification in 2016, the new treaty would become applicable as of 1 January 2017 in the case of Germany and as of 1 January/April/July 2017 (depending on the type of tax) in the case of Australia.

Germany and **Turkmenistan** signed a new tax treaty on 29 August 2016. The treaty will replace the tax treaty between Germany and the USSR that was initially concluded in 1981 and is still applicable to Turkmenistan. The new treaty will not become applicable before 1 January 2018.

As announced earlier, the new treaties with **Japan** (signed on 17 December 2015) and the **Netherlands** (signed on 11 January 2016) are ratified and will apply as of 1 January 2017.

An amending protocol to the tax treaty with **Macedonia** was signed on 14 November 2016.
German tax authorities issue a circular on the attribution of economic ownership in the case of securities transactions; law change expected for “cum/cum”-trades

For securities lending transactions extending through the dividend record date, the question arises who should be regarded as the receiver of the dividends. In this regard, the economic ownership in the securities must be transferred to the borrower, so that he is entitled to a credit of the withholding tax for the dividends received.

The German Ministry of Finance (BMF) on 11 November 2016 issued a circular following a decision of the Federal Tax Court (BFH). The circular explains principles for the attribution of economic ownership in the case of securities lending transactions, spot transactions and other securities transactions. The general rule is that the economic ownership is transferred to the borrower in such transactions. In exceptional cases, i.e. where securities are transferred for a short period beyond the dividend record date or the borrower’s ownership position appears to be of a merely formal nature, the economic ownership remains with the lender. For holding periods of less than 45 days the borrower bears the burden of proof that this is not the case.

According to the tax authorities, the following criteria should be considered in an overall assessment: In cases when
- the parties to the agreement or third parties derive a tax advantage and the overall remuneration for the securities transaction is based on this tax advantage;
- the borrower does not derive any liquidity advantage from the receiving and making of payments in connection with the securities transaction;
- the exercise of voting rights has been contractually excluded or restricted;
- the borrower may be deprived (by termination, for example) of the borrower’s legal position under the securities agreement at any time or at very short notice;
the economic ownership should not be attributed to the borrower. However, irrespective of the above-mentioned criteria, a positive pre-tax yield from the securities transaction for the borrower and a transfer of legal ownership before the dividend record day would indicate an attribution to the borrower.

From 1 January 2017, a related law change is being introduced within the CbCR legislation package. The law change would require a minimum 45-day ownership around the dividend date and economic exposure to value movements for a dividend recipient to be able to claim dividend withholding tax refunds (a similar rule for withholding tax credit entitlement already exists).

Interpretation of the term “permanent establishment” – trade tax exemption even without treaty exemption?

In case I R 50/15, the Federal Tax Court (BFH) had to decide which rule takes precedence if under domestic law a foreign permanent establishment (PE) exists, but under the applicable treaty, no exemption should be granted. The case dealt with the Turkish procurement office of a German tax resident. Under German domestic tax law, this office clearly constituted a PE abroad, and hence the taxpayer claimed that no trade tax should be levied on the income allocable to the PE (trade tax is only levied on income earned in a German PE). The tax authorities denied the exemption on the basis that under the “auxiliary and specific activities”-exception of the tax treaty with Turkey, the procurement office was in fact not deemed to constitute a PE and hence not taxed in Turkey. In its decision, the BFH sided with the taxpayer, and clarified that the domestic trade tax exemption for foreign PE income did not depend on the existence or not of a treaty exemption, and in fact applied even in the complete absence of a tax treaty. Due to the future proposed narrowing of the “auxiliary and specific activities”-exception as proposed by the OECD in its Action 7, it can be expected that there will be fewer cases in the future where similar fact patterns can lead to non-taxation in the PE country without German trade tax inclusion.
German court decisions

Taxing the repayment of capital contributions from non-EU corporations violates EU law

The German Federal Tax Court (BFH) issued two decisions on 13 July 2016 (VIII R 47/13 and VIII R 73/13) ruling that the taxation of a repayment of capital contributions made to non-EU corporations violates EU law. Pursuant to German law, capital contributions to German and other EU corporations can be repaid on a tax-neutral basis, provided that the injection of capital was traced on a specific tax contribution account. In July, the BFH held that this restriction to German and EU corporations violates the principle of equal treatment, as laid out in the German constitution, as well as the free movement of capital, as outlined in Art. 63 of the Treaty on the Functioning of the European Union.

Both cases relate to reorganization measures of US corporations where the shares of a controlled subsidiary are distributed by the parent corporation to its shareholders (“spin-off”). In cases where the shareholder is a German investor, the question arises whether such a distribution of shares should be treated as a taxable dividend or as a non-taxable repayment of capital contributions. According to the BFH, a comparative legal analysis is required to determine whether such payment should qualify as a repayment of capital contributions or as a dividend distribution for purposes of German law. If the payment is made from current and accumulated earnings and profits, it should be characterized as a dividend distribution. If and to the extent, however, the distribution exceeds the nominal capital and the earnings and profits recorded in the previous years, it should be characterized as a repayment of capital contributions. Likewise, the balance sheet of the company established under foreign law can serve as a basis for this analysis.

German Federal Tax Court (BFH) rules on non-deductibility of indirect costs for holding entities

On 15 June 2016, the German Federal Tax Court (BFH, I R 64/14) ruled that indirect costs of a holding entity which is solely engaged in forming and selling corporations may fall under the German participation exemption of Sec. 8b para. 2 Corporate Income Tax Act (CITA) and therefore may not be tax deductible. The court overruled the initial decision of the lower tax court of Cologne (dated 1 October 2014, case reference 10 K 3593/12).

For German tax purposes, capital gains derived by a corporation from the disposal of shares in subsidiary corporations are generally tax exempt at the level of the selling entity for corporate income tax (CIT) and trade tax (TT) purposes (Sec. 8b Para. 2 CITA). The capital gain is calculated as the difference between the selling price less the related transaction costs and the book value of the sold shares. 5% of the capital gain is deemed a non-deductible business expense.

German tax law does not define the term “transaction costs”. According to settled case law, costs are to be treated as transaction costs if the costs arise in the context of the sale, and a connection to the disposal can be established. Hence, for the qualification and allocation of costs it has to be determined if the costs relate to the ongoing business operation of the selling entity (in principle fully deductible) or rather to tax exempt share disposals (non-deductible).

In the case, the tax court had to decide if indirect costs (e.g. rental cost for office space, personnel expenditure and other current expenses) were to be seen as transaction costs in the context of Sec. 8b para.2 CITA. In this particular fact pattern, the plaintiff was a pure holding entity whose sole business purpose comprised the formation and subsequent sale of shelf companies. The tax court concluded that due to the lack of other business operations not falling under the participation exemption, the ongoing business purpose of the entity already established the connection of the indirect costs to the share disposals and, consequently, there was no room for any allocation of the indirect costs to other business operations. Therefore, nearly all of the indirect costs were qualified as non-deductible transaction costs.

In addition, the tax court also ruled that the short-term trading rules of Sec. 8b Para. 7 CITA, which suspend the participation exemption (and consequently also the non-deductibility of transaction costs) for certain holding entities that acquire shares with the objective to realize a short-term trading profit, did not apply in the case at hand. Thus, the court confirmed its long-standing view that the short-term trading rules do not apply to shares that are newly formed, as opposed to shares being acquired from a third party.
Sale of real estate as partial transfer of a business as a going concern

On 6 July 2016, the Federal Tax Court (BFH) decided on a case covering the sale of a leased commercial property (XI R 1/15).

The BFH decided that if a seller transfers a leased commercial property and the acquirer carries on the leasing of said real estate only with respect to a part of the property, the sale of this part represents a transfer of a business as going concern according to Sec. 1 (1a) VAT Act. As far as the acquirer uses the other part for its own business purposes and does not continue the leasing activity of the vendor, the conditions of a TOGC (transfer of a going concern) are not met. The BFH did not follow the opinion of the tax office and the Lower Tax Court, both of which denied a treatment as a TOGC.

The BFH clarified that also a part of a property can be an independent business unit and thus, a “part of assets” (“Teilvermögen”) in terms of Art. 19 of Directive 2006/112/EC. The BFH argued that the question cannot be answered based on national civil law or national income tax law. The term “part of assets” is a term of European law and therefore underlies an autonomous interpretation based on the law of the European Union. The review of the requirements of a transfer of a business as a going concern is limited to the respective part of assets transferred, without regard to any potential further transfers.

From a practical point of view, sellers should allocate the purchase price (e.g. based on square meters) in similar scenarios already in the sales contract. As far as the acquirer does not continue the leasing activity of the vendor, a clause should be drafted in the contract saying that the vendor opts for VAT with regard to the part of the property which is not subject to the TOGC. Otherwise, the seller will retroactively have to deal with the allocation of the land and its valuation for the purposes of the correction of the input VAT deduction pursuant to Sec. 15a VAT Act.

Can the German treaty overriding provision itself be overridden by a subsequent new treaty?

The German constitutional court (BVerfG) had declared in its decision of 15 December 2015 (2 BvL 1/12) that treaty overriding provisions in German international tax law (e.g. domestic subject-to-tax provisions) are in principle in line with German constitutional principles. However, the question remained whether this also held if a tax treaty was introduced or changed after the treaty overriding provision became enacted, and the newer treaty included different (e.g. more generous exemption) rules than the domestic treaty overriding provision. Arguably, the principle of “lex posteriori” should ensure that the newer law and in this case the treaty should take precedence. The Federal Tax Court (BFH) has now clarified in its decision of 25 May 2016 (I R 64/13) dealing with the application of the German subject-to-tax rule for foreign employment income, that a treaty overriding provision under domestic law can indeed also override a later treaty, and that to this extent, the “lex posteriori”-principle should not apply. In the BFH’s view, treaty overriding provisions are introduced with the specific intent to disregard existing or future treaty provisions, and hence apply regardless of specific treaty wording as well as timing of treaty changes.
Courts rule on conditions for German income tax group (Organschaft) – Required transfer of profits/Important cause for early PLPA termination

Two recent court cases should be of interest for taxpayers with German income tax groups. As a reminder, a German tax group not only requires the parent to own the majority of votes in the subsidiary since the beginning of the subsidiary’s fiscal year, but also the conclusion of a profit and loss pooling agreement (PLPA) for a minimum five-year term, as well as the actual settlement of PLPA-related obligations.

In its case I B 77/15, the Federal Tax Court (BFH) dealt with the question how the actual settlement of profit transfer obligations has to occur. In its view, the mere recording of an obligation in the books is not sufficient to lead to a valid profit transfer and thus would lead to the denial of the tax group. While the BFH does not specifically say so in its decision, it is generally accepted view and practice that a profit transfer should be accepted where the obligation is converted into an interest-bearing receivable and documented as such, or through offset against receivables held against the parent, so that a profit transfer does not always have to occur in cash.

The case 4 K 677/14 decided by the lower tax court of Hesse addresses the increasingly relevant question under which conditions a PLPA can be terminated within the initial minimum five-year term without jeopardizing the previous existence of the tax group. The BFH had recently surprised many observers by holding that an important cause for an early termination of the PLPA under civil law such as a sale of the shares, or legal restructuring, may not necessarily be accepted as sufficiently important cause for tax purposes. Significant uncertainty exists since the BFH judgment, and the Hesse tax court decision has now created at least a precedent which provides more certainty, albeit for quite specific fact patterns only. In the case, tax group parent A held 100% in B and had concluded a PLPA with B in 2004. In 2006, the A group decided to create a divisional structure, and the shares in B were contributed to a new German divisional holding company, C. In this context, A and B terminated their PLPA with effect from the end of 2006, and new PLPAs were concluded from 2007 between A and C, and C and B respectively. In this fact pattern, the court held that as there were valid business/non-tax reasons for the early termination of the PLPA, and for the whole restructuring, the early termination should be regarded as important cause also for tax purposes. Moreover, A and B could have remained in a direct tax group even under the new structure, and in fact were included in a two-tier tax group, so that also from this perspective, a (harmful) merely tax-motivated PLPA termination could be excluded.

German Federal Tax Court has to decide on the VAT treatment of consignment stocks

The German Federal Tax Court (BFH) has to decide on two pending court cases (cases V R 31/15 and V R 1/16) with regard to supplies from consignment stocks located in Germany. Recently, the Lower Tax Court of Lower Saxony (case 5 K 335/14), the Hessian Lower Tax Court (case 1K 2519/10) and finally the Lower Tax Court of Düsseldorf (case 1 K 1983/13) countered a generalized view of the German tax administration as to how to treat supplies from German consignment stocks. The latter two cases are now pending before the German Federal Court of Finance. According to the German tax authorities, suppliers need to register with the German tax authorities for VAT purposes if they dispatch goods from another EU member state into a warehouse located in Germany and keep goods in storage ready for a particular customer. The supplier must account for VAT when the customer calls off goods when they are needed.

The three courts ruled that each case must be looked at individually. Under certain circumstances, for VAT purposes the supply of goods already takes place at the time of the shipment to the warehouse. As a consequence, the suppliers perform zero-rated intra-community supplies of goods (as opposed to local supplies to their customers) and subsequently, do not have to register for VAT purposes in Germany. According to the Lower Tax Court of Lower Saxony, the goods are deemed to be supplied at the place where the shipment to the warehouse begins if the recipient is already determined at the time when the supply of the goods starts (case 5 K 335/14). Deliveries into a German warehouse are out of scope of German VAT when purchase contracts with a specific recipient are already in place. Both the Hessian Lower Tax Court and the Lower Tax Court of Düsseldorf decided that the supplier already performs a supply of goods to the customer at the time the goods are shipped to the warehouse if there is a binding purchase order in place at the time of the shipment to the warehouse; otherwise the supplier performs a local supply from the warehouse (cases 1 K 2519/10 and 1 K 1983/13).

It remains to be seen how the BFH will decide. There is a chance that the current approach of the German tax administration with regard to consignment stocks will be abandoned. Therefore, foreign businesses facing VAT assessment notices which retroactively assess VAT plus interest at 6.0 % p.a. may consider invoking the principles applied by court and hold that indeed no obligation for a German VAT registration arose and therefore, no German VAT had to be reported.
German court decisions

### German Lower Tax Court rules on loss carry back in the context of the change-in-ownership rules

On 21 July 2016, the German Lower Tax Court of Münster (9 K 2794/15 K,F) ruled that current year losses which forfeited due to the application of the change-in-ownership rule can still be carried back to the previous fiscal year. With its decision, the court objected the official view of the German Federal Ministry of Finance. The German tax authorities have appealed against the ruling before the German Federal Tax Court (BFH, I R 61/16).

Under German tax law, losses incurred by a corporate taxpayer can generally be carried forward indefinitely and be used against future positive income within certain limitations. In addition, for corporate income tax purposes (but not for trade tax purposes), an optional one year tax loss carry back limited to a maximum threshold of EUR 1 million is available. These loss utilization rules are further restricted by the change-in-ownership rules. Sec. 8c CITA generally leads to the forfeiture of any tax loss carryforwards upon certain direct or indirect shareholder changes, unless one of the exceptions applies. If a harmful change-in-ownership event occurs during a fiscal year in which a loss is incurred, the current year tax losses until the date of the ownership change are also forfeited.

The current tax court ruling dealt with the interaction of the rules regarding the loss carry back and the change-in-ownership. In the case at hand, a German GmbH was subject to a harmful ownership change in the course of FY 2013. The parties were in agreement that its losses incurred up to the transfer date could not be carried forward into future fiscal years. In addition, the parties also agreed that the carry back of the current loss that was incurred after the change-in-ownership event was not restricted, as the wording of the law clearly implies that only losses up to the transfer date are impacted by the rules at all. However, the plaintiff requested to carry back not only the loss after the transfer date, but the entire loss generated in the course of FY 2013 to the prior year despite the change-in-ownership event.

The tax court agreed with the view of the plaintiff and ruled that the current year losses incurred until the ownership change can be carried back to the previous fiscal year. The court justified its decision by recurring on the general rationale and purpose of Sec. 8c CITA which only aims to restrict the use of losses by parties who have not generated these losses. However, by way of carrying back forfeited losses to the previous fiscal year only those shareholders benefit from the use of losses that also generated these losses in the past.

The current decision is of particular interest as the court objected the official opinion of the German Ministry of Finance (BMF) stated in a decree from 2008 and in the draft version of its new decree on Sec. 8c CITA (the final version of this new decree is expected shortly). Taxpayers with similar fact patterns should keep the affected tax assessment notices open in order to benefit from the possibility to carry back current year losses if the BFH confirms the local court’s decision.

### Profit adjustment under German transfer pricing rules to be scrutinized by the ECJ

With its decision dated 28 June 2016, the local tax court of Rhineland-Palatinate referred the question to the European Court of Justice (“ECJ”) as to whether a profit adjustment resulting from a comfort letter which a German corporation issued to banks financing its European subsidiaries was in line with the freedom of establishment under the Treaty on the Functioning of the European Union (TFEU) (case reference 1 K 1472/13). The case will require the ECJ to comment again on the compatibility of profit adjustments in case of related party transactions after the landmark decision of the ECJ in the case SGI (decision dated 21 January 2010, C-311/08).

In the case to be decided (case reference C-382/16, Hornbach-Baumarkt), a German corporation issued a comfort letter to banks financing its European subsidiaries. That issuance resulted in a contractual relationship between the parent and the subsidiary being the beneficiary of the comfort letter for which under the arm’s length principle a compensation should have been paid. The referring court seeks guidance on the question whether a profit adjustment would be in line with the freedom of establishment. In its SGI decision, the ECJ had held that transfer pricing rules, which only apply in cross-border situations, are in principle justified, however, the taxpayer must have the possibility to prove commercial justification for the transaction. Most commentators interpreted this ECJ statement in a way that a taxpayer must have the opportunity to bring forward reasons for deviating from the arm’s length principle for valid business reasons. The ECJ now has to specify whether it is willing accept in principle a deviation from the arm’s length principle in intra-group transactions and, if yes, to set out the reasons which may justify such a deviation.
In two decisions dated 8 July 2016 (case reference 2 K 2995/12) and 31 August 2016 (case reference 2 K 721/13), the local tax court of Cologne referred the German anti-treaty shopping rule of Sec. 50d para 3 German Income Tax Act (ITA) to the European Court of Justice (ECJ) allowing the ECJ for the first time to test that rule against the freedom of establishment of the Treaty on the Functioning of the European Union (TFEU) and against the anti-abuse provision of the EU Parent-Subsidiaries Directive (PSD).

In the first case (case reference C-504/16, Deister Holding), a German individual held a German subsidiary (together with several other German and non-German subsidiaries) via a Dutch holding entity which also debt-financed two of its subsidiaries. The holding owned office space and employed two individuals for carrying out its activities. The German anti-treaty shopping rule in its version as applicable until 2011 stated that a foreign company cannot claim refund of German withholding tax or apply for an exemption certificate to the extent the company was held by shareholders which would not be entitled to the refund or exemption if they derived the income directly and if (i) there were no economic or other valid reasons for the interposition of the foreign company, or (ii) the foreign company does not derive more than 10 percent of its overall gross earnings for the respective fiscal year from its own business activities, or (iii) the foreign company does not participate in general commerce by means of an appropriate business organization.

Even though the Dutch holding could demonstrate relatively strong substance for carrying out its holding activities, the referring court, in interpreting the rule, concluded that the Dutch holding did not pursue own business activities. Further the court did not accept the reasons brought forward for the interposition of the holding (arguing that the Netherlands provided better financing opportunities, enhanced loss reporting possibilities and better possibilities to attract new investors or shareholders) as valid economic reasons for the interposition of the holding.

The local tax court of Cologne seeks guidance from the ECJ whether in the given case the application of sec. 50d para 3 ITA is a permissible measure to combat abusive circumvention of national laws. In particular, the referring court is wondering whether the absence of a possibility to prove that the (predominant) intention for implementing the specific structure was not the aim to avoid taxation renders the rule inapplicable. Further, the court doubts whether an abusive scheme could be deemed at all as in a purely domestic situation the taxpayer would have been entitled to full credit of the withholding tax and hence the interposition of the Dutch holding should not have been beneficial for the German taxpayer. And finally, the referring court raised the question whether in the light of the Cadbury Schweppes decision (dated 12 September 2006, C-196/04) the existing substance as such should preclude Germany from applying an anti-abuse rule.

In the second case referred to the ECJ (case reference details not yet been published), a Danish parent of the distributing German entity was ultimately held by a Singapore-based individual through a Cyprus-based entity. The Danish parent held over 25 participations in Danish and EU subsidiaries, but neither employed staff nor owned own office space. It owned real estate and carried out the financial oversight and the oversight over the profits of its participations. The referring court seeks guidance as to whether in the given case the denial of the dividend withholding tax refund under Sec. 50d para 3 ITA was permissible under Union Law. In particular, the court raised the question whether an abusive practice can be assumed in cases where the (permanent) interposition of a holding company was part of a strategic concept of the group and the holding was located in the country in which a significant part of the group activities are carried out. Further, the referring court was wondering whether the substance requirements set forth in the Cadbury Schweppes decision also apply to mere holding companies and if so, whether the resources made available by other group companies to the holding company need to be considered in this context.
Recent decision of tax court of Muenster not in line with OECD-MC economic employer principle

The tax court of Muenster recently published a decision that is not in line with the current OECD approach regarding the determination of the so-called economic employer principle of Art. 15 OECD-MC.

In the case at hand, a German resident taxpayer temporarily worked for a group company in the UK. Salary costs were cross-charged to the UK company with a flat hourly rate that included a portion for the actual salary costs, but also overhead costs such as IT and training costs, etc. Surprisingly, the court determined the economical employer by looking only at the cross-charge, but disregarding other facts (such as integration, reporting lines, risk bearership, etc.). According to the court, the work of the employee for the UK company was comparable to services provided by a third party due to the nature of the cross-charge. Thus, the economic employer was determined to be the German company. As the employee was in the UK for a period not exceeding the applicable 183-day threshold and did not work for a PE of the home company in the UK, the court ruled that income relating to the work in UK could not be tax-exempt in Germany, even though the income relating to UK working days was actually taxed in the UK, which led to double taxation.

According to Art. 15 OECD-MC and the respective commentaries, income from employment should be subject to tax in the state where the work is rendered if an employee works in a country where his (economic) employer is located (from day one). In such cases, the right of taxation for income from employment does not fall back to the resident state even if the employee does not exceed the applicable 183-day threshold. Under German tax law, the economic employer is obligated to withhold wage tax for such employees for their income to the extent that the treaty provides a taxation right (e.g. for income relating to German working days for treaty non-residents). Recent wage tax audits have shown that the German tax authorities are more interested now in such cases than in the past, and quite often disputes arise around the economic employer term according to the applicable double tax treaty. The German tax authorities tend to interpret the term quite broadly in inbound cases, but are more reluctant to accept a non-German economic employer (in outbound cases, such as in the court case described above).

According to the OECD, the term "employer” has to be interpreted in accordance with the substance-over-form principle. According to the OECD, in group secondment cases it has to be determined by looking at the overall facts if it appears that

- an employee renders services on behalf of his civil law employer to a group company (no economic employer in host country) or
- if an employee is actually working for a group company in the host country like an ordinary employee despite the fact that he still has an employment contract with his home country employer (economic employer in host country).

The applied cross-charge modalities are just one of many factors that need to be analyzed. Decisive factors are e.g. reporting lines, who bears the risk of insufficient work, who pays for e.g. sick leave costs, whether the employee can be substituted by another one, etc.

Once a decision is made, the cross-charge modalities have to follow this decision in line with the arm's length principle. In cases where the home company renders services, generally a day rate or hourly rate with markup is to be charged to the host (service fee) and in cases where the employee is integrated into the host company, because he is working for the host company like an ordinary employee, typically a direct cross-charge (cost allocation, i.e. actual costs, without markup) and taxation of income in the host country is required from day one. Thus according to the OECD, cross charge modalities and the economic employer are a consequence of the overall employment facts. The mere type of cross-charge chosen (service fee/cost allocation) can thus be an indication for the underlying facts, but not the decisive factor of whether an employee does or does not have an economic employer in the host country.

These general principles were applied by the German tax authorities in the past. In a binding tax directive of the Federal Ministry of Justice dated 12 November 2014, local German tax authorities are directed to apply the substance-over-form principle when determining the economic employer and thus follow the OECD approach in this regard, even though there is some deviation in details.
German court decisions

The substance-over-form principle, however, was not followed by the tax court of Münster in its recent decision regarding the economic employer. The court should have asked the parties to substantiate the underlying facts of the secondment case more clearly in order to be able to decide on the case in line with the current OECD approach and the approach of the German Ministry of Justice. Should the simplified approach of the court become common practice in Germany, this will increase the risk of double taxation in particular for outbound cases (as in the court case).

For inbound cases, the court ruling seems to have the advantage that the determination of the economic employer becomes easier and provides planning opportunities (e.g. to avoid income tax implications for short-term secondments to Germany). However, employers should be aware that the tax court ruling is not binding for the tax authorities outside the decided case. Furthermore, in its simplicity, the ruling contradicts the current binding tax directive of the Federal Ministry of Justice. Thus, the findings of the court should be applied with care.

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EU law

The ECJ acknowledges invoice correction with retroactive effect

On 15 September 2016, the European Court of Justice (ECJ) decided on two cases (C- 518/14 Senatex GmbH and C- 516/14 Barlis 06) covering invoice requirements and the point in time when input VAT can be deducted.

To date, the German tax authorities deny the deduction of input VAT stated in an invoice that does not meet the formal requirements of an invoice in accordance with German VAT law. As a consequence, the deduction of input VAT is denied in tax audits for the assessment year in which the invoice was originally received and input VAT deduction is postponed until the year in which the invoice is corrected. This triggers interest expense for the taxpayer at the rate of 6.0 % p.a. The ECJ now expressively admitted the retroactive effect of revised invoices.

Considering that the case Senatex GmbH deals with a German case, it is expected that existing German case law will be reversed. Taxpayers who are currently confronted with this issue in current VAT audits should invoke the ECJ judgments and keep their assessments open until a final revised view becomes generally accepted by the tax authorities.

In case C-518/14 Senatex GmbH, a VAT identification number was missing on the previously issued invoices. According to the ECJ the right to deduct the input VAT may not be denied if the substantive conditions for the right to deduct input VAT are met and the VAT was paid in the course of economic activities. The ECJ recalled in its decision that the right to deduct input VAT is an integral part of the VAT scheme and may in principle not be limited and is excisable immediately in respect of all taxes charged on transactions relating to inputs. The ECJ emphasizes that the fundamental principle of the neutrality of VAT requires that the taxpayer is entitled to deduct the input VAT if substantive requirements are met, even if the taxpayer has failed to comply with some formal requirements. The ECJ considers the burden of paying interest as an infringement of this fundamental principle.

In case C-516/14 Barlis 06, the ECJ further commented that the tax authorities have to also consider the conditions of the right to deduct the input VAT if substantive requirements are met, even if the taxpayer has failed to comply with some formal requirements. The ECJ considers the burden of paying interest as an infringement of this fundamental principle.

Nevertheless, one should bear in mind that these ECJ judgments do not mean that taxpayers no longer need to prove whether an invoice received from other taxpayers is in line with formal invoicing requirements. A faulty invoice still does not entitle the taxpayer to deduct the input VAT and should be corrected immediately. The ECJ emphasized in both judgments that the taxpayer is only entitled to deduct the input VAT under the preconditions that first, an invoice is received and can be presented by the respective invoice document. Tax authorities are obliged to also consider other information gained from any other sources provided by the taxpayer.

Furthermore, current practice of the German tax authorities is still not in line with these decisions and it will probably take some time until a new commonly accepted practice is established in Germany.
Foreign investors not located in the European Union who are interested in acquiring a company located in Germany or at least a 25% interest therein should be aware that the acquisition may become subject to review and prohibition by the German Federal Ministry of Economics and Energy (“the Ministry”). The provisions of the Foreign Trade Act allow such review and prohibition if the transaction endangers the public order or security of the Federal Republic of Germany, regardless of the size of the company and sector in which the company is active.

In principle, the parties are not obliged to inform the Ministry about the acquisition and it is the Ministry’s responsibility to obtain knowledge about the acquisition (see exemption below regarding the acquisition of a company which is active in a security-sensitive area), but the rule is that the Ministry is allowed to initiate the review process within a period of three months following the signing of the acquisition agreement. If the Ministry starts the review process, the foreign investor has to provide the Ministry with the transaction documentation. Following receipt of the transaction information, there is a subsequent two-month period in which the Ministry can conclude whether the acquisition endangers the public order or security of the Federal Republic of Germany, and as a result, can prohibit it with the consent of the German federal government. If the Ministry prohibits the transaction, the parties must reverse such transaction if already completed.

However, if the company is active in a so-called security-sensitive area such as manufacturing of weapons, other military equipment or products with IT-security functions, special rules apply. In particular, the parties have to inform the Ministry in advance of the contemplated acquisition and must not consummate the transaction prior to the approval by the Ministry or expiry of a one-month waiting period. Further, in contrast to the requirement that the Ministry may only prohibit an acquisition if it endangers the public order or security of the Federal Republic of Germany, in case of the acquisition of a company in a security-sensitive area, the Ministry can prohibit the transaction if Germany’s safety interests are endangered by it.

Currently, there are discussions to refine and broaden the definition of the term “security” as used in the provisions of the Foreign Trade Act in order to enable the Ministry to examine an acquisition thoroughly and allow its prohibition more easily. It is to be expected that the parliamentary process for this legislation reform will begin in January 2017.
EY publications and events

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Upcoming EY events

Roadshow payroll tax 2017

- Review and outlook on developments in German payroll taxes: New legislation, important court decisions, report on experiences from recent tax audits and views of the German tax and social security authorities

Language: German
Event contact: Linda Sternberger, linda.sternberger@de.ey.com
Date and location:
- Berlin  Wednesday, 15 February 2017
- Cologne  Tuesday, 21 February 2017
- Dortmund  Thursday, 2 March 2017
- Dresden  Wednesday, 8 March 2017
- Dusseldorf  Wednesday, 22 February 2017
- Frankfurt  Wednesday, 8 March 2017
- Freiburg  Tuesday, 7 March 2017
- Hamburg  Tuesday, 14 February 2017
- Hanover  Thursday, 16 February 2017
- Heilbronn  Thursday, 9 March 2017
- Leipzig  Tuesday, 7 March 2017
- Mannheim  Wednesday, 8 March 2017
- Munich  Tuesday, 7 March 2017
- Nuremberg  Monday, 13 February 2017
- Stuttgart  Tuesday, 21 March 2017

Update Internationale Steuern

- In-depth analysis of recent international tax and transfer pricing developments
- Country updates from key markets, e.g. US tax reform discussion, China transfer pricing developments

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Date and location: 8 March 2017 in Munich
Event contact: Aleksandra Blachowska, aleksandra.blachowska@de.ey.com
EY German contacts
Cities in alphabetical order

Friedrichstraße 140
10117 Berlin
Phone +49 30 25471 0
Telefax +49 30 25471 550

Katharinenklosterhof 3
28195 Bremen
Phone +49 421 33574 0
Telefax +49 421 33574 550

Westfalenstraße 11
44141 Dortmund
Phone +49 231 55011 0
Telefax +49 231 55011 550

Forststraße 2a
01099 Dresden
Phone +49 351 9352 0
Telefax +49 351 9352 550

Graf-Adolf-Platz 15
40213 Düsseldorf
Phone +49 211 9352 0
Telefax +49 211 9352 550

Barbarossahof 18
99092 Erfurt
Phone +49 361 6589 0
Telefax +49 361 6589 550

Wittekindstraße 1a
45131 Essen
Phone +49 201 2421 0
Telefax +49 201 2421 550

Mergenthalerallee 3-5
65760 Eschborn/Frankfurt/M.
Phone +49 6196 996 0
Telefax +49 6196 996 550

Bismarckallee 15
79098 Freiburg
Phone +49 761 1508 0
Telefax +49 761 1508 23250

Rothenbaumchaussee 78
20148 Hamburg
Phone +49 40 36132 0
Telefax +49 40 36132 550

Landschaftsstraße 8
30159 Hannover
Phone +49 511 8508 0
Telefax +49 511 8508 550

Titotstraße 8
74072 Heilbronn
Phone +49 7131 9391 0
Telefax +49 7131 9391 550

Börsenplatz 1
50667 Cologne
Phone +49 221 2779 0
Telefax +49 221 2779 550

Grimmaische Straße 25
04109 Leipzig
Phone +49 341 2526 0
Telefax +49 341 2526 550

Theodor-Heuss-Anlage 2
68165 Mannheim
Phone +49 621 4208 0
Telefax +49 621 4208 550

Arnulfstraße 59
80636 Munich
Phone +49 89 14331 0
Telefax +49 89 14331 17225

Forchheimer Straße 2
90425 Nuremberg
Phone +49 911 3958 0
Telefax +49 911 3958 550

Gartenstraße 86
88212 Ravensburg
Phone +49 751 3551 0
Telefax +49 751 3551 550

Heinrich-Böcking-Straße 6-8
66121 Saarbrücken
Phone +49 681 2104 0
Telefax +49 681 2104 42650

Maggistraße 5
78224 Singen
Phone +49 7731 9970 10
Telefax +49 7731 9970 11

Mittlerer Pfad 15
70499 Stuttgart
Phone +49 711 9881 0
Telefax +49 711 9881 550

Max-Planck-Straße 11
78052 Villingen-Schwenningen
Phone +49 7721 801 0
Telefax +49 7721 801 550

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London
Phone +44 20 7951 4034

New York
Phone +1 212 773 8265

Shanghai
Phone +86 21 2228 6824

Tokyo
Phone +81 3 3506 2238
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