The recently enacted US tax reform (“Tax Cuts and Jobs Act”) of course primarily impacts US companies and individuals as well as foreign companies with a taxable presence in the US, but there could also be indirect effects that one should be aware of. In Germany, these could exist in particular in the following areas:

German CFC rules – passive income imputation

Broadly speaking, the German CFC rules lead to an attribution of the passive income of a controlled (by German residents) foreign entity to the German direct or indirect shareholder(s) if such income is effectively taxed abroad at less than 25% (as measured under German tax principles). Where there is an imputation, foreign tax paid can in principle be credited against German CIT, but not against trade tax, so that double taxation can arise. Passive income for the purposes of the German CFC rules is determined per entity, i.e. an operating company may have individual items of income, which are passive in nature and hence become imputable (e.g. interest income, royalties on acquired IP not related to the operating business). Historically, the US has rarely created CFC income imputation risk, as the high nominal (and effective) tax rate made sure that even if there was passive income, it would not be imputable under the high tax exception. This could now change as the US federal CIT rate has dropped to 21%. The analysis is not straightforward, however, as state and local taxes on income should also be considered for the ETR comparison, and these may take the US tax burden to 25% or higher.

Continued on page 2
On the other hand, the application of deductions related to foreign-derived intangible income (FDII) may mean that such FDI income might effectively be taxed at well below 25% (on a federal level at 13.125%). Thus, a case-by-case analysis is necessary to conclude whether German-held US investments trigger potential German taxes on imputation amounts. If this is the case, planning could in some cases be available to mitigate or avoid the effects of the German CFC income imputation.

It should also be considered that in light of the requirements of the European Anti-Tax avoidance Directive, a reform of the German CFC income imputation legislation is expected, with likely effect from 2019. As part of that reform, the low taxation-threshold might be reduced from 25% to possibly 20%, although details are not yet known. Hence, depending on the final outcome of the legislative process, US investments may be more or less at risk from falling under German CFC income imputation, and the legal developments will need to be closely monitored by affected taxpayers.

German royalty deduction limitation

Since the beginning of this year, Germany operates a deduction limitation regime for certain royalties paid to foreign related parties, where the royalties are subject to a preferential tax regime and low (<25%) taxed at recipient level, and where the preferential tax regime is not in line with the OECD's nexus approach (see German Tax & Legal Quarterly 2017 issue 2 and Global Tax Alert dated 2 May 2017 for further details). It is currently unclear whether the FDII system introduced in the US constitutes a preferential regime in the sense of the German royalty deduction limitation rules. If it did, this would lead to a 47.5% denial of royalty deductions for German CIT purposes, where the recipient is benefitting from a tax rate effectively reduced to 13.125% under the US FDII regime. First commentators see the FDII regime as not in scope of the German royalty reduction limitation, as the intent of the German rule is to target non-OECD-compliant IP boxes, though not broader exemptions or incentive regimes which do not grant preferential tax treatment only to IP income. As the wording of the law is sufficiently open to also allow a broader application, the question of its application in the context of FDII remains unanswered for the moment, and official guidance on this point is as yet not existing, but may be forthcoming according to unofficial statements by tax administration representatives.

More information on the US tax reform can be found here.

New German legal regulations for women in 2018

With effect as of January 2018, the German legislator implemented several new legislations with the intention to enhance and extend the protection of women.

Maternity protection

Since 1 January 2018, the German legal provisions for the protection of pregnant and nursing women have been strengthened. In particular, maternity leave regulations also apply to students, the period of protection after childbirth of a disabled child is extended to twelve weeks and a dismissal protection after miscarriage has been implemented. In addition, Sunday or holiday work is permissible if the pregnant woman agrees. Further, with special permission of the competent supervisory authority, night work (from 8 pm to 10 pm) is permissible. While this sounds like a worsening of the legal position, the intention driving the changes is to reduce the disadvantages for women after pregnancy and child birth and to modernize the regulation.

Further, a real novelty in work protection laws was introduced: Employers have to carry out a risk assessment of the workplace risks a pregnant or nursing woman would be exposed to - irrespective of whether a woman is currently employed on this workplace -, document the result of the risk assessment and possible protection measures (if any) and inform all employees (including male employees) about it. As soon as a woman informs the employer about her pregnancy, the evaluated protection measures have to be implemented and the employer shall proactively offer a discussion about further adapting the working conditions. Employers are therefore well advised to familiarize themselves with these new legal provisions.

Equal pay

In order to achieve equal rights and equal pay, employees in companies with more than 200 employees shall have the right to request information about the individual criteria for their own wage and the average wage of comparable employees.

The prohibition of discrimination on the ground of gender is not new and was already stipulated in the General Equal Treatment Act (Allgemeines Gleichbehandlungsgesetz, AGG), but the new German Remuneration Transparency Act (Entgeltransparenzgesetz) shall prevail for the matters of equal pay. The right to request wage information is intended to make wage structures and gender effects of pay more transparent and to enable women to enforce equal treatment.
Legislation

Germany’s Government Coalition Agreement includes list of planned legal and tax legislative proposals for 2017-2021

Last year’s election results in Germany have led to unprecedented difficulties in forming a new government in Germany. After negotiations to form a coalition of the German Christian Democratic Parties, the pro-business FDP, and the environmentalist Green Party failed, a renewal of a “grand coalition” of the Christian Democratic Parties and Social Democrats will be established. On 7 February 2018, the leadership of these parties agreed to form a new government, with Ms. Merkel as the Chancellor, for the legislative period 2017-2021.

In Germany, the multi-party government is based on a coalition agreement, which is in essence a politically binding work plan for the future government. The 180-page strong document also includes a short summary of planned legal and tax legislation projects. As with most political agreements, the coalition agreement neither provides for technical details, nor for any certainty as to when and how the agreed objectives will be realized, and the agreement calls for a mid-term evaluation of the work plan, including the addition of new measures. The Coalition and the Coalition Agreement have already been approved by the Christian Democratic Parties and must still be approved by the members of the Social Democratic Party (voting runs between 20 February and 2 March 2018). Some uncertainty remains concerning the approval of the Social Democratic Party members. In the event of a failed approval, Chancellor Merkel could either try to form a conservative minority government or pave the way for new elections.

The coalition agreement contains the following taxation measures and policies:

**Business taxation**
- A commitment to support a Common Consolidated Corporate Tax Base (CCCTB) including minimum tax rates. The Government will seek to form a French/German initiative concerning steps for a formation of a joint economic zone, which shall also include proposals for uniform company and bankruptcy laws. On 20 February 2018, the current German Federal Finance Minister Peter Altmaier stated that both countries will negotiate details of the initiative in a bilateral treaty by the end of 2018. The initiative should also be seen as a reaction to increased international business location competition as a consequence of the United States tax reform.
- A commitment to fight tax evasion, tax avoidance, unfair tax competition and money laundering.
- Introduction of measures for appropriate taxation of the digital economy, including equitable taxation of large digital enterprises (the agreement lists four US multinationals as examples).
- Full implementation of the European Union’s (EU) Anti-Tax Avoidance Directive (ATAD and ATAD2), which includes in particular an adaption of the German controlled foreign company legislation, added rules governing hybrid structures, and amendments to the German interest limitation framework.
- Adoption of tax incentives for research and development (R&D) activities, in particular for small- and medium-sized enterprises, which are based on personnel and project cost (Note: the entire budget tableau foresees 2018-2021 financial support for R&D activities of €2 billion and only a portion of that will be apportioned to tax incentives).
- Review of whether the tax administration’s useful life tables need to be adapted to incentivize the acquisition of innovative “digital economy product investments.”
- Introduction of certain benefits for start-up investments, such as temporary relief from monthly value added tax (VAT) filings, and a review concerning the potential introduction of other tax incentives to foster private investment in start-up enterprises.
- The close-out of certain opportunities to avoid Real Estate Transfer Tax in share deal transactions. According to the agreement, the expected increase in tax revenue “can” be used by the States to lower their individual Real Estate Transfer Tax rates.

**Taxation of individuals**
- Repeal of the 25% flat tax system on interest income (which would result in the taxation of interest income at ordinary progressive tax rates).
- Incremental repeal of the so-called Solidarity Surcharge (a surcharge of 5.5% on income tax – no repeal of the surcharge is apparently considered for corporate income tax purposes).
- Introduction of certain incentives for electric vehicle use (business use and employee benefit taxation of electric vehicle use).

**VAT**
- Combatting VAT evasion in internet commerce transactions: Providers of internet market platforms shall be made liable for lost VAT revenue if providers do not curtail transactions of non-VAT compliant market participants.
- Facilitating the collection of import VAT to improve the competitiveness of German harbor, airport and other logistic enterprises.
- At the EU level, support for the application of the reduced VAT rate for commercially traded objects of art, e-books, e-papers and other digital information media, including an ongoing defense of the reduced VAT rate for printed media.
- Support for the introduction of a Financial Transaction Tax in the EU context.
Legislation

Other tax measures

- A commitment to general bureaucratic reduction measures, including the harmonization of commercial and tax law provisions, and the objective to accelerate the business tax audit process.
- A basket of tax incentives to further the investment in residential real estate in the low- to mid-priced rental market.
- A commitment to increase the capacity of the Central Tax Office in Bonn, a branch of the German tax authorities which currently handles many aspects of nonresident taxation (such as withholding tax exemption and refunds).

Further, the coalition agreement contains substantial measures and policies in certain areas of employment and other law areas. Some of the most important changes for companies are:

Labor law

- Stricter regulations of fixed-term employment: The maximum term shall be limited to 18 months including only one extension of term. Also, employers with more than 75 employees may only use these fixed-term contracts for 2.5% of their staff.
- Fixed-term employment with cause shall no longer be permissible if the individual held an unlimited employment contract with the same employer before or one or more fixed-term contracts with a total duration of at least five years.
- Right to work part-time for a limited period: In companies employing more than 45 employees on a regular basis, the employees shall generally be in a position to request working part-time for a specified period and afterwards return to full-time. However, if the number of employees is less than 200, the employer will be obligated to allow only one out of 15 employees to work part-time.

Corporate and company law

- New laws on corporate sanctions in case of legal infringements shall be introduced, e.g. the current maximum fine of €10 million shall be increased to a maximum of 10% of the revenue of companies with more than €100 million in revenue. Furthermore the principle of “naming and shaming” shall be introduced, i.e. the coalition agreement provides for public announcement of sanctions.
- An expert commission shall prepare proposals for a fundamental reform of the partnership law; yet, no details are known, but the reform shall serve to adapt the partnership law to the circumstances of modern economic life.
- In order to protect the interests of minority shareholders and to increase legal certainty, the provisions in the German Stock Corporation Act on deficiencies of resolutions as well as the arbitration procedures in court (Spruchverfahren) shall be revised.
- New kind of company for scientific cooperation: according to the coalition agreement it shall be checked whether a new legal form for a company to be used for a scientific cooperation shall be introduced.
- In case of online registrations of companies, efficient controls including identity controls shall be established in order to ensure that registrations are complete and correct.
- The European harmonization of the cross-border relocation of the seat of companies (Directive on the transfer of seat) as well as the introduction of the European Private Company shall be supported.
- The criteria for the qualification as small and medium-sized enterprises shall be amended in respect of the number of employees (to be raised from 250 to 500 employees) so that more companies can benefit from the exemptions provided for such companies (e.g. reporting obligations).
Update on the German treaty network

In late 2017, a number of double tax treaties (DTT) were ratified by Germany – just in time to become applicable as of 1 January 2018. This group of newly applicable German treaties comprises the DTTs with Armenia, Finland and Turkmenistan as well as the new DTT with Panama that only applies on income from the operation of ships or aircraft in international traffic. Another peculiarity of the Panama DTT is that it applies retroactively as from 1 January 2017.

In addition to the recent DTT implementation work, German authorities are engaged in numerous negotiations. According to an official DTT update, Germany is currently involved in negotiations with 61 countries in order to revise or amend existing treaties or negotiate entirely new DTTs on income and capital as well as several additional treaties on ships and aircraft or information exchange. The first major achievement in treaty negotiations is when a new treaty or protocol is officially initialed. From October to December 2017, this step was completed with Costa Rica, Finland, Poland and Portugal. Apparently, even newly changed treaties such as the ones with Costa Rica and Finland are subject to further negotiations.

Moreover, Germany will likely start to ratify the OECD’s Multilateral Instrument (MLI) in 2018. Germany will take a two-step approach. In a first step, the MLI treaty itself will be ratified. This is likely to happen by the end of 2018. In addition to that, German domestic law requires that all domestic implementation laws of the 35 German DTTs that are covered by the MLI (so-called Covered Tax Agreements – CTAs) will be changed. German officials have stated that this process will take some time and the MLI provisions will apply on a first subset of the German CTAs not before 1 January 2019, maybe even 1 January 2020.

VAT on e-commerce: New rules adopted

On 5 December 2017, the European Council adopted one directive and two regulations making it easier for online businesses to comply with VAT obligations.

As of 1 January 2019, a threshold of €10,000 will be implemented for companies rendering supplies of telecommunication services, broadcast services and electronically supplied services. This allows businesses to continue applying the normal VAT declaration rules in their home country for annual cross-border sales below this threshold.

According to the current VAT law, companies are obliged to either register for VAT purposes in the country of the recipient of such services or declare the foreign VAT via the “one-stop shop” procedure, i.e. currently there are specific obligations already as of the first EUR of turnover in this regard.

As of 1 January 2021, extensive simplifications for distance sales (supplies of goods) will become effective including the following:

- The MOSS-procedure will also be extended to distance sales of goods, both intra-EU and from third countries.
- The VAT exemption for small value consignments will be abolished.
- The current threshold for distance sales of goods will be replaced by the €10,000 threshold for electronically supplied services.
- Distance sales from non-EU countries will be exempted from import VAT.
- Additionally, online platforms will be made liable for collecting VAT on the distance sales they facilitate.

The new regulations are particularly welcome news for e-commerce businesses engaged in the supply of goods, as the one-stop shop will relieve online traders of having to register for VAT in each of the member states in which they sell goods. The member states will have time until 31 December 2018 and 31 December 2020 to transpose the corresponding provisions of the directive into national laws and regulations.
In a response to a written question of a member of parliament of the German Green Party, a deputy of the Federal Ministry of Finance explained its position with regard to the income taxation and VAT treatment of cryptocurrencies such as Bitcoin in Germany. While informational only in nature and non-binding, the response may nonetheless serve as an indicator on the view of tax consequences on Bitcoin transactions in Germany. The following comments are made:

• The exchange or re-exchange of cryptocurrency into € or another cryptocurrency within one year after the prior acquisition will generally lead to a private sales transaction (Privates Veräußerungsgeschäft) subject to tax. Losses from private sales of cryptocurrencies can be offset against profits from other private sales transactions. Private sales with profits of less than €600 per calendar year or sales which were realized outside the one-year minimum holding period are exempt from personal income tax.
• If the cryptocurrencies are acquired or produced in the course of a business activity and with the intention of generating business income, the profits resulting from a later sale or exchange of the cryptocurrency will be classified as income from trade business (Einkünfte aus Gewerbebetrieb). The costs of mining of the cryptocurrencies are immediately deductible as operating business expenses.
• The European Court of Justice (ECJ) clarified the VAT treatment of the exchange of Bitcoin into a “conventional” currency with its decision in the case “Hedqvist” dated 22 October 2015 (C-264/14). The ECJ decided that the exchange of “conventional” currencies into units of the virtual currency Bitcoin and vice versa are to be treated as a supply of service for consideration and VAT exempt. As far as the cryptocurrency has no other purpose than a pure payment instrument, the usage of Bitcoin will be classified as equal to the use of “conventional” currency and will thus not be subject to VAT. According to a follow-up letter issued by the German Federal Ministry of Finance on 27 February 2018, such principles shall also be applied in German VAT law. Furthermore, mining of cryptocurrencies shall be treated as not subject to VAT as it does not constitute a service for a consideration.
• Please note that in an accompanying statement reference was made to the strong role of the German Federal Agency for Financial Market Supervision (BaFin) that has an oversight role for exchange platforms dealing with electronic currencies such as Bitcoin.
BMF updates guidance on disclosure obligations

On 5 February 2018, the German Federal Ministry of Finance (BMF) published an updated version of its guidance on the disclosure obligations set out in section 138 and section 138b of the General Fiscal Code. The updated decree replaces the old version of 15 April 2010 and provides for additional guidance on the new disclosure obligations, which were introduced into German law with the bill on the combat of tax avoidance on 24 June 2017.

Pursuant to the law, from 1 January 2018 onwards German-resident taxpayers will be obliged to disclose setting up foreign permanent establishments, the purchase and sale of participations of at least 10%, or participations with a value of at least €150,000, in foreign entities, associations and funds (e.g. property trusts). Additionally, information must be provided on the activities of the relevant foreign entity, association, fund and foreign permanent establishment. The disclosure obligations also apply if a resident taxpayer obtains control over the business and financial activities of a company established in a third country. This disclosure obligation, inter alia, applies to credit institutions, financial service providers, payment service providers and investment brokers.

The BMF guidance outlines that for the calculation of the 10% threshold, direct and indirect participations must be included. Furthermore, business relationships with so-called “third-country companies” (= non EU / EEA companies) have to be reported if the taxpayer alone or together with a related party can directly or indirectly exert a controlling or decisive influence on corporate, financial or business matters of a third-party company. According to the BMF, such an influence is assumed, among others, where the possibility of making all significant decisions of the management, the business policy as well as other essential business decisions lies with the German taxpayer, irrespective of the existence of a direct or indirect participation in the capital or assets or the holding of voting rights in the third-country company. The BMF points out that there already is an obligation to disclose if such an influence is objectively possible without the need to factually exercise the influence.

The notifications according to section 138 of the General Fiscal Code are generally to be submitted together with the tax return for the tax period in which the facts to be notified have been realized. The official form provided by the tax authorities needs to be used.

Lower tax court of Muenster rules against opinion of the German tax authorities: Income from initial discounting of liabilities considered as interest income according to interest expense limitation rule

On 17 November 2017, the lower tax court of Muenster (4 K 3523/14 F) ruled on the consideration of interest income resulting from the initial discounting of liabilities for the purposes of the interest expense limitation rule (section 4h Income Tax Act). The decision contradicts the current administrative opinion of the tax authorities. An appeal against the decision has been permitted, but not yet been filed with the German Federal Tax Court (BFH).

The deduction of interest for tax purposes is limited by the German interest expense limitation rule. Based on this rule, interest expenses can generally be deducted in the amount of interest income received by the taxpayer without limitations. Any exceeding interest expenses (so called “net interest expenses”) are only deductible at 30% of the EBITDA for tax purposes (a few exceptions to this rule exist). The law defines “interest income” as revenue from monetary claims of any kind which have increased the profit of the entity. Further it is stated that the discounting of non-interest bearing or low-interest bearing liabilities also gives rise to interest income.

In this regard it is the current opinion of the tax authorities (expressed in a public letter ruling) that any income resulting from the initial discounting of non-interest bearing or low-interest bearing loans is not to be considered as interest income in the meaning of the interest expense limitation rule. For several years, this opinion has been discussed controversially in the professional tax literature.
German court decisions

The current case concerned exactly this tax technical question. It had to be decided if the income generated by a German partnership from the initial discounting of two non-interest bearing loans at the end of the FY is considered “interest income” for purposes of the interest expense limitation rule.

The lower tax court ruled in favor of the taxpayer and allowed the consideration of the respective interest income, arguing that the wording of the law, which explicitly allows the consideration of interest income from the discounting of non- or low-interest bearing liabilities, does not provide any room for interpretation. The court further stated that neither the law itself nor the legislative materials allow for an exception in cases where the liability is discounted for the first time.

The recent ruling is generally positive for taxpayers being debtors of non-interest bearing loans, as it may in certain cases allow for additional interest deductions under the interest expense limitation rule. However, it needs to be taken into account that in case of non-interest bearing receivables also additional interest expenses may be generated accordingly. It remains to be seen if an appeal will be filed and, in such case, if the BFH will confirm the position of the lower tax court.

The recent ruling of the lower tax court does not affect the pending proceedings with the German Constitutional Court on the question if the interest expense limitation rule in its entirety is to be seen as not constitutional. Against this background it is still recommended to keep any assessments relating to the interest expense limitation rule open until a final decision has been made by the Constitutional Court.

BFH expresses new view on RETT-blocker structures

The Federal Tax Court (BFH) has changed its case law and now refers for the indirect unification of shares for German real estate transfer tax (RETT) purposes via an intermediary partnership (RETT-blocker) no longer to the legal participation in the joint property, but to the share in capital.

For RETT-blocker structuring, an intermediary partnership has often been used to avoid RETT when acquiring shares in a property-owning corporation. Prior to a law change in 2013, such RETT-blocker structures were used to avoid a RETT-able event, even though economically 95% or more of the shares in a German property-owning company were transferred.

The BFH held in its decision of 27 September 2017 (II R 41/15), contrary to its prior judgement (BFH decision dated 8 August 2001, II R 66/98), that such structures are now also subject to RETT. With regard to an intermediary partnership which directly or indirectly holds shares in an entity with German real estate, the participation in the company capital is decisive.

In the case of indirect shareholdings it no longer depends on whether a company in the legal form of a corporation or a partnership is used as an intermediate RETT-blocker. In the view of the BFH, indirect shareholdings should be treated in a neutral way with regard to the legal form. Furthermore, the BFH requires an at least 95% share in capital for the existence of an indirect share acquisition via an intermediary partnership.

In the present case, the tax court also rejected the taxpayer’s claim that there should have been a legitimate expectation for the continued application of the old case law. The tax court argues that the former case law (II R 66/98) refers to the former legal situation until 31 December 1999. As the decrees of the financial administration had not yet been published when the facts were realized, those cannot establish a protection of trust.

It remains to be seen whether the tax administration responds with a non-application decree (BStBl. I 2016, p. 477) just as for the comparable decision (decision of 12 March 2014, II R 51/12) or agrees with the view of the BFH.

The regular assessment period is 7 years, in case the tax authorities have not been informed in the past about the transaction through a RETT notification. Hence, in the case at hand at least transactions which took place between January 2011 and June 2013 can be affected. Since in June 2013 a new provision (Sec. 1 para. 3a RETT-Act) was introduced to target such RETT-blocker structures, no further transactions using the present RETT avoiding transaction structure should have been executed. Therefore, transactions after June 2013 should in general not be affected by the new decision. Transactions in the past should be reviewed individually, in particular against the background of the existing obligation to file a RETT notification.
German court decisions

**BFH case highlights need for advance planning for tax group implementation**

In its case I R 80/15, the German Federal Tax Court (BFH) had to judge on a - formally - failed tax group, and whether the tax authorities had to grant the benefits of a tax group despite the fact that the legal prerequisites had not been met. German tax law inter alia requires the legally valid conclusion of a profit and loss pooling agreement (PLPA) between a controlling parent and the controlled subsidiary until the end of the subsidiary’s first fiscal year for which the tax group shall apply. Legally, the PLPA becomes valid with registration into the subsidiary’s trade register. This final step, however, is not in the taxpayer’s control, as it is carried out by the judge in charge of the trade register. In the case decided, the filing for PLPA registration (i.e. the last step which the taxpayer could directly control) took place on 26 October 2006; however, actual registration of the PLPA only occurred on 26 January of the next year, i.e. more than three months later, and thus too late for PLPA validity in 2006. The BFH, in line with the tax office, rejected the taxpayer’s claim for acceptance of the tax group on the basis of the clear wording of the law. It is not known whether the taxpayer as a consequence now tries to claim damages from the trade register under public liability law principles.

While this is an extreme case (and a more than three-month period between filing for PLPA registration and actual registration is very rare), it highlights the need to engage in advance planning for tax group creation.

**Federal Tax Court gives guidance on how to distinguish between trading and private renting of immovable property**

In Germany, income derived from renting or leasing immovable property can be categorized either as private asset management (so called “income from rental of a property or land”) or as trading income. The distinction is particularly relevant for the question whether trade tax is payable (only on trading income). In general, renting is classified as private asset management, as long as the economic overall view does not indicate a trading intention. On the other hand, a trading intention is assumed whenever the lending and renting activities can be seen as economically independent, sustainable and profit-driven. Moreover, a trading intention is deemed to exist whenever more than three properties are sold within five years, irrespective of any connected renting of property.

In its decision dated 28 September 2017, IV R 50/15, the German Federal Tax Court (BFH) provided further guidance on how to differentiate between private and trading income from immovable property. The BFH stated in its judgement that the line between private and trading real estate management is crossed when – in consideration of all objective circumstances – the main purpose of the construction or purchase of a real estate asset was not its long-term leasing and renting, but its resale. This means that cases where, from an economic overall view, real estate was purchased or built with the purpose of selling it even after a long-term leasing or lending period for a pre-determined selling price can be regarded as one connected transaction. Therefore, income realized throughout the lending or leasing period as well as the gain of the (re-)sale are categorized as trading income.

In general, trading income triggers German trade tax in addition to German (corporate) income tax, while income derived from private asset management is only subject to income tax. For purposes of trade tax, there exists a net deduction for passive rental activity of immovable property. Such deduction is provided to the extent that an entity’s business consists solely of a passive rental activity and that it avoids any other activities which it may render as a commercial business. In the light of the abovementioned judgement, it remains to be seen to what extent this trade-tax deduction will be subject to stricter interpretation.
German court decisions

Lower tax court rules on German taxation right regarding interest income that is only partially taxed in a US permanent establishment

On 29 May 2017, the German lower tax court of Munich (7 K 1156/15) ruled that interest income in a US permanent establishment of a German taxpayer that is only partially “effectively connected” US income and hence only partially taxed in the US is nevertheless fully tax exempt in Germany under the German/US double tax treaty 1989 (DTT). The court objected the view of the local tax office, which has appealed against the decision before the German Federal Tax Court (BFH, I R 45/17).

In the case at hand, a German corporate taxpayer earned interest income from certain securities which were attributed to the taxpayer’s US permanent establishment. In accordance with the US Treasury Regulations, a portion of these interest earnings were excluded from the taxable basis and treated as “non-effectively connected income”. Thus, the interest earnings were only partially subject to tax under US tax law. Consequently, the German local tax office held the view that such partial non-taxation in the US would disallow an exemption of the interest earnings in Germany under the “subject-to-tax clause” of Art. 23 Para. 2 Sent. 2 of the DTT. This rule effectively limits the German tax exemption of US income to income that is “taxed” in the US in accordance with the DTT. That is, for income that is not taxed in the US the exemption method cannot be applied.

The court decided that, in line with the wording and intention of Art. 23 of the DTT, even a partial taxation of the interest in the US is still sufficient for the income to qualify as “taxed” US income. The taxation right only falls back to Germany if the income category is not taxed, but not insofar as items of income are not taxed. A partial non-taxation in the US is, therefore, irrelevant for the purpose of the switch-over clause, which does not allow for a split of income into a taxable and a non-taxable part. The decision is in line with earlier decisions published by the BFH on similar rules, where it was clarified that the lawmaker would have to explicitly use the term “insofar” if it was intended to capture an only partial non-taxation of income. In this regard, the view of the court may also be relevant for the interpretation of the similar switch-over clause in Art. 23 Para. 4 Lit. b) of the currently applicable German/US double tax treaty 2006, which contains a similar wording (if instead of insofar). An open question is, however, whether a partial non-taxation of income may be sufficient for a restriction of the exemption method under the domestic switch-over clause of Sec. 50d Para. 9 Sent. 4 of the German Income Tax Act, which was only introduced as of 2017.

It remains to be seen whether the BFH will confirm the lower court’s decision and, possibly, even provide indications regarding its interpretation of the corresponding domestic switch-over clause as well.

Management PE in case of an internationally operating independent consultant

The Munich tax court in its case 9 K 3041/15 of 31 May 2017 had to decide on a situation which at first sight appears somewhat exotic, but presumably has significant and growing relevance in today’s economy. The case dealt with a Uruguayan resident, who had IT consultancy engagements in Germany, which he carried out as an independent contractor at the client’s site in Germany (during 6 months in 2013). The consultant had rented an apartment in Germany while working here, but also kept his family home in Uruguay. While the consultant claimed not to have created a permanent establishment (PE) in Germany, and hence not to be liable to German tax, the tax authorities and also the Munich court held that the consultant had created a taxable presence in Germany, as a) any business must have at least a management PE (i.e. there is no business without a PE), b) the existence of a (management) PE in Uruguay could not be substantiated, and thus, by default, the management had to be in Germany, and c) there was a fixed presence in Germany (the apartment), from where the management of the consultancy business was carried out during the time of the German contract. The taxpayer is trying to have this case examined by the highest German tax court (case pending under I B 62/17); the Munich court originally did not allow an appeal.

An interesting question this case leaves open is how the tax situation would have been judged had the consultant not rented an apartment, but rather stayed in one (or several different) hotel(s) in Germany. Generally, a power of disposal, and thus a fixed presence, is denied in case of a hotel room, and it would therefore be hard to construe a management PE in such circumstances.
German court decisions

**Federal Supreme Court confirms that fines in compliance defense case can be reduced if the company implemented a compliance management system**

There is still a substantial number of companies in Germany without a compliance management system (CMS) although it is apparent since a decision of the district court Munich in the year 2013 that the prevention of internal process weaknesses in a company is worthwhile. In this decision, the court ruled that the management of a company may be liable for criminal conduct of employees if no effective CMS has been implemented. In such case, high fines due to a violation of the supervisory duties and even prosecution for aiding criminal conduct are possible.

These principles have now been confirmed by the German Federal Supreme Court (BGH) in its decision dated 9 May 2017. The court recognized for the first time that a company’s implementation of a CMS constitutes a mitigating factor for the assessment of fines imposed on a company where violations committed by its employees are imputed to the company.

In the case at hand, an officer of a trading company paid bribes to members of the Greek government. The bookkeeping department of the company had already implemented a system to avoid payments of bribes and the employee circumvented this control system by using fictitious consulting agreements and dummy companies.

The court stated that the implementation of a CMS can be considered a mitigating factor when assessing the amount of fines against the company. Furthermore, the BGH stated that also subsequent efforts of a company to enhance its internal processes that were found deficient may be taken into account to assess or reduce fines.

With the decision of the BGH it has now finally been clarified that establishing and maintaining a CMS may limit a company’s liability for legal infringements. Accordingly, companies are encouraged to continue working on their compliance culture, processes and systems and to establish, maintain and improve an effective CMS. This also serves to protect the senior executives from being held personally liable under civil law or even criminal law.
ECJ rules German anti-treaty shopping rule infringes Parent-Subsidiary Directive and freedom of establishment

On 20 December 2017, the Court of Justice of the European Union (ECJ) issued its decision in the combined German cases C-504/16 (Deister Holding AG) and C-613/16 (Juhler Holding A/S). These cases concern the application of the (old version of the) German anti-treaty shopping provision, section 50d para 3 German Income Tax Act (iITA).

Under the German anti-treaty shopping rule as applicable until 31 December 2011, a foreign company cannot claim a 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% 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. The current version of the anti-treaty shopping rule is similar, but excludes the 10% requirement for own business activities.

The ECJ ruled that this provision infringed both the European Union (EU) Parent-Subsidiary Directive and the right of freedom of establishment. According to the ECJ, the (old version of) the German anti-treaty shopping rule is not specifically designed to solely exclude wholly artificial arrangements, but more generally covers “any situation where persons who would not have been entitled to such an exemption if they received the dividends directly have holdings in a non-resident parent company.” The ECJ further added that pursuant to the German legislation the non-resident parent has no possibility to provide evidence of the existence of economic reasons for its establishment, i.e. there is no possibility for the parent company to rebut the presumption of fraud or abuse of law. Furthermore, pursuant to the ECJ, the fact that the non-resident parent company is only a holding-management entity cannot per se indicate the existence of a wholly artificial arrangement. Indeed, the ECJ requires an assessment of the relevant situation on a case-by-case basis.

The decision rendered by the ECJ sheds light on a Member State’s leeway to design anti-abuse rules in the field of countering treaty or directive shopping schemes. In particular, the fact that asset management of a foreign entity may by itself not constitute an indication of an abusive fact pattern and the fact that valid business reasons for the interposition of a foreign entity need to be assessed from a group’s perspective may also render the current German anti-treaty shopping rule in many cases inapplicable. This should be further clarified in the yet to be awaited decision of the ECJ in the pending case C-440/17, GS. Still open dividend WHT refund claims relating to the period 2007 until 2011 which the German Federal Tax Office denied because it so far applied the German anti-treaty shopping rule should be further pursued, provided it can be proven that there is no wholly artificial arrangement.

German local tax court grants Parent-Subsidiary Directive protection for an indirect shareholding in a German corporation

In a decision dated 13 September 2007 (case reference 2 K 2933/15), the German local tax court of Cologne held that a foreign shareholder is entitled to the 0% dividend withholding tax rate under the EU Parent-Subsidiary Directive (PSD) even though the shareholding in the German entity was held indirectly through a German non-trading partnership (GbR).

In the case at hand, a Dutch cooperation held approx. 33% in a German GbR, which in turn held 100% of the shares in a German corporation. In 2014, the German corporation made a distribution from which it withheld German withholding tax at the statutory rate of 26.375%. The foreign investor applied for a full refund of the tax withheld and argued that he was entitled to full exemption from dividend withholding tax under the PSD. The tax authorities did not grant full exemption. They took the view that, since the wording of the PSD required a direct shareholding of the parent company and its subsidiary which distributed a dividend, the holding shareholding through the GbR by a foreign investor was not eligible to the benefits of the PSD.
EU law

It rejected the applicant’s argument that for tax purposes a GbR is generally treated as a disregarded entity and therefore also needs to be disregarded for purposes of establishing whether a qualifying shareholding under the PSD is given.

The local German tax court of Cologne now decided in favor of the claimant. The court saw in the given case a direct shareholding within the meaning of the PSD and the German implementation rules. The court noted that for tax purposes the property and income of a GbR is allocated directly to its members and took the view that the requirement of a direct shareholding was fulfilled. Since the further requirements of the PSD for a qualifying shareholding were met, the court concluded that the 0% withholding tax rate was applicable. Notably, the court did not refer this question to the European Court of Justice, which is optional for a local tax court in a situation where EU law based rules need to be interpreted.

The case is now pending before the German Federal Tax Court (BFH, case reference: I R 77/17) as the tax authorities filed an objection against the decision in the first instance. It remains to be seen whether the BFH follows the line of argumentation of the tax court of Cologne or whether the BFH will involve the European Court of Justice and ask for a binding interpretation of the PSD.

Foreign EU corporate investors holding a substantial shareholding of more than 10% in a German corporation via a (German or foreign) partnership which is treated as disregarded for tax purposes may consider to apply for a full refund of withholding taxes in case the further requirements of the PSD are met in the given case.

The question of whether a direct shareholding is given might not only be relevant in EU situations. A number of double tax treaties exist which require for beneficial dividend withholding tax treatment to apply a direct shareholding of the recipient in the distributing entity. Third-country investors indirectly holding German shares through a partnership should consider seeking advice whether in their specific situation a more beneficial treatment under the relevant double tax treaty could be achieved.

Full input VAT deduction on development expenses?

The European Court of Justice (ECJ) softened the right to deduct input VAT in its decision in the Bulgarian Iberdrola case (C-132/16). This is good news for companies who incur costs resulting from the construction of development facilities for the municipality or other public bodies. Neither German Federal Tax Court case law (e.g. V R 12/08 dated 13 January 2011) nor the Administrative Guidelines for VAT currently allow taxable persons to deduct the input VAT from such costs given the argument that the supply of such development facilities to the municipality is free of charge. The ECJ already allowed the input VAT deduction resulting from development facilities in a previous case (C-126/14 dated 22 October 2015; Sveda). But given the fact that in the Sveda case the taxable person was not obliged to supply the facilities to the municipality free of charge, the current rigid German position has not clearly become obsolete by this case. This may change now as the ECJ decided in the Iberdrola case that the taxable person is entitled to deduct the input VAT from costs for development measures performed on a third party’s assets if they are essential for the company to carry out its economic activity and therefore have a direct and immediate link to the taxed output transactions carried out by the taxable person. The fact pattern behind the Iberdrola case is at least very close to the typical fact pattern of development expenses for which the German tax authorities still uphold a denial of input VAT deduction.
EY publications and events

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Upcoming EY events

**Update Internationale Steuern**
- In-depth analysis of recent international tax and transfer pricing developments
- Country updates
- Case discussion with tax administration representative

Language: German  
Event contact: Aleksandra Blachowska, aleksandra.blachowska@de.ey.com  
Date and location: 20 March 2018 in Munich

**Deutsches International Tax & Transfer Pricing Forum**
- In-depth analysis of recent international tax and transfer pricing developments from various points of view
- Special focus on post-BEPS developments, digitalization and current regulatory changes and developments

Language: German  
Event contact: Katharina Beckfeld, katharina.beckfeld@de.ey.com  
Date and location: 28-29 May 2018 in Mainz
EY German contacts
Cities in alphabetical order

<table>
<thead>
<tr>
<th>City</th>
<th>Address</th>
<th>Phone</th>
<th>Telefax</th>
</tr>
</thead>
<tbody>
<tr>
<td>10117 Berlin</td>
<td>Friedrichstraße 140</td>
<td>+49 30 25471 0</td>
<td>+49 30 25471 550</td>
</tr>
<tr>
<td>28217 Bremen</td>
<td>Lloydstraße 4-6</td>
<td>+49 421 33574 0</td>
<td>+49 421 33574 550</td>
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<tr>
<td>44141 Dortmund</td>
<td>Westfalenstraße 11</td>
<td>+49 231 55011 0</td>
<td>+49 231 55011 550</td>
</tr>
<tr>
<td>01099 Dresden</td>
<td>Forststraße 2a</td>
<td>+49 351 4840 0</td>
<td>+49 351 4840 550</td>
</tr>
<tr>
<td>40213 Düsseldorf</td>
<td>Graf-Adolf-Platz 15</td>
<td>+49 211 9352 0</td>
<td>+49 211 9352 550</td>
</tr>
<tr>
<td>99092 Erfurt</td>
<td>Barbarossahof 18</td>
<td>+49 361 6589 0</td>
<td>+49 361 6589 550</td>
</tr>
<tr>
<td>65760 Eschborn/Frankfurt/M.</td>
<td>Mengenthaler Allee 3-5</td>
<td>+49 6196 996 0</td>
<td>+49 6196 996 550</td>
</tr>
<tr>
<td>45131 Essen</td>
<td>Wittekindstraße 1a</td>
<td>+49 201 2421 0</td>
<td>+49 201 2421 550</td>
</tr>
<tr>
<td>79098 Freiburg</td>
<td>Bismarckallee 15</td>
<td>+49 761 1508 0</td>
<td>+49 761 1508 23250</td>
</tr>
<tr>
<td>20148 Hamburg</td>
<td>Rothenbaumchaussee 78</td>
<td>+49 40 36132 0</td>
<td>+49 40 36132 550</td>
</tr>
<tr>
<td>30159 Hannover</td>
<td>Landschaftstraße 8</td>
<td>+49 511 8508 0</td>
<td>+49 511 8508 550</td>
</tr>
<tr>
<td>74072 Heilbronn</td>
<td>Titotstraße 8</td>
<td>+49 7131 9391 0</td>
<td>+49 7131 9391 550</td>
</tr>
<tr>
<td>50667 Cologne</td>
<td>Börsenplatz 1</td>
<td>+49 221 2779 0</td>
<td>+49 221 2779 550</td>
</tr>
<tr>
<td>04109 Leipzig</td>
<td>Grimmaische Straße 25</td>
<td>+49 341 2526 0</td>
<td>+49 341 2526 550</td>
</tr>
<tr>
<td>68165 Mannheim</td>
<td>Theodor-Heuss-Anlage 2</td>
<td>+49 621 4208 0</td>
<td>+49 621 4208 550</td>
</tr>
<tr>
<td>80636 Munich</td>
<td>Arnulfstraße 59</td>
<td>+49 89 14331 0</td>
<td>+49 89 14331 17225</td>
</tr>
<tr>
<td>90402 Nuremberg</td>
<td>Am Tullnaupark 8</td>
<td>+49 911 3958 0</td>
<td>+49 911 3958 550</td>
</tr>
<tr>
<td>88212 Ravensburg</td>
<td>Gartenstraße 86</td>
<td>+49 751 3551 0</td>
<td>+49 751 3551 550</td>
</tr>
<tr>
<td>66121 Saarbrücken</td>
<td>Heinrich-Böcking-Straße 6-8</td>
<td>+49 681 2104 0</td>
<td>+49 681 2104 42650</td>
</tr>
<tr>
<td>70629 Stuttgart</td>
<td>Flughafenstraße 61</td>
<td>+49 711 9881 0</td>
<td>+49 711 9881 550</td>
</tr>
<tr>
<td>EY German Tax Desks</td>
<td>London</td>
<td>+44 20 7951 4034</td>
<td></td>
</tr>
<tr>
<td>EY German Tax Desks</td>
<td>New York</td>
<td>+1 212 773 8265</td>
<td></td>
</tr>
<tr>
<td>EY German Tax Desks</td>
<td>Shanghai</td>
<td>+86 21 2228 6824</td>
<td></td>
</tr>
<tr>
<td>EY German Tax Desks</td>
<td>Tokyo</td>
<td>+81 3 3506 2238</td>
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