German State of Hessen proposes initiative to support economic investment and limit certain tax measures

On 16 October 2014, the Ministry of Finance of the Federal State of Hessen issued a press release announcing that the Federal State of Hessen plans to introduce a legislative initiative to the Federal Council (Bundesrat - the German Upper House) with the objective to support economic investment and to curtail aggressive tax planning. The topics of the initiative are:

- Introduction of a measure against “patent box” and similar intellectual property taxation regimes established by other jurisdictions. According to the proposal, royalties paid to any group affiliate should only continue to be deductible as an expense in Germany if those payments are subject to tax in the hands of the affiliated recipient with a tax rate of 25% or higher.
- Temporary introduction of the declining-balance tax depreciation method for investments made during years 2015 and 2016.
- Repeal of LIFO (last in, first out) as an allowed convention for inventory tax accounting purposes.
- Repeal of the capital gains exemption for stock sales of corporate sellers, if the seller's interest in the sold company’s shares is below 10%.

The State of Hessen estimates a €400 m net tax revenue loss upon implementation of the measures. Note that this project is currently only an initiative of one of the sixteen German states and that all information is based on the cited press release. However, with regard to the proposal to restrict the tax deduction of royalties, the
German Government coalition declared previously in 2013 that unilateral changes in the area of royalty taxation should be considered in the event that the BEPS project does not result in an appropriate outcome until 2015. Details concerning the timing of the initiative or the language of any to be proposed legislative project are currently unknown. It is also unclear at this time how the royalty part of the project would overcome tax technical hurdles which would have to be addressed in the European Union (EU) context. For example, the regular effective tax rate of many EU States is already below 25%, and even in certain German municipalities, the overall German effective tax rate on corporate income can drop below 25%.

The proposal regarding the restriction on tax exemptions of certain capital gains deals with a current mismatch in the current German tax law for certain less than 10% corporate shareholders. Under current domestic tax law, dividends received by less than 10% corporate shareholders are generally fully taxable, whereas the sale of such minority shares may still be subject to a 95% tax exemption. In order to avoid certain planning options which currently benefit from this mismatch, the State of Hessen intends to further align the rules regarding the tax exemption of capital gains with the rules regarding the tax exemption of dividends.

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