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Draft guidance on cross-border debt financing released

Content

On 14 August, the German Ministry of Finance (BMF) published the eagerly awaited draft revision of the administrative principles on transfer pricing with regard to the new regulations on intra-group financing relationships and financing services introduced earlier in 2024 as part of the "Growth Opportunities Act". Interested parties have been invited to provide comments until early September, which may still lead to changes in the final guidance expected for later this year.

The new regulations for intercompany financing, as outlined in Sec. 1 para. 3d of the Foreign Tax Act (AStG), stipulate that taxpayers can only deduct interest expenses from cross-border financing activities, such as loans or the use of debt instruments, if the taxpayers meet two criteria. First, they must show that they can service both the principal and interest payments for the entire duration of the loan-period (debt capacity/cash-flow test). Second, they must prove that there was a legitimate business reason for the financing and that the borrowed funds were used specifically for that purpose (business-purpose test).

Consultation on transfer pricing guideline revision regarding financing transactions started

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Additionally, the interest rate for the cross-border intercompany financing relationship transaction must not exceed the interest rate based on the better of either the stand-alone rating of the borrower or the overall group-rating unless it is demonstrated, in a particular case, that a credit rating deviating from but nonetheless derived from the group credit rating is in line with the arm's-length principle.

Furthermore, a new provision in Sec. 1 para. 3e AStG includes a rebuttable presumption that any intercompany cross-border financing arrangements that are mediated, arranged or forwarded are considered a low-risk routine service. This is also applicable to captive treasury centers and captive financing companies. How such low-risk routine service should be remunerated is only briefly described in the explanatory notes to the bill. According to these, the remuneration for such transactions is typically to be determined based on the cost-plus method considering directly attributable operating costs but not including refinancing costs in the cost base. A markup between 5% and 10% is considered as not unreasonable. In addition, refinancing costs can be taken into account with a risk-free return.

The wording of the rules is rather general and, hence, requires substantial interpretation to be applied in practice. It is therefore a welcome development that the issued draft guidance illustrates the tax authorities' interpretation of some of the key question surrounding rules.

In general, the draft guidance emphasizes at the outset that the provisions of Sec. 1 para. 3d and 3e AStG are to be applied in accordance with the OECD Transfer Pricing Guidelines (Chapter X).

Regarding the debt capacity test, the draft guidance clarifies that this test is not per se failed only because re-financing of the initial financing might be required. Moreover, the tax authorities confirm that assets acquired with the borrowed funds can be included within the review as to whether the assets of the borrower are sufficient to cover the debt. Furthermore, the draft guidance confirms that high-risk financing relationships can be arm's-length. On the flipside, it states that the financing needs to be "meant seriously". This requirement exceeds the wording of the law. While it is grounded in case law, in principle, the BMF seems to interpret the requirement not in line with the case law, but rather in line with the OECD Guidelines (in particular, para. 10.12ff.). From this follows that the BMF requires a number of further criteria to be fulfilled in order to accept a financing transaction, such as a defined term of the loan, interest being charged based on agreed payment terms and the general ability of the borrower to borrow funds from third parties at comparable conditions.

The draft guidance further confirms that using debt to finance a dividend distribution to shareholders is a valid business purpose and suggests that taxpayers should utilize available excess cash prior to acquiring additional funds through borrowing. The BMF outlines that taxpayers must show compliance with the rules by providing evidence that they can service their debt, which may involve presenting a refinancing forecast. Additionally, they must confirm that payments are being made as stipulated in the financing agreement. Taxpayers are also required to clearly state the intended purpose of the financing and detail how the funds are being utilized in practice, all with a reasonable degree of certainty to meet the regulatory expectations.

Lastly, the draft guidance clarifies that the debt capacity and the business purpose test are understood as "to the extent" type rules, meaning that the interest deduction would only be denied to the extent the requirements are not met and the interest is, therefore, considered to not be at arm's-length. This constitutes a deviation from the actual wording of the law.

Concerning the credit rating to be used to determine the maximum interest rate, the draft provides that an existing rating of the ultimate parent entity can be used if a rating for the overall group does not exist. If a rating for the ultimate parent is not available, the determination of a rating based on the group's existing financing costs vis-à-vis third parties is accepted.

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It is further clarified that a rating differing from the group rating can also be used to determine the interest rate if the taxpayer can prove that a rating derived from the group rating complies with the arm's-length principle. Unfortunately, the draft lacks criteria for the required proof.

Regarding the above, the draft guidance also provides for a transition period for existing financing relationships. Sec. 1 para. 3d AStG is not to apply to expenses based on financing relationships that were agreed and implemented before 1 January 2024 unless the financing was changed significantly after 31 December 2023 or continues beyond 31 December 2024. Effectively, this means that affected financing relationships could be adjusted as required until 31 December 2024.

Concerning the application of Sec. 1 para. 3e AStG, the BMF is essentially maintaining its previous interpretation in rec. 3.125 of the previous Administrative Principles on Transfer Pricing 2023. According to the new draft, the determination of an arm's length price for the lending of capital between related parties is generally based on the comparable uncontrolled price method. However, low-risk financing entities are limited to a risk-free return. When loan granting and control over associated functions or risks are divided among different entities, additional transactions may be recognized, requiring appropriate compensation for the entity in control, especially if it is a German entity.

Although not explicitly stated in the draft, this suggests that the BMF does not interpret Sec. 1 para. 3e AStG as providing for a correction of an arm's length interest expense at the level of the borrower. This would be in accordance with corresponding case law and OECD principles. A transition rule concerning Sec. 1 para. 3e AStG is not included in the draft guidance.

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New major tax cuts package with uncertain prospects for implementation

The German Federal Cabinet approved the draft of the Tax Advancement Act on 24 July 2024. This legislation is part of the federal government's growth initiative and includes several key measures, such as:

- Extension of the declining balance depreciation for movable fixed assets, which is currently only applicable to assets acquired or produced by the end of 2024, until the end of 2028. The depreciation rate is proposed to be two and a half times the straight-line depreciation, with a maximum of 25%.
- Introduction of a declining balance depreciation for electric vehicles which are purchased from 1 July 2025 to 31 December 2028. The rule would allow to deduct 40% of the acquisition costs in the year of acquisition.
- The pool for low-value assets is planned to be available from 2025 for assets with acquisition or production costs ranging from EUR 801 to 5,000. The expense, which was previously spread over five years, may be spread over three years in the future. In addition, the current obligation to document low-value assets in a special register may be eliminated.
- The maximum assessment basis for the R&D allowance is planned to be increased from EUR 10 million to 12 million for eligible expenses incurred after 31 December 2024.
- Company car taxation: The cost cap for the reduced taxation of electric vehicles will be increased to EUR 95,000.
- Introduction of a reporting obligation for domestic tax arrangements, closely modeled on the existing obligation for cross-border tax arrangements. The new disclosure obligation, if enacted, would not start before 2026.
- Inflation adjustment of the progressive income tax system for the assessment periods 2025 and 2026.
- Extensive changes to the wage tax deduction for spouses and life partners, which are planned to take effect around 2030.

All measures taken together, the fiscal impact of the bill is expected to rise to nearly EUR 21 billion. Given the tight public budgets on federal as well as on state level, it remains highly questionable if the bill can achieve the support of the states in the Federal Council. A first state statement is expected on 27 September 2024.

In a separate tax bill, which is more likely to achieve parliamentary support in its planned form, the Government plans to implement the extension of the electricity tax relief for manufacturing companies as agreed in the growth initiative. Currently the manufacturing sector benefits from a temporary relief that effectively reduces the tax to the EU minimum level of EUR 0.5 per MWh and is planned to expire at the end of 2025. The new bill, if enacted, would codify the relief without any time limit.

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Future Financing Act II released

In a comprehensive Future Financing Act II, which was released on 27 August 2024, the Federal Government plans to implement financial market related measures of the growth initiative. The bill contains several changes in the Investment Tax Act as well as in the Capital Investment Code. It aims, e.g., at promoting fund investments in renewable energies and infrastructure as well as improving the tax framework for venture capital investments. In addition, the bill provides for an extended option for individuals to transfer gains from the sale of shares in corporations to other investments in corporations. For this purpose, the current cap is planned to be increased from EUR 500,000 to EUR 5,000,000 as of 2025. Further measures include a relaxed dismissal protection for employees with very high incomes in the financial sector and the reduction of the minimum nominal value of shares of joint-stock companies to less than EUR 1.

It is expected that the Future Financing Act II will not be finalized before 2025.

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Tax reform proposals released by independent expert commissions

Two expert commissions, which were officially appointed by the German Federal Ministry of Finance (BMF), have presented numerous reform proposals for a "simplified corporate tax" and a "citizen-friendly income tax". Notably, the "simplified corporate tax" working group presented a comprehensive report filled with numerous detailed proposals. Although the commission's explicit mandate did not include dealing with the corporate income tax and personal income tax rates, it unequivocally stated that "in an international comparison, a development of the tax burden on business profits towards 25% appears competitive."

Some specific proposals from the commission include:

- Corporate income tax: Return to 100% exemption of dividends and capital gains (elimination of the 5% "deemed nondeductible expense" penalty).
- Corporate tax group: Abandonment of the requirement for a profit transfer agreement. Instead, introduction of a qualified majority shareholding of at least 75% of voting rights and capital stock.
- Expanded loss offset: Temporal and quantitative extension of loss carryback, introduction of loss carryback for trade tax, and elimination of minimum taxation restrictions on loss carryforwards.
- Global minimum tax (GloBE): Establishment of permanent safe harbor rules and replacement of all specific anti-abuse provisions with the global minimum tax (especially CFC rules).
- Improvement of the credit for foreign taxes, including a transition from per-country limitation to overall limitation.
- Limitation of the Tax Haven Defense Act to a single defensive measure.

Even though the collected proposals appear well-founded and sufficiently concrete, it is not expected that the governing coalition will promptly introduce a comprehensive package of corporate and income tax reforms. Instead, the reports are intended more as a starting point for a broad professional discussion, paving the way for a tax reform yet to be tackled. However, it is planned to implement at least some points with a manageable effect on tax revenue during the current legislative period, which runs until mid-2025. The coalition had promised to review the commission reports as part of the growth initiative approved by the Federal Cabinet on 17 July 2024. Some points could, for example, be incorporated into the Tax Advancement Act.

The reports of the expert commissions are available (in German only) *under this link.*

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Discussion draft of the Minimum Tax Adjustment Act published

The Federal Ministry of Finance published on 20 August 2024 the discussion draft of the Minimum Tax Adjustment Act (MinStGAnpG). The act aims to incorporate administrative guidelines of the OECD (in particular, the so-called Agreed Administrative Guidance 3 from December 2023) — with a focus on the application of the CbCR Safe Harbor — into national law. Associations and interest groups have until 6 September 2024 to submit their comments.

The amendments to the Minimum Tax Act include, among other things, the requirement that the information used for calculating the CbCR Safe Harbour for the respective tested tax jurisdiction must uniformly come from the same data source for all business units, to ensure consistency. Therefore, the corporate group should use either the reporting packages with which it prepares the consolidated financial statements or the annual financial statements of the business units that were prepared using a recognized or approved accounting standard for the creation of the country-by-country report. In particular, if reporting packages are used, they need to be in line with CbCR requirements such as the use of aggregated data rather than consolidated data, i.e. prior to consolidation adjustments and ▶

intercompany profit eliminations. Less strict rules apply to permanent establishments and non-material entities. In addition, sec. 1.3 of the Agreed Administrative Guidance of December 2023 regarding purchase price accounting adjustments (with the prerequisite that for years beginning after 31 December 2022 the group must have filed CbCR including these adjustments), as well as sec. 2.6 regarding hybrid arbitrage arrangements is transitioned into German legislation for purposes of the safe harbor calculations. Furthermore, the legislator adjusts the consideration of deferred taxes as part of the full calculation in cases where they are not disclosed due to offsetting of deferred tax assets and deferred tax liabilities and due to exercise of an option not to do so.

In addition to the changes mentioned above, the Federal Ministry of Finance uses the Minimum Tax Adjustment Act to make editorial adjustments and administrative simplifications in the Minimum Tax Act.

Guidance provided by the OECD in the Agreed Administrative Guidance of June 2024 is not included in the draft legislation.

Associations and interest groups are invited to comment on the discussion draft by 6 September 2024. It is expected that the parliamentary process will not be concluded in 2024.

Aside from the draft of the Minimum Tax Adjustment Act, no detailed information is yet available with respect to the notification requirement as stipulated in sec. 3 of the Minimum Tax Act; an implementing ordinance is not expected to be issued before late fall. The notification regarding the entity heading the German minimum tax group shall be submitted in standardized electronic format no later than two months after conclusion of the first year of application of the German Minimum Tax Act.

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Shortened deadline for transfer pricing documentation

With the DAC7 Implementation Act, the legislator enacted numerous changes to German tax procedural law in 2022, beyond the implementation of DAC7, particularly adjustments aimed at modernizing tax audits.

As part of these adjustments for the modernization of tax audits, the deadline for submitting transfer pricing documentation in all cases was shortened to 30 days after the request or after the announcement of the tax audit order (Sec. 90 para. 4 German Fiscal Code (AO)).

Prior to the amendment, the law provided a deadline of 30 days only for records of extraordinary business transactions (e.g., transfers of assets as part of restructuring activities). In all other cases, i.e., ordinary business transactions, the taxpayers were required to submit the records within 60 days.

The shortened deadline is applicable for the first time to all taxes and tax refunds that arise after 31 December 2024. It is important to note that the shortened deadline also applies to taxes and tax refunds that arise before 1 January 2025 if a tax audit order is announced for these taxes and tax refunds after 31 December 2024.

The timely submission of transfer pricing documentation is particularly important considering the impending sanctions in cases of non-compliance of the comprehensive documentation obligations. If the transfer pricing documentation according to sec. 90 para. 3 AO is not submitted, submitted late or is deemed unusable, a penalty must be imposed (sec. 162 para. 4 AO). In cases of late submission of the transfer pricing documentation, a penalty of up to EUR 1 million may be levied, with a minimum of EUR 100 for each full day of delay.

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Planned measures by the government to reduce bureaucracy

The German government is striving to reduce the bureaucratic burden for companies. To this end, the Federal Cabinet adopted the draft for a relief law (the Bureaucracy Relief Act IV) in March 2024, which is being discussed in the German parliament and is intended to relieve the German economy of costs of around EUR 944 million per year. The draft of the Relief Act essentially includes several measures.

The retention periods for accounting documents under commercial and tax law are to be shortened from ten to eight years, which reduces storage costs.

Additionally, a central database of powers of attorney is to be created for tax advisers. Employers no longer have to issue written powers of attorney to their tax consultants for the respective social security institutions. A general power of attorney shall suffice. It shall be electronically entered in the database and can be accessed by all social security institutions. According to estimates, nine out of ten powers of attorney will be eliminated as a result.

There will also no longer be an obligation for German citizens to register in hotels. With 129 million tourist overnight stays in Germany every year, the annual time spent by citizens is to be reduced by almost three million hours and the economy is to be relieved by costs of around EUR 62 million annually.

Another key measure is to allow more digital legal transactions: So-called written form requirements are to be lowered to text form requirements. Unlike the written form, the text form does not require a handwritten signature: For example, an e-mail, a text message or a messenger message is sufficient. This will make it possible to process many legal transactions digitally in the future. Other measures include, for example, the digitization of operating cost statements for rental agreements and the possibility of digitally reading passports during flight handling in the future.

In addition to the above, further measures shall provide even more relief from bureaucracy. In June 2024, the Federal Government adopted a drafting aid for an amendment to the Bureaucracy Relief Act IV, which includes among others the digital employment contract as key measure. It shall be possible to conclude an employment contract completely digitally. It should be possible to draft the main contractual terms and conditions in text form (in particular by e-mail) instead of in written form and transmit them electronically to the employee concerned.

The economy is to be relieved of a further EUR 2.6 million per year in compliance costs. It is envisaged that entrepreneurs/companies who transfer their business premises to the area of responsibility of another trade authority only have to notify the new authority.

In addition, listed companies are to be relieved of the burden of preparing their annual general meetings. In the case of remuneration-related resolutions, it will be sufficient to make the necessary documents accessible solely via the company’s website.

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German BMF regulations comment on Advance Mutual Agreements, including Advance Pricing Agreements

In 2021, the German legislature introduced a new legal basis in Germany for bilateral and multilateral Advance Mutual Agreements (Advance Pricing Agreements (APAs) and other Advance Agreements under a double tax treaty) under Sec. 89a German Fiscal Code (AO). Since then, numerous practical questions regarding the new regulation remained unanswered, and tax practitioners eagerly awaited the corresponding update, which the German Ministry of Finance (BMF) ultimately issued on 26 June 2024.

The update represents the first time that the BMF has formally commented on the new provision for bilateral and multilateral Advance Mutual Agreements (Sec. 89a AO). The new AEAO applies for the first time – in accordance with the statutory application rule for Sec. 89a AO – to all Advance Mutual Agreement procedures and binding tax rulings for which applications were received after 8 June 2021.

For more detailed information, please refer to the *EY Global Tax Alert dated 30 July 2024.*

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German Pillar Two draft minimum tax returns published

In May 2024, the German Federal Ministry of Finance published the Pillar Two draft minimum tax returns. According to the German Pillar Two law, a minimum tax return needs to be filed in addition to the GloBE Information Return (GIR). This additional filing is due as the GIR formally does not qualify as a tax return and could also be filed abroad. Thus, the purpose of the minimum tax return is mainly to specify any top-up tax amounts owed by the filing German resident Constituent Entity (if an MNE group has more than one Constituent Entity located in Germany for Pillar Two purposes, only the minimum group tax parent ("Gruppenträger") is liable for any German Pillar Two top-up tax, if any, and must file the minimum tax return even in case no top-up tax is due).

In line with this purpose, the draft minimum tax return is a lean document just comprising two pages. It mainly requires taxpayers to provide information who files the return, for which fiscal year, where and when the GIR has been filed and what amount of Income Inclusion Rule (IIR) top-up tax, Undertaxed Profit Rule (UTPR) top-up tax or German Domestic Minimum Top-up Tax (DMTT) is due for the fiscal year, if any. Further, the draft minimum tax return allows to enter the registration and disclosure IDs for any cross-border arrangements filed under the German Mandatory Disclosure Rules (MDR or DAC6) concerning Pillar Two for the fiscal year, if any.

From a formal point of view, the minimum tax return is a tax declaration (Steueranmeldung) meaning that a tax assessment will only be issued if the tax authorities calculate a different amount of IIR, UTPR or domestic minimum top-up tax. The minimum tax return needs to be filed electronically to the local tax office competent for the filing Constituent Entity generally within the same deadlines as for the German (corporate) income tax returns but not earlier than the GIR (i.e. within 18 months after the end of the group's first fiscal year to which Pillar Two applies, for later fiscal years within 15 months after the end of the group's fiscal year).

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BMF publishes final version of tax authority guidance regarding Tax Haven Defense Act (StAbwG)

In the official guidance dated 14 June 2024, the tax authorities comment on practical questions of interpretation of the Tax Haven Defense Act (StAbwG), which has been applicable since 2022. The Tax Haven Defense Act has recently found a wider application in practice, since Russia was put on the blacklist of countries covered and defined as "tax havens" starting 1 January 2024.

The Ministry of Finance (BMF) revised the original draft of 30 November 2023 in numerous places. The following points are especially relevant for taxpayers:

- Further explanations regarding the definition of business relations and participations affected by the StAbwG were included. The guidance now provides additional examples regarding transactions of a partnership in or with reference to blacklist countries. It also addresses business transactions via a permanent establishment and "dealings" between head office and permanent establishment.
- Timing aspects regarding the non-deductibility of expenses were clarified: In the case expenses resulted from the acquisition or production of assets (in particular depreciation), it is decisive whether – at the time of acquisition or production of the asset – the relevant jurisdiction had been on the blacklist. If at that time the jurisdiction had not been on the blacklist (but was put on the blacklist only subsequently), the deductibility should not be restricted. However, according to the BMF, this does not apply to expenses from ongoing transactions (e.g. rental contracts). In this case, it is decisive whether – at the time the deduction should be taken for tax purposes – the relevant jurisdiction is on the blacklist.
- Obligations under public-law (e.g. taxes and fees) and certain transactions closely related to these obligations were excluded from the scope of the StAbwG. In the draft version, taxes and fees had only been excluded from the application of withholding tax under the StAbwG.
- A simplification rule is included for withholding tax purposes: When a country is removed from the blacklist, tax declarations can generally be amended. The tax authorities now make it clear that they also accept that tax is no longer withheld and paid after the EU blacklist has been updated (but before the StAbwV has been updated correspondingly).
- The guidance does not substantially change the previous contents regarding the interaction between double tax treaties and the StAbwG.

The guidance also confirms previous guidance regarding the first-time application of the reporting under sec. 12 StAbwG. Under sec. 12 StAbwG taxpayers are required to document details about business relations to related and non-related parties in blacklist jurisdictions and to submit such documentation to the local tax office (and in certain cases the Federal Tax Office) within one year after the end of the respective fiscal year. For fiscal years which started before 31 December 2022, the documentation shall only be due on 31 December 2024.

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Updated guidelines on taxation of employee share ownership

The German Federal Ministry of Finance has updated its guidelines on the taxation of employee share ownership, reflecting the recent amendments introduced by the Future Financing Act (Zukunftsfinanzierungsgesetz, ZuFinG). The revised document covers the main beneficial tax treatments, i.e. tax exemption and tax deferral. The final version includes several modifications compared to the draft issued in April 2024.

The updated circular provides comprehensive details on the tax exemption, which has been increased to EUR 2,000 under sec. 3 No. 39 of the German Income Tax Law (EStG). It outlines the eligible groups of employees and types of asset participations, the possibility of claiming the exemption multiple times across different employments, and specifics on valuation. The tax exemption is only applicable when the program is available to all employees who have been with the company for at least one year. However, employees with access to insider information under the EU Market Abuse Regulation or similar laws may be excluded. This exclusion is designed to prevent legal violations and does not compromise the tax exemption for other eligible employees.

The final version of the circular also addresses the participation of employees engaged in international assignments. Expatriates (outbounds) can generally be excluded from participation programs. However, there remains uncertainty regarding the application of these rules to foreign employees seconded to Germany (inbounds). The circular specifies that merely having a veto right to exclude certain employees or groups does not invalidate the program's tax exemption. The conditions for the exemption would be violated only if and when such exclusions are actually implemented, but without affecting prior tax years.

Additionally, the circular provides further explanation on the deferred taxation option under sec. 19a EStG. It clarifies that the taxation of restricted shares can also be deferred. The expanded scope of sec. 19a EStG, as introduced by the ZuFinG, is explained in detail. Companies are eligible for deferred taxation only if they are less than 20 years old and meet specific preconditions, such as having fewer than 1,000 employees and an annual turnover not exceeding EUR 100 million or a balance sheet total of no more than EUR 86 million. The circular also elaborates on the procedures concerning the termination of employment and the employer's liability, the verification of untaxed benefits by the local tax authorities, and payroll documentation requirements. It also discusses the application of the reduced tax rate during the wage tax procedure on benefits received before 1 January 2025, as this regulation was removed for payroll purposes by the Growth Opportunities Act (Wachstumschancengesetz). As a result, after 2024 employees must submit a tax return to benefit from the reduced tax rate on granted employee shares. Furthermore, the German Government plans to introduce a corporate clause in sec. 19a EStG. Generally, deferred taxation for employee shares of a group company would introduce more flexibility. Since the preconditions of sec. 19a EStG must be met by the whole group, the drafted clause seems a little too restrictive. The circular does not yet include the corporate clause proposed in the government's draft. Should sec. 3 no. 39 or sec. 19a EStG undergo further amendments in this context, another update to the circular is to be expected.

The new regulations outlined in the circular are effective retroactively from 1 January 2024.

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German property tax – Proof of the lower fair market value now possible

With effect to 1 January 2022, approx. 37 million property tax returns were newly filed. These returns are the basis for a new valuation of all German properties until these will be newly valued again with effect to 1 January 2029. On the basis of the new valuations, the new German property tax will be levied as of 2025.

For purposes of the valuation, most of the Federal States follow the Federal model (Bundesmodell). Some Federal States have implemented their own model, e.g. Bavaria, Baden-Württemberg or Hesse. Unlike under these deviating models, the valuation under the Federal model aims at a market valuation, however, with several assumptions replacing "true market factors". Irrespective of this, proving a lower fair market value – like for the RETT or inheritance tax valuation – had initially not been foreseen by law.

After the tax returns were filed by the taxpayers (the general filing deadline was 31 January 2023), tax assessment notices were issued. Taxpayers then filed several million appeals against these assessment notices, in many cases because of constitutional concerns. Several cases have even reached the courts. On 27 May 2024, the first two cases were decided by the Federal Tax Court (BFH), which referred the cases back to the Lower Tax Court of Rhineland-Palatinate. Alongside this referral, the BFH did not decide whether the valuation was in line with the constitution or not. However, the court decided that taxpayers may prove that the standardized value applicable for the property tax is at least 40% higher than the fair market value and then request the lower fair market value as the property tax valuation base ("40% rule").

In reaction to the BFH, the tax authorities issued a decree on 24 June 2024, under which all taxpayers may now prove that the fair market value is by at least 28.6% lower (= 1 – (1 / 140%)) and then apply such value. Further, on a preliminary basis, a suspension of up to 50% of the property tax payment (Aussetzung der Vollziehung) may be sought on this basis. Further, certain Federal States have started legislative changes covering the 40% rule as well. North Rhine-Westphalia has already finalized the legislative process. It is possible that the Federal law will be changed in this respect before year end as well.

Against this background, all property owners should check if the property valuations under the Federal model can be reduced. For taxpayers which have already received a binding and final tax assessment notice for the valuation for 1 January 2022, a correction for the subsequent years may be requested. Given that the first payments under the new valuation base are made as of 2025, it should effectively be irrelevant if the valuations are reduced as of 2022, 2023 or 2024.

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German Federal Tax Court rules on dividend withholding tax refunds

On 22 August 2024, the Federal Tax Court (BFH) published its decision in the cases of a French FCP and a Luxembourg SICAV, concluding that prohibiting foreign funds from claiming the German withholding tax exemption on dividends violated the free movement of capital under Art. 63 TFEU. The applicable statute of limitations for tax reclaims is four years, starting the year after the dividend was paid. The discriminatory tax law was in place from 2004 to 2017, as Germany amended its tax rules in 2018 to align the taxation of resident and nonresident funds. The BFH also held that Member States must reimburse tax amounts levied in breach of EU law and pay interest calculated according to national German provisions. The interest rates should generally be 0.5% per month, but the court left open whether rates must be lowered to 0.15% per month for 2019 onward due to changes in German tax law. Investment funds from both EU and non-EU countries should review these decisions to determine their impact. The court's rulings are based on the free movement of capital, making them relevant for investment funds outside the EU as well. The decisions do not directly affect other investment vehicles like pension funds or life insurance companies, which are subject to special regulations under German law. However, European case law suggests that these regulations may also violate the free movement of capital under certain conditions.

A detailed tax alert on the matter can be *found here.*

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BFH decides that loss deduction restriction of Sec. 8c KStG (change of control-restriction) does not apply to offsettable losses pursuant to Sec. 15a EStG that are attributed to a corporation as a co-entrepreneur of a KG

Section 15a para. 1 sentence 1 Income Tax Act (EStG) stipulates that the share of the KG's loss attributable to a limited partner may not be offset against other income from business operations or income from other types of income if a negative capital account of the limited partner arises or increases, i.e. the loss offset is effectively limited to the partner's capital at risk. According to Sec. 8c (1) sentence 1 Corporate Income Tax Act (KStG) tax losses forfeit in case of change in ownership in a corporation of more than 50%.

In the underlying case the German Federal Tax Court (BFH) had to decide whether the loss deduction restriction in the event of a harmful acquisition of more than 50% of the shares is applicable to offsettable losses pursuant to Sec. 15a EStG resulting from the participation of a GmbH in a KG as well.

In its ruling dated 24 April 2024 (case ref.: IV R 27/21), the BFH ruled that Sec. 8c (1) sentence 1 KStG does not apply to offsettable losses pursuant to Sec. 15a EStG. The rule only applies to losses of corporations and is not applicable to losses of a KG that are attributed to a corporation participating as a limited partner. In the absence of a legal basis, these losses can also be used after a detrimental change of shareholder. On this point, the BFH contradicts the tax authorities.

Due to the lack of relevance to the decision, the BFH was able to leave open the question of whether Sec. 8c (1) sentence 1 KStG (detrimental change of shareholder of more than 50%) is unconstitutional. The question of the constitutionality of the provision is still pending before the Federal Constitutional Court (case reference 2 BvL 19/17). Taxpayers should monitor the further developments.

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BFH doubts the constitutionality of the loss offsetting limitation rule for forward transactions (hedging)

Under the German Income Tax Act (EStG), losses from forward transactions within the meaning of Sec. 20 para. 2 sentence 1 no. 3 International Tax Act (AStG) (= transactions on the stock exchange or over-the-counter (OTC) trades where the fulfillment of the contract, i.e., the acceptance and delivery of the goods, foreign currency, or securities, is scheduled for a later date, but at a price determined on the day the deal is concluded) may only be offset against profits from similar forward transactions. Additionally, the loss offsetting is limited to EUR 20,000 per assessment period. Losses exceeding this amount may be carried forward to subsequent years and can only be offset up to an amount of EUR 20,000 annually against profits from forward transactions. A loss carryback is not permitted.

Now, the Federal Tax Court (BFH) raises serious constitutional concerns about the described loss offsetting limitation rule for forward transactions. The BFH identifies a double discrimination that is not in accordance with the equality principle under Article 3 para. 1 of the German Constitution (case reference V III B 113/23, AdV). Firstly, this is based on the fact that taxpayers with losses from forward transactions (as capital investments) are not allowed to offset these losses against all other profits from capital investments. For losses from capital investments other than forward transactions, this is not the case. Secondly, profits and losses from forward transactions are taxed asymmetrically. This violates the objective net principle, according to which profits and losses are to be treated equally for tax purposes. In addition, the BFH states that due to the loss offsetting limitation of EUR 20,000, one cannot even assume a complete compensation of losses over the total period. Lastly, the BFH does not see any justification for such unequal treatment.

In the past, the BFH had already considered the loss offsetting limitation rule for losses from the sale of shares to be unconstitutional due to the violation of Article 3 of the German Constitution and has referred the question to the Federal Constitutional Court (pending under case reference 2 BvL 3/21). In the present case, the BFH ruled on the issue in interim legal protection, the main proceedings are still pending. As part of the main proceedings, the matter will probably be referred to the Federal Constitutional Court.

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BFH confirms German tax treatment of "carried interest" type, disproportional profit allocations

In a decision dated 16 April 2024 (case reference VIII R 3/21), the BFH had to decide whether the income allocation in a Cayman Islands Limited Partnership (LP), in which German investors had invested, was to be accepted for German tax purposes. The income allocation according to the partnership agreement included "carried interest" type provisions, typical in the private equity industry. Based on these provisions, the fund initiator-backed general partner in the LP essentially had the right to earn 30% of investment profits made in the partnership if a defined internal rate of return on the investment was surpassed, despite having contributed only a fraction (0.1%) of the capital in the partnership. In a tax audit, the German tax administration took the view that the disproportional income allocation in favor of the general partner was to be regarded as disguised service compensation by the partners, and hence assessed German-resident LPs as if they had earned an income share based on the capital contributions only, and without taking into account the carried interest. In one of the years under review (and similarly today), the deemed service compensation would generally not have been deductible for the German LPs, so that a significant tax disadvantage would have resulted.

Upon appeal, the BFH sided with the taxpayer, similarly to earlier 2018 case law (in a slightly different context) and held that as long as the disproportional partnership profit allocation was the result of an agreement between partners with conflicting economic interests and did not lead to a payment obligation of the partnership even in the absence of overall profits, it was to be respected and accepted from a tax perspective. This case law should have broader applicability beyond the private equity industry and should give comfort where disproportionate profit allocation schemes are considered for commercial motives.

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Further ruling on the requirements for a cross-border transfer of business functions

In its ruling dated 3 August 2023 (case reference 10 K 310/19) the Tax Court of Niedersachsen commented on the German so-called "transfer of function" rules and denied again that those rules were applicable in the case under review (see for first ruling of the tax court *EY German Tax and Legal Quarterly 2023 | Q3*). In the case at hand German companies within an internationally active corporate group manufactured products in Germany based on non-exclusive, turnover-dependent manufacturing licenses and sold them in their own name and on their own account to customers in the German market. As of 1 January 2011, the business model of the group was restructured, and a Europe-wide principal structure with an entrepreneurial company in Switzerland was established. As part of this restructuring, the license agreements of the German manufacturers were ordinarily terminated by the licensor. At the same time, the German companies concluded new contract manufacturing agreements with the principal in Switzerland. From January 2011 onwards, distribution in Germany was carried out through a German distributor, which operated as a so-called "Limited Risk Distributor" for the principal to serve the German market. According to the new contract, the contract manufacturing was remunerated based on the cost-plus method; the remuneration for the distribution function was based on the transactional net margin method (TNMM). As part of the restructuring, the German contract manufacturer received compensation payments for their participation in the principal structure. These were determined using calculation of the so-called transfer package. The valuation was carried out based on a two-year capitalization period for the production function (remaining term of the contract) and a five-year capitalization period for the distribution function or the German customer base.

In the view of the tax authority, the restructuring of the business model constituted a transfer of business functions and of valuable business potential.

According to the tax court of Lower Saxony, the legal requirements for a "transfer of business function" as stipulated in Sec. 1 of the German Foreign Tax Act (AStG) were not met since no assets, other advantages, or business opportunities were transferred to a foreign related party. Even the fact that the German companies had obtained management services (such as negotiation of Europe-wide supply contracts and key account support) from a related company in France before the restructuring of the business model, for which they had paid a cost-plus-based remuneration, was deemed irrelevant by the court. Furthermore, according to the court's opinion, the calculation of the compensation payments was in accordance with the arm's length principle and even in favor of the German companies.

The judgement was issued on the previous version of Sec. 1 AStG and the former Order Decree Law on Transfer of Business Functions (Funktionsverlagerungsverordnung). Especially, considering the case at hand the decision of the tax court is likely to have considerable practical significance. Therefore, the Federal Tax Court's (BFH) final decision is eagerly awaited (pending case reference I R 54/23).

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Saxony local tax court applies reorganization RETT exemption to interposition of non-EU indirect owner of German real estate-owning partnership

One of the pitfalls of the German Real Estate Transfer Tax (RETT) rules is their applicability to transactions that happen outside of Germany and only indirectly impact German real estate-holdings. In the case decided by the Saxony fiscal court on 9 November 2023 (2 K 939/20; the taxpayer was represented by EY), a sovereign investor outside of the EU had held German real property indirectly through a KG partnership, and in 2017 had contributed the indirect 100% ownership in the KG to a new corporation founded in its country of origin, i.e. outside the EU. In principle the indirect transfer of the KG interests should have been subject to German RETT, as a new 100% owner was inserted in the ownership chain. However, the court judged that the exemption for intra-group reorganizations and share-for-share contributions was available, despite the fact that the wording of that German law provision required the contribution to be to an EU or EEA company, which was not the case here. The court came to this extensive application of the exemption for intra-group reorganizations by referring to the non-discrimination article in the relevant German tax treaty with the investor's country (which was comparable to article 24 of the OECD model treaty), and as a consequence decided against RETT being due.

The decision is being appealed against (BFH case reference II R 33/23).

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Translation of intra-year foreign currency receivables in EUR

Assets acquired in foreign currency, which also include monetary receivables, must be translated into the currency of the annual financial statement (in Germany: EUR) in accordance with the nominal value principle. While commercial law contains an explicit provision in favor of the so-called "mid-market spot exchange rate" (Devisenkassamittelkurs) for these cases, there is no corresponding provision in tax law.

The Hessian Tax Court had to deal with the translation of a foreign currency receivable and creditable Chinese withholding tax, particularly in the context of profit distributions from a foreign corporation. The case was controversial, as investment income is partially tax-exempt while exchange rate gains are fully taxable. The plaintiff used the exchange rate of the OANDA platform for the translation, which resulted in a taxable profit of approximately EUR 2.8 million. The tax office, on the other hand, used the higher ECB reference rate, which resulted in a profit of approximately EUR 4 million.

The problem arose because there are no longer any generally binding official exchange rates since the ECB reference rates were introduced. The ECB reference rates are mainly used for information purposes while the OANDA rates are used for transactions. The tax authorities use the ECB reference rate as the basis for the translation of foreign withholding taxes, but also allow the use of the monthly VAT conversion rates for reasons of simplification. The plaintiff wanted to use the latter rate, which resulted in a difference of around EUR 166,000 in its favor. ▶

German court decisions

In a ruling dated 26 October 2023 (case reference 7 K 854/20), the tax court has now decided that the translation must be carried out exclusively based on the ECB reference rate. In accordance with former BFH case law on the translation of the receipt of wages, the tax court clarified that there is no right of choice for the taxpayer to apply the tax-favorable conversion rate. The court thereby rejected the use of the OANDA rates or the monthly VAT conversion rates as a generally valid and objectively ascertainable rate should be used.

The ruling shows that exchange rate changes can have significant tax implications. In practice, this means that the ECB reference rate must be used for tax balance sheet reporting in order to avoid expensive surprises during tax audits. However, it should be noted that translations using the ECB reference rate can also be advantageous for tax purposes in the event of exchange rate losses, as these are not subject to deduction restrictions in the context of shareholdings in corporations and can therefore be fully taken into account.

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German Federal Court demands clear information regarding all paid services ordered in online transactions

In a ruling by the German Federal Court of Justice (BGH) on 4 June 2024 (case reference X ZR 81/23), the court addressed the evolving landscape of consumer rights in electronic commerce, focusing on the transparency of online transactions and the obligations of entrepreneurs towards consumers.

The ruling concerned the case of a consumer who subscribed to a Prime membership while booking a flight through an online platform. The company offered discounts when booking a flight if a test subscription was concluded for a Prime membership. This test subscription was initially free, but if it was not canceled within 30 days, it was automatically converted to a paid subscription, which was indicated during the ordering process. A consumer booked a flight with the discounted price by clicking on the button labeled "buy now". As the consumer did not cancel the membership, the membership fee was debited. The consumer then filed an action for repayment of the full amount of the Prime membership plus interest and was found to be right by the BGH.

The court determined that the company operating the platform failed to make it sufficiently clear that by clicking the "buy now" button, the consumer enters into two separate contracts - one for booking the flight and another for the Prime membership, including a payment obligation after the free trial period.

The court's decision was based on the interpretation of sec. 312j para. 3 and 4 of the German Civil Code (BGB), according to which a consumer must be able to recognize from the order button that he/she is committing to a payment obligation for the services provided. The ruling emphasized that if multiple contracts are concluded with a single order process, the order button must contain a clear indication that the consumer, by clicking the button, is issuing a declaration aimed at concluding different contracts. Only if the consumer is given all the necessary information when ordering, is he/she prevented from making a rushed decision.

Furthermore, the BGH clarified that if a contract is deemed ineffective due to non-compliance with the transparency requirements in question, entrepreneurs cannot claim compensation for benefits provided to the consumer. The protective intent of these stipulations would be undermined if an entrepreneur who did not sufficiently clarify that a service is subject to payment - as a result of which the contract is not legally valid - could demand compensation from the consumer after having provided the service.

The decision highlights the importance of consumer protection in electronic commerce, reinforcing the idea that businesses must ensure that their online ordering processes are designed to make payment obligations clear to consumers, including explicit information on the order button.

Companies must adapt their practices to align with these legal standards.

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Advertising with the term "climate neutral" is misleading without explanation

The Federal Court of Justice (BGH) has once again dealt with the German competition law requirements for advertising with environmental protection terms and signs. In its judgment of 27 June 2024 (case reference I ZR 98/23), it clarified that special legal standards apply to the assessment of environmental advertising claims. As the environment is generally recognized as an asset in need of protection, advertising is often done by promoting special environmental compatibility. Advertising that uses environmental protection terms and signs such as "climate neutral" must therefore meet strict requirements for accuracy, unambiguity and clarity of the advertising message.

The defendant, a confectionery manufacturer, advertised its products as being produced "climate neutrally." Via internet address or by scanning a QR code, further information on the claimed climate neutrality could be accessed. The plaintiff, a qualified trade association, argued that this statement was misleading as it was not made clear that climate neutrality would only be achieved through compensation payments. The mere reference to a website for further information was insufficient.

The BGH found that the advertising was misleading within the meaning of Sec. 5 para. 1 of the German Act Against Unfair Competition because it did not make clear that the claimed climate neutrality was only achieved through compensation payments. The advertising statement "climate neutral" does not refer to the defendant's company, but expressly to the production of the products sold. This falsely suggests that measures to avoid CO_2 emissions could have been taken during production process. Explanatory information merely outside the advertising itself (e.g. reference to a website), which consumers can only find out through their own activity, is not sufficient. Without a clear explanation of the underlying measures in the advertising itself, the claim "climate neutral" is misleading. This could be of considerable importance for consumers' purchasing decisions.

Once again the BGH emphasizes the need for transparent advertising with regard to environmental information. Companies that advertise their products with ambiguous environment-related terms must regularly explain their specific meaning clearly and unambiguously in the advertising itself. For the term "climate neutral", this means that it must be made clear in the advertising itself whether climate neutrality is achieved through CO_2 reduction, compensation or a combination of both measures.

In general, the ruling strengthens consumer protection in the area of environmental advertising and substantially restricts the much-criticized "greenwashing" for the German market. In this context, it remains to be seen whether and how the handling of "greenwashing" will also develop on a European level through the proposal to substantiate explicit environmental claims ("Green Claims Directive").

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European court of justice: Taxability of internal transactions in VAT groups

On 11 July 2024 the European Court of Justice (ECJ) decided on transactions between members of a VAT group (case reference C-184/23). The German Federal Tax Court had asked the ECJ whether such internal transactions should fall within the scope of VAT or not.

The case at hand involves a German foundation governed by public law. This foundation operates a university (non-economic activity) and also engages in VAT-liable services (hospital operations). The foundation is the parent entity of a limited liability company that provides cleaning services for both the university and the foundation's hospital operations. The question arose whether these internal transactions between the subsidiary and its parent (foundation) should be subject to VAT, especially considering that the university's operations are treated as non-economic and thus as non-taxable.

The German Federal Tax Court (BFH) had referred two key questions to the ECJ. Firstly, is Germany's current practice of exempting internal transactions within a VAT group from VAT correct? Secondly, should these internal services be subject to VAT if the recipient is not fully entitled to input VAT deduction?

The ECJ rules that services exchanged within a VAT group, which is characterized by legal independence of its members but members who are united by financial, economic, and organizational ties, should not be taxed under VAT. This shall apply even if the recipient of the services is not entitled to full input VAT deduction. This is based on the fact that the VAT group scheme objective is to prevent abuses and ensure fiscal neutrality, and taxing internal transactions would contradict this goal.

The ECJ also highlights that the concept of a VAT group was fundamentally designed to prevent the accumulation of taxes through non-taxable internal transactions.

For businesses not entitled to deduct input VAT, the ECJ emphasizes the importance of maintaining "organizational" fiscal neutrality. The VAT group scheme serves not only as an administrative simplification but is also destined to allow businesses to avoid non-deductible VAT.

The results of the judgement are particularly relevant for companies in industry sectors with limited input VAT deduction right, such as banks, insurance, real estate companies, health, education etc. They should now be able to rely on the concept of non-taxability of supplies within a VAT group. As regards input VAT deduction for supplies purchased from third parties (outside the VAT group), however, input VAT deduction should only be possible as far as there is a link of this input to taxable output supplies.

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EU AI Act in Force: How Germany plans to enforce it and tackle deepfakes

With the beginning of August 2024, the Artificial Intelligence Act (Regulation (EU) 2024/1689, or AI Act) is in force. This act governs AI systems and General Purpose AI models, such as OpenAI's GPT-4, throughout their entire lifecycle – from development to market introduction, usage, and eventual termination. Various stakeholders along the AI lifecycle (including providers, deployers, importers, and distributors) have numerous intertwined obligations to adhere to. High-risk AI systems, subject to most of these obligations including conformity assessments, are identified by regulators as posing – besides outright prohibited AI systems – the highest risks to health, safety, or fundamental rights within the EU. The AI Act's regulatory approach mirrors that of other product safety regulations under the EU's New Legislative Framework. As an EU regulation, it uniformly applies across all 27 member states, harmonizing AI system rules entirely. However, individual member states are responsible for enforcing these new AI regulations. Germany, for example, has one year from the act's entry into force to designate at least one notifying authority and one market surveillance authority specific to the AI Act (Articles 70(1), 113(b)). On 15 May 2024, the Digital Committee of the German Bundestag hosted a public session titled "National supervision of artificial intelligence complex". Discussions involved expert evaluations of the pros and cons regarding Germany's implementation of these authorities – considering either a federal approach with the Bundesnetzagentur or a state approach with existing data protection authorities. The former suggestion should likely be the favored one, considering experiences from enforcing the EU General Data Protection Regulation (Regulation (EU) 2016/679, GDPR) in Germany. Besides the Digital Committee's session, other significant stakeholders, including the outgoing federal Commissioner for Data Protection and Freedom of Information, voiced their perspectives. For the future enforcement of the AI Act, the next months will remain interesting to observe.

Concurrently, EU legislators are not the only ones actively working on AI-related laws. In May 2024, Bavaria introduced a legislative proposal aimed at protecting personal rights from deepfakes under criminal law. On 21 August 2024, the German Bundesrat presented a draft for this law. The main feature of the proposal is to introduce a new Sec. 201b into the German Criminal Code, imposing prison sentences or fines for "violation of personal rights through digital forgery" (Verletzung von Persönlichkeitsrechten durch digitale Fälschung). This development indicates increasing rules and regulation not only of AI systems themselves but also of their data outputs (and inputs).

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Impact of the EU Product Safety Regulation on product recalls

The EU Product Safety Regulation (EU) 2023/988, which comes into effect on 13 December 2024, constitutes a significant regulatory shift with direct implications for companies across the entire European Union. This regulation is directly applicable in all EU member states, meaning that no national legislation is required to implement its provisions. As such, concerned manufacturers and importers of consumer goods must comply with the new requirements. For the first time, consumers are to be entitled to remedial action against the company responsible for the recall in the event of a product recall. This is intended to make participation in a recall more attractive for consumers and to thus improve the practical implementation rate for product recalls.

Companies concerned – primarily manufacturers and importers in the Business-to-Consumer (B2C) sector – are now required to offer consumers at least two out of three types of remedies in the event of a product safety recall: repair, replacement, or refund. The refund must be at least the full price paid by the consumer, regardless of the product's usage or depreciation over time.

One significant modification of the new regulation is the absence of a statute of limitations for these claims. This means that consumers can assert their rights to remedies without concern for the limitation periods that apply to general warranty claims. This provision represents a considerable shift from traditional warranty laws, where claims are subject to expiration after a certain period. ▶

For companies, this means that they must be prepared to face the financial and operational impacts of these new obligations. The potential costs associated with refunds, in particular, could be substantial, as they require reimbursement of the full purchase price without deduction of a compensation for the use of the product. This could lead to significant financial exposure, especially for high-value or long-lasting consumer goods.

Moreover, the regulation stipulates that the remedies should not cause significant inconvenience to consumers. This includes that the consumer must not bear the costs for shipping or returning the recalled product, and for non-transportable products, the responsible party must arrange for collection. This further emphasizes the consumer-centric approach of the regulation.

Accordingly, the EU Product Safety Regulation also has implications on the internal processes of the economic actors concerned. They need to ensure that their product safety monitoring, recall procedures and customer communication strategies are robust and compliant with the new regulation. This may require revising existing contracts, enhancing quality control measures, and updating insurance policies to cover the new risks.

Economic actors in the consumer goods sector must now take proactive steps to align with the regulation and to manage the associated risks.

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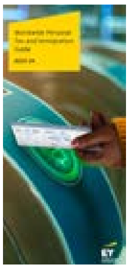

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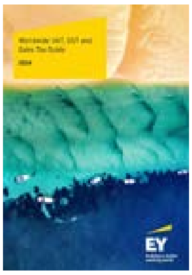

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