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Coalition agreement presented

First insights into tax policy of the German "traffic light" government coalition

Content

In its coalition agreement published on 24 November 2021, the so called "traffic light coalition" of the Social Democrats (SPD), the Greens and the Free Democrats (FDP) presented a detailed tax policy program. As already announced in a first preliminary paper presented in October, there are no plans for wealth tax and no increase in inheritance tax, but also no significant business tax reform. Instead, the plans contain numerous minor changes in tax policy.

To stimulate private investments, the coalition announces the creation of an investment premium for climate protection and digital assets in 2022 and 2023. The exact design is not set out yet, but as the aim is to facilitate a so-called "super depreciation", this may enable businesses to set off more than 100% of the purchase costs or at least allow for depreciation based on a significantly shortened useful life. Housing investments will benefit from an increase of the straight-line depreciation from 2% to 3% per year. ▸

Coalition agreement presented

Furthermore, the coalition wants to extend the currently expanded loss offsetting (due to Covid-19) until the end of 2023 and permanently extend the loss carryback to the immediately preceding two assessment periods. Partnerships may benefit from a review of the rules on the taxation of retained earnings and the newly introduced check-the-box election. Ideally, the review will be followed by adjustments which could significantly improve in particular the taxation of retained earnings of partnerships.

On the other hand, a — not further defined — expansion of withholding taxation has been announced, e.g. by adapting double taxation agreements. Furthermore, the interest barrier shall be supplemented by an "interest rate limit", which is also not further specified. Related to the current international tax discussion, the new coalition partners state their intention to engage actively for the introduction of the global minimum taxation.

In the field of tax administration, the new Government plans to promote digitalization, especially by modernizing and accelerating tax audits, digitizing the taxation procedure through the appropriate use of new technologies and improvement of interfaces. New regulations shall be aimed at being digitally implementable. The most far-reaching initiative in this context will be a new electronic reporting system for the creation, review and delivery of invoices, a so-called e-invoicing or e-reporting.

The new partners furthermore aim at stepping up the fight against tax evasion, money laundering and tax avoidance. For companies with a turnover of more than EUR 10 million, the reporting obligation for cross-border tax arrangements is planned to be expanded to domestic tax arrangements.

To facilitate the acquisition of owner-occupied residential property, the German Federal States will be given the opportunity for flexible rules in real estate transfer tax, which may amount to personal allowances. To fund this measure, a higher RETT will be imposed on corporate real estate acquisitions via share deals.

The "traffic light" coalition is committed to the constitutional debt ceiling. From 2023, the federal budget should again meet their requirements and borrowing should only be possible within narrow limits. Financial leeway is, among other measures, planned to be created by an announced review of the budget for superfluous, ineffective and environmentally and climate-damaging subsidies. For example, the tax treatment of diesel vehicles in the motor vehicle tax is to be reviewed and tax advantages relating to the economic use of electricity are to be reduced. On the other side, the financing of the renewable energy surcharge via the electricity price is to be terminated per 1 January 2023.

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Act to Combat Tax Avoidance and Unfair Tax Competition applicable as of 2022

The German Act to Combat Tax Avoidance and Unfair Tax Competition that was passed this summer will in general take effect as of 1 January 2022. The new act aims at encouraging jurisdictions deemed to enable harmful tax practices to change their behavior by way of preventing companies and individuals from maintaining business relationships with those non-cooperative countries.

A draft German government directive that is expected to be passed by mid-December names the non-cooperative jurisdictions relevant for the bill in accordance with the EU blacklist that was updated on 5 October 2021. Thus, American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, US Virgin Islands and Vanuatu will be in the focus of the new German regulation in 2022. For more information on the EU blacklist see our *EY Global Tax Alert dated 6 October 2021*.

The provisions under the new act are to be applied whenever a taxpayer maintains business relations or investments in or with a non-cooperative tax jurisdiction. In such case, the new rules stipulate increased obligations to cooperate in terms of documentation and disclosure. Furthermore, several sanctions can apply.

As of 2022, a stricter CFC taxation regime applies to CFCs domiciled in non-cooperative tax jurisdictions. Furthermore, for inbound investors the nonresident tax liability is to be extended to income from financing relationships, from insurance and reinsurance services, from the provision of other services and from trade if the income is received by a company or individual resident in a non-cooperative jurisdiction and is deducted as an expense in Germany. The tax on the related payments is to be withheld at source at a rate of 15% and paid to the Federal Central Tax Office.

In case a jurisdiction is listed on the EU blacklist and the related German government directive for three subsequent years, sanctions apply on dividends and capital gains that stem from a corporation resident in such a jurisdiction. Specifically, the tax exemption for corporates pursuant to Section 8b Corporate Income Tax Act and comparable provisions in tax treaties as well as the flat withholding tax rate of 25% for individuals and the 40% exemption for partnerships do not apply.

If the relevant jurisdiction is listed four years in a row, expenses from business transactions with individuals or companies resident in the jurisdiction may not be deducted in Germany as operating or income-related expenses.

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Germany and Mexico update their DTA

Germany and Mexico have signed an amending protocol to their current double taxation agreement (DTA). The purpose of the protocol is to implement measures to prevent the base erosion and profit shifting derived from the Multilateral Instrument (MLI), in accordance with the positions taken by Mexico and Germany. It establishes a holding period for dividends, limitation of benefits provisions for payments to permanent establishments (PEs) and a new requirement for activities that are not deemed to create a permanent establishment. Further details are provided in our *EY Global Tax Alert dated 4 November 2021*.

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Germany and the United States will exchange CbC report for financial years beginning in 2020

Once again, Germany and the United States have agreed in a joint declaration that they will effect the information exchange on country-by-country reporting (CbCR) via the so-called spontaneous exchange of information based on the existing double taxation agreement (DTA).

Consequently, if a U.S. parent company submits a CbCR to the U.S. federal tax authority IRS, the obligation to submit the CbC report as an alternative for subsidiaries and permanent establishments of U.S. corporations in Germany for the relevant financial years does not apply accordingly (Sec. 138a para. 4 General Fiscal Code). The joint declaration applies to CbC reports for fiscal years beginning on or after 1 January 2020 and before 1 January 2021.

For financial years beginning as of 2021, it is expected that German and US authorities can permanently exchange the reports based on an intergovernmental agreement signed on 14 August 2020 via the so-called "automatic exchange" of CbCR. The pending domestic implementation of the agreement, which is a precondition for Germany to finally ratify the agreement, will likely take place in 2022.

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Unconstitutionality of interest on tax payments and tax refunds with an interest rate of 6% p.a. and accounting consequences

On 8 July 2021 the German Federal Constitutional Court (BVerfG) decided that the interest on tax payments and tax refunds with an interest rate of 6% per year is partly unconstitutional (i.e. if levied for periods after 31 December 2018). According to German tax law, the relevant yearly interest rate on tax payments and tax reimbursements is 6% per year starting 15 months after the end of the relevant tax year. This decision gives rise to questions about accounting under German GAAP and IFRS for interest on tax payments and tax refunds for interest periods from 1 January 2019 and onwards. For interest periods up to 31 December 2018, a continuation ruling was issued, and the interest rate of 6% p.a. has to be applied. In case the accounting was based on a lower tax rate for this period, an adjustment has to be made in the books.

Both German GAAP and IFRS require for the recognition of a receivable on an interest claim to be virtually certain to be realized. For the recognition of a provision, it is, however, necessary that the future payment will be probable. For the valuation of the receivable or provision the interest rate to be used is subject to an estimation.

There is legal uncertainty about the interest rate to be applied from 1 January 2019 onwards, as a new legal regulation is only expected by mid-2022. It is likely that we will see a range of plausible interest rates in accounting practice. As a general rule, a case-by-case consideration is required about the assessment of the future interest rate and its conformity with the constitution decision. ▶

Legislation

When accounting for provisions for interest on tax payments, no interest rate within a plausible interest range will be obviously wrong. It is expected that we will see diversity in practice. In the case of claims for repayment of overpaid interest on tax payments, one could argue that a receivable in the amount of the difference between the future expected interest rate (currently a certain interest range) up to the current legally defined interest rate of 6% would be virtually certain and could therefore be capitalized. For the recognition of a receivable for interest on tax reimbursements, an interest amount at the lower end of the interest range could be considered virtually certain. A provision for a possible repayment of already received interest on tax reimbursements has to be recognized if probable. This depends on the taxpayer's assessment if a repayment has to be made. There is a protection of confidence rule that is under discussion and may protect taxpayers from repayment of already received interest if the interest was assessed prior to the publication of the court decision on 18 August 2021.

It remains to be seen whether and how the legislator will take the decision as an opportunity to make changes in related fields where interest rates according to tax legislation are above market interest rate. This is e.g. the case for discounting of long-term obligations under German tax legislation with an interest rate of 5.5% p.a. For the tax valuation of pension provisions, an interest rate of 6% has to be used. There is a case pending before the German Federal Constitutional Court challenging the discount rate of 6% p.a. for pension provisions.

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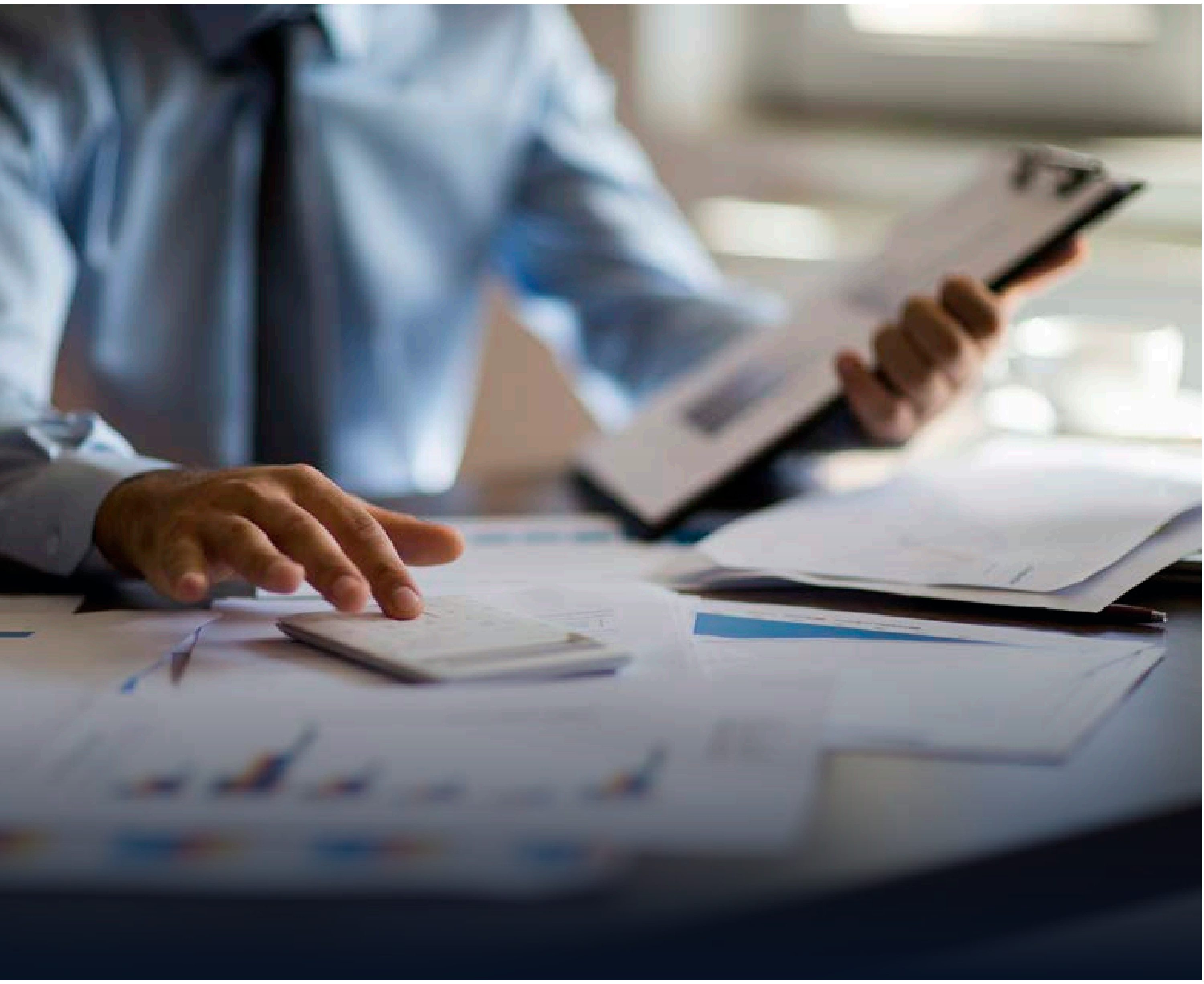

German Ministry of Finance issues guidance on dispute resolutions for income and property taxes

On 27 August 2021, the German Ministry of Finance (BMF) issued a letter titled "Leaflet regarding dispute resolutions in the field of income and property taxes" (the Letter).

The Letter supersedes the BMF letter dated 9 October 2018, Leaflet on international mutual agreement and arbitration proceedings in the field of income and property taxes. It contains general information on how dispute settlement procedures are carried out in Germany and thereby comments on dispute settlement procedures under double tax treaties (DTTs), under the European Union (EU) Arbitration Convention and under the EU DTT Dispute Settlement Act (EU-DTT-SBG). The latter, the EU-DTT-SBG, represents an alternative to the existing procedures under a DTT or under the EU Arbitration Convention for cases where both involved entities are resident in EU Member States. However, the Letter does not address cases of advance dispute avoidance procedures (e.g., advance pricing agreements), for which a separate BMF letter is expected.

In addition, general procedural questions regarding the application are clarified for all procedures. Thereby, existing regulations and long-standing procedural practice have now become more restrictive to a certain extent. Among other things, the letter states that in principle the application must be submitted in German language including a translation in the common working language (generally English) of the countries involved. A taxpayer can submit an application in a common working language (i.e., without a separate German version) only with the prior consent of both the German competent authorities and responsible local tax office, which is of particular importance for determining the deadlines. Another critical aspect is the position of the BMF that an application is only deemed to be submitted within the deadline if all required documents as defined in the Letter have been submitted by the taxpayer and are available to the German competent authority. The Letter further contains clarifying notes with respect to the relationship between dispute resolution procedures and domestic appeal proceedings and with respect to the relationship between MAP and withholding tax refund procedures.

In light of increasing legal uncertainties in the application and interpretation of the arm's-length principle in Germany, the Letter is of high practical relevance for taxpayers. They should review the changes with respect to dispute settlement procedures in Germany, such as application deadlines, scope and language of the application, and assess any implications relevant to their dispute resolution strategy.

You can find a more detailed discussion in our *EY Global Tax Alert dated 7 September 2021*, which summarizes the key aspects of the Letter.

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Federal Tax Court (BFH) confirms tax treatment of preferred shares

When receiving payments from a participation in a foreign company, the question arises whether they qualify as dividends or as interest. Whereas dividends received are under certain conditions fully or partially tax exempt, interest income is generally fully taxable. To distinguish between dividends and interest, the foreign participation rights must be compared to German legal types of equity or debt participations. In a court case dated 18 May 2021 (I R 12/18), the Federal Tax Court (BFH) carries out an overall legal and economic assessment and comments on the comparison of legal types in connection with the qualification of shares in a foreign company.

In the case at hand (year of dispute 2001), a German GmbH held a participation in a US company ("X Inc.") via preferred shares. These preferred shares carried voting rights and were related to a division of X Inc., the Financial Asset Securitization Investment Trust ("FASIT"). The FASIT was not separated from X Inc. in terms of assets and a so-called "Regular Interest" in the FASIT was created through the issue of the preferred shares.

It was disputed whether the income resulting from these shares qualifies as dividends or as interest. The BFH proceeded in two steps:

(1) In a first step, a classification was made according to general principles, both regarding the form of a company and the financial instrument. The court concluded that X Inc. was comparable to the legal form of a German stock corporation (AG), and the issued preferred shares corresponded to shares. Thus, the BFH excluded a classification as debt-like profit participation rights ("Genussrecht"), which made the statements of the local fiscal court on the so-called profit participation right test obsolete.

(2) Only in a second step did the BFH examine whether the preferred shares were structured as required under stock corporation law. The participation was classified according to property rights and participation rights, but the specific features of the stock corporation law (e.g., non-voting preferred shares; provisions of the articles relating to dividends or participation in the liquidation proceeds) were also considered.

The concrete examination was carried out by means of a legal and economic overall assessment: Starting point was the classification as shares and the question whether special features of the design spoke against a membership participation. Individual debt-like elements did not harm the classification as shares in principle.

Hence, the BFH rejected a strict commitment to the criteria of participation in profit and liquidation proceeds by way of a literal interpretation of Section 20 (1) no. 1 ITA.

Since the German correspondence principle, which ties the German to the foreign tax treatment, was only introduced after the year of dispute, the fact that the US qualified the dividends as (deductible) interest did not affect the qualification as tax-free income.

The case has practical implications as the previously often conducted profit participation right test is now only to be applied in cases in which the participation right is classified as comparable to a profit participation right. Rather, it is sufficient if the participation rights are structured in accordance with the German requirements of company law — including its special features.

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Relief from dividend WHT despite interposition of asset-managing partnership

According to the Federal Tax Court (BFH), a dividend distribution by a German corporation to its foreign (EU) parent company is to be completely relieved from dividend withholding tax ("WHT") under the EU parent subsidiary directive even if an asset-managing civil law partnership is interposed as an intermediary between the foreign parent and the German corporation. The BFH considers this to be a direct participation within the meaning of Section 43b (2) sentence 1 of the German Income Tax Act (ITA).

Generally, for dividends paid by a German corporation, upon application, no dividend WHT is levied if the dividend is distributed to a parent company that has neither its registered office nor its place of management in Germany but is tax resident in another EU jurisdiction and has at least a 10% direct participation in the subsidiary (minimum participation) for a period of at least 12 months.

By decision of 18 May 2021 (I R 77/17), the BFH has now commented on the requirement of a "direct" participation within the meaning of the relevant rule in a case (year of dispute 2014), in which a Dutch cooperative held its participation in a German stock corporation via an interposed asset-managing civil law partnership.

The BFH has affirmed the relief of the WHT on the distribution made. The interposition of the asset-managing civil law partnership is not harmful for the requirement of a "direct" participation. The BFH based its decision on the transparency treatment granted by Section 39 (2) no. 2 General Fiscal Code (GFC), according to which the participation in the domestic stock corporation held in the total assets of the asset-managing civil law partnership is to be regarded proportionately as the Dutch cooperative's own assets. Contrary to the opinion of the Federal Central Tax Office (BZSt), the wording of Section 43b (2) sentence 1 ITA does not preclude this inclusion of the participation via the asset-managing civil law partnership.

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Classification of a US LLC as a partnership or corporation

US company law offers significant flexibility when setting up an entity in the legal form of a limited liability company (LLC). Therefore, if an LLC generates income in Germany, the question arises whether it is comparable to a German partnership (and, thus, must be treated as transparent for German income tax purposes), or whether it is rather comparable to a corporation and must be treated as non-transparent from a German income tax perspective.

In two recent decisions of 18 May 2021 (I B 75/20 and I B 76/20), the German Federal Tax Court (BFH) had to decide on the classification of a US LLC with a single shareholder as a partnership or as a corporation. The BFH confirmed that the classification of a US LLC must be based on the so-called comparison of types, considering the characteristics detailed in the Circular issued by the German Ministry of Finance on 19 March 2004 in a wholistic assessment. ▶

According to this Circular, the classification must be made based on the following criteria:

1. Centralized management and representation (if the LLC is member-managed, this speaks in favor of a partnership, whereas the use of external managers is rather typical for a corporation);

2. Limited liability (an unlimited liability speaks in favor of a partnership, a limited liability speaks for a corporation);

3. Free transferability of shares (restrictions in the transferability are rather common for partnerships, since shares in corporations can usually be transferred without any restrictions);

4. Profit distribution (free withdrawals without a formal resolution speak in favor of a partnership, and a formal profit distribution resolution is rather typical for corporations);

5. Capital contributions (in partnerships, contributions are not required or could also be made through the provision of services, whereas a corporation requires capital contributions to be made by its shareholders);

6. Lifetime (a partnership may automatically be terminated upon certain events, whereas a corporation generally has an unlimited life);

7. Profit allocation (partnerships can allocate their profits according to various criteria, in corporations they are generally allocated according to share capital);

8. Formation requirements (especially for corporations, the formation requirements are rather formalized).

Applying these criteria to the specific LLCs at hand in a holistic view, the BFH concluded in both cases that the LLCs qualified as corporations. The court also clarified that the US tax treatment was irrelevant for the assessment. Also, the number of shareholders was insignificant. Consequently, even with regard to "one-member LLCs", which are generally regarded as transparent for tax purposes, the principles of the so-called comparison of types must be applied. The court hence confirmed its view that a specific case-by-case analysis is required when classifying a US LLC for German tax purposes.

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BFH raises doubt whether German sourcing rules for EU dividends are in line with EU law

Where a foreign company distributes funds to a German shareholder, the distribution can in principle be treated as a (generally) tax-neutral return of capital or as a dividend distribution, which is 95% tax-free for a qualifying corporate shareholder. The determination whether the payment is a return of capital depends on whether the distributing entity is an EU entity or resident in a non-EU country, where the rules for EU investments interestingly are much stricter:

- For EU companies, the distributing entity needs to obtain a certificate from the German Federal Tax Office, certifying the amount of capital repayment, as calculated under German rules – this is typically a complex and time-consuming exercise, and, as said, the certification application can only be filed by the distributing company, not by the German shareholder. Thus, if the distributing company does not obtain such certificate, the German shareholder cannot claim a tax-free return of capital.

- On the contrary, no such certification obligation exists for distributions by non-EU companies, and the German shareholder can independently prove the sourcing of distributions, e.g. by pointing to the corporate law origin of a distribution under foreign law (e.g. release of share premium, reduction of share capital).

This obvious discrimination of EU vs. non-EU investments has been confirmed as acceptable in past German Federal Tax Court (BFH) case law. In two new decisions (VIII R 14/20 and VIII R 17/18, both dated 4 May 2021), the BFH has now raised doubts whether the inability of the German shareholder and distribution recipient to claim return of capital-treatment itself (rather than having to rely on a certification obtained by the distributing EU company) can constitute a violation of the EU freedom of capital movement, in particular in cases where an actual return of capital seems likely based on the corporate law treatment at the level of the distributing entity. The cases have been referred back to the lower courts to assess this likelihood in the given case.

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Tax neutrality of US spin-off for portfolio shares

In the view of the German tax authorities, the transfer of shares in the context of a foreign spin-off previously led to the taxation of capital gains. Now the Federal Tax Court (BFH) ruled in a series of similar cases (in particular, VIII R 9/19 and VIII R 15/20 dated 1 July 2021) that a spin-off carried out under US law was comparable to a German spin-off. Consequently, such spin-offs can generally be realized in a tax-neutral manner for German investors.

Viewed in isolation, the share allotment in the context of a spin-off leads to a taxable capital gain for the German shareholders in the form of a distribution in kind. In the case of portfolio (free float) shares, however, a tax neutral roll-over is allowed if the transfer of the shares takes place in the context of a spin-off ("Abspaltung") to another corporation (Section 20 (4a) sentence 7 German Income Tax Act). It was previously disputed under which conditions a foreign spin-off is comparable to a German "Abspaltung".

The US spin-off in dispute had the following characteristics: The US parent company contributed its corporate client business to a US subsidiary corporation. The parent company allocated its (pre-existing) shares in the subsidiary to the shareholders, so that the shareholders held the same proportion of shares in both companies.

The tax authorities held the view that the term "spin-off" used in the relevant German income tax provision corresponds to the term used in the German reorganization law. Thus, in addition to the question of whether Section 20 (4a) sentence 7 ITA is applicable to foreign reorganizations at all, the view was held that the foreign reorganization would have to have the essential structural features of a spin-off under German law. In the case of a US spin-off, this was not the case according to the tax authorities, in particular because the US spin-off resulted in a transfer of assets by way of singular succession and not a partial universal succession as in the case of a spin-off under German law. Instead, a US spin-off was seen as a contribution in exchange for the granting of company rights in the acquiring legal entity to the shareholders of the transferring legal entity.

The BFH now commented on this topic in such a way that Section 20 (4a) sentence 7 ITA must also be applied to foreign transactions based on the free movement of capital in conformity with EU law. In the present cases, the free movement of capital was applicable because the shares were free float. Consequently, the court considered an interpretation of the spin-off concept to be necessary. Accordingly, a foreign transaction does not have to correspond in every aspect to a spin-off under the German Reorganization Act. Rather, it is sufficient if a similar result comparable to the spin-off under German law is achieved. The transfer of assets by means of partial universal succession, which merely serves legal simplification, is not a prerequisite for sufficient comparability. According to the court, it is sufficient that, in the context of a spin-off, parts of the assets are transferred to another corporation in which the shareholders of the transferring company are granted share rights in return. Consequently, the distribution in kind of these shares at the time of the subscription could be carried out on a tax neutral basis.

It remains to be seen if the tax authorities will apply this decision in similar cases or even in a wider context beyond privately held free float shares.

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German Federal Tax Court publishes decision regarding (old) German anti-treaty shopping rule

In a recently published decision, the German Federal Tax Court (BFH) upheld a decision of the tax court of Cologne regarding a foreign entity interposed between a German resident and its German resident subsidiary GmbH. The Federal Tax Office wanted to deny a withholding tax exemption certificate on the basis that a German resident did not have a right to reduce withholding tax under an applicable double tax treaty (or EU Directive), but only had a right to credit withholding tax against his personal income tax liability in case he had held the shares in the GmbH directly.

The BFH now made it clear – reiterating past case law of the European Court of Justice (ECJ) and past own case law – that the pre-June 2021 anti-treaty shopping rule had to be interpreted in a way that it allowed the taxpayer to show that the specific structure did not qualify as abuse. In this context, the court stressed that the fact that a German tax resident could fully credit withholding taxes in a direct investment scenario was a strong indication to demonstrate that the non-resident entity was not interposed for tax reasons. The fact that the interposition allowed for a deferral of the 5% inclusion of dividend income at the level of the parent entity is not sufficient for the structure to qualify as abuse. The BFH also said clearly that in such a scenario, the tax authorities then had to bring forward additional arguments why the structure should be viewed as abuse as the fact that the indirect shareholder was entitled to the same level of relief was "at first" sufficient for the structure not to be viewed as abusive.

The decision itself only relates to the rule in effect until June 2021. However, it may also have implications afterwards as the new anti-treaty shopping rule, which entered into effect on 9 June 2021, includes a principal purpose test-type escape from the anti-treaty shopping rule. It thus appears likely that the same arguments should apply to cases where German residents interpose a foreign entity in-between themselves and a German GmbH currently.

The decision may, however, also have broader implications under the new rule: The new rule limits the "look-through" approach which applied under the former anti-treaty shopping rule in a way that an applicant entity may only rely on the treaty entitlement of its shareholder(s) to the extent the shareholder is entitled to the same level of withholding tax relief under the same legal instrument (i.e. effectively the same tax treaty or the same EU Directive). Applying the principles of the BFH case law also to these cases, it can be expected that the level of withholding tax relief of the applicant's shareholders would also need to be considered in the context of the escape rule at least in cases where the interposed entity is an EU/EEA resident entity. Applying the view of the BFH to these cases, this would mean that the same level of withholding tax relief would provide a strong case for purposes of the escape rule and that the Federal Tax Office would need to bring forward additional reasons why they view a structure as abusive.

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Partial value increase for foreign currency loans

As a general rule, liabilities have to be accounted at the value at the time the liability arises. This also applies to liabilities that are subject to currency rate fluctuations. A partial value increase can only be considered in case the increase in the exchange rate is deemed to be permanent as the change in the exchange rate at the balance sheet date is expected to be of a lasting nature. This is typically denied in case of long-term foreign currency liabilities.

The Federal Tax Court (BFH, decision of 10 June 2021, case ref. IV R 18/18) has recently confirmed that a partial write-up due to an expected permanent increase in the value of liabilities from foreign currency loans is permissible if the Euro value has fallen against the foreign currency due to a fundamental change in the economic or monetary policy data of the currency areas involved. This applies to all foreign currency loans, regardless of the remaining term. The court assumed such a fundamental change during the European sovereign debt crisis prior to 2010. A write-up as of 31 December 2010 was, therefore, confirmed. However, the court denied a typifying approach that would allow write-up in case the currency rate fluctuation exceeded a certain threshold (e.g. 20%).

In a second case (decision of 2 July 2021, case ref. XI R 29/18), the BFH confirmed a fundamental change with regard to a decision of Swiss National Bank that announced in September 2011 an exchange rate change of the Swiss Franc from CHF 1.55 for EUR 1 to CHF 1.20 for EUR 1.

The decisions are of particular relevance as the BFH for the first time gave examples for its understanding of a "fundamental change". As a typifying approach is not allowed, a partial value increase for foreign currency loans only applies in exceptional circumstances that have to be looked into on a case-by-case basis.

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Recent rulings in Germany concerning intercompany financing

In October 2021, Germany's Federal Tax Court (BFH) issued three rulings concerning intercompany financing. Together they provide a comprehensive view on many controversial issues in German tax audits surrounding intercompany financing.

The BFH decision I R 4/17 from 18 May 2021 dealt with a Dutch financing company that had granted a series of intercompany loans to its German affiliate. The taxpayer supported the arm's length character of the intercompany interest rates with conventional benchmarking studies based on a stand-alone credit rating, which relied on proprietary rating software by one of the big rating agencies and a bond search. In its widely commented decision, the lower tier tax court of Munster ruled that the studies should be rejected as the software algorithm was not publicly accessible. The tax court also expressed the view that stand-alone ratings of group entities cannot be performed reliably. On this basis, the tax court decided that the arm's length interest rate should equal the lender's weighted average cost of capital, which in consequence completely ignores any specific data of the intercompany borrower.

The BFH decision I R 62/17 also from 18 May 2021 dealt with an intercompany loan granted by a Dutch company to a German holding, which passed on the loan to an affiliated German GmbH. The purpose of the loan was the financing of an acquisition by the GmbH. Other sources used to fund the acquisition comprised a bank loan with an interest rate of 4.78% and a loan from the third-party vendor of the acquisition target at 10%, both granted directly to the German GmbH. The lower tier tax court of Cologne dismissed the vendor loan as comparable because of the possibility that the high interest rate compensated a relatively low acquisition price. The court decided instead that the intercompany interest rate should not exceed the third-party bank loan, therefore, ignoring the taxpayer's economic analysis and that the intercompany loan was subordinated to both the bank and vendor loan. ▶

German court decisions

The BFH decision I R 32/17 from 9 June 2021 is a revision of the BFH decision from 9 June 2019, which was deemed necessary as the participating judges had signed off a decision that deviated from the published decision. In the original decision, the BFH ruled that write-downs of a German lender can be rejected if – in violation of the arm's length principle – the lender omitted securing the loan. The open issue was to which extent the arm's length principle allows to compensate such omissions with additional risk premiums.

In summary, in all three decisions the BFH confirmed largely OECD standards and its recently published Chapter X. Most notable is that intercompany interest rates can exceed bank interest rates if they compensate for subordination or second lien securities. Credit rating software can be used for assessing credit risk of intercompany borrowers. Credit risk depends on the economic circumstances of the borrower, not the lender, and in particular not the functional profile of the lender. Group support should be considered if third party lenders would consider it. The most reliable method for determining intercompany interest rates is the comparable uncontrolled price method even if conducted with adjustments. The most reliable method is not the cost of capital method. Relevant comparable third-party data are not necessarily bank interest rates, but possibly interest rates for junior loans. Furthermore, the rulings confirm that the arm's length principle is not only concerned with the interest rates but also with other conditions of the loan. Therefore, if intercompany loans charge higher rates to compensate missing collateral, it is necessary to test whether third parties would have granted such unsecured loans or whether they would have required collateral.

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Revenue based intercompany charge as hidden dividend distribution

The Lower Tax Court of Hamburg (decision of 17 March 2021, case ref. 2 K 172/18) had to decide whether the compensation for an intercompany service charge solely based on revenues of the service recipient is at arm's length.

In the underlying case a holding company agreed with its subsidiary a compensation based on the subsidiary's turnover in return for various support and advisory services. Over a 5-year period, the compensation paid – except for one year – did not offset the costs incurred at the level of the holding company in connection with the services provided. Upon audit the tax authorities came to the opinion that third parties would not have agreed on a revenue-based charge and, therefore, treated the payments made as a hidden dividend distribution. The court sided with the tax audit that turnover without considering costs incurred on the level of the service provider is not the appropriate basis for calculating an intercompany service charge. A revenue-based charge does not guarantee cost recovery as well as the possibility of an appropriate profit markup.

The court did not admit an appeal against its decision but the appeal against non-admission is pending before the Federal Tax Court (case ref. I B 34/21).

Taxpayers that apply a service charge solely based on revenues should in any case consider adding a review of the charges based on costs incurred in the service agreement. The decision is nonetheless surprising and is also criticized in literature as it denies a deduction for the intercompany charges even though the – in the view of the court – appropriate charge would have been even higher.

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Brexit — consequences for British companies in Germany

The Munich Higher Regional Court follows the hard line of German courts in connection with Brexit and its consequences. In its judgement dated 5 August 2021 (case number 29 U 2411/21), the court denies the capacity of being a party to court proceedings (Parteifähigkeit) and legal capacity (Rechtsfähigkeit) of a British Limited which has its administrative headquarter (Verwaltungssitz) in Germany.

In the case at hand, an online retailer for cosmetics wanted to obtain an injunction under antitrust law in summary proceedings (Eilverfahren) with regard to a price fixing for cosmetic products. However, the application was not successful, as the company, a British Limited with its administrative headquarters in Germany, has neither the capacity of being a party to court proceedings nor legal capacity in the court's opinion and the application was therefore inadmissible.

The background to this decision is a long-running dispute on the question which law applies to a company which was established in one country but has its seat in another country. Because there is no special conflict law for corporate disputes, the so-called seat theory (Sitztheorie) applies according to case law in Germany. The term "seat" is understood to mean the administrative headquarters of the company, i.e. the place where the company's head office is located and where the management actually carries out its activities. Within the borders of the European Union (EU), however, the seat theory interferes with the freedom of establishment (Niederlassungsfreiheit) regulated in Art. 49 et seq. of the Treaty on the Functioning of the European Union (TFEU). According to the established case law of the European Court of Justice, the seat theory is not applicable to companies in EU member states as it violates the free choice of the company's seat. Instead, the so-called foundation theory (Gründungstheorie) is to apply to disputes involving companies in EU member states. According to this theory, the law of the state in which the company was founded shall apply. With regard to third countries (non-EU/EEA countries), however, the seat theory continues to apply in Germany unless otherwise agreed in bilateral agreements.

The Munich Higher Regional Court now faced the specific question which of the two theories applies to British companies — in this case a Limited Company — after the United Kingdom's withdrawal from the EU. For a long time, the foundation theory continued to apply due to explicit regulations in the transition period. The Munich Higher Regional Court has now ruled that a continuation of the foundation theory does not follow from the Trade and Cooperation Agreement between the EU and the United Kingdom of 24 December 2020 because it does not contain any provisions that contain a legal position equivalent to the freedom of establishment enshrined in Art. 49 TFEU.

But why was the legal capacity of the Limited with administrative headquarters in Germany now denied by the court? The reason for this is that under German company law, legal forms unknown to German law — such as the Limited organized under English law — cannot simply be transferred to Germany or acknowledged as a "German" company. The consequence of this is that company forms which are not expressly mentioned in German law do not have legal capacity if their administrative headquarters are in Germany because only German legal forms are acknowledged as German companies and are therefore not capable of being parties to court proceedings. Such companies are not to be treated as non-existent in every case, but — depending on the actual structure — may be regarded as similar to the German legal forms of the civil law partnership (Gesellschaft bürgerlichen Rechts) or the general partnership (Offene Handelsgesellschaft) or — as in the case decided by the Munich Regional Court with only one shareholder — as a sole proprietorship with the consequence of full personal liability.

This ruling has far-reaching consequences as it now seems clear that German courts are following a trend towards a "hard Brexit". This means that there will be no special treatment for UK companies. It is therefore strongly recommended in the case of administrative headquarters of a British company located in Germany to convert existing British company forms in order to ensure legal capacity and the capacity of being a party to court proceedings and to avoid unlimited personal liability. In such cases, the tax effects of such conversions are to be considered as well.

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VAT fully chargeable at the point in time when service is rendered – even in case of instalment payments

By judgement of 28 October 2021 (C-324/20 – X-Beteiligungsgesellschaft), the European Court of Justice (ECJ) has taken a decision on the point in time when VAT becomes due for the supplier. In particular, the case deals with a supplier who rendered a service against instalment payments extending over five years. The service was fully rendered, but the payments of the customer were due only over time. In this regard, the ECJ sets out that according to Art. 63 and 64 of the European VAT Directive the respective VAT is chargeable at the time when the supply of service is rendered. This VAT becomes declarable and payable in full for the supplier, even though he will receive the consideration from the recipient only over a longer period of time.

This decision differs from an earlier decision of the ECJ in the case of a player's agent who was paid over three years for a supply of agency business services to a football club. In this particular case (C-548/17 - baumgarten sports & more), the ECJ ruled in favor of a fractional chargeability of VAT in line with the payments received from the customer.

The difference between these two cases lies in the fact that in the recent case decided on 18 October 2021 the service was carried out fully and only the payment of the customer was contractually divided in instalments. Insofar, VAT becomes due on the full consideration, nevertheless. To mitigate the cash flow burden, the servicer should try to agree with his customer to be entitled to raise a first instalment invoice that includes the full VAT amount, so that the further instalment invoices only cover the fractional payments of the remaining net amounts of the consideration.

In contrast to the above, in cases where the service itself is rendered over time (e.g. rental services, intermediary services) and where the consideration for such services is also paid fractionally over time, VAT becomes due in parallel with each payment.

Practically, for ongoing payments for supplies of services, taxpayers must thoroughly differentiate the two described different categories because any incorrect treatment causes a risk of late VAT payment for the supplier (and corresponding sanctions of the tax authorities when this incorrect treatment is detected in audits or is self-disclosed by the taxpayer) or a risk of partial denial of input VAT deduction for the recipient. The differentiation between the two categories may not always be simple and straightforward. Therefore, in complex cases where different interpretations appear comprehensible, taxpayers may decide to seek confirmation of their treatment of the tax authorities beforehand.

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Revaluation of 35 million German real estate assets as of 2022

In October 2019, the lower house of German parliament (Bundestag) passed the property tax reform package. This means that all real estate located in Germany will have to be revalued as of 1 January 2022. Based on these new property tax values, property tax will be levied from 1 January 2025. This therefore means that all property owners will have to revalue their properties or provide the relevant information to the tax authorities. In preparation for this valuation, the Federal Ministry of Finance most recently presented drafts this summer for two state decrees on the application of the new valuation regulations for real estate tax (AE Bew GrSt) and implementation of the reform. These decrees are only relevant with respect to those federal states that apply the federal model and thus have not exercised the right to enact a state-specific valuation procedure. As things stand at present, the following federal states have, on the other hand, enacted their own valuation procedure or intend to do so: Baden-Württemberg, Bavaria, Hamburg, Hesse and Lower Saxony. It can be assumed that the final versions of the drafts will be available in time for 1 January 2022. Currently still officially unconfirmed is the announcement that the declarations will probably have to be submitted for all properties in the period July to October 2022. Property owners should therefore address the topic of the property tax reform in the short term and start obtaining the relevant property data.

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The most important changes to the Real Estate Transfer Tax Act as of 1 July 2021

With effect from 1 July 2021, the latest real estate transfer tax reform has now come into force. Not only does it bring uncertainty, but practical handling has also become more difficult. For example, in addition to lowering the relevant shareholding thresholds for share transactions from 95% to 90%, the reform also provides for the extension of (retention) periods from five to ten years (in some cases 15 years). This means that a change of partners in a real estate partnership is now subject to real estate transfer tax if at least 90% of the shares in the company's assets are directly or indirectly transferred within ten years. As of 1 July 2021, this also applies for the first time to real estate-owning corporations.

While previously effected changes of shareholders in real estate-owning corporations are not taken into account, with regard to real estate partnerships, on the one hand, share movements in a ten-year period prior to 1 July 2021 are also counted for the determination of the 90% threshold and, on the other hand, the 95% threshold is maintained in parallel for a transitional period of five years until 30 June 2026. Thus, both the acquisition of real estate-owning corporations with the involvement of an independent co-investor and the exit of existing RETT blockers are no longer easily possible without incurring real estate transfer tax. In the case of existing RETT blocker structures, it should also be noted that the legislator has declared the previous 95% limit to continue to apply indefinitely in the case of share unification, provided that a shareholding of at least 90% but less than 95% already existed prior to 1 July 2021. This is intended to make it more difficult to dissolve existing RETT blocker structures. Finally, intra-group restructurings can possibly trigger real estate transfer tax several times and should therefore always be examined in advance from a real estate transfer tax perspective.

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EY publications

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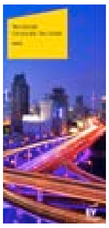
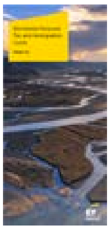


Worldwide corporate tax guide (2021 edition)
The worldwide corporate tax guide summarizes the corporate tax systems in more than 150 jurisdic-tions.



Worldwide personal tax and immigration guide (2020-2021)
This guide summarizes personal tax systems and immigration rules in more than 160 jurisdictions.

Worldwide VAT, GST and sales tax guide (2021 edition)
This guide summarizes indirect tax systems in 137 jurisdictions.

Upcoming EY events

The safety and wellbeing of our guests, EY people, and the local community are our primary concern. Given the unpredictable nature of the situation, EY will not host any physical events for the time being. However, we are pleased to continue to offer webcasts on relevant issues under the following link:

www.ey.com/de_de/webcasts

Webcast "BEPS 2.0: Säule II nach der EU Richtlinie"

The publication of the OECD considerations regarding a global effective minimum tax (GloBE) as well as the proposal for a EU directive will change international tax law considerably and impact the tax competition between states as well as the taxation of multinationals.

In this German-language webcast, we will discuss the following practical questions and required next steps: How will the effective tax rate (ETR) be calculated and how do the GloBE rules work? What should companies bear in mind with regard to structuring under the new tax rules? What changes have to be addressed with regard to tax reporting? What new processes have to be established in companies to ensure compliance with the new pillar II rules?

More information (in German) can be found here.

Date and location: Webcast, 18 January 2022, 10:00-11:00 am German time
Language: German
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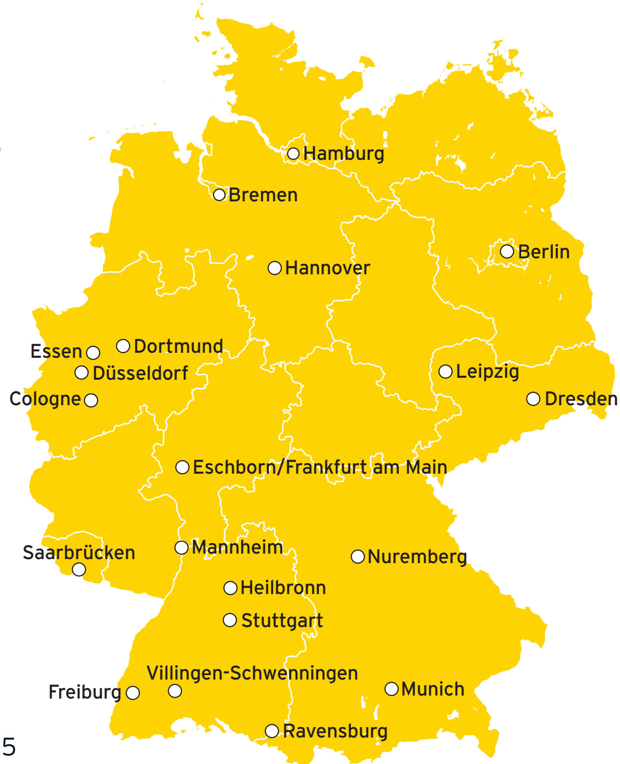

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This quarterly report provides high-level information on German tax developments relevant to foreign business investing in Germany.

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