Building a better working world

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Starting shot for Pillar Two implementation in Germany

Discussion draft of BEPS 2.0 Pillar Two implementation bill published by German Ministry of Finance

Content

The German Federal Ministry of Finance (BMF) published a first draft (discussion draft) of a BEPS 2.0 Pillar Two implementation bill on 20 March 2023.

The language of the discussion draft is closely aligned with the requirements of the EU Directive as well as the OECD Model Rules. Nevertheless, the approach to implementing the following aspects is noteworthy:

Qualified Domestic Minimum Top-up Tax (QDMTT)
The discussion draft provides for the introduction of a QDMTT in Germany. The QDMTT is in principle to be calculated according to the general GloBE rules, so the discussion draft does not take advantage of the modifications/deviations considered acceptable by the OECD as outlined in the Agreed Administrative Guidance. ▸

Starting shot for Pillar Two implementation in Germany

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Safe Harbours

The discussion draft includes the Transitional CbCR Safe Harbour and Non-Material Constituent Entities Safe Harbour, which were already included in the Safe Harbour guidance published by Inclusive Framework on BEPS in December 2022. In addition, the discussion draft provides for a QDMTT Safe Harbour, which is not limited to EU Member States, but also applies to non-EU countries. The aim of the QDMTT Safe Harbour is to significantly reduce the administrative burden by eliminating the need for an MNE group to perform a GloBE calculation in addition to the QDMTT calculation required by local law. In this respect, the discussion draft precedes the OECD Inclusive Framework, which earlier this year announced that further work on the development of a QDMTT Safe Harbour will be necessary.

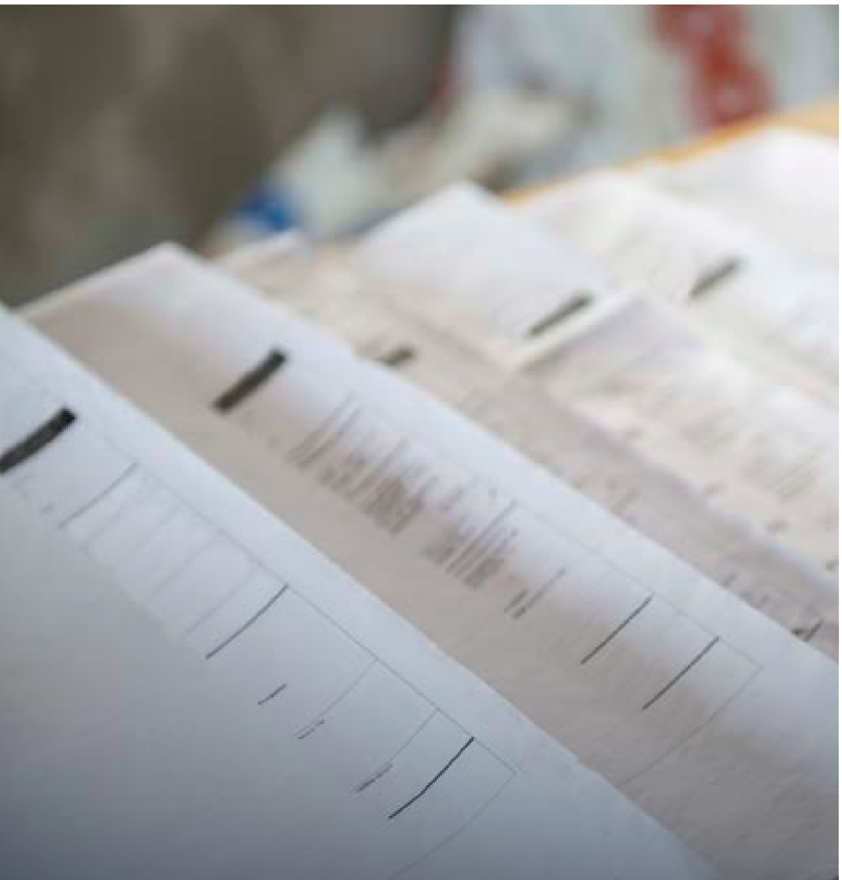
Filing obligations

In addition to the obligation of filing the GloBE Information Return, the discussion draft introduces a second filing requirement: A Constituent Entity resident in Germany needs to file a tax return electronically with the competent local tax office. In case of more than one Constituent Entity resident in Germany, the tax return must be filed by a newly defined Minimum Tax Group Parent (MTGP). The MTGP owes the top-up tax within one month after the return was submitted. The MTGP is — in the following order — a German UPE, a German Constituent Entity and holding (if it holds shares directly or indirectly in all other German Constituent Entities) or a German resident Constituent Entity selected by the MNE group. The concept of MTPG ensures that only one tax return needs to be filed.

The discussion draft does not yet specify the penalties for non-compliance and, thus, does not yet include the penalty relief provided in the Safe Harbour guidance of the Inclusive Framework on BEPS.

It should further be noted that the Agreed Administrative Guidance published by the Inclusive Framework on BEPS on 2 February 2023 has not yet been incorporated into the discussion draft.

Stakeholders now have the opportunity to comment on the discussion draft bill by 21 April 2023. Public consultations are a regular part of German tax legislation. Given the immense complexity of the Pillar Two implementation, the BMF has already announced to present a revised second draft bill and start a second consultation afterwards. Such a second draft bill could be expected around June 2023. Under the BMF's current plans, the Federal Government will start the official legislative procedure with a further revised government draft bill not before August 2023. The subsequent parliamentary deliberations are expected to last until November/December 2023.



The upcoming intense discussions between lawmakers and stakeholders may result in numerous changes to the newly available first draft bill. This may not only affect Pillar Two implementation details. In addition, German business associations are also pushing for a long-awaited change of the German Controlled Foreign Company (CFC) rules to the bill. While currently German CFC rules apply to CFCs that are taxed at an ETR of below 25%, German businesses as well as some tax policy makers of the governing coalition hope to align this rate to the Pillar Two minimum tax rate of 15%.

More details on the German Pillar Two implementation bill are available in the *EY Global Tax Alert "German Federal Ministry of Finance publishes draft BEPS 2.0 Pillar Two implementation bill"* dated 22 March 2023.

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Finance Ministry announces tax policy plans for 2023

The German Federal Ministry of Finance has announced a set of new or expanded tax incentives to foster the economic recovery.

In addition to the implementation of the Global Minimum Tax (BEPS Pillar 2), the ruling coalition aims to facilitate a modernization of tax law and to set new growth impulses with new legislative initiatives, even if a corporate tax reform is not on the agenda. The following can be expected in the first half of the year:

Various measures are discussed to be implemented in a **relief package**, which will improve investment activity and resilience in particular of small and medium-sized enterprises. The initiative for this bill focuses on the introduction of an investment premium, as already agreed in the coalition agreement, especially for investments in the transformation and modernization of the economy to reduce CO_2 emissions. The investment premium will likely take the form of a tax credit and may benefit from the relaxation of EU state aid regulations that are likely to be shortly adopted on EU level as a reaction to the US Inflation Reduction Act. In addition, the already existing tax credit for research and development is to be expanded significantly. Also under consideration are a more favorable taxation of retained earnings for partnerships, the extension of the declining balance depreciation to investments in 2023 and better depreciation conditions for small and medium-sized enterprises.

Another objective is the modernization of the capital market and the facilitation of access to equity for start-ups, growth companies and small and medium-sized enterprises (SMEs). With the **Future Financing Act** (Zukunftsfinanzierungsgesetz), the Ministry of Finance wants to improve the framework for employee share ownership by increasing the tax allowance for such ownership as well as extending the regulations on deferred taxation of non-cash benefits from employee shareholdings. In addition, the initiative plans corporate and financial market law measures to simplify listing requirements and post-admission obligations by reducing the minimum capital for an IPO to EUR 1 million and by improving the possibility of raising equity capital.

But businesses will also face new measures against profit shifting and tax evasion that will increase compliance costs and, in some cases, will lead to higher tax bills. At the end of 2022, the coalition already announced a **Tax Fairness Act** (Steuerfairnessgesetz), which partly deals with the implementation of restrictive measures already announced in the coalition agreement. These include, among other things, an obligation to report certain domestic tax arrangements, the extension of withholding taxes and an – as yet undefined – limit on the level of the tax-deductible interest rate for intra-group payments. Furthermore, there are plans for measures against so-called trade tax havens, i.e. German municipalities that apply a trade tax rate close to the minimum rate of 7%, and arrangements with family foundations. A national list of tax havens is also to be drawn up, thus extending the scope of the Tax Havens Defense Act. In return for the list, the partial abolition of register case taxation contained in the Annual Tax Act 2022 could be continued, which could significantly reduce the burden of the register case taxation remaining after the Annual Tax Act 2022.

It is also becoming more and more likely that the Federal Ministry of Finance intends to launch the second stage of implementation of the **Multilateral Instrument** (MLI) at the beginning of 2023. According to the current status, the MLI, which was already signed in 2017 by Germany, is intended to bring 14 German double taxation agreements up to the level of the OECD-BEPS project. Unlike most other countries, Germany needs a second domestic bill to be able to apply the MLI. Assumed that this second step is completed during 2023, the 14 covered tax agreements could be modified by the MLI, in general, as of 2024. For many other double tax treaties, Germany has meanwhile chosen bilateral negotiations to integrate BEPS measures in its treaty network.

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Real estate transfer taxes increasing in Northern and Eastern Germany

Real estate transfer tax rates are set on a state level in Germany. Hamburg and Saxony are the latest states to announce an increase of the applicable rate of real estate transfer tax. With effect from 1 January 2023, the real estate transfer tax rates were increased to 5.5 percent in both federal states. According to the coalition agreements signed in 2022, the real estate transfer tax will not change in other federal states. At 3.5 percent, Bavaria currently has the lowest real estate transfer tax rate. The national average is in the range of 5 to 6.5 percent.

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Implementation of the EU Conversion Directive (UmRUG and UmRMitbestG)

On 20 January 2023, the German lower house of parliament (Bundestag) passed the Act implementing the Conversion Directive (UmRUG-BGBl. I 2023, Nr. 51 v. 28.02.2023). The Act entered into force on 1 March 2023 after being published on 28 February 2023 and the new regulations essentially only apply to corporations (AG, SE, KGaA, GmbH). The law is subject to a transitional period for conversions that are already in progress. The previous law shall apply if the respective contract/resolution for conversion was concluded before 1 March 2023 and the conversion is filed for registration by 31 December 2023. Previously, the Bundestag already passed and approved the Act on the Implementation of the EU Transformation Directive on Employee Participation (UmRMitbestG) on 1 December 2022 in connection with the implementation of the Transformation Directive on employee co-determination. This introduces the Act on Employee Co-determination in the Event of Cross-Border Transformation of Legal Form and Cross-Border Demerger (MgFSG) and adapts the existing provisions of the Law on the Co-Determination of Employees in the Event of a Cross-Border Merger (MgVG).

In the context of employee co-determination, the negotiation requirements for the reduction of co- determination or the disadvantage of foreign employees in the case of cross-border mergers already applied, but with a threshold of 500 employees. Now, based on the new law, the obligation to negotiate will already take effect if the company changing its legal form, splitting up or participating in a merger employed an average number of employees in the six months prior to the disclosure of the plan which corresponds to at least 4/5 of the threshold for corporate co-determination provided for in the national law of the Member State concerned. However, if the employee limit of 4/5 is exceeded, companies can still only rely on Articles 49, 54 TFEU and the case law on freedom of establishment.

The UmRUG establishes a legal framework for cross-border changes of legal form and demergers (Aufspaltung, Abspaltung und Ausgliederung) and amends the existing procedure for cross-border mergers within the EU/EEA. For the first time, there is an EU-wide minimum standard for creditor protection. Creditors of a German company involved in a cross-border transformation as the transferring legal entity are entitled to security so that their claim cannot be jeopardized by the transformation. The commercial register issues the conversion certificate only when it has been ensured that no creditor has asserted claims for security or the security has been provided. The rights of shareholders to withdraw from the company against cash compensation and to assert a claim for improvement of the exchange ratio now exist in all forms of cross-border conversion. The claim to improvement of the exchange ratio exists both in the case of national and cross-border conversions and in the future not only for the shareholders of the transferring entity, but also for the shareholders of the acquiring entity.

For stock corporations to improve their exchange ratio, they can now foresee the possibility for the issue of shares in their conversion plan or agreement. Furthermore, the substitute liability (Ausfallhaftung) of the legal entities involved is also limited. In the case of both purely domestic and cross-border demergers, this applies uniformly to the net assets allocated to them in each case. ▶

Legislation

The Act now regulates the obligation to prepare a merger report and the associated audit report or to conduct a merger audit for the special case that the same person holds all shares of the transferring and acquiring company. As part of the announcement of the merger plan, the meeting of shareholders shall now take place no earlier than one month after the announcement of the merger plan. Additionally, the spin-off plan or its draft must contain additional information such as an indicative timetable and information on the valuation of the assets and liabilities remaining with the transferring company.

To avoid abusive arrangements, cross-border conversion measures shall be subject to judicial abuse control if there are any corresponding indications. The court must examine whether the cross-border merger is to be carried out for abusive or fraudulent purposes which lead or are intended to lead to evading or circumventing EU or national law, or for criminal purposes.

In this context, the right to obtain information has been modified. In the context of abuse control, the registry courts may hear trade unions of the companies involved or also request documents from public domestic bodies. The adopted version of the law also contains provisions on the mutual notification obligations of the registry courts of the new or transferring company via the European Business Registers Interconnection System (BRIS).

German tax aspects of the implementation
For tax law, the UmRUG is of particular importance regarding the expansion of cross-border transformations. In principle, the German Reorganization Tax Act (UmwStG) forms the legal basis for reorganization tax law. However, the UmwStG has significant relations to civil reorganization law (UmwG). Even though they are two separate areas of law, tax reorganizations and contributions must always be permissible and effective under the civil law provisions.

Besides, the UmwStG is based to some extent on the EU Merger Directive (Directive of 19 October 2009, RL 2009/133/EC) and thus on EU requirements. The aim of the Merger Directive had already been to harmonize and thus facilitate cross-border transformations. Due to the (so far) lack of possibilities under civil law for cross-border transformations and the mandatory principle of congruence of company law for reorganization tax law, cross-border demergers and changes of legal form were in some cases not possible for tax purposes in the past if the acquiring or transferring company was a domestic legal entity. In this respect, the expansion of the possibilities under civil law for cross-border changes of legal form, relocations of registered offices and demergers is also to be welcomed from a tax perspective.

However, there will still be no legal basis for cross-border reorganizations of partnerships. In this respect, too, tax law is already more far-reaching, in that it globally permits contributions of businesses, parts of businesses and co-entrepreneurial shares to a domestic or foreign partnership of the same type at book value in accordance with Sec. 24 UmwStG. Also, with regard to merger and demerger cases, tax law is more far-reaching than civil law, despite the UmRuG. The Corporate Income Tax Modernization Act (KöMoG) has internationalized these cases and, with effect from 1 January 2022, book value-linked transfers (with ensured German taxation of unrealized gains) are also possible beyond the EU/EEA area for shareholders from third countries upon application. However, the comparability of foreign reorganizations with domestic reorganizations must continue to be ensured. Likewise, the principle of congruence of company law continues to apply, so that in the future, an even further opening up of civil law would be desirable for tax purposes in order to create a secure legal framework.

In addition, it is interesting from a tax point of view that if German companies want to relocate their registered office to another member state, they are no longer obliged to liquidate and reestablish the company as a result of the UmRUG. Since the relocation is considered to be a change of legal form, e.g. no real estate transfer tax will be triggered. Thus, new restructuring possibilities have been created, which could be relevant for real estate-owning companies.

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CbCR – Extension of automatic exchanges continues

On 9 February 2023, the lower house of the German parliament, Bundestag, approved the implementation law for the bilateral agreement on the exchange of country-by-country reports with the USA. Ratification of the agreement in the current year is thus likely. Furthermore, on 10 February 2023, the Bundestag approved a regulation that includes Barbados in the group of third countries with which CbCRs are automatically exchanged.

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New UBO reporting obligations for foreign entities and structures with German real estate

The new year has started with new Ultimate Beneficial Owner (UBO) reporting obligations for foreign entities that have direct or certain indirect ownership in German real estate. Even share deals that date back a long time can now trigger reporting obligations. The respective reporting is due by 30 June 2023. Non-compliance with these rules can result in significant penalties combined with a publication of the penalty assessment on the internet ("naming and shaming"). For more information regarding the new reporting obligations, please refer to our *English-language EY Tax Alert dated 13 February 2023*.

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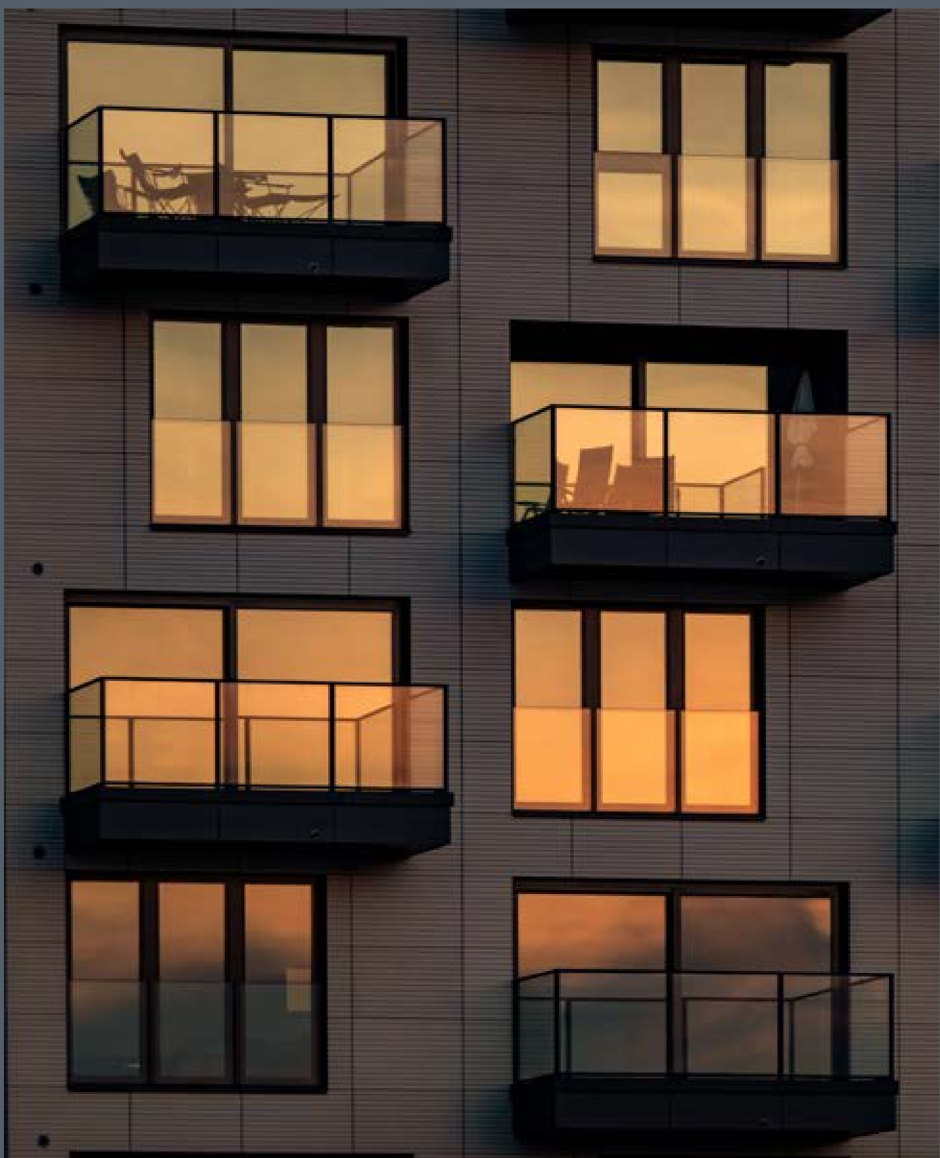
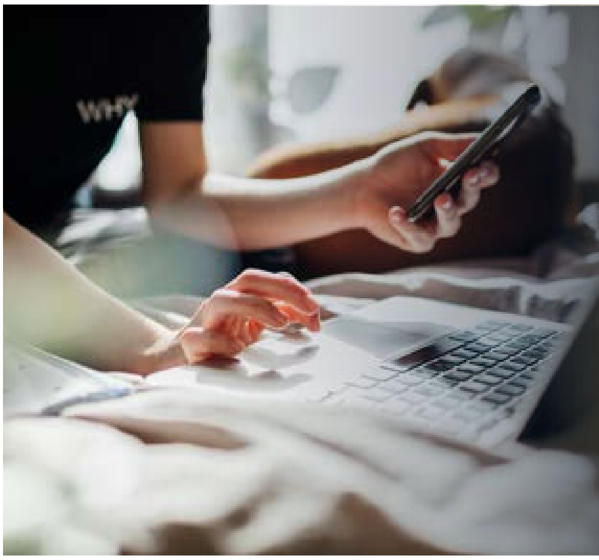


Implementation guidance on the Platform Tax Transparency Act



As of 1 January 2023, new reporting requirements for digital platform operators are applicable in the European Union. Against the background of the EU Directive 2011/16/EU on improving administrative cooperation in the field of taxation ("DAC7"), Germany passed the new Platform Tax Transparency Act (Plattformen-Steuertransparenzgesetz, PStTG).

A number of questions which may have arisen for businesses in this regard were addressed in a comprehensive and binding FAQ published by the German Federal Ministry of Finance on 2 February 2023. The FAQ are intended to clarify various uncertainties regarding the interpretation of the PStTG, thereby supporting the correct implementation and application of the newly introduced law.

Inter alia, the FAQ state that inter-company platforms are not exempt from the reporting obligations. They further explain that in the case of commission transactions, the decisive factor determining the reportable supplier is the person entering into the legal obligation with the customer on the platform. Furthermore, consulting and brokerage services are generally regarded as so-called "personal services" which are covered by the scope of the PStTG. The FAQ also address to which extent service bundles and vouchers are to be reported by DAC7 platforms. In addition, the FAQ confirm that only non-European platform operators are obliged to submit a full DAC7 registration application. German-based operators are only obliged to notify the German Federal Central Tax Office about their obligation to submit DAC7 returns.

Besides practical questions regarding the application of the law, the FAQ reiterate that if an EU Member State or the European Union provides an electronic interface for the verification of tax numbers or VAT identification numbers and this service is provided free of charge, platform operators are obliged to use this service to verify the validity of such numbers provided by sellers using their platform.

The German Federal Tax Office will publish the DAC7 reporting file and DAC7 reporting portal in the course of 2023. A technical description of the data to be reported to the German Tax Authorities has, however, already been published.

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Extension of the administrative support measures for taxpayers

The COVID-19 pandemic has caused considerable economic damage in large parts of Germany. Considering the strained economic situation of German taxpayers, the scope of support measures of the German tax authorities for substantial tax relief has been extended within the current letter of the German Ministry of Finance (BMF) dated 12 December 2022. The measures were established for the first time as of 9 April 2020 and include, among others, tax relief with regard to donations, tax relief for non-profit organizations and certain VAT measures related to the COVID-19 crisis (e.g., special treatment for donations of medical equipment). Over the course of the pandemic, the measures have been expanded and extended several times. With the current letter, these measures are now extended beyond the year 2022 until end of December 2023.

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German tax authorities

Updated circular on German Investment Tax Act

In two circulars dated 30 December 2022, and dated 4 January 2023, the German Ministry of Finance updated its circular on the German Investment Tax Act 2018 (GITA).

The circular dated 30 December 2022 relates to the taxation of investment funds that are structured and qualify as special investment funds under Chapter 3 GITA, i.e. whose investment conditions and actual investments meet the requirements of Sec. 26 GITA, and which have also exercised the so-called transparency option. In the event that the transparency option is exercised, the special investment fund is treated as tax transparent for German-sourced dividends and other German-sourced income, and this income is subject to capital gains tax at the investor level, i.e. to a withholding tax paid by the respective withholding agent ("Entrichtungsstelle"). The withholding agent must consider the tax status of the respective investor when deducting the tax, i.e. in general also exemptions or refunds of capital gains tax claimed by the investors.

The circular specifies the obligations of the withholding agent to avoid so-called "cum/cum transactions" and similar exclusively tax-driven structures in the event that a reduction of the capital gain tax deduction to 0% is claimed by the investor. In particular, in case of equity interests or profit participation certificates ("Genussrechte") held by the special investment fund, the withholding agent must check in accordance with Sec. 31 para. 3 GITA and Sec. 36a German Income Tax Act whether the required minimum holding period is fulfilled at the level of the special investment fund (with respect to the interests/ certificates above) and at the level of the investor (with respect to the units in the special investment fund).

In addition, the circular stipulates changes for the tax certificates that the withholding agent must prepare uniformly for the special investment fund and its investors. Tax certificates received prior to 1 January 2024 will remain in original form with the special investment fund, and copies will be sent to investors. Tax certificates received on or after 1 January 2024 will be sent to investors in original form and to the special investment fund as a copy. From now on, tax certificates are only permissible without any redactions with regard to the other investors.

The circular dated 4 January 2023 relates to the taxation of investment income which investors derive from investment funds under Chapter 2 GITA. This investment income includes the so-called "Vorabpauschale", an advance lump sum, which shall ensure a lump-sum taxation in the event that the distributions of the investment fund fall short of its increase in value.

The "Vorabpauschale" is the amount by which the distributions of an investment fund within a calendar year fall short of the base return ("Basisertrag") for that calendar year. The base return is determined by multiplying the redemption price of the investment unit at the beginning of the calendar year by 70% of the base interest rate ("Basiszins"). According to the circular dated 4 January 2023, the base interest rate for calendar year 2023 is 2.55%, and the base return accordingly 1.785% (= 70% x 2.55%). Due to a negative base interest rate, the "Vorabpauschale" was not applicable in 2021 and 2022. Pursuant to Sec. 18 para. 3 GITA, the "Vorabpauschale" 2023 is deemed to be received by the investors on the first working day of the following calendar year, i.e. on 2 January 2024.

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German tax authorities

Extended warranties granted by dealers and manufacturers – German insurance premium tax and value added tax considerations

As of 1 January 2023, extended warranties granted by dealers and manufacturers to their customers against a separate remuneration are considered VAT-exempt insurance services subject to German insurance premium tax (IPT) under certain circumstances. In such cases, dealers and manufacturers may be obliged to report and pay IPT irrespective of whether they qualify as an insurer from a supervisory law perspective. Furthermore, potential VAT effects resulting from the provision of VAT-exempt insurance services have to be considered, e.g. with regard to input VAT deduction.

The application of these principles requires comprehensive changes with regard to tax compliance processes and the underlying systems (submission of insurance premium tax returns, reporting of VAT-exempt services, determination of the deductible input VAT) as well as with regard to invoicing processes and systems (no invoicing of VAT, disclosure of insurance premium tax related information, etc.).

Many products are offered by dealers or manufacturers together with an extended warranty commitment from the dealer or the manufacturer which can be purchased for a separate fee. This allows the customer a more comfortable use of the purchased product and the dealer or manufacturer to generate additional revenue.

According to a judgment of the German Federal Tax Court (BFH) from 2018, such guarantee promises of a car dealer are not considered dependent ancillary services to the supply of the vehicle, but an independent service for VAT purposes. Under the respective warranty agreement, the car dealer promised against a separate fee to cover future repair costs. This qualifies as insurance relationship for German IPT purposes according to the judgment. The respective services are therefore exempt from VAT pursuant to Sec. 4 No. 10 lit. a German VAT Act and subject to German IPT. This is based on the argument that the car dealer as guarantor assumes the customer's risk of the malfunction of the car against a separate fee.

On the basis of various decrees, the Federal Ministry of Finance (BMF) has adopted the principles of this judgment with effect from 1 January 2023. The decree on the application of the German VAT Act was amended accordingly. The principles apply to all industries and not only to the motor vehicle trading business. As a result, contractual guarantee promises granted by a dealer or manufacturer to the customer against separate remuneration, where the customer receives a claim for repair or repair costs against the dealer or manufacturer in the case of damage, are considered an insurance relationship according to the German IPT Act. The dealer or manufacturer is considered the insurer for German IPT purposes and, thus, has to pay and report the IPT. This requires a registration for insurance premium tax purposes with the German Federal Central Tax Office and the submission of periodical insurance premium tax returns. Due to the VAT exemption of insurance services, the input VAT deduction at the level of the guarantor is (proportionally) excluded for supplies of goods and services assumed with regard to the warranty services provided.

Exceptions apply in connection with so-called full maintenance contracts and, under certain circumstances, in cases where the products are always sold including the warranty extension without separate remuneration. Further specifics must be considered in the case of multi-person constellations (e.g. distribution chains etc.) and in connection with the separate insurance of the guarantor against the warranty risks.

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BFH confirms the constitutionality of the solidarity surcharge

The German solidarity surcharge is a supplementary levy on income tax and corporation income tax within the meaning of Article 106 (1) No. 6 of the German Constitution. It has been levied to finance the German reunification since 1995. The legal basis is the Solidarity Surcharge Act 1995 (SolZG 1995). In addition, both Solidarity Pact I (1994 to 2004) and Solidarity Pact II (2005 to 2019) provided for further fiscal measures in connection with the German reunification.

In the current case, the German Federal Tax Court (BFH) had to decide whether the levying of the solidarity surcharge is still constitutional in the fiscal years 2020 and 2021 after the expiry of Solidarity Pact II on 31 December 2019. This was confirmed by the BFH in its ruling of 17 January 2023 (IX R 15/20). The BFH has (so far) not made constitutional objections to the continuation. According to the BFH, the additional financing needs of the German government due to reunification would continue in 2020 and 2021 (e.g. in the area of pension insurance). Since the original purpose had not yet ceased to exist for 2020 and 2021, the BFH was not concerned with a possible reallocation of the solidary surcharge to finance the COVID-19 pandemic or the Ukraine war. Further, the BFH considers the resulting unequal treatment, i.e. the fact that from 2021 onwards only the recipients of higher incomes will be burdened with the solidary surcharge due to increased exemption thresholds, to be justified. In the decisive case, the BFH thus saw no reason to submit the question of constitutionality to the Federal Constitutional Court. However, there is still a constitutional complaint pending (2 BvR 1505/20), where individual members of the German Federal Parliament are opposing the continuation of the SolZG 1995. A fundamental decision by the German Federal Constitutional Court in this regard remains to be expected.

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BFH confirms: Without proper execution of P&L transfer agreement and corresponding book entries, a fiscal unity is invalid

In two recent decisions, the German Federal Tax Court (BFH) commented on the question of the actual execution of a profit and loss transfer agreement required for the recognition of a fiscal unity for income tax purposes. The court sticks to the strict, formal view it has already held in the past.

Generally, among other requirements, the recognition of a fiscal unity for income tax purposes requires a profit and loss transfer agreement that is effective under civil law, concluded for a period of at least five years, and which is properly executed during its entire period of validity. In two cases to be decided by the BFH, it was disputed whether a profit and loss transfer agreement had been properly executed before the expiry of the minimum term of the agreement. The lack of such execution would lead to the fiscal unity not being recognized for tax purposes retroactively from its establishment.

The court decided that such execution is to be denied if the claim for the assumption of losses against the controlling company is not shown in the balance sheet of the controlled company (I R 37/19). This also applies if the payment of the loss compensation amount is actually made. According to the BFH, the profit and loss transfer agreement must actually be "lived" during the entire period of validity, i.e., the corresponding receivables and liabilities must also be recorded in the annual financial statements.

Furthermore, the BFH clarifies that the criterion of actual execution cannot be fulfilled by preliminary annual financial statements (I R 29/19). For the proper execution, the result to be shown in the final annual financial statements following accounting principles is decisive.

In summary, a profit and loss transfer agreement is not properly executed if a loss compensation claim is not booked at all, or if an (incorrect) profit and loss transfer had been booked in merely provisional annual financial statements. The court also clarified that, unlike mere incorrect amounts booked in the financial statements of the controlled entity, these types of formal mistakes cannot be cured for the past.

Consequently, given that the profit and loss transfer agreements at hand had not yet fulfilled the five-year minimum term, the fiscal unities were considered invalid as from their beginning. However, the court left the question open if such invalidity would also have existed from the beginning (as opposed to only for the particular erroneous year) if the minimum term had already been completed. In professional tax literature, this question is widely denied.

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BFH defines scope of trade tax add-back for leasing fees

Under German trade tax law, certain expenses are not 100% deductible in determining the trade tax basis. The law requires an add-back to the trade tax basis e.g. in the following amounts:

- 25% of all interest expense;
- 12.5% of all rental/leasing fee expense for immovable assets;
- 6.25% of all royalty expenses; and
- 5% of all rental/leasing fees for most movable assets.

The effect of these add-backs can be substantial, as the trade tax rate can range between 7 and 16%, with average rates in Germany being around 14%.

In a recent case, the German Federal Tax Court (BFH, decision dated 20 October 2022, III R 33/21) had to decide whether maintenance costs for cars leased by a company, and on-charged as part of the leasing contract with the lessor formed part of the basis for the – in this case 5% – trade tax basis add-back. The court confirmed this view by the tax office and held that the definition of what the leasing fee encompasses has to be seen from an economic perspective, and taking into account the typical legal allocation of obligations under a leasing contract. In the case of car leasing, the lessor is typically obliged to make available a car that is adequately maintained, and hence it follows that the typical contractual allocation of duties was for the lessor to take care of maintenance and then pass on the respective cost to the lessee, as was the case here. It follows from the decision that additional compensation/service elements especially in leasing agreements will have to be considered for the calculation of trade tax add-backs; if one wanted to achieve a more favorable trade tax outcome, it could in individual cases be considered to agree on different contractual arrangements, allowing a separation of these costs from the leasing fee itself.

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The BFH rules on the tax recognition of incongruent advance profit distribution resolutions

According to the administrative opinion, a profit distribution that deviates from the participation ratios (so-called incongruent profit distribution) is to be recognized for tax purposes if it is effective under civil law. In the case of a GmbH as a distributing company, this is the case if the articles of association stipulate a different distribution standard than the participation ratio or if the articles of association contain a clause according to which a deviating profit distribution can be decided annually with the consent of the affected shareholders or unanimously.

The Federal Tax Court (BFH, decision of 28 September 2022, case ref. VIII R 20/20) now had to decide whether incongruent advance profit distribution resolutions unanimously adopted without a basis in the articles of association were effective under civil law and thus to be taken as a basis for taxation. In the case to be decided, an individual held 50% of the shares in the distributing limited liability company and a limited liability company held the other 50% of the shares, the sole shareholder of which was the individual. The shareholders of the distributing company unanimously decided on the incongruent advance profit distribution in favor of the GmbH shareholder.

In the opinion of the tax office, the incongruent advance profit distribution resolutions were void for lack of compliance with the requirements for such resolutions (in particular notarial certification and entry of the resolution in the commercial register). The shareholder, who had not received any profit distribution, was therefore to be attributed a hidden profit distribution and, due to the existence of an abuse of the tax system pursuant to Sec. 42 Fiscal Code (AO), half of the profit shares.

In its ruling, the BFH contradicted the tax authorities. The incongruent advance profit distribution resolutions adopted were effective and binding under civil law as distribution resolutions that broke through the articles of association at certain points. Thus, it had not been the intention to make a new provision in the articles of association for a general distribution of profits deviating from the shareholding ratios that would have required registration in the commercial register.

Because of their effectiveness under civil law, the resolutions were to be recognized under tax law. The shareholder to whom no profit was distributed according to the resolutions therefore had no income to pay tax on. Thus, the BFH also denied the existence of a hidden profit distribution and an abuse of the tax system. For taxpayers considering incongruent profit distributions, the decision offers more flexibility and certainty.

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Identification of the controlling company within the meaning of the group clause under German RETT law

According to the so-called group clause of Sec. 6a German RETT-Act ("RETT-Act") a legal transaction taxable under Sec. 1 para. 1 No. 3, para. 2a to para. 3 RETT-Act is tax-exempt, among other things, due to a split, spin-off, spin-off and transfer of assets. According to the wording of the law, the tax exemption requires, in particular, the transformation transaction to exclusively involve a controlling company and one or more companies dependent on this controlling company or several companies dependent on a controlling company. A dependency exists if the controlling company holds at least 95% of the shares directly or indirectly or partly directly and partly indirectly without interruption within five years prior to the legal transaction and five years after the legal transaction (so-called pre- and post-retention periods).

In a further development of its case law on the group clause for German RETT from 2020, the BFH now comments on the determination of the controlling company in the case of multi-level shareholdings. It contradicts the restrictive view of the tax authorities, according to which the controlling legal entity is decisive.

In its judgement of 28 September 2022 (case ref. II R 13/20), the Federal Tax Court (BFH) now confirms its case law from 2020 and develops it further to the effect that the determination of the "controlling company" and the "dependent company" is based on the respective transaction benefiting under Sec. 6a RETT-Act. In the case of multi-level shareholdings, it is thus irrelevant that the controlling company itself is dependent on one or more other companies. It is also irrelevant whether, in the case of dependent companies, further companies are dependent on the controlling company if these companies or companies themselves are not involved in the conversion process. In this respect, the BFH does not share the restrictive view of the tax authorities, according to which the controlling company is the ultimate legal entity that fulfills the requirements of Sec. 6a Sentence 4 RETT-Act (identical state decrees of 22 September 2020, para. 3.1). In contrast to the tax authorities, the BFH considers the controlling company closest to the dependent company as relevant.

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German Federal Tax Court rules on details regarding the credit of foreign taxes

In a recently published decision (case ref. I R 14/19 dated 17 August 2022), the Federal Tax Court (BFH) clarified important questions regarding the credit of foreign taxes in Germany. In the case decided, a German GmbH engaged in various IP development projects, where the IP developed was subsequently licensed to a Chinese related party. The German taxpayer wanted to credit the withholding taxes levied on the royalties received against its German tax liability in line with the tax treaty and the German rule on foreign tax credits. ▸

German court decisions

When calculating the maximum amount of creditable foreign taxes for a specific country, various restrictions need to be observed, the most important one being that costs in economic relation to the royalties received have to be deducted from the foreign royalty income received, thus lowering the maximum creditable amount of foreign taxes. The details of such calculation were now subject to review by the BFH.

According to the BFH, the economic relation would need to exist between specific expenses and equally specific income (rather than types of activities) and an exclusive relation between the two is not required. Thus, a taxpayer could split the costs in relation to the royalties on a project basis, so that if they incurred significant costs for a project which is still in a development phase (and where no royalties are received yet) this would not (negatively) impact the maximum credit amount for other more mature projects where royalties are received (but only minimal costs are incurred in Germany). The BFH decision therefore provides taxpayers engaging in different development activities with the opportunity to maximize their creditable foreign taxes provided their cost allocations can be clearly documented.

Irrespective of the BFH decision, taxpayers who claim tax credits for foreign taxes should be aware of the obligation to deduct expenses for purposes of the calculation of the maximum credit amount as otherwise this could lead to an incorrect overstatement of creditable taxes in Germany.

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BFH rules on the allocation of the "cost of the transfer of assets" based on the inducement principle

In the case of a merger of corporations, the receiving entity generates a transfer gain in the amount of the difference between the book value of the shares in the transferring entity and the value at which the transferred assets are to be taken over, minus the so-called "cost of the transfer of assets". The transfer gain is left out of account, i.e., the gain is neutralized off balance sheet. However, in the event of an upstream merger, 5% of the transfer gain corresponding to the receiving corporation's share in the transferring entity are subject to taxation. As a result, costs that are to be allocated as "cost of the transfer of assets" are non-deductible. Therefore, the allocation of costs as "cost of the transfer of assets" is very relevant in practice, especially in tax audits. So far, it has been disputed whether the allocation of costs is based on the inducement principle or whether the costs were finally spent for the transfer of assets. In particular, it was unclear if real estate transfer tax incurred by the so-called consolidation of shares (within the meaning of Sec. 1 para. 3 no. 1 RETT-Act), as a result of a merger of corporations with shares in real estate owning corporations, is qualified as "cost of the transfer of assets".

In a current ruling, the German Federal Tax Court (BFH) decided that in the case of an up-stream merger the real estate transfer tax incurred by the consolidation of shares is to be treated as non-deductible "cost of the transfer of assets" within the meaning of Sec. 12 para. 2 sentence 1 Reorganisation Tax Act. The treatment as "cost of transfer of assets" shall be based on the inducement principle and not on the fact whether the costs were finally spent for the transfer of assets. In addition, it is irrelevant for the BFH whether the assessment of the real estate transfer tax was lawful, and therefore this could be left open in the specific case (ruling of 23 November 2022, I R 25/20).

This case is to be distinguished from cases in which the real estate transfer tax is incurred by the transfer of real estate, e.g. merger of real estate owning corporations. In the latter case, the real estate transfer tax belongs to the expenses of the acquisition and therefore is not allocated to the non-deductible "cost of the transfer of assets".

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Lower tax court interprets Cadbury Schweppes-exemption from CFC rules in case of outsourced activities

In a decision dated 22 September 2022 (6 K 2661/18), the lower tax court of Cologne had to decide whether the German rule implementing the ECJ case law "Cadbury Schweppes" (C-196/04) allows the allocation of outsourced activities to a controlled foreign corporation (CFC), enabling the German ultimate shareholder of the CFC to apply the substance-based escape from German CFC income imputation. In the facts of the case, a Dutch BV with no employees nor premises in the Netherlands had entered into film right licensing transactions, and earned a profit from this business, which was low-taxed (ETR < 25%), so that the German tax authorities wanted to impute the respective profit to the ultimate German shareholder. The German shareholder claimed application of the substance-based "Cadbury Schweppes" exemption from CFC imputation, arguing that the significant substance of another Dutch group company, whose employees actually acted as directors on behalf of the licensing CFC, could be allocated to the CFC for purposes of the substance test. Based on an analysis of the ECJ case law and the intent of the German law implementing this case law, the court sided with the taxpayer, and allowed the substance-based escape from the German CFC rules to apply. In this connection, it was also noted that there did not seem to be an apparent tax motivation in using the particular CFC for the licensing transaction, and that the licensee also had its tax presence in the Netherlands, so that there also was a geographical link to this country. The case is finally decided.

It should be noted that Germany has changed the wording of the "Cadbury Schweppes" escape in its CFC rules with effect from 2022, so that now the outsourcing of activities to "third parties" is explicitly treated as harmful, and it is required that the CFC carry out its income-generating functions with own personnel and resources. Hence, under current law, the case might be decided differently, although doubts are raised in literature whether the tightened escape clause is actually in line with the EU freedom of establishment principle.

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German court decisions

Decision on the application of the Double Tax Treaty fallback clause

The Düsseldorf Tax Court had to assess the treatment of Dutch wages under income tax law and the applicable Dutch/German DTT. The plaintiff was exclusively resident in Germany and received wages from a Dutch employer. He made use of the so-called 30% rule: According to Dutch law, the employer can pay the employee 30% of his wages tax-free without having to provide evidence of actual costs incurred.

However, the tax office took this exempt portion of the salary into account when determining the German tax base. The exempted 30% of the salary was not subject to Dutch taxation and was therefore taxable in Germany. The plaintiff, on the other hand, argued that the Netherlands had also exercised its right of taxation insofar as the 30% rule had been applied. Germany therefore had to exempt the wages from taxation under treaty law insofar as they were attributable to the activity carried out in the Netherlands.

However, the Düsseldorf Tax Court did not agree and dismissed the action in its ruling of 25 October 2002 (case ref. 13 K 2867/20 E). According to the rules of treaty law, Germany only had to exempt those parts of the salary from the German tax base that had actually been taxed by the Netherlands. In view of the court this was not the case for the 30% share, since this regulation, according to its wording and from an economic point of view, was a tax exemption and not a flat-rate deduction of income-related expenses. The decision has been appealed to the Federal Tax Court (BFH, case ref. I R 51/22). Taxpayers should therefore monitor the decision of the BFH.

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Tax court of Cologne clarifies withholding tax relief for S-Corporation receiving dividends from Germany

In a recently published decision (dated 16 November 2022 – 2 K 750/19), the tax court of Cologne ruled on a question with particular relevance to US investors investing into Germany. The case concerned a US S-Corporation which held a 100% share in a German GmbH. The S-Corporation itself was held by US individuals and trusts. The S-Corporation/its shareholders sought full withholding tax relief for dividends distributed by the GmbH, which was rejected by the Federal Tax Office (BZSt) based on the argument that the requirements for such relief were not met because the eligibility for full relief would need to be tested at the level of the shareholders of the S-Corporation rather than the S-Corporation itself. Even though the case concerned an S-Corporation, the decision is also highly relevant for LLCs which are treated as transparent from a US tax perspective but as a corporation from a German perspective.

The tax court ruled against the tax authorities and confirmed the view of the taxpayer that eligibility for full relief from withholding taxes had to be determined based on the direct (hybrid) shareholder (i.e. the S-Corporation). According to the court, such shareholder has to be granted full relief where the direct shareholder which received the dividend is a corporation treated as transparent for US tax purposes provided that (i) the dividend is subject to tax in the US at the level of the persons to which the income of the transparent entity is allocated; (ii) the minimum ownership and holding periods under Art. 10 para 3 of the Germany-US treaty and (iii) the requirements of the "Super-LOB" in Art. 28 of the Germany-US treaty are met. From a procedural perspective, however, the claim would need to be filed by the shareholders of the S-Corporation because of a specific procedural rule in the German tax code. Even though the latter rule was slightly amended recently, the principles of the decision should also apply after the law change.

It can be expected that the tax authorities will appeal the decision, so that a final decision can only be expected once the Federal Tax Court has ruled on the matter. Taxpayers in similar situations should be aware of the issue and should consider alternative means of profit repatriation until this matter is finally settled by the courts.

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ECJ decides on several questions posed by the BFH regarding German VAT group

The German Federal Tax Court (BFH) asked the European Court of Justice (ECJ) several questions in connection with the German VAT group concept. In its two judgements dated 1 December 2022 (C-141/20 and C-269/20), the ECJ decided on these questions.

One question the BFH asked the ECJ was whether German VAT law may stipulate that not the VAT group as such, but only the controlling company is determined as the taxable person for the group. According to German VAT law, the VAT group is represented solely by its controlling company. The controlling company is the entrepreneur and not the VAT group as independent taxpayer or the controlled companies. The BFH asked the ECJ whether this is in line with the VAT Directive. As a result, the ECJ decided in both judgements that a member state is not precluded from designating the controlling company as the sole taxable person. In other words, the German concept is in line with EU Law.

Another question concerned the conditions for the VAT group. In addition to the economic and organizational integration, the financial integration is also required. Regarding the financial integration, both German jurisprudence and tax authorities are of the opinion that in addition to the majority of shareholding there must also be a majority of voting rights held by the controlling company. The ECJ has ruled that this view is not in line with the VAT Directive. The controlling company must be able to enforce its will in the controlled company, but this does not necessarily require a majority of voting rights. This can also be ensured by other means, e.g. a controlling agreement (so-called Beherrschungsvertrag).

Furthermore, the BFH asked about the status of a VAT group member as independent tax payor. The ECJ ruled that a VAT group member could still be seen as an independent tax payor. Currently, the meaning of this statement is under debate. In particular, it remains to be seen how the BFH will interpret this statement in its upcoming final decision on the referred case. It could have an impact on the VAT treatment of the transactions within the VAT group (so-called Innenumsätze), which currently are treated as not taxable, but which could be interpreted as taxable if the controlled company is seen as independent (meaning acting as an entrepreneur) even if it is integrated in the VAT group.

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ECJ decides on VAT amounts invoiced incorrectly for services provided to final consumers

The Court of Justice of the European Union (ECJ) has held that a taxable person is not liable for VAT amounts incorrectly shown on an invoice if there is no risk of loss of tax revenue on the ground that the service recipients are exclusively final consumers who are not entitled to deduct input VAT (P GmbH v Finanzamt Österreich, Case C-378/21 of 8 December 2022).

The request for a preliminary ruling was made by the Austrian Federal Finance Court in proceedings between P GmbH (P) and the Austrian tax office concerning the tax authorities' refusal to allow an adjustment of P's VAT return as P had incorrectly stated on its invoices a VAT amount calculated on the basis of an incorrect VAT rate.

Taxpayer P operated an indoor playground. During the period in dispute P issued invoices to its customers, which are final consumers, incorrectly charging VAT at a rate of 20% whereas the correct VAT rate applicable to its services was only 13%. When P realized that the correct VAT rate was the reduced rate of 13%, P adjusted its VAT return so that the excess VAT would be credited to it by the tax authorities. ▸

EU law

The Austrian Court referred questions to the ECJ asking if the taxpayer was liable to pay VAT invoiced incorrectly to final consumers. If the first question was answered in the affirmative, the referring court asked whether there is a need to correct invoices if there is no risk of tax loss and an invoice correction is effectively impossible. The Austrian court further asked if the fact that a VAT adjustment would benefit the taxpayer precluded the correction of VAT.

The ECJ held that a taxable person who has supplied a service and who has stated on the invoice an amount of VAT calculated on the basis of an incorrect rate is not liable under Art. 203 VAT Directive for the part of the VAT invoiced incorrectly if there is no risk of loss of tax revenue on the ground that the recipients of that service are exclusively final consumers who do not have a right to deduct input VAT.

As the ECJ ruled that there was no obligation to pay the incorrectly charged VAT, there was no need to answer the questions concerning the invoice correction and the unjust enrichment defense.

The decision of the ECJ will restrict the current view of the German tax authorities according to which the VAT liability for overstated VAT arises even if the recipient is not entitled to deduct input VAT. But it should be assumed that the judgement may not be applied to incorrect VAT statements on invoices issued to another taxable person.

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ECJ: Application of the triangulation simplification rule requires exact invoicing indications by the involved intermediary party

For certain chain transactions, the scope of the "triangulation simplification rule" may be applicable, which reliefs the intermediary party from further VAT registration obligations in the destination Member State. The application of the "triangulation simplification" rule requires that

a) the transport is ascribed to the first supply in a chain transaction,
b) the three parties involved in the chain transaction are three different entrepreneurs using their VAT ID issued from three different Member States,
c) the intermediary party has reported the triangulation within its European Sales Listing and has issued an invoice which indicates the application of the zero-rated triangulation rule and the transfer of the VAT liability to the recipient.

In Luxury Trust Automobil (C-247/21), the ECJ referred to settled case law (Hans Bühler C-580/16) and again highlighted the material requirements for the application of the triangulation simplification rule, such as the invoice requirements. According to the EU VAT Directive, any necessary comments must be included in the invoice issued by the intermediary party. This also concerns the remark with regard to the transfer of the tax liability. Thus, the mere reference to the zero-rated triangulation is not sufficient.

Further, the ECJ ruled that the retroactive adjustment of any comments on the original invoice is not possible.

Therefore, a proper invoicing process for zero-rated triangulation sales must be implemented. Otherwise, the intermediary party runs the risk of severe VAT burdens and related administrative costs in its home country and the country of destination of the goods.

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Spotlight

Recent developments regarding crypto assets

On 8 December 2022, the European Commission proposed a Directive amending the Directive on Administrative Cooperation (2011/16/EU). In essence, the European Commission intends a comprehensive reporting regime for crypto assets, e-money and central bank digital currencies, rooted in the OECD's Crypto-asset reporting framework (CARF), inclusive of the extension of the scope of the Common Reporting Standard (CRS). Germany is expected to implement the proposed rules, which are most likely not to change in major terms, in accordance with the Commission's desired schedule, resulting in application of the new reporting requirements of crypto-asset service providers by 1 January 2026. However, this is subject to the political agreement of the Directive. Germany is not expected to implement reporting requirements for crypto-asset service providers on a unilateral basis. In addition to crypto assets, the proposed Directive also targets high net-worth individuals and prescribes minimum sanctions for failing reporting requirements.

Apart from these EU-wide developments, the German Federal Tax Court (BFH) issued its first judgment regarding crypto assets (IX R 3/22). While outcries against taxation of crypto currencies in the crypto community were loud, the BFH decision should have silenced them. Crypto currencies held as a private investment asset are subject to regular personal income taxation in Germany. After a holding period of one year, they can be sold free of taxation. The assets are attributable to the person who has them at his or her disposal. It remains to be seen whether the unsuccessful plaintiffs will go the extra mile and approach the Federal Constitutional Court for a judgment. The section which currently prescribes the taxation of crypto assets for individuals was already challenged several times in front of the Federal Constitutional Court, both for interest payments and capital gains resulting from the disposal of shares.

The judgment of the BFH concerned crypto currencies as one sub-group of crypto assets. While some derivations can be made to the crypto assets, questions remained unanswered regarding the general treatment of crypto assets other than crypto currencies. Apart from that, especially the German VAT crypto landscape continues to show a lack of both administrative and judicial guidance.

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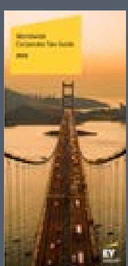

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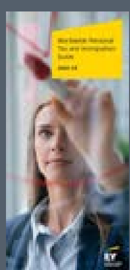

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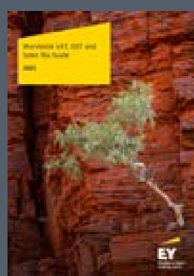

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