Important legal changes

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Update ZollkodexAnpG: Bundesrat select committees ask for changes

The Bill to Amend the Tax Management Act to Conform to the Customs Code of the Union and to Revise other Tax Rules (Customs Code Amendment Bill) is on its next lap. The select committees of the Bundesrat (provincial chamber of Parliament) have presented their recommendations for suggested alterations in a paper of more than 100 pages. These include a call to tax capital gains on the sale of shares held as portfolio investments in the interests of equal treatment with dividend income. Other suggestions are for an extended definition of corporate groups in the context of group reorganisations without loss forfeiture from change of shareholders, measures against tax-free income from hybrid financing instruments and expense double-dips, limitation on the balancing payments permitted in connection with a tax-free contribution of assets in exchange for new shares as well as many other points. The Bundesrat is due to resolve its position in its session of November 7, 2014.

The select committees of the Bundesrat charged with reviewing the bill of the government have finalised their comments and suggestions. It is now up to the Bundesrat to decide in its next session on November 7 how much of the present paper it wishes to adopt in its own comments to the government. The next step will then be the government's reply on November 12.

As of today it is impossible to foretell the demands the Bundesrat will ultimately make on the government, let alone the reaction of the government and, later, the Bundestag. However, the statement of the Bundesrat can be expected to launch a process of political compromise of currently indeterminate outcome. If no agreement can be reached between the two chambers of Parliament, the Bundesrat could refuse its approval of the bill. This would delay enactment into 2015 after a reconciliation procedure has led to a compromise. In spite of these uncertainties at this early stage of proceedings, we feel it worthwhile calling attention to some of the farther-reaching suggestions of the committees.

Company portfolio holdings – Demand for taxation of capital gains.

Political debate has once again focused on the taxation of capital gains from the sale of shares held by companies as marketable securities or portfolio investments. The select committees have suggested the Bundesrat strive for an amendment to the Corporation Tax Act to abolish the present exemption of capital gains on the sale of shares from an investment of less than 10% in the share capital of the issuing company. The committees wish to to mirror the tax charge on dividends from portfolio holdings to prevent avoidance schemes designed to take advantage of the differing treatment. The demand is neither new nor unexpected.

Originally, all dividends were tax-free income in the hands of other companies. However the withholing tax on dividends paid abroad was only refundable to the treaty rate. This meant that dividends paid on portfolio holdings to corporate shareholders in the EEA were generally burdened with the treaty tax rate as a final burden. This discrimination of EEA shareholders was held by the ECJ held to be an infringement on the free movement of capital. The government reacted in 2013 with a change in the law to charge dividend income on portfolio holdings to corporation tax, thus removing the disparity in treatment between domestic and EEA shareholders. However, the government made no similar change to the rule exempting capital gains on the sale of share from corporation tax, so that since then a corporate owner of a portfolio investment has had a tax interest in realising a capital gain, rather than receiving a dividend.

The government recognised at the time that this disparity in treatment might give rise to undesirable avoidance schemes. It therefore formally minuted its intention to carefully monitor abuse attempts. The provinces now see their fears of last year confirmed and the select committees suggest that there have been cases of abuse in practise despite the tax restrictions on the loaning of securities.

Loss relief for companies – call for extended group definition

The select committees have called for an extended definition of a corporate group in the context of the exemption from loss relief forfeiture on a change of shareholders. The exemption was enacted in December 2009 in order to allow group reorganisations without endangering any loss carry-forwards. According to the official explanation at the time, the intention was to exempt all group internal share transfers from the loss forfeiture rules where the group was held by a single natural person or corporate shareholder and no new shareholders or minority interests were involved. However, the wording of the provision missed part of the point. In particular, the share transfers to or from the ultimate parent are not covered by the exemption. Thus, for example, a 100% subsidiary cannot transfer its investment in its own subsidiary to its parent without destroying the future loss relief inherent in the subsidiary's loss carry-forward. There is also some doubt as to whether the exemption applies to groups led by a partnership or sole trader. The select committee members see these shortcomings as leading to arbitrary results, which could call the constitutional validity of the forfeiture rule into question. In particular, SMEs are likely to be disadvantaged under present law. The suggestion is to reword the exemption provision to apply it to all share transfers within a group that lead to no change in the ultimate ownership of the shareholding rights. This revision should apply retroactively from the initial application of the exemption provision – share transfers on or after January 1, 2010.

Measures to counter the tax effects of hybrid instruments

The committee members saw a need to include measures in the bill to counter the tax effects of hybrid financing instruments. There are many examples of the large-scale use of such instruments to achieve full exemption of income or a double deduction of expense. The Bundesrat has already called on the government to strive for concerted action within the EU to end such possibilities of "white income" or expense "double dips" and now draws the government's attention to the OECD BEPS efforts to the same end.

Expense deduction conditional on taxation of the income by the recipient

The amendment now requested should make the deduction of business expenses conditional on their corresponding treatment by the recipient as taxable income. This is aimed in particular at hybrid financing instruments seen by the debtor as a loan and by the creditor as equity capital. The consequence is that the debtor may deduct the consideration as interest expense, whilst the creditor records it as a tax-free dividend. Germany has recently closed this tax planning avenue with a provision to charge an otherwise tax-free dividend to corporation tax if it was deductible from the taxable income of the payer. However, similar rules have not yet been enacted in many foreign countries.

The change now suggested addresses the expense deduction. Tax deduction of the expense is now to be denied if the income is either not declared by the recipient or is exempt in his hands because his tax jurisdiction does not see the instrument as a loan. Indirect beneficiaries are to be included in order to prevent avoidance through nominees.

The suggestion should take effect for all business years ending after the promulgation of the act.

No double deduction of expenses

Different tax expense attribution rules in different countries can lead to an expense deduction in more than one state for the same outlay. German partnerships are a particular case in point. A foreign partner can attribute his costs incurred in connection with his partnership share to the partnership and claim an expense deduction at home for the same costs as local business expenses. This is potentially possible for partners from countries that do not follow the German concept of allocating expense to a partnership without actually charging it.

The suggested amendment would deny a tax deduction for all business expenses deducted from taxable income in another state. This wording is general and thus not solely applicable to partnership expenses of partners.

This suggestion, too, should take effect for all business years ending after the promulgation of the act.

Limitation on balancing payments on tax-free contributions in kind

Business units and investments leading to a majority holding may be contributed in kind for book value – and therefore tax-free – in exchange for shares in the recipient corporation. Under present law, the tax exemption is preserved if the transferor receives, apart from the newly issued shares, consideration in cash or in kind – usually in cash – as a “balancing payment” of no more than the book value of the assets contributed. There is no restriction on the amount of the balancing payment on tax-free contributions to partnerships. These rules have been under discussion for some time.

It is now suggested limiting the balancing payment in all cases of tax-free contributions in kind in exchange for shares to 10% of the book value of the assets contributed. This amendment should apply to all contributions reported to the trade registry from January 1, 2015 or where the beneficial ownership in the assets contributed passes on or after that date.

Other suggested amendments include

- The income tax rules on the spread of the cost of assuming commitments should also be applied to the assumption of debts and obligations
- The inherent tax obligation in respect of the as yet undistributed earnings of partnerships taxed at a preferential rate by the partners should be carried forward on tax-free merger of the partnership.
- Retroactive amendment of the real estate transfer tax rules on indirect changes in partnerships to conveyances from January 1, 2002 onwards.

Otherwise, the select committees call on the Bundesrat to press for government action on a range of simplification measures, some of which have been repeatedly suggested without apparent echo.

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