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Packet of measures against profit reduction and profit shifting: Federal Assembly (Bundesrat) responds.

At a sitting on 23 September 2016, the Federal Assembly (Bundesrat) has responded to the draft of the Act to Implement the Amendments to the EU Mutual Assistance Directive and to Introduce Further Measures to Combat Profit Reduction and Profit Shifting ("the draft Act") and proposed further measures.

The packet of measures was confirmed by the Cabinet on 13 July 2016 and is intended to implement some of the recommendations of the BEPS (Base Erosion and Profit Shifting) Action Plan of the OECD and also to implement the amendments to the EU Mutual Assistance Directive. Originally conceived as a means of improving transparency in favour of the tax authorities, the draft Act contains numerous further amendments, which could have important implications for business. The Bundesrat's recommendations and requests for review must now be reviewed by the government. A brief description of the most significant recommendations follows:

Introduction of a new rule on special business expenses of foreign taxpayers

The Bundesrat takes the view that the draft Act should include measures to prevent the double deduction of business expenses by partnerships. Currently it may be possible for foreign partners of a partnership to obtain a double deduction of business expenses, if the partner claims a deduction of expenses in Germany as special business expenses and claims a deduction of the same expenses abroad, where the country in question does not recognise the legal institute of special business assets ("Sonderbetriebsvermögen"). The Chamber of the States ("Länderkammer") suggested that, through the introduction of a new section in the Income Tax Act (ITA), the deduction of special business expenses should be restricted in Germany, where the same expenses are deducted again from the tax base in another country. The suggestion makes no requirement that the double deduction should occur in the same tax period.

Thus the prohibition of the deduction in Germany should also occur, where the deduction is claimed in the other country in a previous period of assessment, fiscal year, financial year or calendar year or in a subsequent one. The proposed section should also include a rule, whereby the prohibition of the deduction should not occur where the deduction reduces income, which is included in the tax base of the other country. In such as case it would be necessary to provide evidence that the income was actually taxed, which would be the case if the taxpayer could prove that the income had been included in the foreign tax base. In the absence of a specific date being set for the introduction of the new rule, it would take effect on the day after the publication of the Act.

The Bundesrat does not take the view that the introduction of such a rule would impinge on the current work of the working committee responsible for combatting hybrid mismatch arrangements. The view is taken that the measure corresponds to the spirit of the OECD's proposal under Action Plan 2 of the BEPS Project, but is not directly affected by it.

Moderation of Section 50 i ITA proposed

Section 50 i (1) ITA

Section 50 i (1) ITA was introduced in 2013 following pressure from the Bundesrat with the aim of preventing the tax-free exit from Germany, under the terms of a double tax treaty, of assets or shareholdings transferred to a deemed commercial partnership. Since the section has in many ways overshot its objectives, the Bundersrat has now requested that the application of the sub-section should be restricted in temporal terms to cases where

- Germany's right to tax the capital gain on the disposal of the transferred asset/shares or the deemed gain on the withdrawal from the partnership of the transferred asset/shares is limited or excluded before 1 January 2017.
- The German right to tax did not exist at the date of the contribution of the assets or shares to the partnership or where Germany's right to tax the contribution is limited or restricted before 1 January 2017.

Thus the new rule would bring about a break in the application of Section 50 i ITA at the end of 2016/ beginning of 2017. If the restriction to Germany's right to tax occurs after 31 December 2016, normal tax exit rules should apply.

Section 50 i (2) ITA

Section 50 i (2) ITA is another measure introduced in 2014 at the behest of the Bundesrat to prevent a perceived method of avoiding Section 50 i (1) ITA. Under this sub-section, groups of asset transferred as part of a reorganisation or a contribution, which comprise assets or shares within the meaning of Section 50 i (1) ITA are always to be recorded at their fair market value (FMV) without regard to the provisions of the Reorganisations Taxes Act. The same applied to the tax neutrality available under sub-sections 6 (3) and (5) ITA, where the assets/shareholdings transferred were assets within the meaning of Section 50 i (1) ITA. This meant that a tax charge could arise even in a case where there was a structural change of a deemed commercial partnership into a commercial/trading partnership. It has been recognised for some time now that Section 50 i (2) ITA goes well beyond its purpose, because it leads to an obligatory realisation of hidden reserves regardless of whether the transfer itself leads to a restriction of Germany's right to tax. The only consequence of this recognition up to now is that the Federal Ministry of Finance issued a circular on 21 December 2015, according to which the tax authorities should restrict the application of the sub-section by concession.

In its explanation the Bundesrat now requests a retrospective amendment of Section 50 i (2) ITA. This should not only provide a legal framework for a more limited application, but should also restrict the application to a greater extent than the Federal Ministry of Finance's circular, in that the wording of the provision should be brought in line with its actual goal, namely to prevent using tax avoidance schemes to avoid the application of Section 50 i (2) ITA through Section 20 Reorganisations Taxes Act. Accordingly, the proposed Section 50 i (2) ITA provides that in the case of a contribution of a business, business segment or partnership share according Section 20 (1) Reorganisations Taxes Act, any assets and shareholdings, which were transferred into a partnership within the meaning of Section 15 (3) ITA before 29 June 2013, must be recorded at FMV. However, this should only be applied to the extent that the right to tax the capital gain on the disposal of the shares received is excluded or restricted. The application of the FMV should now, in contrast to the previous treatment, only apply to the relevant asset itself and not to the group of assets. To the extent that Germany's right to tax is otherwise restricted or excluded through a reorganisation or contribution, the general rules of exit taxation should apply. The provision should be applicable to contributions, which were made according to contribution agreements concluded after 31 December 2013.

An amendment of Section 50 i (2) ITA in relation to its effect on Section 6 (3) ITA should also be implemented. According to that provision the application of tax book values upon the transfer of a business, business segment or partnership share is only possible if the taxation of the hidden reserves is assured.

Application of Section 12 (5) Reorganisations Taxes Act to cross-border mergers

According to its current wording Section 12 (5) Reorganisations Taxes Act assumes a full distribution by a transferring company, where, as a result of a merger, the assets are transferred to a non-taxable or tax exempt sphere of the acquiring company. This distribution gives rise to a charge to withholding tax, to the extent it is not a return of a capital contribution. Since the provision assumes that the acquiring company has a non-taxable or tax exempt sphere, it generally only affects domestic public bodies, domestic corporate charities and limited corporate taxpayers, which are tax exempt by virtue of statute. In all other cases, in particular in cases of cross-border mergers into foreign entities, the reserves of the transferring company are not subject to German withholding tax.

This situation should now change according to the recommendation, which states that Section 12 (5) Reorganisations Taxes Act should also be applicable to asset transfers to a “corporation not subject to domestic taxation”. No information is currently available with regard to the date on which the amendment should take place.

Limited tax liability on transfers of business interests.

Currently, capital gains arising from the disposal of shareholdings in companies, which do not form part of a domestic permanent establishment, are only subject to German taxation according to Section 49 ITA, if the conditions of Section 17 ITA are met (i.e. where the transferor has held a direct/indirect shareholding of at least 1% at any time in the 5 years prior to the transfer). A new sub-section should be included in Section 49 ITA, according to which a limited tax liability should arise on disposals of shareholdings in companies, where the income realised from these shareholdings constitutes income within the meaning of Section 20 (2) ITA. A further condition is that more than 50% of the value of the company’s assets relates directly or indirectly to domestic immoveable property. The result of the Bundesrat’s recommendation is that in future capital gains arising from the disposal of direct or indirect shareholdings in companies holding real property will be subject to German taxation regardless of the level of the shareholding. Important to note is that the application of the provision hinges on the location of the real property and not on whether the company is resident or not. The background to this change is that Germany is concluding an increasing number of tax treaties which contain an article equivalent to Article 13 (4) of the OECD model treaty, which provides for the right to tax such capital gains; however, despite the treaty provisions, domestic law does not currently provide for a corresponding chargeable event.

Reintroduction of the taxation of short selling for private transactions

The Bundesrat is seeking the reintroduction of Section 23 (1) No. 3 ITA, which was abolished with the introduction of flat rate tax at source. The intended result is that profits arising from short selling would again be taxable as a private disposal transaction. The background being that foreign currency transactions, according to which the disposal occurred earlier than the acquisition (so-called short selling), are currently not included in the tax base. The same should apply to other assets, which fall under Section 23 ITA for all intents and purposes, such as, for example, gold and other precious metals. The Bundesrat has asked for the new rule to take effect on the day after the date of the publication of the Act.

Statutory definition of professional activity under Section 32d ITA to be defined further.

Under Section 32 d (2) 1st Sentence No. 3 ITA, the taxpayer may apply for income received from a shareholding in a company to be taxed according to the normal tariff rather than at the flat rate at source rate. The condition of the application is that the taxpayer has a holding of at least 1% and is “professionally active” for the company. The provision was introduced by the 2008 Finance Act. A problem has arisen, however, since the Supreme Tax Court decided in a judgment issued on 25 August 2015 (VIII R 3 /14) that the wording of the provision did not define - either qualitatively or quantitatively – what constitutes the professional activities of the shareholder for the company. In reaction to this decision the Bundesrat has requested that a rule be introduced, whereby the condition of “professional activity” is only met where the person is able, through his work, to exercise a significant entrepreneurial influence on the economic activity of the business. A simple professional activity, such as that of a clerical assistant or a warehouse worker, would not meet the criteria. The new rule should take effect on the day after the date of the publication of the Act.

Qualification of severance payments as remuneration for a previous employment activity for tax treaty purposes.

A new sub-section should be introduced into Section 50d ITA, which should provide that severance payments be treated as remuneration for a previous employment activity for tax treaty purposes to the extent that other special treaty rules do not apply. The background is that the Supreme Tax Court has held that the provision in the tax treaties which corresponds to Article 15 of the OECD model treaty prevents Germany from taxing severance payments made for the termination of an employment in Germany to a person who was resident in the other treaty state at the time of the payment.

Special Non-Business Expenditure Deduction for Limited Taxpayers

The Landerkämmer has made two further recommendations on the back of the European Court of Justice (ECJ) decision in Grünewald (C-559/13), according to which a limited taxpayer should, within the framework of Section 50 ITA, be entitled to deduct special non-business expenditure in the form of support payments made in connection with a transfer of assets in the form of a gift. Firstly, Section 50 should be amended immediately and with retroactive effect for all open years to implement the Court’s decision. Furthermore, as a corresponding amendment, the Bundesrat has also recommended that, through an amendment of Section 49 (1) No. 7a ITA and with effect from the 2017 assessment period, where a support payment is treated by either an unlimited taxpayer or by a limited taxpayer as a deductible special non-business expense, the related income received should also be subject to tax in the hands of a limited taxpayer recipient. The Länderkammer took the view that this rule could be further justified by the fact that not only do such support payments made by a transferee of the assets emanate from a domestic income source, but they also, as a matter of fact, reduce the income flowing from that domestic source.

The Bundesrat has asked the Federal Government to review the following points:

- *Interpretation of the arm's length principle in Article 9 of the OECD model treaty/ Section 1 (1) Foreign Transactions Taxes Act:* there has been a request to consider whether the phrase "irrespective of the terms of a tax treaty" should be included in the wording, in order to make clear that the provision should be considered as a treaty override, overriding Article 9 of the OECD model treaty.
- *Amendments to the Trade Tax Act with regard to the inclusion in the trade tax base of add- backs and passive income emanating from business establishments located in low-tax jurisdictions*: The proposed amendments to Sections 7 and 9 of the Trade Tax Act should be thoroughly examined to establish whether they can actually hinder tax structures developed to avoid trade tax. The request specifically mentions the structures, where licences and trademarks surrendered to a foreign subsidiary entity for a consideration are in turn surrendered for a consideration by that entity.
- *Dividend receipts by a surrendering entity in a tax consolidation group ("Organschaft")*: The Länderkammer has expressed doubt as to whether the proposed provision will actually achieve its goal and as to whether it is viable in practice. Further it was recommended to introduce a right of election in Section 36 (2b) of the draft Trade Tax Act, so that Section 7a Trade Tax Act may also be applied retroactively, since the decision of the Supreme Tax Court may also lead to the taxpayer being in a worse position with regard to Section 7a Trade Tax Act.
- *Add-backs*: The effects of Section 7a Trade Tax Act should be reviewed with regard to its interaction with the add-back provision Section 8 No. 12 Trade Tax Act, as in some circumstances this may also lead to an add-back of foreign tax.

Schlagwörter

EU Mutual Assistance Directive, Profit Reduction, Profit Shifting