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Cases
Decrees

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Amendment of tax loss utilisation rules for corporations

Under certain conditions, changes in shareholders and the admission of new investors will in future be possible without giving rise to a forfeiture of losses carried-forward. On 23 December 2016 the Act for the Further Development of Tax Loss Utilisation for Corporations was published after having been adopted by the German Parliament (*Bundestag and Bundesrat*) on 20 December 2016.

The new rules represent a significant change for corporations in the tax treatment of loss utilisation. Previously a corporation's unutilised losses could be subject to (partial) forfeiture, where there was a change in the shareholder ownership above certain levels ("harmful change of ownership"). A new provision has now been introduced into the Corporation Tax Act, according to which it is possible to apply for relief from the forfeiture of tax losses after such a harmful change in ownership.

An application under the new provision can only be successful, to the extent that the corporation has maintained exclusively the same business since the corporation was established or at least has maintained exclusively the same business in the last three periods of assessment before the period of assessment in which the harmful change of ownership arose. Furthermore during this period the corporation cannot have been a controlling enterprise in a tax consolidation group ("Organträger") nor can it have held an interest in a commercial partnership.

In addition to the above, the provision lists a number of harmful events; where any of these harmful events have occurred in the above mentioned three year period, the corporation will not be entitled to the relief.

The relief from tax loss forfeiture does not apply to losses which were incurred in a period prior to a previous discontinuance or dormancy of the business. This would apply, in particular, to situations where the corporation had discontinued its business in the past and then started a new business.

The corporation must apply for application of the relief in its tax return for the period of assessment in which the harmful change of ownership occurred.

Earmarked loss carry-forward: The whole of the loss carry-forward available at the end of the period of assessment in which the harmful change of ownership occurred, will become an earmarked loss carry-forward. It may be set off against profits arising in future years subject to the rules of minimum taxation.

Harmful events: Any earmarked loss carry-forward which has not already been utilised will be forfeit if the business is discontinued or if any of the harmful events listed in the provision occur. In such a case, the corporation will be able to retain the earmarked loss carry-forward to the extent that the corporation has hidden reserves. This only applies however to hidden reserves which existed at the end of the period of assessment, which preceded the period of assessment in which the harmful change of ownership occurred.

Other important conditions:

- The earmarked loss carry-forward must be separately declared and assessed.
- The provision will apply to harmful changes of ownership, which occur after 31 December 2015.
- No application for non-forfeiture may be made for "old" losses incurred in periods prior to a discontinuance or dormancy of the business. In the case of a discontinuance or dormancy occurring prior to 1 January 2016, it may not be possible to allocate the losses properly as these events may have occurred far back in the past. Accordingly an application for non-forfeiture is completely excluded in these cases.

The provision also applies accordingly to any interest carry-forward and to any loss carry forward for trade tax purposes.

German Government adopts bill to combat tax avoidance

On 21 December 2016 the German government adopted a bill to combat tax avoidance and to change certain other tax provisions. The Government's main intention is to make it more difficult for German taxpayers to avoid tax by using letter-box companies. In addition to numerous provisions imposing obligations on the taxpayer to co-operate with the tax authorities, the bill abolishes the bank secrecy rules.

The aim of the new bill is to enable the tax authorities to obtain detailed information about business relationships between German taxpayers and letter-box firms in tax havens and to that end to provide the tax authorities with new investigatory powers. Here a brief summary of some of the proposed measures.

Obligation to report the acquisition of qualified holdings: The existing rules regarding reporting obligations relating to the acquisition of qualified holdings in foreign entities are to be changed so that the treatment of direct and indirect holdings are standardised. The bill also provides for an extension of the reporting deadline until the tax returns are filed.

Reporting obligations for non-EU directly or indirectly controlled partnerships, companies, associations and estates: In future taxpayers are also obliged to report business relationships to non-EU partnerships, companies, associations and estates which they directly or indirectly control irrespective of whether they have a formal interest in the enterprise or not. A breach of this obligation will lead to an extension of the statute of limitations. Furthermore a breach can lead to a penalty of up to € 25,000.

Financial institutes to be liable for tax shortfalls: In future financial institutes will, under certain conditions, be obliged to report to the tax authorities, business relationships of German taxpayers with non-EU entities, where the financial institution established the relationship or acted as an agent. A failure to report can result in the financial institution becoming liable for any tax shortfalls resulting from its omission. Furthermore a breach can lead to a penalty of € 50,000.

Abolition of bank secrecy rules: The so-called bank secrecy privilege should be abolished. This is to be distinguished from the civil law bank secrecy privilege according to which data transmission by banks to other enterprises is protected. Whilst this bank secrecy privilege did not entitle the banks to refuse to provide the tax authorities with information, it did limit the tax authorities' powers of investigation. It may be noted that investigations without cause will continue to be prohibited.

Extension of Automatic Access Procedures: The procedure for the automatic access to accounts for tax purposes should be extended. Under the new rule it will be possible for the tax authorities to investigate cases where a German taxpayer has either the sole power of disposal over or is the economic beneficiary belonging to an account or depot of an individual, a partnership, a company, an association or an estate with his/its residence, registered office, headquarters or place of management outside Germany. In addition the data retention period for banks should be extended to 10 years after account closure.

Procedures for collection of information defined: The tax authorities' options to collect information should be codified in accordance with Supreme Tax Court case law.

Collection and recording of tax identification data: As part of their identification procedure, banks must also collect and record the tax identification data of the account holder and of each person with a power of disposal. This information will be provided exclusively to the tax authorities as part of the procedure for collection of information.

New obligations for the retention of documents: A new obligation for the retention of documents should be imposed on persons, who, alone or with related parties, can exercise directly or indirectly a controlling or dominant influence over a non-EU entity in company law matters or in financial or business matters. In future, it should be open to the tax authorities to carry out a tax audit of these taxpayers' affairs without requiring special justification.

Catalogue of tax evasion offences considered as extremely grave extended: Tax evasion arising through a hidden business relationship with a non-EU entity controlled by the taxpayer should be included in the catalogue of tax evasion offences considered as extremely grave. As a result the limitation period for the investigation of such offences will be extended to 10 years.

Also included in the bill is a general extension of the limitation period in cases of tax evasion from 5 years to 10 years.

Restriction of tax relief on royalty payments: draft bill released as part of the efforts to combat harmful tax practices

On 25 January 2017 the German government published a draft bill proposing a restriction of tax relief on royalty payments made to related parties from 2018 onwards.

According to the proposal, the deduction of expenses for royalty payments made to related parties is to be restricted, where:

- the corresponding royalty income is subject to a preferential tax treatment (for example patent box or other IP regimes), in the hands of the related party; and

- the effective taxation of the royalty income is below 25%.

If these two foregoing conditions are met, relief will not be available to the extent the effective tax rate is below 25%.

Under the proposal the rules should not apply to royalty payments made to a licensor who has developed the underlying intangibles himself. This exception should not apply to trade marks.

The "self-development" exception corresponds to the Nexus Approach developed as part of Action 5 of the OECD BEPS Action Plan (Harmful Tax Practices). The Nexus Approach looks for a direct nexus between the income receiving benefits under an IP regime and the expenditure contributing to that income.

The proposed provision also includes rather wide rules intended to prevent the routing of license payments via a country with a non-preferential tax regime. In this regard the final related-party recipient of the royalty income is to be the point of reference.

The proposed rules should apply to expenses incurred after 31 December 2017.

According to the official government justification, the legislation has been proposed, because the grandfathering rules for existing preferential tax treatments foreseen by the OECD are regarded as being too beneficial by Germany.

Bundesrat gives its assent to the packet of measures against profit reduction and profit shifting

In its last session of the year 2016, the Federal Assembly (Bundesrat) gave its assent to the Act to Implement the Amendments to the EU Mutual Assistance Directive and to Introduce Further Measures to Combat Profit Reduction and Profit Shifting

This packet of measures, which came into effect on 1 January 2017, will give almost € 25 billion worth of relief to taxpayers. In particular low earners, families and lone parents will benefit.

Official Pronouncements

Administration publishes regulations on branch profits

On December 22, 2016 the finance ministry has published its regulations, “administrative principles”, on the allocation of business profits between a head office and its foreign permanent establishments. The same principles apply to cross-border profit allocations between two branches of a business from a third country. These regulations follow the “authorised OECD approach” (AOA) now enshrined in Sec. 1 sub-sec. 1 of the Foreign Tax Act and generally applicable unless a double tax treaty determines otherwise – typically the case with older treaties – and the other country insists on an unchanged treaty application with double taxation of income as a result.

The regulations define the scope of the arm’s length principle, certain terms, the relationship of the PE rules to other domestic rules and to double tax treaties, as well as consequences for cases involving tax credits and local business tax.

The regulations deal in particular with the assignment and attribution of personnel functions, (tangible and intangible) assets, opportunities and risks and equity/capital. It also comments on the legal (contractual) relationship between branch and other companies of the group.

Above all, the finance ministry tries to clarify certain areas of doubt such as, e.g.,

- The acceptance of cost allocation in cases of branches
- The possibility of a proportionate attribution of intangible assets
- The simplification rules for the determination of capital based on the capital allocation method
- The asymmetrical treatment of local and foreign branches with respect to adjustments of branch capital during the year
- The financing functions in case of branches which are generally considered as a service and must be remunerated on a cost basis.

There are various transitional rules for tax years 2013 and 2014. In summary, the taxpayer is well advised to review the regulations carefully and closely monitor the future developments. There are serious impacts to be expected as regards the taxation of branches. In many cases there will be a need for action.

Supreme Tax Court Cases

Tax exempt assumption of liabilities

Where an entrepreneur undertakes to enter into a tenancy (landlord and tenant) for a consideration, the supply is tax exempt according to Section 4 No. 8 (g) VAT Act.

The procurement and assumption of liabilities, sureties and guarantees as well as the administration of securities by the creditor are VAT exempt according to applicable EU law. This exemption has its derivation in financial services (cf. the ECJ decision *Velvet & Steel Immobilien* from 19 April 2007 – C-455/05).

In the case at hand the appellant, a real estate management company, assumed tenancy obligations towards the purchaser of real estate. The purchaser had stipulated that he was only prepared to purchase the real estate if an additional specific percentage of the empty space was let for a period of 5 years. Accordingly, the seller and the appellant came to an agreement under which the appellant undertook to enter into a tenancy agreement "directly with the purchaser of the real estate".

Subsequently, during the course of a tax audit, the tax authorities reached the conclusion that, as a result of the agreement, the appellant had made a taxable supply which was subject to VAT and increased the taxable turnover accordingly. Both administrative appeal and the appeal to the lower tax court were unsuccessful. The Supreme Tax Court, however, took another view. The Supreme Tax Court raised doubts, as to whether the supply was even taxable. In any event, if the supply were taxable, it would be tax exempt under Section 4 No. 8 (g) VAT Act. According to Supreme Tax Court case law, this provision applies to the assumption of a bidding guarantee for a consideration. On a similar basis, the taxable waiver of a rental guarantee is also tax exempt, if the grant of a rental guarantee is tax exempt or would be tax exempt if a compensation were paid.

Supreme Tax Court judgment V R 18/16 of November 30, 2016 - published on January 11, 2017

No trade tax addback for rent paid to foreign trade fair companies

The Supreme Tax Court held that there is no addback for trade tax purposes for amounts paid by a German company arranging for participation in foreign trade fairs on behalf of others.

According to Sec. 8 no. 1 e Trade Tax Act one quarter of the total of (currently) one half of the rent paid for the use of immovable fixed assets in the ownership of another must be added back to the trading profit subject to trade income tax. In a case before the Supreme Tax Court the question arose if this would also apply for rentals paid by a GmbH to foreign trade fair companies for the provision and use of grounds in exhibition halls.

The GmbH had organized the participation in foreign trade fairs in its own name but on behalf of the Federal Republic of Germany and the State of Bavaria. It paid a fee for the space in the halls and for various other necessary and connected services. The rental expense was added back to trading profit by the tax office under the addback provision of the Trade Tax Act. The Supreme Tax Court, however, found that the add back is not justified.

First of all, there was no use of immovable fixed assets under the ownership of another. The GmbH acted on behalf of others which would preclude the assumption of fixed assets from the outset. The court went on to say that an addback under the trade tax regime presupposes that the assets were to be fixed assets of the lessee had he been the owner himself. But this does not apply for the GmbH, since there would be no reason for it to keep the specific exhibition ground constantly ready and for permanent use.

Supreme Tax Court judgment I R 57/15 of October 5, 2016 - published on January 4, 2017

10 percent threshold for input VAT deduction for private use only

The Supreme Tax Court held that the right to deduct input VAT may be excluded only in cases in which the goods acquired are used, to an extent greater than 90%, for purposes other than the taxable person's business, and not where the goods are used for non-economic purposes (such as: in the course of public activities).

According to local VAT law input VAT may be deducted in respect of the tax due on the supply of goods and services by another commercial operator for the purposes of his or her business. If the entrepreneur uses the intra-Community supply, importation or acquisition of goods for the purposes of his business for less than 10%, such supply, importation or acquisition is deemed not to have been made for the purposes of his business (Section 15 sub-sec. 1 VAT Act) and – as a result – an input VAT deduction would not be possible. This is in accordance with a relevant Authorizing Decision of the EU Council.

A public body (the *Landkreis Potsdam-Mittelmark*) purchased assets which were almost exclusively used for non-economic activities (in the case on hand, they were used in the course of the activities as public authority), but also to a minor decree (2,7%), for business activities. The tax authorities denied deduction of the underlying input VAT since the assets were used for business activities below the set minimum threshold of 10%. The Supreme Tax Court had presented the case to the ECJ. The ECJ (case reference: C-400/15, *Landkreis Potsdam-Mittelmark*) has held that the above Council Decision in which member states are authorized to refuse an input VAT deduction presumes that the respective assets are used more than 90% for purposes other than those of a taxable person's business; the term "non-business use" (where an input VAT deduction is denied) refers to the private use of the assets only, and is not meant to include other non-economic activities such as the activities of a public body.

Accordingly, the Supreme Tax Court now agreed with the applicant (the *Landkreis*). The refusal to grant the VAT deduction is contrary to EU law. Germany is not authorised to exclude the right to deduct input VAT in cases where the use of the goods relates to non-economic activities is greater than 90%. Non-economic use falls outside the scope of VAT, contrary to the use for non-business purposes. The *Landkreis* is therefore entitled to a proportional deduction of 2.7% of the input VAT.

Note: The above ECJ/Supreme Tax Court decision relates to the year 2008. The situation is different from 1 January 2016.

Supreme Tax Court judgment XI R 15/13 of November 16, 2016 - published on January 4, 2017

Depreciation of wind turbines not before transfer of risk

Tax depreciation for wind turbines presupposes economic ownership of the asset. A change in economic ownership requires that any risks are transferred to the purchaser/customer.

The Supreme Tax Court held that economic ownership of an asset is not transferred at the time it generates income but rather when the risk of accidental destruction and accidental deterioration of the asset passes to the buyer. The contractual agreements to that effect are crucial.

A German partnership (KG) operated a wind farm consisting of five wind turbines. Each wind turbine on a farm is a separate asset which is to be depreciated, or amortised, separately. In December 2003 the KG entrusted a GmbH with the turnkey construction of the turbines. The purchase price was payable in instalments. The GmbH in turn engaged another company with delivery and installation of the wind turbines and also to take them into operation. According to the contract, the risk of accidental destruction and accidental deterioration of the turbines should not pass before installation was completed. The turbines were first put into operation in November 2004. In September 2005 the wind turbines were inspected and accepted by the GmbH. The KG wished to depreciate the turbines from November 1, 2004 based on a useful life of 16 years. The tax office declined and demanded depreciation to begin from September 2005. This was confirmed by the Supreme Tax Court.

Although possession of the turbines was with the KG as early as November 2004 and the KG took advantage (use) of the turbines already from that day, the underlying insurance contract provided coverage to start not before acceptance of the turbines. The court went on to point out that the supplier of the asset still had to bear the risks until final acceptance, namely in the event of technical problems which might occur during the trial operation of the wind turbines. That payment of the full purchase price was made as early as December 2004 did not have an impact on the economic ownership and hence not influence the judgment of the court

Supreme Tax Court judgment IV R 1/14 of September 22, 2016 - published on December 7

No extension of inheritance tax privilege for repeated transfers to transfers taxable abroad

The Supreme Tax Court finally ruled that the German inheritance tax privilege relieving repeated transfers within the same family should not be extended to previous transfers taxable in another member state.

Background: According to the German Inheritance Tax Act a provision for partial credit for the tax previously paid on a prior transfer of the same estate during the previous ten years is available. The credit declines with time, is only available for transfers between spouses or relatives in the direct line and is calculated on the basis of the current transfer, but may not be higher than the proportional amount of the previous charge. Transfers of estates previously taxed abroad are therefore excluded from credit.

The case: A mother living with her daughter in Austria inherited on the latter's decease. The transfer was charged to Austrian inheritance tax. The mother then moved to Germany and died shortly afterwards, leaving her estate to her German resident son. The latter claimed the privilege based on the legislative intent of avoiding double taxation and cited the free movement of capital when the tax office refused to grant it.

ECJ decision: On June 30, 2016 (C-123/15, *Feilen*) the ECJ has held that the German inheritance tax privilege relieving repeated transfers within the same family need not be extended to previous transfers taxable in another member state. It was the Supreme Tax Court who has asked the ECJ for a ruling on the case. According to the ECJ the free movement of capital would not be restricted because the two situations – a previously foreign estate taxed abroad and a home estate taxed at home – are not comparable. There was no obligation on Germany to relieve Austrian taxation. Rather, the German relief remained a wholly German matter. The ECJ went on to add that, in addition, the resulting restriction on the freedom of capital movement can be justified on the basis of the coherence of the German tax system, which credits a German tax previously paid by in effect the same taxpayer from a German liability now to be borne.

The Supreme Tax Court followed and came to its final judgment in the hitherto pending procedure. The German legislative intent was to partially relieve a double charge to tax on transfer within the immediate family within a short period of time by waiving part of the overall inheritance tax due and payable in Germany. The principle of granting tax advantage for "double inheritances" as set forth in Sec. 27 of the German Inheritance Tax Act reflects a logical symmetry. That "mirror effect" would be disturbed if that tax advantage were also to benefit persons inheriting assets which did not give rise to the imposition of German inheritance tax.

The advantage resulting from the reduction in inheritance tax is thus directly linked to the fact that there had already been an imposition of inheritance tax in respect of the previous acquisition by inheritance of the same asset. The objective is to reduce, in the case where there are multiple transfers of the same asset within a period of 10 years between persons in Tax Class I, by up to 50%, the inheritance tax relating to that asset in so far as it has resulted in the imposition of tax on the previous transferee.

Supreme Tax Court judgment II R 37/13 of September 27, 2016 published on December 21

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