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PwC Reports

Leaving the EU: Brexit and its impact on German businesses

The time has come to say goodbye: On 29 March 2017 UK Prime Minister Theresa May formally invoked Article 50 of the Lisbon Treaty thus initiating the formal negotiations for her country's departure from the European Union. A PwC special report looks at the potential outcome with respect to tax, legal and people.

For more detailed information visit our Tax & Legal News site at

http://blogs.pwc.de/german-tax-and-legal-news/2017/03/29/leaving-the-eu-brexit-and-its-impact-on-german-businesses/

Plans to restrict the deduction of royalty expenses to combat tax planning by international groups

On 25 January 2017 the federal government approved a draft of the Act to Combat Harmful Tax Practices in connection with the Licensing of Rights. The intention is to prevent multinational businesses from transferring their royalty income to countries, which offer such income preferential treatment. Such preferential tax regimes (so-called Licence Boxes, Patent Boxes or IP-Boxes) are considered not to meet the demands of the OECD and G20 BEPS Project. A new provision is to be introduced to the Income Tax Act (ITA) for this purpose; the new provision should be applied to expenses arising after 31 December 2017.

In Action 5 of the Final Report of the BEPS Project, the participating countries agreed upon a framework for measures, according to which the states might provide for a preferential tax treatment (Licence Boxes, Patent Boxes or IP-Boxes) to certain income resulting from qualifying intellectual property ("IP"). The so-called "nexus" approach examines, whether such a preferential treatment is dependent upon the amount of research and development ("R&D") activities of the taxpayer benefitting from the scheme. It is based on general principles, which apply to tax benefits for R&D and similar expense-orientated tax rules. Under these expense-orientated tax rules, expenses and tax benefits are directly related to one another, because the expenses will be applied to the calculation of the tax benefit. The nexus approach extends this general principle to tax provisions, which apply to income realised after the creation and utilisation of IP. With regard to the value of the IP, the ratio of the taxpayer's own costs (i.e. the expenses incurred through the taxpayer's own R&D activities and R&D activities performed by a third party on behalf of the taxpayer) are put into proportion to the overall costs of development, which include additional acquisition costs for IP and expenses for contract research by related parties. The total income arising from the value of the IP is deductible in this proportion. To the extent that the income deemed to benefit from the preferential regime does not exceed this amount, the regime meets the substantial activity requirement. With effect from 1

July 2016, no new IP or taxpayers may be admitted to preferential regimes which do not apply the nexus approach. In existing cases, such (non-compliant) preferential regimes may continue to apply until 30 June 2021 at the latest.

As the existence of preferential regimes, which do not apply the nexus approach, cannot be excluded in the future and as a large number of German tax treaties apply a zero tax rate on royalty payments, it is still conceivable that businesses will shift their royalty income to the relevant countries. In order to avoid this, a new section into the ITA will be added with the new bill. “We will no longer tolerate international groups shifting their royalty income to tax havens, unless there is a connection to R&D there”, stated Wolfgang Schäuble, the Minister of Finance, in the cabinet resolution. The Bundesrat also recently demanded such defence measures in a resolution and requested that, at the very least, a workable solution should be introduced in the current legislative period.

According to the upcoming new section in the ITA expenses incurred for the licensing of rights by a related party (within the meaning of Section1 (2) of the Foreign Transactions Act (“FTA”)) will be non-deductible or only partially deductible, to the extent that the payment – in the hands of the recipient – is subject to a low tax rate (income tax rate of <25%) and the low tax rate is not a result of the standard tax rate in the country in question but rather arises from a special preferential regime (e.g. a Licence Box).

To stop any further avoidance, the new provision should also apply to situations under which further related parties are inserted in between. Furthermore branch undertakings are then also considered to be payers and recipients within the meaning of the provision. Insofar as the conditions apply, only that proportion of the expenses will be deductible that corresponds to the ratio that the income tax rate borne by the recipient bears to a tax rate of 25%. This means that the higher the tax burden on the recipient the greater the deductible proportion by the payer.

However, there should be no restrictions to the deduction, where the low rate of taxation of the income in the creditor’s hands is the result of a preferential regime, which only applies to rights which underlie a substantial activity. According to the draft this will only be the case where the creditor has, to a greater extent, developed the right within the parameters of his own business activity. This exception does not apply where the preferential regime benefits trade mark royalties.

An exception to the general rule is also to be applied where the income arising from the royalty payments is treated and taxed as deemed income under CFC rules (Sec. 10 FTA). This exception is intended to avoid a double taxation which would arise through a denial of the royalty expense with a parallel taxation of the related royalty income under CFC rules.

Note: In February 2017 the government responded to parliamentary questions regarding the names of EU Member States which – according to its understanding –operate such a preferential tax regime for so-called Licence Boxes and the extent to which these countries are introducing checks. The Parliamentary State Secretary Dr. Michael Meister stated (verbatim): “The following European Member States have a so-called Licence Box: Belgium, France, Great Britain, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Spain, Hungary, Cyprus. With effect from 1 March 2014 Austria introduced a restriction to the deduction of interest and royalty payments in §12 No. 10 of the Austrian Corporate Income Tax Act. The Austrian rule provides for a complete disallowance of the expense, where the income in the hands of the recipient is not subjected to a CIT rate of at least 10 per cent. To the extent that there is taxation of at least at the rate of 10 per cent, a full deduction of the expenses is allowed.” Source: Deutscher Bundestag – Drucksache (printed matter) 18/11220 from 17 February 2017

US corporate tax reform planned

2017 seems to be the year for tax reform: There are currently major changes to the US tax system discussed that may also have a significant impact on German companies. German tax consequences of potential restructurings in response to the upcoming US tax reform must therefore be considered already at an early stage and the current developments be constantly monitored.

With Republicans controlling Congress and the White House in 2017, tax reform is back on top of the agenda in Washington. However, major disagreements over details remain. What is sure is that the proposed corporate tax reform is the most significant in years. Several proposals are currently on the table.

For more detailed information visit our Tax & Legal News site at

http://blogs.pwc.de/german-tax-and-legal-news/2017/03/09/us-corporate-tax-reform-planned/

The long and winding road: Trade Facilitation Agreement now in force

A successful conclusion of a long negotiating process: The TFA, short for Trade Facilitation Agreement, entered into force on 22 February 2017 and brings along a number of improvements mainly in trading with developing countries. It is hailed as the greatest success since the founding of the WTO, the World Trade Organization, and shows the commitment of the members for a multilateral trading system.

The TFA contains provisions for expediting the movement, release and clearance of goods, including goods in transit. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. The Agreement will help improve transparency, increase possibilities to participate in global value chains, and reduce the scope for corruption.

The TFA is divided into three separate sections. Section I contains provisions for expediting the movement, release and clearance of goods. Section II contains special implemental provisions as regards developing countries. Lastly, Section III contains provisions that establish a permanent committee on trade facilitation at the WTO and national committees to be established by each member.

Most of the measures to facilitate global trade – at least in part – are already practiced by industrial countries. Thus, the biggest effects will be felt in trade with developing countries. These countries should be given substantial support in the implementation process.

New Ministry of Finance Circular planned: Federal Government and Federal States agree upon a Revision of the Treatment of Cum/Cum Transactions

The federal government and federal states have agreed unanimously upon the criteria for a revision of the tax treatment of existing cum/cum structures. The tax authorities of the federal states could then – according to comprehensive and standardised criteria – attack cum/cum transactions, which were executed before the change in the law as at 31 December 2015.

The agreement was reached when the heads of the tax departments of the respective federal and states Ministries of Finance met in Berlin between 1 and 3 March 2017. A new Ministry of Finance circular will be prepared to implement the decision. The existing Ministry of Finance circular of 11 November 2016 will continue to apply to the beneficial attribution of securities transactions.

Federal cabinet approves new rules as part of the fight against money laundering and financing of terrorism

On 22 February 2017 the federal government approved a draft bill to implement both the fourth EU money laundering directive and the EU regulation on the transfer of funds as well as to reorganise the Central Financial Transactions Investigation Agency. The intention is to up-date and strengthen measures developed to prevent money laundering and the financing of terrorism.

The Central Financial Transactions Investigation Agency ("Zentralstelle für Finanztransaktionsuntersuchungen" – "FIU") will be restructured and will obtain more staff: Previously the *FIU* was known as the Central Authority for Suspect Reporting ("*Zentralamt für Verdachtsmeldungen*") at the Federal Police Department within the Ministry of the Interior. It will now be transferred to the General Customs Directorate, i.e. within the Ministry of Finance. Furthermore its responsibilities and competencies will be revised according to the provisions of the fourth EU Directive on money laundering. One area of focus will lie in operative and strategic analysis. In addition the *FIU* should, for the first time, have a filter function, the aim of which is to reduce the burden on the prosecution authorities. In future only credible suspicions should be passed on to the prosecutor.

Draft bill lays the foundations for a central electronic transparency register: This is intended to disclose information on the beneficial owners of an enterprise. The aim being more transparency and thus to hinder the abusive use of companies and trusts for the purpose of money laundering and offences underlying it, such as tax evasion and the financing of terrorism. The bureaucracy for businesses should however be kept at a minimum by the utilising information on any interests held already available in existing registers, such as the commercial register.

Penalty levels to be significantly increased: Penalties for serious, repeated and systematic offending are to be significantly increased to secure compliance with the money laundering regulations. Furthermore, in future the authorities will publish all penalty notices, which can no longer be disputed, on their website.

Official Pronouncements

Promoting electrical mobility: Further tax relief for private use of electric-powered cars

On November 17, 2016 a new law came into force providing for tax incentives (income tax / employee withholding tax) in the area of electrical mobility, namely for electric-powered cars and hybrid vehicles. The Federal Finance Ministry has issued a decree dealing with details of the new regulation.

The Income Tax Act was amended to the effect that additional benefits granted by the employer for the electric charging of such cars at a fixed business (plant) location of the employer or at a place of a related company are tax exempt. The same applies to the private use of energy charging devices (power-grid) provided by the employer (note: recharging at any other places is not tax exempt). A decree issued by the tax administration in December 2016 provides clarification of the relevant tax issues in connection with electric cars. The tax incentives also cover registered electric bikes and so called pedelecs (pedal electric cycles) with a maximum speed above 25 km/h. Tax exemption is granted not only for private cars but also for business cars. Furthermore, any taxable benefit resulting from a transfer of a charging device by an employer (done free of charge or at a reduced price) or any subsidies to that effect both of which are granted in addition to the salary paid may be subject to a lump sum taxation of 25 % (plus any surcharge taxes thereon). The new rules came into effect on 1 January 2017 and are for a limited period of time (i. e. until the end of 2020). It should be noted, though, that – at the present stage of events – there is no VAT exemption for such benefits.

In summary, both hybrid and electric cars play a key role in shaping sustainable mobility. Their energy-efficient drives offer a significant advantage over vehicles with conventional combustion engines. The new rules set in force effectively complete the need to reduce greenhouse gas emissions.

Taxation of company cars in case of leasing

In December 2016 the Finance Ministry issued a decree dealing with the tax implications of privately used company cars in case of a leasing, whereby also commenting on an earlier judgment of the Supreme Court on a so called "government lease".

Employees entitled to use company cars privately calculate the monthly taxable benefit at a fixed rate of 1 % of the list price of the car when new. However, the taxpayer has the alternative of taxing the actual cost of the private use of the car as determined on the basis of an accurate mileage log detailing the business journeys. In a decision of December 18, 2014 the Supreme Tax Court held that neither of those methods may be applied if the vehicle is leased by the employer and the employee is the economic / beneficial owner of the car. This would be the case if – due to specific legal features – the employee would be in a similar position as a lessee. The case at hand involved the car lease of a local authority at reduced rates due to special conditions granted to it in its capacity as public body ("government lease"). In December 2016 the Finance Ministry issued a decree to that effect stating that the aforementioned decision of the Supreme Court could not be followed if the right to a private use of the company car is either laid down in the employment contract or if it results from other regulations governed by labor law. In its decree the ministry also clarifies various other scenarios on these issues, especially if and to what extent the judgment of the Supreme Tax Court should be applied to other (non-governmental) situations. It is in conclusion of the Finance Ministry's Decree that the judgment of the Supreme Tax Court has almost no significance in other cases.

Tax authorities finalise standards for the automatic exchange of financial information

The tax authorities have now published the final Ministry of Finance circular answering questions in connection with the application of the exchange of financial information and the FACTA agreement. The draft versions of the circular had previously been released and these are now in a final version.

In the fight against cross-border tax evasion and other practices showing a lack of discipline for tax purposes, the OECD has developed a standard for the automatic exchange of information on financial accounts (CRS – Common Reporting Standard). On 29 October 2014 Germany committed itself – in conjunction with numerous other countries – to implement a system for exchange. The CRS obliges financial institutes to report to the German tax authorities information on financial assets, which are managed in participating countries on behalf of taxpayers. This information is exchanged between the tax authorities of participating states.

The conclusion of the so-called FACTA agreement between the USA and Germany on 31 May 2013 also introduced rules on the automatic exchange of tax relevant data from financial institutes. This was also intended to induce more honesty in tax matters cross-border.

The Ministry of Finance has now produced a 96 page document to clarify the various issues.

VAT situation for the public sector

The Federal Finance Ministry issued a decree dealing with the Value Added Tax situation for the public sector as revised in the course of the Tax Amendment Act 2015.

In the course of the Tax Amendment Act 2015 the VAT situation for the public sector was restructured entirely in order to conform to local and EU jurisdiction and to the VAT System Directive on these and similar matters. In general, activities of those entities are not of a business nature and thus not VATable inasmuch as they are performed within the capacity as public authority. This would be different, however, if the non-taxation would significantly distort competition. If entities governed by public law, however, carry out (taxable) activities listed in Annex I of the Principal VAT Directive they will always be viewed as a business for purposes of VAT. The tax reform for public bodies was enacted beginning January 1, 2016. As a matter of practice, though, the new rules are implemented since January 1, 2017. A transitory rule until December 31, 2020 is granted with the option to be taxed under the auspices of the old law; application to that effect had to be submitted by December 31, 2016. The Federal Finance Ministry has also issued a decree dealing with specific questions relating to the application of the new VAT rules. Details of the transitory provision are explained in the decree, especially details of the withdrawal of the option to be taxed under previous (old) law and questions relating to the input VAT.

Supreme Tax Court Cases and From Europe

No economic ownership of lessee in case of a sale-and-lease back

A mere put option by the lessor at a favorable price does not necessarily lead to the attribution of economic ownership of the assets to the lessee. In its judgment the Supreme Tax Court once more confirms that economic ownership must be determined on a case-by-case basis.

Generally, a sale and lease-back is a sale by the customer to the leasing company followed by a service by the leasing company (lessor) to the customer (the monthly rentals). The lessor records the assets in his balance sheet and claims depreciation and also possible refinancing costs while on the other hand recording the rent as taxable income. The distinction depends on the circumstances of the case, namely on the economic ownership of the underlying assets. Economic ownership presupposes that the owner exercises effective control over the asset whereby excluding others (i. e. the legal owner) from affecting the economic good during the normal period of its useful life (Section 39 sub-section 2 No. 1 sentence 1 of the German Fiscal Code).

In the case before the Supreme Tax Court a limited partnership (KG) purchased electronic information systems from the manufacturer (seller) which the latter had developed and also specific automatic dispensing machines for bacterial cultures. The KG in turn leased back the assets to the seller (lessee) over a base lease period of 48 months. The KG (lessor) had a put option whereby lessee was obliged to “re-purchase” the assets at an unreasonable high price at the end of the base lease term. For that reason, the tax office did not accept that the KG was the economic owner of the leased assets.

First and foremost, the Supreme Tax Court held that the seller of the automatic dispensing machines retained economic ownership at all times since the assets were specially fitted for his needs. In the case of electronic information systems the court reached quite an interest conclusion: The useful life of the asset being longer than the base lease period together with the KGs favorable put option at the end of the base lease term does not necessarily assume transfer of economic ownership to the lessee. Quite so, the lessee could not – for the rest of the asset’s useful life – legally exclude the KG from having an influence whatsoever or affecting the assets in any way. A mere put option of the lessor is alone not sufficient. Rather, the lessee (seller) must have been in a situation which ensures economic exclusion of the KG at all times, e.g. additionally by way of an extension option or purchase option.

Supreme Tax Court judgment IV R 33/13 of October 13, 2016 published on February 8, 2017

No extended trade tax deduction on the disposal of an interest in a real estate partnership

Profits arising from the sale of an interest in a partnership are not to be included in the extended trade tax deduction for real estate enterprises.

According to Section 9 no. 1 2nd Sentence of the Trade Tax Act (TTA), in place of the deduction under Section 9 No. 1 1st Sentence TTA (lump sum deduction of 1.2% of the assessed value of the real estate), enterprises, which exclusively manage and use their own real estate, may make an application to make an (extended) deduction relating to the part of the trading income which relates to the management and use of their own real estate.

B AG (a company) was initially the sole limited partner in the A KG (a limited partnership). In 2004 B AG sold a number of interests in its limited partnership holding and subsequently held an interest of 6%. In that year (2004) A KG managed a single logistics property in Hamburg Harbour. In its trade tax return for the year it declared total income from a trade, including the gains on disposals of the partnership interests made by B AG. An application was made for an extended deduction in the sum of the whole trading income.

The tax office argued that Section 9 No. 1 6th Sentence TTA explicitly excluded the deduction of gains on disposals of this type. A KG countered this argument by contending that Section 9 No. 1 6th Sentence TTA was introduced through a change in the law on 9 December 2014 but that the disposals of the partnership interests had been completed before the law came into force; a retrospective application of the provision would be unconstitutional. The Supreme Tax Court did not consider this argumentation, but rather came straight to the conclusion that the extended deduction (Section 9 no. 1 2nd Sentence TTA) did not apply in the first place.

According to the Supreme Tax Court the extended deduction provision applied solely to untainted income arising from the actual management of real estate (i.e. actually carried out) and not to gains arising from the disposal of a share in a partnership interest. These were operating profits. The reasoning given for this view was that when a partnership interest was sold in an enterprise which managed real estate, the consideration received was not as a rule just fixed in relation to the proportional share in the real estate. Rather the consideration also took into account the forecasted earnings, the potential increases in value and the opportunities to make profits. Accordingly the partial sale of a partnership interest did not amount to the mere exploitation of real estate but rather went beyond the management and use of own real estate.

Supreme Tax Court judgment IV R 14/13 of 8 December 2016, published on 15 February 2017.

Write-downs to fair market value resulting from foreign exchange rate differences on investment units are to be added back off-balance sheet

Where a company, which has acquired investment units in US dollar denominated equity funds, writes down the value of the investment units to their fair market value following an unfavourable development in the foreign currency exchange rate, the company must add the write down back off-balance sheet.

Background: The question before the tax courts was whether foreign currency exchange losses arising from the valuation of investment units could be recognised in calculating the income for corporation tax purposes. The plaintiff (a German limited company – GmbH) had valued the investment units at their lower fair market value as at the balance sheet dates. (this was a permissible treatment) The company sold the investment units and made a profit in US dollar terms. However, due to the fall in the foreign currency exchange rate, a loss was incurred in Euro terms. The tax office recognised the loss as such, but added it back off-balance sheet according to Section 8b (3) 3rd Sentence Corporation Tax Act. This treatment was confirmed by both the lower tax court and the Supreme Tax Court.

Reduction of profits arising from write-downs to fair market value are to be neutralised off-balance sheet: According to Section 8 (2) of the Investment Tax Act the investor's gain arising from the shares during the time of ownership (i.e. the difference between the gain on the shares as at the valuation date and the gain as at the date of acquisition – "pro rata temporis gain") is relevant for the determination of the level of the off-balance sheet add-back. According to the Supreme Tax Court such pro rata temporis loss had been incurred on the shares. Such a reduction in value does not only occur where the stock market price of the shares held by the investment fund goes down, but also where the value of the shares at the balance sheet date has sunk because of a fall in the foreign currency exchange rate. For tax purposes no differentiation is to be made between those two types of losses, i. e. losses incurred through changes in the stock market price and losses incurred through changes in the foreign currency exchange rates. According to the Supreme Tax Court the purpose of the Investment Tax Act is – following the so-called investment tax law transparency principle – to put investors in funds on a par with direct investors. This should also apply to investments in equity funds. Thus an off-balance sheet add back is also required where the investor decides to write down the value of a fund unit due to a foreign currency exchange loss to ensure an equal tax treatment with direct investors.

Existing symmetry of the rules excludes a breach of EU law: The Supreme Tax Court took the view that the off balance sheet add-back did not amount to a restriction of the EU basic freedoms. The add-back did indeed mean that, ultimately, the foreign currency exchange rate loss was not recognised for tax purposes. However, in the opposite case of an exchange rate gain, which is reflected through a pro rata temporis gain, the law provides for a tax exemption (Section 8 (1) and (3) of the Investment Tax Act and Section 8b (2) Corporation Tax Act).

Supreme Tax Court judgment I R 63/15 of 21 September 2016, published on 15 February 2017

Interest paid by foreign partner deductible also in case of two-tier partnership

In a decision published in March 2017 the Supreme Tax Court held that – in the case of a two-tier partnership structure – the interest expense of a Dutch partner holding only an indirect share in a German limited partnership is nevertheless tax deductible when computing his limited German tax liability resulting from his investment in the German partnership.

Assets assigned by a partner to the partnership are referred to as "assigned business assets I" (*Sonderbetriebsvermögen I*). Income directly derived from these assets and expenses incurred in direct connection therewith are similarly classified. On the other hand, assets and liabilities remaining in the possession of a partner, but used by him in connection with his share in the partnership are also attributed for tax purposes to the assets of the partnership "assigned business assets II" (*Sonderbetriebsvermögen II*). The same applies to the related items of income and expense. These income and expense items are included in the results of the partnership, but are then allocated to the partner concerned as prior profit shares or charges.

The case before the Supreme Tax Court involved a Dutch BV who was the sole limited partner of a German limited partnership (a GmbH & Co. KG). The BV took a loan from its Dutch parent in order to finance its investment in the German partnership. Later the BV contributed its share in the German partnership to a Dutch partnership (CV) thus holding only an indirect interest in the German KG via the Dutch CV (the upper-tier partnership). The question arose whether the interest expense of the BV would still be tax deductible when calculating the taxable income attributable to it and emanating from its share in the KG. The German tax office refused, pointing out that –as a result of the sale to CV – the loan financing of BV could no longer be viewed to be in connection with its share in the German (lower-tier) partnership.

The Supreme Tax Court sided with the appellant (i. e. the German partnership) and considered the loan as still being connected with the investment of the BV in the German partnership and thus the interest to be deductible from the German tax basis of the BV. The Court's reasoning was that – also in the case of a two-tier partnership – the BV as a partner in the upper-tier partnership (CV) may nevertheless claim "assigned business assets II" on the level of the German (lower-tier) partnership and thus deduct the interest paid in connection with the loan financing. The income received by BV from its investment in the German partnership (business) is treated as income from a trade or business for which a permanent establishment is maintained in Germany and subject to limited tax liability in Germany. It follows that the related interest expense thus reduces the German taxable income attributable to the Dutch BV.

Supreme Tax Court judgment I R 92/12 of October 12, 2016 published on March 8, 2017

ECJ rules on Subject-to-tax requirement of the Parent-Subsidiary Directive

The subject-to-tax provision of the Parent-Subsidiary Directive, whereby distributed dividends are exempt from withholding tax, requires that the dividends are taxed in the hands of the parent company. In practice, this necessitates actual payment of the tax.

In 1999 and 2000, a Belgian Real Estate Investment Company distributed dividends to its two Dutch parent companies qualifying as "fiscal investment institutions" (FII) subject to a zero rate of corporation tax in the Netherlands. The Belgian tax authorities refused to grant the Parent-Subsidiary-Directive (PSD) withholding tax exemption for these dividends claiming that FIIs do not fulfil the subject-to-tax requirement of the PSD.

The ECJ agreed and held, that the PSD does not merely require that a company should fall within the scope of the tax in question but also seeks to exclude situations involving the possibility that despite being subject to tax, the company is not actually liable to pay that tax. Although FIIs are formally not exempt from tax in the Netherlands, they are practically in a situation in which they are not liable to pay that tax. The entitlement to be taxed at a zero rate is according to the ECJ tantamount to not subjecting those companies to corporation tax.

Such an interpretation is in accordance with the overall objective of the PSD ensuring tax neutrality of the distribution of profits by a subsidiary to its parent company through the elimination of a possible double taxation of those profits. Where a parent company is entitled to a zero rate of taxation for all its profits the risk of double taxation of profits is ruled out altogether.

The ECJ case reference is C-448/15 *Wereldhave Belgium and Others* judgment of March 8, 2017

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