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Real estate transfer tax exemption on conversions illegal state aid?

On 30 May 2017 the Supreme Tax Court decided to refer to the European Court of Justice (ECJ) the question of whether the real estate transfer tax (RETT) exemption on conversions – in Section 6a Real Estate Transfer Tax Act – constitutes illegal state aid.

In the case in question the taxpayer, a public limited company/stock corporation, had, for a period of more than 5 years, been the sole shareholder of a subsidiary which was the owner of real estate. In the relevant period the subsidiary was merged into the taxpayer. The tax office took the view that the merger gave rise to a transfer subject to RETT, for which, however, no exemption under Section 6a Real Estate Transfer Tax Act was available.

According to this provision certain taxable transfers made in the course of a conversion (e.g. a merger) can be exempted from RETT. The exemption is available provided that the parties to the conversion comprised a controlling enterprise and a controlled enterprise. Under the provision the controlling enterprise had to have held at least a 95% interest in the controlled enterprise in both the 5 year period prior to the transaction and in the 5 year period after it.

The lower tax court upheld the taxpayer's appeal and the tax office appealed to the Supreme Tax Court.

On the domestic law question on the interpretation of Section 6a Real Estate Transfer Tax Act as it applied to the facts, the Supreme Tax Court viewed the merger of the subsidiary into the taxpayer as a transaction covered by Section 6a Real Estate Transfer Tax Act. The fact that it was impossible for the appellant to continue to hold the shareholding in the subsidiary after the merger did not invalidate the relief. The Supreme Tax Court further commented on the interpretation of the term "controlling enterprise". The Court favoured a broad interpretation of the term, stating that it was not a requirement that the controlling enterprise should be an entrepreneur within the meaning of Section 2 of the VAT Act. From a domestic law point of view, therefore, the Supreme Court would have ruled in favour of the taxpayer on the points in question. However, the final decision had to be postponed until the state aid process (see below) will be completed.

The Supreme Tax Court decided to refer the matter to the ECJ on the question as to whether the RETT relief in Section 6a Real Estate Transfer Tax Act constituted illegal state aid within the meaning of Article 107(1) Treaty on the Functioning of the European Union (TFEU). This provision prohibits any state aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods.

The Supreme Tax Court took the view that the ECJ should be asked to clarify whether Section 6a Real Estate Transfer Tax Act gave rise to a selective advantage because (i) it only applied to conversions (e.g. mergers, de-mergers, asset transfers) but not to other reorganizational measures (ii) it excluded group enterprises where the controlling enterprise in the group did not hold an interest of more than 95% in the controlled enterprise or where the interest in the controlled enterprise was not held for the whole of the minimum holding period (i.e. as such giving rise to a disparity between the treatment of economic operators).

The Supreme Tax Court was, however, of the opinion that the provision was justifiable as the chargeable events under Sections 1 (1) No.3, 1 (2a) and 1 (3) Real Estate Transfer Tax Act were defined too broadly from a RETT perspective and thus needed to be corrected in certain group-related circumstances by limiting the scope of application.

If the ECJ sees a case of illegal state aid under Article 107(1) TFEU, Section 6a Real Estate Transfer Tax Act would become non-applicable until the European Commission reached a decision about its compatibility with the internal market. A decision in the instant case would also have to be postponed until that time.

Supreme Tax Court decision II R 62/14 of 30 May 2017, published on 14 June 2017

Curtailment of loss relief for companies in part unconstitutional

The German Constitutional Court held that the rules for curtailment of loss relief on change of shareholders to be in breach of the formal provisions of the constitution under the principle of equal treatment insofar as changes of more than 25% and up to 50% of the shares in a company within a period of five years are concerned.

The rules for the curtailment of loss relief on changes of shareholder in Sec. 8c Corporation Tax Act (CTA) were introduced for years from 2008. Basically, loss carry forwards are to cease if more than 50% of the shares in the loss making company are directly or indirectly acquired by a single acquirer or his related party over a period of five years. If more than 25% but no more than 50% are transferred in this way, the loss carry forward is reduced in proportion to the transfer. Two exceptions were introduced from 1 January 2010: The first provided for the preservation of loss carry forwards on certain group internal reorganizations and the second to protect them up to the level of the hidden reserves of the company.

On 23 December 2016 the Act for the Further Development of Tax Loss Utilisation for Corporations was published whereby the government modified the existing curtailment of loss relief on changes of shareholders by introducing a new Sec. 8d CTA with (retroactive) effect from 1 January 2016. According to new Sec. 8d CTA the loss curtailment rules of Sec. 8c CTA do not come into play where the business operation does not change (this, however, to be subject to further conditions).

The relevant section in question, Sec. 8c sub-sec. 1 sentence 1 CTA, dealing with changes of more than 25% and up to 50% of the shares in a company within a period of five years, is unconstitutional. According to the Constitutional Court there is no justification for the unequal (different) treatment of companies in cases of a harmful change of ownership, i. e. where more than 25% but no more than 50% are transferred and where the loss carry forward is then reduced in proportion to the transfer. The court sees no plausible reason to assume a (harmful) change of identity of the company without taking further into account the business assets and / or the type of business of the company. The court left it open whether this should be judged differently in situations where more than 50% of the shares are transferred. Whether, following the introduction of new Sec. 8d CTA from January 2016, Sec. 8c CTA would thereafter meet the constitutional requirements remains to be seen and would be subject to a separate examination.

Since the appellant in the case at hand was a limited company (GmbH) the court did not have to elaborate on other situations, namely if and to what extent the loss curtailment rules would apply to other corporations and to certain other transfers.

The Constitutional Court finally held that the present rules for loss relief in case of change of shareholding of more than 25% up to 50% be amended by December 31, 2018 and with retroactive effect from 1 January 2008 and up to fye 31 December 2015. If the legislators do not comply with this obligation the relevant Sec. 8c sub-sec. 1 sentence 1 CTA would be held incompatible and invalid retroactive from 1 January 2008.

Constitutional Court resolution *2 BvL 6/11* of March 29, 2017; official press release of May 12, 2017

Multilateral Convention to counter aggressive tax avoidance arrangements has been signed

On 7 June 2017 Germany together with the representatives of over 60 countries signed the multilateral convention, which should transpose the main recommendations of the G20/OECD Project against Base Erosion and Profit Shifting (BEPS Project) into existing bilateral tax treaties.

The adjustments made by the so-called “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting” (MLI) should ensure that German tax treaties are more resistant to abusive tax arrangements. The emphasis will now not only be on the avoidance of double taxation but also on the avoidance of non-taxation. The overriding principle is that profits should be taxed at the place where the entrepreneurial activities and thus the value creation take place.

The ratification of the MLI in Germany should go ahead in the coming legislative period. The first changes in the German bilateral treaties could then apply as early as 2019.

Federal Ministry of Finance, Press Report of 7 June 2017

Bundesrat approves the legislation to combat tax avoidance

In its sitting on 2 June 2017 the Bundesrat (the Upper House) approved the legislation which the government introduced at the end of last year following the publication of the Panama Papers.

The aim of the new legislation is to achieve more transparency in cross-border business transactions. Further the tax authorities’ options for detecting the use of foreign domiciled companies for tax avoidance should be increased. Whilst the Federal States have expressly greeted the measures for more transparency, they also demanded the introduction of further steps to combat international tax avoidance. Here a brief summary of some of the 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 legislation also provides for an extension of the reporting deadline up until the date on which the corporation tax or income 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. In addition 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. A breach can lead to a penalty of up to € 50,000.

Abolition of bank secrecy rules: The so-called bank secrecy privilege has been 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 is 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 of an account or depot belonging to 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 compilation of collective information defined: The tax authorities' options to gather collective information are 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. Previously the so-called legitimation examination was limited to the name and address.

New obligations for the retention of documents: A new obligation for the retention of documents should be imposed on taxpayers, 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 will 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 is now 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.

Furthermore there is a general extension of the limitation period applicable to the payment of tax from 5 years to 10 years in cases of tax evasion

Bundesrat approves legislation introducing restrictions on the deduction of royalty payments

In its sitting on 2 June 2017 the Bundesrat (the Upper House) approved the Act to Combat Harmful Tax Practices in connection with the Licensing of Rights. The new legislation is intended 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. The new provision should be applied to expenses arising after 31 December 2017 and is to be introduced by way of a new provision in the Income Tax Act (ITA)

The new section (Section 4 j ITA) provides that expenses incurred through licensing rights from a related party (within the meaning of Section 1 (2) of the Foreign Transactions Act (FTA) are 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, Patent Box). Where there is more than one creditor, the lowest tax charge will be relevant.

The provision also applies to situations under which additional related parties are interposed. Furthermore branch undertakings may also be considered as 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.

Under the provision, a foreign partnership treated as a transparent entity, e.g. a check-the-box transparent corporation, will also be considered to be a creditor.

The restrictions will not apply if the foreign preferential regime follows the nexus approach of the OECD (see Chapter 4 of Action 5 the Final Report of the BEPS Project).

EU Council to adopt ATAD II Directive on hybrid mismatches

On 29 May 2017 the Council of the EU formally and unanimously adopted the Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries (ATAD II).

The amended Anti Tax Avoidance Directive (ATAD II) has a broader scope than ATAD I as it also covers hybrid mismatches with third countries and more categories of mismatches. The formal adoption of ATAD II follows the political agreement reached by EU Member States in the ECOFIN Council on 21 February 2017 and the opinion of the European Parliament issued on 27 April 2017.

The Member States will need to transpose the provisions of ATAD II by 31 December 2019 and apply them as of 1 January 2020. This applies to both mismatches between Member States and between Member States and third countries. By way of derogation, the reverse hybrid entity rule (requiring taxation of income to the extent not otherwise taxed) will need to be transposed by 31 December 2021 and be applied as of 1 January 2022.

OECD publishes International VAT/GST Guidelines

The International VAT/GST Guidelines now published present a set of internationally agreed standards and recommended approaches to address the issues that arise from the uncoordinated application of national VAT systems in the context of international trade. The Guidelines were adopted as a Recommendation by the Council of the OECD in September 2016.

Value Added Tax (VAT) has become a major source of revenue for governments around the world. Some 165 countries operated a VAT at the time of the completion of the International VAT/GST Guidelines in 2016, more than twice as many as then 25 years ago. As VAT continued to spread across the world, international trade in goods and services has also expanded rapidly in an increasingly globalised economy. One consequence of these developments has been the greater interaction between VAT systems, along with growing risks of double taxation and unintended non-taxation in the absence of international VAT co-ordination.

The International VAT/GST Guidelines focus in particular on trade in services and intangibles, which poses increasingly important challenges for the design and operation of VAT systems worldwide. They notably include the recommended principles and mechanisms to address the challenges for the collection of VAT on cross-border sales of digital products that had been identified in the context of the OECD/G20 Project on Base and Erosion and Profit Shifting (the BEPS Project).

OECD press release published on April 12, 2017

Official Pronouncements

Tax administration issues guidelines on use of group name

The German Finance Ministry has commented on possible profit adjustments under Sec. 1 Foreign Tax Act with respect to the use of group name and logo between the taxpayer and a related party.

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

http://blogs.pwc.de/german-tax-and-legal-news/2017/04/11/tax-administration-issues-guidelines-on-use-of-group-name/

Supreme Tax Court Cases and From Europe

No deduction of final branch losses following EU law

Payments made to a purchaser to compensate for a poor economic position following the transfer of an interest in a partnership may not be deducted from the domestic tax base to the extent they are attributable to a foreign branch (i.e. a permanent establishment for tax treaty purposes) of the partnership.

In 1999 the appellant, a GmbH, assigned its interest in a limited partnership ("the KG") to the second limited partner. The KG held an Italian branch. The Italian branch had incurred losses in the years 1996 to 1998, which were separately assessed under Section 2a (3) Income Tax Act. Due to the expected losses of the KG, the appellant agreed in the course of the transfer to pay a compensation payment. This compensation payment was partially attributable to the Italian branch.

The tax office treated that part of the compensation payment attributable to the Italian branch as a non-deductible expense. Further it took the view that the relevant conditions had been met to reincorporate the Italian branch losses, which had been deducted in earlier tax years.

The lower tax court allowed the appellant's appeal with regard to the deductibility of the expense. However the Supreme Tax Court reversed this decision. The compensation payment could neither be deducted as business expense nor could it be deducted as a so-called "final" loss. The decisive issue was the so-called "symmetry thesis", according to which the tax treaty exemption of foreign income was attached to both positive and negative income. ECJ and Supreme Tax Court case law has ruled up to now that, due to the freedom of establishment rule, a loss deduction from the corporation tax base should be possible if and to the extent that the taxpayer can prove that the losses are "final" losses, namely they cannot, under any circumstances, be utilized by the foreign branch for a tax set-off. The Supreme Tax Court applied this rule not only to circumstances where the losses could no longer actually be utilized in the source state but also to circumstances where, whilst the loss utilisation was theoretically still possible in the other state, in reality it could just about be excluded and where such a loss deduction abroad became available contrary to expectations, it would, from an administrative law point of view, still be open to the German tax authorities to make a subsequent adjustment.

The ECJ has, however, in the meantime revised this case law. In its decision of 17 December 2015 (C-388/14 *Timac Agro Deutschland*), the ECJ held that, where there was no objectively comparable domestic situation, no concerns should arise from an EU law point of view, where a Member State, in the event of a transfer by a resident company of a permanent establishment situated in another Member State, excludes the possibility, for the resident company, of taking into account in its tax base the losses of the establishment transferred where, under a double taxation convention, the exclusive power to tax the profits of that establishment lies with the Member State in which the establishment is situated.

Whilst the Supreme Tax Court sees dogmatic doubt in the *Timac Agro* Deutschland decision, in the instant case it followed the view of the ECJ and refused a further referral to that court.

Supreme Tax Court judgment I R 2/15 of 22 February 2017, published on 17 May 2017

Preemptive warnings to competitors subject to VAT

A company dealing in the field of electronic data processing served its competitors with prior written warnings due to violations of general business terms and conditions and received reimbursement of the expenses incurred. The tax office assumed a taxable service being subject to VAT. The Supreme Tax Court confirmed this view.

A provision of services is taxable if there is a direct link between the service provided and the consideration received. A supply of services is therefore taxable only in the case of a legal relationship (connection) between the service provider and the recipient and in the course of a mutual exchange of services, i. e. the remuneration received by the provider of the service constituting the value actually given in return for the service supplied to the recipient.

In the opinion of the Supreme Tax Court the reimbursement of costs is the value of consideration for the warnings and – by issuing the warnings – the company indeed provided a benefit to its competitors, namely by giving them the opportunity to resolve the dispute prior to initiating court proceedings. Following the principle of equal treatment, which applies in VAT matters through the principle of fiscal neutrality, the services in question should be treated consistently, irrespective whether the warning is legally based on the right to compensation (compensation for damage; Sect. 9 of the Act Against Unfair Competition) or via an enforcement of claims by written warning (together with a cease and desist order; Sect. 12 Act Against Unfair Competition).

Supreme Tax Court judgment XI R 27/14 of December 21, 2016 published on April 12, 2017

VAT exempt assumption of a liability

The Supreme Tax Court held that the commitment to enter a rental agreement is a VAT exempt service.

A real estate management company (appellant) assumed the lease obligations against the buyer of a property. The buyer wanted to acquire the object from the seller only on the condition that a certain share of the vacant space was rented additionally for a period of five years. The seller and the appellant therefore agreed that the latter should take over tenant obligations directly against the buyer of the property. This brought the tax administration to conclude that a VATable service took place. Initially, the lower tax court dismissed the complaint of the appellant. The Supreme Tax Court, though, reversed this decision and agreed with the real estate management company.

According to German VAT law “the assumption of obligations, guarantees and other securities and the negotiation of those transactions” is exempt from VAT. Initially, the German Supreme Tax Court had some doubts whether the transaction is within the scope of German VAT law at all. Notwithstanding, it concluded that the appellant had accepted a monetary liability which in any case fell under the VAT exemption. The appellant had received a payment from the seller in an amount of all net rental fees as agreed, while the rental fee was payable monthly for the five years to come. Therefore, the appellant had, in economic terms, merely obtained an interest advantage. According to the Supreme Tax Court it did not matter whether the appellant would himself conclude the rental agreement or whether he would enter into an existing rental agreement.

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

Participation certificates: Interest or profit sharing under Austrian treaty?

In a dispute between Germany and Austria on the right of taxation of payments from registered certificates an ECJ advocate general has suggested that such interest should be taxed only in the country of residence of the beneficial owner unless such debt-claims explicitly provide the creditor with a participation in the debtor's profits.

A dispute currently pending before the European Court of Justice (ECJ) relates to the interpretation and application of Article 11 of the double tax treaty between Austria and Germany as regards the right of taxation of interest from registered participation certificates (profit participation certificates – known as '*Genussscheine*') acquired by UniCredit Bank Austria AG (Bank Austria) from the German Westdeutsche Landesbank (WestLB) as the issuer of the certificates. According to Art. 11 (1) of the treaty "interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State". Apart from this general rule Art. 11 (2) states "that income from rights or debt-claims with participation in profits (...) or income from profit-participating loans and profit-sharing bonds, may also be taxed in the State in which it arises, in accordance with the laws of that State". Interest is thereby defined as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, Art. 11 (3) of the treaty.

Under the terms of issue, the amount of the annual payment was a percentage of the nominal value of the certificate ranging from 4.4% to 7.4%. Since the issuer had made profits over the entire holding period of the certificates the interest had always been paid at the fixed annual rate as provided for in the terms of issue. Austria claims that the remuneration from the certificates is not a "participation in profits" within the meaning of Article 11 (2). Germany takes the contrary view and also claims the right to tax the interest. Since a mutual agreement procedure initiated by Austria failed in 2011 the case was brought before the ECJ. In its opinion the Advocate General (AG) feels that the context in which the phrase "income from ... debt-claims with participation in profits" is used and the objective and meaning of Article 11 of the German-Austrian treaty calls for a strict interpretation and be limited to situations in which the remuneration from the debt-claim varies and depends – at least partially – on the amount of the debtor's profits. In the case at hand, though, the certificates grant an entitlement to the payment of annual interest at a fixed predetermined rate calculated on the basis of the nominal value of those certificates. The terms of issue do not provide that the interest rate is to be supplemented, at the very least, by a variable element representing a part or a share of the profits made by the debtor. Thus, irrespective of the amount of profit of the debtor, the interest rate is based solely on the nominal value of the certificates.

In conclusion, the AG considers that the claim made by Austria must be granted and therefore proposes to the Court to hold that the term 'income from rights or debt-claims with participation in profits' – as contained in Article 11(2) of the double tax treaty between Germany and Austria – covers income which provides a creditor with a part or a share of the debtor's profits, but not income which varies only in the event of losses incurred by the debtor. As to the latter, the AG concedes that the interest rate may be reduced to zero where the debtor incurs losses. However, if no losses are incurred in subsequent years, the creditor would be entitled to payment of arrears during those years and therefore this is rather a suspension of the interest until the bank returned to profitability rather than a clause for participation in profits.

It should be noted, that the German Supreme Tax Court in an earlier judgment I R 53/09 of 26 August, 2010 has held otherwise, namely that a contractual profitability condition renders the interest profit-dependent and thus entitles Germany to withhold tax on the interest paid to the Austrian recipient (creditor).

The ECJ case reference is C-648/15 *Austria v Germany* opinion of April 27, 2017.

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Editor's Office

Emma Moesle
PricewaterhouseCoopers GmbH
Friedrich-List-Straße 20
45128 Essen
Tel.: +49 201 438-1975
E-Mail: emma.moesle@de.pwc.com

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