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# Bundesrat approves the Act to Modernise Corporate Income Tax

**UPDATE: In its session on 25 June 2021, the Bundesrat gave its approval to the Act to Modernise Corporate Income Tax Law. The Bundesrat thus followed the recommendation of the Finance Committee. The law is should enter into force on 1 January 2022.**

*See below for more details.*

On 24 March 2021, the Federal Cabinet approved the German Federal Ministry of Finance's draft legislation to modernize corporation tax ("Bill to Modernise Corporation Tax Law"). The first reading before the Bundestag is expected on 22 April 2021.

With this bill the government is taking a first step towards introducing a so-called "option model", which provides commercial partnerships with the option of being treated as corporations for tax purposes.

In addition, the bill contains proposals to modernise and make more international the tax regulations in relation to corporate reorganisations, to replace the concept of so-called "tax balancing items" in relation to deviations in profit transfers within a tax group (Organschaft) and to revoke the rule prohibiting the deduction of losses arising from currency fluctuations on shareholder loans.

However, the current draft does not include the expected reform to relief on retained profits (Section 34a of the German Income Tax Act (ITA), which had previously been discussed alongside the introduction of the "option model".

The changes in more detail:

**Corporation Tax election ("Option Model")**

**General**

Section 1a of the draft bill is intended to introduce a general provision for the so-called "option model" for corporation tax. This is to be achieved through an extension of the catalogue listing those companies subject to unlimited corporation tax in Section 1 Corporation Tax Act ("CTA) to include "companies" exercising this option.

**Application to opt for corporation taxation**

Pursuant to Section 1a (1) CTA, a commercial partnership can submit an irrevocable application for income taxation purposes to its local tax office. This results in the applicant being treated substantively and procedurally as a corporation and its partners as the non-personally liable members of a corporation. The application must be filed before the beginning of the financial year from which the option is to apply.

Since the application relates to the taxation of all partners, the draft provision requires that a majority of at least ¾ of the votes cast must agree to the application.

However, for civil law purposes the entity remains a partnership, so that - according to the explanatory memorandum - provisions such as Section 28 CTA, which relate to nominal capital, will not be applicable

The option is not available to investment funds within the meaning of the Investment Tax Act. Further, the option will not be available, where an entity, after exercising the option, is not subject to a corporation tax liability comparable to the German unlimited corporation tax liability in the state in which the management is located; this is intended to prevent qualification conflicts.

**Transition to corporate income taxation**

Pursuant to Sec. 1a (2)CTA, the transition to corporation tax is to be treated as a change of legal form. In particular, Section 25 in conjunction with Sections 20 et seq. of the Reorganisations Taxes Act are to be applied accordingly. The time of the change of legal form is deemed to be the end of the financial year immediately preceding the "option year"; a conversion with retroactive effect for tax purposes is not possible. The equity of the partnership per the tax balance sheet is added to the tax contribution account of the corporation. In the context of the change of legal form, an amount subject to subsequent taxation pursuant to Section 34a ITA (retained earnings) is to be disclosed.

**Legal consequences of the option at shareholder level**

According to Section 1a (3) CTA the typical legal consequences are to apply at shareholder level when the option is exercised, so that, for example, benefits arising from the corporate relationship will be taxable as hidden profit distributions and, for example, interest, rent, etc. paid by the corporation are to be taxed according to the relevant income stream and no longer as special business income.

**Return to transparent taxation**

Under Section 1a (4) CTA an application can be made to reverse the option for the future, so that the partnership is no longer treated as a corporation and its partners to no longer treated as the non-personally liable shareholders. In terms of timing, the application is to be made before the beginning of the financial year from which transparent taxation is to be applied.

The reverse option will similarly be treated as a change of legal form under Section 9 Reorganisation Taxes Act and may also not be made retroactively.

A reverse option will be implemented automatically if the conditions in Subsection 1 no longer apply; according to the explanatory memorandum, this can be the case in particular if the commercial partnership becomes a non-trading partnership (Gesellschaft bürgerlichen Rechts – GbR) or there is no longer any corporation tax liability in the country of management.

Since the option cannot be exercised by a sole proprietor, the regulation also provides that the company is deemed to be dissolved when the penultimate partner leaves the partnership. Where that last partner falls within the personal scope of application of the Reorganisation Taxes Act, the company is deemed to have been converted; if the personal scope of application is not available, liquidation follows in accordance with Section 11 CTA

**Trade Tax**

Pursuant to Section 2 (8) of the draft Trade Tax Act, the opting partnership is also to be treated as a corporation for trade tax purposes and its partners as non-personally liable shareholders of a corporation.

### Further consequential amendments

Corresponding consequential amendments are also regulated in Sections 17 and 20 ITA

### "Internationalisation" of the Reorganisation Taxes Act

The Act is intended to extend the personal scope of application of the Reorganisation Taxes Act in part to third country cases. This concerns conversions with participations of corporations as the transferring legal entity (Second to Fifth Part of the Reorganisation Taxes Act). As such Section 1 (2) Reorganisation Taxes Act will be deleted.

Furthermore, Section 12 (2) and (3) CTA will also be abolished and Section 8 (1) No. 10 FTA will be amended following the changes to the personal scope of application in Section 1 Reorganisation Taxes Act.

As a result:

- Merger of a corporation into a partnership or natural person or the change of legal form of a corporation into a partnership (Section 3 Reorganisation Taxes Act et seq),
- merger or demerger between corporations (Sections 11 to 15 Reorganisation Taxes Act ) or
- division or spin-off into a partnership (Section 16 Reorganisation Taxes Act),

can be organised not only in EU/EEA but also in third country cases. The material scope of application (Section 1(1) Reorganisation Taxes Act) remains unchanged. The comparability with a domestic conversion as defined by the Reorganisation Act is still a requirement.

Parts 6 to 8 of the Reorganisation Taxes Act (Sections 20 to 25) are not covered by the extension of the personal scope of application to third country cases. Here, the restriction of the personal scope of application currently contained in Sec. 1 (4) Reorganisation Taxes Act is to remain unchanged.

The amendments to the Reorganisation Taxes Act are to be applied for the first time to conversions whose taxable transfer date is after December 31, 2021.

### Replacement of the so-called balancing items in group taxation

### General

The draft provides for a change in the corporation tax treatment of any deviations between the profit transfer as per commercial law and income attributable to the tax group parent under tax law arising during the existence of a tax group (Organschaft). The previous concept of so-called tax group balancing items is to be replaced. According to current rules, a special asset or liability balancing item is to be created in the tax balance sheet of the tax group parent whenever such deviations arise. The relevant adjustment corresponds to the ratio of the tax group parent's interest in the nominal capital of the tax group subsidiary.

### Amended Section 14 (4) CTA

In future, where the transferred profit to the tax group parent is lower than the profit of the tax group subsidiary in its tax balance sheet the deviation will be regarded as a contribution by the tax group parent to the tax group subsidiary. Where the transferred profit is higher, the deviation will be regarded as a return of contribution by the tax group subsidiary to the tax group parent. As a result, the deviation will directly reduce or increase the shareholding valuation in the tax balance sheet of the tax group parent. In this context, transfers of profit or loss by the tax group will be deemed to occur at end of the financial year of the tax group subsidiary.

Whereas the tax group balancing items were only to be created in proportion to the shareholding, the full amount of the short transfer is to lead to a contribution and the full amount of the excess transfer is to lead to a return of contribution.

**Adjustments to Section 27 CTA**

Section 27 (1) sentence 3 of the draft CTA provides for direct access to the tax contribution account in the case of excess transfers during the existence of the tax group. In contrast to excess transfers generated during the pre-tax group period, excess transfers generated during the tax group period do not constitute income from investments.

In addition, Sec. 27 (6) Sentence 2 of the draft CTA should stipulate that excess transfers made during the existence of the tax group reduce the tax contribution account before other payments.

**Application and transitional provisions**

*First-time application*

The amended provisions are to be applied for the first time to deviations occurring after 31 December 2021, whereby the date of the deviation will depend upon the end of the tax group subsidiary's financial year.

*Transition to new treatment*

Balancing items still existing in the tax balance sheet of the tax group parent for tax group deviations under the current system and applicable until 31 December 2021, are to be reversed in the first financial year that ends after 31 December 2021. According to the draft bill, the reversal of balancing item assets is to lead to an increase, while the reversal of balancing item liabilities is to lead to a reduction in the shareholder investment value of the tax group subsidiary in the tax balance sheet of the tax group parent.

If the total balancing item liability exceeds the total balancing item assets and the book value of the tax group parent's investment in the tax group subsidiary, this will constitute income from the investment for which (partial) relief may be available under Sections. 3 No. 40 and 3c (2) ITA and Section 8b CTA.

*Option to form a profit-decreasing reserve*

Any income from an investment arising from the change in treatment will be transferred to a reserve account decreasing profits in future periods. The reserve is generally to be released to income in the financial year in which it is created and in each of the nine subsequent financial years at a rate of one tenth per annum. The reserve is to be released in full to increase profits if the tax group parent's shareholding in the tax group subsidiary is sold. The conversion of the tax group subsidiary into a partnership/individual, the hidden contribution of the shareholding in the tax group subsidiary and the dissolution of the tax group subsidiary are all deemed to be equivalent to a sale. (Partial) relief may be available under Sections. 3 No. 40 and 3c (2) ITA and Section 8b CTA.

**Foreign Currency Losses in Section 8b CTA**

The draft bill also provides that foreign exchange losses incurred by a corporation on a loan receivable or comparable position vis-à-vis another company in which it holds or held an interest of more than 25% will no longer be non-deductible under Sec. 8b (3) Sentence 4 CTA.

The same will apply to exchange losses incurred by related parties of the shareholder and to exchange losses in connection with so-called third-party recourse (Sec. 8b (3) Sentence 5 CTA).

The amendment should apply for the first time to profit reductions within the meaning of Sec. 8b (3) Sentences 4 and 5 CTA occurring after 31 December 2021.

**Schlagwörter**

Corporation tax, Exchange rate losses, commercial partnerships, tax group