Important legal changes

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Breaking News

First Draft Issued: The Federal Ministry of Finance has published a package of measures designed to combat base erosion and profit shifting

The draft of the "Act to implement the amendments to the EU Mutual Assistance Directive and to implement further measures to combat the reduction of profits and profit shifting", as its name suggests, is primarily intended to implement the recommendations of the BEPS-Project ("Base Erosion and Profit Shifting"), to intensify transparency between the tax administrations, as well as to implement the amendments to the EU Mutual Assistance Directive. However, it is important to note that the Draft also contains numerous amendments, which may have a considerable impact on business. In this special edition we summarise and appraise the most important changes.

Changes to the interpretation and application of tax treaties

The changes are intended to ensure that the substance of the arm's length principle as set out in Section 1 of the Foreign Transactions Act (FTA), and which is contained in tax treaties, should, in future, only be applied in line with the rules of the FTA. According to the Federal Ministry of Finance (MoF) this "clarification" is necessary especially because, the German Supreme Tax Court, in its judgments I R 23/13 of 17 December 2014 and I R 29/14 of 24 June 2015, interpreted the tax treaties in such a manner that the tax treaties could be construed as restricting the application of Section 1(1) FTA.
Furthermore, "other potential opportunities for tax avoidance and profit shifting flowing from the interpretations of the Supreme Tax Court" should be restricted.

Application of the Subject-to-Tax-Rule in Section 50d (9) 1st Sentence of the Income Tax Act or in a tax treaty, even when only portions of income are not taxed or taxed at a low rate ("Atomisation")

In order to prevent the non-taxation or low-taxation of certain types of income earned by an unlimited taxpayer, Section 50d (9) of the Income Tax Act (ITA) links the entitlement to apply the tax exemption method to the relevant income to the taxation of the said income in the other State. According to the section, no exemption of income is permitted where, under the tax treaty, the same income may not be taxed in the other State or where the rate of tax may be restricted under the treaty. The same prohibition applies where the taxpayer is not taxed on the income in the other State due to his status as a limited taxpayer in that other State.

In the past the German tax authorities have taken the view that this section also applied where the income was only partially taxed or where it was partially taxed at a lower rate. This view was challenged by the Supreme Tax Court: in its decisions of 20 May 2015 in the appeal cases I R 68/14 and I R 69/14, the Court held, that despite the reversal of the right to tax set out in Section 50d (9) ITA, the exemption of the income could be allowed even where the other State only applied its right to tax under the treaty on part of the income.

In the view of the MoF, the non-application of Section 50d (9) ITA, where only part of the income is subject to tax, has “inequitable consequences”.

The amendments set out in the Draft are intended to ensure that in the future the Subject-to-Tax-Rule in Section 50d (9) 1st Sentence ITA will apply to that part of the income which is only partially taxed or which is partially subject to a lower rate of tax in the other State.

Contrary to Supreme Tax Court case law (see I R 127/95 from 27 August 1997) the tax authorities also took the view that, in tax treaty cases, the Subject-to-Tax-Clause applied where only a part of the income had not been taxed in the other State. This new rule should codify the tax authorities’ interpretation.

Inclusion of Section 10 FTA add-back of foreign passive income in the trade tax base

In its decision of 11 March 2015, the Supreme Tax Court decided that that the add-back of foreign passive income proscribed by Section 10 FTA constitutes income, which is attributable to a foreign permanent establishment. Accordingly, so the Supreme Tax Court, the add-back must be deducted under Section 9 No. 3 1st Sentence of the Trade Tax Act (TTA), when calculating the trade tax base of the domestic business.

The MoF, however, takes the view that this ignores the legislator’s original intention when it introduced Section 7 FTA et seq. In future, under the new rule, foreign passive income is expressly considered to be part of the profits of the domestic business under Section 7 TTA. As a result, the deduction under Section 9 No. 3 1st Sentence TTA is not relevant. Furthermore, as before, no credit of the foreign corporation tax against the German trade tax will be permitted, which may lead to excess foreign tax credit and a double taxation.

Inclusion of low-taxed foreign branch income according Section 20 (2) 1st Sentence FTA in the trade tax base

Furthermore, according to the Draft, the principle of territoriality applicable to trade tax should also be excluded for cases in which the taxpayer realises interim passive income for CFC purposes through a foreign branch. Under the proposed rule, income from a foreign branch, as defined by Section 20(2) 1st Sentence FTA, will be treated as income of the domestic business of the taxpayer. This fiction will apply regardless of whether or not the branch is located in a state with which Germany has concluded a tax treaty and regardless of whether the tax treaty applies the credit method rather than the exemption method. As a result, it will be necessary in future, for businesses, whose income hitherto was subject to a tax credit, to check whether they have low-taxed passive income. Such income will then also be subject to trade tax; it is not intended to allow a credit of the foreign tax against the trade tax.

Over and above this, the planned new rules state that, in cases in which income within the meaning of Section 20(2) 1st Sentence FTA is realised through a foreign partnership, the inclusion of this income in the trade tax base will not be reversed through a deduction under Section 9 No. 2 TTA.

Insofar as the taxpayer can show, in accordance with Sec 8 (2) FTA, that the branch has its own economic activity, then there will be no fictional add-back of the foreign passive income for trade tax purposes.

5 per cent add-back to trade tax base of dividends received from a controlled entity in a tax group

In its decision of 17 December 2014 (I R 39/14), the Supreme Tax Court held that the receipt of dividends through a controlled entity in a tax group does not lead to the application of Section 8b (5) of the Corporation Tax Act ("CTA" – i.e. the add-back of 5 per cent of the dividend as a fictional non-deductible business expense) for trade tax purposes. This means that a more favourable treatment is applied to dividends received through a controlled entity in a tax group than from an entity which is not a controlled entity in a tax group. This imparity should be corrected by the new draft Section 7a TTA.

The new draft Section 7a TTA does not affect the so-called theory of fractured unity or the general principle of the separate calculation of trading income each by the controlling entity of a tax group and by the controlled entities. According to the new rule, the deduction of dividends received according to Section 9 No. 2a, 7 or 8 TTA does not apply at the level of the controlled entity. The draft section proscribes that the deduction of dividends received according to Section 9 No. 2a, 7 or 8 TTA only applies to the controlling entity, applying Section 15 1st Sentence, No. 2 Sentence 4 CTA as before.

Amendment of the conditions for the application of Section 3 No. 40 Sentence 3 ITA and Section 8b (7) CTA for the prevention of tax avoidance schemes. In short:

- Exclusion of the application of Section 3 No. 40 Sentence 3 ITA and Section 8b (7) CTA for shareholdings, which, in the case of credit institutions and financial service institutions, are attributable to the trading portfolio within the meaning of the Commercial Code at the time the assets are initially included in the business property,;

- Exclusion of the application of Section 3 No. 40 Sentence 3 ITA and Section 8b (7) CTA for shareholdings, which, in the case of financial businesses, are disclosed as current assets at the time the assets are initially included in the business property;

- The financial businesses affected by Section 3 No. 40 Sentence 3 ITA and Section 8b (7) CTA will be restricted to those financial businesses, which credit institutions and financial service institutions, directly or indirectly, hold a majority interest in;

- Application of Section 3 No. 40 Sentence 3 ITA and Section 8b (7) CTA to non-EU/ non-EEA countries.

Do you have any questions?

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