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News in brief

Official Pronouncements

Draft discussion document for the promotion of R&D

In a draft discussion document the Federal Ministry of Finance has revealed plans for an annual research and development (R&D) grant costing a total of € 1.25 billion per annum. The plans provides for an initial duration of four years, after which an evaluation will follow. The Finance Ministry is thus currently planning total subsidy to the value of € 5 billion. According to the draft, the federal and state governments should each pay half of this amount.

The aim of the planned new regulations is to improve Germany's competitiveness as a business location and, in particular, to promote the attractiveness of Germany globally as a business location for new businesses and investment. To this end, an internationally competitive framework is to be created. For – according to the official view – Germany is one of the last countries within the EU (and possibly even within the countries of the OECD) that has not introduced R&D tax incentives.

<u>The basics…</u>

The plan is to introduce a new tax incentive scheme for R&D encompassing basic research, industrial research and experimental development. The scheme will be linked to personnel expenditure and will be available to all taxable enterprises irrespective of their size or the type of their economic activity. The regulations are to be contained in a separate tax statute ancillary to the Income Tax / Corporation Tax Acts .

<u>In more detail…</u>

The allowance will be available to both unlimited and limited taxpayers (including partnerships and associations) within the meaning of the Income Tax Act and the Corporation Tax Act. Tax exempt companies will not be able to benefit.
The basis of calculation for the grant ("assessment basis") will be the wages and salaries (as defined by Section 19 Income Tax Act) of the applicant's employees so far as these employees are working on an eligible R&D project. The assessment basis will be capped at € 2 million per company and per financial year. For affiliated companies, the assessment basis will only be available once for the group as a whole (group assessment).

The research grant will amount to 25 percent of the assessment basis per financial year (i.e. up to a max of € 500k p.a.) and should not exceed € 15 million per company over the life of a particular R&D project. This maximum amount has been set to ensure that the grant will conform with EU State Aid rules.

Research allowances will have to be applied for. The application should be submitted at the end of the financial year to the applicant's local income tax office (for partnerships, to the tax office responsible for the uniform and separate determination of income).

In order to obtain the grant, a certificate of eligibility must be submitted. The task of verifying and classifying the eligibility of the relevant R & D project will be assigned to an appropriate body outside the financial administration.

In principle, the research grant can be obtained even where other subsidies or state aid is provided (cumulative funding).

Furthermore, the provision of a research grant will be subjected to an evaluation under State Aid rules.

The allowance will be fixed at the end of the financial year and paid out within one month of the notification of the decision. According to the planned Research Allowance Act, the subsidy will not be considered as taxable income nor will it reduce the expenses deductible as operating expenses or income-related expenses. This is to ensure that 100 % of the grant is paid to the business entitled to it, irrespective of tax-rate progression.

Period of application / entry into force:

The Research Allowance Act is to enter into force the day after its publication in the Federal Gazette, and is initially to apply for 6 months. The period of validity will then be extended depending on the decision of the European Commission on the period of validity permissible under State Aid Rules.

Source: Draft discussion document of the Federal Ministry of Finance on the draft law on tax incentives for research and development (as of 27 February 2019)

Tax Court Cases

Non-deductible deemed business expenses not to be derived from merger profits within a tax group

If a corporation is merged into its parent company, which in turn is a controlled company within a corporation tax group (fiscal unity/"Organschaft") with a corporation as the controlling company ("Organträger"), the Supreme Tax Court has ruled that no flat-rate deemed business expenses are to be added back to profits under Section 8b (3) sentence 1 of the German Corporation Tax Act (CTA) either at the level of the parent company or at the level of the controlled company, where the said non-deductible flat-rate deemed business expenses are derived from a merger gain.

With this decision, the Supreme Tax Court judges rejected the practice of the Finance Ministry in its circular of 11 November 2011.

The dispute revolved around the question as to whether the tax office had correctly added back 5% of the merger gain as deemed non-deductible business expenses under § 8b (3) of CTA to the profits of the ultimate controlling company of a corporation tax group.

Facts

The appellant, an AG as the parent company of the Group held all shares in B-GmbH, which in turn held more than 95% of the shares in C-GmbH. C-GmbH was also a shareholder of D-GmbH with a stake of more than 95%. Corporate tax groups had been set up between the appellant and B-GmbH, between B-GmbH and C-GmbH, and – indirectly – between B-GmbH and D-GmbH, respectively.

The controlled company of the indirect tax group (D-GmbH) was not sold, but merged into C-GmbH (the interim company of the indirect tax group), i.e. the dispute was not about the assessment of a capital gain, but of a merger gain within the meaning of Section 12 of the German Transformation Tax Act.

Applying Section 15 1st sentence no. 2 CTA, according to which the participation exemption (under Section 8b CTA) was only to be applied at the level of the (ultimate) controlling company (the so-called "gross method"), the tax office had treated 5% of the merger gain as taxable in the hands of the appellant as the ultimate controlling company.

The judgment

Section 12 (2) 1st sentence (on the book value transfer) together with 2nd sentence (on the applicability of Section 8b CTA in merger cases) of the Transformation Tax Act 2006 are intended to have the effect that, in the case of an upstream merger - as here- of the subsidiary into the parent company, the merger profit at the level of the surviving corporation is treated as the profit from the sale of an investment within the meaning of § 8b (2) 1st sentence 1 CTA. The consequence of this would be that the transfer profit would have to be "exempted" and 5% of this profit would have to be added to the result of surviving company (here C-GmbH) as a non-deductible operating expense.

However, the non-application of Section 8b (1) to (6) CTA under in Section 15 1st sentence 1 no. 2 CTA means that the participation exemption is not taken into account when determining the income of the controlled company, but is only applied at the level of the controlling company(this is referred to as the "gross method") .

In this decision,the Supreme Tax Court addressed the previously controversial question of the extent to which this "gross method" can also be applied in the case of a merger profit from an upsteam merger to a controlled company in a tax group.

The Supreme Tax Court rejected the so-called "gross method" in this instance and was of the opinion that in the present constellation the add-back of flat-rate deemed business expenses did not apply to the merger profits from the merger of D-GmbH either at the level of C-GmbH or at that of B-GmbH or at the level of the appellant as ultimate controlling company.

The application of Section 8b CTA to the income of the surviving corporation provided for in the Transformation Tax Act 2006 is unconditionally suspended by Section 15 1st sentence 1 no. 2 1st sentence CTA where the surviving company is a controlled company in a tax group.

According to Section 15 1st sentence 1 no. 2 1st sentence CTA, Section 8b (1) to (6) CTA are not to be applied when determining the income of the controlled company.

In a next step, it is a requirement of Section 15 1st sentence 1 no. 2 2nd sentence CTA that, in order to apply Section 8b CTA at the level of the controlling company, the income attributable to the controlling compay from the controlled company must "include" the participation income. In this case, however, the income attributable the controlling company (B-GmbH) did not include the merger profit, because this was disregarded according to Section12 (2) 1st sentence Transformation Tax Act 2006. It, therefore, follows that Section 8b CTA (including Section 8b (3)) could not be applied at the level of the ultimate parent as the merger profit were not "included" in the income attributable to the controlling company.

Source: Supreme Tax Court judgment of 26 September 2018 (I R 16/16), published 27 March 2019

Unlimited tax liability with dual residency

The fact that a taxpayer has both a residence in Germany and a residence abroad does not, according to a ruling by the Supreme Tax Court, preclude the existence if an unlimited tax liability even when the foreign residence constitutes the centre of the taxpayer's vital interests

The taxpayer was resident both in Germany and in Romania and had had his main place of residence had been Romania since 2002. In his German income tax returns for the years 2003 to 2009, he declared himself to be subject to limited taxation and included the income earned in Germany from business operations, self-employment and income from renting and leasing various properties. The Tax Court also accepted the limited tax liability. As a result, his income earned in Romania was not included in the tax base.

The Supreme Tax Court took a different view of the case in two essential respects and has referred the case back to the tax court for a second hearing and decision.

In the opinion of the Supreme Tax Court, the assumption of the tax court that the taxpayer had a residence in Germany during the years in dispute had not been properly reviewed.

Furthermore, the tax court had wrongly reached the conclusion that a taxpayer with residences both in Germany and abroad could not be subject to unlimited income tax if his main place of residence was abroad.

<u>Appeal admissible</u>

The assessment, as to whether the residence is maintained and used, is in essence a question of fact. In this respect, the Supreme Tax Court, as a court of appeal pursuant to the Code for Tax Courts, is bound by the facts established by the tax court and their evaluation of the same. The higher court can, as a matter of settled case law, only review the conclusions of the tax court where these can be considered to illogical or in breach of general principles of common experience.

In the current case the tax court's conclusion that the taxpayer had a domestic residence did not involve sufficient findings of fact. The tax court just assumed that the taxpayer's domestic residence existed in all the years under review on the grounds that the apartment maintained there was suitable for permanent living and was at least occasionally visited by the taxpayer. However, the findings were made regarding the furnishing of the apartment in question, its actual occupancy, its availability or the taxpayer's intention to use the property. Accordingly, the case was returned to the tax court for a proper review and evaluation of the facts.

<u>Dual residence does not exclude unlimited tax liability</u>

According to the Supreme Tax Court, the fact that the taxpayer was resident in Romania did not exclude an unlimited tax liability. Section 8 of the General Tax Code allows a taxpayer to have several residences simultaneously. These can be located inland and/or abroad. In this respect, the provision recognisably assumes the equivalence of all residences of a person, since it only requires the existence of "a" residence without any further distinction. Section 8 of the General Tax Code does not differentiate between "principal residence" and a "secondary residence". The only decisive factor is whether it can be shown objectively that the taxpayer maintains the dwelling for the purposes of his own habitation.

Furthermore, so the Court, it cannot be inferred from the wording of Section 1 (1) 1st sentence of the Income Tax Act that only the residence which represents the centre of the vital interests can give rise to an unlimited tax liability. In this respect, the Supreme Tax Court referred to its earlier rulings on this subject (e.g. judgment of 25 May 2016 – I B 139/11), according to which a domestic residence leads to an unlimited income tax liability of a taxpayer even if the centre of his vital interests is abroad.

There was also no general principle of international tax law according to which every person may only be treated as subject to unlimited taxation by the state in which he holds the centre of his vital interests. In this respect, the question of whether there is unlimited tax liability in Germany must be distinguished from the question of where a person is deemed to be resident within the meaning of a double tax treaty ("DTT"). If an individual is resident both in Germany and abroad, he has a permanent residence in both states, rather than being resident only in the state with which he has closer personal and economic relations (centre of vital interests).

The Court noted that Article 4 (2) (a) DTT Germany/Romania, clearly only defines the term" residence" for the purposes of the application of the DTT itself. It state that residence "for the purposes of this treaty" means "a person resident in a Contracting State" and "a person resident in a Contracting State" means "a person resident in a Contracting State", inter alia, who, under the law of that State, is liable to tax there on account of his place of residence.

Source: Tax Court decision of 23 October 2018 (I R 74/16), published on 20 March 2019.

Düsseldorf Tax Court: Issue of shares as part of corporate action (spin-off) not taxable distribution-in-kind

According to the Düsseldorf Tax Court in a ruling of 29 January 2019 (press release from 2 April 2019), the issue of shares in Hewlett-Packard Enterprise Company (HPE) to shareholders of Hewlett-Packard Company (HPC) did not constitute taxable income.

Background

HPC carried out a corporate action in 2015: on 31 October 2015 it changed its name to Hewlett-Packard Incorporated (HPI). Subsequently, on 1 November 2015, it transferred its corporate customer business to a subsidiary, HPE, by way of a so-called "spin-off" . For one old share in HPC, the shareholders received one share in the renamed company HPI and one additional share in HPE. An international agency issued a new international securities identity number (ISIN) for the HPI share.

The plaintiff was a shareholder of HPC. His custodian bank withheld tax on the value of the issue of HPE shares. In his income tax return, the plaintiff claimed that the tax certificate issued by his bank was incorrect. The transaction was a tax-free stock split. The tax office, however, took the view that the share allotment was taxable as a distribution-in-kind. In this regard the tax office relied on a circular of the Federal Ministry of Finance dated 20 March 2017 (BStBl I 2017, 431).

Judgement

The tax court took a different view. The allotment of HPE shares is not a taxable event. The special income tax provisions for corporate action had to be applied. The spin-off carried out by HPI was a spin-off within the meaning of those special provisions. This spin-off did not give rise to any taxation at the point when the shares were allotted, because under the special provisions the new shares took the place of the existing shares. Through the application of the relevant special provisions the tax court was able to assume the continuation of the acquisition costs.

In its judgment, the tax court presented a detailed analysis about the concept of 'spin-off'. In doing so, it contradicted the Finance Ministry's circular, according to which in the event of a spin-off from a company not domiciled in the EU/EEA area, the ISIN of the spin-off company must be retained. The court did not consider the award of a new ISIN for a company, which had merely been renamed, as harmful.

The Court pointed out that the allocation of shares could become relevant for tax purposes at a later date. A final tax appraisal of the transaction had to be be made when the shares concerned were sold.

Harald Junker, Vice President of the Düsseldorf Tax Court emphasised the broad impact of the ruling: "The question of the tax consequences of the spin-off of Hewlett-Packard Incorporated in 2015 is also likely to be of significance for the corporate actions of other companies and thus for a large number of shareholders. It remains to be seen whether the tax authorities will lodge the appeal – which has been authorised by the tax court – because [the decision] deviates from the Finance Ministry circular."

Source: Düsseldorf Tax Court decision of 29 January 2019 (Case No. 13 K 2119/17 E): Press release 2 April 2019

From Europe

ECJ: Passive income attribution from controlled companies resident in third countries

The European Court of Justice has held that the German provision for the taxation of controlled company income from invested capital from outside the EU might fall under the "grandfather" clause of Art 64 TFEU, provided the German legislation has remained substantially unchanged since that date. It is now for the Supreme Tax Court to decide finally whether this is the case.

For some decades the Foreign Transactions Tax Act (FTTA) has acted as a brake on the transfer of profits to controlled companies with passive income in low tax regimes by adding the amount sheltered to the taxable income of the shareholder. If a company is a controlled company with income from invested capital , and if certain other conditions of Sec. 7 FTTA are fulfilled, that controlled company income is added to taxable income for both corporate and trade income tax purposes (the "attributed amounts").

A German parent company held a 30% participation in a subsidiary located in Switzerland that mainly had passive income and the tax office claimed the add-back of controlled company income from invested capital. The ensuing request for a preliminary ECJ-ruling by the Supreme Tax Court concerns the interpretation of Articles 63 TFEU (Free Movement of Capital) and 64 TFEU ("grandfather" clause / standstill clause). One of the key questions to be answered in the case at dispute is if the German passive income attribution rules (i.e. Sec. 7, 7a of the 2005 version of the FTTA applicable for the year in dispute) fall under the "grandfather" provisions of Art 64 of the TFEU, allowing the continued application of restrictions on the free movement of capital in force on December 31, 1993. This is the case if the present German legislation remained substantially unchanged since that date.

The referring Supreme Tax Court therefore asked the ECJ: First, whether Article 64(1) TFEU allows a restriction on free movements of capital between a Member State and a third country relating to direct investment, even though the scope of the FTTA-legislation in question has been extended after 31 December 1993 to also cover other types of investments, including 'portfolio' investments. Of major importance to the decision is also (second question) that the relevant provision in the FTTA in force on December 31, 1993 was in fact substantially amended in 2000 (with effect from January 1, 2001). The adoption of this regulation, however, was replaced in 2001 (i. e. before ever being applied in practice) by legislation essentially identical to that applicable on 31 December 1993.

German CFC rules may comply with EU law due to "grandfather" clause – The ECJ answered the two questions as follows:

First question: Article 64(1) TFEU allows a restriction to be applied on movements of capital between a Member State and a third country relating to direct investment, even though the substantive scope of the legislation at issue was extended after 31 December 1993 to also cover other types of investments, including 'portfolio' investments. The ECJ also held that the German tax amendment reducing the shareholding threshold for passive intermediary companies from 10% to 1% does not in itself affect the applicability of the "grandfather" clause.

Second question: In general, the ECJ sees the legislation in the FTTA as identical to that of 31 December, 1993 even if was substantially amended after 31 December 1993 but never came into force. Nevertheless, the referring Supreme Tax Court still has to determine whether, in the case at hand, the 2000 reform of the German CFC rules was adopted together with provisions effectively deferring the applicability of that reform, despite its entry into force.

Alternative scenario – ECJ gives a third answer

Finally – and in the event the Supreme Tax Court should conclude that the relevant provisions in the FTTA do not fall under the standstill clause – the ECJ then further examined whether an infringement of the free movement of capital is justified. According to the ECJ the German attribution rules in question could constitute a restriction of the free movement of capital that may be justified by overriding reasons in the public interest. A justification would be based on the need to prevent tax evasion or to counter merely artificial arrangements with the primary objective or one of its primary objectives to avoid paying the tax normally due on the profits generated by activities carried out in Germany. The ECJ went on to point out that the attribution of the controlled company income takes place automatically without providing the taxpayer with an opportunity to show to the tax authorities that his shareholding is not the result of an artificial scheme. On the contrary, the taxpayer should be able to provide commercial justification for the chosen arrangement and / or to prove the genuine nature of the intermediary company's economic activities.

Therefore, as the case in dispute involved a third country, it would be for the Supreme Tax Court to assess whether a legal framework existed between Germany and Switzerland which provided the German tax authorities with a suitable tool to verify that the taxable person's shareholding in the Swiss company is not the result of an artificial scheme. Only in the absence of such an agreement would the German FTTA-rules be appropriate and not constitute an infringement to the fundamental freedom of the movement of capital.

Source: European Court of Justice on 26 February 2019 i (C-374/17) The ECJ case reference is C-135/17 X judgment of February 26, 2019.

News in brief	
Extended trade tax deduction also possible for shareholdings in real estate management companies	Under the extended trade tax deduction, rental income derived by entities whose activities are limited to the administration of their own real property is deductible from the trading income subject to trade tax. The Grand Senate of the Supreme Tax Court held that this trade tax deduction is also available for a commercial GmbH & Co. KG with respect to its interest in a pure asset-management civil law partnership. *https://blogs.pwc.de/german-tax-and-legal-news/2019/04/03/extended-trade-tax-deduction-also-possible-for-shareholdings-in-real-estate-management-companies/*
Real Estate Transfer Tax Act: changes planned to the treatment of "share deals"	The Federal Ministry of Finance is planning to introduce a bill based on the proposals made by the Finance Ministers' Conference in November 2018 in relation to the Real Estate Transfer Act (RETT Act). It is currently envisaged that the changes, which are likely to be discussed in the Cabinet at the end of April 2019, should be included in the Finance Act 2019. *https://blogs.pwc.de/german-tax-and-legal-news/2019/03/29/real-estate-transfer-tax-act-changes-planned-to-the-treatment-of-share-deals/*

Input VAT claims and Brexit	Prior to the announcement on 21 March 2019 that Brexit may be postponed until either 12 April 2019, 22 May 2019 or possibly later, the British tax and customs authorities (HMRC) issued guidance on 18 March 2019 on the changes to VAT IT systems in the event of the United Kingdom leaving the EU on 29 March 2019 without a deal. *https://blogs.pwc.de/german-tax-and-legal-news/2019/03/22/input-vat-claims-and-brexit/*
No withholding tax on fees for online advertising	In the past in some individual cases, tax audits in Bavaria considered fees paid to foreign online companies for "advertising services" as the transfer of advertising rights. This caused irritation and some excitement with respect to a possible obligation for German withholding tax to be deducted at source from those payments. In the course of internal discussions and under the leadership of the Bavarian tax administration a joint agreement has now been reached amongst the tax administrations of all German states ("Länder") – with a favourable outcome. *https://blogs.pwc.de/german-tax-and-legal-news/2019/03/21/no-withholding-tax-on-fees-for-online-advertising/*
ECJ provides guidance on beneficial ownership and abuse of rights	On 26 February 2019, the ECJ issued its judgements in the joined cases T Denmark and Y Denmark -v- the Danish Ministry of Taxation (C-116/16 and C-117/16) and N Luxembourg 1, X Denamrk A/S, C Danmark I and Z Denmark ApS -v- the Danish Ministry of Taxation (C115/16. C-118/16, C-119/16 and C-299/16). These cases related to the question of whether dividend and interest payments were exempt from withholding tax, when the payments were made from a Danish company to a EU-resident company, and then(fully or partially) passed on by the EU-resident to the ultimate parent resident in a third country. *https://blogs.pwc.de/german-tax-and-legal-news/2019/02/28/ecj-provides-guidance-on-beneficial-ownership-and-abuse-of-rights/*
Expatriate exit taxation contravenes the Agreement for Free Movement of Persons	The ECJ held that the expatriate exit tax rule under Section 6 Foreign Tax Act contravened the principle of non-discrimination contained in the Agreement for the Free Movement of Persons between the EU and Switzerland. *https://blogs.pwc.de/german-tax-and-legal-news/2019/02/28/expatriate-exit-taxation-contravenes-the-agreement-for-free-movement-of-persons/*
Input tax deduction for advance payment despite non-delivery of ordered goods	The purchaser of thermal power units, which were not delivered due to fraud, shall not be denied the right to deduct input tax from an advance payment if the supply appeared to be certain at the time of payment. In three decisions, the Supreme Tax Court follows a judgment of the European Court of Justice (ECJ), to which it has referred the cases earlier for a preliminary ruling. *https://blogs.pwc.de/german-tax-and-legal-news/2019/03/08/input-tax-deduction-for-advance-payment-despite-of-non-delivery-of-ordered-good/*

If you would like to follow the latest news on German tax as it breaks, please visit our Tax& Legal News site at https://blogs.pwc.de/german-tax-and-legal-news/

From PwC

Guide to Doing Business and Investing in Germany

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http://www.pwc.de/en/internationale-maerkte/doing-business-and-investing-in-germany.html

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