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# Corporate Tax Law in Germany: Recent Changes and a Look Ahead

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# PRACTITIONERS' CORNER

## Corporate Tax Law in Germany: Recent Changes and a Look Ahead

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In this article, the authors discuss several recent legislative developments affecting corporate taxpayers in Germany and look ahead at potential developments on the horizon.

Germany enacted anti-base erosion and profit-shifting legislation in December. The most important changes for corporate taxpayers include:

- the disallowance of deduction of expenses for partnerships because of cross-border hybrid mismatch structures (section 4i German Income Tax Act (Einkommensteuergesetz, or EStG));
- revisions to the treaty override provision of section 50i EStG;
- a narrowing of the scope of the exception to the participation exemption for banking and financial institutions (section 8b German Corporate Tax Act (Körperschaftsteuergesetz, or KStG)).

Further, a separate bill extended the German loss forfeiture regime. The new section 8d KStG provides for a separate elective regime allowing taxpayers to maintain any current tax losses or tax loss carryforwards in specific cases. This bill took effect January 1, 2016.

### Partnership Anti-Double-Deduction Law

#### Unique Partnership Tax Creates Double-Dip Issue

German tax law treats partnerships as flow-throughs, meaning income is allocated to the partners and taxed in their hands. However, partnerships are subject to trade income tax.

Interest expenses incurred by a partner that are linked to partnership business (for example, interest expenses connected to acquiring the partnership interest) are treated as special business expenses and are deductible for German tax purposes at the level of the partnership. If the partner is a nonresident, the partner becomes subject to German-source taxation on any income from the partnership. Interest expenses incurred by the foreign partner (who receives a foreign tax deduction) are also tax deductible in Germany, resulting in the double-dip deduction.

The foregoing structure is frequently used by U.S. multinational corporations as a path into Germany, given the double-dip opportunity and because any profit repatriations out of the German partnership could be made free of any German withholding taxes.[1] Therefore, the rather complex anti-treaty-shopping provision would not apply.

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[1] *See* Wolfgang Kessler, Pia Dorfmueller, Wolfgang Schmidt, and Tobias Teufel, "European Holding Entities in Germany: Partnerships as Attractive Alternatives," *Tax Notes Int'l*, Sept. 3, 2001, p. 1217.

Under prior law, any interest expense deduction (that is, where the foreign partner took a loan linked to his interest in the partnership with an interest deduction both abroad and in Germany) could only be denied in Germany if the German partnership was the parent in a German tax group (Organschaft) and to the extent the interest deduction triggered a loss in Germany.[2]

### New Anti-Hybrid Rule for German Partnerships

The government has resumed an effort that began in late 2014 when the German states proposed the introduction of a new section 4, paragraph 5a EStG. The 2014 proposal would have extended anti-hybrid measures to individuals and partnerships using a far-reaching rule that would have denied a deduction of expenses when the corresponding income was not taken into account as taxable income.

The new law (the First Act to Implement Measures against Base Erosion and Profit Shifting (Gesetz zur Umsetzung der Änderungen der EUAmtshilferichtlinie und von weiteren Massnahmen gegen Gewinnkürzungen und -verlagerungen)) is not as far-reaching as the 2014 proposal because the scope of the new anti-hybrid measures is limited to partnerships. The new section 4i EStG disallows the German tax deduction in the German partnership structure discussed above. The German government took immediate action since the EU anti-tax-avoidance directive (COM(2016)26) refers only to corporations, but not to partnerships. The new rule applies for tax years ending after December 31, 2015. Disallowed expenses cannot be carried forward; they are denied entirely.

### Potential Violation of EU Law

During the legislative process, it was noted that this new section 4i EStG might violate EU law, since the rule only applies to nonresident or double resident taxpayers. It is uncertain whether the new provision could be justified by sufficiently important reasons. The Court of Justice of the European Union has previously ruled that the potential for a double deduction is not a sufficient justification for a restriction on the freedom of establishment when the state is still able to tax the income of the relevant taxpayer.[3]

## Restriction of the Treaty Override Provision

In the past, a German partnership holding was sometimes used to avoid German exit taxes when an owner wanted to change his state of residence. These partnerships usually did not carry out any trade or business. The German Federal Fiscal Court (Bundesfinanzhof) has held that this type of partnership does not constitute a permanent establishment as would be necessary for Germany to maintain its taxing right. The German tax authorities, which previously treated these structures as permanent establishments, have adopted the court's view. However, to ensure that Germany would not lose additional tax revenue on already existing structures, the German government designed section 50i EStG, a far-reaching treaty override provision for German partnership holdings. In practice, paragraph 2 of the provision proved too far-reaching, so that in the past three years no reorganizations or succession plans were implemented, since the rule (as worded) might have also applied to purely domestic cases and would have led to a full recognition of built-in gains.

This rule was recently amended with retroactive effect to January 1, 2014, so that the heavily discussed version of section 50i EStG will have no effect. In a nutshell, the provision was brought back to its initial goal and applies when a partner of a nonoperating partnership moves his residence out of Germany or a partnership interest is contributed to foreign EU corporation. In both cases, Germany would have lost its taxing right on any (future) capital gains without the treaty override provision.

### Potential Violation of EU Law

Notably, the new provision does not distinguish whether the partner's new residence would be an EU member state or a third country. It is unclear why the bill does not provide a special clause for EU cases, such as an interest-free tax deferral like that in the German exit provision applying to shareholders of a German corporation.

It is questionable whether discrimination against partners in a German nonoperating partnership who intend to move within the EU could be legally justified. Hence, the next amendment of section 50i EStG may follow soon.

## Limit on Participation Exemption Exception

The German participation exemption provides a corporate tax exemption for dividends received or capital gains recognized by corporate shareholders owning a stake of at least 10 percent in the relevant entity. Likewise, losses from the disposal of shares should not be tax deductible. Even though the participation exemption does not mandate a minimum holding period, it required that the shareholding was not for purposes of trading, an exception that typically affected financial institutions.[4] However, the wording of the law did not limit the exception to those institutions and it could also apply to holding companies that acquired and sold the same shares within one to two years, that is, shares

[2]Section 14, para. 1, no. 5 KStG; 2013 Dual Consolidated Loss Rule.

[3]*See Philips Electronics UK Ltd.*, C-18/11 (CJEU 2012 ).

[4]Section 8b, para. 7, second sentence KStG.

held as current assets.[5] On the one hand, holding companies used this limitation on the participation exemption to achieve a tax deduction of any capital losses. On the other hand, this limitation provided for some uncertainties about whether realized capital gains would actually be tax exempt.

Recognizing that the limitation on the participation exemption was used to claim a tax deduction for any capital losses, the government has now narrowed the limitation to actual financial institutions.[6] Holding companies outside the industry are no longer within the scope of the exception.

## Alternative Tax Loss Carryforward Regime

### Background: Rule on Forfeiture of Tax Losses

According to the change of control rule in section 8c KStG, tax losses are forfeited if a specified percentage of subscribed capital, membership rights, interest rights, or voting rights in a corporation are transferred indirectly or directly to an acquirer. This applies on a pro rata basis if more than 25 percent are transferred within five years and results in complete forfeiture if more than 50 percent are transferred within the same five-year period.

Within the change of control regime of section 8c KStG, losses are maintained to the extent of hidden reserves (built up by the loss company) and in specific intragroup transfer scenarios.[7]

### New Alternative Regime by Election

Under the newly introduced provision of section 8d KStG, tax losses are entirely deductible at the taxpayer's election if specified conditions are met. In order to qualify, the loss company must have carried on the same business for at least three years before the harmful share transfer. The term ''business'' means the company's entire business activity, maintained with a consistent profit motivation and defined by qualitative characteristics, in particular: the offered services and products, the customers and suppliers base, the markets served, and the qualifications of the employees.

The election is not available if the loss company:

- terminates a business;
- suspends a business;
- changes the business purpose;
- starts an additional business;
- invests in a partnership;
- is a parent in a German tax group; or
- transfers assets below fair market value.

These are all considered harmful events.

If these conditions are met, the taxpayer may elect a new alternative regime, which provides for a survival of tax losses. If a harmful event occurs, the company forfeits tax losses incurred as of the end of the calendar year before the harmful event. Hence, if a partial share transfer would lead to a pro rata forfeiture under the standard regime, and the taxpayer elects the new regime, the entire losses — not only pro rata — are forfeited if a harmful event occurs.

### Critical Analysis

Germany introduced the new regime under section 8d KStG as a response to economic circumstances. The expiration of unused tax losses in the event of a change of control, as happened under the prior regime, was nonsensical from both an economic and legal viewpoint, especially since these cases have little in common with loss trafficking. Therefore, the new rule is welcome because it provides further loss utilization opportunities to reduce unnecessary tax obstacles for those seeking added capital resources.

Still, the new regime contains very restrictive conditions. In particular, the requirement of an identical and continued business may pose a challenge. Entities that are relying on investments are also likely to be making (necessary) changes to their business model. The effectiveness of the new regime will depend on whether loss entities in need will truly be able to take advantage of it.

Since the new section 8d KStG regime states its own system of loss deduction, it should not give rise to any EU state aid discussions.

## Future Amendments on the Horizon

### Limitations on Deductions Under IP Box Regimes

A draft bill published on January 25, 2017, as now voted on by the government, introduces a new section 4j EStG restricting the deduction of royalty payments.[8] The proposal would cover (1) intragroup payments (2) to a foreign intellectual property rights holder (3) who is a related party and (4) whose corresponding royalty income is effectively taxed at a rate below 25 percent due to an IP box regime.

In accordance with the nexus approach of BEPS action 5, the new rule only applies to cases in which the IP box regime offers tax incentives even though the rights holder did not actually bear the research and development expenses for the intellectual property, especially if the right has been acquired or the IP was

[5]Circular IV A 2-S 2750a-6/02 of the Ministry of Finance of July 25, 2002.

[6]Section 8b, para. 7 KStG.

[7]*See* Pia Dorfmueller and Maximilian Meyer, ''Germany Broadens Intragroup Exception to Change of Control Rule,'' *Tax Notes Int'l*, Jan. 4, 2016, p. 77.

[8]*See* Ryan Finley, ''Proposal Would Disallow Deductions Involving Harmful IP Boxes,'' *Tax Notes Int'l*, Jan. 2, 2017, p. 57; and Ryan Finley, ''Germany Passes Anti-Patent-Box Law as Neighbors Keep Pre-BEPS Regimes,'' *Tax Notes Int'l*, Jan. 30, 2017, p. 423.

developed by a related party. To the extent the effective tax rate is below 25 percent, the payment is not deductible for German tax law.

### Reporting Obligations of German Residents

Another draft bill, published on December 21, 2016, is touted as Germany's response to the ''Panama Papers affair.'' It would add new obligations for residents to report the existence of a decisive influence on some entities outside the EU to section 138, paragraph 4 of the Fiscal Code of Germany (Abgabenordnung). The individual obligations are backed up by corresponding obligations for financial institutions. The intent of these reporting obligations is to ensure an appropriate degree of transparency in cross-border business relationships between domestic taxpayers and foreign entities. ◆

### COMING ATTRACTIONS

A look ahead to upcoming commentary and analysis.

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