Tax Exemption for Restructuring Gains

In its meeting on 27 April 2017, the Bundestag (lower house of the German parliament) adopted the law to counter harmful tax practices in connection with the licensing of rights (Anti-Patent-Box Law).

The law contains, among others, the tax exemption for restructuring gains. The planned reintroduction of a statutory tax exemption for restructuring gains is a reaction of the German legislator to the decision of the Grand Senate of the Federal Tax Court (BFH) of 28 November 2016 (GrS 1/15). The BFH has ruled that the tax privileges for restructuring profits provided for in the so-called Restructuring Decree of the Ministry of Finance (BMF guidance dated 27 March 2003) violate the constitutional principle of legality of administrative actions (see March 2017 Edition of German Tax Monthly). The legal provision has become necessary in order to increase legal certainty for enterprises in restructuring proceedings.

By way of a new legal provision (§ 3a EStG-E - draft Income Tax Act), restructuring gains from a waiver of debt for the purpose of a company-related restructuring shall be tax exempt if the taxpayer provides evidence for the necessity and capacity of a recapitalization of the company at the time of the debt cancellation, the suitability of the debt cancellation for business reasons, and the creditor’s recapitalization intention. At the same time, restructuring costs (in particular payments on debtor warrants and expenses for e.g. the restructuring plan and restructuring advisory) may not be deducted, independently of the assessment period in which they accrue.

Double privileges could arise if full tax exemption is granted for restructuring gains even though there is an unused potential to set off tax losses that could be carried forward to future assessment periods. In order to prevent such unjustified double privileges, a certain potential to set off losses is to be exhausted up to the amount of the restructuring gain reduced by the non-deductible restructuring costs. In this regard, the new regulation includes a comprehensive list of tax losses in the order of which the loss exhaustion is carried out.
The revisions shall first be applicable to cases where the debt was fully or partially waived after 8 February 2017 (date of publication of the above-mentioned decision of the Grand Senate). In cases where up to this key date the debt cancellation was announced or a binding ruling by the tax office was issued, any equitable measures of the above-mentioned hitherto existing restructuring decree of the BMF shall continue to be applicable on grounds of the protection of legitimate expectations. Furthermore, in cases where a binding ruling is available and the debt cancellation has been pronounced after 8 February 2017, taxpayers shall be able to choose between the application of the new provision or the provision on the protection of legitimate expectations.

In addition, a new BMF guidance dated 27 April 2017 was published which contains regulations concerning protection of legitimate expectations for waivers of debt which arose before 8 February 2017 and tax rulings which were issued before or after this key date.

The revisions, however, still require an approval under state aid law by the EU Commission before entering into force. The law is pending consent by the Bundesrat (upper house of the German Parliament), which will possibly be granted on 2 June 2017, as well as the promulgation in der Federal Law Gazette.

Change of Control Rules (§ 8c KStG) partially Incompatible with Constitutional Law

With its decision of 29 March 2017 (2 BvL 6/11), the Federal Constitutional Court [BVerfG] ruled that the German Change of Control Rules pursuant to § 8c Corporate Income Tax Law [KStG] as it stood up to 31 December 2015 are partially unconstitutional.

The plaintiff of the initial proceedings is a corporation with two shareholders that closed the years 2006 and 2007 with a loss. In 2008, it generated a profit. As a result of the loss carryforwards, almost no corporate tax and trade tax was due in 2008. A deduction of losses, however, was not possible because 48% of the shares in the company were transferred to an acquirer in 2008. According to the German Change of Control Rules, if within a five-year period more than 25% and up to 50% of the share capital is transferred to an acquirer, unused losses are forfeited pro rata (§ 8c (1) sent. 1 KStG). If, however, more than 50% of the share capital is transferred, unused losses are forfeited in total. Hence, in the case at hand, losses were forfeited pro rata (48%) pursuant to § 8c (1) sent. 1 KStG.

According to the decision of the BVerfG, the pro rata loss forfeiture (§ 8c (1) sent.1 KStG) in cases where more than 25% and up to 50% of the share capital is transferred is incompatible with the general principle of equality (Art. 3 (1) Constitutional Law). The regulation treats corporations differently depending on whether or not there is a detrimental change in ownership. In the event of a detrimental change in ownership, losses are forfeited pro rata although the economic capacity of the corporation is not changed by the mere transfer of share capital. The provision is based on the principle that the taxable entity who wants to make use of the loss deduction must be identical with the taxable entity who incurred the loss. It is not apparent, according to the BVerfG decision, why in cases where more than 25% and up to 50% of the share capital are transferred, a change of identity of the corporation should be assumed as a rule.

The reason for temporally limiting the declaration of incompatibility until 31 December 2015 lies in the introduction of an exception effective as of 1 January 2016, the new § 8d KStG. According to this new rule, tax losses shall be retained despite a detrimental change in ownership within the meaning of § 8c KStG provided that the corporation has maintained the same business operations since its formation or at least for a period of three years. The BVerfG is of the opinion that a separate examination is necessary to establish whether the introduction of the new section has reduced the scope of applicability of § 8c (1) sent. 1 KStG to such extent that the norm now meets the constitutional requirements.

The decision exerts direct effect on detrimental transfers of share capital of more than 25% and up to 50% executed between 1 January 2008 and 31 December 2015. For cases dated from 1 January 2016 onwards (subject to the provisions of the new § 8d KStG) it remains to be seen whether a relevant case will be referred back to the BVerfG for a new decision.

The BVerfG obliged the legislator to decide on a revision by 31 December 2018 with retroactive effect for the period of time between 1 January 2008 until 31 December 2015 and to remove the assessed violation of the constitution. Should the legislator fail to meet this obligation, the provision in the extent of its incompatibility shall on 1 January 2019 be rendered invalid with retroactive effect as of the date of its entry into force.

The legal revision to be created must at least cover all cases not yet final and conclusive. Cases affected by the decision of the
BVerfG should therefore (continue to) be kept open. Particular attention should be paid to prevent the assessment from becoming statute-barred.

The decision-making principles should also apply to the forfeiture of trade tax losses insofar as more than 25% and up to 50% of the shares in a corporation are transferred.

The BVerfG did not decide on the question whether or not the total forfeiture of losses in the event of a detrimental transfer of share capital of more than 50% (§ 8c (1) sent. 2 KStG) is unconstitutional. In these cases, in particular the change of the economic identity of the corporation may be assessed differently since a majority participation is being transferred. To resolve this question, a procedure, which had been suspended until the issuance of the BVerfG decision, is currently pending before the Federal Tax Court (I R 31/11).

**BFH (I R 2/15): No Deduction of So-called Final Permanent Establishment Losses Pursuant to EU Law**

In its judgment of 22 February 2017, the Federal Tax Court (BFH) ruled that so-called final losses of foreign permanent establishments may not be deducted even under EU law. Thus, the BFH has abandoned its previous case law.

A corporation resident in Germany (GmbH) was a member of a German partnership (KG), which maintained a permanent establishment in Italy. The GmbH sold its share to another partner of the KG. Since future losses were expected for the KG, the GmbH compensated the acquirer for purchasing its share. The local tax office denied the deduction of the compensation payment as business expenses to the extent that it related to the Italian permanent establishment, because pursuant to the Double Tax Treaty Italy (DTT Italy), the exemption method applied to the income of the Italian permanent establishment in Germany.

The BFH agreed with the local tax office and denied the deduction of the compensation payment to the extent that it related to the Italian permanent establishment. The BFH explained that a deduction is not permissible, because the principle of symmetry applies which means that both the positive and negative income of the permanent establishment was covered by the DTT exemption method. Recognizing the expenses in derogation of this principle based on the EU fundamental freedoms is also no longer possible considering the most recent case law of the CJEU.

Until recently the BFH assumed for so-called final permanent establishment losses that can definitely no longer be utilized in the source state that a deduction is to be granted in Germany because otherwise this would amount to discrimination compared to losses of domestic establishments - and thus to a breach of the freedom of establishment (BFH decision of 5 February 2014, I R 48/11). With this reasoning, the BFH followed the case law of the CJEU (C-446/03, “Marks & Spencer”; C-414/06 “Lidl Belgium”; C-123/11, “A Oy”).

However, according to the view of the BFH the CJEU no longer upholds its previous principles since the decision in the Timac Agro case (17 December 2015 - C-388/14) (see **January/February 2016 edition of German Tax Monthly**). In the opinion of the BFH this decision shows that the CJEU holds the view that a foreign permanent establishment covered by the exemption method and a purely domestic case are not comparable. As a consequence, a restriction of the fundamental freedoms is already precluded due to the principle of symmetry.

Another case involving final permanent establishment losses is currently pending at the BFH (BFH I R 18/16). It remains to be seen whether the BFH reaffirms its decision or whether it will make a new request for a preliminary ruling to give the CJEU the opportunity to detail its position on final losses. Considering the BFH’s relatively clear reasoning, however, this appears rather unlikely.

**Bundestag Decision on the Anti-Patent-Box Law**

In its meeting on 27 April 2017, the Bundestag (lower house of the German parliament) adopted the law to counter harmful tax practices in connection with the licensing of rights (Anti-Patent-Box Law).

The Anti-Patent-Box Law is designed to restrict the tax deductibility of royalty expenses and other expenses for the licensing of rights to related persons under certain conditions. For further details regarding the Anti Patent Box Law see **January/February 2017 edition of German Tax Monthly**.

The version of the law adopted by the Bundestag includes further amendments, in particular an increase of the value limit for the immediate write-off of low cost assets and a tax exemption for INVEST and EXIT Grants.

The acquisition or manufacturing costs for limited-life movable fixed assets can immediately be written off in full provided they do not exceed 410 € (so-called low cost assets). This upper value limit, which has remained unchanged for several decades, shall now be in-
creased to 800 €. Instead of an immediate write-off a collective item, to be written off across a period of five years, can be formed for assets the acquisition or manufacturing costs of which exceed 150 € but not 1,000 €. In this case, assets with acquisition or manufacturing costs of up to 150 € can be written off immediately. The value limit of 150 € shall be increased to 250 €. The increased value limits shall first be applicable to assets that have been acquired, manufactured or contributed to the business assets after 31 December 2017.

The INVEST Grant for so-called venture capital shall enhance the attractiveness of equity investments, in particular for newly established corporations. The subsidy granted by the government to private investors has so far been tax-exempt under certain conditions. Since the requirements for an INVEST Grant for venture capital changed in December 2016, the existing tax exemption is to be aligned to the new grant conditions. In connection with the amendment of the grant conditions, an additional grant ("EXIT amendment of the grant conditions. In connection with the alignment to the new grant conditions, the existing tax exemption is to be increased in December 2016, an INVEST Grant for venture capital shall enhance the attractiveness of equity investments.

In its decision of 9 February 2017, the Lower Tax Court of Hamburg ruled that Art. 9 (1) Double Tax Treaty (DTT) Turkey has no overriding effect over the add-back provision of § 8b (3) Sent. 4 Corporate Income Tax Law (KStG), because the provision has to be considered as a special abuse provision relating exclusively to the domestic case.

According to § 8b (3) sent. 4 KStG, profit reductions arising in the context of a loan receivable or the realization of collateral provided with respect to the loan may not be considered when determining the income of the corporation, if the loan is granted by a shareholder who holds or held more than 25% of the stated or share capital. If it is possible to establish that an unrelated third party would also have granted, or would not have demanded repayment of, the loan under otherwise identical circumstances, there will be no add-back pursuant to § 8b (3) sent. 6 KStG.

In the case at issue, a German parent held 100% of the shares in a Turkish subsidiary to which it granted an unsecured loan. On 31 December 2011, the parent wrote down the book value of the loan receivable to the lower going-concern value.

The question at issue was whether Art. 9 (1) DTT Turkey overrides the provision of § 8b (3) sent. 4 KStG, so that the off-balance sheet add-back of the amount of the write-down to the lower going-concern value would not apply. The plaintiff held the view that Art. 9 (1) DTT Turkey precludes the application of § 8b (3) KStG.

However, the Lower Tax Court of Hamburg ruled that Art. 9 (1) DTT Turkey has no overriding effect over the add-back pursuant to § 8b (3) sent. 4 KStG. The principle of "dealing at arm’s length" according to Art. 9 (1) OECD Model Tax Convention (OECD MTC) and Art. 9 (1) DTT Turkey does not preclude the off-balance add-back of profit reductions. The rulings passed in the context of § 1 Foreign Transactions Tax Law (ASTG) have no implications for the case at issue.

In addition, according to the Lower Tax Court of Hamburg, the provision of § 8b (3) KStG qualifies as an anti-abuse clause exclusively relating to the domestic case, because if a write-down to the lower going-concern value of a loan is added back pursuant to § 8b (3) sent. 4 KStG, the profit reduction will only have an effect on the balance sheet in the domestic context. Hence, there is no reason to subject the write-down to a provision under treaty law corresponding to Art. 9 (1) OECD MTC. Section 8b (3) sent. 4 KStG is applicable in the present case.

Appeal has been filed against this judgment. The proceedings are pending with the Federal Tax Court (BFH) under the case number I R 19/17.

Guidance by the Federal Ministry of Finance Regarding the Application of the New § 36a German Income Tax Law

In conjunction with the introduction of the Investment Taxation Reform Act (InvStRefG) promulgated on 26 June 2016, the new § 36a was included in the Income Tax Law (EStG). The new provision allows investors to credit withholding tax on German dividends provided that they hold the shares for at least 45 days (so-called minimum holding period around the dividend record.
As of the date of the document, legal and economic owners would need to assume at least 70 percent risk of loss in value within this period of time (see January/February 2016 and July 2016 edition of German Tax Monthly).

The guidance issued by the Federal Ministry of Finance (BMF) on 3 April 2017 governs the application of the new § 36a EStG. In the guidance the BMF expresses its view on, amongst other matters, the minimum holding period and the 70% minimum risk of change in value.

With regard to the minimum holding period, the BMF provides explanations on the due date of capital income, the beginning and end of the actual holding period and the calculation of the holding period.

The guidance provides two alternatives as to how to calculate the minimum risk of change in value. In addition, the BMF specifies cases in which the necessary risk of change in value does not exist.

In this context the BMF voicing doubts in particular about securities lending transactions, repo transactions and equity swap contracts.

These substantiations might also be relevant for taxpayers covered by the scope of § 50j EStG. This provision was introduced in conjunction with the Anti-BEPS I Law, which was promulgated on 23 December 2016. It contains a rule for the avoidance of so-called cum/cum treaty shopping, following the provision of § 36a EStG regarding the minimum holding period and the minimum risk of change in value (see January/February 2017 edition of German Tax Monthly).