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Federal Ministry of Finance on Economic Reasons Justifying a Business Transaction at Non-Arm's Length Conditions

In its decision of 31 May 2018, the Court of Justice of the European Union (CJEU) ruled in the case C-382/16 "Hornbach-Baumarkt" that a provision such as that of § 1 German Foreign Transactions Tax Act (AStG) must grant the resident taxpayer the option to demonstrate that conditions were agreed due to economic reasons arising from the status as shareholder of the non-resident company. In the case at hand, a subsidiary was reliant on the transfer of capital to expand its business operations. In such cases, economic reasons could justify granting of capital from the parent company at non-arm's length conditions.

According to § 1 AStG, the income of a taxpayer from a business relationship to a related party abroad is to be corrected, if his income is reduced by the fact that he does not base his income determination at arm's length conditions.

By letter dated 6 December 2018, the German Federal Ministry of Finance (BMF) responded to the aforementioned CJEU judgment. Accordingly, in the opinion of the BMF an income correction is to be waived, if the taxpayer is able to demonstrate relevant economic reasons that necessitate an agreement deviating from the arm's length principle in order to safeguard the otherwise threatened economic existence of the group as such or parties related to the taxpayer (so called restructuring measure). Restructuring measures are targeted at preventing over-indebtedness or insolvency and ensuring the ability of the group or related party to continue as a going concern. The taxpayer is required to demonstrate the necessity of a restructuring measure, particularly the need for restructuring and the ability to restructure on the part of the group or related party.

As the CJEU based its judgment on freedom of establishment, the ruling is not applicable for third country situations. In the cases concerned, it is necessary to investigate whether economic reasons exist, which justify an agreement at non-arm's length conditions.

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Data Exchange for Country-by-Country Reporting between Germany and the USA for 2017

The German Federal Ministry of Finance has published a joint statement by the competent authority of the Federal Republic of Germany and the competent authority of the United States of America on implementing spontaneous exchange of country-by-country reporting. Accordingly, country-by-country reporting is to be exchanged for financial years commencing in 2017.

Under German law, certain domestic companies which prepare consolidated financial statements or are included in the consolidated financial statements of a non-domestic company must prepare a so-called 'country-by-country report' and submit it to the German Federal Central Tax Office. This standardized report serves to provide the tax authorities with information on the entrepreneurial activities as well as potential tax risks of transfer pricing arrangements of multinational groups.

The purpose of the joint statement by the competent authority of the Federal Republic of Germany and the competent authority of the United States of America is to increase international tax transparency through the spontaneous exchange of country-by-country reporting by means of group KPIs and to improve access by their tax authorities to information on the global distribution of income, taxes paid and certain indicators of the location of economic activity in tax jurisdictions in which multinational corporations are active, in order to assess major transfer pricing risks and other risks in connection with base erosion and profit shifting.

The joint statement applies to country-by-country reporting of multinational corporations for financial years commencing after 31 December 2016 and before 1 January 2018. Spontaneous exchange is a transitional solution, which will be replaced by continuous Automatic Exchange of Information (AEOI) on conclusion of an appropriate administrative agreement with the USA. Such a transitional solution was already introduced for country-by-country reporting for financial year 2016 and will be extended by one year by way of the joint statement.

Federal Tax Court (I R 52/16): Taking into Account Non-Domestic Losses based on Switch-Over Clause

In its judgment of 11 July 2018, the Federal Tax Court [BFH] decided that the so-called 'switch-over clause' in German tax law covers both positive and negative income due to a lack of differentiation in the law. Accordingly, losses incurred abroad may also have to be taken into account for tax deduction purposes.

The switch-over clause always applies to cases where a contracting state to a tax treaty has been attributed the right to tax income generated in that country, however does not actually exercise this right to tax due to a diverging interpretation of the tax treaty. As a consequence, no taxation occurred abroad (so-called qualification conflict, § 50d (9) German Income Tax Act [EStG]). In such a case, German tax law denies the exemption of income that would in fact be imperative under the tax treaty and considers this income part of German taxable income. This is to prevent non-taxation of the income.

In the case of the above judgment, the plaintiff was an independent lawyer who maintained an office in Brussels (Belgium) in 1991 to 2004 in addition to his own law firm in Germany. At this office, he employed a lawyer who represented the German law firm and also managed engagements from Brussels. The office generated substantial losses. The German tax authorities considered the office maintained by the plaintiff in Brussels a 'fixed establishment' within the meaning of the tax treaty, according to which Belgium has tax jurisdiction under the tax treaty. On the part of the Belgian tax authorities the plaintiff was however not considered resident in Belgium. Consequently, losses were not determined in Belgium.

In dispute was whether the switch-over clause also covers negative income (losses), so that the plaintiff could deduct these in Germany.

The Lower Tax Court of Munich affirmed existence of a 'fixed establishment' within the meaning of the tax treaty in Belgium as well as applicability of the switch-over clause also to losses. As Belgium does not actually exercise the right to tax attributed to it under the tax treaty, the losses in Germany are not tax-exempt, but should be deducted in Germany.

The Federal Tax Court [BFH] has also confirmed the fundamental applicability of the switch-over clause to losses. As the retroactive consideration of losses has a beneficial effect for the taxable entity, retroactive introduction of the switch-over clause in 2006 would also not have a detrimental effect. However, a condition for applying the switch-over clause in the years under dispute would be that non-taxation in Belgium must be based on a diverging interpretation of the tax treaty and not be caused by national regulations on limited tax

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liability in Belgium. In the case at hand, the Lower Tax Court of Munich, as trial court, would therefore be in charge of the investigation (so far not conducted) as to why the losses were actually not determined.

This is because the switch-over clause was expanded in 2007 – albeit without retroactive tax effect – so that also in cases, in which actual non-taxation (despite the right to tax under the tax treaty) is based on provisions of the foreign national tax law, the switch-over clause applies as well.

It remains to be seen how the Lower Tax Court of Munich decides.

Lower Tax Court of Hesse (8 K 1279/16): Participation Exemption for Trade Tax Purposes for Dual Resident Corporations

In its judgment of 19 October 2018, the Lower Tax Court of Hesse ruled that the participation exemption for trade tax purposes may also be applied in cases where the corporation paying dividends is domiciled abroad and has its management in Germany (dual resident corporation).

Pursuant to German tax law, dividends received by a German corporation are trade tax-exempt at a rate of 95% if certain conditions are fulfilled (so-called participation exemption for trade tax purposes). The preconditions are dependent upon where the corporation paying dividends is domiciled. If it is domiciled in Germany, the participation exemption for trade tax purposes is applied in cases of an ownership interest of at least 15% in the corporation paying dividends at the beginning of the taxation period. If it is a corporation that has its registered office and place of management in another EU member state, an ownership interest of at least 10% at the beginning of the calendar year is sufficient. If it has its registered office and place of management in a non-member state, an ownership interest of at least 15% since the beginning of the calendar year is required. Moreover, the corporation paying dividends must have active operations.

In the case under dispute, a limited liability company [GmbH] with registered office and management in Germany (plaintiff) held all the ownership interests in a dual resident corporation (having its registered office in Belgium and management in Germany; hereafter "T"). In the year under dispute (2009), T distributed profits (dividends) to the plaintiff.

In dispute was whether the participation exemption for trade tax purposes should be applied at the level of the plaintiff or whether the dividends were subject to trade tax in full at the plaintiff.

The tax office denied application of the participation exemption for trade tax purposes on the grounds that, according to the law, the corporation paying dividends must either have its registered office and management outside Germany or be domiciled (resident) in Germany. A corporation was only resident in Germany if it has its registered office and management in Germany.

However, the plaintiff was of the opinion that for residency in Germany is sufficient if the corporation only has its management in Germany. If the participation exemption for trade tax purposes were not to apply to the payment of dividends by dual resident corporations, this would amount to an unjustifiable unequal treatment under European law.

The Court ruled in favour of the plaintiff deciding that only 5% of the dividends paid was subject to trade tax in the case at hand. The term "domiciled in Germany" would have to be interpreted such that this not only applies to corporations with domestic management established in Germany but also to entities established in other countries which are comparable to a German corporation in terms of their legal structure and whose management is located in Germany. This was also in line with the intent and purpose of the participation exemption for trade tax purposes, meaning that distributed profits are not to be taxed twice, i.e. both at the level of the distributing corporation and the recipient.

As this decision is subject to appeal (appeal pending before the German Federal Tax Court under file number I R 43/18) it remains to be seen how the BFH will decide.

Lower Tax Court of Hamburg (6 K 77/16): Carryover of Book Values in the Event of Spin-off

In its judgment of 18 September 2018, the Lower Tax Court of Hamburg ruled that in a case where the preconditions for sale are demonstrably created as a result of the division, spin-off at book value is not possible even if the harmful sale does not actually occur until after the end of the five-year period or if the 20% threshold is not exceeded.

If the assets of a corporation are transferred to other corporations as a result of split-up or spin-off, the transferred assets must be recognised at fair market value.

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Alternatively, they can be recognised at their book value upon application if certain conditions are fulfilled. However the option to use their book value does not apply if as a result of the split-up the requirements for sale to external parties are fulfilled (§ 15 (2) sent. 3 German Reorganisation Tax Act [UmwStG]). This can be assumed according to the law if within five years of the transfer date for tax purposes shares in a corporation involved in the split-up are sold that represent more than 20% of the shares in existence prior to the split-up of the corporation taking effect (§ 15 (2) sent. 4 UmwStG).

In the case decided by the Lower Tax Court of Hamburg, all the ownership interests held in E-GmbH were split off to form the new company L-GmbH in 2008 with retroactive tax effect from 31 December 2007. The objective of restructuring was to sell the shares in L-GmbH to third parties. For this reason, spin-off of the shares in E-GmbH to the company still to be established (L-GmbH) was already agreed in the contract of sale dating back to 2007. The local tax office was of the opinion that in this case a restriction on sale applies and therefore denied book valuation.

The Court ruled in favour of the tax authorities deciding that tax-neutral carryover of book values is not possible in the case at hand. The Lower Tax Court emphasised that the provision of § 15 (2) sent. 3 UmwStG is independent in its scope of application irrespective of § 15 (2) sent. 4 UmwStG. Consequently, if the preconditions for sale are demonstrably created as a result of the division (restriction on sale pursuant to § 15 (2) sent. 3 UmwStG), spin-off at book value would also not be possible in cases where the harmful sale does not actually occur until after the end of the five-year period or if the 20% threshold is not exceeded (preconditions of § 15 (2) sent. 4 UmwStG). The Court clarified further that the restriction on sale in particular refers to scenarios in which it was already ensured on the date of division through a contractual agreement between the future parties to the sale that the planned sale is to be implemented. The provision of § 15 (2) sent. 4 UmwStG (exceeding the 20% threshold within five years of the division) was not to be understood as definitive. In other cases it would have to be ascertained on a case-by-case basis whether the preconditions for sale are created and this therefore constitutes abuse. This would have to be judged on the basis of the specific circumstances of the individual case. The Lower Tax Court of Hamburg thereby upheld the administrative opinion of the Finance Ministry of Brandenburg in its decree of 16 July 2014 and of the Finance Ministry of Hamburg in its decree of 13 April 2015 and ruled contrary to the judgment of the Lower Tax Court of Berlin-Brandenburg of 31 May 2018 (9 K 9143/16; appeal pending I R 27/18).

This decision is still subject to appeal; the appeal is pending before the German Federal Tax Court under file number I R 39/18.

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