German Tax Monthly

Information on the latest tax developments in Germany

May | 2019

Federal Ministry of Finance Guidance on Tax Deduction for Online Advertising

There have been cases in recent months where tax authorities subjected payments to non-resident portal operators for online advertising to the deduction of withholding tax. This has created uncertainty especially as this approach of individual tax offices was not based on a coordinated opinion agreed between federal and state tax authorities. The tax offices concerned were instructed to keep such cases open until the position at federal/state level was clarified, so that advertisers would not be taxed. The highest federal and state tax authorities had already intermittently agreed in March that proceeds from online advertising are not subject to withholding tax. This legal view has now been upheld by the German Federal Ministry of Finance [BMF] in the form of official guidance.

Taxpayers that are not resident in Germany are subject to limited tax liability for their German-source income. Such income can include income from the time-limited assignment of rights or the assignment of a right to use commercial, technical, scientific and similar expertise, knowledge and skills, which are used in Germany. The income tax on such income is imposed by way of a tax deduction. The payment debtor must make the tax deduction for the account of the creditor and pay the withheld tax to the Federal Central Tax Office.

According to the BMF guidance of 3 April 2019, payments received by non-resident platform operators and internet service providers for the placement of online advertising on internet pages are not subject to tax deduction. Tax is withheld neither for the time-limited assignment of rights nor for the assignment of a right to use commercial, technical, scientific and similar expertise, knowledge and skills in such cases. Therefore, the payment debtor is not required to withhold, pay or file for such withholding tax.

This applies to payments for advertising during searches using online search engines and online intermediation platforms, for social media advertising, banner advertising and other similar online advertising and irrespective of whether and under what

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circumstances payment arises on the basis of specific contracts (e.g. cost per click, cost per order or cost per mille, revenue share).

The guidance is applicable to all open cases.

Federal Tax Court (I R 16/16): Transfer Gain from Upstream Merger in the Case of a Tax Group

In its judgment of 26 September 2018, the Federal Tax Court [BFH] ruled that in the case of upstream merger into a controlled entity, the general non-deductibility of business expenses pursuant to § 8b (3) sent. 1 of the German Corporate Income Tax Act [KStG] does not apply, neither at the level of the controlled entity nor at the level of the controlling entity.

From a German perspective, an upstream merger resembles an exchange-similar transaction and is therefore treated as a sale in principle. In a merger, the transfer gain or loss is not recognised at the transferee corporation. In addition, non-deductible business expenses in the amount of 5% of the capital gain must be assumed. In the case of a tax group, the provisions of § 8b KStG do not apply at the level of the controlled entity, but only when the income of the controlling entity is determined (so-called gross method).

In the case decided by the BFH, the tax group for corporate income tax purposes consisted of B-GmbH as controlling entity and C-GmbH as controlled entity. C-GmbH, in turn, had participating interests in the subsidiary D-GmbH. With retrospective tax effect as at 31 December 2006, D-GmbH was merged into its parent company, C-GmbH. The tax office was of the opinion, after a tax audit, that the gain on takeover is tax-exempt, however that 5% of this gain must be treated as non-deductible business expenses.

The BFH ruled that 5% of the tax-exempt transfer gain of C-GmbH from the merger of D-GmbH is not to be added back. This is a special case in which the absorbing legal entity is a controlled entity. This has the consequence with respect to the investment income of the controlled entity (dividends and capital gains) that this income is taken into account in a first step when determining the controlled entity's income (gross method). It is only in a second step that the tax exemption and general non-deductibility of business expenses applies at the level of the controlling entity. It is currently under dispute to what extent the gross method can also be applied to transfer gains on upstream merger into a controlled entity. The BFH came to the conclusion that the generally applicable non-deductibility of business expenses is unconditionally suspended if the absorbing entity is a controlled entity. When determining the income of the controlling entity, the gain on transfer must also be disregarded. Accordingly, in the case at hand, the non-deductibility of business expenses applies neither at the level of the controlled entity nor at the level of the controlling entity.

With this judgment, the BFH ruled against the opinion of the tax authorities in marginal ref. 12.07 of the Reorganisation Tax Decree, according to which the non-deductibility of business expenses does apply.

Grand Senate of the Federal Tax Court (GrS 2/16): Extended Deduction for Property for Trade Tax Purposes

Commercially active partnerships and corporations are subject to trade tax. Companies that only manage and use their own real estate can deduct the portion of trade income for trade tax purposes which is attributable to the management and use of own real estate (so-called extended trade tax exemption).

In the underlying dispute, the plaintiff, a deemed commercial partnership (hereinafter referred to as 'KG') had partnership interests in an asset management partnership (hereinafter referred to as 'GbR'). The GbR owned the property. The KG applied an extended trade tax exemption to its share of rental income received from the interests in the GbR.

The question of whether rental income at the level of the KG is subject to extended trade tax exemption was debated within the BFH.

According to the judgment of the Court's first senate of 19 October 2010 (I R 67/09), ownership of real estate requires that it is owned under civil law, i.e. the real estate company is the legal owner of the property. Attribution of beneficial ownership to the real estate company's business assets is not sufficient. Based on this opinion, the real estate must be attributed to the GbR in this case and extended exemption at the level of the KG is precluded.

In the opinion of the referring fourth senate of the BFH (order for reference of 21 July 2016), the definition of own real estate must be interpreted in accordance with tax law. Under tax law, the property of an asset management partnership is attributed to its partners on a proportionate basis. Accordingly, the real estate legally owned by the GbR (under civil law) is property of the KG. The Grand Senate upheld this decision on 25 September 2018.

In the case at hand, the real estate is attributable to the KG.

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Therefore, the KG can make use of the extended trade tax exemption for the rental income attributable to the KG.

Lower Tax Court of Lower Saxony (8 K 163/17): Date of the Existence of the Contribution Asset in the Case of a Contribution with Retrospective Tax Effect

In its judgment of 29 January 2019, the Lower Tax Court of Lower Saxony ruled that – contrary to the opinion of the tax authorities – the requirements for a contribution with retrospective tax effect must be fulfilled at the date of the resolution to contribute or reorganise the entity and not at the retrospective transfer date for tax purposes.

Pursuant to German tax law, it is generally permissible to set the date for the contribution of operations, partial operations or partnership interests in a corporation retrospectively up to eight months prior to transfer ('transfer date for tax purposes'). Contribution also includes the change of legal form of a commercial partnership into a corporation. A Requirement, amongst others, is that it involves one of the exhaustively itemised contribution assets, that all functionally essential operating fundamentals are transferred and that the transferring company in return receives new shares in the transferee.

It the case before the court it was intended to change the legal form of a commercial partnership (general partnership) into a corporation (German limited liability company, GmbH) with retrospective tax effect. The general partnership's business assets consisted exclusively of the participating interest in a limited partnership (GmbH & Co. KG). The general partnership sold this participating interest at the beginning of January 2013 to a third party. It was only after this date that the general partnership's partners decided to change the partnership's legal form at the end of January 2013. In the opinion of the plaintiff, the procedure could be conducted both with retrospective tax effect and without realisation of hidden reserves (at book value), as the requirements were fulfilled as of the transfer date for tax purposes. The retrospective tax effect of the change of legal form was not in dispute between the parties, however was considered pivotal for decision by the court.

The Lower Tax Court of Lower Saxony is of the opinion – contrary to the administrative opinion in the Reorganisation Tax Decree – that for determining whether the requirements for a contribution with retrospective tax effect are fulfilled the circumstances on the date of the resolution to contribute or reorganise the entity is decisive and not the circumstances on the retrospective transfer date for tax purposes. Only if the requirements for a contribution are fulfilled the option of retrospective application becomes available. Therefore, the retrospective effect is the legal consequence of the contribution in the opinion of the Lower Tax Court of Lower Saxony. By selling the only business assets of the general partnership – the participating interest in the limited partnership (GmbH & Co. KG) – at the beginning of January 2013, the partnership, according to the Lower Tax Court, no longer had any operations on the date of the resolution to change its legal form at the end of January 2013 which could have fulfilled the requirements of a contribution within the meaning of the German Reorganisation Tax Act, so that a retrospective effect could not arise as a legal consequence.

Appeal of the decision to the Federal Tax Court was granted due to its fundamental significance and to ensure consistent administration of justice and thus judgment. An appeal was lodged by the tax authorities and is pending under file number I R 13/19. It remains to be seen whether the decision is upheld at the level of the BFH and, if so, how the tax authorities will respond to it.

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Imprint

Published by
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60549 Frankfurt/Main, Germany

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