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Premature end of the German government coalition affects several tax policy initiatives

Early elections set for 23 February 2025

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With the departure of the Free Democrats from the coalition in early November, the Social Democrats and Greens no longer hold a majority in the German Bundestag (lower house of parliament). The government and opposition have agreed to hold early elections on 23 February 2025. As a result, several tax policy initiatives of the coalition are likely to be abandoned.

The specific impact of the coalition's premature end on legislative processes will also depend on whether the current Bundestag can still agree on individual bills with changing majorities before the elections. In his statement on the evening of 6 November 2024, Chancellor Olaf Scholz announced his intention to complete important parliamentary legislative processes by the end of the year. ▶

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Premature end of the German government coalition affects several tax policy initiatives

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However, there are increasing signs that the Conservatives are not willing to help the current minority government achieve a majority for its bills. It is therefore possible that only a few tax measures – if any – will be implemented. This affects the following bills:

- Tax Development Act: The bill includes a comprehensive relief package (e.g., reduction of income tax to offset inflation, extension of declining balance depreciation, incentives for e-mobility), but also mandatory disclosure requirements for domestic tax arrangements.

- Permanent Reduction of Electricity Tax for Industry: The reduction of the electricity tax burden for manufacturing companies to the EU minimum tax rate of 0.50 EUR per megawatt-hour, which is currently only valid until the end of 2025, was supposed to be made permanent.

- Future Financing Act 2: The bill aimed to introduce numerous facilitations in investment tax law. For example, the conditions for investments by investment funds in renewable energies or infrastructure were to be improved.

- Minimum Tax Adjustment Act: The bill included the Agreed Administrative Guidance of the OECD, as far as it has not yet been transformed into German law. In addition, a number of inaccuracies in the German implementation of the minimum tax were planned to be corrected. The Ministry of Finance may still publish another draft version in a consultation process shortly. However, the regular legislative process will not take place until 2025 after the election.

If an agreement between the government and the opposition can still be reached in the next few weeks, the last bills may be passed in the week of 16 December 2024. After the new election, the formation of a new coalition is expected to take two to three months. Therefore, substantial tax legislation is to be expected not before the second half of 2025.

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Annual Tax Act 2024 adopted

As the German Bundestag (lower house of parliament) passed the Annual Tax Act 2024 before the coalition failed, the Federal Council (Bundesrat, upper house of parliament) was able to approve the law as planned on 22 November 2024. The very comprehensive law contains numerous individual measures, including, e.g.:

- Enabling the transfer of assets at book value between partnerships with identical ownership as a response to a ruling by the Federal Constitutional Court.
- Introduction of a group clause for the preferential taxation of an employee equity participation.
- VAT: If a company receives services from a provider who accounts for their VAT on a cash basis, this will affect the timing of when the recipient of the service can claim input tax from the year 2028 onwards.
- Grandfathering provision for the application of the newly introduced transfer pricing rules for cross-border financing relationships.
- Tax Haven Defense Act: Introduction of an exception to the non-deductibility of business expenses for expenses from certain bearer bonds and insurance benefits.
- Introduction of an exit tax on investment shares where the taxpayer holds directly or indirectly at least 1% of the issued investment shares or where the acquisition costs at the time of disposal amount to at least 500,000 EUR.

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New regulations on transfer pricing documentation in Germany

On 29 October 2024, the Fourth Bureaucracy Reduction Act (Viertes Bürokratieentlastungsgesetz) was published in the German Federal Law Gazette. The new law also implements changes to German transfer pricing documentation regulations.

Regulations on transfer pricing documentation were already tightened at the end of 2022 as part of the DAC7 Implementation Act (DAC 7 Umsetzungsgesetz). Thereby, the submission deadlines for Local File and Master File were shortened from 60 to 30 days and should not start with the tax auditor's request, but automatically within 30 days of the announcement of the tax audit, in exceptional cases also upon the specific request of the tax authority outside of a tax audit with a submission deadline of 30 days.

The new regulations on transfer pricing documentation, which will come into force as a result of the Fourth Bureaucracy Relief Act, will bring new requirements and potential relief for taxpayers from 1 January 2025.

A key change is the introduction of a "Transaction Matrix", which must now be created as a separate supplementary document. From 1 January 2025, the taxpayer must submit the Transaction Matrix, together with the Master File and the documentation of extraordinary transactions, within 30 days of the tax audit announcement. A Transaction Matrix should include subject and type of cross-border intra-group transactions, related parties involved, service recipients and providers, affected tax jurisdictions, transaction volumes, contractual basis of the transactions, transfer pricing methods applied, and information whether transactions are not subject to regular taxation in the relevant tax jurisdiction.

The bureaucratic relief is that taxpayers no longer have to submit the complete Local File within 30 days of the start of the tax audit, but only the Transaction Matrix, Master File and documentation on extraordinary transactions. However, during the tax audit, the tax inspector can still request the complete Local File at any time, which must then be submitted within 30 days.

Failure to submit the Transaction Matrix will result in a penalty of at least EUR 5,000. Additionally, further sanctions may apply for non-compliance with the general documentation requirements, such as penalties for late submission or unusable records.

The new regulation applies to all open tax years where the tax audit starts from 1 January 2025 onwards. Our experience shows that the creation of a Transaction Matrix, and especially a complete Local File, takes more than 30 days in practice.

The new regulations aim to enable faster and more efficient tax audits. Companies with cross-border intra-group transactions should prepare for the new requirements and ensure that the necessary documents are prepared in a timely manner to avoid penalties.

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Draft DAC8 Implementation Bill published

Shortly before the end of the German government coalition, the Federal Ministry of Finance (BMF) published a draft DAC8 Implementation Bill. The draft dated 25 October 2024 does not contain big surprises. It mainly intends to implement the tax transparency rules for crypto assets. In their scope, the rules mainly target banks and crypto asset service providers. The rules are closely related to the Markets in Crypto-Assets Regulation (MiCAR).

Roughly one year after adoption in the Council of the European Union in October 2023, plenty of time remains until the first application, starting with the calendar year 2026, with first reporting to be made in 2027. Time will tell how this specific bill advances. However, as the implementation is mandatory, not much change is to be expected, no matter what a new government will look like.

The core of the draft bill for the implementation of Council Directive (EU) 2023/2226 of 17 October 2023 amending Council Directive 2011/16/EU on administrative cooperation in the field of taxation (DAC 8 Implementation Act) is the Crypto Assets Tax Transparency Act (KStTG), which is intended to regulate extensive record-keeping, due diligence and reporting obligations for providers of crypto services. In analogy to the Platform Tax Transparency Act (PStTG), more transparency is to be introduced in another area in the future, the area of crypto assets. Information about transactions carried out by users is to be reported by providers of crypto services. This applies, among other things, to exchanging crypto assets for fiat money (e.g. euros) and transfers of crypto assets. The draft is largely silent on technical details on how the annual report is to be submitted. For other reporting requirements, such details turned out to be of pivotal importance.

In addition, the Common Reporting Standard for financial accounts (CRS) will be expanded to include new digital financial products (amended CRS). The reporting obligations for financial accounts regulated in the Financial Account Information Exchange Act will therefore also apply to e-money products in future. It should also be ensured that derivatives and investment companies that invest in crypto assets are also subject to the reporting obligations. The definitions of financial assets and investment undertakings will be amended. As a result, crypto derivatives held in financial accounts as well as investment undertakings with crypto investments are to fall under the reporting obligations. In addition, the draft bill contains provisions on the implementation of the future data exchange with tax authorities in third countries, which will result from the multilateral administrative agreements on CARF and the amended CRS (Multilateral Competent Authority Agreements, MCAA).

The draft bill also provides for amendments to the Platform Tax Transparency Act (PStTG). In future, reporting platform operators that use an identification service within the meaning of section 6 para. 9 PStTG to identify a provider will have to report the identifiers of the identification service and the EU member state(s) of issue.

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The future of business disputes in Germany: introducing commercial courts

The recent enactment of the "Justizstandort-Stärkungsgesetz," published in the Bundesgesetzblatt on 10 October 2024, and set to come into force on 1 April 2025, marks a significant development in the German judicial landscape. This law introduces commercial courts and the use of English as a court language in civil proceedings, aiming to make the German judiciary more attractive for international commercial disputes.

The core of the reform is the authorization for the German federal states to establish specialized judicial bodies known as commercial courts and commercial chambers. The law provides the legal framework, but it is up to the federal state governments to implement these courts through specific regulations.

Commercial courts are designed to handle high-value commercial disputes, with a minimum dispute value of 500,000 EUR. These courts will be established at higher regional courts (Oberlandesgerichte) and will serve as the first instance for commercial disputes. The jurisdiction of the commercial courts includes civil disputes between businesses, conflicts arising from the acquisition of companies or shares, and disputes between companies and their board members. By concentrating expertise and resources, commercial courts aim to speed up the processing of complex commercial cases. The only appeal from a commercial court decision will be a revision to the Federal Court of Justice (Bundesgerichtshof).

Commercial chambers, on the other hand, will be established at selected regional courts (Landgerichte) for disputes with lower values, ensuring that a wide range of commercial disputes can be handled efficiently. These chambers will handle cases with a dispute value below 500,000 EUR and will also have the option to conduct proceedings in English. The state governments are authorized to determine the specific subject areas for these chambers, allowing for further specialization, such as handling only trade disputes or M&A-related cases.

One of the most notable features of the new law is the authorization for proceedings to be conducted entirely in English. This is particularly relevant for international businesses and multinational corporations. The use of English in court proceedings is expected to reduce language barriers, making the German legal system more accessible to foreign companies. The law also provides for the use of interpreters and translators when necessary, ensuring that parties who are not fluent in English can still participate effectively. Proceedings can be conducted in English if the parties explicitly or implicitly agree to it, or if the defendant does not object by the end of the response period. Additionally, bilingual proceedings are possible if agreed upon or unopposed.

The legislation includes several procedural innovations inspired by arbitration practices. For example, the commercial court and commercial chamber must hold an early organizational meeting with the parties to clarify the organization and course of the proceedings.

Moreover, the legislation includes provisions for the confidentiality of sensitive business information. As of April 2025, German civil courts, including commercial courts and commercial chambers, can classify certain information as confidential, protecting trade secrets and other proprietary data from public disclosure. If such a motion for confidentiality was issued, from the filing of the lawsuit, all trade secrets are protected from disclosure, including the ability to classify information as confidential and restrict access to case documents and information to a limited number of reliable individuals.

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German interest barrier rules: German Federal Ministry of Finance publishes draft of an updated decree

On 9 October 2024, the German Federal Ministry of Finance (BMF) published a draft update of its decree regarding the application of the German interest barrier rules. The update of the former decree issued in 2008 was required since the German interest limitation rules were amended at the end of 2023 by the Secondary Credit Market Promotion Act (Kreditzweitmarktförderungsgesetz). The amended rules are applicable for financial years beginning after 14 December 2023 which do not end before 1 January 2024. With the new provisions, the German rules were aligned with the minimum standards of the Anti-Tax-Avoidance-Directive (ATAD).

In general, the adjustment of the German tax led to a tightening of the provisions for the interest deduction. Since the definition of interest expenses and interest income were broadened to meet the minimum standards of the ATAD, a wider range of expenses is deemed to be relevant for the interest limitation rules. Thus, the draft decree provides for practical examples of instruments generating expenses (and income) which should be subject to the interest limitation rules. It further demonstrates that the German Federal Ministry of Finance is aiming to adjust its position on non-recourse factoring / forfeiting which should now result in interest expenses at the level of the initial creditor. Furthermore, the draft decree illustrates in various examples in which scenarios the exceptions to the interest limitation may become applicable, and it is confirmed that the interest carryforward cannot be utilized under any of the exception rules. Hence, the benefit of the exception rules is limited to current year interest expenses.

Stakeholders had the opportunity to comment on the draft decree until 7 November 2024. Taking into account that the interest rates were increased over the last years and that the scope of the German interest barrier rules was widened with the recent amendment of the provisions, the interest limitation rule has become highly relevant for various businesses. Therefore, numerous stakeholders have submitted comments on the draft decree. The German Federal Ministry of Finance has not indicated when the review of the opinions submitted will be completed and when a final version of the decree can be expected.

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Pillar 2: Upcoming notification requirement for German minimum tax group head

For minimum tax purposes, Germany has introduced a concept called the minimum tax group (Mindeststeuergruppe). To simplify administration, the minimum tax group head is required to file the German minimum tax return and pay the German top-up tax on behalf of all other German Constituent Entities. The concept aggregates all top-up taxes to be paid by German constituent entities into the responsibility of one single entity, known as the minimum tax group head (Gruppenträger).

According to a recent legislatory change, the notification requirement also applies to groups with just one constituent entity located in Germany. Thus, the same deadlines apply for MNE groups irrespective of the number of constituent entities located in Germany.

If the ultimate parent entity (UPE) resides in Germany, it will hold the position of the minimum tax group head. If the UPE is not resident in Germany but there is a German constituent entity acting as the direct or indirect joint parent of all other German constituent entities, that German parent entity will be deemed the minimum tax group head. In all other scenarios, the UPE of the MNE Group can assign the role of minimum tax group head to any German constituent entity. If the UPE does not assign this role, the "economically most significant" entity will be deemed the minimum tax group head.

The minimum tax group head must electronically notify to the German Federal Central Tax Office (BZSt). Information to be submitted is limited including e.g. the name and address of the elected minimum tax group head, certain tax numbers, information on the determination of the entity and contact data. No information on other constituent entities is required. ▶

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The notification is due within two months from the end of the calendar year in which the group falls within the scope of the German Minimum Tax Act. If the financial year of the MNE group aligns with the calendar year, the first notification is due on 28 February 2025. If the financial year differs from the calendar year, the initial notification deadline is 28 February 2026, except in cases with a short financial year ending before 1 January 2025. Any changes in the position of the minimum tax group head must be reported immediately. Electronic filing shall be available starting 2 January 2025.

For more information, please see the *EY Global Tax Alert dated 23 October 2024.*

In addition to changes on the German level, the European Commission has published a proposal to revise the Directive on Administrative Cooperation (DAC9) to implement the Organisation for Economic Co-operation and Development's (OECD's) Global anti-Base Erosion (GloBE) Information Return. DAC9 enables central filing via a "Top-up tax information return" as foreseen in the Minimum Tax Directive and establishes a framework for the exchange of these returns between Member States, ensuring a consistent approach across the European Union (EU). The rules will require multinational enterprises (MNEs) to file Top-up tax information returns, with 2024 as the first year on which to report (by 30 June 2026). For more information on DAC9, please see the *EY Global Tax Alert dated 30 October 2024.*

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BMF finalizes application letter for determination of tax-free and taxable wages according to DTAs for German wage tax withholding purposes

On 8 October 2024, the Federal Ministry of Finance (BMF) published its application letter for determining tax-free and taxable wages according to Double Taxation Agreements (DTAs) for German wage tax withholding purposes, which replaces the initial decree dated 14 March 2017.

With this letter, the tax administration confirms that the newly established principles apply to payroll periods from 2025 onwards. For simplification reasons, the non-application of the daily table will not be objected to until 31 December 2024.

According to the tax administration, the daily table is to be applied (see R 39b.5 para. 2 sentence 4 LStR 2023),

- if the wage is tax-exempt for some days due to a DTA or
- if, due to employment in Germany for only a few days, there is only limited tax liability in Germany for individual days.

The final letter now contains the regulation that the tax administration will not object to the non-application of the daily table contrary to R 39b.5 para. 2 sentence 4 LStR (see introduction of the BMF letter). This relief applies until the end of 2024.

The BMF explains in the new paragraphs 16a and 16b the possibility of a flat-rate approach to the total working days, rounding, and the alternative possibility of considering the employee's presence days in Germany (with corresponding proof by the employee) for determining the so-called tax days.

Regarding the allocation of the remaining wages that cannot be attributed directly, the final letter contains, compared to the draft, an additional alternative of allocation according to agreed working days in the individual calendar month (see para. 9 of the BMF letter). Switching between the alternatives – now a) to e) – is not allowed during a calendar year (uniform principles of accounting, see para. 10 of the BMF letter).

Unlike the draft, the principles of the final (new) BMF letter apply to ongoing wages paid for payroll periods ending after 31 December 2024, and for other payments received after 31 December 2024.

The transitional regulation for the application of the daily table raises the question for employers to what extent payroll periods already settled with the daily table in 2024 should be handled. In principle, the employer must review the payroll ▶

tax deduction carried out within a calendar year at the end of the calendar year or upon termination of the employment relationship and correct any deviations (para. 17).

Therefore, in our view, there is the possibility of retrospectively correcting the payroll accounting already carried out for the year 2024 and considering the originally applicable payroll tax table for the relevant payroll period (e.g., subsequently applying the monthly table leading to a lower tax burden).

We also believe that the payroll tax returns already submitted do not preclude a possible adjustment within the framework of payroll accounting. The payroll tax return is a tax declaration (sec. 150 German Tax Code, AO) and a tax assessment subject to review. It can therefore be changed at least until the issuance of a corresponding payroll tax certificate (sec. 164, 165 AO).

From 2025 onwards, the BMF letter mandates the application of the daily table, regardless of the fact that a corresponding adjustment of the legal provisions has not yet been made.

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BMF releases draft decree on input VAT deduction for financial institutions

The German Ministry of Finance (BMF) recently released a draft decree on input VAT deduction for financial institutions, providing changes and clarifications in the methodology of input VAT deduction. The decree is crucial for financial institutions, particularly banks, as it outlines the responsibilities and methodologies for correctly allocating input VAT between taxable and non-taxable transactions. Although the draft decree specifically mentions financial institutions (i.e. banks) in its title, the principles stipulated are generally applicable to taxable persons not entitled to full input VAT deduction.

According to the draft decree, financial institutions must still apply the general principles of input VAT deduction. Hence, input VAT is fully deductible if it is exclusively attributable to eligible output transactions. Conversely, input VAT is fully excluded from deduction if it is exclusively attributable to VAT-exempt output transactions. Input VAT that is not attributable to either of these two groups, as it relates to both eligible and non-eligible transactions, must be allocated using an appropriate allocation method.

While the BMF emphasizes that various methods can lead to an appropriate economic allocation, segmenting a taxable person's business for input VAT purposes is the preferred approach. Segmentation involves dividing the company into organizationally separable sub-units, ultimately encompassing the entire company. ▶

German tax authorities

Segments could be defined e.g. on the basis of permanent establishments, VAT group entities, business units, product groups etc. The segmentation is to be made according to cost accounting aspects or according to the principle of economic allocation. For each division, an individual input VAT ratio needs to be calculated. Other, still permitted allocation methods must consider the special nature of the banking industry and lead to appropriate results.

For purchased services that cannot be allocated to a specific segment (e.g. overheads relating to all segments), input VAT deduction must be determined at the overall company level using an appropriate so-called "residual key" that includes all activities of the credit institution.

In addition to technical questions regarding input VAT calculation, the BMF also expects documentation and respective records. For credit institutions, the records should also include documentation of the chosen input VAT allocation system to prove its appropriateness. This documentation should include the results of the analysis as to whether the input VAT apportionment is appropriate, as well as the considerations for its selection and determination.

There are further noticeable statements included in the draft decree. For instance, the tax authorities state that they will challenge the input VAT recovery methodology if it is not appropriate in their opinion. Also, for certain situations they claim the right to make estimations.

Please note that the current draft had been shared with the banking associations in Germany who already provided their detailed comments to the BMF. Changes to the decree are therefore still possible before a final version will be published.

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BMF publishes final version of tax authority guidance regarding e-invoicing

The German Ministry of Finance (BMF) published on 15 October 2024 its guidance on the issuance and receipt of e-invoices applicable as of 1 January 2025 providing further definitions and clarifications.

As of 1 January 2025, e-invoicing will become mandatory for B2B supplies subject to German VAT where both supplier and customer are established in Germany (exceptions apply to various VAT-exempt transactions). In this case a customer's consent for an e-invoice is no longer required. E-invoices will have to be issued in a structured electronic format in accordance with the European norm CEN 16931. Invoices in other electronic formats such as PDF will not qualify as e-invoice.

The guidance provides clarifications on various aspects such as more detailed definition of the e-invoice (vs. other invoices) and explanations on the kind of supplies and parties being subject to mandatory e-invoicing (i.e. who qualifies as being established in Germany). It also addresses applicable exceptions from mandatory e-invoicing (e.g. invoices up to EUR 250) and information on additional e-invoicing formats that can be used (hybrid format consisting of the structured format as well as a file being readable by humans such as PDF or other structured formats pre-agreed between supplies and customer compatible with CEN 16931).

Additionally, the guidance addresses the submission and receipt of e-invoices. The BMF does not specify the file format or method of electronic transmission. These are up to the legal agreement between the parties (possible methods are e.g. email or platforms allowing the up-/downloading of the invoice data). Other special e-invoicing aspects covered by the guidance are the content, contracts qualifying as invoice, advance payment and final invoices, invoice correction, self-invoicing and archiving as well as impact on input VAT recovery. ▶

German tax authorities

A transition period has been implemented by the amended VAT Act (Umsatzsteuergesetz). It allows suppliers to opt for issuance of invoices in other formats, i.e. paper or other electronic format for supplies rendered prior to 1 January 2027 (prior to 1 January 2028 for small sized entities and invoices issued via EDI). However, invoice recipients must be ready to receive e-invoices by 1 January 2025 to comply with German VAT rules and safeguard the input VAT recovery as there is no transition period for the recipient side.

Businesses should also prepare themselves for extended mandatory e-invoicing for intra-EU transactions as of 1 January 2030. The VAT in the Digital Age (ViDA) initiative was approved on 5 November 2024 by the ECOFIN. In addition, ViDA also addresses aspects such as digital reporting requirements, taxation of platform economy and introduction of rules reducing VAT registration requirements. For more details, please refer to our *EY Global Tax Alert "EU details on VAT in the Digital Age (ViDA) package" dated 7 November 2024.*

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German tax principles for disproportionate profit distributions

Disproportionate profit distributions occur when profit distributions do not correspond to the share of a corporation shareholder in the share or nominal capital of a company. A simple example illustrates this: A and B each hold a 50% stake in the nominal capital of AB GmbH. In 2024, A receives a profit distribution from AB GmbH, while B does not. Reasons for this could be e.g. that A provides the company with a property free of charge, and B increases his profit reserve.

These aspects are relevant not only in a purely domestic scenario, but also in cross-border scenarios, and the disproportionate profit distribution needs to be accepted by the tax office. Experience shows that this is not a straightforward matter. Generally, the scenarios can give rise to issues such as shifts in values between shareholders, income adjustments on all levels (company and shareholders), withholding tax obligations, etc.

In the past, German tax authorities have been reluctant to accept disproportionate profit distributions if no convincing underlying reason can be presented, especially in cases where the profit distribution agreement is only valid for a short period or is changed repeatedly.

The German Federal Ministry of Finance (BMF) has now issued guidance in this regard to reflect the Federal Tax Court (BFH) case law and to provide its interpretation. However, complexities and uncertainties remain.

For one, it is crucial that the disproportionate profit distribution is legally effective under civil law aspects. In this context, the German tax authorities distinguish between German limited liability companies (GmbHs) and stock listed companies (AGs). As this is a fairly technical and complex matter, it is best to involve German lawyers and tax practitioners early in the process to safeguard the intended outcome despite the remaining uncertainties.

Another aspect that continues to be important is to ensure that the agreement pertaining to the distribution is effective. This particularly concerns approval and majority requirements, but also formal requirements (entry in the commercial register, notarization). If these requirements are not met, the tax authorities will deny the acceptance of the profit distribution for tax purposes.

The guidance makes no reference to abusive planning through such arrangements. It can nonetheless be assumed that the tax authorities will still examine whether the conditions for tax abuse through disproportional distribution arrangements are met. Therefore, it remains important to document factual reasons for the incongruent profit distribution and to be able to explain these reasons to the tax authorities.

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BFH rejects trade continuation requirement for corporation's trade tax losses obtained from a partnership

German trade tax law requires for the offset of trade tax losses carried forward against trading income the identity of the trading person and of the business trade between those who suffered the loss in the first place and now want to utilize them. This means e.g. that if a trading partnership completely ceases operating a loss-making business, the losses stemming from this business are in principle no longer available for offset against the partnership's future trading profits, e.g. from other, unrelated, profitable operations.

Up to now it was unclear if the same trade continuation was required if the partnership first suffered the loss, then was liquidated into its partner corporation (because e.g. in a GmbH & Co. KG structure, the general partner GmbH, which typically holds no economic interest in the partnership, left the KG, and as a consequence the partnership's assets and liabilities now by force of law became the limited partner's property), and the legal successor corporation to the partnership now ceased to operate the originally loss-making trade. Hence, the question was open whether the corporate legal successor to a loss-making partnership was bound to a trade continuation requirement.

In its decision dated 25 April 2024 (case ref. III R 30/2), the BFH sided with the taxpayer, who argued against such trade continuation requirement in a corporate scenario, and based its decision on the concept that for corporations, by law, all income was deemed trading income, and therefore there was only one "trade" for a given corporation, irrespective of the fact whether there were multiple business activities carried out. Thus, as long as the corporation remained in place, the trade tax loss could be carried forward and used against other trading income, irrespective of whether the loss-creating trade was still carried out.

This case law should be considered where losses have been incurred in a trading partnership, and there is a potential need to restructure or even cease the loss-generating business. In such case, if the partnership has a corporate partner currently, it may be beneficial to first liquidate the partnership into the corporate partner, and only thereafter undertake the business restructuring as the restructuring otherwise could jeopardize the future availability of trade tax losses.

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Federal tax court issues ruling clarifying definition and timing of hidden profit distribution

In a decision dated 22 May 2024 Germany's Federal Tax Court (BFH) ruled on a case where a German subsidiary of a US group suffered a loss from cancelling a contractually agreed business relationship with a Venezuelan customer at the request of the US parent. The US parent instructed its German indirect subsidiary to cancel the business relationship due to the embargo imposed by the US government against trading with Venezuelan companies in 2007. The customer sued the German company for indemnification and the case ended in an arbitration by the international Chamber of Commerce, which determined that the German company was liable to indemnify the Venezuelan customer.

The BFH overruled the lower tax court's decision and ruled that the German subsidiary's waiver of compensation from its US parent for the expected damage may constitute a hidden profit distribution. Furthermore, the timing of the hidden profit distribution is the moment when the subsidiary records the expense rather than the moment of the contractual waiver.

The practical relevance of this decision lies in the clarification of the requirements of a hidden profit distribution. The lower tax court, along with many practitioners, views a hidden profit distribution as a zero-sum situation, where one party shifts a benefit to another while the consolidated assets of both parties remain constant. The situation underlying the court case was different in that a loss reduced the amount of consolidated assets and the affiliated parties merely decided who should bear the loss. However, the BFH ruled that if third parties had agreed on a compensation for breaching the contract with the third party, a waiver of such a compensation would violate the arm's length standard. Economically similar situations to such a waiver occur, for instance, when intercompany loans are written down because securities or collateral are absent, even though third parties would have insisted on them.

The lower tax court erred because it denied a hidden profit distribution solely because the economic situation was not zero-sum. Instead, the lower tax court should have assessed whether the German subsidiary, under the arm's length principle, had reason for waiving any compensation from the US parent. This may have been the case if a continuation of the business relationship with the Venezuelan party had created other economic disadvantages for the German subsidiary. For this reason, the BFH returned the case to the lower tax court to reassess the facts.

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BFH decides on investment income allocation to German branches of insurance companies

In a ruling dated 5 June 2024 (case ref. I R 3/22) eagerly anticipated by the insurance industry, the German Federal Fiscal Court (BFH) has addressed important questions regarding the allocation of income between a (foreign) head office and a (domestic) permanent establishment for insurance companies. Concerning the rules for determining the endowment capital and the allocation of assets and investment income to a domestic insurance permanent establishment, the BFH contradicts the opinion of the tax authorities.

From the perspective of international insurance companies with permanent establishments in Germany, the ruling is very positive. Against the background of this ruling, affected companies should verify their approach to the allocation of investment assets and investment income to permanent establishments and review whether the ruling has an effect on the allocation of investment income for years not yet statute-barred as well as with regard to ongoing tax audits.

Basically, there are two methods for determining the endowment capital and the allocation of investment assets and income under German tax law, the Modified Capital Allocation Method and the Minimum Capital Allocation Method.

The Modified Capital Allocation Method first allocates a share of the foreign insurance company's assets to the German branch based on its share of the technical provisions of the entire company. Then, the technical provisions, liabilities, and deferred income are deducted to determine the allocable endowment capital.

A lower endowment capital than under the Modified Capital Allocation Method can only be allocated to the German branch if it better corresponds to the arm's length principle and at least equals the equity required by the German branch under supervisory law if it was considered a stand-alone insurance company (Minimum Capital Allocation Method).

The Federal Ministry of Finance previously considered the endowment capital determined under the Minimum Capital Allocation Method as the lower limit for the endowment capital, also in the case of the application of the Modified Capital Allocation Method. This often resulted in additional allocation of assets and investment income subject to tax in Germany.

However, the BFH now contradicts this view, stating that the Minimum Capital Allocation Method is only applicable if a lower endowment capital than under the Modified Capital Allocation Method is considered. In other words, the endowment capital calculated under the Modified Capital Allocation Method can also be negative according to the BFH without causing the additional allocation of assets and investment income under the Minimum Capital Allocation Method.

Finally, the BFH also confirms that accounts receivable can be included in the asset allocation if they are used to cover technical provisions under supervisory law and that a "significant change" in the endowment capital compared to the beginning of the year, which causes an adjustment of the allocable assets, can be assumed even if it is below the 30% deviation threshold outlined in the administrative principles.

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BFH rules on the "interaction" between the activity proviso under tax treaty law and the provisions on the taxation of controlled foreign companies in German Foreign Tax Law

In the underlying case, a German limited liability company (GmbH) had two permanent establishments, one in Romania and one in Russia. There were two shareholders in the GmbH, one of whom held a majority interest. The permanent establishments provided services, but the majority shareholder (an individual) advised the permanent establishments on the provision of services. The dispute was whether the income of the foreign permanent establishments was subject to the exemption or credit method under the relevant treaties.

The German Federal Tax Court (BFH) ruled that the income is not exempt in Germany because the switchover to the credit method is to be carried out under the activity proviso (BFH decision of 3 July 2024, case ref. I R 4/21). According to Article 7, para. 1 in conjunction with Art. 23, para. 2 DBA-Russia/Romania, business profits are generally exempt in Germany if they are earned by a Russian/Romanian permanent establishment. However, the activity proviso under the agreement requires a switchover to the credit method if the domestic taxpayer does not prove that the gross income of the permanent establishment comes exclusively or almost exclusively from active activities within the meaning of the Foreign Tax Act (AStG). Under the Foreign Tax Act, certain activities (such as services) are only considered "active" if they do not involve the assistance of a Germany-based related party. In the present case, a harmful act of assistance was fulfilled because the permanent establishments involved the majority shareholder to provide their services.

In this context, the foreign permanent establishment is considered to be a foreign company within the meaning of the AStG and all exceptions and reverse exceptions to the provisions of the AStG must be included. This means that harmful assistance by the domestic shareholder in the meaning of the AStG has to be considered. Taxpayers should therefore take care in cross-border cases to comply with the activity reservations of the AStG if they want to ensure the exemption of income generated by foreign permanent establishments under the respective double taxation agreements.

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BFH comments on entitlement of partnerships to a tax treaty and on scope of trade tax reduction for foreign permanent establishment income

Only commercial enterprises operating in Germany are subject to German trade tax. In principle, a commercial enterprise is operating in Germany if a domestic permanent establishment is maintained for it. By contrast, income from permanent establishments located abroad is to be deducted from the trade income.

In its decision of 5 June 2020 (case ref. I R 32/20), the BFH commented on the allocation of income to the sources of income and the attribution of income to the various permanent establishments under double tax treaties. The dispute was about the amount of income of a GmbH & Co. KG subject to trade tax in Germany. The KG, with its management headquarters in the Netherlands, operated in Germany in the residential construction business, primarily on its own property and partly on third-party property. It sold its own property after construction.

The BFH clarified that only the income of a domestic permanent establishment can be subject to trade tax due to the construction work. The BFH examined restrictions arising from the double taxation agreement between Germany and the Netherlands for the person entitled under the agreement. In the case in question, however, this was not the limited partnership, but rather its two shareholders (both in the legal form of a GmbH), since the limited partnership was not a "person" within the meaning of the applicable agreement.

The BFH decided that a right of taxation conferred under a tax treaty does not result in foreign permanent establishment income having to be considered in the trade income. Even an agreement within the framework of a coordinated tax audit by the German and Dutch tax authorities (so-called joint audit), according to which the capital gains should be taxed in Germany alone, cannot override the domestic link for trade tax purposes.

The BFH confirmed the fundamental application of the national criteria for apportionment to cross-border cases. Furthermore, it considered an allocation based on selected value-added contributions without carrying out a functional and risk analysis to be an unsuitable estimation method.

Foreign taxpayers with domestic permanent establishments should check to what extent the determination of trade tax corresponds to the principles of the judgment.

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Two German courts decide on gift taxation for disproportionate shareholder contributions into their companies

A shareholder's contribution to their company can, in certain cases, trigger German gift taxes if it enriches other shareholders. In this context, two recent rulings by the Münster Tax Court and the Federal Tax Court (BFH) provide additional legal certainty.

A disproportionate contribution occurs when the rights granted for a capital contribution do not match the company's proportional value. The Münster Tax Court needed to determine if such a contribution amounted to a gift from the contributing shareholder to the other shareholders thus enriched.

In this context, there has been debate regarding whether every disproportionate capital contribution should be classified as a gift to the other shareholders, or if it also necessitates the contributor's awareness that the contribution is intended to be partially gratuitous. The wording of the law is not clear on this aspect. ▶

German court decisions

The Münster Tax Court ruled on 23 May 2024 (case ref. 3 K 2585/21 Erb) that taxability requires the contributor's intention for the disproportionate capital contribution to be partly gratuitous, opposing the tax authorities' prevailing opinion. The intent for gratuitousness is given where the donor is aware of the gratuitous nature of the gift and thus understands that they are providing their service without obligation and without any legal connection to a consideration. A fractured family relationship (in this case, between siblings) can indicate that the acquisition of shares should not occur partially gratuitously due to the familial affection, but rather that an arm's length price is assumed.

The decision is currently under appeal at the BFH. Therefore, it remains to be seen whether the BFH will confirm the decision.

In an earlier ruling dated 19 June 2024 (case ref. II R 40/21), the BFH confirmed that, generally, disproportional contributions do not constitute taxable gifts, provided that the contributions are credited to a "personal capital reserve" of the contributing shareholder.

However, shareholders should consider that the formation of such personal capital reserves requires a corresponding legal basis in the entity's operating agreement and that corresponding resolutions must be legally effective under civil law. Otherwise, the German tax authorities will likely not recognize the crediting to separate capital reserves and assume a gift.

Nonetheless, the decision underscores the necessity for shareholders to respect the personal capital reserve following its establishment. In the present case, the later intentional waiver of the contributing shareholder's personal capital reserve effectively resulted in a gift to the other shareholders.

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Artificial Intelligence cannot be named as inventor in patent applications

On 11 June 2024, the German Federal Court of Justice (BGH) issued a landmark decision in case no. X ZB 5/22, addressing the issue of whether an artificial intelligence (AI) can be named as an inventor in patent applications.

The case involved a patent application filed for a food or beverage container with specific structural features. The application initially named an AI system as the inventor. The German Patent and Trademark Office (DPMA) rejected the application, arguing that only individuals could be named as inventors. The applicant appealed the decision, leading to the involvement of the BGH.

The BGH upheld the DPMA's decision, stating that only individuals can be named as inventors within the meaning of sec. 37 para. 1 of the German Patent Act (PatG). The court emphasized that the legal framework recognizes the inventor's right to be named, which inherently applies to individuals. The use of AI during the development of a technical solution does not affect this requirement. The court addressed the practical aspects of using AI in the inventive process. It acknowledged that while AI can significantly contribute to discovering new technical solutions, a human element is always involved in programming, training, and directing the AI. Thereby, the court clarifies that, as with the use of traditional tools, the applicant must carry out the necessary assessment based on his/her knowledge. Therefore, an individual can always be identified as the inventor and AI can also not be registered as a "co-inventor" or otherwise assume the position of an inventor.

Only the alternative request of the applicant to include, in addition to the naming of an individual as inventor, an addendum stating that this inventor had caused the AI to generate the invention was successful. The court considered this to be a permissible (but legally irrelevant) addition that does not affect the purpose of the PatG. ▶

This decision is in line with rulings by the European Patent Office and other patent offices in the US, England and Australia, in which the registration of AI as inventor has also been rejected. The ruling reinforces the necessity of naming an individual as inventor, even when AI plays a significant role in the inventive process. It underscores the importance of human oversight and contribution in the inventive process.

The BGH decision reinforces the principle that, despite the growing role of AI in innovation, the recognition of inventorship remains a uniquely human attribute and provides clarity on the formal requirements for patent applications involving AI. However, the question of how the use of AI systems affects the substantive requirements for patentability remains unanswered and is explicitly not the subject of the BGH decision.

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Decision on employee stock option programs – forfeiture of unexercised virtual options

The Munich Regional Labor Court (LAG) ruled on 7 February 2024 (5 Sa 98/23) that virtual options offered to employees can be forfeited upon leaving the company. Virtual options differ from special compensations tied to company profits or revenues, as they merely offer the possibility of a gain without guaranteeing it.

In the case presented, the plaintiff was employed by the defendant from 1 April 2018 to 31 August 2020. The defendant had offered a virtual stock option program that simulated participation in the company's capital. These options were to be "vested" over time, becoming exercisable in stages to encourage long-term engagement. According to the terms, the options would be forfeited if the employment ended before a vesting event. The plaintiff resigned before such an event and unsuccessfully attempted to claim the options, leading to a lawsuit.

The Munich Labor Court dismissed the claim, and the LAG confirmed this decision. The contractually agreed forfeiture clause was valid and violated neither the General Terms and Conditions (AGB, sec. 307 ff. BGB) nor the principle that earned wages cannot be withdrawn, as it only removed a potential earning opportunity.

Employee participation programs are fully subject to AGB control according to case law. Virtual options are part of the contractual remuneration as a voluntary benefit provided by the employer and therefore have the character of compensation. They offer the employee a chance to participate in an increase in value in case of a vesting event. Unlike special bonuses, for which strict rules apply to cut-off date clauses, virtual options are less a consideration for services rendered by the employee. Rather, they offer a profit opportunity and an incentive for future efforts and therefore have a significantly greater speculative character. Virtual options, like stock options, justify strict forfeiture and binding clauses. Due to their speculative nature, a regulation that provides for the forfeiture of all subscription rights without compensation upon termination of the employment relationship is permissible, regardless of the reason for termination. This is particularly true in the case of a linear forfeiture over time. After the employee leaves, the incentive effect for participation in the company's future economic development ceases.

The LAG also ruled that the principle of equal treatment was not violated. The defendant had waived the forfeiture clause for employees still employed at a certain date after the plaintiff's departure. The LAG decided this did not constitute unequal treatment, as the cut-off date provision was a permissible "time-based standardization."

The decision aligns with previous rulings by the German Federal Labor Court (BAG), which in 2008 (10 AZR 351/07) determined that legal principles applicable to special payments, such as bonuses, do not fully apply to stock options. This decision was criticized in labor law literature for denying the remuneration character of stock options. The LAG decision confirms the previous jurisdiction of the BAG.

It is noteworthy that the appeal with the BAG was granted, as virtual options are becoming increasingly important in employment contracts. Further decisions by the highest court could provide legal certainty. However, it remains to be seen whether the BAG will confirm its previous jurisdiction.

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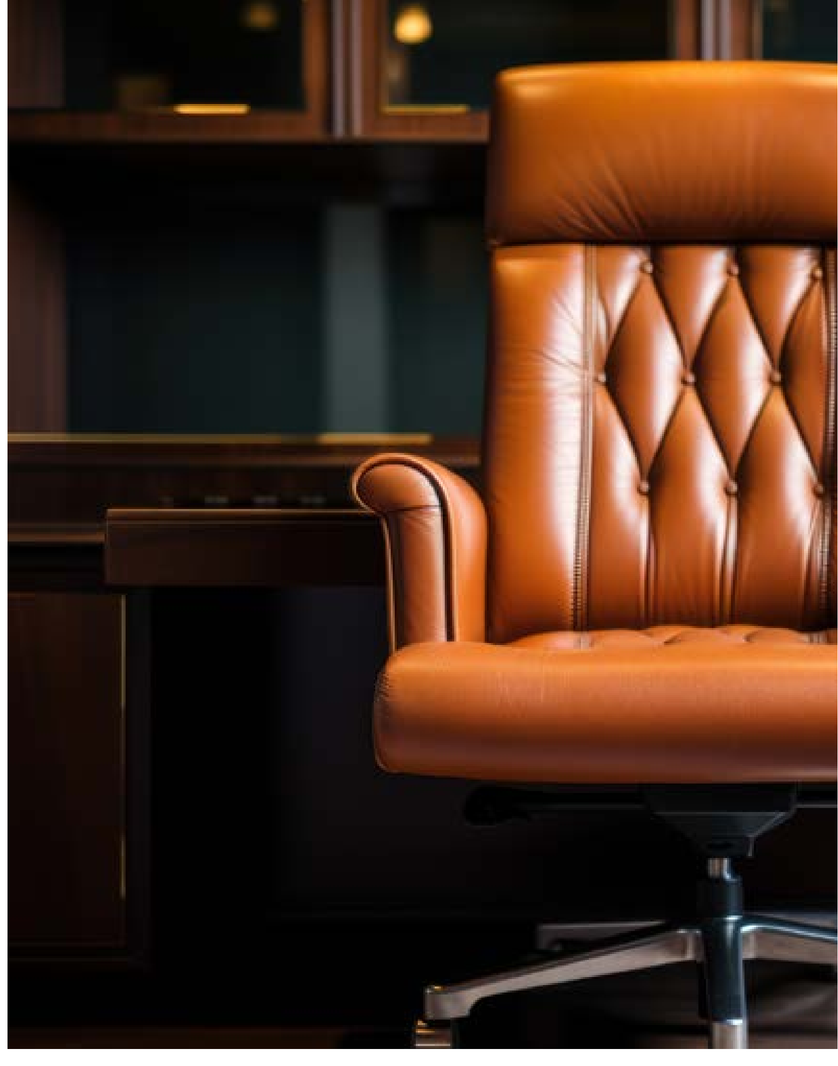
Liability of the former managing director for delaying insolvency

In its judgment of 23 July 2024 (case reference II ZR 206/22), the Federal Court of Justice (BGH) made practice-relevant decisions on the temporal scope of managing directors' liability for delaying insolvency. According to this decision, even a dismissed managing director can be liable to creditors for breach of the obligation to file for insolvency for damages that arise after his dismissal if the risk created by his breach continues to exist and has become the cause of the subsequent harmful event.

In the case decided, the plaintiff had concluded four investment contracts with several sales companies, which all belonged to a company group, between 2013 and 2016. At around the same time, the former managing director held office. Three investment contracts were concluded before the managing director's dismissal, the fourth afterwards. Already in 2007, the business model of the aforementioned company group began to falter and a Ponzi scheme emerged. However, insolvency applications were only filed in 2018.

The BGH found that the sales companies had been overindebted since 2011 and that the managing director had violated his obligation to file for insolvency under sec. 15a of the German Insolvency Code (InsO). Damages arising from the conclusion of the investment contracts, including the fourth contract, are to be compensated. Decisive for the compensability of damages arising from the fourth contract is that pursuant to the German Civil Code (BGB) and the InsO, a dismissed managing director is in principle also liable for damages suffered by new creditors who only entered into contractual relationships with the company after his dismissal if the risk created by the failure to file for insolvency still exists at the time the damage occurs.

Purpose of the obligation to file for insolvency is, among other things, to keep companies that are ready for insolvency out of business to protect creditors from damage. Even though managing directors' duties as corporate body ex nunc cease to exist with their dismissal, this purpose continues even after their dismissal. In this respect, breaches of this duty that have already been committed are not retroactively eliminated and thus, if the risk persists, can (partly) cause damage even from subsequent contracts concluded by the company. If insolvency had been filed, these contracts would not have been concluded.



The judgement shows that managing directors should take their duty seriously to monitor the economic situation of the company and, if necessary, to obtain an overview of the company's assets and to file for insolvency timely in order to avoid personal liability even after their dismissal. According to the BGH, the causality of their failure to file for insolvency for subsequent damages of new creditors is not interrupted solely by the passage of time or by the fact that a subsequent managing director may have again violated the obligation to file for insolvency.

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BFH adopts ECJ VAT treatment regarding retrospective corrections of falsely stated invoices in intra-Community triangular transactions

The recent ruling by the German Federal Tax Court (BFH) on 17 July 2024 (case ref. XI R 35/22) has significant implications for businesses involved in intra-Community triangular transactions. This case addressed whether errors in handling these transactions can be corrected retroactively for VAT purposes.

Intra-Community triangular transactions are designed to simplify certain chain transactions across EU member states. Typically, an intermediary purchaser would need to register for VAT in the destination country. However, pursuant to sec. 25b of the German VAT Act (UStG), the intermediary can avoid this registration if specific conditions are met. These conditions include submitting a proper European Sales Listing and – even more importantly - indicating the triangular transaction and the transfer of tax liability on the invoice.

In the case at hand, the plaintiff operated a whole-sale business selling machines as middle party, i.e. purchased from the manufacturer and sold to customers in various EU countries, whereby the machines were directly dispatched from the manufacturer to the end customer. Each party used the VAT ID of their country of residence. However, the invoices of the plaintiff (middle party) did not carry a reference to the triangular transaction and the reverse charge.

An audit revealed that the plaintiff had not followed the formal requirements of the simplification rule of sec. 25b UStG and, therefore, assessed German VAT. The plaintiff attempted to correct the invoices and preliminary returns retroactively to cancel the taxation with VAT, but the tax office rejected these corrections.

The BFH has clarified that for the final purchaser to be the VAT debtor in a triangular transaction, the intermediary's invoice must explicitly state the recipient's tax liability (reverse charge). This requirement cannot be corrected retroactively. The initial issuance of a compliant invoice is essential, otherwise the simplification does not apply. Subsequent corrections are insufficient. With this ruling the BFH adopts the ruling of the European Court of Justice (ECJ) dated 8 December 2022. However, as an important additional aspect in comparison to the decision of the ECJ, the BFH explicitly states that an invoice correction takes effect ex nunc. This means that according to the BFH it should be possible to remedy the formal deficiencies with ex nunc effect. This should help taxpayers to avoid the VAT burden without initiating a VAT registration in the destination country.

In any event, the intermediary purchasers must meticulously follow invoice requirements, including explicitly indicating the triangular transaction and the recipient's tax liability. Any failure to meet these conditions triggers a VAT burden and significant administrative efforts to mitigate this burden.

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New BFH and Lower Saxony Tax Court rulings on wage tax treatment of business events

The Federal Tax Court (BFH, case ref. VI R 5/22, dated 27 March 2024), and the State Tax Court of Lower Saxony (case ref. 8 K 66/22 dated 23 April 2024) clarified in two recently published decisions important questions regarding the treatment of company events for wage tax purposes.

When employees participate in a company event (Betriebsveranstaltung) organized by their employer, the expenses for the event are proportionally recorded as wages for the participating employees. For this monetary benefit, there is an exemption amount of 110 EUR per employee for up to two company events per year. According to the German Income Tax Act (EStG), a company event is defined as a company event on a social level (such as a Christmas party, to which the workforce and their companions are invited).

Additionally, the employer can tax the monetary benefits of a company event at a flat rate of 25% of the benefit. This flat-rate tax must be borne by the employer.

In the BFH case, the company organized a Christmas party to which only the members of the board were invited. Another Christmas party was held for the upper (corporate) management circle of the plaintiff's companies at three adjacent locations.

The tax authority treated the expenses for both Christmas parties as taxable wages and taxed them at an individually determined flat rate of 81% and 62%, respectively. The company argued that the parties could be taxed as company events at the flat rate of 25% applicable for company events. The BFH confirmed that the Christmas parties were company events within the meaning of sec. 19 (1) sentence 1 no. 1a sentence 1 EStG. The court deemed the fact that the events were not open to all employees as immaterial.

According to BFH case law under the old legal situation (applicable until 2014), participation needs to be generally open to all employees for an event to qualify as a company event. Under the new law, this condition is merely a prerequisite for granting the exemption amount of 110 EUR per employee. For deciding whether an event meets the requirements for flat-rate taxation the legal definition in sec. 19 EStG is decisive, as the BFH points out. With this ruling, the BFH explicitly contradicts the opinion of the tax administration.

The ruling of the Lower Saxony Tax Court concerned the question of whether the reception for the farewell of the CEO could be considered a tax-privileged event in the company's interest or a private event (and a non-monetary benefit for the CEO). In addition to former and current board members of the financial institution, selected employees, the supervisory board, public figures, representatives of banks, associations, press representatives, and eight family members of the departing CEO were invited. The company bore the costs of the reception.

The tax administration rejected the more favorable treatment as an event in the company's interest and wanted to tax the entire expenses as benefit for the departing CEO. The tax court disagreed with this view. The crucial factor for the court was that, based on the overall circumstances, it was an event organized by the employer. The employer acted as the host, determined the guest list, and mainly invited business contacts. Additionally, the event took place on the employer's premises. The tax court based its reasoning on the BFH ruling of 28 January 2003 (case ref. VI R 45/99). Furthermore, according to the court, a farewell has an even closer connection to the employer's business area than an employee's milestone birthday, which was the subject of this BFH ruling.

This ruling is of particular interest because the tax court's argumentation could also be applied to other employer events, such as the celebration of an inauguration, a change of office or function, or an employee's milestone anniversary. However, the tax authorities have lodged an appeal against the decision with the BFH (case reference VI R 18/24).

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Close enough isn't enough for wage tax and payroll in Germany!

Navigating wage tax and payroll compliance in Germany is complex, but it is crucial for employers to understand their responsibilities to avoid potential penalties and legal consequences. This article shows our experience where international companies struggle the most.

In Germany, employment income resulting from work physically performed in Germany is subject to wage tax withholding if there is a German employer as defined by law (sec. 38 German Income Tax Act, EStG). This includes a permanent representative, a branch of a foreign company, or a hosting company that economically bears the wages.

Once this initial hurdle of employer qualification has been successfully overcome, employers must complete several registrations for wage tax and social security to meet wage tax regulations in Germany. They must also ensure proper payroll setup and ongoing compliance. This includes paying wage tax and social security contributions monthly, considering all salary components both cash and non-cash compensation items.

According to sec. 8 EStG income includes all monetary payments and benefits in kind from employment. And here is where things start to get complicated. What may qualify as a simple Christmas gift to an employee in one country might be considered a taxable benefit in Germany. Gifts to customers and business associates are also very popular – and frequently challenged by the tax authorities. The German tax system has created options for flat-rate taxation, but those who want to be compliant must first navigate the jungle of regulations. Even the desire for healthy and fit employees, which is addressed through employer-paid gym memberships, quickly results in additional taxable wages.

Moreover, international assignments pose significant wage tax challenges in terms of cross-border compliance, which are aggravated by the Federal Ministry of Finance's letter dated 12 December 2023.

Anyone who thinks they have plenty of time to correct German payroll and retroactively tax benefits in kind will be quickly disabused of that notion. The payroll of the current year can only be corrected until end of February of the following year in the regular process.

If the mistakes reach back into prior, non-time-barred periods, it is essential for the employer to disclose and correct this lack of compliance without undue delay to the tax authorities to prevent procedural risks for the management. Tax offices might regard the incomplete or incorrect declaration of wage tax as tax evasion and the subsequent correction as self-disclosure exempting from punishment for financial motives (e.g. tax fraud interest which requires a deliberate behavior). This holds especially true if multiple periods and high amounts are involved. Furthermore, wage tax audits out of the regular audit plan for the company could be announced.

Compliance with wage tax and payroll regulations is crucial for German employers, especially those with an international workforce. EY offers expert guidance and support.

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How artificial intelligence transforms the tax function

The tax community has shown reluctance to adopt artificial intelligence (AI) despite its growing importance in various sectors. This hesitation stems from a lack of understanding of AI's specific applications in tax functions. However, with the rise of precise AI tools, tax departments can greatly benefit from integrating AI into their systems and day-to-day workflows.

AI technologies are diverse and can be sorted into 3 categories: expert systems, machine learning, and generative AI. Each of the technologies serves distinct purposes:

1. Expert systems are rule-based and adapt to new situations without explicit programming, ensuring transparent, logical decision paths that are suitable for audit trails and compliance checks. In tax functions, they assist in evaluating data based on tax laws and regulations, thereby ensuring that tax procedures are consistent and compliant with legal standards.
2. Machine learning models, on the other hand, excel at analyzing large historical datasets to predict future outcomes and classify the data, which is useful in areas like transfer pricing and VAT classification. These models learn from previous data and improve their accuracy over time.
3. Generative AI, which includes models like GPT, creates new content by simulating human language skills. This is useful for analyzing and drafting unstructured data (e.g., text), such as in tax documents and communications.

The key to developing practical use cases for tax functions is often to combine these tools in a smart way. The benefits of a successful integration of AI systems are evident: Automating repetitive tasks and decision-making processes increases the overall efficiency of tax departments, reduces the need for manual intervention and leads to significant cost savings. AI systems enhance the accuracy of tax processes, reducing the risk of errors and non-compliance. Finally, a higher degree of automation reduces stress and the workload of tax professionals, allowing them to focus on strategic and more value-added activities.

Over the last months, many tax use cases have been developed that are already applied in practice, such as:

- Analyzing large amounts of invoices to detect the correct VAT classification and potentially applicable withholding tax rate,
- Summarizing and evaluating large amounts of data during a tax due diligence,
- Checking tax assessment notices and comparing them to the initial tax declarations,
- Creation of individualized tax clauses in contracts, or
- Answering specific tax questions based on pre-defined and curated sets of trusted input data, such as qualified tax literature, previously prepared tax memos and historic tax audit reports.

How to begin the journey? A typical transformation process starts by understanding the possibilities of how technology can - already today – provide measurable benefits to the tax function. This can best be demonstrated through real life examples and practical use cases. Considering the specific pressure points in the tax department, brainstorming own ideas of how such use cases can be applied or modified to fit the own tax function can then be a useful next step. Once the outcome of such brainstorming session is assessed based on benefits, complexity and execution speed, an implementation plan can be developed. Also, training the own workforce in adopting new technologies is an important element. Often, initial pilot projects can demonstrate the value of AI integration and gradually expand its use across the tax function. This will not only streamline the tax operations but also position the department at the forefront of technological innovation.

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Spotlight

Navigating the operating model transformation

The current economic situation in Germany is confronting companies with major challenges. Many companies therefore want to undergo a transformation of their operating model. The current EY study "The future of the German economy 2024", a German-language summary of which can be found *here*, shows the following:

- Almost 80% of the industrial managers surveyed have low expectations of the German economy.
- The main reasons for the weak economic growth are seen in bureaucratic overregulation, shortage of skilled workers, political mistakes, energy costs, inefficient administration and high non-wage labor costs.
- One in three industrial companies plans to relocate jobs abroad.
- 37% intend to outsource services and production steps.
- 45% plan new locations abroad.
- 63% expect job cuts in Germany.

As a reaction, many companies are seeking investment opportunities in an international context.

Companies looking beyond German borders and taking transformation measures
To cope with this situation, companies are taking operating model transformation measures which may involve decisions to either invest into new business abroad or to shift existing business activity (most notably production) from Germany to abroad. Any such transformation measure will impact the value creation footprint and operating model of the group and hence needs to be planned holistically considering not only operational but also legal and tax implications. Key challenges on the tax side relate to (i) how material and value flows need to be adjusted to remain well aligned with the operating model, and (ii) how to avoid significant adverse tax risks such as exit taxes when structuring the transformation. To navigate these challenges, we often observe three categories of measures based on time horizon and complexity.

1. Short-term financial measures
Key question: How can we increase income in Germany?

- Target: Short-term improvement of the income situation in Germany to secure strategic central functions in Germany (e.g. strategic purchasing, strategic sales, IP generation).
- Examples of potential tax/transfer pricing measures: Review and adjust central charges (service charges, license fees, etc.) if there is potential for income repatriation, utilize tax loss carry forwards, etc.

2. Short to medium-term structural measures
Key question: How can we keep strategic central functions in Germany?

- Objective: Optimizing production costs (energy, labor, and non-wage labor costs) at German production sites to secure strategic central functions in Germany.
- Examples of potential measures: Benchmarking to validate production cost levels, business case calculation including tax and possible incentive effects, conversion of production plants to contract/toll manufacturing, domestic outsourcing, foreign outsourcing, etc.

3. Medium- to longer-term structural measures
Key question: How can we organize strategic central functions abroad?

- Objective: Securing the future by reorganizing strategic central functions and production at suitable foreign locations in the medium to longer term.
- Examples of potential measures: Location benchmarks, business case calculation incl. tax and possible incentive effects, conversion of the transaction and function model at home (contract/toll manufacturing, limited risk/contract services), conversion of the transaction and function model abroad (regional/global hubs, IP development, strategic investments). ▶

Necessary tax safeguards for the transformation measures

These measures give rise to a number of tax issues. When central functions are transferred abroad, issues such as withholding taxes on license fees and technical services come into focus. Here, it is important to understand the nature of the charges in a dialogue with representatives of relevant central departments to draw the right tax conclusions considering relevant double tax treaties. Under customs duties regulations, the question may arise as to whether central charges influence the customs value. To do this, supply and service flows must be analyzed and subjected to a customs duty assessment. For VAT purposes, it is important to correctly determine the place of performance and to use appropriate VAT registration numbers. At the same time, income tax specifics in foreign countries, such as local regulations on license fee deduction restrictions or BEAT (Base Erosion and Anti-Abuse Tax) effects must not be overlooked.

In addition to local location factors such as talent, labor costs and political security, tax criteria such as tax rate levels, treaty network, grants and incentives, global minimum tax effects, depreciation rules also play a central role in structural measures. For HR topics, cooperation with labor lawyers is critical. Relocation of functions requires a comprehensive understanding of the entire value chain, including structuring of the relocation process, changes in the supply and service relationships, assessments of the (tax) accounting treatment in Germany and abroad, in close coordination with other corporate divisions such as the relevant functional area and — for valuation matters — controlling.

Conclusion: Operating model transformations require not only a robust business case, but also careful - and early - consideration of tax aspects. Only legally certain and sustainable tax structuring can minimize risks and make optimal use of the available opportunities.

EY has a fully aligned interdisciplinary team of project-proven operating model transformation specialists that is ready to help with these challenges.

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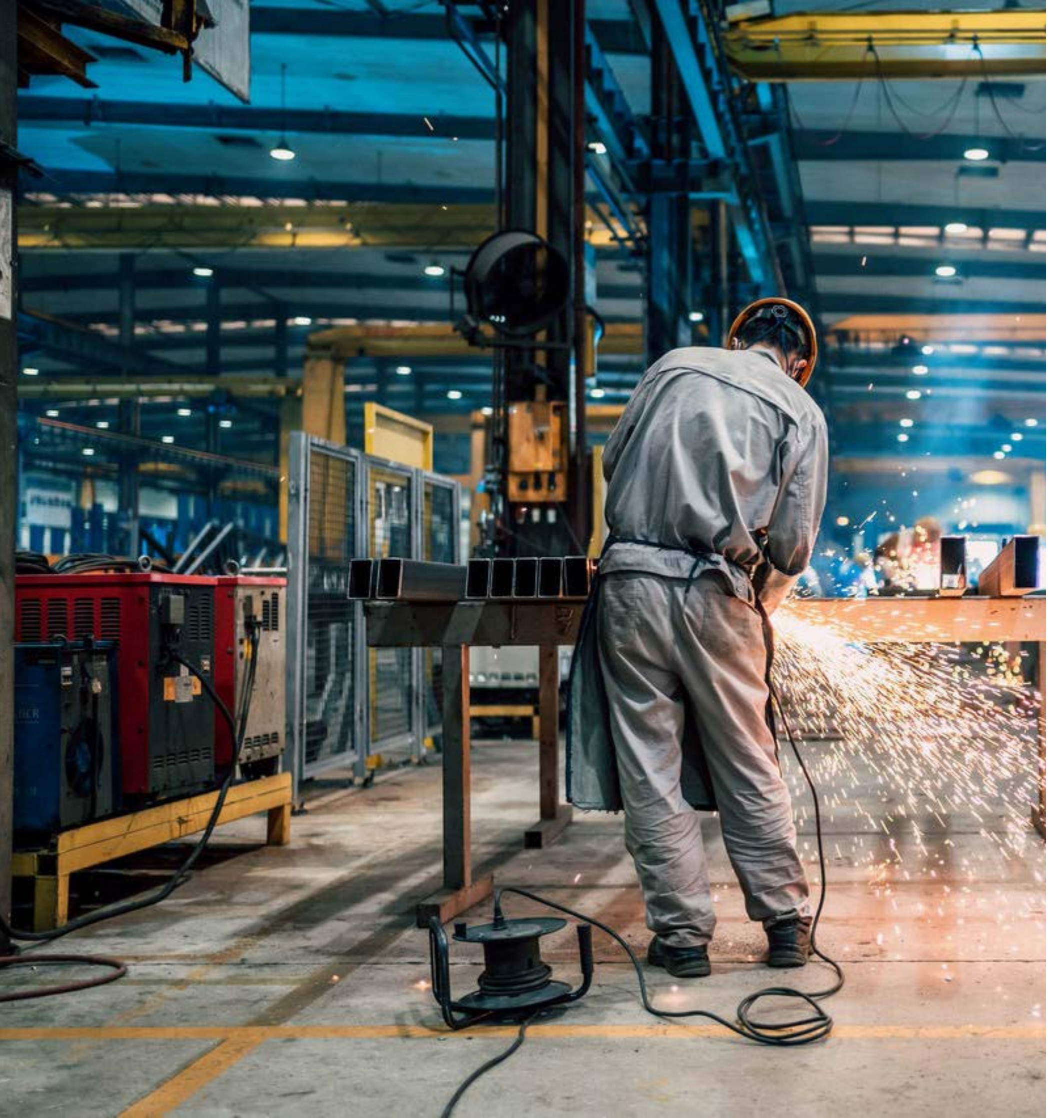

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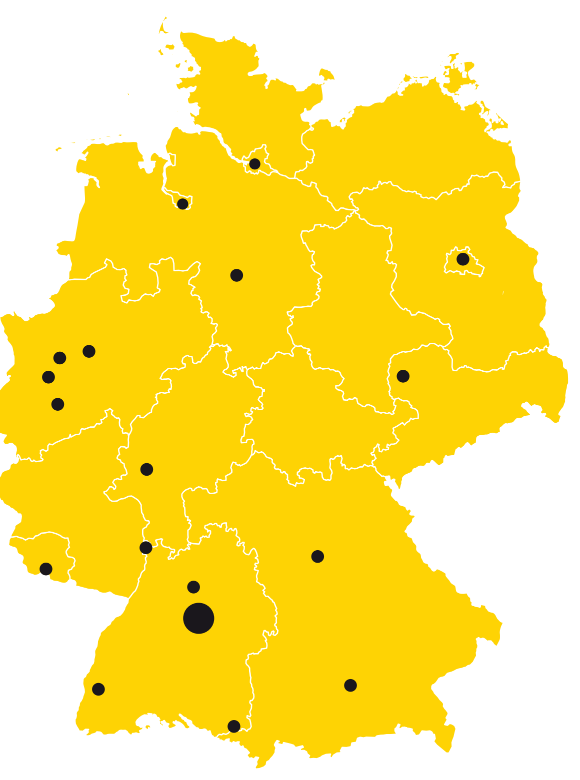

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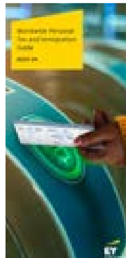

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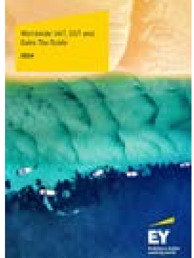

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