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Updated Administrative Principles Transfer Pricing issued

German Ministry of Finance issues updated guidance clarifying German transfer pricing rules

Content

On 6 June 2023, the German Federal Ministry of Finance (BMF) issued updated Administrative Principles Transfer Pricing (AP TP) clarifying the German transfer pricing rules. The guidance is neither binding for taxpayers nor for the courts but only indicates the point of view of the tax authorities.

The updated AP TP replace the previous version of the AP TP published on 30 September 2021 and are intended to align the AP TP to the current TP rules in Germany.

Key change is the inclusion of new administrative guidance on the German cross-border transfer of function rules to align the existing Administrative Principles on Transfer of Business Functions as of 13 October 2010 with the recent legal changes of the cross-border transfer of function rules in the German Foreign Tax Act and the corresponding updated Order Decree Law on Transfer of Business Functions (Funktionsverlagerungsverordnung). ▸

Updated Administrative Principles Transfer Pricing issued

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In particular, the updated AP TP provide clarification on the definition of a "transfer of function" and the calculation of the transfer package (e.g., consideration of tax effects) by following the stricter legal rules compared to the previous law. Additionally, the BMF has a more restrictive view on some aspects not regulated by law. Specifically, the new guidance no longer includes a de minimis rule as a threshold for a transfer of function and, hence, further tightens the application of transfer of function rules for taxpayers.

With respect to intercompany financing transactions, the BMF aligns its interpretation on the examination of income allocation between entities involved in financing transactions with recent German jurisprudence of the Federal Tax Court on the determination of intercompany interest rates for intercompany loans. In particular, the controversial view of the BMF that interest expenses exceeding the risk-free market return are not deductible at the level of borrower group entities unless the financing company is "able and authorized" to control the financial investment and bear the corresponding risks, was changed. The BMF now clarifies that the interest rate should be determined based on the economic circumstances of the borrower (and not the lender).

The provisions of the updated AP TP apply to all open tax cases effective immediately, with the exemption of cross-border transfer of functions realized before 1 January 2022, for which the existing Administrative Principles on Transfer of Business Functions as of 13 October 2010 are still applicable.

For more detailed information, please refer to the **EY Global Tax Alert dated 20 June 2023.**

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Update on DTAs with Bulgaria, Latvia, Lithuania, Sweden and Switzerland

Germany updates and renews its Double Taxation Agreements (DTAs) on an ongoing basis and continues its strategy of implementing BEPS project contents through bilateral negotiations instead of utilizing the MLI mechanism. Currently, the domestic implementation of three amended Double Taxation Agreements (DTAs) with Latvia, Lithuania, and Bulgaria is about to be finalized. To come into effect, the ratification documents of the DTAs must be exchanged between Germany and the contracting states after the completion of the domestic legislative procedures.

The three DTA amendment protocols primarily implement treaty-related measures of the OECD BEPS project. For example, all three protocols adjust the preamble according to the model of Article 6 of the Multilateral Instrument (MLI), now encompassing the purpose of avoiding opportunities for non-taxation or low taxation. Additionally, the existing agreements are supplemented with a so-called Principal Purpose Test to prevent treaty abuse. The Latvian and Lithuanian amendment protocols, among other things, also include an obligation to make corresponding adjustments in case of profit corrections.

If the ratification documents are exchanged by the end of November (Latvia) or before the end of the year (Lithuania and Bulgaria), the amendment protocols could come into effect this year and would generally be applicable as from 1 January 2024.

The amendment protocol to the DTA between Germany and Sweden was signed on 18 January 2023. The protocol introduces numerous changes to the previous agreement text from 14 July 1992 and also implements the minimum standard provisions of the BEPS project, such as a new preamble, corresponding adjustments, and a Principal Purpose Test. The articles on information exchange and assistance in tax collection are completely redrafted. However, the withholding tax rates remain unchanged. Additionally, Germany and Sweden have agreed to remove the provisions regarding the taxation of estates, inheritances, and gifts from the existing agreement.

As the formal domestic implementation process started in May, it can be expected that Germany is ready to exchange the ratification documents by October. The amendment protocol enters into force on the thirtieth day after the exchange of ratification documents and is generally applicable from 1 January of the subsequent calendar year. Depending on the upcoming legislative process and, in particular, on how swiftly both countries will formally exchange the ratification documents, the new DTA could be applicable at the earliest as from 1 January 2024, though a one-year postponement to 1 January 2025 cannot be ruled out. Nevertheless, Articles 29 (information exchange) and 30 (assistance in tax collection) of the agreement are (retroactively) applicable as of the date of entry into force of the amendment protocol.

In addition, Germany and Switzerland have reached a consultation agreement on the basis of the existing double taxation agreement. The consultation agreement relates to the interpretation of the allocation of taxation rights in the case of income from employment of senior executives.

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Germany has implemented public Country-by-Country Reporting (CbCR)

Just in time before the implementation deadline on 22 June 2023, the German federal parliament approved the domestic implementation of the EU's public Country-by-Country Reporting on 10 May 2023. Final amendments significantly tightened the previous draft bill.

The law for the Implementation of Directive (EU) 2021/2101 regarding the disclosure of income tax information by certain companies and branches transposes the obligation to prepare public Country-by-Country Reportings (public CbCR) into national law as provided in the EU Accounting Directive.

The disclosure obligation to publish a report on income tax information applies for German-based Multinational Enterprises (MNEs) or standalone corporations operating abroad if their revenue exceeds a total of EUR 750 million for each of the last two consecutive financial years. The reporting obligation is also triggered for non-EU based MNE groups exceeding the revenue threshold in case they have a medium or large sized subsidiary in Germany. Further, non-EU-based MNE groups or standalone corporations with revenues of more than EUR 750 million and with a branch in Germany with revenues exceeding EUR 12 million for each of the last two consecutive financial years are also covered by the reporting obligation.

The report must be made publicly available and must include, e.g., information on the type of business activities, the number of employees, pre-tax profit, and income taxes incurred. For third countries that are not listed on the EU blacklist of non-cooperative jurisdictions or that have not been on the so-called "grey" list of the EU for two consecutive years, the information only needs to be provided in aggregate form but not broken down by country.

The new public reporting is generally due within 12 months as of the date of the balance sheet of the relevant financial year and for the first time for financial years starting after 21 June 2024. To reduce compliance effort, companies are granted the option to report the information based on the (undisclosed) CbCR report according to the OECD BEPS project, which has been in force since 2016 and was implemented in Section 138a AO (German Fiscal Code).

During the parliamentary process, the law on implementing the public CbCR was tightened in comparison to the Government draft bill. One of the changes refers to the option to temporarily omit certain required information in justified cases in the reporting if the disclosure of such information would be seriously prejudicial to the commercial position of the company. The omitted information must be published in a later report at the latest in the fourth financial year after the reporting period in which the information was omitted in the report. In contrast, the draft bill provided for a duration of five years. Furthermore, the upper limit of the fine and penalty framework was raised from EUR 200,000 to EUR 250,000.

Affected companies should assess the impact of the new reporting obligation on their business and, in particular, their broader public tax reporting strategy.

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Germany implements a new levy on single use plastics from 2024

Based on the provisions of the EU Single Use Plastics Directive, Germany has implemented the provisions into national law almost without changes. A new levy obliges operators that place single-use plastics on the market to contribute to, amongst others, the costs of cleaning in public areas. The revenue from the levy will, to a large part, be provided to the cities and communities operating the cleaning of the environment and incurring cost from this public service.

The levy will cover the period from 2024 with the first declaration and payment in 2025. Unlike other reporting schemes, this levy comes with additional formal requirements. An auditor, accountant or tax adviser must check and confirm the declaration. If the company is not registered in Germany, a representative established in Germany must be appointed and registered.

From 2024 it will be possible for operators to register. It is also possible to apply for rulings as to whether a product is covered by the new regulations or not.

In general, the following types of products will be covered by the levy:

- Containers for food whose contents are intended for immediate consumption.
- Food containers made of flexible material (wrappers and packaging) containing food intended for immediate consumption.
- Beverage containers that can hold up to three liters of liquid.
- Beverage cups with covers and lids.
- Wet wipes used for household and personal hygiene.
- Balloons that are dispensed to consumers (i.e., not those used for industrial or commercial purposes).
- Cigarettes and other tobacco products, including filters.
- Lightweight carryout bags.
- Fireworks (containing plastics, from 2027)

The obligations will apply to German manufacturers distributing covered products on the domestic markets, as well as importers, intra-EU acquisitions and also (foreign) eCommerce operators to ensure a level playing field. Initial discussion shows that especially the coverage of "Food containers made of flexible material (wrappers and packaging) containing food intended for immediate consumption" appears to be a major challenge for businesses as this very wide term includes a large variety of food packaging (e.g. foil packaging of potato chips, sweets and many other foods).

A number of politicians in the EU and in Germany as well as stakeholders reflecting the interest of the cities and communities have expressed their desire to expand this list of goods in the future (e.g. to packaging made from glass, paper, cardboard and others).

The amount of levy depends on the type of packaging. For example, wet wipes are charged EUR 0.06 per kilogram, while beverage cups without a deposit are charged EUR 0.245.

Violations will be sanctioned, for example, if false quantity declarations are made or distributors fail to register. Also, authorities can seize goods placed on the market in situations of circumvention. Goods that are not registered may not be placed on the market or sold in Germany. It is also planned to oblige online platforms to check distributors for compliance with the regulations.

Businesses operating large product portfolios and multiple trade chains into Germany should expect to put significant effort into the implementation and the ongoing reporting. Projects to prepare for the new regulations should be kicked off as early as possible. Otherwise, meeting the official deadlines may prove to be a challenge.

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Update on further German tax legislation projects

The next few months could bring a series of tax-related draft bills from the Federal Ministry of Finance (BMF). In addition, the pillar 2 implementation will absorb considerable lawmaking resources in the second half of the year.

In recent months, there has been significant tension within the federal coalition government. In addition to energy policy, the coalition partners are particularly at odds over the federal budget for 2024. Several tax legislation projects have been put on hold until a comprehensive agreement within the coalition is reached, which could be the case in early July. To our knowledge, the following initiatives have been prepared and are awaiting approval from the coalition leadership:

- The details of the **Tax Fairness Act**, which was first announced about nine months ago, are still largely unknown. However, the Act is expected to contain a national tax haven list, which would apply in addition to the existing EU blacklist. It is anticipated that the measures of the Tax Haven Defense Act will also apply to countries that are only considered "tax havens" from a German perspective. German "trade tax havens" may also come under scrutiny, for example, through an increase in the minimum trade tax rate. The introduction of a reporting obligation for domestic tax arrangements, closely aligned with the existing reporting obligation for cross-border tax arrangements (DAC6), is also considered to be certain. Less is known about the exact design of the announced interest limitation rule, which would apply in addition to the interest barrier and is expected to create a ceiling for tax-deductible intra-group interest rates, e.g. to the amount of the group refinancing rate. Additional measures of the bill may affect property taxation, withholding taxes, and arrangements involving family foundations. However, no details are available yet.

- A **relief package** could contain interesting incentives if the Finance Minister can secure the necessary funding for it within the coalition. So far, only the investment premium for climate protection, which will be designed as a tax credit similar to the R&D allowance (Forschungszulage), is confirmed. The existing R&D allowance may also be expanded to become more attractive with a higher funding amount and potentially the inclusion of material costs. For partnerships, adjustments to the retained earnings privilege and the optional model are being considered. According to the BMF, small and medium-sized enterprises (SMEs) can hope for a more attractive investment deduction or special depreciation. Improvements in loss offsetting are also under discussion. Doubts remain as to whether the declining balance depreciation rates will be extended to the current year, as announced at the beginning of 2023. Furthermore, not all of the aforementioned proposals may survive the ongoing budget negotiations.

- An **Annual Tax Act** has also been announced for 2023. However, reliable information on its contents is not yet available. The Act may contain the introduction of **mandatory electronic invoicing for B2B transactions**, for which a discussion proposal has been available since March.

- The Ministry of Finance is also planning a **bureaucracy relief package**. It is expected that only a few thresholds, exemption amounts, etc., will be raised slightly once again.

- Directly linked to the budget negotiations and also included in the coalition agreement is an attempt to **eliminate climate- and environment-damaging (tax) subsidies**. However, the BMF is reportedly being cautious, especially regarding the often-discussed commuting allowance and company car taxation.

- Following the **modernization of partnership company law** that will become effective as of 1 January 2024, tax law adjustments will be necessary to avoid unintended consequences in income tax law as well as regarding inheritance tax and **real estate trade tax** with respect to partnerships.

Legislation

- For the **Future Financing Act**, a first draft was made available in April 2023. Among several regulatory and corporate law measures, the bill aims to make employee share ownership more attractive from a tax perspective. For details, please refer to the article below. In light of the aforementioned coalition dispute, the revised government draft bill is not expected until early July and will likely be less generous than originally intended.

- In addition to the bills mentioned above, the implementation of the global minimum taxation, which must be implemented by the end of the year, is about to enter the legislative process in the second half of 2023. After the BMF released a first discussion draft bill on 20 March 2023, a second draft bill will likely follow still before the summer break, opening a second round of public consultation. A further adjusted government draft bill is expected for August and the finalization of the bill will probably take until November or December 2023.

In the next issues of the German Tax & Legal Quarterly, we will update you on any progress made with regard to these legislative projects.

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Revised tax framework for employee share ownership

Encouraging share ownership among employees within a company can yield significant benefits, as it transforms their role into that of shareholders. By becoming shareholders, employees align their interests with the positive economic development of the company, while also pursuing personal profit. Moreover, their active participation establishes a stronger connection to the organization.

However, the transfer of shares to employees, whether through salary conversion or additional remuneration, triggers tax implications. In principle, the advantage derived becomes taxable as a compensatory benefit. To prevent employees from being taxed on non-cash items, commonly referred to as "dry income," various countries, including Germany, have established specific tax regulations for employee participation schemes.

The current regulations in Germany, particularly the tax-free allowance for share grants of EUR 1,440, are comparably less attractive on an international scale. For instance, Ireland offers a tax-free allowance of EUR 12,700, Austria up to EUR 7,500, and Spain plans to increase the tax-free amount to EUR 50,000. With the "Zukunftsfinanzierungsgesetz" (Future Financing Act), Germany now intends to revise the tax framework for employee share ownership. A draft bill of the Federal Ministry of Finance (BMF), dated 12 April 2023, proposes an increase of the tax-free amount in Germany to EUR 5,000. However, beyond the condition that a participation must be offered to all employees of a (group) company that have been employed for one year or longer, the draft bill also introduces an implicit holding period of three years (otherwise tax-free amounts would not be considered as increasing the cost base). Additionally, the tax allowance of EUR 5,000 will only apply if employees receive shares in addition to their other salary, thereby eliminating the possibility of salary conversion. These additional limitations have faced considerable criticism, as there are concerns that the intended purpose of the law may not be achieved.

The other revision is intended to improve the possibility to defer taxation of a benefit in kind until shares are sold and cashflow materializes, i.e. eventually mitigating dry income. Apart from a broader set of companies that could make use of the deferral going forward due to higher thresholds (e.g. 500 instead of currently 250 employees), the main change will be that neither leaver cases nor the end of the maximum term of 20 years (increase from 12) will trigger taxation if the employer guarantees to handle payroll obligations upon actual sale of shares. In particular the venture capital community has been asking for this improvement, with yet to be seen market reactions as all advantageous tax treatments require granting of real shares, whereas in particular start-ups nowadays usually operate with virtual, bonus-like incentive schemes in Germany – not only for tax reasons. In future, therefore, the German capital markets culture will play a role as important as the practicability of administrating real share plans, also in light of governance aspects.

The final legislation is anticipated to be enacted in the latter half of this year, applicable as of 2024.

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German Finance Ministry releases discussion draft on pending introduction of e-invoicing

Against the backdrop of the proposals recently presented by the European Commission, the German Federal Ministry of Finance has published a proposal for the mandatory introduction of e-invoicing for domestic B2B transactions. A formal legislative process has not yet begun. Read more about the contents of the discussion proposal in our **EY Global Tax Alert dated 20 April 2023**.

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German government agrees on final draft of law governing collective actions (VRUG)

Implementing the EU Directive 2020/1828, the new Verbandsklagenrichtlinienumsetzungsgesetz (VRUG) is set to introduce a new system of collective enforcement possibilities of consumer rights in Germany.

Due to globalization and digitalization, the number of cases in which a large number of consumers raise claims based on the same facts or practices has increased in recent years. The best-known example is probably the diesel emissions scandal, which affected millions of consumers and led to hundreds of thousands of individual or collective lawsuits. Germany introduced its domestic law on injunctive actions (UKlaG) as well as the declaratory model action (Musterfeststellungsklage) in 2018, enabling so-called qualified entities to file for declaratory court rulings which then have to be individually enforced by the consumers.

However, as the previous EU directive on injunctive action and its respective national law limited the protection of the collective interest of consumers to injunctions, and representative actions offered different levels of protection of legitimate expectations in different member states, the EU identified a need for action. With Directive 2020/1828 the EU intends to counter distortions of competition and to restore consumer and business confidence in the internal market and ensure effective enforcement of consumer protection law.

The deadline for the implementation of the EU Directive 2020/1828 expired in December 2022. The EU has stipulated that the new law is to be applied from 25 June 2023 on. After lengthy discussions, the German government agreed on a final draft of the VRUG in March 2023, which is intended to enter into force on 25 June 2023 at the latest.

The new law will enable consumers to claim damages, repairs, replacements, price reductions, contract terminations and refunds in collective redress for infringement of consumer rights.

This applies to both purely domestic and cross-border cases. In the draft bill, the German government also decided to classify small businesses with fewer than 50 employees and annual revenues of less than EUR 10 million as consumers within the meaning of the VRUG. ▶

Legislation

According to the draft bill, qualified consumer associations that have a minimum number of members and are enlisted in a special register are entitled to bring collective actions on behalf of the affected consumers as long as they receive less than 5% of their funds from private companies.

Collective action differentiates between opt-in and opt-out procedures. In the opt-in procedure, consumers must actively join the collective action; in the opt-out procedure, they must actively withdraw if they do not wish to participate. Apart from the mandatory opt-in of consumers joining a foreign representative action, the EU Directive 2020/1828 leaves the choice between opt-in and opt-out to the Member States. The German government preferred the opt-in procedure because it is more in line with the German legal system. According to the current draft, users can register to join the collective action until two months after the first oral hearing. However, the registration deadline is a controversially discussed topic and might be subject to changes before being finally agreed on. Similarly, discussions on whether the suspension of the statute of limitations should only apply to consumers who have joined the collective action or to all affected consumers are likely to take place.

Third-party financing of collective actions is permissible in principle. However, the draft bill contains inadmissibility criteria that serve to prevent abuse. For example, third-party financing by a competitor of the defendant is excluded.

In case the court finds the defendant liable, the latter is sentenced to the redress applied for by the plaintiff (e.g. compensation or payment for damages, repair, cure of defects, refunds etc.). The implementation procedure is carried out by a court-appointed administrator who is to satisfy consumers who present sufficient proof as requested by the court in its ruling.

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Implementation of the EU Whistleblower Directive

On 11 May 2023, the lower house of the German parliament (Bundestag) passed the Whistleblower Protection Act (Hinweisgeberschutzgesetz – "HinSchG") implementing mainly the Directive 2019/1937 of the European Parliament and of the Council on the protection of persons who report breaches of Union law ("Whistleblower Directive"). The HinSchG shall come into force as of July 2023. It intends to provide a stronger protection for whistleblowers when reporting violations of German or Union law. The requirements of the HinSchG may force employers to establish respective internal reporting channels for this purpose.

The HinSchG distinguishes between three kinds of whistleblowing: an internal reporting within the employer's organization, an external reporting to a German authority, and a public disclosure. A whistleblower can make use of an internal or external reporting subject to the whistleblower's discretion, whilst a public disclosure is only permissible if, inter alia, an external authority reporting failed or an urgent threat to public interests exists.

Generally, all employers with 50 or more employees must establish a respective internal reporting line as part of the mandatory whistleblower system. Such employers are obliged to set up reporting offices and to provide employees with information on the reporting process. In addition, employers need to make sure that the established internal reporting line is equipped with the personnel and material resources to effectively assess and handle reported incidents. Employees entrusted with the function of the internal reporting line must also be qualified and independent. In particular, potential conflicts of interest should be avoided and confidentiality should be ensured by a separation of the internal reporting line from other departments. ▶

Legislation

As of July 2023, this initially applies to employers with at least 250 employees, while employers with fewer employees are not yet bound by these requirements during a transition period. Those employers have to comply with these obligations as of 17 December 2023.

If a works council is established at the employer, the works council must be informed about the implementation of the envisaged whistleblower system. In principle, the works council has a right of co-determination regarding the design of the (digital) internal reporting line. Further, a works council has the opportunity to determine the relevant training requirements and measures with the employer with regard to the specific knowledge of employees working for the internal reporting line. However, the works council has no direct right of co-determination in the context of investigations resulting from a report. Nevertheless, works council information and/or co-determination rights may arise on a case-by-case basis.

Fines up to EUR 50,000 can be imposed in each case of a violation of the HinSchG. Employers should therefore act now.

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Draft bill published for the new Working Time Act in Germany

Following decisions by the European Court of Justice (ECJ) and the German Federal Labor Court (BAG), the German government must tighten the requirements for recording working hours. To this end, the Federal Ministry of Labor has now presented a draft bill for the new version of the Working Time Act (Arbeitszeitgesetz - ArbZG-E). Although the legislative process has not been completed yet, important changes are expected in terms of recording the beginning, ending and duration of daily working time.

The employer will be obliged to record the start, ending and duration of the working time of its employees on the day on which the work is performed. In general, this must be done electronically. Recording in any other way (e.g. by using a paper timesheet) is only possible in exceptional cases, e.g. due to regulations in collective agreements, company or service agreements or for companies with less than 10 employees. The recording can be done by the employees themselves or delegated to third parties (e.g. supervisors). However, the employer remains responsible for the proper recording. Despite these strict regulations, trust-based working time should remain possible, so that employees can continue to freely determine the start and end of their working time. Nevertheless, the employer has a duty to take "appropriate measures" to ensure that they become aware of violations of statutory provisions. A violation of the specific working time recording as well as the two-year retention period can be punished with a fine of up to EUR 30,000.

Due to the narrow legal requirement, there is no scope for the works council to have a right of co-determination as to whether the recording of working hours should take place. However, it does have a right of co-determination regarding the implementation of the statutory obligations, such as the design of the working time recording.

If there is a collective agreement, the parties can deviate from the statutory regulations, for example, regarding the electronic form of the daily working time recording. Certain groups may be excluded from the recording obligation if the total working time cannot be measured or determined in advance due to special characteristics of the activity performed.

The implementation period is one year. For companies with fewer than 250 employees, this period is extended to two years and for those with fewer than 50 employees to five years.

In summary, the new draft law mainly takes the interests of employees into account. It is a first draft by the Federal Ministry of Labor and Social Affairs and will still be discussed and amended. However, employers are advised to familiarize themselves with electronic working time recording, as this obligation will most likely come into force.

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Further improvements to the German R&D tax credit for companies researching and developing in Germany

Since 2020, German companies regardless of their size can claim up to EUR 1 million funding per year for their research and development (R&D) activities under the German R&D tax credit (Forschungszulage, for projects that started on 2 January 2020 at the earliest). However, more than half of the research-based companies are not yet using the funding. In addition to current discussions in the German Federal Ministry of Finance (BMF) to further extend the credit, the BMF published a new letter on this regime on 7 February 2023 to further facilitate its use.

With this new letter, it has now been made clear that companies that are horizontally linked to each other via pure asset-managing company structures (e.g. private equity funds, venture capital funds) or such structures of private investors (business angels) and in which investment companies cannot coordinate with each other, are not to be regarded as affiliated companies within the meaning of the R&D Tax Credit Act (Forschungszulagengesetz). This means that such companies can benefit from the maximum annual funding independently of each other.

Further simplifications concern the documentation. Thus, if employees are entrusted with other activities outside the funded R&D project, the work assignment in the beneficiary R&D project can also be carried out based on internal company documentation and does not have to be substantiated by means of suitable records, as was previously the case. Nevertheless, a comprehensible and meaningful documentation of beneficiary R&D projects and the associated expenses continues to be of great importance to avoid risks in possible later audits.

Possible eligibility also for German companies operating under general R&D contracts

Already in its previous letter on the R&D tax credit, the BMF defined special criteria for contract research between affiliated companies to allow wider use of the credit. Even if a comparison with the transfer pricing structure and documentation is recommended to avoid risks, companies that research and develop within the framework of contract R&D services or profit-split method as best transfer pricing and are taxable in Germany can therefore also benefit from the credit.

Specifically in this case, non-eligible contract research can only be assumed between affiliated companies if the following criteria apply cumulatively for a specific R&D project:

- Specific contracting of an R&D performing company in the same company group by the parent company or another affiliated company with a special task for a specific R&D project,
- definition or significant co-determination of the goals of the R&D and the ways of implementation by the contracting company (regarding a specific R&D project),
- agreement of a separate fee or fixed budget for the R&D project, and
- lack of permission of the contracted company without the consent of the contracting company to commission further third parties to carry out subtasks (regarding a specific R&D project).

If these criteria are not met, it can be assumed that the group-internally contracted company is carrying out its own R&D project. For a corresponding German company, this could mean that it could be eligible for funding despite existing (general) R&D contracts and cost allocation, e.g., to the parent company. If these criteria for contract research are met, the contracting company, if resident in Germany, could be entitled to claim the R&D tax credit for the specific project. If this company is based abroad, it would not be eligible for funding.

Thereby, it is not decisive where the IP generated in the context of the funded R&D activities is used. ▶

German tax authorities

First deadlines for applications expire at the end of 2024
Applications for the German R&D tax credit can also be submitted retroactively until the expiry of the assessment period, which is generally 4 years beginning at the end of the calendar year in which the entitlement to the credit arose. Accordingly, the first application deadlines will expire at the end of 2024.

Companies should allow enough time to set up the process, including selecting suitable projects and creating the necessary interfaces between the tax and R&D departments, HR and controlling, especially when applying for the first time. Once the process is set up, this will allow efficiencies in the coming years.

If eligible companies have not filed an application by now, it is recommended to do so in good time and ideally this year in order not to come under time pressure regarding the process and duration of application.

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Tax treatment of jouissance rights

Dated 11 April 2023, the German Federal Ministry of Finance (BMF) has published the final decree on the tax treatment of jouissance rights (so called "Genussrechtskapital"). The principles of this decree will be applied by the tax authorities to all open cases.

The decree tries to achieve a comprehensive presentation of jouissance rights as mezzanine capital and discusses the following aspects in a structured manner:

- Definition of jouissance rights, taking into account, in particular, civil law including a distinction from hybrid financing variants "participatory loan" (Partiarisches Darlehen) and silent partnerships (Stille Gesellschaft)
- Statements of when, from a tax accounting point of view, equity capital (so-called equity-like jouissance rights) or debt capital (so-called obligation-like jouissance rights) is given. In this respect, the financial administration has also positioned itself on jouissance rights "in a crisis" and discusses constellations with conversion and option rights (Wandlungs- und Optionsrechte)
- Specification of constellations in which accounting prohibitions or deferrals under tax law must be observed, as a result of which obligation-like jouissance rights should not (yet) be accountable for tax accounting purposes
- Tax treatment of the jouissance right's remuneration to be paid by the issuer (i.e. tax deductibility vs. non tax deduction)
- Tax aspects of the debt mezzanine swap in relation to jouissance rights ▶

German tax authorities

The existence of this decree is fundamentally positive because for the first time since 1986 there is a summarizing position of tax authorities' perspective on this topic which is sensibly structured and largely based on established Federal Tax Court case law.

The decree also provides clarity structurally; especially it confirms the "two-stage examination logic" of (i) tax balance-sheet categorization of the jouissance right and then (ii) application of the income determination principles for assessing the payments made under the jouissance right. Another positive aspect is the tax authorities' clear position that as long as there is an obligation-like jouissance right, the current remuneration to be paid represents tax-deductible expenses, even if accounting prohibitions or deferrals under tax law should apply.

Nevertheless, caution is still required in some cases and questions remain unanswered, such as the following:

- The decree states that there shall basically not be an obligation-like jouissance right in existence if such capital has been injected on a permanent basis due to the lack of an actual repayment obligation.
  If this line of thought is applied to mandatory convertible bonds (Pflichtwandelanleihe), the present decree might question the current accounting practice for mandatory convertible bonds under tax law. Because from today's perspective, such bonds constitute debt-capital for tax purposes up to the time of their conversion.

- Since 1986, tax authorities have issued six (!) administrative letters ending up with different results of the tax treatment of jouissance rights. With the present decree, one of them is now repealed, whilst all others remain in place. It therefore cannot be ruled out that the tax authorities could continue to apply selectively disadvantageous aspects of the old letters that have not been repealed.

- The decree does not comment on the tax treatment of the jouissance rights holder (e.g. the applicability of the capital gains exemption of Sec 8b Para 2 CITA, the application of Sec 8b Para 4 CITA in connection with equity-like jouissance rights as well as the application of the trade tax nesting privilege). In addition, it remains unclear whether there is access to (or exit from) the tax deposit account (Steuerliches Einlagekonto) in case of equity-like jouissance rights.

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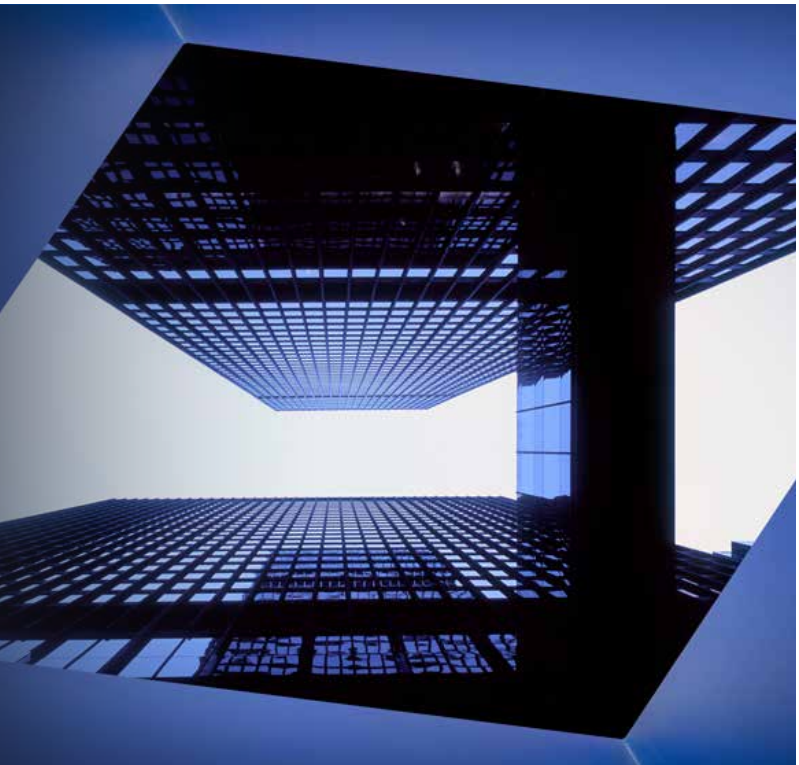
FAQs issued on new UBO reporting obligations for foreign entities and structures with German real estate



The year 2023 started with new Ultimate Beneficial Owner (UBO) reporting obligations for foreign entities that have direct or certain indirect ownership in German real estate. Even share deals that date back a long time can now trigger reporting obligations. On 5 May 2023, the German Federal Office of Administration (Bundesverwaltungsamt, BVA) issued new Frequently Asked Questions (FAQs) about various aspects of the German Transparency Register. The newly added FAQs mainly deal with details regarding the recently introduced obligations. In particular, the authorities' statements on multi-tier structures and the scope of the escape clause should be highly relevant for German inbound structures. For more information, please refer to our **English-language Tax & Law Alert dated 11 May 2023**.

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German Ministry of Finance publishes clarification on the VAT treatment of chain transactions

With a decree dated 25 April 2023, the German Federal Ministry of Finance (BMF) updated the German VAT Administrative Guidelines concerning the VAT treatment of chain transactions, in particular with reference to the transport allocation and the communication of the VAT ID number.

A chain transaction takes place when several parties are involved in the supply of the same goods, and these are transported from the first party directly to the last party in the supply chain (one transport). In such chain transactions, the movement of goods is assigned to only one of the supplies, all other supplies in the chain are so-called non-moved supplies. Only the moved supply can be VAT exempt (as intra-EU supply or as export supply).

If the first party or the last party in a chain transaction organizes the transport, the movement is ascribed to the first or the last supply. If a party in the middle of the supply chain arranges the transport, the decree shall adjust the German view of the tax authorities to the EU rules stipulated in Art. 36a EU-VAT Directive.

Accordingly, the middle party in a chain transaction who organizes the transport becomes a so-called intermediary operator. By using a specific VAT ID number, the intermediary operator can determine the allocation of the moved supply and thus, if necessary, avoid a registration obligation in another country. The new EU regulation largely corresponds to the legal situation previously applicable in Germany. From a purely German perspective, therefore, there was not much need for change. Nevertheless, there were still unanswered questions, including the use of the terms (1) "transport arrangement" and (2) "communication of the VAT ID number" in the cross-border context.

The BMF has now updated Sec 3.14. of the German VAT Administrative Guidelines accordingly:

Transport arrangement:

- If the transport is not carried out with own means of transport, but by an independent third party, the placing of the order with this third party is decisive.
- A different allocation is only permissible if the party proves that the transport was carried out for the account of another party of the chain transaction and that this other party actually bore the risk of accidental loss of the goods during the transport.

Communication of the VAT ID number:

If the intermediary operator is responsible for the transport of the goods, the supply of the preceding party to him is generally to be qualified as the moved supply. This does not apply if the intermediary operator uses a VAT ID number issued to him by the Member State of the beginning of the movement of goods vis-à-vis the preceding party before the start of the transport.

The interpretation of the term "use" varies between the individual Member States. The BMF has defined the following criteria for Germany for the term "use":

- Positive action by the intermediary operator is required at the latest by the time of delivery. A subsequent change of the used VAT ID number is ineffective.
- The VAT ID number used should be recorded in writing in the respective order document. Verbal use requires documentation of the VAT ID number and the time of use.
- However, it is sufficient if the use is deliberately made once for all future deliveries.
- Use may exceptionally be assumed to be implied if all parties have made the assessment uniformly and have fully complied with their related declaration obligations.

From a German perspective, there are no major changes as Germany already applied these principles before the introduction of the quick fixes. But there are some remaining points that have not yet been regulated uniformly throughout the EU with regard to chain transactions and that will continue to remain inconsistent (e.g. different rules for transports with two or more stopovers).

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German Federal Tax Court decides on the applicability of the margin split method concerning intercompany financing

On 22 February 2022 Germany's Federal Tax Court (BFH) decided on the applicability of the margin split method of determining arm's length interest rates, and confirmed the acceptability of this method in the specific case. In the underlying case (simplified), a German GmbH had lent funds to one of its shareholding managing directors. The decision may seem surprising because in two landmark decisions on 18 May 2021, the BFH ruled that the standard method for determining arm's length interest rates is the comparable uncontrolled price method. In this new decision the BFH stated that the rulings from 18 May 2021 are still upheld. The BFH emphasized that the particular circumstances of the current case led to this new decision.

"Private" lending scenario: The borrower owned 60% of the shares in the German GmbH and worked there as a managing director, rendering the loan as a personalized and private transaction. The company did not charge any interest for the amounts borrowed by the managing director. The German GmbH acting as lender did not engage in any other lending activities. Other evidence regarding an arm's length interest rate was not available. In particular, no data was presented concerning specific comparable loan transactions.

The BFH confirmed the decision of the regional tax court: Against this background, the regional tax court estimated the interest rate as the middle value between a typical bank deposit rate, which was 0% at the time, and a bank credit rate, which was estimated with 9% based on typical revolving overdraft rates for private households, taken from statistics of the German Bundesbank. The middle value is based on the regional tax court's general experience that private lenders and borrowers often share the margin between banking deposit and credit rates.

This decision is relevant for cross-border intercompany financing transactions because German tax auditors often try to use this margin split method for assessing interest rates. Especially in inbound transactions tax auditors often propose interest rate decreases for German intercompany borrowers based on this method. The decision from 22 February 2022 makes it clear that the margin split method should be used only in transactions characterized by private elements and non-commercial loans. Our understanding is that for loans funding commercial investments the comparable uncontrolled price method would be the method of choice. Another important qualification is that the decision concerned a domestic transaction. For cross-border transactions, the German Foreign Tax Act explicitly states that the hypothetical arm's length test should be conducted when no comparable data exists. No decision is available yet whether the margin split method complies with this test.

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Bundesfinanzhof

The shareholder of a corporation is not entitled to challenge the notice on the separate determination of the tax contribution account issued against the corporation

An assessment on the separate determination of the tax contribution account is issued as part of the tax assessment of a corporation. The Federal Tax Court (BFH) had to decide whether the shareholder of a corporation is entitled to challenge the notice on the determination of the tax contribution account. The BFH ruled against this, since only the corporation was the addressee of the notice (decision of 21 December 2022, case ref. I R 53/19). Although the determination is also of importance for the shareholder, he is not entitled to challenge the notice on the separate determination of the balance of the tax contribution account issued against the corporation.

A shareholder's own right of appeal (so-called third-party right of appeal) is only considered in exceptional cases. In the case law of the tax courts, the question of whether the substantive factual effect of the assessment notice gives rise to a third-party right of challenge for the shareholders of the corporation is the subject of controversial discussion. The BFH has now denied this due to the lack of a legal loophole.

In this respect, the BFH drew a distinction from cases in which the BFH granted the transferor the right to challenge the corporate income tax assessment of the receiving company on the grounds that the valuation for contributed assets on which it was based was too high. The BFH justified the exceptional right of third-party appeal in this case by stating, among other things, that the corporation was not legally able to successfully challenge the corporation tax assessment in this point (due to the lack of disadvantage caused by an excessively high valuation). This distinguishes the constellation from the case of the tax contribution account, since the corporation can have the assessment notice fully reviewed out of court and in court.

In addition, the granting of legal standing due to the lack of notification to the shareholders would lead to the complete invalidity and non-limitability of assessment notices, so that they would in fact be deprived of appealability. In the view of the BFH, this is not compatible with the requirement of legal certainty.

Shareholders who are affected by a tax assessment of their company should therefore carefully consider whether they can file an appeal themselves or whether they must request the company to file an appeal.

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Federal Tax Court comments on the trade tax add-back of rental expenses for a trade fair and congress organizer and a sponsor of sporting events

Rental expenses for movable and immovable assets are to be added back (partially) for trade tax purposes. Whether such an addition has to be made has been the subject of several tax court rulings in the past, especially in the case of trade fair organizers.

In a recent case, the Federal Tax Court (BFH) ruled on the add-back of rental expenses for movable and immovable assets for a trade fair, exhibition and congress organizer (ruling of 19 January 2023, case ref. III R 22/20, not published). In the underlying case, clients could book an event or production from the organizer as a complete package (in addition to use of the location, also organisation, such as advertising, provision of infrastructure, scheduling, etc.). The organizer rented movable and immovable assets for the event or production accordingly. Like the tax office, the lower court added these rental expenses to the trade tax in accordance with Sec. 8 no. 1 letters d and e German Trade Tax Act (GewStG). The BFH overturned the ruling of the lower court and referred it back for reconsideration. For the BFH, the findings of the tax court were not sufficient for the existence of fictitious fixed assets. The lower court had not sufficiently taken into account the business purpose of the company. For the BFH, the fixed asset character required by Sec. 8 no. 1 letters d and e GewStG depended on whether the organizer had to keep the same assets for a longer period of time or comparable assets for a short period of time in order to be able to organize new events again and again (with the consequence of an add-back). In contrast, the classification as fictitious current assets (consequence: denial of the add-back) is supported if the assets in question are only expected to be used for a single event and are not interchangeable with other rented movable and immovable assets. In this case, the BFH considers rented locations or equipment to be part of the "event" product.

In another recent ruling, the BFH does not consider sponsoring agreements to be rental and lease agreements within the meaning of the trade tax act, but rather contracts of their own kind. Due to the impossibility of separating the individual elements of performance, the BFH rejected the addition of sponsoring expenses for trade tax purposes. In the underlying case, the addition of expenses for perimeter advertising and the use of a club logo for advertising purposes came into consideration.

In contrast to the tax office, the BFH considered the underlying sponsoring contracts to be contracts of their own kind with inseparable performance obligations. It therefore ruled out the addition of sponsoring expenses for trade tax purposes (ruling of 23 March 2023, case ref. III R 5/22).

Taxpayers should carefully observe the criteria established by the BFH to avoid a trade tax addition in similar cases.

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Limited deductibility of losses from cross-currency interest rate swaps

The deductibility of losses realized by forward transactions (e.g., hedges, swaps etc.) against other income can, unless the forward transactions are linked to certain banking or other business operations, be denied and the losses can only be offset against profits from other (forward) transactions in the same fiscal years. Any non-deductible excess loss can be carried forward to offset future profits of the same category.

An escape is applicable for forward transactions that occur in the ordinary course of business (e.g. hedges for the procurement of goods). Hence, an objective functional relationship between the hedged transaction/risk and the hedging transaction is required (in addition to the subjective connection of both relationships). Therefore, the hedging transaction must be – at least – objectively suitable to compensate the risk arising from the underlying transaction and such transaction must also be part of the ordinary course of business.

The Federal Tax Court (BFH) decided on 9 February 2023 (IV R 34/19) that the escape cannot be applied if the forward transaction does not reduce but instead increases the risk position of the business. In the decided case, the taxpayer entered into a variable-interest-rate EUR-loan agreement with a bank (underlying transaction). To compensate the interest rate risk, the taxpayer entered into a cross-currency interest rate swap forward transaction. However, in addition to the hedging of the interest rate, the hedging transition also included a currency element. This currency element introduced an additional currency risk to the underlying transaction (i.e., swap from EUR to CHF).

It was not challenged by the BFH that the loan agreement was a transaction in the ordinary course of business and that the combined cross-currency / interest rate swap was a forward transaction within the meaning of the German tax law. However, the BFH challenged the argumentation of the taxpayer that a hedging transaction requires the forward transaction to compensate at least partially for a risk resulting from the underlying transaction. According to the BFH, the introduction of a new risk would not even meet the requirement of a hedging transaction from an objective point of view. Furthermore, the BFH argued that the cross-currency interest rate swap cannot be split into two transactions, i.e., one transaction to mitigate the interest rate risk and another transaction to mitigate the currency risk, as both risk elements are legally combined in one agreement.

In summary, the deduction of losses stemming from a (combined) cross currency interest rate swap is not limited only if all elements of the hedging transaction mitigate respective risks and do not introduce new risks.

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BFH denies double attribution of real estate property for RETT purposes in trust relationships

A trust agreement covering real estate allows the trustor to transfer the ownership of a property to the trustee whereby the trustor remains beneficiary of the property's proceeds. As a result, the legal title and the right of exploitation may vest with different parties. For German real estate transfer tax (RETT) purposes, the transfer of the legal title as well as granting or transferring an exploitation right can stipulate a taxable event.

Further, it should be considered that RETT is not only levied on the transfer of real estate but could also be triggered when shares in an entity owning domestic real estate are directly or indirectly transferred. In case a trust relationship is established, the question arises whether either the trustee (owning the legal title) or the trustor (owning the exploitation right) or both have to be regarded as "real estate owning entities", so that the transfer of at least 90% of the entity's shares should be subject to German RETT. ▶

German court decisions

In a recent case, the German tax authorities outlined their opinion that if legal and economic ownership vests with different parties due to a separation of the exploitation right from the legal title, both entities should be regarded as real estate owning entities for German RETT purposes. Thus, RETT can be triggered in case either the shares in the trustee (holding the legal title) or the trustor (holding the exploitation right) are transferred.

The BFH disagreed with the view of the tax authorities and denied the double attribution of real estate property in trust relationships for RETT purposes. In line with existing case law, the court stated that the question of whether an entity "owns" real estate for RETT purposes is neither determined by civil or valuation law nor by economic ownership. The decisive factor is purely the attribution for RETT purposes. According to that, a property is attributable to an entity if RETT was triggered by that entity based on a preceding taxable event. It follows that an asset is no longer attributable to an entity if the property has been subject to a taxable disposal to another party.

In the current case, the property's exploitation right was transferred, which triggered RETT at the level of the beneficiary, i.e. the trustor. Considering the attribution for RETT purposes as outlined above, the property shall from that moment on no longer be attributable to the trustee, even if the trustee still holds the legal title. As the trustee is no longer regarded as a real estate owning entity for RETT purposes, the shares in the trustee can be transferred without triggering German RETT regarding the respective property.

Please note that trust relationships as well as their implications for RETT purposes differ in practice and should be assessed carefully and on a case-by-case basis.

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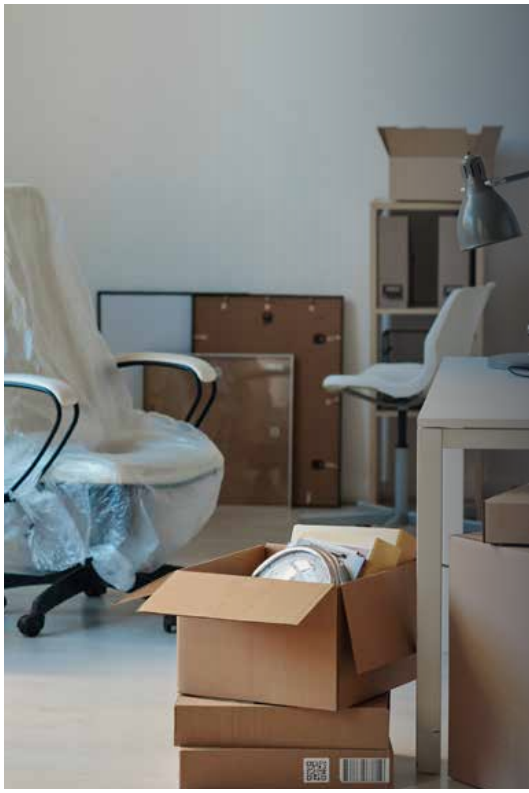
Moving abroad without triggering exit tax?

Moving abroad from Germany can have significant tax consequences, especially if substantial assets are held in Germany. For example, if an individual holds at least a 1% shareholding in a corporation, such as a GmbH (limited liability company), the shares are deemed to have been sold at the time of relocation. Although no actual capital gain has been realized, income tax is due on the notional profit and is generally due immediately. Since 2022 it is generally irrelevant to which country the relocation takes place. It is possible to apply for a seven-year interest-free tax deferral but only upon provision of a collateral to the tax authorities. In this regard, special attention is therefore to be paid to the so-called return regulation, which under certain conditions allows the tax to be remitted retroactively.



Anyone who returns to Germany within seven years (return period) and fulfils further conditions (such as no sale or transfer of the shareholding) can ultimately escape exit taxation. However, this requires an initial deferral of income tax involving a corresponding application and, in most cases, also a collateral. Regarding the requirements of the return regulation, it was unclear until recently whether the relocating individual had to already have the intention to return at the time of departure to achieve a tax remittance or whether the actual return to Germany would be sufficient. This question has now been decided by the Federal Tax Court (BFH). According to the BFH, the actual return within the return period is decisive and thus at least the (later) existence of the intention to return is sufficient, although this only applies for the general case of returning within seven years (ruling of 21 December 2022, I R 55/19). ▶

German court decisions

Upon additional application, the tax office may extend the return period by another five years (so-called extension option). The BFH did not comment on the requirements for this option in the present ruling. However, due to the different language, an intention to return could be required for the extension period.

Although the ruling still applies to the legal situation valid for relocations up to and including 31 December 2021, it also provides good arguments for its application to the current legal situation. Since the tax authorities have not yet reacted to the ruling, it therefore remains advisable to document the reasons for the intention to return (for example by means of a temporary employment or rental contract) in addition to the actual return within the return period.

However, it is to be hoped that the tax authorities will follow the opinion of the BFH, not least to provide certainty in the application of the option of return for all parties involved.

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German Federal Tax Court denies deduction of final losses of a permanent establishment following the judgement of the ECJ in case W (C-538/20)

On 22 February 2023 (I R 35/22) the German Federal Tax Court (BFH) gave its final ruling following the judgment of the Court of Justice of the European Union (ECJ) in the request for a preliminary ruling in the case W (C-538/20). The BFH decided that the so-called final losses of a German corporation which were incurred in course of the closing of its permanent establishment in the United Kingdom are non-deductible for corporate income tax and trade tax purposes because the income of the permanent establishment was tax exempt in Germany under the relevant double tax treaty in the relevant years.

The plaintiff in the main proceeding was W, a public limited company that operated as a security trading bank and whose registered office and place of management were in Germany. In 2004, W opened a branch in the United Kingdom. As that branch did not make any profits, W closed it during the first half of 2007, so that the losses incurred by that establishment could not be carried forward in the United Kingdom for tax purposes. The tax authorities denied the deduction of such final losses in Germany with reference to the relevant provisions of the double tax treaty between Germany and the United Kingdom.

On 6 November 2019 (I R 32/18), the BFH had previously referred the case to the ECJ in a request for a preliminary ruling because it was unsure whether the losses incurred by W's permanent establishment should not be taken into account for the calculation of the tax payable by that company in Germany under the freedom of establishment (Art. 49, 54 TFEU). The BFH argued that the ECJ case law resulting from its decision in Bevola and Jens W. Trock (C-650/16) did not provide a clear answer to that question in the particular case where the exemption of foreign profit is provided for by a double tax treaty.

On 22 September 2022, the ECJ decided in the preliminary ruling proceedings (C-538/20) that it would not contravene the free movement of establishment (Art. 49, 54 TFEU) if a member state denies the deduction of "final" losses that are incurred in course of the closing of a permanent establishment situated in another member state in case the member state has waived its taxation right under the relevant double tax treaty. The ECJ outlines that in contrast, in the case Bevola and Jens W. Trock (C-650/16) the member state of residence of the company which requested that the final losses incurred by its non-resident permanent establishment be taken into account had not, by means of a double taxation convention, waived its power to tax the establishment profits. Moreover, it had decided unilaterally not to take into account the profits and losses incurred by non-resident permanent establishments of resident companies, which would be different. ▶

German court decisions

Taking the decision of the ECJ in this preliminary ruling into account and in line with its previous judgments, the BFH states in its most recent decision of 22 February 2023 (I R 35/22) that under relevant provisions of the double tax treaty between Germany and the United Kingdom, the net income of the permanent establishment is subject to the exemption method, while it emphasizes once more that the net income symmetrically covers both profits and losses. It also states that final losses incurred in the case at hand are not a result of a unilateral tax provision. The BFH therefore takes the view that the losses incurred in the permanent establishment of W in the United Kingdom are not deductible.

The most recent decisions of the BFH following the judgement of the ECJ in W (C-538/20) lead to more legal certainty in case of final losses in case they are exempt under the relevant double tax treaty. In such case, they are generally to be considered non-deductible while in case the losses derive from the application of unilateral tax provisions they may potentially be deducted. Against that background, taxpayers should review their tax position in detail.

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New referral to ECJ on intra-group supplies

The German Federal Tax Court (BFH) decided on 26 January 2023 (V R 20/22) to refer generic and important questions relating to the effects of fiscal grouping for VAT purposes to the European Court of Justice (ECJ).

The BFH asks whether all supplies carried out between the controlled company and the controlling company (intra-group supplies) are non-taxable (as they are treated under current practice). Furthermore, the BFH requests a clarification in how far it makes a difference whether the recipient of the group-internal supplies is potentially entitled to input VAT deduction. These questions are primarily triggered by two preceding ECJ judgments of 1 December 2022.

The BFH's referral to the ECJ has great significance. If intra-group supplies were taxable, this would fundamentally change the German fiscal grouping rules. In industry sectors where VAT exempt output transactions are carried out (banks, insurance companies, social sector), VAT groups are established precisely to be able to provide intra-group supplies without VAT. Even though there are good arguments for leaving the current treatment unchanged, it remains to be seen how the ECJ will respond to this new request.

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Cologne tax court decides on the coordinated external audit

In a high-profile ruling by the Cologne tax court, a taxpayer unsuccessfully tried to defend himself against the admissibility of a coordinated external audit by the German tax authorities with the administrations of other European countries.

Coordinated external audits serve to clarify cross-border issues, for example, transfer pricing issues or international restructurings. They are either carried out in several countries at the same time (so-called "simultaneous audits"), or "joint audits" take place, in which tax auditors from different countries jointly carry out an audit. If necessary, this can take place with the participation of foreign officials on site. In this context, the question of whether such coordinated audits are also permissible if there are no business relationships between the participating states themselves (that could be the subject of a joint investigation) is disputed. It can be observed, for example, that European states in particular join forces within the scope of such audits in order to jointly examine the transfer pricing system involving a centralized entrepreneur entity ("principal company"). In these cases, the local companies generally do not have business relationships with each other, but only with the principal company. As a rule, however, the principal state does not participate in the audit and thus has no influence on the audit activities.

The Cologne tax court has now ruled in favor of the tax authorities in such a case. In the context of interim legal protection, the court had to assess the legality of the coordinated external audit with regard to a franchise model and the appropriateness of the prices applied to the payments within a multinational group of companies. In particular, due to the non-participation of the principal company in the coordinated external audit, the plaintiff was of the opinion that the information within the scope of the coordinated external audit was not relevant for the implementation of domestic taxation. The tax court does not follow this view of the plaintiff in its decision of 17 January 2022 (2 V 827/21). Accordingly, the comparison of parallel business relationships between the countries involved and the principal company could also be useful for the review of appropriateness. The Cologne tax court states that, for example, profit shifting is possible in principle through different pricing structures in the countries. The mere possibility of relevance is sufficient for the participation of a coordinated external audit.

The decision of the tax court is not surprising against the background of its previous case law. However, it is very regrettable that the tax court did not allow the appeal before the Federal Tax Court (BFH) in this important matter. Irrespective of this, it can also be expected for the future that the tax authorities will be given a wide scope of discretion in participating in coordinated tax audits. On the other hand, practice shows that coordinated tax audits can also have advantages for taxpayers, because procedures run in parallel in several countries and can then ideally be completed more or less simultaneously.

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Tax court of Nuremberg denies the application of the AOA due to the absence of a dealing

For all financial years starting after 31 December 2012, Germany treats a permanent establishment (PE) of a company having its head office in another state like a separate and independent enterprise for income tax purposes and implemented therewith the basic principles of the Authorized OECD Approach (AOA) in Section 1 of the Foreign Tax Act (FTA) and the Regulation for the Profit Attribution to Permanent Establishments (PE Regulation). Accordingly, the arm's length principle is generally applicable to transactions (dealings) between the head office and the PE.

Under the PE Regulation, in cases of construction and assembly PEs, the involvement of the PE in the construction and assembly contract is rebuttably considered as a dealing. This is to be regarded as a service provided by the construction and assembly PE to the head office and is regularly remunerated according to a cost-based transfer pricing method (i.e. cost-plus method). However, in a recently published decision (dated 27 September 2022, case ref. 1 K 1595/20), the tax court of Nuremberg ruled that no fictitious markup rates are to be applied between the head office and its assembly PE, and that only costs are to be reimbursed. ▶

German court decisions

In this particular case, a Hungarian corporation (head office) rendered contractual services to third parties. The extent to which the domestic assembly PE of the Hungarian head office was involved in the provision of services is not clear from the description of the facts by the tax court. However, the PE charged its own costs to the Hungarian head office without any markup. The German tax office assumed that there was a dealing between the PE and the head office and calculated the profit of the PE in accordance with Sec. 32 PE Ruling, taking into account a (fictitious) mark-up rate of 10%.

The tax court of Nuremberg disagreed with the approach of the tax office. For the court, there was no evidence of an assumed service relationship (dealing) between the head office and the PE and hence Sec. 1 para 5 FTA would not be applicable. The judges therefore treated the payments made by the Hungarian head office as mere reimbursements of costs.

The case is now pending at the Federal Tax Court (BFH, I R 45/22) so that a final decision is still open. Against the background that the AOA in German tax law is located in the transfer pricing adjustment provision of Sec. 1 FTA instead as part of the profit determination rules, the BFH will rule in particular on the relationship between Sec. 1 para 5 FTA in connection with the PE Ruling and the general profit determination rules in German tax law.

In comparable cases, taxpayers should keep the proceedings open until this matter is finally decided by the BFH.

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Lower tax court accepts a loss carry back in case of a retroactive merger

Pursuant to Sec. 8c para. 1 Corporate Income Tax Act (CITA) tax loss carry forwards as well as current year losses forfeit in case of a change of control. The lower tax court of Cologne had to decide whether current year losses up to the date of the harmful change in ownership can nevertheless be carried back in previous years (ruling of 8 December 2022, case ref. 13 K 198/20). In the underlying case, all shares of a GmbH were acquired during the year. After acquisition, the GmbH was merged into its new shareholder. While the GmbH was profitable in previous years, it incurred a loss during the current financial year until the harmful change in ownership. The court ruled in favor of the taxpayer that a carry back of the losses incurred until the harmful change in ownership is allowed. The decision has been appealed to the Federal Tax Court (BFH, case ref. I R 1/23). Taxpayers should monitor whether the BFH confirms the ruling of the lower tax court.

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Regional tax court of Baden-Württemberg ruled: Foreign exchange losses on shareholder loans also deductible even before FY 2022

As a consequence of the participation exemption regime, losses (e.g. impairments) in connection with shareholder loan receivables are generally not tax deductible for corporate income tax purposes. Basically, a loan is considered a shareholder loan if the lender and the borrower are related parties. Also, financial relationships which could be considered as comparable to a shareholder loan could be affected.

It was discussed controversially for a long time whether the denial of the deductibility of losses according to Sec. 8b para. 3 sentence 4 of the German Corporate Income Tax Act (CITA) included currency losses, e.g. losses resulting from a non-EUR denominated loan due to a deteriorated exchange rate upon realization from the perspective of the German lender, in particular as in the corresponding case of foreign exchange gains, these are fully taxable.

Effective for FY 2022, a law change was introduced to expressly exclude exchange rate-driven (FX) losses from being denied for deduction purposes. Hence, there is now a symmetry between FX gains and losses whereby both are fully tax effective.

In its ruling of 27 September 2022 (6 K 1917/20), the regional tax court of Baden-Württemberg ruled for the previous tax treatment until and including FY 2021 that Sec. 8b para. 3 sentence 4 CITA is not applicable to foreign exchange losses. This result is based on a restrictive interpretation of the rule: Although the wording of the rule is quite broad, according to its original meaning the rule shall only prevent arrangements in which the denial of the deductibility is circumvented by granting shareholder loans instead of equity in related party scenarios. In contrast, FX effects are not under control of the parties. In particular, the FX losses are not caused by the corporate relationship and are completely independent of the arm's length nature of the loan. Instead, they are only caused by market conditions. Furthermore, the tax court states (as well as the legislator within the recent legislative process) that it should be intended to eliminate the aforementioned asymmetry that prevailed until FY 2022.

Due to the broad scope of the rule, the decision of the tax court is of high importance, especially for cases still open due to tax audits or appeals.

Since the appeal against the decision is now pending before the Federal Tax Court (BFH, I R 11/23), the BFH has the opportunity to comment on this longstanding controversial discussion and clarify the position regarding the deductibility of FX losses. However, it has to be noted in this context that there is also a second decision pending before the BFH (I R 41/20) which was decided earlier in 2020 also by the tax court of Baden-Württemberg (3 K 1486/19) – and as a surprising fact, another senate of the same tax court confirmed in the previous ruling the view of the tax authorities, namely to apply Sec. 8b para. 3 sentence 4 CITA on FX losses.

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ECJ rules that German taxation of non-German resident specialized property funds is not in line with EU law

On 27 April 2023, the Court of Justice of the European Union (ECJ) decided in the request for a preliminary ruling of the German Federal Tax Court (BFH) in the case L Fund (C-537/20) that the German rules for the taxation of non-German resident specialized property funds, as applicable until 31 December 2017, are not in line with the free movement of capital (Art. 63 of the treaty of the functioning of the European Union, TFEU).

L Fund is a property fund set up as a specialized investment fund under Luxembourg law (SIF-FCP), with neither its registered office nor its central administration in Germany. The fund is a closed-end fund with only two institutional investors. In the relevant years, L fund had received income from renting out its properties and from the sale of some of them. Under German tax law it was therefore liable to tax with its German-sourced income. In contrast to domestic open-ended investment funds, L Fund could not benefit from the exemption from corporate income tax provided for in the German Investment Tax Act because it was a foreign fund. The exemption from corporate income tax of domestic funds is based on the so-called transparency principle, under which income is taxed only once, at the level of the investor, who must pay tax on dividends distributed or on income equivalent to such distribution in the case of a fund which retains the income it receives. As Germany has no taxation rights on non-resident investors of foreign funds, the law provided that to ensure the taxation of the non-resident investor in Germany the foreign fund was subject to taxation in Germany.

In the view of the ECJ, the difference in tax treatment of German resident and non-resident funds restricts the free movement of capital and is not justified by overriding reasons of public interest, in particular not the coherence of tax systems and the balanced allocation of the power of taxation between the Member States. Even if the ECJ states that the referring court has to determine whether the direct attribution of income from property to non-resident investors and the taxation of resident investors compensate for the exemption granted to those funds, the court pointed out that the legislation goes beyond what is necessary in order to ensure the coherence of that tax system. The consistency of the tax systems could also be maintained if non-resident specialized property funds could benefit from the exemption from corporate income tax, provided that its investors pay a tax equivalent to which investors in resident specialized property funds are liable. Regarding the balanced allocation of taxation, the ECJ states that a Member State cannot rely on the need to ensure a balanced allocation of the power of taxation between Member States in order to justify the taxation of non-resident funds which receive such income where a Member State has chosen not to tax resident funds on their domestic income.

The judgement of the court is in line with the decision in Fidelity Fund (C 480/16) and Allianz-GIFonds (C 545/19) and indicates once more that German legislation of the German investment act until 31 December 2017 was inconsistent with EU law. For specialized property funds, the BFH is expected to soon render a final decision in the main proceeding (I R 33/17). Also, decisions of the BFH in other pending proceedings in case of a French FCP (I R 1/20) and a Luxembourg SICAV (I R 2/20) should be rendered soon. Taxpayers who have filed protective claims in the past should monitor the further development and pursue pending refunds for relevant years.

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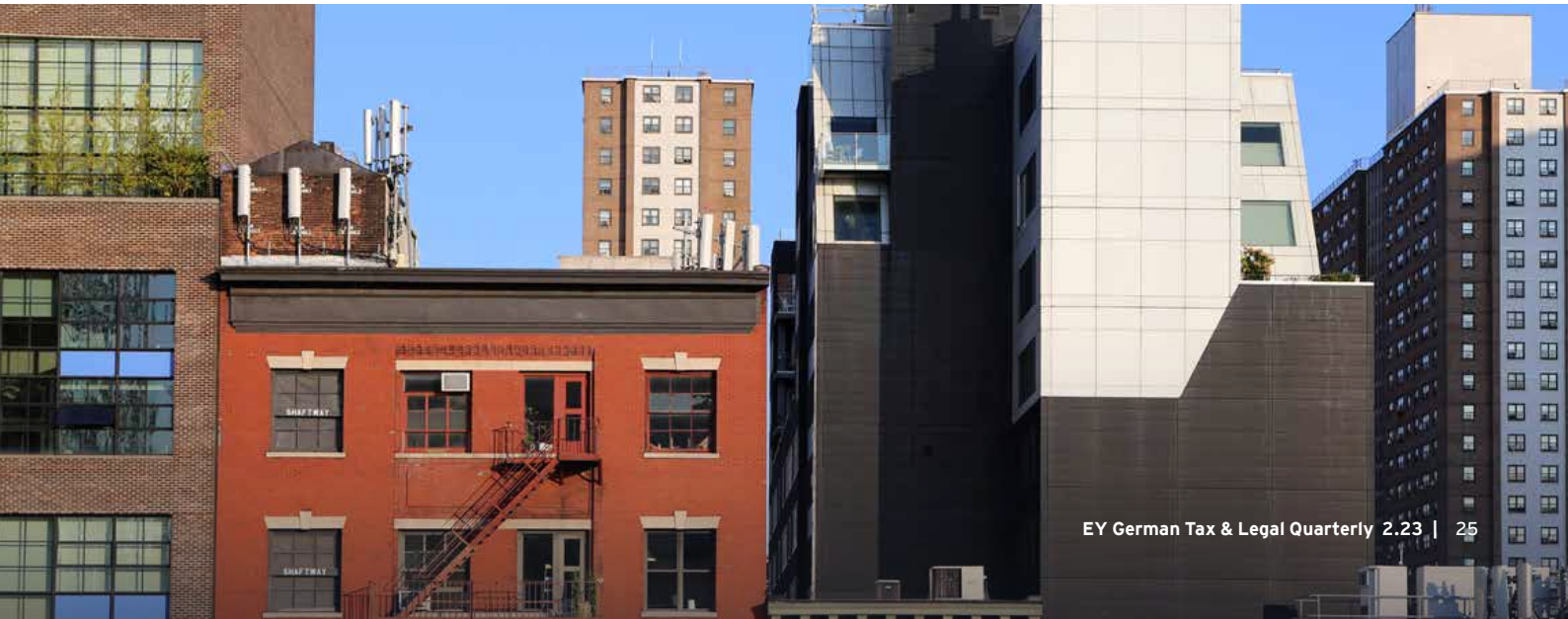

Breach of RETT notification obligation could result in double taxation

German Real Estate Transfer Tax (RETT) is not only levied on the transfer of domestic real estate but can also be triggered when shares in an entity owning real estate located in Germany are directly or indirectly transferred. The list of taxable events which cover so-called share deal scenarios has been extended over time to close legislative loopholes used for saving RETT in accordance with applicable law. As of today, the German RETT Act provides seven different taxable events only related to share deals.

The relevant threshold for the transfer of shares triggering RETT of currently 90% applies to all taxable events for share deals. However, the legal technicality of the taxable events varies and accordingly the time of taxation and the relevant taxpayer may differ.

Due to the variety of rules, several taxable events can be triggered in the course of one transaction. Accordingly, signing of the share purchase agreement as well as the legal transfer of shares (closing) each constitute a taxable event. To avoid double taxation, the law itself foresees a subsidiarity of the taxation at signing to the taxation at closing. As a result, RETT should be levied only at closing of the transaction.

According to the German tax authorities, the subsidiarity principles should only apply if the taxable events are triggered at the same time. Thus, if the dates of signing and closing deviate, RETT might be triggered twice. This view was recently codified by the German legislator when introducing Sec. 16 para. 4a RETT Act as the legal basis for these scenarios. Pursuant to the new rule, the assessment of the taxable event triggered at signing is suspended upon application if and when RETT is triggered at closing, i.e., when the shares are transferred in rem. Importantly, the taxpayer is only entitled to apply for the suspension if the competent tax authorities have been notified about both taxable events (at signing and at closing) in a timely and complete manner. A denial of the application should result in a situation where RETT is levied twice for the same share transfer.

Considering the notification period of two weeks for domestic taxpayers and one month for foreign taxpayers as well as the extensive list of required information, the timely and complete filing of the RETT notifications is a challenge in practice. To meet the German RETT notification obligations, we recommend addressing the topic at an early stage of a share deal transaction. As purchaser of shares, it should also be considered to include respective clauses in the share purchase agreement and to align with the seller on the information gathering process.

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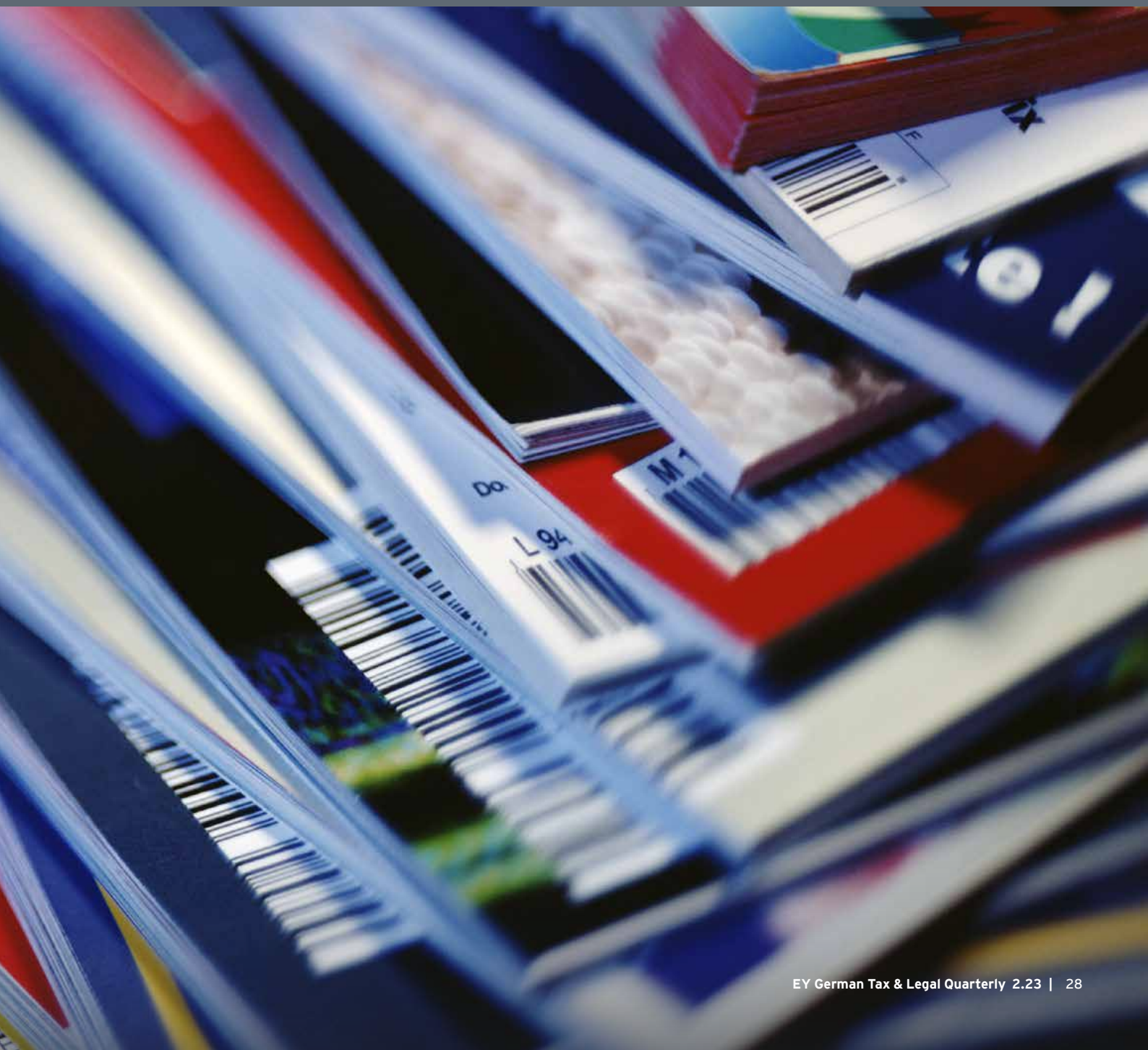

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