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German government publishes draft bill for Growth Opportunities Act

Draft bill proposes the most significant corporate tax changes in Germany in 15 years

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The German Federal Government agreed on a draft bill with several new tax incentives to support the economy on its way out of the current recession. The Growth Opportunities Act primarily focuses on the areas of loss offsetting, investment and research incentives including enhanced tax depreciation opportunities as well as a more attractive taxation for partnerships. However, it also contains counter-financing measures, especially concerning interest deductions and new mandatory disclosure rules covering certain domestic tax arrangements. In total, the government draft bill, which was agreed on 30 August 2023, provides for an annual tax relief of EUR 7 billion and comprises the most significant corporate tax changes in Germany in 15 years, with a special focus on SMEs. Since some of the new tax incentives are intended to apply only temporarily while the more restrictive measures of the package are expected to remain, the budget effects are likely to decrease over time. ▸

German government publishes draft bill for Growth Opportunities Act

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The key measures of the package are:

New premium for climate protection investments

A newly introduced premium for climate protection is planned to apply for the years 2024 to 2029. The premium is to be available for investments in new and existing depreciable movable fixed assets that are part of an energy-saving or energy-management system. The premium would amount to up to 15% of the investment, but would be capped at EUR 30 million per taxpayer.

Increased R&D allowance

In case of the existing R&D allowance of 25% of the qualifying expenses, the maximum base is to be tripled to up to EUR 12 million and extended to also cover the acquisition and production costs of depreciable movable fixed assets used in a qualifying R&D project, resulting in a maximum benefit of EUR 3 million per year. For SMEs, the R&D allowance will be increased to 35%. In addition, the draft foresees increasing the portion of expenses for contract R&D that can be considered in the base of the allowance to 70%.

Tax loss deduction

Regarding the utilization of tax losses, the draft proposes several substantial changes: The tax loss carryback for individual income tax or corporate income tax (CIT) purposes is to be extended to up to three years (currently two years) and the increased amounts of EUR 10 million for an individual and EUR 20 million in case of joint assessment of individuals temporarily introduced as a measure within the COVID-19 pandemic (otherwise EUR 1 million / EUR 2 million) are to be made permanent. For loss carryforwards, the percentage limit up to which losses brought forward above EUR 1 million may be offset against current income will increase from the current 60% to 80% in the years 2024 to 2027.

Interest deduction limitation

The draft bill provides for a comprehensive reform of the interest deduction limitation. Both the equity escape clause and the group exception for businesses not part of a group are to be adapted to the requirements of the ATAD by means of individual adjustments to the definition of a group and the stand-alone feature, among other things. Accordingly, the stand-alone clause should only apply if the taxpayer is not closely related to any person according to sec. 1 para. 2 Foreign Tax Act (AStG) and does not possess a permanent establishment outside the state of residence of the taxpayer.

A separate rule would deny the deduction of interest expenses paid to related parties to the extent the interest rate exceeds a variable maximum rate. The maximum interest rate is defined as the base interest rate according to the German Civil Code (currently 3.12%) plus 200 basis points. However, if and to the extent that the taxpayer can demonstrate that the taxpayer as well as the ultimate parent of the group could only procure funds at a higher interest rate (with otherwise equal conditions), this higher interest rate is the maximum interest rate for purposes of the rule. Moreover, the bill allows a substance exception under which the rule would not apply if the lender has appropriate substance in the jurisdiction of its residence. ▶

Legislation

Reporting obligation for domestic tax arrangements
A reporting obligation for national tax arrangements would be introduced and would closely follow the implemented mandatory disclosure regime for international tax arrangements.

Updated rules for partnerships
The "check-the-box" election for partnerships to be taxed as corporations is to be adjusted to increase its attractiveness. The scope of the application would be extended to all partnerships (currently only available to certain partnerships). In addition, the timing will be adjusted so that it would be possible to elect to be taxed as a corporation as of the foundation of a partnership (currently only permitted as of the first fiscal year after foundation). In addition, the taxation scheme for retained earnings of partnerships will be expanded.

New rules for depreciations
For movable fixed assets acquired after 30 September 2023, and before 1 January 2025, a declining balance depreciation of up to 25%, up to a maximum of 2.5 times of the linear balance depreciation, is to be reintroduced for a limited period. Furthermore, a declining balance depreciation of 6% will be available for newly constructed residential buildings. In addition, more attractive deprecation rules are planned for low-value assets and for SMEs.

Additional changes
In addition, the draft bill proposes amendments to several other rules, such as:

- Changing the claw-back provisions within tax-neutral demergers; effectively, the proposal seeks to counteract case law that deems a share transfer of 20% or less within five years after a tax-neutral demerger as not harmful
- The gradual introduction of mandatory electronic invoices as of 2025 (for more details, please see the article below on "Draft bill envisages the introduction of an e-invoicing obligation for domestic B2B supplies in Germany")
- Increasing the de minimis threshold for income from the delivery of electricity within the extended trade tax reduction for real estate businesses from tax year 2023 onward
- Implementing the European Union Mutual Assistance Directive for joint audits
- Increasing lump-sum allowances for meals and for company events

The German government plans to obtain the approval of both German parliamentary chambers by the end of 2023. It is expected that during the further parliamentary proceedings, several changes will be made to the draft bill.

Please also see the *EY Global Tax Alert dated 6 September 2023.*

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Germany kicks off new national funding program "Klimaschutzverträge" — Carbon Contracts for Difference

The German Federal Ministry for Economic Affairs and Climate Action (BMWK) has launched the new funding instrument "Klimaschutzverträge" in draft form, which aims to accelerate the transformation of energy-intensive industries towards climate-friendly processes.

In summer 2023, the BMWK conducted the first preparatory procedure for the new funding instrument "Klimaschutzverträge" based on the concept of Carbon Contracts for Difference (CCfDs).

"Klimaschutzverträge" — Carbon Contracts for Difference
This new financing instrument, which is still in draft form and must be notified at the European Commission, is intended to enable a combined CAPEX and OPEX funding on the basis of private-sector hedging contracts over a period of 15 years. CCfDs are designed to give companies planning security against certain price developments and to help mitigate price risks, e.g., for energy/electrical power.

However, due to the planned double-acting funding mechanism, there may be a corresponding repayment to the funding provider if the transformative process becomes increasingly profitable compared to the conventional process.

Who is eligible for funding?
The planned "Klimaschutzverträge" are intended to transform projects in the energy-intensive industries that are subject to the EU emissions trading system, such as glass, ceramics, basic materials, cement, lime and steel.

In this context, eligible projects must save 90% of CO_2 compared to the reference system (defined as the currently market-dominant production technology) in the last year of the "Klimaschutzvertrag". Other criteria include a minimum size of the reference systems of more than 10 kt CO_2 equivalent per year. According to the current draft funding guideline, eligible projects should as a general rule enter into operation 36 months after grant notice (extension to 48 months is possible).

How do you apply for a "Klimaschutzvertrag"?
The funding in form of a "Klimaschutzvertrag" is awarded through a competitive procedure. The applicant calculates the amount of funding by comparing the costs of the transformative project plant with the costs of the conventional reference plant under consideration of green premium price add-ons. The relevant evaluation criteria include the funding efficiency and relative greenhouse gas emission avoidance compared to the conventional reference system. The basis for determining the funding efficiency are additional costs per ton of CO_2 avoided.

It is planned to conduct funding calls twice a year. In preparation for each bidding procedure, a so-called preparatory procedure may be carried out to support planning procedures at the BMWK. Companies wishing to participate in the subsequent bidding procedure are obliged to participate in the preparatory procedure first. The next preparatory procedure is expected to be launched in the first half of 2024.

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Luxembourg and Germany agree on an amending protocol to the DTA

In July 2023, the Ministries of Finance of Luxembourg and Germany agreed on an amending protocol to the existing double taxation agreement (DTA) of 23 April 2012. The protocol contains a significant amendment regarding the taxation of fund structures. In future, investment funds in the legal form of a Luxembourg "Fonds Commun de Placement" (FCP) – which are frequently encountered in practice – should themselves be eligible for treaty benefits (previously, the protocol to the DTA of 23 April 2012 only provided for "partial treaty eligibility" insofar as the shares in the FCP were held by persons resident in Luxembourg). This may have an impact particularly on equity funds in the legal form of an FCP that generate income from securities lending and repo transactions with German shares over the dividend record date. In future, the treaty protection for "other income" under Article 20 of the DTA should apply to this income.

In addition, the minimum standards of the BEPS project under treaty law and new rules for cross-border workers are to be implemented in bilateral relations with Luxembourg. Depending on the upcoming domestic implementation procedure and if the instruments of ratification are exchanged before the end of the year, the amending protocols may enter into force this year and would in principle be applicable as of 1 January 2024. Otherwise, the application would likely be delayed until the year 2025.

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DTAs with Austria, Switzerland and Mexico

Germany signed amendment protocols to the double taxation agreements (DTAs) with Austria as well as with Switzerland on 21 August 2023. Both DTAs focus on the bilateral implementation of BEPS measures according to the OECD multilateral instrument (MLI).

The amended DTA with Austria will also cover new rules for cross-border works. The amendment protocol to the DTA with Mexico signed on 8 October 2021 entered into force on 6 August 2023. It will, in general, be applicable as of 2024 and implements several MLI measures.

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Discussion draft on the Real Estate Transfer Tax Reform published

After the Federal Ministry of Finance (BMF) published a key points paper on the reform of the RETT-Act in June 2023, a discussion draft for a so-called RETT Amendment Act (GrEStNG) has emerged. The draft is currently being voted on by the federal-state governments. The RETT reform would come into force on 1 January 2024 and would generally apply to transactions made after 31 December 2023. Whether the RETT Amendment Act will be passed as introduced by the BMF remains uncertain and the intended implementation timeframe appears rather unlikely. For future transactions involving real estate or real estate owning companies, it is nevertheless advisable to consider the consequences of the new draft of the RETT Amendment Act at an early stage. Read more about the content of the discussion draft in *our EY Tax Zoom of 20 July 2023*.

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Draft bill envisages the introduction of an e-invoicing obligation for domestic B2B supplies in Germany

The recent draft bill of the Growth Opportunities Act (Wachstumschancengesetz) stipulates the introduction of an e-invoicing obligation for domestic B2B transactions between two entrepreneurs established in Germany.

Though an e-invoicing obligation violates the current regulations of the Value Added Tax Directive, the EU Council explicitly authorized Germany to introduce such rules.

The draft bill newly defines the term electronic invoice. Only invoices which are issued, submitted and received in a structured electronic format and allow electronic processing qualify as electronic invoices. An electronic invoice has to comply with the provisions of the Directive 2014/55/EU, which means that it has to be in accordance with the CEN Norm EN 16931. Invoices which do not meet the above mentioned criteria, such as paper or pdf invoices, qualify as so called "other invoices".

The e-invoicing obligation is limited to domestic B2B transactions between two entrepreneurs established in Germany. Such establishment in Germany is given in case the entrepreneur has its seat, place of management or fixed establishment (in case the fixed establishment is involved in the respective turnover) in Germany. Vice versa, entrepreneurs which are registered but not established in Germany would according to the current status of the draft bill not be affected by the e-invoicing obligation.

Though the new regulations apply from 2025 onwards for turnovers performed in 2025, invoices can still be issued in paper or in another electronic format that does not comply with the regulation for electronic invoices (such as pdf documents) in case the recipient agrees. Nevertheless, the entrepreneur has to be able to receive electronic invoices. However, from 2026 onwards the e-invoicing obligation becomes mandatory. For turnovers performed until the end of 2027 also invoices that do not comply with the electronic format CEN Norm EN 16931 are permitted as long as the recipient agrees and it is submitted within the EDI procedure.

The introduction of a mandatory e-invoicing obligation leads to substantial challenges for businesses as it requires an intensive and time consuming preparation and implementation process with an early and constant engagement with this topic.

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German minimum tax plans: Update on deferred taxes and accompanying measures

The German minimum tax implementation bill is on its way through the legislative process. Following the discussion draft and the ministerial draft, a revised government draft is now available. The government draft of 16 August 2023 supplements the regulations on the minimum tax in particular with the following new elements:

- In German local GAAP, mandatory exceptions from the accounting of deferred taxes resulting from the application of the Minimum Tax Act or corresponding foreign minimum tax laws are added for German local GAAP individual and annual financial statements. The exception is modelled on the International Accounting Standards (IAS 12.4A) and is intended to prevent companies that prepare their financial statements in accordance with the German Commercial Code from being obliged to calculate deferred GloBE taxes - unlike for IFRS or US GAAP. As soon as the International Accounting Standards Board has reviewed the IAS regulation, the German local GAAP exemption will also be examined.

- The regulations in the Minimum Tax Act on deferred taxes will be adjusted in detail, but it is still not intended to take deferred taxes into account for minimum tax purposes irrespective of the exercise of the option pursuant to section 274 German Commercial Code. This may have a negative impact on the tax rate and the amount of adjusted covered taxes, provided that a change in accounting is not possible for other reasons. ▶

Legislation

- Compared to the ministerial draft, the regulations on business units that are subject to a group taxation regime in a tax jurisdiction (Sec. 35 MinStG-E) have become stricter. In Germany, this applies to the fiscal unity (Organschaft) for income tax purposes. The option granted in Sec. 35 (1) MinStG-E to apply the consolidation principles of the ultimate parent company to transactions between these companies must no longer be exercised uniformly only for the business units actually subject to the group taxation regime (members of the fiscal unity), but also uniformly for all business units located in this tax jurisdiction (Sec. 35 (2) MinStG-E). In addition, the original explicit provision allowing the premature withdrawal of individual members from the fiscal unity for good reason has been dropped.

- Inclusion of a provision in Sec. 91 MinStG-E, according to which all business units as well as joint ventures and joint venture subsidiaries are obliged to provide the filing entity with information required to prepare the tax return.

- A new Sec. 17 MinStG-E implements a provision of the OECD Administrative Guidance, according to which financial instruments are to be classified uniformly as equity or debt capital for the issuer and the holder. In case of deviations, the issuer's classification applies.

Besides the minimum tax implementation, the government draft bill includes some complementing domestic measures. The most important measure is that the low tax threshold under the German CFC income imputation rules is to be reduced from 25% to 15%. However, the previously contemplated abolition of the trade tax inclusion of CFC income imputation amounts is no longer envisaged. Also, the so far foreseen abolition of the limitation of deductibility of royalty payments to taxpayers subject to non-OECD Action 5-compliant preferential taxation has been dropped. Instead, it is planned to also reduce the low tax threshold in this provision to 15% and to thus reduce the scope of application of the royalty deduction limitation rule barrier.

On 29 September 2023, the German federal council (Bundesrat) is to adopt a position. The subsequent deliberations in the German federal parliament (Bundestag) are likely to result in further detailed changes to the minimum taxation and possibly also to the complementing measures. Both government institutions must have approved the law by 15 December 2023 at the latest so that the minimum tax can be implemented by the end of 2023 as provided for by the EU Minimum Tax Directive.

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Act to Modernize the Law on Partnerships – overview of upcoming changes

The Act to Modernize the Law on Partnerships (Gesetz zur Modernisierung des Personengesellschaftsrechts, MoPeG) was already passed in 2021. The extensive new regulations will come into force mostly on 1 January 2024.

The reform focuses on the law of civil partnerships (Gesellschaft bürgerlichen Rechts, GbR). The provisions in the German Civil Code (Bürgerliches Gesetzbuch, BGB) on civil law partnerships have been completely redrafted. The main change concerns the statutory recognition of the legal capacity of the GbR.

Amendments of the German Commercial Code (Handelsgesetzbuch, HGB) on the law governing commercial partnerships (Personenhandelsgesellschaften) also mostly relate to the comprehensive changes to the BGB. While the law governing general partnerships (Offene Handelsgesellschaft, OHG) has been comprehensively reworded, the changes to limited partnerships (Kommanditgesellschaft, KG) are of a more marginal nature. MoPeG in part merely reflects case law and legal literature developed in recent years, such as the legal capacity of the externally acting GbR. The main amendments are the following:

A company register will be introduced with the consequence that in future there will be a GbR without legal capacity, an unregistered but legally capable GbR, and a legally capable GbR registered in the company register (so-called "eGbR"). However, there is no obligation for every GbR to be registered in the newly created company register. ▶

Legislation

In order to be able to acquire real estate or other registered rights in the future (e.g. registration of the eGbR in the list of shareholders of a German limited liability company (GmbH)), registration is required. With the entry in the company register, corresponding entries in the transparency register pursuant to section 20 Anti-Money Laundering Act (Geldwäschegesetz, GwG) are required.

Furthermore, the eGbR will then be a legal entity eligible for transformations according to the Transformation Act (Umwandlungsgesetz, UmwG).

Partnership law becomes more similar to corporation law with regard to the participation ratios of partners; the voting power is therefore – in principle – no longer based on per capita shares but on the contributions made (comparable to capital contributions). Services - different to corporations - can be eligible contributions. If no values of contributions have been agreed, the shareholder shall continue to be obliged to make equal contributions.

Further, it is now possible to elect an administrative seat (Verwaltungssitz) within Germany. A foreign administrative seat deviating from the domestic contractual seat is also possible (subject to acceptance in the host country). This allows eGbRs to freely choose their administrative seat. This shall also apply to other commercial partnerships, which makes it possible for partnerships to conduct their business activities outside Germany and still retain the German legal form.

The German legislative has codified some more "best practices", e.g. the so-called unified partnership (Einheitsgesellschaft), in which the limited partnership is at the same time the sole partner of its general partner; this is now also recognized by law.

Apart from that, the commercial partnerships are now open for so-called liberal professions (subject to professional laws) and a default law for partnership resolution is introduced. With regard to limited partnerships, the distinction between the contribution under corporate law and the liability sum to be registered in the commercial register is made linguistically more precise.

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New provisions for the German financial markets due to the Future Financing Act

The government draft of the Act on the Financing of Sustainable Investments (Zukunftsfinanzierungsgesetz; ZuFinG), which was adopted on 16 August 2023, contains new proposals in capital market law and company law as well as changes to the tax framework for employee share ownership.

The main objective of this draft is to introduce comprehensive tax, corporate and financial market law measures to modernize the capital market and facilitate access to the German capital market for start-ups, high-growth companies (Wachstumsunternehmen) and small to medium-sized enterprises (SMEs) and to make the capital market more attractive overall. Some of the measures are listed below:

- One of the main measures is to reduce the minimum capital for an initial public offering (IPO) from EUR 1.25 million to EUR 1 million to simplify the IPO process. It will also be possible to apply for listing without the previously required accompaniment by an issuing officer.

- With the introduction of a so called "Börsenmantelaktiengesellschaft" (BMAG), the approach to the capital market via a stock corporation or SE shall be simplified for start-ups and growth companies. A BMAG is a shell company (Mantelgesellschaft) which is established for the purpose of achieving listing on the stock exchange. Consequently, the object of such BMAG is the management of its own assets, the preparation and execution of its own IPO and the preparation and completion of the takeover transaction that meets the criteria described in the listing prospectus and relates to a company that is not listed on a stock exchange. ▸

Legislation

- To help founders/start-ups retain strategic control over their company even as they are raising additional investors and equity, multi-voting shares (so called Mehrstimmrechtsaktien) shall be reintroduced into German stock corporation law. According to the governmental draft, it will be possible to issue multiple-vote shares with voting rights of up to 10:1.

- In the future, legal communication with the Federal Financial Supervisory Authority (BaFin) will be expanded to include the option of electronic communication.

- A further modernization of the capital market relates to the introduction of so-called electronic shares, which can be issued under the Electronic Securities Act (Gesetz über elektronische Wertpapiere, eWpG). Registered shares will be offered in two electronic forms: as central register securities and as crypto securities. Bearer shares, on the other hand, remain limited to central register securities.

- To facilitate capital increases and to speed up the process, the simplified exclusion of subscription rights (vereinfachter Bezugsrechtsausschluss) in stock corporation law shall be raised from 10% of the capital stock to 20%. In addition, the limits for conditional capital (bedingtes Kapital) in the case of business mergers and for subscription rights of employees and members of management are to be raised from 50% and 10% to 60% and 20% respectively.

- Finally, an area exemption for general terms and conditions (GTC) from GTC control is introduced in contracts between banks and other financial service providers that hold licenses under the German Banking Act (KWG), the German Securities Institutions Act (WpIG) and the German Payment Services Supervision Act (ZAG). This is intended to ensure that contracts can be structured in accordance with international standards.

- For income tax purposes, the framework for employee share-plans (e.g. stock options) shall be amended. The tax allowance for free or discounted transfer of employee shares is to increase to EUR 5,000. However, shares of more than EUR 2,000 per calendar year must be provided in addition to the salary owed anyway (additionality requirement). The scope of application for deferred taxation to avoid "dry income" shall also be extended.

- For indirect tax purposes, a tax exemption for consortium leader services shall be established. Furthermore, investing in renewable energy sources is to be made easier for alternative investment funds.

The Federal Council (Bundesrat) will give its opinion on the government draft on 29 September 2023 before the draft is submitted to the Federal Parliament (Bundestag) for further parliamentary deliberations. The legislative process is expected to be completed by the end of 2023.

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German tax authorities

Revised BMF decree on the so-called "group clause" for RETT purposes

After the Federal Tax Court (BFH) recently contradicted the tax authorities' restrictive interpretation of the determination of the controlling company in the context of the RETT group clause, the tax authorities have reacted by revising their identical decrees of the supreme tax authorities of the federal states on the group clause for RETT (Sec. 6a RETT-Act) purposes of September 2020. The new decree dated 25 May 2023 replaces the previous decree dated 22 September 2020 and applies to all open cases. The main updates are as follows:

Bundesfinanzhof, Foto: Andreas Focke

In addition to the implementation of the BFH case law and editorial adjustments of the decree to the new legal situation resulting from the RETT reform, in particular the introduction of Sec. 1 para. 2b German RETT Act including the reduction of the participation limits and the extension of the deadlines, the tax authorities have made further selective adjustments. Correspondingly, in particular the examples of the decree were adjusted to the legal situation applicable as of 1 July 2021.

In its ruling of 28 September 2022 (case ref. II R 13/20), the BFH confirmed its case law on the group clause for RETT from 2020 and developed it further to the effect that the determination of the "controlling company" and the "dependent company" is based on the respective transaction of reorganization favored under Sec. 6a RETT-Act. In this respect, the BFH contradicted the restrictive view of the tax authorities, according to which the controlling company is the ultimate legal entity that fulfills the requirements of Sec. 6a Sentence 4 RETT-Act (identical state decrees of 22 September 2020, para. 3.1).

Insofar as a controlling company and one or more companies dependent on this controlling company are involved in the taxable legal transaction pursuant to the group clause, the decree adopts the BFH case law. According to this, the controlling company is the company directly involved in the taxable reorganization transaction. If several entities dependent on a controlling company are involved in the reorganization the decree states that, based on the reorganization, the closest legal entity in the chain of ownership that fulfils the requirements of the group clause is the controlling company. According to the decree, it is also irrelevant here whether, in the case of multi-level shareholdings, the controlling company itself is dependent on one or more other companies.

If no entity fulfils the requirements set out above, the decree excludes the applicability of the group clause.

The decree also comments on keeping to the holding periods in the case of universal succession in the case of communities of heirs and states that these holding periods must be kept to insofar as a legal succession can be assumed for the undivided community of heirs. A universal succession in case of reorganizations under the German reorganization act or comparable foreign law still triggers a violation of holding periods.

Furthermore, in its new decree, the tax authorities apparently detailed their view on economic activity in cases of shelf companies and pure holding companies. In a decree dated 22 September 2020, the tax authorities classified shelf companies and pure holding companies, for example, as "non-economically active companies". As a result, there were previously doubts as to whether, in accordance with the general principles, these companies could also participate in the market via a shareholding in a dependent company and, to this extent, be economically active or be able to provide the controlling company with such a shareholding. This requires that at least one dependent company involved in the reorganization process is economically active on the market. According to the new decree, this is apparently now also to apply to companies that are not economically active themselves (e.g. shelf companies and pure holding companies), so that an interest in an intermediate holding company, which in turn has an interest in an economically active company, should therefore also be sufficient from the perspective of the controlling company.

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Travel agent margin scheme for non-EU travel agencies

Pursuant to Sec. 25 German VAT Law, tour operators must apply the tour operator margin scheme (implementation of Art. 306-310 EU-VAT-Directive). Based on this special VAT scheme, such companies may not deduct input VAT incurred for services bought for onward sale to customers (e.g. hotel costs, passenger transport costs etc.). On the other hand, the tour operator must only tax the margin generated within his sale of a travel package.

By decree of 29 January 2021 the German Federal Ministry of Finance set out that tour operators may not apply this special VAT margin scheme if they are established outside the EU. However, a transitional suspension of this precluding rule for third-country operators was foreseen. This transitional rule was already extended by another decree and now has been extended again until 31 December 2026 by a recent decree of the Federal Ministry of Finance (BMF) published on 27 June 2023.

Consequently, tour operators established in third countries have the choice to either apply the tour operator margin scheme or to apply the regular VAT scheme. The latter could be advantageous in case of B2B transactions because thus non-deductible input VAT can be avoided. If the business customers of a tour operator qualify for input VAT deduction (based on their business activity), full neutrality of VAT can be ensured by not applying the margin scheme. Interestingly, this choice is not available for tour operators established in the EU. EU tour operators must apply the margin scheme – also for B2B transactions. Therefore, tour operators established in third countries may have a tax advantage compared to EU-domiciled tour operators if the customers are businesses.

This rule does not only apply for tour operators whose main business is that of a travel agency. Instead, it applies to any company buying and selling "travel services" in its own name. Therefore, also intra-group transactions may be affected (e.g. an entity within a group is taking care of business travels of other group companies).

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New administrative rules for "mutual agreements on facts" between German tax authorities and taxpayers

The German Federal Ministry of Finance (BMF) recently tightened their administrative regulations governing the so-called "mutual agreement on facts" between tax authorities and taxpayers in an administrative circular dated 23 June 2023. In cases where facts remain uncertain / are unclear even after an extensive tax audit, the German rules allow that tax authorities and taxpayers agree on their understanding of the facts in a mutual written agreement. This agreement is then binding for the tax authorities as well as for the taxpayer alike and serves as a basis for the subsequent tax assessment. According to the recent update of the administrative regulations, in case of facts impacting cross-border relationships between the German taxpayer and a foreign related party (e.g. function incurred, risks assumed by the German entity), mutual agreements on facts should only be concluded in exceptional circumstances. In addition, the adjusted regulations stipulate that in those cases the agreement will also have to be signed by the (foreign) headquarter of the international group. By this, the German tax authorities want to avoid that the mutual agreement on facts is challenged by the foreign related party in case the subsequent tax assessment leads to double taxation for which the taxpayers seek relief in a mutual agreement procedure.

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German tax authorities

German anti-hybrid rules: German Federal Ministry of Finance publishes draft decree

On 13 July 2023, the German Federal Ministry of Finance (BMF) published a draft decree regarding the application of German anti-hybrid rules. The German anti-hybrid rules were enacted in 2021 and generally apply – with retroactive effect (!) – to all expenses accruing after 31 December 2019. The rules focus on a potential whole or partial denial of deductibility for expenses in Germany to the extent that the resulting earnings are not taxed at all or – in the case of financing transactions – are "low taxed" due to a hybrid-mismatch or deductions taken twice (deduction/non-inclusion, double-deduction). Not only "direct" transactions are covered where a German taxpayer is the counterparty of the transaction, also imported mismatches have to be analyzed.

The draft decree is more of a descriptive nature and mainly provides guidance on standard structures and questions, but does not provide a complete coverage of the currently discussed unclear issues. In particular, the examples do not include a comprehensive overview on the tax authorities' view on questions that are highly relevant in practice (e.g., related to the use of check-the-box structures in a US context).

Stakeholders had the opportunity to comment on the draft decree until 10 August 2023. The BMF has not indicated when the review of the opinions submitted will be completed and when a final version of the decree can be expected.

More details on the draft decree on the German anti-hybrid rules are available in the *EY Global Tax Alert "German Federal Ministry of Finance publishes draft decree regarding the application of anti-hybrid rules"* dated 18 July 2023.

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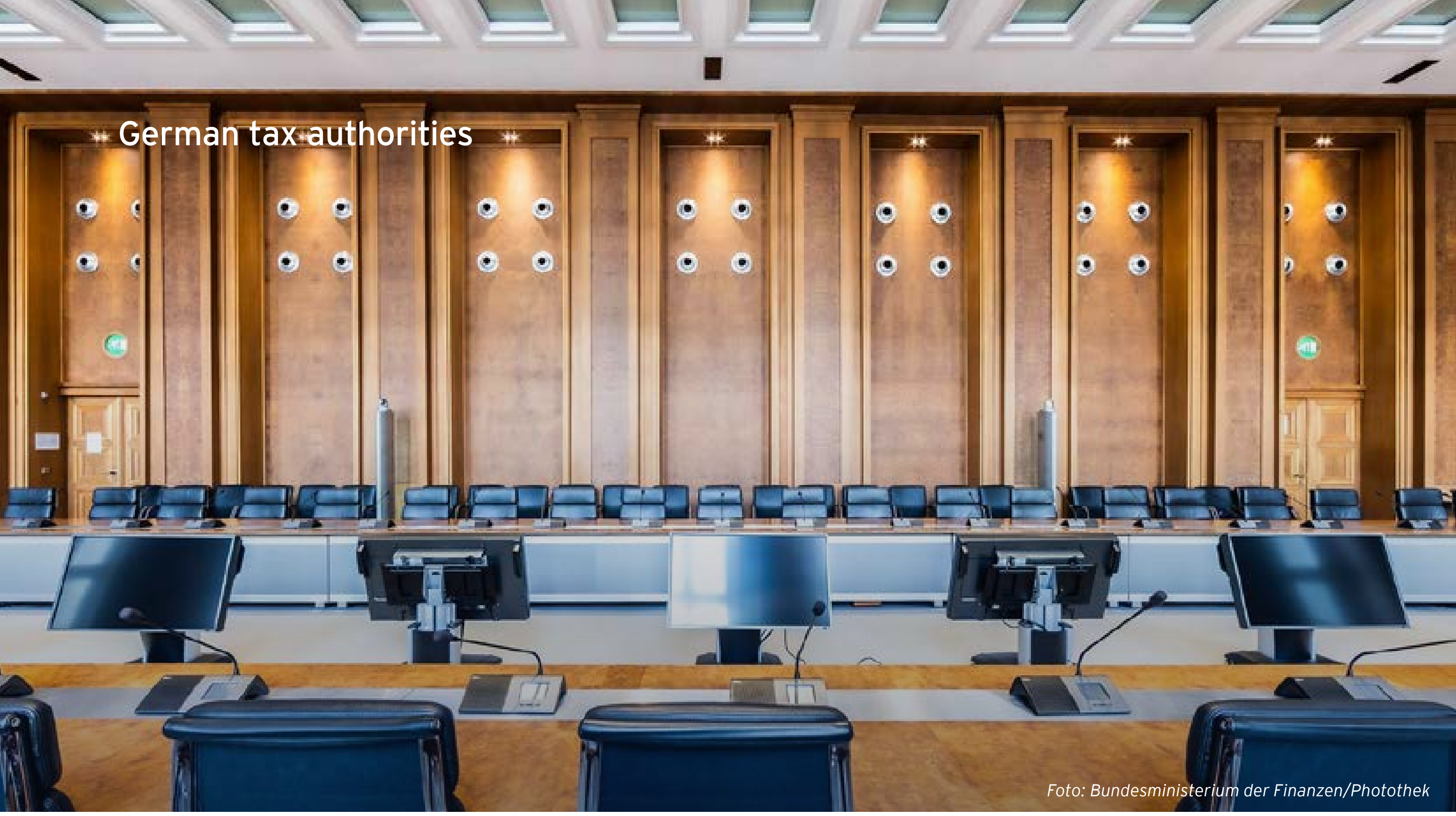
Draft decree on the application of the new Foreign Tax Act published

On 19 July 2023, the German Federal Ministry of Finance (BMF) published a draft decree on the application of the new Foreign Tax Act (AStG) in particular with regard to the revised provisions on the taxation of Controlled Foreign Corporation (CFC) and the exit taxation for individuals based of the ATAD Implementation Act, which entered into force on 1 January 2022 as well as the stricter CFC taxation under the Defence against Tax Havens Act (DTHA).

On 19 July 2023, the BMF published a draft decree on the Principles of Application of the Foreign Tax Act ("AStG Decree"), which shall replace the current decree, published on 14 May 2004. The long-awaited draft decree is very comprehensive, comprising 1,025 paragraphs over 251 pages, and includes, among other things, explanations of the provisions of the AStG as amended by the ATAD Implementation Act as of 1 January 2022. Specifically, it provides, inter alia, explanations on the following areas of the FTA:

Regarding the principles for the adjustment of income in cross-border related party transactions, the decree refers to the recently updated Administrative Principles of Transfer Pricing (BMF Decree of 6 June 2023). For details, please see the *EY Global Tax Alert dated 20 June 2023*.

The ATAD Implementation Act has reformed the provisions on the so-called exit taxation for individuals pursuant to Sec. 6 AStG. The exit taxation for individuals provides that individuals who hold shares in corporations as part of their private assets are subject to capital gains tax if their unlimited tax liability in Germany ends due to the cessation of their domicile or habitual residence. However, in the case of a temporary absence, the exit taxation does not apply. As expected, the BMF comments in particular on the issues related to the so-called "relocate back rule" (Rückkehrregelung) (i.e. the intention to relocate back and the actual relocation) and on the due date of the tax claim (tax deferral in case of reference to the "relocate back rule" apparently without providing security). ▶



German tax authorities

Foto: Bundesministerium der Finanzen/Photothek

The draft includes a new introductory section on CFC taxation. In addition to the regular CFC taxation, the BMF also comments for the first time on the stricter CFC taxation for CFCs in EU black-listed territories under Sec. 9 of the Defence against Tax Havens Act (DTHA). According to the stricter CFC taxation not only so-called "passive" income, but all low-taxed income of a black list-territory CFC corporation is subject to the (stricter) CFC taxation. Furthermore, this section contains, among other things, statements on the relationship between the German general anti-abuse rule (Sec. 42 General Fiscal Code) and the CFC taxation as well as statements on the distribution of the burden of proof.

The draft of the AStG decree contains comprehensive explanations on the in-scope CFCs, in particular on indirectly held participations and the application of the CFC rules to foreign (non-resident) taxpayers owning CFCs through a German permanent establishment. Especially the control concept has been revised by the ATAD Implementation Act. In the draft of the decree the BMF uses various examples to comment on the control concept. In addition, the BMF provides statements on the condition of being "related" through acting in concert and the relationship between CFC and investment taxation.

Within the framework of Sec. 8 para. 1 AStG (which defines what is "good" and what is "bad" CFC income), the BMF presents details of the statutory catalogue of so-called "active" income. By way of introduction, based on the jurisdiction of the German Federal Tax Court (BFH) it is stated that individual activities with a considerable economic weight are not to be grouped together but are to be subsumed independently under the catalogue of Sec. 8 para. 1 AStG, even if they are economically related to other activities. Of particular practical relevance are the participation requirements of passive income earned on goods and services purchased from or sold to related enterprise as well as the correspondence regulations for dividend income and corporate reorganization matters, which have been standardized for the first time.

The BMF comments in detail on the so-called CFC "motive test" or anti-abuse test to Sec. 8 para. 2 AStG. Among other things, the substance criteria, in particular the concept of so-called presence of a substantial business activity as well as material and personnel resources are defined in more detail. The BMF explicitly clarifies that, according to the wording of the law, the "motive test" is not to be applied in third-country, non-EEA cases, unless they are investment companies within the meaning of Sec. 13 AStG. According to the controversial view of the BMF, however, Sec. 13 AStG should only apply to non-controlled investment companies.

The regulation on low taxation (Sec. 8 para. 5 AStG) continues to be based on an effective tax rate of 25%. There was no reconciliation with the draft bill on the BEPS 2.0 Pillar Two implementation, which proposes bringing the threshold rate down to 15% by 1 January 2024. It is stated that a foreign corporation that generates passive income is not considered as being taxed at a low level just because its income is taxed at the level of another entity in the context of a group taxation (e.g., fiscal unity or consolidation). If a foreign corporation that is part of a group of consolidation earns passive income, the proportionate income tax burden attributable to this income must be determined separately for that company. ▶

German tax authorities

The BMF has also taken a comprehensive position on the determination, qualification, and taxation of the CFC income, so-called CFC amount (Hinzurechnungsbetrag) regulated in Sec. 10 AStG.

The ATAD Implementation Act reformed the previous relief system in the case of dividends from income that was already subject to CFC imputation by abolishing the former tax exemption provision and introducing a so-called reduction amount (Kürzungsbetrag) pursuant to Sec. 11 AStG. If the taxpayer receives remuneration from a participation in a foreign corporation for which CFC amounts have been subject to income tax and corporate income tax, a reduction amount must now be deducted when determining the sum of the income; this also applies to capital gains. The decree offers detailed information to the new relief system of Sec. 11 AStG by providing examples and comments, among other things, on the determination of the reduction amount, the so-called CFC correction volume (Hinzurechnungskorrekturvolumen), and the special features in the case of a tax group.

The BMF also comments in detail on the so-called switch-over clause of Sec. 20 para. 2 AStG, which provides for a switch from the exemption method to the crediting method in certain permanent establishment cases and which has not yet been mentioned in detail in the current decree. The BMF also comments, inter alia, on the definition of the term "permanent establishment" within the meaning of Sec. 20 para. 2 AStG and situations covered by the regulation, with reference to the BMF Decree of 26 September 2014.

In addition, the draft decree also provides for significant changes and extensive additions regarding the application of the provisions on tax credit (Sec. 12 AStG), participation in investment companies (Sec. 13 AStG) and the procedural obligations of the taxpayer (cooperation, information and declaration obligations pursuant to Secs. 16 to 18 AStG). Regarding the provisions on tax credit under Sec. 12 AStG, the BMF confirms its view that a credit against trade tax is excluded.

The updated AStG decree should be applicable to the AStG in the version applicable from 1 July 2021. The final decree is expected to be published during the second half of 2023.

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German court decisions

BFH refers question to ECJ on how to determine the customs value of EU-generated label design as a free add-on service

The question raised by the German Federal Tax Court (BFH) to the European Court of Justice (ECJ) on how to determine the customs value of EU-generated label design as a free add-on service is interesting as it concerns the extent to which the privilege of EU know-how provided as assistance is to be included in the customs value.

The case results from a Hamburg tax court decision. In this case, the court had to decide whether the cost of print files which were provided as an assistance for labels printed outside of the EU and which were connected directly to the imported goods is relevant to the customs value of the imported goods. More specifically, the case deals with the interdependency of the term "container" and customs valuation and two obviously not fully aligned paragraphs in Art. 71 of the Union Customs Code (UCC).

The importer imported its products in cans which were labelled, and the paper labels were firmly attached to the cans. These paper labels were designed in the EU and the design was provided free of charge electronically as assistance to the seller. The importer considered the cost for the labels as such, but not the assistance, as part of the declared customs value. ▶

The main customs office subsequently levied import duties on the grounds that the customs value of the imported goods should also include the costs for the cans. The reason is that Art. 71 para 1 lit. a) ii) UCC defines that the cost of containers, which are treated as being one with the goods in question, are supplementing the customs value of the imported good. Pursuant to tariff classification rules (General Provision 5a), cans are assumed to fall under the definition of "container". Therefore, the customs authorities treated the cans as containers and allocated all costs of the containers (including the assist developed in and provided by the EU purchaser) as part of the customs value.

However, the importer argued that the assistance is not customs value relevant as it falls within the scope of the add-on provisions in Art. 71 para. 1 lit b iv UCC for so-called intellectual provisions, which stipulates that engineering, development, artwork, design work, and plans and sketches undertaken in the EU and necessary for the production of the imported goods are exempt (the so-called "EU privilege").

The case is interesting because it not only deals with the interpretation of the term "container", but specifically asks for clarification if the EU privilege covers only the actual product or also its container and to which extent.

Indirectly, the decision will imply to which extent the EU privilege is to be interpreted.

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BFH sheds further light on harmful activities for Extended Trade Tax Deduction

The Extended Trade Tax Deduction (ETTD) enables taxpayers which exclusively rent out own real property to deduct the proceeds from such real property letting from the trade tax base. It is of pivotal importance for the real estate sector in Germany. In three recent decisions the German Federal Tax Court (BFH) has further refined its jurisprudence on harmful activities regarding the "exclusivity" requirement:

In its decision of 23 March 2023 (III R 49/20) the BFH made clear that cleaning services rendered for other persons than tenants and for other spaces than those collectively utilized by the tenants are harmful for ETTD regardless of their amount or relation to the rental income. In the underlying case, the relevant taxpayer (a GmbH) had provided cleaning services not only for the tenants but also for flats belonging to its shareholders (but located in the same building). The BFH considered such services to be harmful (ETTD was disregarded and the GmbH's entire rental income was effectively subjected to trade tax).

The decision of 20 May 2023 (III R 53/20) concerned a real estate owning GmbH which additionally conducted the administration of a real estate owning GmbH & Co. KG as general partner and received compensation for taking over the unlimited liability ("Haftungsvergütung"). The BFH again ruled that such activity and compensation is harmful for ETTD (with regard to the GmbH's own property).

A slightly different fact pattern was object of the decision of 9 March 2023 (IV R 25/20): The BFH ruled that compensation payments made to partners of a partnership ("Sondervergütungen") do not qualify for ETTD benefits regardless of the respective partner being subject to trade tax or not. This, however, does not result in the ETTD being entirely unavailable; "only" for the respective compensation payments (e.g. shareholder loans, management services, etc.) the exemption would not be available. The BFH recognized that the respective provision might be considered excessive in certain cases (such as the one at hand) but still considered the wording of the law to be clear and binding.

In summary, it can – once more – be noted that the scope for ETTD is quite narrow and any activities other than letting of real estate are in principle harmful. Therefore, such activities should be i) entirely refrained from, ii) carried out by other entities or iii) at least carefully assessed from a tax perspective prior to their factual implementation.

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German court decisions

German Federal Tax Court confirms non-deductibility of "final losses" in cases where the DTT provides for a subject-to-tax clause

In its decision dated 12 April 2023 (case reference I R 44/22, formerly I R 49/19 and I R 17/16) the German Federal Tax Court (BFH) held in a case where a taxpayer sought deduction of final losses incurred in its Italian permanent establishment (PE) that in this specific case the subject-to-tax clause in the Double Tax Treaty (DTT) with Italy does not apply and that the loss recognition was not possible under the jurisprudence of the European Court of Justice (ECJ) on final losses and under the principle of equal treatment of the Charter of Fundamental Rights of the EU and of the German constitution.

Bundesfinanzhof, Foto: Andreas Focke

In the case at hand, a German taxpayer maintained a PE in Italy in the years 2004 to 2008. Throughout this period the PE incurred losses, both under German and under Italian tax principles. The taxpayer applied for a recognition of these losses in its German tax returns. It argued that the Italian (negative) income was not "effectively taxed" in Italy and hence, that income was not Italy-sourced according to the subject-to-tax clause of para. 16 of the Protocol to the DTT Italy-Germany dated 18 October 1989 providing for a fall-back of the otherwise exempted income. Furthermore, since the PE was finally closed, these losses were to be recognized under the ECJ case law on final losses.

The BFH held that the subject-to-tax clause does not apply because the losses incurred in the Italian PE were recognized in the Italian tax base. While the BFH conceded that the subject-to-tax clause in principle applies to foreign losses, it held that a set-off with profits, which in the given case was not possible as no profits were made in any of the years of the PE's existence, was not necessary for an "effective taxation" in Italy (as required by the subject-to-tax clause).

The BFH further held that in situations where the applicable DTT contains a subject-to-tax clause according to the most recent jurisprudence of the ECJ a loss recognition was not mandatory under the Freedom of Establishment. In its decision dated 22 September 2022 (case reference C-538/20, "W"), the ECJ had decided that where a DTT provides for the exemption method, there is no obligation of the country of the head office to recognize "final" PE losses, which could not be utilized in the country of the PE anymore (e.g. because the PE was closed). According to the BFH, the rationale of that ECJ decision was also applicable to the present case.

Furthermore, the ECJ decided that the denial of the loss recognition does not infringe the principle of equal treatment of the Charter of Fundamental Rights of the EU and of the German constitution as the fact that Germany agreed on the exemption method excluding both profits and losses from German taxation is a sufficient factual reason for the differential treatment of foreign final losses.

It remains to be seen whether the BFH will apply the rationale of the ECJ decision in "W" also to cases where a switch-over rule applies. A switch-over rule replaces, where its specific conditions are met, the otherwise applying exemption method with the credit method. In its Nordea Bank decision dated 17 July 2014 (case reference C-48/13), the ECJ had held that where the credit method was the general rule for PE income in the applicable DTT, a claw-back of past losses after the closing of a foreign loss-making PE infringed the freedom of establishment.

German taxpayers seeking a recognition of final foreign PE losses should now review whether in the given case a switch-over clause (either under the applicable double tax treaty or under German national law) could provide for a recognition of such losses in Germany. According to the decision of the BFH in the case I R 44/22, a mere subject-to-tax clause would not be a sufficient basis for a recognition of final losses under EU law where the specific conditions for its application are not met.

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Prohibition of loss offsetting in the case of conversions also applies to contributions

According to the German Reorganisation Tax Act (UmwStG) conversions such as mergers can taxwise be carried out with up to 8 months retroactive effect. However, Sec. 2 para. 4 UmwStG prohibits the offsetting of positive income of the transferring legal entity with losses that can be offset, remaining loss carryforwards, negative income that has not been offset and an interest carryforward of the acquiring legal entity in the retroactive period.

In its ruling of 12 April 2023 (case reference: I R 48/20), the Federal Tax Court (BFH) decided that this provision also applies in the case of a contribution of business assets to a corporation. This also already follows from the provision of Sec. 20 sub-section 6 UmwStG and is independent of an intention to abuse on the part of the taxpayer. Although Sec. 2 sub-section 4 UmwStG was introduced in the legislative procedure in 2013 to prevent abuse, this idea is not reflected as a constituent element. Furthermore, the BFH ruled that the provision of Sec. 2 para. 4 UmwStG also applies to trade tax, even if trade tax uses different terminology (e.g. instead of "income", "trade income"). According to the BFH, there are no constitutional objections to Sec. 2 sub-section 4 UmwStG. Taxpayers should observe that in all cases of retroactive conversion according to the UmwStG tax losses of the acquiring legal entity cannot be offset with profits of the transferring entity.

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BFH grants suspension of execution for loss assessment notice pursuant to Sec. 8c KStG

According to Sec 8c (1) sentence 1 Corporate Income Tax Act (KStG) as a general rule tax loss carry forwards as well as interest carry forwards forfeit in case of an acquisition of shareholdings of more than 50%.

In the case at hand, the loss carryforwards of a GmbH were reduced in full pursuant to Sec. 8c (1) KStG as a result of a detrimental acquisition of shares (more than 50%). An appeal filed against the loss assessment notices concerned (disputed year 2016) is suspended in light of the proceedings currently pending before the Federal Constitutional Court (BVerfG, case reference 2 BvL 19/17). In these proceedings, the BVerfG has to clarify the question whether Sec. 8c sentence 2 KStG in the version of the law enacted in 2008 is compatible with Article 3 of the German Constitution, because in the case of a direct share transfer of more than 50% within 5 years, the unused losses are completely disregarded. The GmbH applied for a suspension of execution of the loss assessment notices concerned (disputed year 2016). This suspension has now been granted by the BFH (decision of 12 April 2023, case reference I B 74/22 (AdV)).

In contrast to the lower court (Munich tax court, decision of 12 December 2022, case reference 7 V 1753/22) the BFH is in favor of a stay of execution, as there are serious doubts about the constitutionality of the norm. In its decision of 29 March 2017 (case reference: 2 BvL 6/11), the BVerfG had ruled that the original sentence 1 of Sec. 8c KStG (partial forfeiture of losses in the case of harmful acquisitions of shareholdings from 25% to up to 50 %), which was comparable for the BFH, was unconstitutional. In the weighing of interests for the suspension of execution, the interest of the persons concerned in the suspension outweighed the other interests. Taxpayers should consider if they want to apply for suspension of execution in case tax losses are disregarded due to a harmful change in shareholdings.

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BFH decides on input VAT deduction by a management holding company following ECJ decision

On 15 February 2023 the German Federal Tax Court (BFH) gave its final judgement (XI R 22/18, published on 13 July 2023) concerning the right to deduct input VAT by a management holding company following the decision of the Court of Justice of the European Union (ECJ) in the request for a preliminary ruling in the case Finanzamt R v W GmbH (C-98/21, judgement dated 8 September 2022).

In essence, the judgement confirms that a management holding company may only deduct input VAT insofar as the input services received relate to its own taxable output supplies or form part of the general costs of its own economic activity.

The case concerned a German management holding company, W GmbH, which provided management and accounting services against consideration, subject to VAT, to its subsidiaries. W GmbH also made non-taxable shareholder contributions to its subsidiaries consisting in the supply of various services in exchange for a participation in the general profits. The subsidiaries only had a very limited input VAT deduction right as their output activities were largely exempt from VAT.

In its VAT returns, W GmbH deducted the whole of the input VAT paid in respect of the services obtained, i.e., also in respect to services that were connected to the provision of services contributed to the subsidiaries.

The BFH has held that a management holding company is not entitled to deduct input VAT levied on purchase transactions obtained from third parties if

(i) the input services received are not directly and immediately linked with the holding company's taxable output supplies but linked to its shareholder contribution in kind, which is not subject to VAT,

(ii) the input services received are not directly and immediately linked with the holding company's own output transactions but to the activities of third parties (here: subsidiaries),

(iii) the input services received are not included in the price of the taxable supplies provided to the subsidiaries and

(iv) the input services do not form part of the general costs of the holding company's own economic activity.

This important judgement sets out that there are limits to the input VAT deduction right in holding structures, even if the holding company is an "active" holding company performing taxable supplies to its subsidiaries.

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Federal Tax Court: Arrangement fees do not fall under the German interest barrier rules

The German interest barrier rules (Sec. 4h Income Tax Act, EStG) limit the income tax deduction of interest expenses under certain conditions. For borrowers that are subject to these rules, it is therefore relevant which of the total costs associated with a loan agreement qualify as interest expenses. In its decision dated 22 March 2023 (XI R 45/19), the Federal Tax Court (BFH) decided that arrangement fees are not considered interest expenses within the meaning of the interest barrier rules. Due to new legislative developments, the decision might, however, only have historical relevance.

In the case mentioned above, which occurred in the year 2011, the borrower received a syndicated loan. For the conclusion of the loan agreement, the borrower had to pay a so-called arrangement fee in the event of a successful conclusion of the contract for the brokerage activities of the syndicate leader, which was not refundable. It was now under dispute whether this arrangement fee fell under the term interest expenses within the meaning of the interest barrier rules, as argued by the tax office in charge.

However, in the view of the court, only fees for the temporary provision of borrowed capital were to be considered interest expenses within the meaning of Sec. 4h EStG in its version as applicable in the case at hand. For classification as interest expense, it depends on whether, from an economic point of view, the fee was paid as consideration for the possibility of using borrowed capital. Accordingly, the BFH contradicted the understanding of the fiscal authorities, which also treat commissions and fees as interest expenses within the meaning of Sec. 4h EStG. In the case in dispute, the arrangement fee was a fee for the brokerage activities of the syndicate leader and thus not interest expenses within the meaning of the rules. In addition, the court emphasized that interest rates regularly depend on the amount and term of the loan. The arrangement fee in the case at hand was based only on the agreed loan amount and not on the amount actually drawn, which was another argument for the court's decision.

Generally, at least for historical periods, it could be considered to apply this decision also to similar one-time fees, such as commissions or brokerage fees that are independent from the loan amount actually drawn and the loan terms. However, for future cases the recent extension of the interest definition based on the Growth Opportunities Act (Wachstumschancengesetz) must be considered, which provides for an adaptation of the interest concept to Article 2 of Directive (EU) 2016/1164 (ATAD) and thus an extension to economically equivalent expenses and expenses related to obtaining borrowed capital.

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Lower tax court of Lower Saxony rules on the German "transfer of function" rules

In its ruling dated 16 March 2023 (case ref. 10 K 310/19), the lower tax court of Lower Saxony commented on the German so-called "transfer of function" rules and denied that those were applicable in the case under review. In the case at hand a production facility in Germany was closed. The production volumes were taken over by a foreign related party. The transferring entity sold products only to related distribution entities of the group. In addition, according to the court, no transfer of valuable production know-how, technology or IP took place because the group company that took over the production volumes already had access to these via a cost sharing agreement. In view of this, the court came to the conclusion that the legal requirements for a "transfer of function" as stipulated in Sec. 1 of the German International Tax Act were not met since no assets, other advantages or business opportunities were transferred to a foreign related party. ▶

German tax authorities

The ruling is not final yet but will be subject to review of the German Federal Tax Court (BFH). Thus, it is currently uncertain to which extent the ruling will ultimately be sustained. In addition, the relevant rules in the German tax code have recently been further tightened. Nevertheless, given that the ruling is one of the first court decisions on the German transfer of function rules ever, it is of significant practical importance for taxpayers and provides important clarifications that should also be relevant under the new rules (e.g. a clearer, more narrow definition of the very broad term "chances"). It also demonstrates that challenging German tax audits' positions with regard to transfer pricing in tax courts can be a successful strategy to push back on ever more aggressive tax auditors.

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Duesseldorf tax court decides that the general German switch-over clause on foreign passive PE income requires a majority participation in a foreign partnership

In two decisions dated 18 April 2023 (6 K 3278/19 K and 6 K 501/20 K), the Duesseldorf tax court commented on the requirements for switching from the exemption method to the credit method according to the switch-over clause of Sec. 20 (2) German Foreign Tax Act (AStG). According to the tax court, and contrary to the view of the tax authorities, the provision requires the existence of a majority interest of a domestic partner in a foreign partnership.

In both cases, the taxpayer generated income from a U.S. partnership in which it held a 30% interest. Due to a (partial) tax exemption of the income in the USA, the tax office assumed that the partnership's passive income was low-taxed and added it to the domestic tax base of the taxpayer under Sec. 20 (2) AStG. The taxpayer objected against this inclusion of foreign income arguing that in cases of a foreign partnership the switch-over rule requires that the taxpayer holds a majority interest in that partnership (which is in line with the prevailing view in the professional literature). The tax authorities are of the opinion that the legal consequence of Sec. 20 (2) AStG applies irrespective of the size of the interest in the foreign partnership.

The Duesseldorf tax court followed the prevailing view in the tax literature and ruled that Sec. 20 (2) AStG did not apply in the cases at hand due to the lack of control by German partners. According to the tax court, both the wording of the rule and its rationale speak for a control requirement in this rule.

In each case, the tax court allowed an appeal on the grounds of fundamental importance of the case. Although the rulings concern the provision of Sec. 20 (2) AStG in an old version, the legal question is, according to the tax court, also relevant for the currently valid version of the provision.

Germany taxpayers with investments in foreign partnerships affected by the application of the general switch-over provision of Sec. 20 (2) AStG should now review whether in the specific case a minority shareholding exists which might render that rule unapplicable, and should object to the respective tax assessments by relying on these decisions of the Duesseldorf tax court. It should, however, be noted in this regard that until 31 December 2021 a control of the foreign partnership would also be given if the taxpayer held a majority in that partnership together with other unrelated German taxpayers.

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ECJ rules that add-back of portfolio dividends for German trade tax purposes is in line with EU law

On 22 June 2023, the Court of Justice of the European Union (ECJ) decided in the case H Lebensversicherung (C-258/22) that the free movement of capital does not preclude a legislation of a member state under which dividends from holding in non-resident companies of less than 10% are to be added back to that basis of assessment of the company's business tax, if and to the extent those dividends were deducted from the basis of assessment at a previous stage of that calculation, whereas dividends from comparable holdings in resident companies are included from the outset in the basis of the assessment, without being deducted or consequently added back to that basis of assessment.

The claimant was H Lebensversicherung, an establishment governed by public law that operated an insurance business. In the 2001 assessment period, it had received dividends from non-resident capital companies in which it held less than 10% shareholding of the capital. H Lebensversicherung exercised an option available under German law in the year 2001 to treat 20% of the received dividends as tax exempt under the German participation exemption rule. However, under the applicable trade tax rules, 20% of the dividends were added back to the taxable profit. In contrast, dividends from holdings in resident companies were not subject to the add-back rules but did in the year 2001 from the outset not benefit from the German participation exemption regime. The German Federal Tax Court (BFH) doubted that the German rules were in line with the free movement of capital because the add back of dividends only applied in case of investments in holdings in non-resident capital companies, however also noting that it would seem unlikely that the existing two stages of calculation for the basis of taxation would discourage investors from investing in non-resident companies.

In its decision, the ECJ states that the different taxation does not lead to an unfavorable treatment. It outlines that the two stages of calculation for non-resident holdings compared to German holdings both include all dividends in the assessment and lead to the same tax burden. Therefore, it does not discourage investors from investing in non-resident holdings and therefore does not restrict the free movement of capital. The ECJ previously decided in the case STEKO Industriemontage (C-377/07), which concerned German loss deduction rules, that the different treatment of shareholding of less than 10% for resident and non-resident companies in 2001 violates the free movement of capital. However, the ECJ outlines that in this case, the tax treatment did lead to a higher tax burden in case of investments in non-resident companies.

The decision of the ECJ relates to the add back of trade tax payments in case of a German-resident company investing in non-resident holdings. Non-resident investors may instead still suffer discrimination under the free movement of capital in case they receive dividends from resident holdings. On 27 April 2023, the ECJ ruled in the request for a preliminary ruling of the BFH in the case L Fund (C-537/20), stating 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. Regardless of the decision of the ECJ in the case at hand, non-resident investors investing in resident holdings in Germany should therefore generally review if they are eligible for potential WHT refunds.

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Spotlight

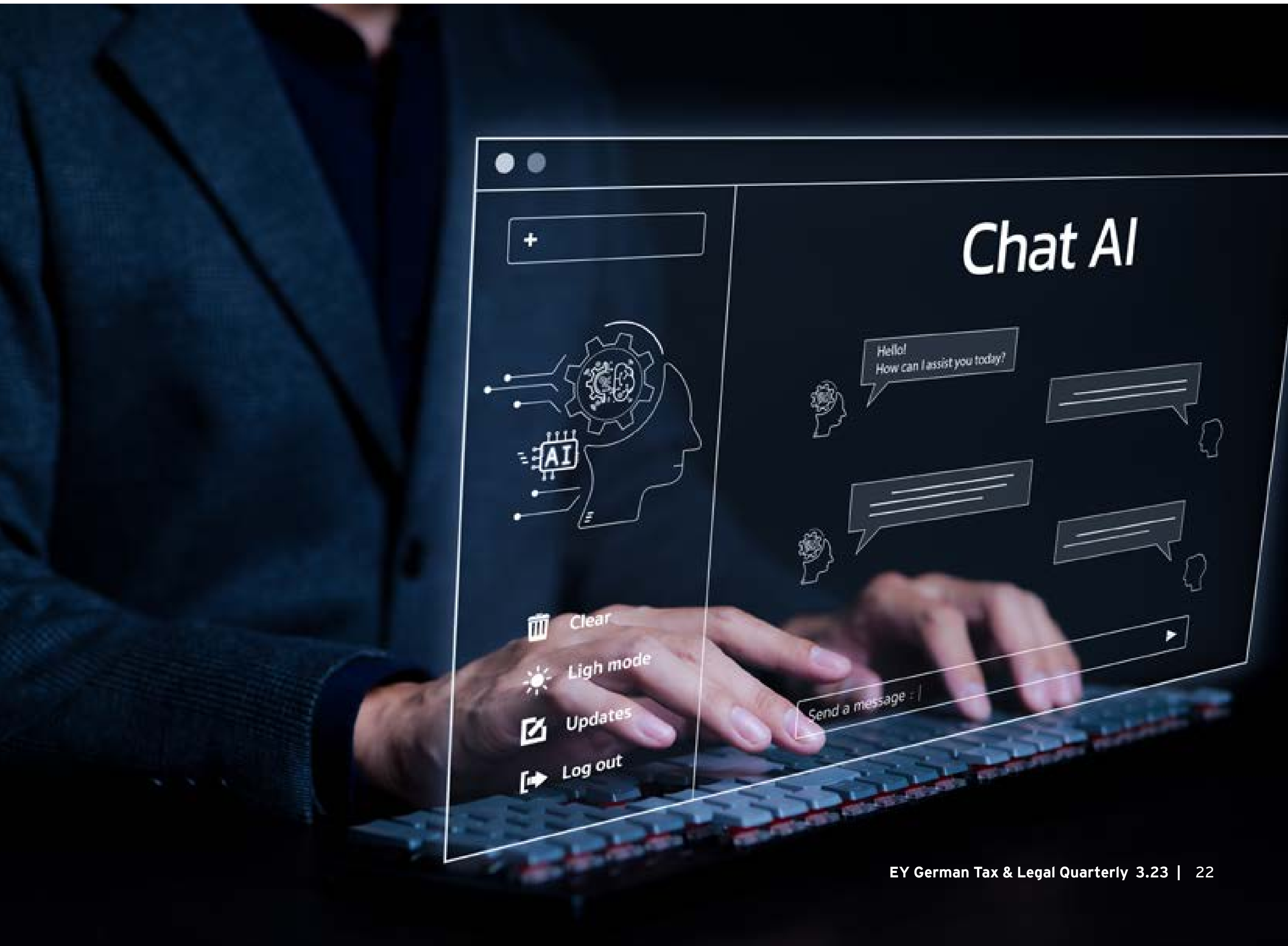
The upcoming EU Artificial Intelligence Act – new compliance requirements

ChatGPT as generative AI has brought the topic of Artificial Intelligence (AI) with unexpected momentum into the headlines, everyday corporate life but also onto the agenda of our future working world. Conversely, there is a fear that we will lose control and eliminate much of today's often demanding and fulfilling human work. At the EU level, the Artificial Intelligence Act (AIA) will soon impose risk-oriented requirements on AI systems. Initially criticized as overregulation, there is now a broader consensus regarding the need for regulation. After a first draft in 2021, the final adoption is expected by the beginning of 2024 at the latest. The fines shall be substantial, reaching up to EUR 30 million or 6% of a company's global annual turnover, whichever is higher.

Designed to regulate and govern the development, deployment, and use of artificial intelligence systems within the EU, this ambitious regulatory framework aims to strike a balance between fostering AI innovation and protecting fundamental rights, values, and safety with a human-centric approach. The complex requirements need holistic implementation as was the case with GDPR. In the light of tight timelines, companies are already starting the design of specific AI governance and risk frameworks.

Scope

The AIA will cover a wide range of AI applications, from chatbots and recommendation systems to critical areas such as healthcare, transportation, and law enforcement. AI systems under the AIA will probably be defined as system that is based on inputs, operates with varying levels of autonomy, and generates outputs such as content, predictions, recommendations, or decisions. Insofar also tax tools fulfilling tasks autonomously can fall in the scope of the AIA (e.g. tax compliance analytics). ▶



Spotlight

Risk-based approach
Only high-risk AI systems trigger more complex requirements: AI systems in critical sectors such as healthcare, transportation, and law enforcement, but also HR management fall into this category. They require risk management, high-quality data, transparency, human oversight and conformity assessments. As per the growing importance of generative AI, so-called foundation models have been introduced into the legislation where providers shall comply with similar but softened principles compared to for high-risk AI. Low risk AI systems will only be subject to transparency obligations.

Data governance and documentation
The AIA also emphasizes the importance of data governance as AI systems rely heavily on data. Developers must ensure that their AI models are trained on high-quality, unbiased data. Additionally, they must maintain comprehensive records of the data sources and algorithms used.

International impact
The AIA has far-reaching implications beyond EU borders. Companies worldwide that wish to access the EU market will need to adhere to its regulations, potentially setting a precedent for AI governance on a global scale.

Implementation of the AIA also considering privacy, copyright and trade secrets
The AIA will require significant efforts in implementation to meet the requirements across companies and organizations. The regulation specifically asks for accountability and quality management. On top of that, privacy, copyright and trade secret compliance as well as consolidation with existing data and AI ethical guidelines must be ensured. Insofar all AI systems must be captured, assessed and risks mitigated. This requires an appropriate compliance management system. Specific processes must be designed and rolled out. Relevant stakeholders such as IT, data management and legal as well as business users, e.g. the tax department, should be included.

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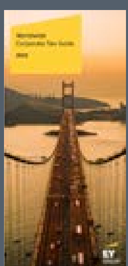
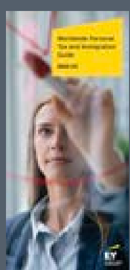
EY publications

Please find pdf-versions of the EY publications listed below by clicking on the related picture. Browse the full range of our in-depth guides covering corporate tax, indirect tax, personal taxes, transfer pricing and law matters in more than 150 jurisdictions *here*.



Worldwide corporate tax guide 2022
The worldwide corporate tax guide summarizes the corporate tax systems in 160 jurisdictions.



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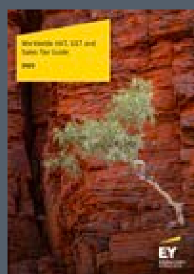

Worldwide VAT, GST and sales tax guide 2023
This guide summarizes indirect tax systems in 149 jurisdictions.

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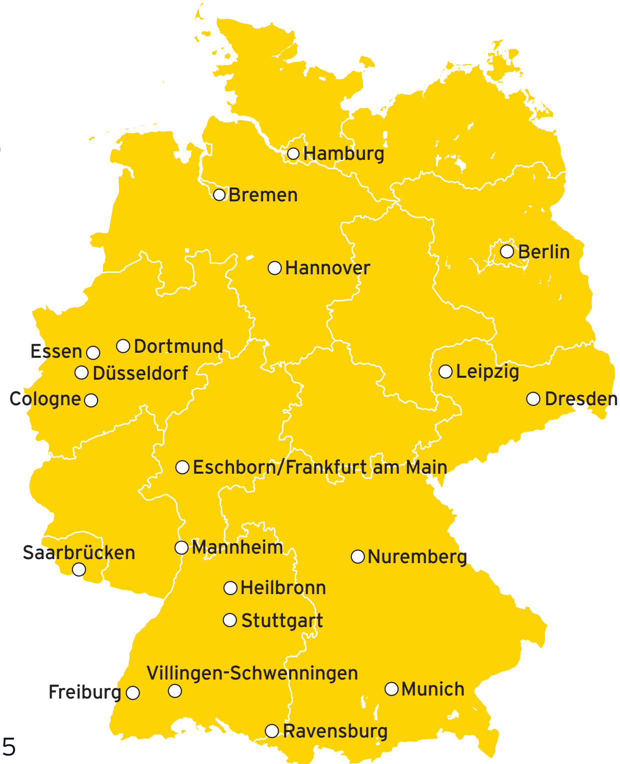

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About this quarterly report
This quarterly report provides high-level information on German tax developments relevant to foreign business investing in Germany.

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