Linklaters

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Tax Alert.

First implementation of BEPS into German domestic law passed.

Act implementing the amendments of the Mutual Administrative Cooperation Directive and of further measures against base erosion and profit shifting passed by the German Parliament (*Bundestag*) and the Upper House (*Bundesrat*).

On 1 December 2016, the Bundestag and on 16 December 2016, the Bundesrat passed the *Act implementing the amendments of the Mutual Administrative Cooperation Directive and of further measures against base erosion and profit shifting* ("**BEPS 1-Implementation Act**").

This Act is the German tax legislator's first step to implement the recommendations for actions developed by the OECD on behalf of the G20 (consisting of the world's 19 economically most powerful countries and the European Union) to prevent base erosion and profit shifting ("**BEPS**") into German domestic law.

Against this backdrop, the main objective of the BEPS 1-Implementation Act is to implement solutions concerning certain BEPS Action Points and the specification of the EU Mutual Administrative Cooperation Directive. The focus lies in particular on BEPS Action Points 5 (measures to counter harmful tax practices) and 13 (transfer pricing documentation and country-by-country reporting) as well as on the mandatory automatic exchange of information within the European Union regarding cross-border tax rulings and advance pricing arrangements of internationally associated enterprises (see 1 below). In addition, the legislator takes this opportunity to counter the recent case law of the Federal Court of Finance (*Bundesfinanzhof* – "**BFH**") regarding international tax law (see 2 below) and trade tax (see 3 below) which is disagreeable in the fiscal authorities' view as well as to introduce measures to prevent certain tax planning strategies (see 4) in the future.

It can be assumed that further legistlation regarding the other BEPS measures will follow as soon as the preparations at German domestic level and at international level (OECD and EU) have been concluded.

The BEPS 1-Implementation Act which has been passed goes well beyond the measures to prevent base erosion and profit shifting still provided for in the government draft. Besides, some merely technical adjustments as well as new provisions to relieve taxpayers, (e.g. higher basic personal and child) allowances), have been included.

Content

1 Implementation of initial BEPS measures into German domestic tax law

1.1 Extension of cooperation obligation in cross-border situations

The documentation requirements of multinational enterprises (“**MNEs**”) regarding transfer pricing will be extended by a change of Sec. 90 para. 3 of the German General Tax Code (*Abgabenordnung* – ”**AO**”), which is based on BEPS Action Point 13 "Transfer Pricing Documentation and Country-by-Country Reporting". The transfer pricing documentation will consist of a master file (so-called "**Master File**"), a country-specific, company-related documentation (so-called "**Local File**") and a country-specific report (so-called "Country-by-Country Report" – "**CbCR**"). With the introduction of CbCR and the relevant reporting obligations in a new Sec. 138a AO, the minimum standards and reporting obligations resulting from the changes to the EU Mutual Administrative Cooperation Directive on 25 May 2016 (published 3 June 2016) are also implemented.

1.1.1 Master File

In future, companies that are part of a multinational group of companies and have had a turnover of at least EUR 100m in the previous year will be obliged to prepare a Master File. The Master File shall provide an overview of the nature of the group’s global business operation and its transfer pricing systematics (Sec. 90 para. 3 sent. 3 AO). The Master File shall contain the following information:

- the organisational (i.e. legal and holding) structures and geographical locations of the respective companies and permanent establishments,
- the respective enterprise’s business operation,
- the overall strategy for the use of intangible assets in the value chain, particularly in terms of development, ownership and utilisation, as well as
- the nature of its financing.

A multinational group in this sense consists of at least two companies located in different countries or an enterprise that operates at least one permanent establishment in another country (Sec. 90 para. 3 sent. 4 AO).

The additional information shall allow the tax authorities to obtain a better understanding and assessment of the enterprise’s transfer pricing policy in its economic, legal, financial and tax-related context.

1.1.2 Country-specific and company-related documentation

The current obligations to create a local transfer pricing documentation will be adapted to the OECD recommendations for BEPS Action Point 13. In future, the country-specific and company-related documentation is to be divided into a documentation of the facts and circumstances and an arm’s length documentation. Also to be documented in the context of the arm’s length documentation, in addition to the transfer prices and conditions agreed as well as their economic and legal bases are the date of transfer price determination, the selection and application of the transfer pricing methods and the external comparison data used (Sec. 90 para. 3 sent. 2 AO).

Providing this information is already compulsory in the German Administration Principles-Procedures[1] as part of a transfer pricing documentation, so the need for the taxpayer to make changes and the respective additional burdens should be within reasonable limits.

1.1.3 Country-by-Country Report – CbCR

In addition to the *Master File* and *Local File,* companies located in Germany that are parent companies of multinational groups and have a consolidated turnover of more than EUR 750m will need to create a so-called Country-by-Country Report (CbCR) to be submitted to the German Federal Central Tax Office (*Bundeszentralamt für Steuern* – "**BZSt**") (Sec. 138a para. 1 AO). If an enterprise located in Germany is part of a foreign group, it is in principle neither obliged to prepare nor to submit a CbCR for the group. However, this does not apply if a German group company has been obliged by a foreign group parent company (so-called Reporting Entity) to submit the foreign company's CbCR to the BZSt (Sec. 138a para. 3 AO) or if it has special cooperation obligations (Sec. 138a para. 4 AO, see below). Generally, the CbCR must be submitted no later than one year after the end of the fiscal year for which the CbCR needs to be prepared (Sec. 138a para. 6 sent. 2 AO). In detail:

- **Content**: The report is divided into three sections. An overview should show an allocation of economic activities to the countries in which the group operates. Furthermore, ten different key figures (*inter alia*, revenues from third parties and other third-party income as well as revenues from related entities (these should be stated separately), annual profit (loss) before income tax and income tax paid during the relevant fiscal year), based on the consolidated financial statement should be documented (Sec. 138a para. 2 no. 1 AO). In a second section, all group companies and permanent establishments are to be listed separately by the countries shown in the overview. The major business activities of the group companies and the permanent establishments are to be provided (Sec. 138a para. 2 no. 2 AO). This regulation reflects the recommendations set out in Annex III of the OECD Final Report on BEPS Action Point 13. In the third and last section, information required in the group parent company's view for a proper understanding of the two aforementioned sections is to be listed (Sec. 138a para. 2 no. 3 AO).

[1] Cf. BMF Circular dated 12 April 2005, re the principles of auditing the profit allocation between related persons with cross-border transactions as regards the duties of determination and cooperation, adjustments of income and mutual agreement and arbitration procedures (Administration Principles-Procedures), Federal Tax Gazette Part I 2005, p. 570.

- **Particular cooperation obligations for foreign groups**: If a group with a foreign group parent company fails to provide the BZSt with the CbCR, all domestic group companies will be obliged to file the CbCR themselves (so-called "secondary mechanism"). If the respective CbCR is not available to a German domestic group company and if the information required to prepare such CbCR is also not available, such group company is obliged to inform the BZSt accordingly and to submit all available and obtainable information within the one-year period as specified in Sec. 138a para. 6 sent. 2 AO. For a domestic group company, the due date for filing may be extended under certain requirements (see Sec. 138a para. 4 sent. 4, para. 6 sent. 2 AO-E for further details).

- **Extension of tax declaration obligations**: In order to enable the tax authorities to identify the enterprise obliged to file the CbCR, additional tax declaration obligations shall be implemented (Sec. 138a para. 5 sent. 1 AO). Domestic companies with a foreign group parent company are obliged to declare at which tax authority and by which company the CbCR is being filed (Sec. 138a para. 5 sent. 2 AO). Otherwise the respective German group company shall itself be obliged to file the CbCR on the due date (Sec. 138a para. 5 sent. 3 AO).

- **Exchange of information**: The CbCR should be forwarded to the BZSt by data transmission and adhering to the officially prescribed data forms (Sec. 138a para. 6 sent. 3 AO-E). According to the legislator's reasoning, the legislator expects that a transitional solution will be necessary until the technical provisions therefor are fully implemented. The BZSt will be authorised to transmit to the competent German tax authorities CbCRs of foreign groups which it has received from foreign tax authorities (Sec. 138a para. 7 sent. 1 AO). The BZSt will also be authorised to transmit to the competent foreign tax authorities CbCRs of domestic companies (Sec. 138a para. 7 sent. 2 AO). The basis for the automatic exchange of information with foreign authorities is an administrative agreement signed by the BZSt on 27 January 2016 (Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports – "**CbC MCAA**") which has already been signed by 50 countries as of 7 December 2016. The Mutual Administrative Assistance Act shall be amended accordingly to implement the required legal basis to the CbC MCAA (Sec. 7 para. 10 EUAHiG).

Violations of the cooperation obligation pursuant to Sec. 138a AO may be sanctioned with an administrative fine of up to EUR 10,000 (Sec. 379 para. 4 AO). Compared to the previous provision, the scope of fines has been increased by EUR 5,000.

1.1.4 Authorisation for decrees and accompanying rules

The contents and the scope of the transfer pricing documentation - in particular with regard to the Master File and the country-specific, company-related documentation - are to be specified in more detail in the German Regulation on Documentation of Profit Allocation (*Gewinnabgrenzungsaufzeichnungsverordnung* – "**GAufzV**"). For that purpose, the GAufzV is to be specified in more detail in line with the recommendations in Annex II of the OECD Final Report on Action Point 13 (Sec. 90 para. 3 sent. 11 AO). The amendments to the GAufzV, however, are not part of the current Act.

Finally, a failure to comply with the filing obligations in connection with CbCRs will qualify as a fiscal offence (Sec. 379 para. 2 no. 1c AO).

1.1.5 Applicability

The amendments to Sec. 90 para. 3 AO regarding the cooperation obligations to shall be applicable for the first time to fiscal years beginning after 31 December 2016 (Sec. 22 para. 1 sent. 4 EGAO).

The preparation of CbCRs is scheduled for fiscal years beginning after 31 December 2015 (Sec. 31 sent. 1 EGAO). The particular cooperation obligations for foreign groups (Sec. 138a para. 4 AO) and the extension of tax declaration obligations (Sec. 138a para. 5 AO), however, shall be applicable for the first time to fiscal years beginning after 31 December 2016 (Sec. 27 sent. 2 EGAO) in order to ensure a reasonable transitional period.

1.2 Automatic exchange of information on so-called tax rulings

On 8 December 2015, the European Council resolved an amendment of the EU Mutual Administrative Cooperation Directive[2] as part of the EU package of measures for tax transparency. This amendment is to enable a mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements of internationally associated enterprises (so-called "Tax Rulings"). At the same time, this amendment is to take into account BEPS Action Point 5 "Measures to counter harmful tax practices".

One positive aspect to be recognised is that the information to be submitted to the EU Commission falls clearly behind such information to be exchanged between the member states.

In detail, the automatic exchange of information on Tax Rulings shall be regulated as follows:

1.2.1 Type of exchange of information

The exchange of information is to be made in regular intervals on the basis of predetermined parameters. An ad hoc transmission of information, for instance due to a prior request, is not intended (Sec. 2 para. 2 EUAHiG).

[2] Cf. Council Directive (EU) 2015/2376 dated 8 December 2015 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, Official Journal No. L 332 p.1.

1.2.2 Covered Tax Rulings

The definition of covered Tax Rulings in the BEPS-1 Implementation Act is as follows:

- **Advance cross-border ruling** means any agreement, communication, or any other action with similar effects issued by or on behalf of German tax authorities (at the federal, regional or local level) to a particular person or a group of persons. It is not relevant whether the ruling will still be applied. In an advance ruling, the authority adopts a formal position as to the interpretation or application of a legal or administrative provision under tax law at the federal, regional or local level with regard to a cross-border transaction. The recipient of such advance ruling does not necessarily need to participate directly in such transaction (Sec. 2 para. 3 sent. 3 EUAHiG). Cross-border transactions in the aforementioned sense in particular relate to transactions with at least one involved party also resident in another member state (Sec. 2 para. 7 and para. 8 EUAHiG). The provision also covers such advance rulings issued in the context of a tax audit (Sec. 2 para. 3 sent. 2 EUAHiG).
- The term "**advance pricing arrangements**" will also be defined by legislation. Advance pricing arrangement shall mean any agreement, communication, or any other action with similar effects issued, amended or renewed by or on behalf of German tax authorities. Advance pricing arrangements are issued to a particular person or group of persons who are entitled to rely on such arrangement. Prior to cross-border transactions between associated enterprises, such arrangement specifies an appropriate set of criteria for the transfer pricing determination for those transactions or regulates the attribution of profits to a permanent establishment (Sec. 2 para. 4 EUAHiG). The actual application of such advance arrangement is irrelevant. Cross-border transactions in the aforementioned sense are transactions with at least one involved party also resident in another member state or transactions with at least one component of cross-border impacts (Sec. 2 para. 8 EUAHiG).

Enterprises are "associated enterprises" in the aforementioned sense where (a) an enterprise participates directly or indirectly in the management, control or capital of another enterprise or (b) the same persons participate directly or indirectly in the management, control or capital of two enterprises involved (Sec. 2 para. 5 EUAHiG). Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises (Sec. 2 para. 6 EUAHiG).

As set out in the legislator's reasoning, the tax rulings recorded include in addition to binding information as set out in Sec. 89 para. 2 AO binding commitments pursuant to Sec. 204 AO and unilateral pre-approval for transfer prices in connection with advance pricing agreements as set out in Sec 178a para. 1 AO.

1.2.3 Information to be submitted

Among the information to be exchanged between the tax authorities of the member states are in particular (Sec. 7 para. 7 EUAHiG):

(i) Personal data and where applicable, personal data regarding the group of persons;

(ii) A summary of the content, including a description of the relevant business activities or transactions provided in abstract terms to the extent that such information would not lead to a disclosure of a commercial, industrial or professional secret or a commercial process, or information whose disclosure would be contrary to public policy;

(iii) Start date and end date of the Tax Ruling;

(iv) Description of the set of criteria and methods used for the determination of the transfer pricing.

To the extent a non-member state was involved in the conclusion of a Tax Ruling, information will only be disclosed to the other member states if such disclosure is permitted under the relevant tax treaty with the non-member state and if the competent authority of the non-member state gives permission for such disclosure (Sec. 7 para. 5 sent. 2 EUAHiG). Should an approval be denied, at least such information as provided in the application for the respective Tax Ruling must be disclosed by the relevant member state to the other member states (Sec. 7 para. 5 sent. 3 EUAHiG).

1.2.4 Applicability

Such Tax Rulings are to be disclosed which have been issued, reached, amended or renewed after 31 December 2016 (Sec. 7 para. 3 EUAHiG).

For Tax Rulings issued, reached, amended or renewed between 1 January 2012 and 31 December 2016, the following applies:

(i) Tax Rulings issued, reached, amended or renewed in the years 2012 or 2013 are only to be disclosed if the respective Tax Ruling was still valid on 1 January 2014 (Sec. 7 para. 4 sent. 2 no. 1 EUAHiG).

(ii) Information on Tax Rulings issued, reached, amended or renewed between 1 January 2014 and 31 December 2016 will be subjected to the reporting obligations upon the taking effect of the BEPS 1-Act irrespective of their validity (Sec. 7 para. 4 sent. 2 no. 2 EUAHiG).

Tax Rulings are exempted from the reporting obligations, however, if they were issued prior to 1 April 2016 to particular persons or groups of persons whose group-wide annual net turnover amounted to less than EUR 40m and who do not predominantly pursue financing and investment activities (Sec. 7 para. 4 sent. 3 and 4 EUAHiG). However, what is meant exactly by financing and investment activities can neither directly be deduced from the legal wording nor from the legislator’s reasoning.

2 Further changes in international taxation

2.1 Elimination of ambiguities in the interpretation and application of double taxation treaties

It is intended to eliminate current ambiguities in the interpretation and application of double taxation treaties ("**DTTs**") by way of amendments in Sec. 50d para. 9 EStG and the introduction of Sec. 50d para. 12 EStG and to create a legal basis for the implementation of certain DTT administrative agreements. The initially contemplated introduction of a precedence of the arm's length principle pursuant to Sec. 1 AStG over the arm's length principle as defined under the German double tax treaties has not been implemented (see our Tax Alert of June 2016).

2.1.1 Clarification to the unilateral switch-over clause in Sec. 50d para. 9 EStG

The switch-over clause in Sec. 50d para. 9 EStG shall be clarified. The provision already orders the non-applicability of an exemption method provided for in the DTT on certain foreign source income of a German tax resident if said income is not taxable or only a reduced tax rate is applied (reduced by the DTT) in the source country due to a different interpretation of the DTT provisions (so-called conflict of DTT terminology (*DBA-Qualifikationskonflikt*)). In such case, the foreign source income is to be included in the domestic tax base and any potential foreign taxes may only be credited against German taxes due.

In future, the provision in Sec. 50d para. 9 EStG shall also be applied in cases where only part of the foreign source income (and not the entire foreign source income), e.g. from certain sources or transactions, is not taxable or only a reduced tax rate is applied due to a conflict of DTT terminology.

With this amendment the legislator responds to a deviating case law of the BFH which, with regard to the current wording of Sec. 50d para. 9 sent. 1 no. 2 EStG, has decided[3] that an exemption of the income is applied even if the other contracting state exercises its taxation right under the DTT for income within the scope of foreign source taxation on merely part of the income.

This new provision shall become effective on 1 January 2016 (Art. 19 para. 2 in conjunction with Art. 8 BEPS 1-Implementation Act).

2.1.2 Taxation of cross-border compensation payments

With its judgement dated 10 June 2015 (IR 79/13, BStBl II 2016, 326), the BFH has ruled that compensation payments due to a termination of employment are only to be taxed in the state of residence since such compensation payments are not an additional remuneration for the previous employment. This is also not affected by a consultation agreement which states that the former state of employment has the taxation right in order to avoid untaxed income.

The decision concerned Switzerland, although similar agreements also exists with Austria, Belgium, Luxembourg, the Netherlands and the

[3] Cf. BFH judgements dated 20 May 2015, I R 68/15, BFHE 250, p. 96, and I R 69/14, BFH/NV 2015, p. 1395-1395.

United Kingdom of Great Britain and Northern Ireland. In order to avoid Germany being prevented from executing its taxation right in such cases, an additional provision will now be introduced in Sec. 50d para. 12 EStG.

Sec. 50d para. 12 sent. 1 EStG deems that compensation payments made due to the termination of employment activities are regarded as supplementary remuneration for previous employment for purposes of a DTT. If a specific DTT expressly provides for a separate provision (consultation agreement) regarding the treatment of such compensation payments that deviates from sentence 1, then Sec. 50d para. 12 sent. 2 EStG shall ensure that such deviating provision remains applicable. Sec. 50d para. 12 sent. 3 EStG finally provides for a resurgence of Germany's taxation right in case of a negative qualification conflict (risk of double non-taxation).

2.1.3 Creation of a domestic legal basis for the implementation of certain DTT administrative agreements

A new domestic legal basis is introduced in Sec. 2 para. 3 AO in the form of two powers to issue statutory ordinances in favour of the BMF.

On the one hand, an authorisation to adopt regulations is introduced according to which Germany may switch from the exemption method to the credit method if Germany is the country of residency and the respective DTT provides for such procedure (Sec. 2 para. 3 no. 1 AO). On the other hand, the BMF shall be authorised to also enact regulations with regard to the application of the so-called state of the fund clause (*Kassenstaatsklausel*) in the context of administrative agreements with foreign authorities. This is meant to enable the application of the state of the fund clause to cases where public duties are being carried out in private legal form (Sec. 2 para. 3 no. 2 AO).

The amendments of Sec. 2 para. 3 AO are to take effect on 1 January 2017 (Art. 19 para. 2 in conjunction with Art. 2 BEPS 1-Implementation Act).

2.2 Prevention of a double deduction of business expenses for partnerships

The introduction of a new Sec. 4i EStG-E is meant to counter a double deduction of business expenses for partnerships going forward. The new provision targets situations where refinancing interest are deducted as "special" business expenses both at the level of the company in Germany (so-called *Sonderbetriebsausgaben*) and abroad at the level of the shareholder (as own expenses). Technically, this denial of a deduction has been implemented as follows:

- Pursuant to Sec. 4i EStG-E, expenses of the partner of a partnership may not be deducted as special business expenses in Germany to the extent that such expenses also reduce the tax basis in another state.
- The deduction of business expenses will nonetheless be granted if such amounts reduce income that at the level of the same taxpayer (i.e., the partner of the partnership) is subject to actual taxation in Germany as well as in the other state (Sec. 4i sent. 2 EStG). Insofar the burden of proof rests with the taxpayer.

According to the legislator's reasoning, the application of the two aforementioned provisions shall require neither a coincidence in time regarding the double deduction nor with regard to the taxation of income in the other state:

- The deduction disallowance will still take effect even if such deduction has been or is claimed in the other state in another assessment period.
- If it can be proven that the respective income is taxable in the other state either in a preceding or subsequent assessment period, there are no grounds for a deduction disallowance.

The new provision is to take effect on 1 January 2017 (Art. 19 para. 2 in conjunction with Art. 8 BEPS 1-Implementation Act).

2.3 Narrowing-down of present scope of application of Sec. 50i EStG and clarification in Sec. 6 para. 3 EStG

According to the legislator's intention, Sec. 50i EStG shall apply to capital gains from sales and withdrawals and ongoing revenues from a non-resident treaty-protected taxpayer's share in a deemed commercial partnership (*gewerbliche geprägte Personengesellschaft*) or in a commercially tainted partnership (*gewerblich infizierte Personengesellschaft*), provided that the business assets or shares according to Sec. 17 EStG were contributed to the relevant partnership prior to 29 June 2013. Thus, the regulation is intended to protect the domestic tax base and prevent "tax losses running into billions".

Nevertheless, it became apparent that Sec. 50i para. 2 EStG, which even excludes certain mergers of and contributions to the partnerships mentioned above from the privilege for a book value roll-over results in an excessive tax burden to which the BMF has responded in the meantime by providing considerations of equity in certain cases.[4]

Due to the revised version, the applicability of Sec. 50i para. 2 EStG is basically narrowed down to cases in which the exclusion or limitation of Germany's right to taxation comes into effect prior to 1 January 2017 on the basis of a contribution according to Sec. 20 of the German Conversion Tax Act (*Umwandlungssteuergesetz*, "**UmwStG**").

According to the respective transitional provision, the amendment of Sec. 50i para. 2 EStG will apply to contributions based on agreements concluded after 31 December 2013 (cf. Sec. 52 para. 48 sent. 4 EStG in its revised wording). Hence, the revised version applies retroactively from the date of the first applicability of the regulation.

In consequence of the amendment of Sec. 50i EStG, the wording of Sec. 6 para. 3 sent. 1 EStG (in its revised form) was also amended, as the reference to Sec. 6 para. 3 EStG previously set out in Sec. 50i para. 2 EStG was cancelled. Hence, Sec. 6 para. 3 sent. 1 EStG (in its revised form) explicitly states that, with regard to the gratuitous transfer of a business, a branch of activity or a partnership interest respectively, the principle of book value roll-over may only be applied under the condition that Germany's right to taxation of hidden reserves is guaranteed.

The new provision will take effect on the day following the announcement of the BEPS 1-Implementation Act.

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[4] Cf. BMF Circular dated 21 December 2015, Federal Tax Gazette Part I 2016, p. 7.

2.4 Further amendments

2.4.1 Extension of the exchange of information in the context of the German Act on the Exchange of Information on Financial Accounts

In the context of the German Act on the Exchange of Information on Financial Accounts (*Finanzkonten-Informationsaustauschgesetz* – ”**FKAustG**”), the Federal Republic of Germany automatically transmits information relating to financial accounts held by non-EU citizens with German financial institutions to the EU member states. Against the backdrop that the European Union has repeatedly concluded agreements on the automatic exchange of such information with third countries and will probably continue to conclude such agreements in the future, the Act on the Exchange of Information on Financial Accounts is to be extended accordingly (Sec. 1 para. 1 no. 3 and no. 4 FKAustG).

2.4.2 Prolongation of the storage period for FATCA-relevant data

In future, financial institutions or third parties appointed by them will have to retain the evidence verified for purposes of complying with identification and due diligence obligations under the FATCA-USA-Implementing Regulation for a period of six years (Sec. 8 para. 9 FATCA-USA-Implementing Regulation). Evidence means all documents on the basis of which the FATCA-status of the respective ac-count holder has been verified.

Both new provisions are to take effect on the day after the publication of the Act (Art. 19 para. 1 BEPS 1-Implementation Act).

3 Tightenings in the field of trade tax

3.1 Reducing participation exemption within a trade tax group

With its judgement dated 17 December 2014 (I R 39/14, Federal Tax Gazette Part II 2015, 1052), the BFH has decided that dividends earned by group companies forming part of an affiliated group for trade tax purposes with a corporate as parent company may be fully exempt from trade tax. The fiction of Sec. 8b para. 5 of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* – “**KStG**”), according to which 5% of the dividend income qualifies as non-deductible business expenses (so-called *Schachtelstrafe*), will not be applied. Thus, it was so far beneficial to receive dividends via group companies belonging to a tax group for trade tax purposes rather than through affiliated companies which do not belong to one tax group for trade tax purposes.

Under the new Sec. 7a of the German Trade Tax Act (*Gewerbesteuergesetz* – “**GewStG**”) the so-called *Schachtelstrafe* shall be applied also to dividend income earned by group companies when determining the trade income within the group.

The aforementioned provision also applies to dividend income which is exempt on the basis of a DTT (Sec. 7a para. 3 GewStG).

The new provision in Sec. 7a GewStG is to be applied for the first time on dividends received after 31 December 2016 and on expenses accruing after that date (Sec. 36 para. 2b GewStG)

3.2 CFC taxation and trade tax

With its judgement dated 11 March 2015, (I R 10/14, Federal Tax Gazette Part II 2015, 1049) the BFH has decided that CFC income is not subject to trade tax (Sec. 9 no. 3 sent. 1 GewStG).

In the BMF's opinion, this view contradicts the legislator's intention as well as the practice of the tax authorities which is based on that intention. Furthermore, it also considered to contradict Sec. 9 no. 3 sent. 1 GewStG. For that reason, a new provision has been included pursuant to which CFC income (within the meaning of Sec. 10 para. 1 AStG) qualifies as income accruing in a domestic permanent establishment (Sec. 7 sent. 7 GewStG).

In case CFC income is earned by a foreign permanent establishment, a fiction applies according to which such low-taxed passive income is deemed "realized in a domestic permanent establishment" (Sec. 7 sent. 8 half-sent. 2 GewStG). In cases where low-taxed passive income is received through foreign partnerships, such income will no longer be reduced according to Sec. 9 no. 2 GewStG. This fiction applies irrespective of the existence and contents of an existing DTT (Sec. 7 sent. 8 half-sent. 2 GewStG). However, the fiction does not apply if the taxpayer pursues an own economic activity in connection with the passive activities (Sec. 7 sent. 9 GewStG).

Finally, it is explicitly set forth in Sec. 9 no. 3 sent. 1 GewStG that – subject to Sec. 7 sent. 8 GewStG – foreign source income will only be exempt from trade tax if it is earned by the respective enterprise itself. This amendment is also intended to counter the above-mentioned deviating BFH judgement dated 11 March 2015.

The aforementioned provisions of the GewStG will take effect on 1 January 2017 or for the assessment period 2017, respectively (Art. 19 para. 2 in connection with Art. 16 BEPS 1-Implementation Act).

4 Prevention of tax structuring schemes which are disagreeable in the legislator's view

With the BEPS 1-Implementation Act the legislator introduced additional measures to prevent certain tax structuring schemes in the future which are abusive in the legislator's view.

4.1 Restriction of the optional assessment regarding withholding tax

Shareholders holding more than 1% in a corporation who are also employed by the respective corporation are allowed to opt for a 40% tax exemption for dividend income (so-called *Teileinkünfteverfahren*) pursuant to Sec. 3 no. 40 EStG (Sec. 32d para. 2 no. 3 lit. b) EStG). If so, the so-called *Abgeltungsteuer* (final withholding tax) and the associated denial of a deduction of expenses (including capital losses) (Sec. 20 para. 6 and para. 9 EStG) are not applicable. Hence, only 60% of the balance of dividends and related expenses are subject to tax at 60% pursuant to the progressive income tax rate.

In past years, the fiscal authorities only accepted such option if the taxpayer was able to take a decisive entrepreneurial influence on the corporation by means of his professional activity. The BFH has clearly rejected this view (judgement dated 25 August 2015, VIII R 3/14, Federal Tax Gazette Part II, p. 892). According to the respective ruling, neither qualitative nor quantitative requirements regarding the shareholder's professional activity by the company can be derived from the law's wording. The discarded view of the fiscal authorities will now be reflected by legislation: The option to progressive taxation – combined with the deduction of expenses and the 40% tax exemption – will only be available if the taxpayer is able to take decisive entrepreneurial influence on the corporation's economic activity through his professional activity.

The new law shall be applied for the first time to applications for the assessment period 2017 (Sec. 52 para. 33a EStG).

4.2 Prevention of so-called cum/cum treaty shopping

A new Sec. 50j EStG is intended to tighten the prerequisites for a tax credit or refund of withholding tax on dividends in cases of so-called cum/cum treaty shopping structures. The new provision, which shall also cover foreign central securities depositaries (*ausländische Zentralverwahrung*), is expressly designed as treaty override and will take effect on 1 January 2017 (cf. Art. 19 para. 2 in conjunction with Art. 8 BEPS 1-Implementation Act.

Conceptually, Sec. 50j EStG is an accompanying measure to Sec. 36a EStG which has been introduced with the Investment Tax Reform Act dated 19 July 2016. Sec. 36a EStG in particular aim at the prevention of so-called cum/cum transactions and considerably limits the full credit of withholding tax at the level of a domestic recipient of dividend income. A tax credit pursuant to Sec. 36a EStG requires that the taxpayer is the legal and beneficial owner of the securities during a so-called minimum holding period (simplified, a period of 45 days prior to and after the dividend record date), bears a so-called minimum risk of changes in value and – in addition – does not compensate a third party for receiving the respective dividends. For details please refer to our Tax Alert in January 2016.

Sec. 50j EStG covers constellations where a non-resident taxpayer claims a reduction of withholding tax pursuant to a specific DTT to less than 15%. Apart from minority shareholdings in listed corporations (participation quota <10%), profit participating rights which qualify as equity for German tax purposes are also affected .

The requirements of a continuing eligibility for withholding tax relief essentially correspond to those of Sec. 36a paras. 1 to 3 and para. 5 EStG. A *de-minimis*-threshold for dividend income in the amount of a maximum of EUR 20,000 per assessment period, however, is not intended.

The new provision steps aside Sec. 50d para. 3 EStG. Hence, requirements of both – Sec. 50d para 3 EStG and Sec. 50j EStG – need to be met for a withholding tax relief of less than 15%.

4.3 Changes for credit institutions and financial services institutions

Currently, dividends and capital gains from shareholdings held by credit institutions, financial services institutions and financial companies are fully taxable to the extent that the shareholdings (i) are allocated to the trading book in the case of credit institutions and financial services institutions or (ii) serve the short-term proprietary trading in the case of financial companies within the meaning of the German Banking Act (Kreditwesengesetz – "**KWG**"). From the legislator's view, the above rules need to be amended in order to prevent certain tax planning strategies which are focusing on the offset of losses from the sale of those shareholdings or fully-taxable hedging transactions.

The BEPS 1-Implementation Act provides for such limitation of a tax deductibility of certain losses from trading transactions with credit institutions and financial services institutions as well as the limitation of the personal scope of application of the regulations of the so-called financial companies in the meaning of KWG.

4.3.1 Credit institutions

In future, investment income shall only be subject to tax – and may thus allow a tax-effective loss offsetting – if the shareholdings are allocated to the trading book based on the rules of the German Commercial Code (*Handelsgesetzbuch* – "**HGB**"') at the time of their addition to the business assets (Sec. 3 no. 40 sent. 3 half-sent. 1 EStG, Sec. 8b para. 7 sent. 1 KStG). Under the new provision, the commercial perspective shall now be decisive for the taxation.

According to the legislator's reasoning, both income from shareholdings and related hedging transactions shall be taxed separately at the time of realisation despite the fact that both assets have previously formed an evaluation unit within the meaning of Sec. 254 HGB.

4.3.2 Financial companies within the meaning of the KWG

Income from corporate shareholdings of financial companies within the meaning of the KWG will now only be taxable if credit institutions or financial services institutions directly or indirectly hold a participation of more than 50% in such a financial company. A further requirement for the tax liability of the respective income is the fact that the underlying shares qualify as current assets at the level of the financial company at the time of their addition to the business assets (Sec. 3 no. 40 sent. 3 half-sent. 2 EStG, Sec. 8b para. 7 sent. 2 KStG).

The new provision restricts the personal scope of application to financial companies belonging to the banking sector.

Furthermore, the current prerequisite of an acquisition "for purposes of realising short-term gains for such enterprise's proprietary account" shall be replaced by the prerequisite of a recognition of the relevant interests as current assets at the date of their acquisition.

4.3.3 Applicability

With regard to credit institutions and financial services institutions, the new Sec. 3 no. 40 sent. 3 EStG and Sec. 8b para. 7 KStG shall be applied for the first time in the assessment period 2017 (Sec. 52 para. 4 sent. 7 half-sent. 1 EStG, Sec. 34 para. 5 sent. 2 half-sent. 1 KStG). As regards financial companies, any asset is covered by the new provision which is added to the business assets for the first time after 31 December 2016 (Sec. 52 para. 4 sent. 7 half-sent. 2 EStG, Sec. 34 para. 5 sent. 2 half-sent. 2 KStG).

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