Germany's amended Tax Bill 2013 will affect common US MNC structures

June 7, 2013

In brief

Following the German Parliament's approval of the Tax Act that implements the Administrative Assistance Directive and amends tax regulations (Tax Bill 2013 "light"), the German Federal Council on June 7 consented to the bill. The bill now requires the German president's signature and publication in the Federal Gazette for enactment. We expect those formalities to occur soon.

Tax Bill 2013 "light" includes several changes to current law that previously had been proposed in the draft Tax Bill 2013 (see Newsalert dated December 21, 2012 Germany's Company Taxation Bill and Tax Bill 2013: Latest proposals and status). The most relevant issues for US MNCs include:

- provisions closing down certain real estate transfer tax (RETT) blocker structures and exempting further intra-group reorganization from the RETT
- a participation exemption amendment to close down certain hybrid outbound structures
- provisions aimed at inbound structures under which a foreign partner grants a loan or license to a German partnership.
- limitation of loss utilization opportunities in the 'retroactive period' as part of certain reorganizations
- provisions amending the profit determination of a permanent establishment (PE) in line with the authorized OECD approach (AOA) and
- rules ensuring eligibility for German withholding tax (WHT) relief of certain inbound structures involving foreign hybrid entities.

In detail

After a lengthy legislative procedure with various proposals and counter-proposals, the Federal Parliament and the Federal Council finally approved Tax Bill 2013 "light" after agreement during the mediation committee's arbitration procedure held on June 5, 2013. Tax Bill 2013 "light" contains many of the amendments included in the draft Tax Bill 2013 as amended by the mediation committee on December 12, 2012. The initial Tax Bill 2013 was rejected by both legislative bodies in the beginning of 2013. The most relevant changes for US MNCs are discussed below.

Amendment of RETT rules

Closing down certain RETT blocker structures

RETT may be triggered when an acquirer directly or indirectly unifies 95% or more of the shares in an entity owning German real estate. Prior to this amendment, RETT was not incurred when an acquirer utilized a German partnership structure to hold a greater than 95% economic stake in the real estate-owning entity provided that a third party held a minority economic stake. These RETT blocker structures have been used widely so that taxpayers would not incur RETT multiple times upon group restructurings.

Under the new bill, the RETT Act receives a more realistic economic view by considering any indirect ownership. Under the new rules, all indirect ownership in either the capital or the net assets of the real estate-owning company must be considered when determining the 95% threshold. Technically, all pro rata participations are multiplied when determining the relevant ownership percentage.

Observation: Some uncertainties remain, especially for the new term "economic interest."

The provision particularly affects RETT-blocker KG structures. These are structures where typically a German KG directly or indirectly holds 5.1% or more of the shares in a real estate-owning company and a third-party partner holds, for example, 5.1% of the KG, resulting in a minority economic ownership of only 0.26%. As a result, under current law, existing structures including a commonly used 'RETT blocker' could reach the 95% threshold for RETT purposes.

Broader intra-group exemption

The existing intra-group exemption applies only to certain reorganizations as defined in the German Reorganization Act or comparable reorganizations according to the law of another European Union (EU) or European Economic Area (EEA) state. Share-for-share exchanges are not covered.

The intra-group exemption will now cover contributions such as share-for-share exchanges, and other transactions based on the bylaws of the receiving entity. Certain transactions outside Germany (and even outside the EU/EEA) might be covered as well. However, other tight requirements for intra-group exemption such as compliance with certain holding thresholds and periods remain unchanged.

Closing down hybrid financial instrument structures

In light of the EU initiative on aggressive tax planning, the legislation limits the domestic 95% participation exemption to dividends that have not resulted in a corresponding deduction for tax purposes at the level of the distributing entity.

The amendment particularly targets certain cross-border hybrid financial instruments in German outbound structures under which Germany classifies the financial instrument as equity but the foreign country treats the instruments as debt.

Provisions aimed at inbound partnership structures

The Federal Tax Court has ruled that in structures where a foreign partner granted a loan to its German trading partnership (e.g., a German KG), Germany does not have the right to tax the interest income earned by the partner as it is generally not effectively connected to the partnership's German PE, even though under domestic tax law the interest income was treated as income of the partnership. Even a treaty override introduced in Tax Act 2009 as a reaction to the court decision did not grant the right, according to a recent Federal Tax Court ruling.

The new rules are designed to overrule the recent court decision by ensuring Germany's right to tax interest income received by a foreign partner from its German partnership. The rules also apply to other types of income received by the foreign partner from its partnership, such as royalty income.

Limitation of loss utilization opportunities following restructurings

Under the German reorganization tax act, taxpayers could undertake certain restructurings for income tax purposes with retroactive effect (giving rise to a 'retroactive period' between the reorganization tax effective date and its legal effective date. Previously, profits of the transferring entity accruing in the retroactive period generally could be offset against tax losses and interest carryforwards of the absorbing entity.

The new provision aims to shut down certain tax schemes by abolishing this loss utilization within the retroactive period; however, the rule does not lead to a forfeiture of losses in the absorbing entity. An intra-group exception is available provided that both the transferring and the absorbing companies, under the German Commercial Code, belong to the same consolidated group prior to the reorganization's tax effective date.

Introduction of AOA principles into German tax law

Until now, transactions between a head office and its PE or between PEs

of the same entity generally have been disregarded for German income tax purposes. External income and expenses had to be allocated between the PE and the head office.

The bill adopts the AOA's basic principles of the separate entity approach for German PEs. Cross-border transactions between the head office and a PE or between different PEs of the same entity are recognized for income tax purposes and affect the profit allocation to a PE. The transactions must comply with general arm's-length principles in the German transfer pricing rules, including a profit markup.

Eligibility for hybrid entities to claim a WHT refund

When a foreign hybrid entity receives German-source income (e.g., dividends or royalties), there is often a mismatch between the person being taxed on the income and the person eligible for treaty relief.

In such cases the new rules should ensure that taxpayers can still achieve treaty relief.

Under the new rules, Germany will follow the foreign classification of the hybrid entity for purposes of WHT refund claims. For example, a refund of WHT levied on dividends received by a US tax resident via a disregarded LLC that is treated as a regarded entity under German domestic law may be claimed only by the US tax resident, not by the LLC.

What are the tax bill's effective dates?

The amended "light" Taxation Bill includes the following effective dates:

- The amended RETT rules apply to all transactions carried out after June 6, 2013.
- The participation exemption limitation applies to dividends received in fiscal years beginning after December 31, 2013.
- The provisions aiming at inbound financing partnership structures apply to all open tax assessment periods.
- The loss utilization limitations are effective for all reorganizations filed with the commercial register after June 6, 2013. For those reorganizations that do not need to be registered, the new provision applies if the beneficial ownership in the underlying assets is transferred after June 6, 2013.
- The adaption of AOA principles is effective for fiscal years beginning after December 31, 2012.
- The WHT refund rules for hybrid entities apply to income received after the new bill is enacted, i.e., after publication in the Federal Gazette.

The takeaway

US MNCs should:

- Revisit existing RETT structures in light of the new concept of "economic interest"; note that RETT could be triggered multiple times upon an acquisition / intra-group restructuring; and consider new rules for acquisitions and restructurings
- Review planned intra-group restructurings in light of the new RETT exemption for contributions
- Review German outbound hybrid instruments in light of the anti-hybrid rules.
- Revisit the treaty impact on German inbound partnership structures, particularly those where loans or licenses are directly granted by the foreign partner to a German partnership.
- Consider new loss limitation rules applicable to reorganizations filed with the commercial register after June 6, 2013
- Review the impact of AOA principles on existing German PEs or US PEs with a German head office
- Revisit hybrid German inbound structures and consider procedural hurdles when applying for exemption or refund of German WHT, particularly for structures that involve hybrid entities.

Let's talk

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