Tax Law in Germany

Haase / Steierberg

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C.H.BECK

1. Add-backs

The following amounts shall be added back to profit from commercial business activity to the extent they were deducted in determining profit: **17**

- 25 % of the sum of the following (deemed) **interest expenses**
  - interest expense
  - retirement payment
  - profit share of silent partner
  - a fifth of lease expenses for movable property
  - the half of lease expenses for immovable property
  - a quarter of royalty payments for the temporary lease of rights.

  A threshold of 200,000 EUR is applicable before applying the multiplier of ¼.
- The profit shares of the general partner in **partnership limited by shares**
- Profit shares (**dividends**) excluded under § 3 no. 40 EStG or § 8b(1) KStG and the equivalent receipts and received payments from shares in a corporate entity, an association, or an independent property fund within the meaning of the Corporate Income Tax Act, to the extent they fail the holding requirement of at least 15 % in the distributing company.
- Shares in the profit of a **domestic or foreign commercial general partnership,** commercial limited partnership, or other company in which the partners are to be regarded as entrepreneurs (business partners) carrying on a commercial business provided the profit shares were included in determining profits.
- Charitable contributions treated as business expenses for (corporate) income tax purposes.

2. Deductions

The sum of the profit and the add-backs will be reduced by **18**

- 1.2 % of the **real estate value** for tax purposes owned by a taxpayer, who does not engage in real estate business. The taxpayer can alternatively apply for deduction of income derived from the use of real estate property.
- Shares in the **profit of a domestic or foreign commercial general partnership,** commercial limited partnership, or other company in which the partners are to be regarded as entrepreneurs (business partners) carrying on a commercial business provided the profit shares were included in determining profits. This does not apply to life insurance and health insurance enterprises or to pension funds.
- Profit distributions of a **domestic or foreign corporation** if the holding in this company is at least 15 %.
- Profit shares of the **general partner in partnership** limited by shares.
- Profit from commercial business that is not attributable to a German **permanent establishment**.
- **Charitable contributions** up to 20 % of the sum of the profit and the add-backs or up to 0.4 % of the sum of wages and turnover as far as these contributions were paid to recognised organisations.
- Profits from shares in a **corporation with management and registered office outside Germany** at least 15 % of the nominal capital of which has been held by the enterprise without interruption since the beginning of the tax collection period (subsidiary).

C. Thin capitalisation rules

19 The German thin capitalisation rules were completely **revised** in 2008, with effect from 2009. Interest deduction no longer depends on a specific debt-equity ratio.

20 Interest expense in connection with the business is in principle deductible for German tax purposes. However, certain limitations have been introduced to **avoid erosion of the German tax base.** According to § 4h EStG, which is applicable for corporations, too, interest expense incurred by a business is deductible in the amount of interest revenue and, over and above this, only up to 30 % of **EBITDA**.

21 Interest expense that cannot be deducted will be carried forward to the following fiscal years as a so-called interest expense carry-forward. The interest expense carry-forward increases the interest expense of these fiscal years, but not the relevant profit.

22 The deduction of interest expense is not limited to 30 % of the EBITDA for the following **escape clauses** if

– the amount by which interest expense exceeds interest revenue is less than 3 Mil. EUR, or
– the business does not belong to a consolidated group, or does so only proportionally, or
– the business belongs to a consolidated group and its equity percentage at the close of the preceding financial statement date is equal to or greater than that of the consolidated group (equity percentage comparison). An equity percentage up to two percentage point below that of the group is not detrimental.

23 **Equity percentage** refers to the ratio of equity to the balance sheet total. It is determined according to the consolidated financial statements in which the business is included and is determined for the business based on the annual financial statements or the single-entity financial statements.

24 The **financial statements** that are determinative for the equity percentage comparison have to be prepared uniformly in accordance with International Financial Reporting Standards (**IFRS**). By way of exception, financial statements prepared in accordance with the commercial law of an EU Member State may be used, provided no consolidated financial statements according to IFRS are required to have been prepared and disclosed and no consolidated financial statements according to IFRS were prepared for any of the last five fiscal years.

25 Financial statements that were prepared and disclosed in accordance with the Generally Accepted Accounting Principles of the United States of America (**US GAAP**) could be used if no consolidated financial statements under IFRS or the commercial law of an EU Member State must be prepared and disclosed. A **partnership** whose partners are considered to be business partners is directly or indirectly subordinated to a corporation, § 8a(2) and (3) KStG shall apply analogously to the partnership.

I. Exemption from escape clauses

26 The escape clause for a business that does not belong to a consolidated group applies to corporations only if the payments for debt capital that are made to

– a shareholder holding directly or indirectly more than one fourth of the stated or share capital, or
– a related person related to such a shareholder, or
– a third party with a right of recourse against the shareholder holding more than one fourth of the stated or share capital or against a person related to such a shareholder,

do not exceed 10 % of the amount by which the corporate entity's interest expense exceeds its interest revenue, and the corporate entity proves this to be the case.

The equity percentage comparison escape clause is applicable for corporations only if 27
the payments for debt capital of the corporate entity or of any other legal entity belonging to the same consolidated group that are made to

- a shareholder holding directly or indirectly more than one fourth of the capital in a group company, or
- a related person to such a shareholder, or
- a third person with a right of recourse against the shareholder holding more than one fourth of the capital or against a person related to such a shareholder,

do not exceed 10 % of the amount by which the legal entity's interest expense exceeds its interest revenue.

This applies only for interest expense on liabilities that are stated in the **fully consol-** 28
idated financial statements and, if financed by a third party, involve recourse against a shareholder who is not part of the group or against a person related to such a shareholder.

II. Definitions

Relevant profit refers to the taxable profit determined in accordance with the provisions 29
of the Income Tax Act.

For corporation relevant profit is replaced by **relevant income**, which is the income 30
determined in accordance with the provisions of the Income Tax Act and the Corporate Income Tax Act.

Interest expense refers to payments for debt capital that have reduced the relevant 31
profit.

Interest revenue refers to revenue from monetary claims of any kind that have in- 32
creased the relevant profit.

The compounding and discounting of non-interest bearing or low-interest liabilities 33
or monetary claims likewise give rise to interest revenue or interest expense.

A **German business** under the interest deduction rules is a sole proprietorship, a 34
partnership, or corporations. A German consolidated tax group will be viewed as one 'business'. Interest expense of the subsidiary company of the tax consolidation will be considered at the level of the parent of the tax consolidation. Due to German tax consolidation rules, financing within a German tax consolidation group should not trigger any adverse tax consequences.

A business belongs to a consolidated group for purposes of the debt-equity escape 35
clause if, under the accounting standards applied it is or could be consolidated with one or more other businesses.

III. Interest expense carry-forward

The **i**nterest expense carry-forward is assessed separately by the tax office with jurisdic- 36
tion to separately assess the company's profit and loss, and otherwise in the tax office with jurisdiction to assess taxes.

At the time of **termination** or transfer of the business the interest expense carry-for- 37
ward is denied. If a business partner **withdraws from a partnership**, the interest expense carry-forward is denied in the portion that corresponds to the withdrawing partner's

interest in the partnership. Change in ownership rules (→ mn. 74) apply analogously to the interest expense carry-forward.

IV. EBITDA carry-forward

38 Interest expense exceeding interest revenues is deductible up 30 % of the EBITDA of the relevant fiscal year. The portion of EBITDA not used to be offset for interest deduction will be carried forward for the next five years. Interest expense exceeding interest revenues in the following fiscal exceeding the 30 % EBITDA of the current year can be deducted up to the amount of the EBITDA carry-forwards. A first-in-first-out approach applies to the EBITDA carry-forwards, i.e. when using the forwards, the oldest deemed to be used first.

D. Cross-border aspects of German tax groups

39 There are two decisions of the German courts which are **German *Marks & Spencer* cases.** In one of the two cases a German company held EU-based subsidiaries that incurred final losses. The Lower Fiscal Court held that the losses were deductible at the level of the parent company if the parent company entered into a loss assumption agreement with its subsidiary for at least five years. According to the Court, a profit transfer does not require a formal profit and loss pooling agreement, which is in a domestic situation a condition for a German *Organschaft* ('fiscal unity'). On the facts of the case the German parent company was required to ensure adequate capitalisation of its Italian subsidiaries. To meet this obligation, on several occasions the German parent injected cash into the subsidiaries through shareholder loans, which were subsequently converted into equity by loan waivers. The parent company sought to deduct the losses incurred by the subsidiaries based on the **freedom of establishment principle,** arguing that it was legally obliged to assume the losses of its subsidiaries and that the losses became final because the subsidiaries ended their activities. The Lower Fiscal Court ruled against the taxpayer. In its view the German prerequisite of a profit and loss pooling agreement was not fulfilled. The Court stated that a mere '**factual**' **obligation to assume the losses,** i.e. only under the Italian rules, was not sufficient to claim loss compensation for German tax purposes.

40 In another case a taxpayer claimed relief for losses incurred by its Danish corporate subsidiary. The entity incurred substantial losses and was liquidated in 2005, with significant **unutilised tax loss carry-forwards** at the time of liquidation. The German parent applied for a deduction of the losses incurred by the Danish subsidiary arguing that, under the principles enunciated in the ECJ decision *Marks & Spencer*[37], final losses of an EU-based subsidiary must be deductible at the level of the parent company even if no **profit and loss pooling agreement** was in place between the companies. The Lower Fiscal Court rejected the claim of the parent company. According to the Court, the parent company was not even in a situation comparable to the head of a domestic tax group and, consequently, it rejected the argument that there was a restriction of the freedom of establishment principle under the EU Treaty. It further concluded that, even if the disallowance of a loss deduction at the level of the parent company does constitute a restriction,

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[37] ECJ 13.12.2005 case C-446/03, ECLI:EU:C:2005:763 – *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes).*

that restriction would be justified by the need to protect the balanced allocation of taxing rights between the Member States.

The Federal Fiscal Court rejected both appeals against the Lower Fiscal Court decisions. **41**

In the ***Scheuten Solar***[38] case before the ECJ a taxpayer acted against the trade tax add-back for interest expense. In the proceedings before the Federal Fiscal Court, the claimant argued that the add-back constitutes an infringement of the freedom of establishment principle since, in a comparable domestic situation, *Organschaft* could have been established which would have avoided the add-back. Since an *Organschaft* requires a German resident parent company or a domestic branch of a foreign company, the claimant argued that subsidiaries of foreign parent companies are discriminated against. Moreover, an *Organschaft* requires a profit and loss pooling agreement, which must satisfy formal criteria and which is concluded between the parent and the subsidiary for at least five years. The Federal Fiscal Court had referred to the ECJ requesting clarification of whether the add-back of interest under the (old) rules in the Trade Tax Act are in line with the **Interest and Royalties Directive**. Not surprisingly, the Federal Fiscal Court has confirmed that, based on the ECJ decision in Scheuten Solar, the add-back provisions are compatible with the Directive so the claimant could not rely on IRD protection. The Federal Fiscal Court indicated that, in its view, according to the ECJ decision in *X-Holding*[39], the denial of a cross-border tax group could be justified from an EU law perspective because it safeguards a balanced allocation of taxing rights between Member States. According to the Federal Fiscal Court, this concept may also apply to other ongoing tax aspects of a tax group like the exclusion from the trade tax add-back rule for loans between the *Organschaft*-parent and the *Organschaft*-subsidiary. **42**

Further, based on the Federal Fiscal Court's view, a profit and loss pooling agreement between the parent and the subsidiary would be an essential aspect of any argument that a cross-border situation is comparable to a domestic situation where a tax group is established. Since the taxpayer did not conclude a profit and loss pooling agreement with its parent (even though – according to the Federal Fiscal Court – this would have been possible from a legal perspective), the situation was not deemed to be comparable. In practice, therefore, cross-border tax groups are still not possible from a German tax perspective. **43**

E. Dual consolidated loss rules

In connection with the fiscal unity taxation[40] dual consolidation loss rules apply. These rules prevent the utilisation of tax losses of the ultimate German controlling company if the same loss can be used in another country under similar group taxation rules. **44**

[38] ECJ 21.7.2011 case C-397/09, ECLI:EU:C:2011:499 – *Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen-Süd*.

[39] ECJ 25.2.2010 case C-337/08, ECLI:EU:C:2010:89 – *X Holding BV v Staatssecretaris van Financiën*.

[40] → Ch. 3 mn. 1.

F. Bookkeeping abroad

45 According to the German Federal Fiscal Code, book-keeping has in principle to be carried out in Germany. In deference to European law this legal requirement was changed. Now the transfer of electronic bookkeeping abroad was made easier. Under certain conditions it would be possible for a German company or German permanent establishment to **apply for relocation** of its bookkeeping to an EU or non-EU country. The former requirement that the foreign country to which the bookkeeping is transferred must consent to electronic access for the German tax authorities was abolished, as this resulted in significant **practical difficulties.** Taxpayers still have to disclose the physical location of the IT system and the German tax authorities would still need to be able to access the system electronically. Taxpayers applying for a relocation of bookkeeping would need to have a **good history of tax compliance** to be eligible for the concession. Last but not least, the collection of tax must not be put at risk by transferring the bookkeeping abroad.

46 In case where the electronic bookkeeping was transferred without prior permission of the German tax authorities, the tax authorities are allowed to assess a generally applicable **penalty** from 2,500 EUR up to 250,000 EUR for non-compliance.

47 The penalty rule should affect all taxpayers and may result in significant penalty assessments for failure to comply with information requests issued by the tax authorities unless the taxpayer can prove that the authorities did not exercise their administrative discretion correctly. In addition, depending on the type of tax the penalty relates to, it may not be tax deductible.

48 The penalty may be imposed if the taxpayer fails to comply with any one of the **following obligations**:
- Timely submission of requested documentation and information during a tax audit
- Granting of access to electronic accounting systems
- Obtaining permission from the tax authorities prior to relocating electronic accounting systems outside Germany
- Re-transfer of electronic accounting systems back to Germany at the request of the tax authorities; or
- Duty to inform the tax authorities about tax relevant facts

G. Taxation of cross-border dividends

I. General

49 A German subsidiary distributing profit to its foreign shareholder has to **withhold taxes**. The withholding tax rate is 25 % plus 5.5 % solidarity surcharge thereon and deducted from the gross amount of distribution.

50 The withholding tax rate might be reduced according to a d**ouble taxation agreement** concluded between Germany and the state of residence of the shareholder. If the parent company is a EU company in the meaning of the **Parent-Subsidiary Directive,** the withholding tax rate is reduced to 0 % if the shareholder holds at least 10 % shareholding in the distributing company.

51 Relief from withholding taxes can be obtained either by way of a **refund** or an **exemption certificate** can be produced at the time of the distribution (in case the applicant is not an individual).

52 Beside the relief based on the EU Parent-Subsidiary Directive or on a DTA, German tax law provides for a further unilateral relief for corporations. A foreign corporation can apply for reduction of two-fifths of the withholding taxes according to German tax law, i.e. if no **anti-abuse restrictions** apply, the reduction will be granted even in the absence of a DTA. This regulation was introduced at the time the general corporate income tax rate in Germany was lowered to 15 % (plus 5.5 % solidarity surcharge). Refunding two-fifths (40 %) of the withholding tax of 25 % lowers the effective withholding tax rate to 15 %, the same taxation rate as for domestic corporations. This granting of this unilateral relief is subject to the general anti-abuse rules (→ Ch. 7 mn. 93). Non-resident corporations intending to apply for this **unilateral relief** rule would have to demonstrate their substance based on the same requirements as set forth by the German anti-treaty shopping rule.

53 Dividends paid to individuals are liable to a definite withholding tax at a rate of 25 % plus 5.5 % solidarity surcharge.

II. Portfolio dividends

54 **Foreign shareholders** are subject to a definite dividend taxation of 25 % plus solidarity surcharge. The withholding tax rate might be reduced based on a DTA or according to the EU Parent-Subsidiary Directive.

55 German shareholders can credit the amount of withheld taxes against their tax liability. Furthermore, dividend income is tax-free income for **resident corporations, provided that the threshold of 10 % in the shareholding is reached.** However, 5 % of the received gross dividend is deemed to be non-deductible tax expense. Considering the general tax rate for corporate income tax of 25 % (plus 5.5 % solidarity surcharge), the effective tax rate for German corporate taxpayers is for dividend income is approximately 0.8 %. Dividend distribution to foreign investors is subject to an effective tax rate of 26.4 %.

56 The application of the (partial) tax exemption to German corporate taxpayers is unconditioned, i.e. no minimum holding must be fulfilled, and the shareholder has not to provide proof of its substance or on economic reasons for the holding in the German distribution company.

57 Considering EU law, this different treatment is clearly in breach of the to be provided **freedom of free movement of capital**. As Germany was not the only country applying different ways of calculating the tax base for domestic as compared with foreign investors, many of these national regulations were brought to the ECJ.[41] Regarding German tax law, the ECJ ruled that the different treatment of dividend income for German and foreign corporate investors is in breach with the fundamental freedom of free movement of capital. Following these decision foreign EU- and non-EU-investors can **claim the same tax benefits** regarding received dividend distribution as German investors, even if they hold only a minor shareholding in the distribution company (portfolio dividends).

58 To ensure the right of withholding tax relief in view of same treatment under EU law, foreign investors have to comply with **German procedural law** on application for relief. As German tax law does not provide special procedures for claiming relief due to breach of fundamental freedoms, the general procedural rules apply.

[41] ECJ 20.11.2011 case C-284/09, ECLI:EU:C:2011:670 – *Commission v Germany.*

59 In 2012 the Federal Fiscal Court recently published a decision on withholding tax on German dividends paid to a French SAS.[42] In this decision the Federal Fiscal Court held that foreign corporate shareholders have to accept an effective tax on dividends of about 0.8 %). However, the SAS cannot claim relief from withholding tax at source (as would be possible under the Parent-Subsidiary Directive), but instead must request a refund. The Federal Fiscal Court confirmed the earlier view that the **Federal Central Tax Office,** which is the single point of contact for withholding tax reclaims based on tax treaties and the Parent-Subsidiary Directive, is not competent to decide on refunds claimed under primary EU law. As the taxpayer has claimed relief at the Federal Central Tax Office, it lost the case on procedural grounds. The Federal Fiscal Court confirmed that the **local tax office,** i.e. the tax office in whose district assets or the most valuable part of the assets of the taxpayer are located, is the competent agency to decide on the refund request.

60 However, given a foreign portfolio shareholder with multiple German shareholdings it is unclear which types of assets must be considered, where shareholdings are deemed to be located for purposes of the rule and how to determine which shareholding (or other asset) constitutes the most valuable part of the assets of the foreign investor. **Practical experience** shows that it is impossible to safely identify a single local tax office competent for the EU withholding tax reclaims of a foreign portfolio investor.

61 Therefore, it is essential for foreign investors to seek competent legal advice in order to enforce the entitlement for withholding tax relief in accordance with primary EU law.

III. Hidden profit distributions

62 A hidden profit distribution within the meaning of the Corporate Income Tax Act is a decrease in corporate property or a prevented increase in corporate property that is caused by the shareholder relationship, has an impact on the business profit, and is not based on a profit distribution resolution adopted in accordance with the provisions of corporate law. **Inducement by the shareholder** relationship is also present where the decrease or prevented increase in corporate property occurs in favour of a related party.

63 Regarding the relationship between the company and its controlling shareholder, inducement by the shareholder relationship will be assumed to exist where **no clear and unambiguous legally valid** agreement has been entered into in advance that stipulates whether and in what amount compensation is to be paid for a performance rendered by the shareholder, or where a clear agreement exists, but is not adhered to. **Control** of the shareholders must exist as of the time of agreement to or implementation of the decrease or prevented increase in corporate property.

64 Contracts with controlling shareholders must be legally valid to be accepted for tax purposes. Where a requirement of written form applies, this is a condition precedent to legal validity. Legal transactions that do not satisfy the formal requirements prescribed by law are void under § 125 1st sent. BGB. Under this provision, failure to comply with a consensually imposed formal requirement likewise voids the contract 'in case of doubt'. The issue of legal validity turns on whether compliance with the requirement of written form is intended to be a condition precedent to the validity of the amended contract (constitutive written form) or whether the intention is merely to record the content of the contract in writing for evidentiary purposes (declaratory written form). § 53(2) GmbHG requires notarial recordation of changes in the articles of incorporation of a limited liability company. Release of the sole shareholder from the prohibition on self-dealing in

[42] BFH 11.1.2012 – I R 25/10, DStR 2012, 742.