HEUKING KÜHN LÜER WOJTEK

German tax rules regarding tax-avoidance, base erosion, profit shifting and tax transparency as blueprint for other jurisdictions ?

STEP Israel

ADVISING FAMILIES ACROSS GENERATIONS

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Case Study: The Problem

- The client is an Israeli software engineer who owns and uses apartments in Tel Aviv and Berlin
- The client holds all shares in a German software company via his Israeli holding company
- The German company pays IP royalties to another company held by the client in a jurisdiction with a special tax regime for IP revenues ("patent box")
- The client holds all shares in a Swiss company that supplies consultancy services to his German company
- The client is beneficiary of a Jersey trust set up by his late parents

Presentation outline

- The unfriendly German taxation framework
- The tight net of German anti-avoidance and anti-abuse rules
- Anti-treaty-shopping rules
- Limitation of deduction for royalty payments to foreign related "patent box" companies
- German corporate income taxation for foreign companies with German center of management
- CFC rules
- General anti-avoidance rules
- CRS, FATCA and disclosure of foreign investments
- What to do ?

The unfriendly German taxation framework

- German living place constitutes German tax residence; no day-count! World-wide income taxation for German tax residents (tax treaty relief may apply, mostly exemption method)
- Maximum income tax rate 47.475 %; corporation income tax rate approx. 30% (including trade tax)
- German tax residents are subject to gift/inheritance tax on worldwide assets they transfer or receive by way of gift or inheritance
- Maximum Inheritance and gift tax rate 30% for spouse, children and grandchildren; 50% for unrelated recipients
- Income taxation of undistributed trust/foundation income; income and/or gift taxation on trust/foundation distributions
- Extensive information exchange

The tight net of German anti-avoidance and anti-abuse rules

- Anti-treaty-shopping rules: substance requirements for withholding tax reduction
- Limitation of deduction for royalty payments to foreign related "patent box" companies
- German corporate income taxation for foreign companies with German center of management
- Strict controlled foreign company rules; passive income of CFC taxable at level of German resident shareholder
- General anti-avoidance rules
- Implementation of transparency rules: CRS, FATCA and disclosure of foreign investments

Anti-treaty-shopping rules

- German tax law grants relief from withholding taxes on dividends, interest and license payments to foreign recipients under tax treaty rules or EU-Directives
- Anti-treaty-shopping rule (sec. 50d para. 3 ITA): Withholding tax relief can only be claimed **to the extent**:

  (1) the foreign company's shareholders would be entitled to a relief had they received the income directly, **or**
  (2) the foreign company's gross income results from its own business activities, **or**
  (3) for gross income not resulting from the foreign company's own business activities
    a) business or other significant non-tax reason exist for interposing the foreign company **and**
    b) the foreign company has sufficient substance and participates in commercial activities

- Circular Letter of German Ministry of Finance of 24 January 2012 outlines the tax administration's interpretation of these rules: Supply of services to group companies or an active management of more than one significant shareholdings may be regarded as "own business activities"

Substance ?

Limitation of royalty deductions as from 2018

- New Sec. 4j ITA passed on 2 June 2017, based on Action 5 of the OECD BEPS project "to counter harmful tax practices"
- Restriction of tax deduction of IP royalty payments
  - made to directly or indirectly related foreign parties if payments are subject to a preferential tax regime in the country of the recipient
  - and are taxed at an effective rate of less than 25%
  - unless the preferential tax regime requires substantial business activities of the royalty recipient in connection with the development of the IP ("nexus approach", but trademarks are excluded)
- Restriction of tax deduction proportionate to the difference between the preferential tax rate and the 25% tax rate; e.g. a 12.5% rate leads to a disallowance of 50% of the respective royalty payments
- Treaty override: restriction not limited by existing tax treaties
- The restriction (so far) does not apply if the general tax burden in the country of the recipient is below 25%, irrespective of a preferential tax regime for royalty income

German center of management of a foreign company ?

- A foreign company with a German center of management is subject to German corporation income tax
- The German tax authorities will apply this principle before they will try to apply the more specific rules (e.g. anti-treaty-shopping, CFC etc.)
- The center of management of a company is
  - the place where the **everyday decisions** of certain importance pertaining to the organization and the business of the company are made
  - where the actual manager of the company performs his/her management activities (potentially his/her living place)

German controlled foreign company rules

- Undistributed passive income of a CFC that is resident in a low tax country and is controlled by German resident shareholders is proportionally taxed at their level (no participation exemption available)

- Rules generally compliant with EU-Directive 2016/1164 of 12 July 2016 (BEPS-Directive)

- Applicable if German resident individual or corporate shareholders hold more than 50% of the shares in the foreign company, or 1% if the company generates income from certain financial transactions

- Low tax country: actual taxation of less than 25%

- Passive income:
  - income from financial investments
  - rental income, except if tax exempt under a tax treaty
  - royalty income, unless received for self-developed IP
  - income from inter-company trading or services unless the foreign company maintains a sufficient business structure and actually participates in commercial activities
  - dividend income and capital gains from the sale of shares in other companies is qualified as active income (passive under EU-Directive!)

- Escape rule for EU companies, provided they are engaged in actual business activities

- Treaty override: CFC taxation not affected by tax treaties

General anti-avoidance rule and hierarchy of avoidance rules

- German Fiscal Code contains GAAR: Abusive structures are disregarded for tax purposes unless taxpayer can prove sufficient non-tax reasons for choosing the structure
- GAAR test: Would taxpayer have chosen the structure if it did not result in a tax benefit ?
- Foreign companies without any substance and without business purpose will be disregarded (often better than qualification as CFC)
- If foreign company is not disregarded, specific anti-avoidance rules (e.g. anti-treaty-shopping rule) will apply before GAAR

CRS, FATCA and disclosure of foreign investments (1)

- Germany has implemented CRS (as an early adopter) and FATCA as statutory law; the German Ministry of Finance has issued a detailed explanatory letter regarding the relevant definitions and procedures on 1 February 2017
- On 2 June 2017, Germany passed changes to sec. 138 of the Fiscal Code extending the obligations of **all German resident taxpayers** to declare the following foreign investments:
  - direct or indirect investment in foreign corporate entities or asset agglomerations ("Vermögensmassen") of 10% or more or if sum of the related acquisition costs for all such investments exceeds EUR 150.000
  - the fact that the taxpayer alone or together with related persons can directly or indirectly exercise a determining influence on the corporate, financial or business matters of a company outside the EU or EEA
- So far no obligation of German resident trust/foundation beneficiaries to disclose their position unless in case of distributions or allocation of undistributed trust/foundation income
- Statutory voluntary disclosure rules with no or in many cases moderate penalty payments still apply

CRS, FATCA and disclosure of foreign investments (2)

- On 2 June 2017, Germany passed changes to the Anti-Money-Laundering Act based on the 4th EU Anti-Money-Laundering Directive and introduced a "Transparency Register":
  - corporate entities and partnerships which are registered in the German commercial register are obliged to disclose their beneficial owners in the newly established electronic register with, name, date of birth, address, citizenship, type and extent of beneficial ownership
  - the same applies to German resident trustees or administrators of foreign trusts or foundations
  - access to registered information is open to certain governmental bodies, but also to anyone demonstrating a justified interest (e.g. NGOs or journalists engaged in "serious research")
  - beneficial owner may apply to exclude access of non-governmental persons to the register in case this would increase his/her danger to become a victim of fraud, kidnapping, extortion or similar
  - harsh penalties in case on non-compliance to disclosure obligations (e.g. generally up to EUR 100.000; in certain cases up to EUR 1 million or even EUR 5 million)

Case Study: What to do?

- The client is an Israeli software engineer who owns and uses apartments in Tel Aviv and Berlin
  - **Management of client's tax treaty position: maintain tax treaty residence in Israel**
  - **Beware of German inheritance tax (no tax treaty)**
- The client holds all shares in a German software company via his Israeli holding company
  - **Allocate sufficient substance and business activities to the Israeli holding company in order to avoid application of German anti-treaty-shopping rules**
- The German company pays IP royalties to another company held by the client in a jurisdiction with a special tax regime for IP revenues ("patent box")
  - **Observe the German limitation of royalty deductions**
  - **If possible: limit payments to royalties resulting from IP developed by the receiving company**
- The client holds all shares in a Swiss company that supplies consultancy services to his German company
  - **Make sure that the company does not have a German center of management**
  - **Observe the German CFC rules, maintain sufficient substance in Swiss company**
- The client is beneficiary of a Jersey trust set up by his late parents
  - **Comply to German taxation rules regarding trust income and distributions**
  - **If necessary: voluntary disclosure**

  - **Disclose all investments as required under the German transparency rules**

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Vita

- Admitted to the Bar since 1996
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Education and former activities

- Ernst & Young AG, Düsseldorf (1995-1999)
- University of Konstanz (Legal Trainee/Referendar 1993; Assessor 1995)
- German University for Administrative Sciences, Speyer (1994)

Affiliations

- International Bar Association (IBA), Officer of the Individual Tax and Private Clients Committee 2008-2015, Committee Chair 2014-2015
- German Association for Inheritance Law and Property Successions (DVEV)
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