Deloitte.

URL: http://mobile.deloitte-tax-news.de/german-tax-legal-news/mof-publishes-draft-law-proposing-to-modernize-corporate-income-tax-rules.html

25.03.2021

German Tax and Legal News

MOF publishes draft law proposing to modernize corporate income tax rules

Option for partnerships to be taxed as corporations would be introduced, among other measures.

The German Ministry of Finance (MOF) published the draft version of an "Act to modernize the corporate income tax law" on 19 March 2021. The draft law proposal, which has not yet been approved by the government, contains some measures that would provide additional flexibility to taxpayers, including an option for partnerships to be taxed as corporate entities. Other proposed measures include the following:

- An extension of the application of certain provisions of the German Reorganization Tax Code that allow for tax-neutral restructurings, to apply to restructurings involving companies that are resident outside of the EU/European Economic Area (EEA);
- The introduction of new rules for the treatment of certain accounting items within a tax consolidated group that exist as a result of book-tax differences; and
- The abolition of a provision that currently prevents a tax deduction for foreign exchange losses in connection with loans granted to related parties.

Option for partnerships to be taxed as corporate entities
An election for partnerships to be taxed based on corporate tax principles has been the subject of discussion for some time and has been on the government's agenda since March 2020. Based on German tax principles, corporate entities are subject to the federal corporate income tax of 15.825% (including the solidarity surcharge) and the local trade tax, which may range between 7% and 17%, depending on the municipality. The combined corporate income tax rate (including the solidarity surcharge and trade tax) typically ranges between 30% and 33%.

Partnerships are subject to the local trade tax in the same way as corporate entities; however, they are treated as transparent for federal income tax purposes. The income of a partnership is subject to (corporate) income tax only at the level of its partners. For individuals that are partners in a partnership, the combined tax burden on the income of the partnership is generally higher than in the case of a corporate entity, in a case where the profits are retained at the level of the partnership and are not distributed to the partners. For income tax purposes, profits of a partnership are automatically deemed to be distributed to the partners and, therefore, automatically are subject to the higher individual income tax rate that may be applicable at the level of an individual partner (progressive individual income tax rates of up to 45% apply (not including the solidarity surcharge and church tax)). For income tax purposes, the profits of a partnership are taxed at the level of the partners irrespective of a distribution, due to the transparent character of a partnership.

To alleviate this disparity in tax treatment, the draft law proposal includes an option for partnerships to be taxed as corporate entities. The option would be introduced as a right for certain partnerships to make an irrevocable election that would have to be filed with the responsible tax office (although the election would be irrevocable, a future "re-election" to be taxed based on the partnership rules would able to be made for a subsequent fiscal year (FY), as described below). The election would have to be made before the beginning of the FY for which the election is intended to become valid; an election with retroactive effect would not be possible. The election to be taxed as a corporate entity would not change the legal character of the partnership, i.e., for legal purposes and for non-income tax purposes, the partnership would still be treated as a partnership. The election to be treated as a corporate entity for income tax purposes would need to be made by the partnership with approval from at least a 75% majority of the partners.

Trading partnerships and professional partnerships with limited liability would have the right to make the election. The election would not be available for mere asset managing partnerships, private partnerships based on civil law, and partnerships that fall under the provisions of the Investment Tax Act, and would cease to be available for partnerships that have their place of management outside Germany and that (after the election has been made) cease to be subject to corporate income tax in that country (to avoid classification conflicts/hybrid issues).

The election to be taxed as a corporate entity would qualify as a conversion of a partnership into a corporate entity under the German Reorganization Tax Code. However, it would not be possible to effect such a conversion with retroactive effect (as is generally the case for such conversion transactions based on the provisions in the Reorganization Tax Code). As a consequence of the election, the relationship between the partners in the partnership would be governed by the rules regarding the relationship between a corporate entity and its shareholders, i.e., the taxation of dividends and deemed dividends (including withholding tax consequences) would need to be considered.

The draft law proposal does not include a minimum period of time for which the election would have to be made. A re-election to be taxed based on partnership rather than corporate principles, therefore, should be possible with effect from the beginning of the next FY. The re-election to be taxed as a partnership would qualify as a conversion of a corporate entity back into a partnership under the Reorganization Tax Code.

An automatic conversion back into a partnership for tax purposes would be triggered in a case where the partnership becomes a private partnership based on civil law, or where its corporate tax liability in the country of its place of management ceases to exist. A partnership for which an election to be taxed as a corporate entity has been made would automatically be terminated in a case where the partnership has only one shareholder remaining, as the draft law proposal does not include an option for a sole entrepreneur to be taxed based on corporate income tax principles.

The election of a partnership to be taxed based on corporate income tax principles would apply for local trade tax purposes as well.

Although an option for partnerships to be taxed as a corporate entity has been a point of discussion for some time, tax practitioners did not expect to see a draft law proposal published with only short notice before the proposal could be introduced into the formal legislative process (as described further below). The proposed rules would provide additional flexibility, in particular, for small and medium sized businesses that currently operate in the legal form of a partnership. Several questions however remain open, e.g., whether a partnership that elects to be treated as a corporate entity for income tax purposes can qualify as a controlled subsidiary in a German tax group.

Tax-neutral restructurings involving companies resident outside of the EU/EEA

The draft law proposal would make certain reorganizations in which companies resident outside of the EU/EEA are involved eligible for the application of the rules under the German Reorganization Tax Code. Most of the rules of the Reorganization Tax Code were made available more than a decade ago for qualifying reorganizations in which EU/EEA companies are involved. The proposed amendment of the Reorganization Tax Code would make merger and certain spin-off transactions (described in sections 3-16 of the code) eligible for rollover relief in situations involving non-EU/EEA companies as well. However, it would still be required that the foreign merger/spin-off transaction be comparable to such a transaction under German law (in particular, regarding the principle of universal succession). Transactions based on certain provisions of the Reorganization Tax Code (sections 20 and following) would still be available for EU/EEA resident companies only; these would include share-for-share exchange transactions, the transfer of businesses on a standalone basis in return for shares, and the conversion of a partnership into a corporate entity.

The existing measures in the German Corporate Income Tax Code that provide for the conditions for a tax-neutral foreign merger transaction and the consequences of a migration of a company out of the EU/EEA would be abolished; the rules of the German Foreign Tax Act also would be amended in this regard.

The draft law proposal would be applicable for transactions that become tax effective after 31 December 2021.

Treatment of certain accounting items within a tax consolidated group

Under the existing German rules, in the case of a German tax consolidated group, certain book-tax differences at the level of a controlled subsidiary that comes into existence after the tax group has been set up result in special accounting items that could result in a dividend-like taxation. This is based on the mechanics of the German rules for tax consolidated groups, since a consolidated group is not a mere tax concept but is based on legal and accounting principles under which the profits of the controlled subsidiary must be transferred up to the controlling parent entity based on the existence of a profit and loss pooling agreement (which is a valid legal agreement). This is a highly complex area of German tax law that causes issues for both taxpayers and the tax authorities, and which is a much-discussed topic that may arise in tax audits and tax court procedures.

The draft law proposal aims to simplify the rules in this area and to treat book-tax differences that come into existence while the tax group exists as a contribution/repayment of capital with no tax effect. The draft law proposal also includes a transition rule for existing accounting items that have to be eliminated. Any gains resulting from such an elimination could be spread over a 10-year period.

The draft law proposal would provide for the application of the new rules in this regard for FYs ending after 31 December 2021.

Deductibility of foreign exchange losses

Based on the existing German rules, losses that are related to shares in subsidiaries are nondeductible for tax purposes. The same is true of losses that are related to loans granted to subsidiaries in which a participation of at least 25% is directly or indirectly held. The definition of losses "related to" such loans under the existing German rules also includes foreign exchange losses in a case where the loan is denominated in a non-EUR currency.

The draft law proposal would allow taxpayers to claim a tax deduction for such foreign exchange-related losses for loans granted to subsidiaries. This taxpayer-friendly proposal would harmonize the rules for foreign exchange losses and gains related to such loans; under the current rules, foreign exchange gains are taxable, whereas foreign exchange losses cannot be deducted. The proposed change of the rules would be effective for foreign exchange losses that arise after 31 December 2021.

Additional comments

From an overall perspective, the proposed "Act to modernize the corporate income tax law" includes some interesting proposals that would provide additional flexibility to taxpayers. It is expected that the German government is deciding on whether to move the proposals forward and could introduce the draft law into the formal legislative process on 24 March 2021. The chances of success are still unclear, in particular, in light of the upcoming federal elections on 26 September 2021 and the automatic deadline that the elections will impose for any pending law proposals.