GÖRG

Legal Update
Corporate and Tax, Mergers & Acquisitions

Planned Reform of Single Tax Entities

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1. Introduction

The formation of a single tax entity for income tax purposes makes it possible to offset losses incurred by one company against profits realized by another company belonging to the same group. However, section 14 of the German Corporate Income Tax Act (*Körperschaftssteuergesetz* – KStG) requires that the controlling entity (parent) hold a majority interest in the controlled entity (subsidiary) and that a profit-transfer agreement be in place between the two companies.

In such cases, the subsidiary undertaking must also be registered in Germany and its management based in Germany. Management of the parent entity must also be based in Germany. This tax concept is currently undergoing scrutiny for two reasons. First of all, the requirement under German law that the subsidiary be both registered in and managed from Germany is problematic in view of the non-discrimination provisions anchored in European Union law and treaties. A case concerning such an infringement is currently pending before the ECJ (No. 2008/4909). Secondly, the execution and implementation of profit-transfer agreements are susceptible to errors in practice, which can unfortunately result in the creation of a "defective tax entity" with negative implications in terms of taxation such as, for example, intended covert distributions of dividends. Another problem lies in the fact that figures taken for the purposes of the transfer of profit are determined under accounting rules, which means they differ from those used for tax purposes. Given this situation, pending legislative proceedings contemplate changes in the current use of single tax entities.

2. Proposed Alternative Solutions

Prior to the current draft of the law, essentially two different basic approaches were discussed, a group contribution regime, which is derived from a proposal by the Hessian Ministry of Finance, and attribution models based on proposals by the Bavarian Ministry of Finance and the Institut für Finanzen und Steuern.

All of these proposals would require that the controlling company and the controlled affiliate jointly apply to the tax authorities for permission to be treated as a single entity for tax purposes.

The group contribution model would permit intragroup contributions based on the actual transfer of profits. Joint application to the tax authorities by the companies involved would suffice to permit taxation as a group. Payments or claims of group companies would be treated as operating expenses by the payer company. Since transfers of profits should also be possible between individual group companies (and not only between parent and subsidiary) and the amounts unlimited, this model offered a high degree of flexibility. However, a very high shareholder interest, i.e., 95 % of capital and voting rights, was required in some cases.

In the case of the attribution models, taxation as a group would be possible if the controlling company and the affiliated public or private limited company file a joint application and the controlling entity holds a minimum interest of 75 % in the affiliate. Attribution of income would take place without any actual flow of funds, for example, by using what are referred to as tax settlement accounts under the Bavarian proposal.

3. Resolution of the Bundestag of 25th October 2012

On 25th October 2012, the Bundestag passed a bill that modifies the regime for single entity taxation (Bundestag document (*BT-Drucks.*) 17/11180), but it makes no provision for any fundamental change in the sense of an alternative model, calling instead for improvement in the previous single entity model. The approval of the Bundesrat has, however, not yet been forthcoming. This law contains the following changes: the requirement that both the place of registration and the place of management be located in Germany has been abandoned so that all companies registered in the EU or the EEA will qualify as affiliates for the purpose of group taxation. This is to apply to all cases in which final assessment has not yet taken place (section 34(8) of the Corporate Income Tax Act).

As regards controlling entities, the location of management will no longer be a decisive factor under the new legislation. In addition, it will in fact also be possible to include interests in domestic locations of parent entities. The necessary financial integration can therefore also be achieved through an interest in an affiliate held by a location of the parent entity throughout the entire duration of the single entity. In order to take into account the risk of non-taxation, the draft of the law calls for recognition of an undertaking only if the income that can be attributed to it is taxable in Germany under domestic tax law and international conventions. According to section 34(1) of the Corporate Income Tax Act, this change will be applied as of the 2012 assessment period.

In addition, the new legislation will facilitate the execution and implementation of profit-transfer agreements. Existing profit-transfer agreements that contain no reference to the obligatory assumption of losses as required by section 302 of the German Stock Corporation Act, which corresponds to the previous legal requirements, will not stand in the way of the recognition of single entities for tax purposes as long as the losses are actually assumed pursuant to section 302 of the German Stock Corporation Act and the nature of the assumption of losses revised to reflect the change in the law by 31st December 2014. As a result, old agreements must in any case be revised by no later than 31st December 2014. However, such revision of profit-transfer agreements will not be necessary pursuant to section 34(10b) of the Corporate Income Tax Act if the single tax entity ceases to exist before 1st January 2015.

Implementation of agreements will also be facilitated since this is an important prerequisite for the existence of a single tax entity and the current legal situation entails various risks in this regard. In cases in which the transfer of profit is based on annual financial statements prepared for accounting purposes that contain accounting treatment errors, profit-transfer agreements will nevertheless be considered to have been implemented in compliance with the modified law under the following conditions: if (1) the final annual financial statements have been duly prepared; (2) any accounting treatment errors are such as to not have been amenable to discovery by applying the care of an ordinary businessman (this is the case if an unqualified audit opinion has been issued pursuant to section 322(3) of the German Commercial Code in respect of the annual financial statements or in respect of the consolidated financial statements that include the annual financial statements prepared for accounting purposes or in respect of a voluntary audit of the annual financial statements or certification from a tax accountant or auditor on the preparation of the annual financial statements with comprehensive opinions has been issued); and (3) any accounting treatment errors are corrected and any difference remitted or accounted for in the annual financial statements of the affiliate and the parent following detection of the error. These conditions are to apply to all cases in which assessment is not yet final and absolute (section 34(7) of the Corporate Income Tax Act).

A further change concerns the restriction of the use of losses as a result of the abandonment of the double requirement governing domestic registration and management. This requirement is expanded to exclude negative income of a fully taxable parent entity or a fully taxable affiliate not registered in Germany if such income is taken into account for the purposes of taxation of the parent or the subsidiary or some other person in a foreign country that is not a member state of the EU/EEA (no. 5 under the first sentence of section 14(1) of the Corporate Income Tax Act). Here too, this will apply in all cases in which assessment is not yet final and absolute.

Finally, the law makes provision for a procedure for uniform assessment of the income of subsidiaries to be attributed to parent entities and as a result the respective tax bases of parent entities and their affiliates. Taxes paid by the subsidiaries that are to be credited toward the tax liability of parent entities are to be treated accordingly. Since the notice of assessment would have the function of a preliminary notice within the meaning of no. 10 under section 171 of the Fiscal Code (*Abgabenordnung* – AO), a subsequent change in the final assessment of the parent entity would be possible pursuant to no. 1 under section 175 of the Fiscal Code. This provision is intended to apply to assessment periods after 31 st December 2013.

4. Outlook

Although the Finance Committee of the Bundestag supports the complete abandonment of single tax entities in favor of a group taxation model, the coalition opted for smaller changes in the existing system. However, legal recognition of EU/EEA companies as affiliates represents an important step forward. The conveniences with respect to profit-transfer agreements are also welcome since they provide greater legal certainty as regards the existence of single tax entities. The Bundesrat failed to approve the law in late November. It remains to be seen whether the federal government or the Bundestag will initiates conciliation proceedings and what the outcome of such proceedings will be.

Note

This overview is solely intended for general information purposes and may not replace legal advice on individual cases. Please contact the respective person in charge with GÖRG or respectively the author himself: Dr. Thomas Winkemann on +49 30 884503-180 or by email to twinkemann@goerg.de. For further information about the author visit our website www.goerg.com.

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