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Tax Policy Consequences from the End of the German Governing Coalition

1. Current developments at a glance

On the evening of 6 November 2024, the German **government coalition broke** up. Federal Chancellor Scholz dismissed Federal Finance Minister Lindner. Two other federal ministers of the Liberals (FDP) had then asked for dismissal.

Federal Chancellor Scholz is expected to ask for a **vote of confidence** in the Bundestag on 16 December 2024. If the vote of confidence fails, which can be assumed, **new elections** are to be held on 23 February 2025. However, these dates may still be postponed, depending on further negotiations.

Until the vote of confidence, Chancellor Scholz plans to govern with a **minority government**. In the remaining weeks before Christmas, the Bundestag is to vote on all bills that "do not tolerate any delay", Chancellor Scholz said.

In terms of **tax policy** issues, he explicitly mentioned immediate measures for industry. This probably also refers to the draft for a Tax Development Act, which contains measures from this subject area. In addition, there are other tax bills in the draft stage that have not yet been adopted by the Bundestag. In this respect, there may be delays in the legislative procedures or even a cancellation.

Votes from the **opposition** are required to approve the bills. Whether it will be possible to organize majorities is not foreseeable at present.

2. Tax Development Act

The Bundestag resolution on the Tax Development Act, originally planned for mid-October, was delayed due to disagreements in the coalition. The draft law is still in committee deliberations.

In particular, the Tax Development Act is intended to implement investment incentives. The most important measures are:

- **Reform of collective depreciation**: In particular, raising the lower value limit for preferential assets, which can be combined in a collective item, to EUR 800 and the upper value limit to EUR 5,000, as well as shortening the depreciation period of the collective item to three years

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- Continuation of **declining balance depreciation** for movable fixed assets acquired or manufactured in the period from 2025 to 2028 and increase to 2.5 times the linear depreciation, up to a maximum of 25%

- **Introduction of a special depreciation for fully electric and zero-emission vehicles**: Special depreciation over a period of six years starting at a rate of 40%

- **Research allowance**: Increase of the maximum assessment basis to EUR 12 million.

It remains to be seen to what extent the planned measures will be included in the law, if a majority is achieved at all and the law is passed by the Bundestag.

3. Other ongoing legislative projects

The principle of discontinuity applies to the Bundestag. In the case of new elections, this means, that all bills that have not yet been passed by the “old” Bundestag must be reintroduced in the “new” Bundestag and negotiated. Directly affected are legislative projects that have already been introduced into the parliamentary procedure. Other legislative projects, for example, for which only a draft bill of the Federal Ministry of Finance has yet been submitted, are not directly affected by this. However, as a result of the collapse of the government, there may be delays in the further proceedings or even termination.

In addition to the Tax Development Act, the following important tax bills, among others, have not yet been passed by the Bundestag:

- **Act on the Amendment of the Minimum Tax Act:** So far, only a discussion draft of the Federal Ministry of Finance dated 8 August 2024 has been submitted. The draft law is therefore not yet in the parliamentary procedure and would not be directly affected. Whether and how the legislative project will now be continued is open. It would be conceivable that the Federal Ministry of Finance would at least publish a draft bill and hold an association hearing on it.

  Among other things, the law is intended to implement the OECD's new administrative guidelines on the global minimum tax, which contain important concretizations and simplifications.

- **Second Act on the Financing of Future-Securing Investments:** A draft bill of the Federal Ministry of Finance dated 27 August 2024 has been published for this law. This law is therefore not yet in the parliamentary procedure either. It can be assumed that the decision on a government draft will only be made after a new election, if at all.

  The law is intended to further strengthen the competitiveness and attractiveness of Germany as a financial centre and, in particular, to improve financing options for young, dynamic companies. Tax measures include an improvement in the transfer of hidden reserves from the sale of shares in corporations and a strengthening of the fund location and promotion of investments by funds in renewable energies, infrastructure and venture capital through changes in investment tax law.

- **Act on the tax treatment of motor vehicles that can only be operated with e-fuels:** So far, there is also only a draft bill for this law from 20 September 2024, so that the decision on a government draft is not expected until after a new election, if at all.

  The draft law provides for tax incentives for e-fuels-only motor vehicles through preferential treatment in income, trade and motor vehicle tax.

- **Act on the implementation of the so-called DAC 8 Directive:** The same applies to this draft law. A recently published draft bill dated 25 October 2024 is available. Due to delays in the legislative process, the implementation deadline of 31 December 2025 set by the EU may not be met.

  The core of the draft law is a new, EU-wide reporting standard and information exchange for transactions with crypto assets. In addition, the Common Reporting Standard (CRS) is to be expanded to include new digital financial products.

Federal Tax Court (I R 4/21): Foreign Permanent Establishment Income and ‘Switch Over’ Clause

In its judgement of 3 July 2024, the Federal Tax Court commented on the relationship between a ‘switch over’ clause under tax treaty law and national law (section 20 para. 2 Foreign Transactions Tax Act (FTTA)). A ‘switch over’ clause provides for a change from the exemption method to the credit method for passive income of a foreign permanent establishment (PE) (so-called activity restriction). If the ‘switch over’ clause under tax treaty law already applies, the requirements in

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section 20 para. 2 FTTA are no longer relevant.

The plaintiff is a limited liability company (GmbH). In 2004, it had two PEs, one in Romania and one in Russia. The PEs provided services. A shareholder with a majority holding in the GmbH advised the PEs on the provision of the services. In this respect, the GmbH declared income from foreign PEs that was tax-exempt in Germany under the applicable Double Tax Treaty (DTT) on the basis of the exemption method. However, following a tax audit, the tax office concluded that the income from the PEs in Romania and Russia was subject to the credit method rather than the exemption method due to passive income.

The Federal Tax Court also concludes that the exemption method does not apply in the present case. According to Art. 7 para. 1 in conjunction with. Art. 23 para. 2 DTT Romania/Russia, the income generated in the Romanian and Russian PE is generally exempt from domestic taxation. However, according to the respective activity restriction, this only applies if the person resident in Germany can prove that the PE derived its gross income exclusively or almost exclusively from active activities falling under section 8 para. 1 no. 1 - 6 FTTA in the financial year in which it realized the profit. Otherwise, there is a change to the credit method.

According to section 8 para. 1 no. 5 FTTA, the provision of services generally qualifies as an active activity. However, due to the reference in the DTA Romania/Russia to Section 8 para. 1 no. 5 FTA, the provision is not only applicable in principle, but also if the foreign services are provided with the involvement of a domestic shareholder and therefore exceptionally constitute income from passive activities (so-called detrimental involvement pursuant to Section 8 para. 1 no. 5 lit. a FTA). In the present case, the exception is fulfilled due to the harmful cooperation of the majority shareholder in the GmbH.

According to section 20 para. 2 sentence 2 FTTA, the exemption method applies to income from services despite a harmful cooperation within the meaning of section 8 para. 1 no. 5 letter a FTTA. However, the requirements of a national 'switch over' clause are no longer relevant if the 'switch over' clause under tax treaty law already deny the exemption method.

Federal Tax Court (I R 32/20): Trade Tax Deduction for Foreign Permanent Establishment

In its judgement of 5 June 2024, the Federal Tax Court decided that the deduction of the portion of trade income attributable to a permanent establishment (PE) not located in Germany must be made even if Germany would not be prevented from taxing the entire trade income under the relevant double taxation treaty (DTT) and if the German and foreign tax authorities have agreed on full taxation by Germany as part of a coordinated tax audit (joint audit).

Trade tax is levied on all "standing commercial enterprises", provided they are operated in Germany. A business is deemed to be operated in Germany if a PE is maintained for it in Germany. Trade income is the profit from trade operations calculated in accordance with the German Corporate Income Tax Act, which is increased or reduced by add-backs or deductions in accordance with the German Trade Tax Act. Among other things, the portion of the trade income of a domestic company that is attributable to a PE not located in Germany is reduced.

The GmbH & Co. KG (plaintiff K), which belongs to a Dutch group, has its registered office in Germany. Its two shareholders, V GmbH and B GmbH, also have their registered office in Germany. K carried out residential construction in Germany - predominantly on its own land, which was sold after construction, but also to a lesser extent on third-party land. In addition to the construction sites, only a mailbox address was maintained in Germany. The management of K was located in the Netherlands and the construction work was carried out by subcontractors engaged via the group headquarters in the Netherlands.

As part of a joint tax audit, the German and Dutch tax authorities agreed on a division of taxation rights (including for trade tax) to the effect that K's capital gains from the construction projects on its own land would be fully taxable in Germany. A distinction was made for construction projects on third-party land: Profits from construction projects lasting less than twelve months were to be subject exclusively to Dutch taxation, profits from construction projects lasting more than twelve months were to be taxed 80% by the Netherlands and 20% by Germany.

K appealed against the apportionment scale, took legal action and applied for a reduction in the trade tax assessment amounts. The action was partially successful and the Lower Tax Court amended the contested assessments to the effect that, in the context of the deductions, an additional reduction of one third of the profit from business operations was made.

On appeal by the tax office, the Federal Tax Court overturned the judgement of the Lower Tax Court and referred the matter back for a different hearing and decision.

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The Lower Tax Court had correctly assumed that only part of the income earned by K was subject to trade tax. However, the Lower Tax Court's estimate of the profit split between the domestic and Dutch PEs did not fulfil the necessary requirements.

The Federal Tax Court states that K maintained several domestic PEs: Insofar as it acquired, developed and resold domestic properties, these were each "fixed" business facilities. Insofar as K carried out construction work on third-party properties that lasted longer than six months, it had what are referred to as construction PEs.

In the first step, the trade income corresponds to the profit from business operations. The taxation of the income from the construction work on third-party land depends on the question of where the places of management of the shareholders V GmbH and B GmbH were located, which still needs to be clarified.

In contrast, the profits from the sale of the developed properties are not to be proportionately excluded from the basis of assessment for German taxes under the DTT-NL, irrespective of the place of management of the shareholders (income from immovable assets, Art. 4 DTT-NL). Germany would therefore have the sole right to tax the capital gains.

However, in the correct opinion of the Lower Tax Court, the profits from the sale of the developed properties are not fully included in the trade tax assessment basis due to the restriction to domestic PE income provided for in the Trade Tax Act. Since K's business was managed from the Dutch group headquarters, there was a PE there. Income that is only partly attributable to a domestic and partly to a foreign PE and that is not already tax-exempt due to treaty provisions is therefore only included in the trade tax base to the extent that it is attributable to the domestic PE (so-called structural domestic reference of trade tax).

The total trade income of K must therefore be divided between the shares attributable to the domestic PEs and the shares attributable to the Dutch PE and reduced by the portion attributable to the Dutch PE. This deduction is not precluded by the fact that Germany would not be prevented on the basis of Art. 4 DTT-NL from fully subjecting the profit from the sale of the properties to trade tax.

The case had to be referred back to the Lower Tax Court so that it can make the necessary findings on the allocation of the trade income between the domestic PEs and the Dutch PE in the second instance.

Action by the EU Commission against Germany: Free Movement of Capital Restricted for Property Gains

The European Commission has decided to refer Germany to the Court of Justice of the European Union. According to the European Commission, Germany has failed to remove a restriction on the free movement of capital in the tax treatment of reinvested capital gains from the sale of property located in Germany.

Under German tax law, a tax deferral is granted (deduction of capital gains from the acquisition costs of the newly acquired assets) if the profit from the sale of a property is reinvested within six years. One condition is that the property sold must have been part of the fixed assets of a domestic permanent establishment (PE) for at least six years without interruption at the time of the sale.

The EU Commission states that companies established under German law are assumed to have such a PE at the location of their head office (i.e. in Germany), even if they do not carry out any commercial activities in Germany. However, comparable companies established under the law of another EU or EEA member state are not considered to have such a PE in Germany. They are therefore not granted a tax deferral for reinvested capital gains from the sale of German property.

According to the Commission, Germany has not eliminated this unequal treatment of non-resident companies from another EU or EEA member state and is therefore referring Germany to the Court of Justice of the European Union. This difference in treatment constitutes a restriction on the free movement of capital for which there is no convincing justification.

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Editorial team

Dr. Cora Bickert (V.i.S.d.P.)
Directorin, Tax

Veronika Aschenbrenner
Manager, Tax

Alexander Hahn
Senior Manager, Tax

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