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Corporate Tax

Germany – Law & Practice

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Law & Practice

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CONTENTS

1. Types of Business Entity, Residence and Basic Tax Treatment p.4
- 1.1 Corporate Structures and Tax Treatment p.4
- 1.2 Transparent Entities p.4
- 1.3 Determining Residence p.4
- 1.4 Tax Rates p.4

2. Key Features of The Tax Regime p.5
- 2.1 Calculation of Taxable Profits p.5
- 2.2 Special Incentives for Technology Investments p.5
- 2.3 Other Special Incentives p.5
- 2.4 Basic Rules on Loss Relief p.5
- 2.5 Limits on Deduction of Interest p.5
- 2.6 Basic Rules on Consolidated Tax Grouping p.6
- 2.7 Capital Gains Taxation p.6
- 2.8 Other Notable Taxes p.6

3. Division of Tax Base Between Corporations and Non-Corporate Business p.6
- 3.1 Closely Held Local Businesses p.6
- 3.2 Corporate Rates and Individual Rates p.6
- 3.3 Accumulating Earnings for Investment Purposes p.6
- 3.4 Sale of Shares in Closely Held Corporations p.6
- 3.5 Sale of Shares in Publicly Traded Corporations p.6

4. Key Features of Taxation of Inbound Investments p.6
- 4.1 Withholding Taxes p.6
- 4.2 Primary Tax Treaty Countries p.7
- 4.3 Use of Treaty Country Entities by Non-Treaty Country Residents p.7
- 4.4 Transfer Pricing Issues p.7
- 4.5 Related Party Limited Risk Distribution Arrangements p.7
- 4.6 Variation from OECD Standards p.7

5. Key Features of Taxation of Non-Local Corporations p.7
- 5.1 Taxation of Non-Local Corporations Versus Local Subsidiaries p.7
- 5.2 Capital Gains of Non-Residents p.7
- 5.3 Change of Control Provisions p.7
- 5.4 Determining the Income of Foreign-owned Local Affiliates p.7
- 5.5 Deductions for Payments by Local Affiliates p.7
- 5.6 Constraints on Related Party Borrowing p.7

6. Key Features of Taxation of Foreign Income of Local Corporations p.7
- 6.1 Foreign Income of Local Corporations p.7
- 6.2 Taxation of Dividends from Foreign Subsidiaries p.8
- 6.3 Use of Intangibles p.8
- 6.4 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules p.8
- 6.5 Rules Related to the Substance of Non-Local Affiliates p.8
- 6.6 Taxation on Gain on the Sale of Shares in Non-Local Affiliates p.8

7. Anti-Avoidance p.8

8. Audit Cycle p.8

9. BEPS p.8
- 9.1 Government Attitude p.8
- 9.2 Profile of International Tax p.8
- 9.3 Competitive Tax Policy Objective p.9
- 9.4 Key Features of Competitive Tax Policy p.9
- 9.5 Proposals for Dealing with Hybrid Instruments p.9
- 9.6 Territorial Tax Regime p.9
- 9.7 CFC Proposals p.9
- 9.8 Anti-Avoidance Rules p.9
- 9.9 Transfer Pricing Changes p.9
- 9.10 Transparency and Country by Country Reporting p.9
- 9.11 BEPS Process p.10

P+P Pollath + Partners is an internationally operating law firm; its 34 partners and more than 100 lawyers and tax advisers provide high-end legal and tax advice in Berlin, Frankfurt and Munich.
More than half of the P+P professionals specialise in the tax implications of the firm's primary areas of expertise, transactions and asset management and private equity, or are experts familiar with the tax aspects of their own specialities.

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1. Types of Business Entity, Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt the form of a limited liability company (GmbH) or a joint stock company (AG). These corporations are taxed as separate legal entities. The key differences between the two relate to the treatment each receives under commercial law:

- Under a GmbH the shareholders are authorised to give instructions to a managing director, there is a low degree of fungibility of shares and there is a wide range of possibilities for the design of the articles of association.
- Under an AG the supervisory board and the management board are mandatory, with both operating independently from the shareholders regarding business decisions. There is personal liability for the management and supervisory board, and there is a high degree of fungibility of shares.

1.2 Transparent Entities

The type of partnership most commonly used for transparent entities is the Kommanditgesellschaft (KG). The KG is most commonly adopted for investment purposes due to its limitation of liability. Only one shareholder (Komplementär) is unlimitedly liable as the general partner (GP), while the liability of the other shareholders (Kommanditist) is limited to their compulsory contribution. It is also possible to choose a GmbH as the GP; this means that no individual is subject to unlimited liability. The GmbH & Co. KG form is usually chosen for private equity structures.

1.3 Determining Residence

According to German tax law the residence of an incorporated business depends on where (a) the place of management and (b) the statutory/registered seat are situated. Usually, the double taxation treaties provide regulations that the place of effective management is decisive in the case of the dual residence of a corporation (tie-breaker rule).

1.4 Tax Rates

Corporations with a registered seat or with a place of management and control based in Germany are subject to unlimited tax liability in Germany. Non-resident corporations are only taxed on their German-sourced income. The income of a corporation is qualified as business income. Therefore, corporate tax and municipal trade tax are taxed at an approximate rate of 30%.

The corporate tax rate (plus a solidarity surcharge) stands at 15.825%. A special tax rate applies for shares held in other corporations. Dividends received (as of 1 March 2013, only where the shareholding exceeds 10%) and capital gains recognised from the disposal of shares are tax-exempt, although 5% of the proceeds are deemed non-deductible expenses, resulting in a tax rate of 1.5%.

Municipal trade tax ranges from 13% to 17%, depending upon the municipality the business operates in. For trade tax purposes, capital gains from the sale of shares are tax-exempt, whereas dividends received from a German-located corporation are tax-exempt if shareholding amounts to at

least 15% (10% if the shareholding is received from an EU company).

However, regarding capital gains it is expected that the tax exemption for capital gains for corporate income tax as well as trade tax purposes will only apply to shareholdings of at least 10% in future due to recent legislative proposals.

A partnership such as a KG is transparent for income/corporate tax purposes so that profits and losses are taxed at the partners' level. Assets, liabilities and income of the partnership are allocated to the partners in proportion to their partnership interests.

The taxation of individuals' income (who own a business or are a partner in a transparent partnership carrying out a business) generated by themselves or through the partnership generally depends upon their personal tax rate (tax rates up to 47.5%, including solidarity surcharge of 5.5%, and also possibly a church tax). However, dividend payments, as well as capital gains from the sale of shares, are subject to the so-called 'partial income procedure', so that only 60% of the income deriving from dividends or capital gains will be taxed.

2. Key Features of The Tax Regime

2.1 Calculation of Taxable Profits

As corporations are legally obliged to keep records, they have to determine their income through the comparison of business assets and annual financial statements. Generally, tax accounts are based on the financial accounts as according to the principle of decisiveness (Maßgeblichkeitsgrundsatz). However, there are some deviations of tax accounts from financial accounts, such as the restriction of the application of current value tax depreciation to cases of permanent depreciation, the prohibition of provisions for onerous contracts, and the discounting requirement for long-term interest-free liabilities, with interest at below the market rate.

Where taxpayers are obliged to balance, and thus also in case of corporations, profits are taxed on an accruals basis (realisation principle).

2.2 Special Incentives for Technology Investments

There is no specific, comprehensive R&D support by way of special tax treatment in Germany. Instead, multiple specific incentive programmes are offered. On the initiative of the big trade associations the German government has advanced the idea of setting up tax-friendly R&D funding with broad and nationwide impact, an idea that is still currently in development.

2.3 Other Special Incentives

Germany also offers non-tax-related incentives such as non-repayable cash grants, eg in the energy sector. Germany provides special investment incentives to small and medium-sized companies by way of an additional capital allowance of up to 20% of the original costs and investment, and a deduction of up to 40% of the prospective original costs. Additionally, specific incentive programmes are available, eg for the purchase or production of movable assets in Eastern Germany and for the founders of new businesses.

2.4 Basic Rules on Loss Relief

Regarding income and corporate tax, loss relief is granted through the application of three instruments which have to be used successively:

- The positive and negative income of one year is added up.
- The taxpayers may choose to carry back the losses to the previous year, or they may choose to indefinitely carry forward the losses. In the case of carry-back, any losses may be offset against the profits of the preceding year up to EUR511,500. An offset by way of carry-forward is possible up to EUR1 million annually without restriction. Regarding income that surpasses the EUR1 million threshold, in each subsequent year only 60% of this income may be offset against losses carried forward. The transfer of a share percentage of over 25% may result in the forfeiture of carry-forward not yet offset.
- In the case of trade tax, trade earnings may be reduced by loss carry-forward; carry-back is not provided. An offset is possible without restriction against losses of up to EUR1 million; regarding losses exceeding EUR1 million annually, only 60% of losses may be offset against trade earnings.

2.5 Limits on Deduction of Interest

German tax law sets out 'interest barrier regulations'. According to these regulations, interest payable may be immediately deducted. The deductions are not limited to the amount of interest income obtained in the same business year; amounts in excess are only deductible to the amount of 30% of the EBITDA. This restriction does not apply if interest income does not exceed EUR3 million each business year, or if the company is only partially part (partially owned) of the group of companies ("standalone clause"), or if an equity comparison shows an equity equal or higher than the equity of the group of companies ("escape clause"). The standalone clause does not apply to corporations in the case of 'harmful debt financing' (interest payable to the shareholder exceeding 10% of such interest payable that exceeds interest income) by shareholders/persons related to shareholders/third parties with considerable influence on shareholders holding more than 25% of shares in the corporation. The escape clause is not applicable in the case of harmful debt financing within a whole group of companies. Interest exceeding the 30% threshold may be carried forward indefinitely, except in the case of the sale of more than 25% of the shares within five years.

2.6 Basic Rules on Consolidated Tax Grouping
Consolidated tax grouping (Organschaft) enables groups of companies to offset losses and profits within subsidiaries against the profits of their parent company (and profits transferred to the parent company from other subsidiaries). The transfer of the subsidiaries' annual surplus to the surplus reserve (in cases where it is economically justified) will be recognised where (a) the parent company holds the majority of voting rights in the subsidiary, (b) the parent company has unlimited tax liability in Germany, and (iii) a profit transfer agreement has been concluded and executed for at least five years prior. However, it should be noted that the parent company is also liable for the losses of its subsidiaries.

2.7 Capital Gains Taxation
95% of capital gains deriving from the sale of shares in other corporations are tax-exempt.

However, it is expected that the tax exemption for capital gains will only apply to shareholdings of at least 10% in future due to recent legislative proposals.

2.8 Other Notable Taxes
In so far as immovable property is transferred, real estate transfer tax (RETT) becomes due. The applicable tax rate depends on where the immovable property is situated in Germany and varies between 3.5% and 6.5%. If at least 95% of the shares in a corporation or, similarly, at least 95% of the partnership interest in a partnership owning real estate situated in Germany are directly or indirectly transferred the transaction could trigger RETT.

Incorporated businesses are generally subject to VAT; however, they usually are able to claim input VAT as well.

3. Division of Tax Base Between Corporations and Non-Corporate Business

3.1 Closely Held Local Businesses
Closely held local businesses are mostly structured as limited liability companies (GmbH) or as limited partnerships with a limited company as general partner (GmbH & Co. KG).

3.2 Corporate Rates and Individual Rates
If an individual professional does not intend to retain the profits of the corporation, but instead pay out the profits, by way of either salary or dividends, then they face an overall tax burden of up to 50% (in the case of dividends this is split into two levels, the corporate/trade tax on the level of the corporation as well as individual tax at a flat rate). Thus there is no benefit.

3.3 Accumulating Earnings for Investment Purposes
There are no measures in place to prevent closely held corporations from accumulating earnings for investment purposes. The retained earnings of corporations are taxed at a lower rate than distributed profits.

3.4 Sale of Shares in Closely Held Corporations
There are no special taxation rules for closely held corporations; the general rules apply (see below).

3.5 Sale of Shares in Publicly Traded Corporations
Where shares are part of the private assets of an individual, dividends are taxed with a flat tax rate of 25% with an additional 5.5% solidarity surcharge, resulting in a final valid tax rate of 26.375%. Capital gains on the sale of shares are also taxed at this flat tax rate if the individual's stake is below 1%. The 'partial income procedure' (taxation of only 60% of proceeds) is applicable if the stake equals or exceeds 1%, resulting in a tax rate of approximately 30%. There are several restrictions regarding the offsetting of losses – for example, only gains of the same kind of income may be offset. Additionally, actual losses resulting from capital yields must not be offset; instead a lump sum of EUR801 may be offset instead. If the shares are part of the individual's business assets, the flat tax rate of 26.375% is replaced by the personal tax rate for both dividends and capital gains. However, only 60% of dividends for capital gains are taxed and only 60% of operating costs are deductible.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Withholding tax is principally levied on inbound dividends at a rate of 26.375% (including a solidarity surcharge). Non-EU corporations with limited tax liability may request a reimbursement of two-fifths of withheld tax so that the tax burden effectively amounts to 15.825% (including a solidarity surcharge) and is therefore equal to the tax burden for German corporations. The application of this regulation requires that the non-EU corporation is active within Germany. EU corporations that are subject to a limited tax liability benefit from the Parent-Subsidiary Directive. Under this directive they may obtain a 100% tax exemption for dividends, provided that the parent company has held a direct stake of at least 10% in the subsidiary for a continuous period of 12 months or more. Certain activity requirements need to be met (see below).

Only specific interest is subject to withholding tax: this includes profit-related interest, interest collateralised by real estate in Germany and exceptions such as interest resulting

from 'over-the-counter transactions' and interest to be attributed to other types of income.

In all other cases interest income is not subject to limited tax liability and is therefore not subject to withholding tax. Interest paid from an EU corporation to an EU corporation may be tax-exempt if the Interest and Royalties Directive is applicable.

Royalty payments are subject to limited tax liability and withholding tax at an amount of 15.825% is levied from the gross income.

4.2 Primary Tax Treaty Countries
Due to favourable taxation measures granted to EU corporations most foreign investors invest via EU member states. The most common tax treaty countries are the Netherlands and Luxembourg.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents
German tax law has several anti-treaty-shopping clauses in order to prevent the abuse of tax treaties. German tax authorities thus check whether an entity claiming tax relief with reference to a tax treaty generates its income through its own activities and whether there are legitimate reasons to act via the tax-privileged entity in question.

Furthermore, there exist subject-to-tax clauses through which it is prohibited for certain income to be taxed in neither of two treaty countries.

4.4 Transfer Pricing Issues
The main issue in tax audits regarding transfer pricing is ensuring compliance with the arm's length principle. Other issues found are the examination of the transfer pricing methodologies chosen, the assessment of the attribution of beneficial ownership in the companies' assets as declared, and ensuring the fulfilment of formal requirements for when issuing the obligatory reports.

4.5 Related Party Limited Risk Distribution Arrangements
All transactions within a group of companies have to meet the requirements of the arm's length principle.

4.6 Variation from OECD Standards
Germany makes explicit reference to OECD standards in the circulars issued by the Federal Ministry of Justice and case law; legal provisions such as Section 1 of the Foreign Tax Act are based on the OECD standards.

5. Key Features of Taxation of Non-Local Corporations

5.1 Taxation of Non-Local Corporations Versus Local Subsidiaries
Local branches of non-local corporations are not taxed differently to local subsidiaries of non-local corporations.

5.2 Capital Gains of Non-Residents
Capital gains of non-residents on a sale of stock in local corporations are taxed if the shareholding is at least 1%. However, usually the tax treaties eliminate such taxation.

5.3 Change of Control Provisions
There are no change of control provisions resulting in taxation. However, tax losses carried forward might forfeit partially in the case of a change of at least 25% of the shareholding and might completely forfeit in the case of a change of at least of 50% of the shareholding.

5.4 Determining the Income of Foreign-owned Local Affiliates
There are no specific formulas used to determine the income of foreign-owned local affiliates selling goods or providing services, but it must be ensured that the determination follows the arm's length principle.

5.5 Deductions for Payments by Local Affiliates
There are no specific rules regarding the deduction for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. However, the apportionment of funds received within a group of companies has to be carried out in the interest of the whole group, and once again the arm's length principle must be taken into consideration.

5.6 Constraints on Related Party Borrowing
Any borrowing between related parties must comply with the arm's length principle, for the grant of an interest-free loan or where one is granted with an interest below market rates. This can result in a hidden profit distribution. Correlatively, a loan granted with an interest that is above market rates may result in a hidden contribution.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
In principle, the worldwide income of local corporations is taxed in Germany. The part of the income of a local corporation which originates from foreign sources that are taxed in the state of source with a tax comparable to German corporate tax is taxed in Germany, taking into account the tax paid abroad. A 95% tax exemption applies for dividends and

capital gains from foreign sources. If a double tax treaty applies, the regulations laid down there have priority.

For CFC taxation see below.

Local expenses that are treated as non-deductible because of attribution to exempt foreign income are part of the costs of the disposal and other current expenses in the context of the exempt income.

6.2 Taxation of Dividends from Foreign Subsidiaries

Under German tax law, for income to qualify as dividend income the same rules apply regardless of the origin of the dividends from foreign or local sources. Thus, under income tax aspects, 95% of dividend income is tax-exempt, except dividend income derived from free-float below 10%.

For trade tax, the tax exemption for proceeds resulting from foreign subsidiaries is granted if the local corporation holds at least 10% of the subsidiary. Under certain provisions (especially activity) even a sub-subsidiary may benefit from this privilege.

6.3 Use of Intangibles

Intangibles may be transferred or let (royalties) at arm's length conditions resulting in taxable income (transfer price or royalties) at regular rates.

6.4 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules

The passive income of non-local subsidiaries dominated by Germans is taxed in Germany.

The income is added to that of the local corporation and is then subject to low taxation in Germany (below 25%). In the case of passive investment income, the income will be taxed in Germany where the number of German shareholders is over 1%.

6.5 Rules Related to the Substance of Non-Local Affiliates

German tax law provides stringent substance requirements for the exemption from withholding tax with regard to dividends paid by a German corporation to its foreign holding entity.

6.6 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

The gains made by local corporations on the sale of shares in non-local affiliates enjoy the same 95% tax exemption as granted for the sale of shares in local subsidiaries. However, it is expected that the tax-exemption for capital gains will only apply to shareholdings of at least 10% in future due to recent legislative proposals.

7. Anti-Avoidance

Section 42 of the General Tax Code provides for a general anti-avoidance rule which applies in case of abusive tax structures.

8. Audit Cycle

There is no audit cycle prescribed by law. However, audits generally tend to take place once every four years.

9. BEPS

9.1 Government Attitude

Base erosion and profit shifting (BEPS) was explicitly mentioned in the coalition agreement of the German governmental parties. Therefore, the German government took an early initiative to fully support the BEPS project. During the BEPS project, Germany played an outstanding role in accompanying the project both politically and professionally. As Germany already has comparatively strict tax laws, the intention of the German government with regard to BEPS is especially to enforce stricter international taxation standards in the EU and other countries in order to achieve fair tax competition between countries.

Certain parliamentary opposition parties in Germany maintain that Germany should not agree to the Transatlantic Trade and Investment Partnership (TTIP) unless the USA implements the BEPS measures. Otherwise, there would be an unjustified advantage for US companies compared to German or European ones.

9.2 Profile of International Tax

The increasing technological developments and digitalisation in all areas brought about by globalisation creates public concerns that the current applicable international tax law enables tax avoidance and allows BEPS advantages. This development in the European press's reporting began in the UK with Starbucks in 2012, was then extended to other global IT firms and immediately swept over other EU countries. The recent developments (eg Luxembourg leaks) have focused public and political discussions on aggressive tax structures (such as IP boxes, etc) and underlying tax rulings, which lead to tax rates of less than 5%. Hence, European countries plan to inform themselves about tax rulings in order to avoid such practices in the future.

In addition, the German press recently reported that countries that have introduced such aggressive tax structures and underlying tax rulings have hindered the investigations of the EU. Meanwhile, as the persons involved hold positions within the EU, some political parties are demanding the resignation of these persons as their actions were not in line with the European concept. The public and political discussions of the implementation of the BEPS measures are there-

fore greatly influenced by this background and Germany will try to persuade other countries to return to fair and realistic tax competition practices.

9.3 Competitive Tax Policy Objective
As Germany is a strong export country, Germany does not pursue a competitive tax policy objective. In fact, Germany has already introduced anti-abuse and CFC rules in order to limit BEPS. As a result, Germany seeks to achieve international standards for fair and realistic tax competition.

9.4 Key Features of Competitive Tax Policy
Due to its strict tax laws, Germany does not have a competitive tax policy objective.

9.5 Proposals for Dealing with Hybrid Instruments
Hybrid instruments have mainly been used in Germany for cross-border financing. Meanwhile, Germany has implemented a domestic anti-abuse rule (correspondence principle) for interest income from hybrid instruments of foreign corporations that was applicable as of the 2014 assessment year. Furthermore, the very same correspondence principle has been considered in the EU parent subsidiary directive.

It is also intended to introduce the correspondence principle for interest income from hybrid instruments of foreign partnerships or other hybrid instruments that are not yet covered by anti-abuse rules for interest income of corporations.

9.6 Territorial Tax Regime
Germany generally taxes worldwide income, subject to tax treaties, based on which interest income of foreign shareholders usually are not taxed. Originally this was the reason for introducing thin cap rules. However, meanwhile the interest deduction limitation rules have far exceeded this scope and cover national structures as well.

According to these regulations, interest payable may be immediately deducted in the amount of interest income obtained in the same business year; amounts in excess are only deductible up to 30% of the EBITDA. This restriction does not apply if interest income does not exceed EUR3 million each business year, or if the company is not part of a group of companies (“standalone clause”), or if an equity comparison shows an equity equal or higher than the equity of the group of companies (“escape clause”). The standalone clause does not apply to corporations in the case of ‘harmful debt financing’ (interest payable to the shareholders exceeding 10% of such interest payable that exceeds interest income) by shareholders/persons related to shareholders/third parties with considerable influence on shareholders holding more than 25% of shares in the corporation. The escape clause is not applicable in the case of harmful debt financing within the whole group of companies. Interest exceeding the 30% threshold may be carried forward indefinitely, except in the case of the sale of more than 25% of the shares within five years.

9.7 CFC Proposals
With respect to EU law, conflicts may be looming with regard to the general drift of the CFC proposals, particularly with regard to the freedom of establishment. The ECJ has decided in the case of Cadbury Schweppes that CFC rules unjustifiably restrict the freedom of establishment, in case the specific objective of a CFC rule is not to prevent the creation of pure artificial arrangements, which do not reflect economic reality. This means CFC rules need to prevent only structures aiming to escape the taxation of profits generated by activities carried out in a national territory by shifting them into another country. Thus, the case law of the ECJ has limited the application of CFC rules. It is questionable whether the BEPS proposals consider this fact. Apart from that, German tax law already provides for strict CFC rules for offshore subsidiaries whose passive income is taxed at a “low rate” of less than 25%. However, it is expected that BEPS might result in selective changes to this regime.

9.8 Anti-Avoidance Rules
To address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios, Germany has already implemented domestic “anti-treaty-shopping rules” several years ago. According to these regulations, benefits resulting from DTC and/or EU directives (such as the EU Parent-Subsidiary Directive) will not be granted if a company’s main purpose is to gain access to advantageous conditions derived from DTC and/or EU directives. Furthermore, domestic subject-to-tax clauses to prevent undertaxation and non-taxation due to DTC or EU directive benefits and CFC rules are in place. Thus German tax law already provides adequate regulations to address tax avoidance.

9.9 Transfer Pricing Changes
Transfer pricing matters for intellectual property are always a big issue for companies and advisers in Germany, as the evaluation, benchmarking and documentation of IP are always challenged in German tax audits. Generally, Germany is open to changes of its transfer pricing regime in order to achieve international standards. However, there are certain concerns that – in combination with country-by-country reporting – this could result in the publication of secret information of German enterprises.

9.10 Transparency and Country by Country Reporting
Due to German transfer pricing reporting and documentation requirements, some transparency with regard to inter-company cross-border transactions already exists. Furthermore, there are disclosure obligations if a German tax resident (an individual or a legal entity) establishes perma-

nent enterprises or partnerships abroad or acquires shares in foreign corporations. We assume that the draft law for the introduction of country-by-country reporting will be issued by the German lawmakers at the beginning of 2017, with legal effect for business years starting from or after 1 January 2017. In this regard, concerns must be raised, as companies will face further significant administrative barriers in the future.

9.11 BEPS Process

The German lawmaker has codified many regulations to prevent profit shifting and to stabilise the German tax revenue during the last few years. Therefore, literature does not expect the introduction of substantial further domestic anti-avoidance rules due to the BEPS process; however, amendments to the currently applicable rules are being discussed, such as an adjusted interest barrier rule and the definition of and allocation of profits to permanent establishments.

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