# GERMANY


## Law and Practice

**Contributed by:**
Michael Best, Gerald Herrmann and Jannis Lührs
**POELLATH**

## Contents

**POELLATH** is an internationally operating firm, with more than 180 lawyers and tax advisers providing high-end advice in Berlin, Frankfurt and Munich. More than half of its professionals specialise in the tax implications of the firm's primary areas of expertise: transactions, asset management and private equity. POELLATH is particularly renowned for its close combination of tax and legal advice regarding all its main practice areas, such as M&A, private equity, real estate transactions and family businesses. Corporate tax services include the structuring of national and international M&A and subsequent reorganisations, corporate tax planning and the structuring of national and international groups of companies, and the application and interpretation of double taxation treaties.

## Authors

**Michael Best** is a partner at POELLATH and head of the tax department. He has extensive experience in domestic and international tax law, the tax structuring of cross-border acquisitions and real estate transactions, and the structural and ongoing tax aspects of private equity funds, including tax matters for investors and carried-interest holders. He is a member of the German Association of Tax Advisers and has widely published on corporate tax-related aspects, as well as regularly blogging on *"DER BETRIEB Steuerboard"*. Michael is a sought-after speaker on German corporate tax aspects at national and international conferences, such as SuperReturn and Mupet (Munich Private Equity Training).

**Gerald Herrmann** is an associated partner at POELLATH and specialises in domestic and international tax law, general tax planning and tax structuring, with a focus on private equity. He is a member of the renowned German Steuerkreis Regensburg eV, the association for the promotion of tax education and training at the University of Regensburg, and is fluent in English and French as well as his native German. Gerald has widely published on tax-related aspects, as well as regularly blogging on current tax issues and topics on *"DER BETRIEB Steuerboard"*.

**Jannis Lührs** joined POELLATH in 2022 as an associate and is active in domestic and international tax law, focusing on the tax structuring of private equity and M&A transactions and the structural tax aspects of private equity funds. He previously worked for several years in the international tax department of EY and PwC. Jannis studied business administration with a focus on tax law at Mannheim Business School and the University of Magdeburg, and was admitted as a German certified tax adviser in 2022. He has published on tax-related aspects, as well as regularly blogging on current tax issues and topics on *"DER BETRIEB Steuerboard"*.

## POELLATH

Hofstatt 1
80331 Munich
Germany

Tel: +49 89 24240 0
Fax: +49 89 24240 999
Email: muc@pplaw.com
Web: www.pplaw.com

## 1. Types of Business Entities, Their Residence and Basic Tax Treatment

### 1.1 Corporate Structures and Tax Treatment

Businesses in Germany 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, a supervisory board and a management board are mandatory, with both operating independently from the shareholders regarding the 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), which 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. This kind of partnership is referred to as a GmbH & Co. KG, and is usually chosen for private equity structures.

### 1.3 Determining Residence of Incorporated Businesses

According to German tax law, the residence of incorporated businesses depends on where the following are situated:

- the place of management; and
- the statutory/registered seat.

Usually, double taxation treaties (DTTs) regulate that the place of effective management is decisive in the case of a double residence of a corporation (the *"tie-breaker rule"*).

Due to the special circumstances caused by the COVID-19 pandemic, there is a possibility that the place of actual business management may be affected. According to an OECD guideline published on 21 January 2021, when deciding where the place of effective management is located, the place where it is usually located (notwithstanding the COVID-19 pandemic) should be taken into account.

### 1.4 Tax Rates

#### Taxation of Corporations in Germany

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

The corporate tax rate (including 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 an effective corporate tax burden of approximately 0.7%.

Municipal trade tax rates mainly range from 13% to 17%, depending on the municipality in which the business operates. For trade tax purposes, capital gains from the sale of shares are generally tax exempt, whereas dividends received from a corporation are only tax exempt if the shareholding amounts to at least 15%. However, 5% of the proceeds are deemed non-deductible expenses, resulting in an effective trade tax burden of approximately 0.7%.

### Partnerships

Partnerships such as a KG are transparent for income/corporate tax purposes so that profits and losses are taxed at the partners' level. The assets, liabilities and income of the partnership are generally allocated to the partners in proportion to their partnership interests. Municipal trade tax, however, is levied at the level of the partnership (if it conducts a trade or commercial activity).

For fiscal years beginning after 31 December 2021, partnerships can apply to be treated like a corporation for corporate income tax and trade tax purposes (*"check the box"* system). This, however, does not apply for civil law, real estate transfer tax (RETT), inheritance tax or gift tax purposes, so it must be carefully assessed if such option is considered.

The exercise of such option is considered a deemed change of form (*Formwechsel*) from a partnership to a corporation for German income and trade tax purposes, so might result in a taxable event.

### Individuals

The taxation of the income of individuals (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 range up to 47.5%, including a solidarity surcharge of 5.5%, and possibly a church tax. However, dividend payments and capital gains from the sale of shares that are realised in the context of a business are subject to so-called partial-income procedures, so that only 60% of the income deriving from dividends or capital gains will be taxed.

In 2025, the exemption limit on which no solidarity surcharge applies was increased for individuals. However, the solidarity surcharge continues to be levied on the corporate income tax of corporations (particularly GmbHs and AGs), as before.

## 2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

### 2.1 Calculation for Taxable Profits

As corporations are legally obliged to keep records, they have to determine their income through the comparison of business assets based on annual financial statements. Generally, tax accounts depend on the financial accounts 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 and the prohibition of provisions for onerous contracts.

In the case of taxpayers who are required to prepare balance sheets (eg, corporations), profits are taxed on an accrual basis (the *"realisation principle"*).

## 2.2 Special Incentives for Technology Investments

On 1 January 2020, a law was passed that is intended to promote R&D with tax benefits (*Forschungszulagengesetz*). Essentially, all companies are entitled to subsidies, but projects shall benefit only if they fall into the categories of basic research, applied research or experimental development within the meaning of this act. The subsidy consists primarily of a proportionate reimbursement of the wage costs for the employees of the respective beneficiary. The maximum grant is EUR2.5 million, or EUR3.5 million for SMEs.

In order to further stimulate the economy and promote digitalisation, the Federal Ministry of Finance (BMF) has published a circular under which a normal useful life of one year can be taken as a basis for depreciation for certain digital assets, such as computer hardware (including associated peripheral devices), and for the operating and user software required for data input and processing. This allows the full deduction of corresponding acquisition or production costs in the year of acquisition or production. The shortened useful life applies for fiscal years ending after 31 December 2020.

## 2.3 Other Special Incentives

Germany provides special investment incentives to small and medium-sized companies by way of an additional capital allowance of up to 40% of the original costs and investment, and a deduction of up to 50% of the prospective original costs.

## 2.4 Basic Rules on Loss Relief

Regarding income and corporate tax, loss relief is granted through the application of the following instruments.

Firstly, the positive and negative income of one year is netted.

Secondly, taxpayers may choose to carry back the losses to the previous year, or they may choose to carry forward the losses indefinitely. In the case of carry back, any losses may be offset against the profits of the preceding year, up to EUR1 million.

Due to the COVID-19 pandemic, the loss carry back for 2020 and 2021 was EUR10 million, and returned to EUR1 million from 2022 onwards. An offset by way of carry forward is possible up to EUR1 million annually without restriction. Regarding negative income that exceeds the EUR1 million threshold, in each subsequent year only 60% (until 2023 and from 2028 onwards) or 70% (2024 until 2027) of additional income can be offset against such losses carried forward. The transfer of a share percentage over 50% may result in a total forfeiture of carry forward not yet offset. These rules do not apply to the extent there are hidden reserves that are taxable in Germany. Furthermore, these regulations do not apply in the case of intra-group acquisitions of shareholdings (ie, group relief). However, the requirements for this are very strict and hard to meet.

There is another possibility to prevent the forfeiture of the loss carry forward not yet offset if more than 50% of the shares are transferred. This requires that strict conditions are cumulatively met (time-limited application in the tax declaration, continuation of the same business, etc). Furthermore, no so-called harmful event must have taken place (discontinuance of the business, an additional business area is added, etc). When these strict conditions are met, the loss carry forward not yet offset is determined separately as so-called accumulated loss carried forward (*fortführungsgebundener Verlustvortag*) and can be offset against the profits. This accumulated loss carried forward is determined annually. As soon as one of the strict conditions is no longer met, the accumulated loss carry forward is fully lost, unless it is covered by hidden reserves subject to domestic tax.

A case is pending before the Federal Constitutional Court in which it is to be clarified whether the 50% limit is unconstitutional. It is likely that this regulation will also be declared unconstitutional.

In the case of trade tax, trade earnings may be reduced by loss carry forward; carry back is not provided for. 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 subsequent trade earnings. The rules regarding the forfeiture of carry forward are the same as for corporate tax.

## 2.5 Imposed Limits on Deduction of Interest

German tax law provides interest barrier regulations. Interest expenses may be deducted without restriction up to the amount of interest income obtained in the same business year; amounts in excess are only deductible up to the amount of 30% of taxable EBITDA. This restriction does not apply in the following circumstances:

- if net interest income does not exceed EUR3 million each business year;
- if the company is only partially part of a group of companies (the *"standalone clause"*) or
- if an equity comparison shows an equity equal to or higher than the equity of the group of companies (the *"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 the whole group of companies. Interest exceeding the 30% threshold may be carried forward indefinitely (*"interest carry forward"*), except in the sale of more than 50% of the shares within five years.

From 2024 onwards, all three exemptions (exemption limit of EUR3 million, standalone clause and escape clause) do not apply to the extent interest expenses were increased due to an interest carry forward. In addition, from 2024 onwards, the definition of interest will be extended to include economically equivalent expenses and other expenses in connection with the raising of debt (eg, agency fees or arrangement fees).

As of 2024, interest expenses resulting from an intra-group cross-border financing relationship are not deductible if:

- the taxpayer is not able to credibly demonstrate that the capital service could have been provided for the entire term from the beginning and that the financing is economically needed and used for the business purpose; or

- the interest rate to be paid exceeds the interest rate at which the company could finance itself on the basis of the group rating, whereby it is possible to provide evidence of the contrary on the basis of an individual rating derived from the group rating.

### 2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping (*Organschaft*) enables groups of companies to offset the losses and profits within a group of subsidiaries against the profits of their parent company (and profits transferred to the parent company from other subsidiaries). It requires that:

- the parent company holds the majority of voting rights in the subsidiary;
- the shareholding in the subsidiary is allocated to a domestic permanent establishment of the parent company; and
- a profit and loss transfer agreement (PLTA) has been concluded and executed for at least five years.

However, it should be noted that, under the PLTA, the parent company is also liable for the losses of its subsidiaries.

### 2.7 Capital Gains Taxation

In effect, 95% of capital gains deriving from the sale of shares in other corporations are tax exempt, resulting in an effective tax rate of 1.5%. However, from time to time it is discussed that the tax exemption for capital gains will only apply for shareholdings of at least 10% in future.

### 2.8 Other Taxes Payable by an Incorporated Business

If immovable property is transferred, 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 90% of the shares in a corporation or, similarly, at least 90% of the partnership interest in a partnership owning real estate situated in Germany is directly or indirectly transferred to one purchaser or a group of related parties, then the transaction could trigger RETT. Furthermore, the (direct or indirect) transfer of (i) a partnership interest in a partnership owning real estate situated in Germany or (ii) shares in a real estate-owning corporation of at least 90% within a ten-year period to new shareholders could be deemed a taxable event. However, this does not apply for stock exchange transactions in shares of listed companies within the EU/EEA.

### 2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are generally subject to VAT; however, they are usually able to claim input VAT as well. The general VAT rate is 19%, but a reduction to 7% and even to 0% is available for some products and services.

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

### 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 Individual Rates and Corporate Rates

If an individual professional intends not to retain the profits of the corporation but instead to pay them out by way of salary or dividends, they face an overall tax burden of up to 48% (plus church tax if applicable). In the case of dividends, this is split into two levels:

- corporate/trade tax at the level of the corporation (at approximately 30%); and
- an individual tax at a flat rate (26.375% on the remaining 70%).

Therefore, there is no benefit besides a tax deferral.

### 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 the standard tax rates (approximately 30%).

### 3.4 Sales of Shares by Individuals in Closely Held Corporations

There are no special taxation rules for closely held corporations; the general rules apply (see **3.5 Sales of Shares by Individuals in Publicly Traded Corporations**).

### 3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Where shares are part of the private assets of an individual, dividends are taxed at a flat tax rate of 25% with an additional 5.5% solidarity surcharge, resulting in a final valid tax rate of 26.375% (plus church tax if applicable). Capital gains on the sale of shares are also taxed at this flat tax rate if the individual's stake is below 1%. For the determination of the total taxable income from dividends/sale of shares, a lump sum of EUR1,000 is deducted generally.

The *"partial-income procedure"* (taxation of only 60% of proceeds at the progressive tax rate) is applicable if the stake equals or exceeds 1%, resulting in a maximum tax rate of approximately 28.5% (plus church tax if applicable).

If the stake is below 1%, there are several restrictions regarding the offset of losses from capital gains – for example, only gains of the same kind of income may be offset. If the stake equals or exceeds 1%, there is no restriction regarding the offset of 60% of the losses from the sales of shares with other type of normal income (and for investment income under certain circumstances).

If the shares are part of the individual's business assets, the flat tax rate of 26.375% (plus church tax if applicable) 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, resulting in a tax burden of approximately 28.5% (plus church tax if applicable).

The same rules apply for shareholdings in not publicly traded corporations.

## 4. Key Features of Taxation of Inbound Investments

### 4.1 Withholding Taxes

The withholding tax (WHT) is principally levied on dividends at a rate of 26.375% (including a solidarity surcharge, plus church tax if applicable). Corporations with limited tax liability may request a reimbursement of 40% 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.

EU corporations that are subject to a limited tax liability benefit from the Parent-Subsidiary Directive, under which 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. WHT might also be reduced by DTTs.

The European Court of Justice (ECJ) ruled on 26 February 2019 in the context of the so-called Danish Cases that no WHT exemption applies in the case of abusive structures, even if the criteria are met. Whether a structure is classified as abusive depends on certain criteria (eg, conduit only).

Under the recently renewed German anti-treaty shopping rule, a foreign recipient of German dividends will only be entitled to obtain a relief from German WHT to the extent that one of the following conditions is met:

- its shareholders would have been entitled to the same relief if they had received the payment directly;
- the source of the income has a significant connection to an own business activity carried on by the foreign recipient that explicitly does not apply in the case of a conduit situation (Danish Cases); or
- the foreign recipient is a publicly traded company listed on a recognised stock exchange.

If none of these conditions is met, the foreign recipient may prove that none of the main purposes of its involvement is to obtain a tax advantage.

Further limitations are expected under the Unshell Directive (see **9.2 Government Attitudes**).

Only specific interest income is subject to WHT; this includes profit-related interest and exceptions such as interest resulting from *"over-the-counter transactions"* and interest attributed to other types of income.

In certain other cases (eg, interest collateralised by real estate in Germany), there is no German WHT, but the foreign recipient of the interest income has to file a German tax return (limited tax liability).

Interest paid from an EU corporation to another EU corporation may be tax exempt if the Interest and Royalties Directive is applicable. Royalty payments are subject to limited tax liability and WHT at 15.825%, which is levied on the gross income.

## 4.2 Primary Tax Treaty Countries

Due to the 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 to prevent the abuse of DTTs. German tax authorities therefore check whether an entity claiming tax relief with reference to a tax treaty generates its income through its own activities and whether there are considerable reasons to act via the tax-privileged entity in question.

Furthermore, there are subject-to-tax clauses that prevent certain income from being taxed in either of two treaty countries.

Regarding the Unshell Directive, see **9.2 Government Attitudes**.

### 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 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 when issuing the obligatory reports.

### 4.5 Related-Party Limited Risk Distribution Arrangements

All transactions within a group of companies must meet the requirements of the arm's length principle.

### 4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

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

### 4.7 International Transfer Pricing Disputes

Germany has concluded DTTs with 96 countries, most of which follow the internationally used OECD Model Convention, which contains provisions on mutual agreement procedures (MAPs). More recent DTTs often contain provisions requiring arbitration to resolve a conflict following an unsuccessful MAP. About half of the MAPs are transfer pricing disputes, and about 72% of those disputes are resolved by MAPs between the two states. MAPs are quite commonly used by the German tax authorities.

## 5. Key Features of Taxation of Non-Local Corporations

### 5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally, German tax authorities scrutinise compensating adjustments critically and will only recognise them subject to strict conditions. Consequently, compensating adjustments must be based on a previously agreed pricing method that is applied in predefined scenarios of uncertainty and must lead to an *"arm's length"* result.

The underlying Principles of Administrative Procedure have recently been updated. There are no reports on any particular difficulties in operating MAPs. On the contrary, based on MAP statistics from December 2022, only 1.5% of completed procedures involving Germany could not be settled, so the overall operation of MAPs is deemed to be satisfactory.

### 5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-Local Corporations

Generally, there are no differences between local branches of non-local corporations and local subsidiaries of non-local corporations; however, in practice, there are usually problems, or at least discussions, regarding the allocation of income/expenses and assets.

### 5.3 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, the DTTs usually eliminate such taxation.

### 5.4 Change of Control Provisions

A change of control might result in the forfeiture of tax losses carried forward in the case of a change of at least 50% of the shareholding (see **2.4 Basic Rules on Loss Relief**).

Furthermore, RETT could be triggered by certain transactions with corporations/partnerships owning real estate (see **2.8 Other Taxes Payable by an Incorporated Business**).

### 5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No specific formulas are 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.

### 5.6 Deductions for Payments by Local Affiliates

There are no specific rules regarding deductions for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. However, in general, the arm's length principle and the transfer pricing rules must be taken into consideration.

### 5.7 Constraints on Related-Party Borrowing

Any borrowing between related parties must comply with the arm's length principle. The granting of an interest-free loan or of one with an interest rate below market standards by a local affiliate to a parent entity may result in a hidden profit distribution. In comparison, a loan granted with an interest rate that is above market standards to a parent entity may result in income adjustments in cross-border cases.

## 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 that 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. If a DTT applies, the regulations laid down therein have priority. A 95% tax exemption applies for dividends and capital gains from foreign sources if the shareholding is at least 10% (for corporate income tax) or 15% (for trade tax).

For controlled foreign corporation (CFC) taxation, see **6.6 Rules Related to the Substance of Non-Local Affiliates**.

### 6.2 Non-Deductible Local Expenses

If foreign income is tax exempt in Germany, the corresponding expenses that are economically directly connected to such income are not deductible in Germany. Expenses related to dividends and capital gains are tax deductible.

### 6.3 Taxation on Dividends From Foreign Subsidiaries

Under German tax law, for income to qualify as dividend income, the same rules apply regardless of whether the dividends originate from foreign or local sources. Thus, under income tax aspects, 95% of dividend income is tax exempt, unless it is dividend income deriving from a 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 15% of the subsidiary.

### 6.4 Use of Intangibles by Non-Local Subsidiaries

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

### 6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules

Under the German CFC rules, certain low-taxed passive income of a foreign corporation could be subject to German CFC taxation. Such passive income is referred to as low-taxed if the tax burden is lower than 15% (25% for passive income of fiscal years ending before 1 January 2024).

German CFC rules have been fundamentally changed with effect from 1 January 2022 in the course of implementing the Second Anti-Tax Avoidance Directive (ATAD II). One of the fundamental changes has been the introduction of a new *"control concept"*. Based on the new wording, low-taxed passive income is only subject to German CFC taxation if a (single) taxpayer controls the respective CFC. A (single) taxpayer controls a CFC if such taxpayer (alone or together with *"related person"*) is entitled to more than half of the shares, voting rights, capital or profit entitlement. A related person is a person who acts through concerted behaviour with such taxpayer (in relation to partners in a partnership, this is deemed to mean that even one German tax resident minority partner in a partnership implies control over the whole partnership but can generally be disproved if a shareholding of 5% in the partnership is not exceeded and there are no special circumstances). For each foreign corporation realising low-taxed passive income, the (indirect) German shareholders have to file a CFC/PFIC tax return.

This new control concept does not apply with regard to certain passive income referred to as passive investment income (*Einkünfte mit Kapitalanlagecharakter* – PFIC) – ie, CFC taxation applies even below 50%.

Under the revised CFC rules, dividend payments will be determined as passive (investment) income if:

- the dividend payment is tax deductible at the level of the payor; or
- the foreign corporate recipient of the dividend does not own at least 10% of the shares in the payor.

Before the aforementioned changes in the CFC rules, capital gains might have been determined as passive income. Under the (applicable) revised CFC rules, capital gains are generally determined as active income.

In December 2024, the German tax authorities published a proposal to delete the relevant section of the CFC law under which these rules apply for German minority shareholdings – ie, outside of a control situation – retroactively from 2022 onwards. This would reduce the application of the CFC law substantially; however, it is not yet known whether such proposal will be adopted and if so to what extent.

### 6.6 Rules Related to the Substance of Non-Local Affiliates

German CFC rules do not generally relate to the substance of non-local affiliates. However, the carve-out from CFC rules that is provided for EU/EEA corporations requires – alongside other conditions – that the German shareholder proves that the specific income is derived from a substantial economic activity performed in the state of residence of the CFC (the so-called motive test; regarding ATAD III, please see **9.2 Government Attitudes**).

### 6.7 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.

## 7. Anti-Avoidance

### 7.1 Overarching Anti-Avoidance Provisions

Section 42 of the General Tax Code provides for a general anti-avoidance rule that applies in the case of abusive tax structures. At the level of the EU, the Anti-Tax Avoidance Directive (ATAD) establishes a common minimum level of anti-avoidance rules with which every member state must comply.

Germany has implemented a mandatory disclosure regime for cross-border arrangements if one or more specified characteristics (hallmarks) are met and if the arrangements concern more than one EU country or an EU country and a non-EU country (DAC 6). These hallmarks are aimed at aggressive tax avoidance structures but are drafted much more broadly, so non-tax-motivated transactions may also be caught. If one or more hallmarks are met, the person or company who markets, designs or organises a cross-border tax arrangement or makes these arrangements available for use by third parties (an intermediary) has several reporting obligations. The reporting deadline is 30 days after the day on which:

- the structure is made available for implementation;
- the structure is ready for implementation; or
- the first step of implementation of the structure is started.

Failure to comply with these rulings could lead to significant sanctions under local law.

The new German government intends to extend the scope of such reporting obligation to national tax arrangements for companies with a turnover of more than EUR10 million.

The Defence Against Tax Haven Act (*Steueroasen-Abwehrgesetz*) contains several mechanisms to make it more difficult to avoid paying taxes in Germany through a business relationship with a state or territory that is on the EU list of non-co-operative tax jurisdictions (the so-called blacklist), which is amended from time to time. The measures include:

- denial of deducting business expenses;
- tighter CFC rules;
- tighter withholding tax measures; and
- measures relating to profit distributions and sales of shares.

## 8. Audit Cycles

### 8.1 Regular Routine Audit Cycle

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

# 9. BEPS

## 9.1 Recommended Changes

The BEPS 1 Implementation Act passed the German legislation process at the end of 2016, and was the first step towards implementing the recommendations of the BEPS process into domestic law.

### BEPS Action 13

The BEPS 1 Implementation Act led to an extension of co-operation obligations in cross-border situations, based on BEPS Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting). As a result, the transfer pricing documentation now consists of:

- a master file;
- a country-specific and company-related local file; and
- a country-specific country-by-country report.

The information exchange standards and reporting obligations arising from the amendments to the EU Mutual Administrative Cooperation Directive have also been implemented into German law. The amended transfer pricing documentation rules are applicable for fiscal years starting after 31 December 2016.

### BEPS Action 5

As of 1 January 2017, tax rulings (ie, advance cross-border rulings and advance pricing arrangements) issued, reached, amended or renewed after 31 December 2014 must automatically be exchanged amongst EU member states. These amendments take the recommendations made in BEPS Action 5 (Measures to Counter Harmful Tax Practices) into account.

Furthermore, Germany has introduced a provision to limit the tax deductibility of licence fees or royalty payments to foreign-related parties that benefit from preferential tax regimes (such as intellectual property, licences or patent boxes) that are incompatible with the OECD nexus approach of BEPS Action 5 (Measures to Counter Harmful Tax Practices).

In addition, the BEPS 1 Implementation Act introduced a new regulation into domestic law to prevent the double taxation of business expenses (ie, double deduction) for partnerships, effective from 1 January 2017.

### OECD Multilateral Instrument

Germany signed the OECD Multilateral Instrument (MLI) in June 2017. As a first step, Germany would like to amend more than 30 of its 96 DTTs, provided that the other countries agree. In November 2020, the MLI was introduced as part of a national legislative procedure; however, the implementation law only covers 14 DTTs. In compliance with the recommendation of BEPS Action 12 and the EU Directive on Administrative Cooperation in the field of taxation, the German government managed to implement an obligation to notify cross-border tax arrangements into national law within the set deadline of 31 December 2019 (see **7.1 Overarching Anti-Avoidance Provisions**).

### EU Anti-Tax Avoidance Directive

The Federal Ministry of Finance started working on the implementation of the EU Anti-Tax Avoidance Directive at the end of 2019, with the federal government passing a draft law on 24 March 2021. The law passed the German legislation process on 30 June 2021.

## 9.2 Government Attitudes

The German government has fully supported the BEPS project at all times, and Germany played a prominent role in the project, both politically and professionally.

As Germany already has comparably strict tax laws, the particular intention of the German government with regard to BEPS is to enforce stricter international taxation standards in the EU and other countries, in order to achieve fair tax competition between countries.

On 14 December 2022, the EU Commission presented a directive to ensure a minimum level of taxation of 15% of multinational enterprise groups within the EU (published on 22 December 2022). Such directive was implemented into German tax law in 2023 and the minimum taxation applies as of 2024 for multinational enterprises that have generated revenue of EUR750 million or more in at least two of the last four financial years.

Furthermore, the EU Commission intends to work swiftly on regulations to implement the allocation of taxing rights under Pillar One of the OECD plans.

### The Unshell Directive

On 22 December 2021, the EU Commission presented a proposal for a directive in the fight against shell entities (*Briefkastenfirmen*) within the EU (the *"Unshell Directive"*). This proposal (also referred to as ATAD III) intends to establish new transparency standards around the use of shell entities by using a number of indicators related to income, staff and premises to detect entities that exist merely on paper. The implementation at the level of the member states was planned for 2023 so that the national regulations can apply from 2024, but the proposed directive has not yet been implemented due to the concerns of some member states. It is therefore unclear whether this directive will be completed/implemented at all.

On 11 May 2022, the EU Commission presented another proposal for the alignment of the tax treatment of equity and debt under the so-called Debt Equity Bias Reduction Allowance (DEBRA) Initiative. The objective is to reduce tax incentives for debt financed investments and to incentive equity investments by implementing a notional interest deduction on equity and a limited deductibility of interest expenses (deductibility is limited to 85% of interest expenses). Negotiations are currently temporarily suspended and may result in a limited reporting obligation only.

## 9.3 Profile of International Tax

There is public concern over whether the current applicable international tax law is able to keep up with the challenges of globalisation or if it enables tax avoidance and allows base erosion and profit shifting advantages. The discussion was sparked in 2012 by media reports of Starbucks avoiding taxes on a large scale in the UK, and was extended to global IT firms and swept over other EU countries.

Developments such as *"the Luxembourg Leaks"* and *"the Panama Papers"* particularly influenced public and political discussions on aggressive tax structures (such as intellectual property boxes) and underlying tax rulings, which led to tax rates of less than 5%. As a result, not only the German business and political press but also the tabloids frequently reported on such developments. However, neither the BEPS project nor the implementation of its recommendations receives significant media attention.

## 9.4 Competitive Tax Policy Objective

As a strong export country, Germany does not pursue a competitive tax policy objective. In fact, Germany has already introduced anti-abuse and CFC rules to limit base erosion and profit shifting. As a result, Germany seeks to achieve international standards for fair and realistic tax competition.

## 9.5 Features of the Competitive Tax System

Germany does not have a competitive tax system, state aid or other similar constraints that might be particularly affected by anti-BEPS measures.

## 9.6 Proposals for Dealing With Hybrid Instruments

Hybrid instruments have mainly been used in Germany for cross-border financing. Germany has implemented a domestic anti-abuse rule (the *"correspondence principle"*) for interest income and dividend payments from hybrid instruments of foreign corporations, which is applicable as of the 2014 assessment year. Furthermore, the very same correspondence principle has been considered in the EU Parent-Subsidiary Directive.

In line with the BEPS 1 Implementation Act, a separate regulation to prevent the double deduction of business expenses for partnerships has been introduced into German domestic law, effective from 1 January 2017. The recommendations of BEPS Action 2 have largely been incorporated into ATAD II.

In the course of the implementation of the ATAD II regulations, in 2020 Germany enacted a law limiting the tax deductibility of business expenses in the case of hybrid arrangements. The limitation applies, inter alia, if:

- expenses are recorded twice in two countries; or
- an expense is deducted at the level of a German entity but the related income is not subject to taxation in the foreign country due to a hybrid arrangement (or a hybrid legal entity).

## 9.7 Territorial Tax Regime

The German tax regime is residence-based rather than territorial. Germany generally taxes worldwide income, subject to DTTs that usually exempt interest income of foreign shareholders from taxation.

## 9.8 Controlled Foreign Corporation Proposals

With respect to EU law, conflicts may be looming with 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, unless the specific objective of a CFC rule is to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out in national territory. 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 *"low rate"* of less than 15% (25% for passive income of fiscal years ending before 1 January 2024). These CFC rules have recently been renewed and hence no further amendments are expected in the near future; see **6.5 Taxation of Income of Non-Local Subsidiaries Under Controlled Foreign Corporation-Type Rules**.

## 9.9 Anti-Avoidance Rules

To address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios, Germany implemented domestic *"anti-treaty shopping rules"* several years ago (see **4.1 Withholding Taxes**). According to these regulations, benefits will not be granted if a company's main purpose is to gain access to advantageous conditions derived from a DTT and/or EU directives (eg, the EU Parent-Subsidiary Directive).

Furthermore, domestic subject-to-tax clauses to prevent under-taxation and non-taxation due to DTT or EU directive benefits and CFC rules are in place. Thus, German tax law already provides adequate regulations to address the abuse of benefits and tax avoidance in general.

## 9.10 Transfer Pricing Changes

Transfer pricing matters for intellectual property are a crucial issue for companies and advisers in Germany, as the evaluation, benchmarking and documentation of intellectual property are always challenged in German tax audits.

As a result of the transfer pricing documentation concept with the implemented country-by-country reporting, as well as the master file and the local file, intellectual property must be documented more extensively. Therefore, comments must be made regarding the creation, beneficial ownership, chances and risks, etc, of intellectual property. The concept does not radically change things; however, intellectual property will be more transparent for tax authorities in Germany and other countries. Consequently, there are some concerns that this could lead to more challenging tax field audit procedures, including income corrections in Germany and other countries.

## 9.11 Transparency and Country-by-Country Reporting

Due to German transfer pricing reporting and documentation requirements, a certain transparency with regard to intercompany cross-border transactions already existed prior to the BEPS project. Furthermore, there are disclosure obligations if a German tax resident (an individual or a legal entity) establishes permanent enterprises or partnerships abroad or acquires shares in foreign corporations.

Concerns are being raised in connection with the country-by-country reporting that has been implemented by the BEPS 1 Implementation Act, as companies will face further significant administrative barriers in the future. Finally, increased bureaucracy is to be expected due to the new disclosure obligations for cross-border tax arrangements based on BEPS Action 12 (see **9.1 Recommended Changes**).

## 9.12 Taxation of Digital Economy Businesses

Prompted by BEPS Action 1, the EU Commission adopted two legislative proposals in March 2018 relating to the taxation of digital activities in the EU. One of the two draft directives seeks to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. However, the EU draft directive relating to the taxation of digital economy businesses has not yet been adopted, and no German draft legislation has yet been published to this effect.

## 9.13 Digital Taxation

The second legislative proposal relating to the taxation of digital activities that was adopted by the EU Commission in March 2018 (see **9.12 Taxation of Digital Economy Businesses**) sought to impose an interim digital tax but was rejected at the EU finance ministers' meeting in March 2019. As one of the opposing EU members, Germany had rejected the proposed European digital tax in order not to pre-empt an international solution at G20 level. With the publication of the EU directive to ensure a minimum level of taxation of multinational enterprise groups (see **9.2 Government Attitudes**), which is intended to target digital economy businesses in particular, national digital taxes are no longer expected.

## 9.14 Taxation of Offshore IP

Germany has restricted the tax deductibility of licence fees or royalty payments to foreign-related parties that benefit from preferential tax regimes (ie, licences or patent boxes) since January 2018, in order to discourage harmful tax practices relating to offshore intellectual property. This restriction, however, does not apply if a preferential tax regime is compliant with the nexus approach of BEPS Action 5 and hence requires a sufficient degree of substance and research activity on the part of the licensor. From 2024 onwards, tax deductibility is only restricted if the licence fees are taxed below 15% under the preferential tax regime (below 25% before 31 December 2023).