Corporate Income Tax Modernisation Act - First Reading in the Bundestag on 22 April 2021

OPT-IN MODEL, INTERNATIONALISATION OF REORGANISATION TAX LAW, CAPITAL CONTRIBUTION SOLUTION FOR OVERPAYMENT/UNDERPAYMENT OF PROFIT TRANSFERS AND NEW RULES REGARDING FOREIGN CURRENCY LOSSES

Executive summary

- The Corporate Income Tax Modernisation Act (KöMoG, in its German abbreviation) is currently in the legislative process and has not yet entered force.
- It encompasses (i) the introduction of a model for specific partnerships to opt-in to tax classification as a corporation ("check-the-box" rule), (ii) the internationalisation of reorganisation tax law, (iii) the so-called capital contribution solution as a replacement of adjustment items for overpayment and underpayment of profit transfers within the context of a fiscal unity, and (iv) deletion of the prohibition against profit reduction deductions due to exchange rate fluctuations in connection with shareholder loans.
- The corporate income tax („CIT ") option opens up new possibilities in advisory practice. A transition into tax classification as a corporation must observe the particularities of changing legal form under German reorganisation tax law (such as the provisions on special business assets).
- Tax-neutral mergers, splits, and spin-offs will now also be possible in certain cases involving third countries and thus no longer be limited to cases linked to the EU/EEA; however, in addition to so-called comparability in the reorganisation process, a corresponding requirement to be generating taxable income will remain in place for the relevant assets in Germany.

Background and legal developments

On 19 March 2021, the Federal Ministry of Finance sent the first draft bill for a law to modernise corporate income tax law to private sector groups in order to obtain position statements. Just five days later - on 24 March 2021 - the Federal Cabinet adopted the corresponding bill. The first reading in the Bundestag was held on 22 April 2021.

While some tax jurisdictions, such as the USA, have long made it possible to opt-in to tax classification as a corporation with so-called "check-the-box" provisions, German lawmakers had been reticent in this respect. Therefore, it was necessary to use another corporation as an intermediary when someone wanted to leverage certain characteristics of a partnership under civil law[1] yet nonetheless prevent tax attribution to the natural persons behind a partnership in their capacity as partners due to the partnership's transparency. The possibility for partnerships to opt-in to tax classification as a corporation creates the ability to attain "hybrid" classification (partnership with respect to non-tax legal provisions, and corporation for CIT purposes).

Moreover, the non-applicability of reorganisation tax law has been subject to growing criticism in many reorganisation cases involving third countries, especially most recently. Thus, this modification is both timely and necessary.

[1] To cite one example, partnership companies under German law (such as an OHG or a KG) are not fundamentally subject to a legal obligation with respect to labour co-determination.

By eliminating the prohibition against the deduction of exchange rate losses in connection with certain shareholder loans, the legislature is correcting the unequal treatment under current law of profits and corresponding losses in respective hedging transactions.

Opt-in model for partnerships for tax classification as a corporation

In the future, the new law would, upon request, grant commercial partnerships (limited partnerships, general partnerships, and comparable foreign companies) and partnership companies as well as their partners the option of classification as a corporation for the purposes of corporate income and trade tax; and for the purposes of procedural law, as a corporation with shareholders. In general, approval from 3/4 of partners will be necessary to make this request (§ 217 para. 1 of the German Reorganisation Act applies analogously). The transition to tax classification as a corporation will be treated as a change in legal form under German reorganisation tax law. Thus, the tax neutrality of a change in legal form will be governed by §§ 20-23 of the German Reorganisation Tax Act. The draft law does not spell out any specific rules for the special business assets of partnerships, which is why a tax-neutral change in legal form will especially require that functionally material special business assets become business assets of the corporation. Therefore, it may be advisable to transfer special business assets to the company before filing the request for this opt-in. Furthermore, potential deprivation of tax losses must be taken into account pursuant to § 25 Reorganisation Tax Act and in particular pursuant to § 10a TradeB Tax Act, § 15a Income Tax Act.

The draft bill also provides the ability to opt-out, upon request, and return to tax classification as a partnership (so-called reversion option). This reversion, too, is treated like a change in legal form for reorganisation tax purposes.
The draft law does not yet specify a minimum duration for exercising this option, such that it would be possible to make switches on an annual basis. If the option is going to be exercised, then the time of submission will be the end of the financial year in which the request is made, i.e. the financial year preceding tax classification as a corporation. Retroactive application is not provided for in the draft law.

The request for tax classification as a corporation should generally be made before the start of the financial year for which the option is being exercised. Since the Corporate Income Tax Modernisation Act is slated to enter effect on 1 January 2022, a corresponding option request must be filed by 31 December 2021.

Internationalisation of reorganisation tax law

In the future, the scope of German reorganisation tax law is to be extended to certain cases involving third countries. This is being implemented via elimination of § 1 para. 2 Reorganisation Tax Act, which previously required the pertinent companies to have a link to the EU/EEA as a prerequisite for the relevant conversion transactions. That means the following situations will no longer be limited to cases linked to the EU/EEA in the future:

- The merger of a corporation into a partnership company or natural person, or change in legal form from a corporation into a partnership company (§§ 3ff Reorganisation Tax Act),
- A merger, split or spin-off among corporations (§§ 11-15 Reorganisation Tax Act), or
- A split or spin-off into a partnership company (§ 16 Reorganisation Tax Act).

However, the prerequisite for tax neutrality remains that the reorganisation has the structural characteristics of a domestic conversion (so-called comparability) and that no taxation rights be restricted or excluded in Germany. First-time application is planned for transitions whose effective date for tax purposes is after 31 December 2021.

Capital contribution solution for overpayment / underpayment of tax group profit transfers

Overpayment or underpayment of a profit transfer occurs when the amount transferred to a parent company under commercial law does not correspond to the balance sheet profit of the subsidiary company for tax purposes. If the amount transferred as commercial balance sheet profit is higher than the earnings for tax purposes, then there is a so-called "overpayment" of the profit transfer. The converse scenario leads to "underpayment". If the corresponding cause lies in a tax group's time frame, then it is referred to as "tax group" overpayment and/or underpayment of profit transfer, which under current law leads to the formation of so-called active (underpayment) and passive (overpayment) tax adjustment items for the tax group's parent company in the interest of one-off taxation of the corresponding profits on the balance sheet. The draft law provides that the system for creating these kinds of adjustment items will be eliminated. These kinds of tax group overpayment of profit transfers will now apply as the subsidiary company's return of capital contributions to the parent company. This will apply to all underpayments and overpayments of profit transfer taking place after 31 December 2021.

If the tax group parent company still has adjustment items for overpayment and underpayment of profit transfers, then those items will need to be reversed after the first financial year ending after 31 December 2021, subject to the following:

- If an adjustment item on the liabilities side exceeds the sum of the adjustment item on the assets side and the book value of the parent company's stake in the subsidiary company, then it will constitute dividend income subject to the partial income procedure for (corporate) income tax purposes.
- Option to create a reserve: Upon request, distribution of investment income by means of a profit-reducing reserve is possible over 10 years.

No prohibition against deductions for foreign currency losses

Profit reductions of a shareholder stake exceeding 25% in a corporation are not deductible for tax purposes. Associated exchange rate losses also fall under this deduction prohibition; conversely, exchange rate gains are taxable. This unequal treatment of exchange rate gains and losses is to be eliminated by deleting the prohibition against deductions for these kinds of (hedging) transactions. The new rule is to apply for the first time to profit reductions arising after 31 December 2021.

Takeaway and outlook

The "opt-in model" being introduced is a very welcome development in the interest of taxation that is neutral with respect to legal form. For companies which have previously avoided converting a partnership into a corporation for non-tax reasons (such as effects under civil law or commercial law), these amendments are likely to yield new structuring options. Careful analysis of the tax neutrality associated with the change in form triggered by an opt-in remains essential. Partnerships wishing to make use of this option after 1 January 2022 should keep tabs on the ongoing legislative process and, as necessary, spin off any special business assets now in order to be able to file the corresponding request on-time this year.

From the view of practice, further internationalisation of reorganisation tax law and the changes regarding exchange rate losses are likewise welcome developments.

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