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Responding to the challenges ahead

What Tax & Legal departments can do now

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Corporation Tax

Initial considerations

A. Contingent losses

As a result of structural changes in prices, e.g., in natural gas or energy supply, some long-term contracts with fixed prices may result in losses for one of the parties.While provisions for contingent losses from long-term contracts are mandatory for German local GAAP purposes, such provisions are disallowed under tax GAAP, resulting in book/tax differences without any cash tax relief when setting up these provisions. The transfer of contingent liabilities (including provisions for contingent losses) is subject to specific tax rules and requires careful consideration. A compensation payment to terminate long-term contracts should usually not fall under these specific tax rules and be immediately deductible, though. It is recommended to always consider the tax implications of any amendments of long-term contracts.

B. Impairment of (intercompany) receivables

The economic downturn may result in increased difficulties in collecting outstanding receivables, both third-party and intercompany receivables. There are specific rules addressing the deductibility of impairment losses for German tax purposes. In principle, impairment or non-recoverability of third-party receivables results in tax-deductible expenses. For unrealized losses (i.e. impairment losses), there is an election whether or not to follow a write-down under local-GAAP for tax purposes if the impairment is expected to be permanent. For intercompany receivables, the deduction of losses is severely restricted, and it may be advisable not to claim unrealized losses (i.e.: not to perform a valuation adjustment for tax purposes). To prevent non-deductible losses, it may be advisable to engage in loan restructuring measures depending on the treatment at the level of the debtor.

C. Inventory valuation methods

As a result of the interruption of supplychains, many companies increase the inventory of raw materials and unfinished goods to become more resilient. For tax purposes, an election can be made to presume that the most recently acquired goods are used first (last-in-first-out, LIFO method) unless this violates local GAAP principles (e.g., for perishable goods, this election would not be possible). Particularly where prices are increasing, this may be beneficial as the most recently acquired goods would also tend to be the most expensive goods. Once that this election is made, a deviation from this presumed method requires consent of tax authorities. Where no election has been made in the past, an election should be considered in appropriate situations.

D. Increase in interest rates

As a reaction to increasing inflation rates, central banks are increasing reference interest rates. This has a number of tax implications that need to be considered (also see special section on transfer pricing). As a result of the change in market rates, long-term fixed rate loans with a lower interest rate have an inherent value for the debtor while being less valuable for the creditor. The decrease in economic value does not, however, allow a write-down for tax purposes, as it is not permanent and will reverse upon repayment of the principal. However, the built-in loss may be realized upon a transfer of the loan receivable at FMV.

Careful consideration should be given to the tax effects and opportunities of any refinancing measures in response to the increased interest rates.

E. Foreign exchange effects

As indicated above, central banks are increasing reference interest rates worldwide, but the US Fed has acted earlier so far and has set higher rates compared with the European Central Bank, and USD interest rates are expected to stay above Euro interest rates in the near future. This has resulted in a shift in FX-rates where the Euro has weakened against the US-Dollar. In principle, realized FX-gains or losses are taxable/deductible as ordinary income/expenses for German taxpayers. It should be noted that FX-losses are not covered by the limitations on deductibility of expenses for intercompany loan receivables (see B. above). Unrealized FX-losses can only be deducted if there is a permanent change in value. There is case law according to which FX-rate changes are usually considered temporary, at least for long-term liabilities, unless there was a structural and fundamental change in economic data. Hence, according to this case law, write-downs of receivables/increase of liabilities would only be possible in the tax balance sheet where a receivable is written down (a liability is increased) in the local GAAP balance sheet and the change in FX-rates is a result of such structural and fundamental change. Specific considerations apply to the tax treatment of hedging transactions and the termination of hedging constructs.

Manage your annual tax payments

1. Adjust prepayment amounts of current cash tax

If the estimated statutory profits suggest that taxable income will decrease next year, provide such a forecast and a draft tax calculation to the tax office along with the application to reduce the income tax prepayments. Tax authorities have indicated that an adjustment of corporate income tax prepayments will be granted more easily without strict documentation requirements. Taxpayers can also retroactively apply for an adjustment of previous year prepayments to obtain cash tax prior to the filing of the annual return for such year. Such application should also include a provisional balance sheet and a tax calculation.

2. File a tax return early to obtain tax credits early

Tax credits, e.g., domestic WHT from dividend distributions by a German subsidiary to domestic German shareholders, can in various cases only be claimed through a tax return. Therefore, such cash tax requires that the return is filed early. In some cases, you might even consider filing the return early based on provisional statutory figures. Also, early filing of FY 2022 tax returns will help to obtain tax refunds early if prepayments made exceed the calculated tax and tax authorities deny a retroactive adjustment of prepayments (see above). FY 2022 tax return forms are expected to become available in April 2023.

3. Tax prepayment deferral after restructuring
Restructuring measures within a group may lead to a use of current year losses or loss carryforwards against profits of the surviving group company, subject to certain restrictions within the period of retroactivity. The surviving group company may apply for a (full) reduction of its tax prepayments for the restructuring year and subsequent years.

Avoid unnecessary cash repatriation costs (26.375% domestic WHT)

4. Proactively obtain exemption certificates
Only if an exemption certificate exists, a German company is allowed to directly benefit from treaty protection or from the EU Parent-Subsidiary-Directive through reduced WHT rate at source. Even if dividends are not anticipated, exemption certificates can allow German companies to benefit immediately from treaty protection or the EC parent-subsidiary directive under certain circumstances: Under German tax law, various issues could give rise to deemed dividend distributions, which require to withhold tax unless an exemption certificate exists. It should be taken into consideration that the process may consume considerable time (we currently experience response times of about 6-9 months).

5. German interest, even if non-deductible under limitation may avoid WHT
Under German tax rules generally, a certain EBITDA-related amount of interest expense can be deducted immediately. Any excess amount is deferred to future years (see below, no. 18 for details). However, cash payments of interest which can effectively represent re-patriations of profits are regularly not subject to withholding tax under domestic German tax rules. Various strategies exist to increase a German company's leverage that can allow reaching the desired interest expense levels.

These strategies might be extremely useful if the parent company does not pass the test of the German antitreaty shopping rules and applies a withholding tax of 26.375%.

6. Return equity instead of profits
The return of equity may not be treated as dividends under German tax rules and does not require the paying company to withhold tax. The return of equity may require – amongst others – an assessment of (tax) equity amounts ("steuerliches Einlagekonto") by the tax authorities, which is a standard part of the tax return assessment. Although tax laws govern whether a repatriation is treated as return of equity rather than a dividend, there can also be additional legal requirements which you would like to plan in time.

7. Buy back own shares (treasury stock)
In certain scenarios, a German company could consider buying back own shares. The share price is paid in cash to its parent company and – if structured adequately – does not become subject to withholding tax.

8. Formation of German tax group
Distributions from a German subsidiary to a German parent company are also subject to German withholding tax. However, in the case that the German companies form a tax group (Organschaft), current profits of the subsidiary can be transferred to the parent without the obligation to withhold taxes.

9. Cross border merger
If a German company is part of a cross-border merger, the German activities could give rise to German PE of the surviving company. Any retained earnings of the transferred legal entity should not be subject to withholding tax. The merger could generally be effected on a carry-over basis.

Avoid Penalties

10. Avoid late filing penalties
If timely filing of a tax return cannot be accomplished, you could consider filing a tax return based on provisional figures to avoid the assessment of late filing penalties.

11. Avoid interest charges
If 15 months (18 months for 2023, 17 months for 2024, 15 months thereafter) after the fiscal year end have expired but the final tax return can still not be submitted and additional tax payments are expected, a voluntary tax prepayment may reduce the amount of interest assessed on outstanding taxes (interest rate as per tax law 1.8% p.a.) which is not deductible.

In this context, it might also be worthwhile taking a conservative filing position for provisions that have been recognized in the statutory balance sheet. If the issues that gave rise to the provisions may require additional investigation, the corresponding expense might not be deducted in the tax return in the first place but could help later if other ad-justments occur (even in a tax audit) to avoid the post-deadline increase of cash tax liabilities which would give rise to interest penalties. If the result of the investigations allows for tax deductions, these may offset other income adjustment and could therefore avoid additional interest charges.

Defer Income

12. Introduce a deviating fiscal year
If non-tax reasons exist to change a fiscal year from the calendar year to a deviating year end (e.g., adaptation of group standards), the tax for the current calendar year is assessed for the stub period. The tax for the new fiscal year ending in the subsequent year will be assessed after the close of the new deviating fiscal year, i.e.: in the next calendar year. This could generate a cash tax deferral. Tax authority´s consent is necessary in this respect.

13. Transfer of hidden reserves

If certain assets are sold (e.g., immovable property), the profit from the sale will not immediately give rise to a taxable gain but can be reinvested back into assets of similar kinds. If the profit is not reinvested directly, it can be recognized as a reserve reducing the taxable income. The reserve has to be reinvested within four or six years.

It should be considered that if the reserve is not reinvested, it must be reversed at the end of the four/six year-period (increasing the taxable income) and interest of 6% p.a. must be applied for the whole period.

Monetize losses

14. Carry back losses into previous years

Losses can be carried back one year for CIT purposes (not for local trade tax). The use of losses carried back is limited to 10m Euros (as of tax assessment period 2024: 1m Euros). Any remaining loss balance can be carried forward for an indefinite time but will only allow offsetting future income of 1m Euros plus 60% of the remaining positive income. If combined with the introduction of a short fiscal year (#14), the carry-back of losses and the resulting cash refund could be accelerated. Carry-back must be filed in the tax return of the year in which the loss occurred (tax return amendment).

15. Use losses through tax consolidation (Organschaft)

German tax law permits offsetting losses of one group company against positive income of another group company. This requires a parent-subsidiary structure where the parent company owns more than 50% of the subsidiary's shares (votes) at the beginning of the subsidiary's fiscal year and that certain legal steps are taken prior to year-end (signing of profit and loss transfer agreement, approval of the agreement by the shareholders, local court registration).

16. Use losses though accounts receivable factoring

If the legal ownership of the loss company and of the profitable company does not match the parent-subsidiary scheme as required for a tax group, a receivable factoring scheme with built-in discounts will create an expense for the profitable group member (seller) and income of the loss company (factor) upon collection of the full amount of the receivable.

Prepay expenses/royalties

17. Prepayment of expenses/royalties

IP rights, inventory or stock could be sold in advance within the group in order to receive an immediate cash in-flow (discount necessary, accrual setup). If capital gains are realized from such sales, it should be considered if current year tax-losses exist and/or could be generated, e.g., by realizing losses from intercompany sale of assets, in order to reduce cash tax payments resulting from the sale.

Make interest expense tax effective

18. Increase interest deduction above 30% limit

Rising interest rates in combination with the German tax rules, disallowing a taxpayer to deduct interest expense (net of interest income) over and above 3m Euros exceeding 30% of tax adjusted EBITDA, make many more businesses subject to the interest deduction limitation in this year and in the future. The German tax rules, though, foresee a special equity test as an escape – which, if passed, allows to deduct all interest expense.
This equity test can be very complex: Whether the test can be passed should be checked every year prior to the end of the fiscal year. Thus, for taxpayers where the fiscal year equals the calendar year, there is still time to act prior to 31 December 2022. The equity test basically compares the consolidated equity ratio of the parent company and the individual equity ratio of the German subsidiary. If the latter (equity ratio of the subsidiary) is higher, a taxpayer may deduct all interest expense and reduce cash tax liability. For corporations, the equity ratio test is supplemented by the further requirement to demonstrate that at neither the level of German group members nor the level of foreign group members, interest payments made to group companies/affiliates or to third parties who may take recourse to group companies/affiliates do exceed 10% of net interest expense at the level of the respective group entity/affiliate.

Boost distributable profits for repatriation

19. Create additional profits that can be repatriated

If sufficient cash for distributions is available but insufficient book reserves or profits exist, several corporate restructurings (mergers, hive-downs, etc.) can be carried out at fair market values for statutory purposes. These measures may give rise to profits that could then be distributed. At the same time, the transfer could be treated at carry-over basis for tax purposes, which avoids taxable gains to arise from the transaction. Care should be taken, though, about any non-corporate taxes such as Real Estate Transfer Tax.

Your contacts

Dr. Astrid Bregenhorn-Kuhs
Partner
Phone: +49 211 87722 250
abregenhornkuhs@deloitte.de

Dr. Norbert Endres
Partner
Phone: +49 89 29036 8308
nendres@deloitte.de

Dr. Alexander Linn
Partner
Phone: +49 89 29036 8558
allinn@deloitte.de

Christoph Welter
Partner
Phone: +49 711 16554 7486
cwelter@deloitte.de

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