

German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

Legislative Update

2008 Business Tax Reform

Although many technical details are still unclear, the following summarizes the consensus reached by the coalition parties last week regarding the cornerstones of the 2008 business tax reform:

- A reduction of the corporate income tax (CIT) rate from the current 25% to 15% (increased by a 5.5% solidarity levy) will occur.
- Changes to the trade tax (TT) calculation system will lead to an effective trade tax rate of between 12–16%, depending on the municipality. The aim is to achieve a combined corporate and trade income taxation of below 30% for German companies.
- Under the earnings stripping rule, a limitation of (net) interest deductions (all interest, whether from related or third parties) for both CIT and trade tax purposes will have a ceiling of 30% of EBIT (not 70%, as was incorrectly mentioned in last week's tax alert), with the excess to be carried forward. Exceptions apply if net interest per year does not exceed Euro 1 million and/or the taxpayer can prove that the consolidated group to which the borrower belongs has a debt/equity-ratio at least equal to the German borrower (so-called "escape clause"). Apparently, however, the escape clause does not provide a safe harbor and is not an arm's length test; even a minor excess of the German leverage ratio compared to the group's situation would lead to the strict application of the 30% limitation.
- The current German thin capitalization rule would be abolished.
- For the trade tax add-back of interest, to the extent interest expenses are not caught by the earnings stripping rule, 25% of the expenses will be added back in determining the trade tax base. Interest expense for the purposes of the add-back rule would include deemed interest elements in rental and lease payments, as well as royalties. The deemed interest element is proposed to be 25% of the payment (except for immovables leasing, where the rate would be 75%).
- Changes will be made to the taxation of stock lending transactions.
- For transfers of functions abroad, under discussion are additional, far reaching documentation and valuation requirements, as well as the non-deductibility of related expenses.



- German change-in-ownership/loss limitation rules should be revised. Current discussions indicate that it is intended to extend the scope of the rules to also include indirect share transfers and potentially to lower the threshold for harmful share transfers. In return, intra-group transfers may be excluded from the scope of the rules. It is contemplated to replace the asset test under the current rules (i.e. a monitoring period for the injection of new assets into the loss company) with a new approach, according to which the loss carryforward is put in relation to the fair market value of the shares acquired to determine which portion of the losses could still be used after the share transfer.
- The declining scale depreciation/amortization and immediate deductibility for low-value asset acquisitions will be abolished.

Drafting of laws will begin in the next weeks; the intention is to finalize the legislative process by next year's parliamentary summer break. Generally, all measures should take effect from FY 2008.

“SEStEG” – German Implementation of Revised EU Merger Directive

The parliament passed this bill on 9 November with the following key elements:

- As a general principle, intra-EU mergers, spin-offs and contributions will be possible at less than FMV (i.e. also at historic book values) if Germany's taxation right remains unrestricted.
- Where Germany's taxing right for an asset (for any reason) is restricted, this will be treated as a deemed transfer leading to tax on the built-in gain. The taxpayer can defer the taxation of the gain by creating a special reserve, which would have to be released in equal amounts over five years.
- Tax losses will no longer carry over into the surviving entity in a merger.
- 5% of any merger gain will be effectively taxable.
- Remaining CIT credits from the old imputation system will be paid out pro-rata over the next ten years.
- Taxpayers may treat certain distributions from EU-subsidiaries as non-taxable returns of capital if adequate proof is given.
- Holding periods following business contributions: If the shareholder sells the shares received within seven years following a tax-neutral business contribution into a company, the original contribution will retroactively be deemed to be made at FMV (reduced by 1/7 per year elapsed since the contribution). Broadly the same rule applies for share for share exchanges and for a sale of the shares received by the recipient company.

German Anti-Abuse Legislation (Jahressteuergesetz 2007)

The parliament also passed this bill on 9 November. The draft tax bill includes the following key elements:

- Under tightened substance requirements for non-German holding entities, treaty or directive benefits will be denied if and to the extent the company's shareholder would not have been entitled to such benefits if it invested directly in the German subsidiary and at least one of the following conditions is satisfied:
 - There are no economic or other relevant business reasons for the interposition of the foreign company; or
 - The foreign company does not generate more than 10% of its income from its own business activities; or
 - The foreign company does not have adequate business substance to engage in its trade or business (mere administrative functions, outsourced activities or activities carried out by related parties in the same jurisdiction would not be taken into account in determining business substance).

The restrictions would not apply if the foreign company is listed on a stock exchange and if its shares are regularly traded or if it was subject to the rules of the German investment tax act (broadly speaking, investment funds, mutual funds and similar vehicles investing in risk diversified assets).

- The draft bill also includes a general treaty override provision that would allow Germany to impose tax (despite contrary provisions in a tax treaty) on a German tax resident where a diverging interpretation of provisions of a double tax treaty leads to cases of double non-taxation. Moreover, Germany will be allowed to tax income that is not taxable in the other state only because the recipient is taxed as a non-resident in that other state (an exception applies to dividends provided that these dividends have not been treated as tax deductible in the other state).
- The (partial) exemption of certain (deemed) dividends for individuals (50% exemption) and corporations (95% exemption) would only be granted if the corresponding income did not reduce the tax base of the company paying the dividend.
- Hidden contributions that reduce the income of a parent company would lead to a corresponding adjustment (i.e. increase) of the income at the level of the subsidiary.
- Trade tax losses shall be allocated to the partners of a partnership according to rules governing the profit allocation under the partnership agreement, not taking into account any special business income. This rule, which should be mainly relevant to deter-

mine which portion of the losses may be lost if a partner exits a partnership, eliminates effects from a Federal Tax Court (BFH) decision earlier this year (see GTLN 3/2006).

- Last, but not least, the draft law includes a substantial change regarding the rules governing tax rulings. Under the current draft, the tax authorities will be entitled to demand fees for ruling applications. The fees due will be mainly based on the value of the ruling for the individual taxpayer (i.e. based on the amount of taxes at stake). The fees will be based on general court fees and may be substantial because a reference to the fee cap for court fees seems to be missing in the draft law (e.g. for a value, i.e. tax savings of Euro 30 million, fees may reach up to Euro 100,000). Moreover, the amounts at stake may be difficult to determine in a number of cases.

The entry into effect depends on the individual amendment, however, the majority of the rules should come into effect from 1 January 2007. The upper house can be expected to vote on both the mergers draft law (SEStEG) and the anti-abuse legislation (JStG 2007) in November 2006, with both laws to be published prior to year-end.

Berlin raises Real Estate Transfer Tax

The federal state of Berlin decided to increase the tax rate for real estate transfer tax (RETT) from 3.5% to 4.5% as from 1 January 2007. The increase concerns real estate situated in the state of Berlin that is transferred by way of sale or in reorganizations and acquisitions. Until now, a uniform tax rate of 3.5% for RETT has been in force in Germany. According to a 2006 amendment to the German constitution, the German Länder now have the authority to determine the tax rate for RETT themselves, with the effect that the RETT-rate may vary from one federal state to the other. Whether other federal states will raise or even lower the current tax rate of 3.5% remains to be seen.

Court Decisions

BFH rules on capital gains earned by a partnership held by corporate shareholders

In a recently published decision of August 2006, the BFH rejected the tax authorities' widely disputed view that share sales by partnerships with corporate shareholders could not benefit from the capital gains exemption for trade tax purposes. The decision confirms a previous decision of the tax court of Cologne (see GTLN 1/2006). Because the law was amended in 2004, disputes are likely to arise only for the years 2002 and 2003. It is now clear that the capital gains tax exemption also extends to a partnership's trade tax basis.

In this case, the BFH also had to rule on the question of whether the 5% add-back for dividends, which applied only to dividends distributed by non-resident companies in the year under review, was in compliance with the freedoms of the EC treaty. In view of the ECJ decisions in the Bosal and the Keller-Holding case, it was obvious that the rule under review constituted an infringement of EC law for cases in which the actual expenses incurred were less than 5%. It is nevertheless remarkable that the BFH did not submit the case to the ECJ for a preliminary ruling. Because the partnership held a shareholding in a South African subsidiary, the case was not an EU case; instead, it was a case in which the free movement of capital and its applicability in relation to third countries was concerned. The BFH applied the same principles as in relation to EU countries and held that the rule under review constituted an infringement of the free movement of capital provision. The principles of the decision should be relevant for years until 2003, as domestic and foreign dividends were both subject to the 5% add-back from FY 2004. Following the decision of the ECJ in the Fidium Finanz AG case of October 2006 (a non-tax case), in which the ECJ took a very restrictive approach regarding the applicability of the free movement of capital in relation to third countries, it is unclear whether the ECJ will share the BFH's view in future decisions relating to direct tax cases.

Participation exemption for trade tax purposes

Generally, dividends received by a corporation are tax exempt. However, 5% of the dividends are treated as non-deductible business expenses for corporate income tax and trade tax purposes so that in fact only 95% of the dividends are tax exempt. On 26 June 2006, the Tax Court of Munich decided that this 5% add-back did not apply for trade tax purposes, so that dividends should be fully tax exempt for trade tax purposes if the participation exemption requirements (10% shareholding at the beginning of the relevant tax year) are met. At the moment, the case is pending before the BFH. Taxpayers who have received domestic or foreign dividends in the years from 2004 and whose actual expenses incurred are less than 5% should nevertheless refrain from applying the 5% add-back in trade tax returns, making sure to refer to the tax court decision and to keep all relevant trade tax assessment notes open.

Indirect unification of shares taking place abroad must be disclosed by taxpayer

The German RETT Act defines the unification of shares in a company owning German real estate as a taxable event. A unification of shares occurs if a share transfer results in a 95% shareholding being held by one person, company or group of companies. Also an indirect unification of at least 95% of the shares triggers RETT. For real estate transfer tax purposes, it is irrelevant whether a direct or indirect unification of at least 95% of the shares in a real estate holding company takes place abroad (i.e. in the hands of a foreign company) or in Germany – the determinative factor is whether German real estate is affected. In the case decided by the tax court of Hamburg, a US company (company A) that held 51% of the shares in another US Company (company B) acquired the remaining 49% of the shares in company B from a third US company (company C). Company B was the indirect 100% shareholder of companies owning German real estate. The tax authorities considered the new 100% shareholder (company A) as the taxpayer for RETT purposes and the tax court of Hamburg approved this determination. The tax court also confirmed that, even if the unification of shares has taken place abroad in the hands of a foreign company, the foreign company as taxpayer has the duty to make a notification of the taxable event to the German tax authorities pursuant to Sec. 19 of the RETT Act. The case is now pending before the BFH, which is expected to approve the decision.

Legal News

BGH rules on legal challenges of shareholder resolutions after a squeeze out

In a recent judgment of October 2006, the Federal Civil Court (BGH) ruled that a plaintiff did not necessarily lose his authority to continue the challenge of resolutions by the stockholders' meeting of an Aktiengesellschaft (AG) even if he had been successfully excluded as a stockholder of the relevant AG by way of a squeeze out.

In the case decided, the minority stockholders of an AG had challenged the validity of a stockholders' resolution before court. The resolution related to a spin-off of the business of the AG to a newly established GmbH & Co. KG, with a subsequent sale of the participation in the GmbH & Co. KG by the AG to the majority stockholder of the AG. The plaintiff minority stockholders argued that the business of the AG had been sold below fair market value and the majority stockholder thereby had taken an unfair benefit to the disadvantage of the AG and its then minority stockholders. Subsequently (but before the court actually decided on the legal proceedings relating to the challenge of the stockholders' resolution), the plaintiff minority stockholders were successfully squeezed out from the AG.

The regional court (Landgericht) and the upper regional court (Oberlandesgericht) took the view that – as a consequence of the successful squeeze out – the plaintiff minority stockholders had lost their authority to continue the legal challenge. The BGH, however, confirmed the authority for the continuation even after registration of the squeeze out, stating that, if the challenge was successful, the compensation to be received by the minority stockholders in connection with the squeeze out would exceed the compensation actually paid.

The BGH does not seem to draw a clear line between the (substantive) challenge of a stockholders' resolution and a challenge with respect to the adequacy of compensations under separate court proceedings (Spruchstellenverfahren). However, given the BGH ruling, a successful squeeze out does not appear to be an appropriate means to bring ongoing legal challenges under the stock corporation law to an end. For further information, please contact Dr. Tim Luthra (tluthra@raupach-we.de) with Raupach & Wollert Elmendorff Rechtsanwalts-gesellschaft mbH.

Deloitte News

Frankfurt Breakfast Series

Deloitte Frankfurt hosts regular breakfast meetings on international tax developments from EU, US and German perspectives. The next breakfast meeting will take place on 6 December 2006 at 8:30 am in Deloitte's Frankfurt offices and will discuss the management of tax accounting risks (including current developments in financial accounting for taxes under IFRS and US GAAP, uncertain tax positions and tax process developments). If you are interested in attending, or would like to receive invitations for upcoming breakfast meetings, please contact Ms Ebru Özüaydin (eoezueaydin@deloitte.de). The breakfast meetings are conducted mainly in English.

IIR International Tax Seminar

From 4–11 December 2006, IIR Ltd. will be hosting an International Tax Seminar in London that addresses current tax practice and planning opportunities in the UK, Germany, France, Italy and the US, and provides an overview of European holding and financing regimes, taxation in the EU accession countries and EC tax issues. Practitioners of Deloitte Munich will give a presentation on 5 December 2006 on the key features of the German tax system, with an emphasis on corporate taxation and transfer pricing in Germany. To register, or for more information, please contact IIR Ltd. (registration@iir-conferences.co.uk or www.iir-conferences.com/ITS). For a special discount on registration through Deloitte, contact Ms Sarah Gietl (sgietl@deloitte.de).

Year-End Tax Planning Conference

In November and December 2006, Deloitte Germany will host its annual year-end tax planning conferences at the following locations:

- Berlin 7 December 2006
- Düsseldorf 5 December 2006
- Frankfurt 5 December 2006
- Halle/Leipzig 30 November 2006
- Hamburg 29 November 2006
- Hanover 22 November 2006
- Munich 21 November 2006 (with specialist workshops)
- Nuremberg 29 November 2006
- Stuttgart 28 November 2006

The conference will be conducted in German and will focus on current German tax developments and the implications of potential tax law changes. If you are interested in attending or wish additional information, please contact Ms Lolita Blankenstein (lblankenstein@deloitte.de).

Notice

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