

German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

German Lower House Adopts Annual Tax Act 2009 – Overview of Major Proposed Changes

The German Lower House of Parliament adopted the Annual Tax Act 2009 on 28 November 2008. The bill is scheduled for discussion in the Upper House on 19 December 2008, although additional significant changes are not expected.

The Annual Tax Act 2009 as adopted by the Lower House includes several changes to the first draft of the law (see GTLN 5/2008), some of which could have significant implications for taxpayers. Notably, however, the highly controversial elimination of the participation exemption for portfolio dividends and capital gains (see GTLN 5/2008, it was proposed that the exemption would only be available for dividends and capital gains arising in connection with shareholdings of at least 10%) was not included in the bill.

The following table highlights the key proposed changes relevant to foreign investors having German business entities or deriving German source-income:

Annual Tax Act 2009 – Proposed Changes	Effective Date
<p>1. 40% refund of dividend withholding tax under domestic law subject to anti-treaty shopping rule</p> <p>The withholding tax rate reduction for dividends received by nonresident foreign corporations from 26.375% to 15.825% would be subject to the same tightened substance requirements as introduced in 2007 for tax treaty or EC directive relief. This effectively would result in a 26.375% dividend withholding tax for recipient entities that do not meet the German substance requirements.</p> <p>Potential action step</p> <p>If the substance requirements are not met, consider alternative ways to repatriate funds or distribute dividends before 31 December 2008 (triggering a 21.1% dividend withholding tax instead of 26.375%).</p>	<p>Dividends paid or deemed to be paid after 31 December 2008</p>
<p>2. Further tightening of change-in-ownership rules for loss and interest carryforwards</p> <p>The change-in-ownership rule would be extended to cover a direct or indirect change in the partners of a partnership to the extent the partners are corporations or partnerships with corporate partners. As a result, a transfer of a direct or indirect partnership interest of more than 25% to one acquirer would lead to a pro rata forfeiture of interest carryforwards, trade tax loss carryforwards and current year trade tax losses that were incurred until the time of the transfer at the level of the partnership. A transfer of more than 50% to one acquirer would lead to a complete forfeiture.</p> <p>This amendment represents a further tightening of the change-in-ownership rule since under current rules only a direct change in the partners of a partnership leads to a pro rata forfeiture of the loss carryforwards and interest carryforwards (based on the direct partnership interest transferred). The indirect transfer of a partnership interest does not affect trade tax loss carryforwards or interest carryforwards of the partnership under the current rule. Given that the current rule is based on general principles that have not been repealed, the relation between this general concept and the proposed amendment of the change-in-ownership rule is not clear. It should mainly give rise to issues in the case of a direct transfer of 25% or less, or more than 50% of the partnership interest where the two concepts would lead to different results.</p>	<p>Harmful share transfers (or similar transactions) after 28 November 2008</p>

Annual Tax Act 2009 – Proposed Changes

Effective Date

3. No retroactive reorganizations to utilize losses after a change in ownership

Specific wording would be included in the Reorganization Tax Act to disallow the use of interest carryforwards, tax loss carryforwards and current losses after a harmful change in ownership, relying on the retroactivity principle in the Act. According to the revised rule on retroactivity, a loss may be used retroactively only if it had not been forfeited by a harmful transaction in the interim. The wording of the new law specifically targets retroactive step-up transactions, however, it remains to be seen how the tax authorities will interpret the new rule.

Potential action step

If a harmful share transfer took place before 28 November 2008, review whether losses could be used relying on a retroactive reorganization (subject to minimum tax rules).

Generally harmful share transfers (and similar transactions) after 28 November 2008

An exception applies if the seller and the purchaser, in principle, agreed on the share transfer before 28 November 2008 and this is documented in writing and the reorganization takes place before 31 December 2009

4. Bookkeeping in EU permitted

The General Tax Act would be amended to introduce a rule allowing German resident taxpayers to transfer their IT environment for electronic bookkeeping to other EU/EEA countries provided those other countries have an effective exchange of information with Germany. To date, the local tax authorities have permitted this only on a case-by-case basis. Under the new rule, taxpayers still would have to obtain the consent of the German tax authorities, which would be granted only for taxpayers with a history of good compliance.

The taxpayer would have to disclose the physical location of the IT system used and the German tax authorities would need to be able to access the system electronically. The taxpayer also would have to obtain the consent of the other Member State to allow the German tax authorities to access the data stored in that Member State. In effect, the tax authorities of both countries would have to grant permission to transfer electronic bookkeeping abroad.

If the taxpayer does not satisfy the conditions to transfer electronic bookkeeping (e.g. because consent from the foreign tax authorities cannot be obtained or because the electronic bookkeeping is transferred to a third country), the tax authorities still may grant permission if German tax assessment and enforcement will not be impaired. In view of the restrictive conditions to transfer electronic bookkeeping, it is likely that this "exception" will be the norm for applications, so that the decision whether electronic bookkeeping may be transferred to another country would remain at the discretion of the tax authorities. The imposition of penalties ranging up to EUR 250,000 in case of non-compliance is no longer mandatory as proposed in previous drafts of the law, but will be discretionary.

Notably, this change does not affect the paper bookkeeping or the storage of paper VAT invoices: These documents must be retained in Germany and not be relocated to another EU/EEA country.

Potential action step

If a taxpayer wants to relocate or maintain bookkeeping abroad, consent of the tax authorities should be obtained in a timely manner in order to have sufficient time to respond to the tax authorities' reaction prior to a future tax audit.

Applicable from the day after the Annual Tax Act 2009 is officially published

Annual Tax Act 2009 – Proposed Changes

Effective Date

5. Treaty override for interest and other expenses paid to nonresident partners of a partnership

With the proposed law change, the tax authorities would seek to protect their current interpretation of tax treaties with regard to cross-border expenses paid to partners of a partnership in inbound situations.

In inbound situations, this amendment would effectively overrule the Federal Tax Court's (BFH's) interpretation in a recently published taxpayer friendly decision (see GTLN 3/2008). According to the BFH, Germany loses its right to tax the interest income of foreign partners of the German partnership (which may lead to double non-taxation).

Under the new rule, expenses for services, interest payments on loans, payments for the use of assets, etc. paid by the partnership to its partners would have to be treated as business income under the applicable tax treaty in inbound and outbound situations.

In inbound situations, this would lead to the partner's income from such services being subject to tax in Germany. In outbound situations, the right to tax the income from the services would generally be allocated to the country of the partnership. However, the German subject-to-tax clause would continue to apply to prevent untaxed income from potential classification conflicts (which would be relevant in outbound situations if the country of the partnership does not apply a partnership taxation concept that is similar to the German concept).

The law change and the BFH decision should apply only to the tax treatment of payments for services, for the use of assets, loans, etc. by a partnership to its partner. It should not apply to the tax treatment of special business expenses at the level of the (nonresident) partner (i.e. expenses incurred at the level of the partner in connection with its partnership interest), which can be deducted from the taxable income of the partnership under German partnership taxation principles.

Potential action step

Review agreements between a partnership and its partners and consider amendment to achieve the desired tax result for the future.

Since the rule should apply to all cases open for review by the tax authorities, taxpayers that would like to rely on the taxpayer friendly principles in the BFH decision in inbound situations for previous years would have to take their case to court.

Applicable to all cases still open for review by the tax authorities

6. No withholding tax on leasing of movable assets

There would no longer be a withholding tax obligation for lease payments made to nonresident lessors for movable assets under domestic law. However, in non-treaty cases, remuneration paid for movable assets used in Germany would continue to be subject to German taxation. This tax, however, would be levied by way of assessment. In treaty situations, relief from German taxation would therefore no longer be subject to the substance requirements under the anti-treaty shopping rule.

Remuneration paid after 31 December 2008

7. Rental income from real estate for nonresidents

Income from the leasing of real estate would qualify as business income for nonresident corporations (in contrast to the current tax treatment where income from the leasing of real estate qualifies as asset management income and only capital gains from the sale of the real estate qualify as business income). This mainly would have implications for the determination of taxable income (accrual basis rather than cash basis) and for depreciation that can be claimed on the real estate (generally, 3% instead of 2% for real estate that is not used for residential purposes).

FY 2009

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8. Trade tax exemption for real estate companies

In general, payments to a partner of a real estate managing partnership which are treated as profit allocations for tax purposes (e.g. interest on loans granted from a partner to the partnership) would no longer benefit from the trade tax exemption for real estate companies. This change comes in response to a decision of the Tax Court of Düsseldorf (see GTLN 10/2007), which would have opened up planning opportunities for real estate managing partnerships.

Applicable for remuneration paid under agreements concluded (or substantially amended) after 18 June 2008

9. Tax treatment of third-country related losses and business expenses

After several ECJ decisions on the tax treatment of losses incurred in other EU Member States, the European Commission initiated an infringement proceeding against Germany for its discriminatory rules applied to certain situations involving the utilization of cross-border losses. Under these rules, some losses and business expenses incurred with respect to passive investments abroad (e.g. write-downs of certain loan receivables, permanent establishment (PE) losses if the PE was taxed under the credit method, losses from the rental of real estate abroad) could not be offset or deducted. To comply with EC law, the application of these rules would now be limited to third country investments; investments in EU/EEA-countries (with effective exchange of information) would no longer be subject to the limitations.

Applicable to all cases still open for review

It should be noted, however, that this change would not affect losses incurred in a PE where an applicable tax treaty provides for the exemption method to prevent double taxation. Taxpayers would not be able to offset such losses against their German taxable income. And since the ECJ held, in the *Lidl Belgium* case, that this treatment is in principle in line with EC law, it was not necessary for Germany to amend the rules in this regard. The change, therefore, may mainly be relevant for taxpayers with an EU/EEA PE that is taxed under the credit method (e.g. because it earns passive income). In these cases, taxpayers (both corporations and individuals) would benefit from the loss offset in all cases still open for review by the tax authorities.

10. VAT changes

The VAT rules on the place of supply for services and the rules on the refund procedure would be substantially revised as from 2010 (implementation of the EU VAT Package 2010). These changes have an effective date of 1 January 2010.

1 January 2010

11. Other changes

- Investments in EU/EEA countries that are exempt from taxation in Germany (i.e. where an applicable tax treaty provides for the exemption method) would no longer affect an individual taxpayer's progressive tax rate (irrespective of whether the investment is profitable or loss making). This change is relevant only for individuals.
- Various changes would be made to the German withholding tax system, which are mainly relevant for nonresident artists and sportsmen following various ECJ decisions.
- There are several changes to the G-REIT Act aimed at eliminating the double taxation of distributed profits generated by taxable subsidiaries of a G-REIT, which are fully subject to tax in the hands of the investors. Another change aims at eliminating double non-taxation by excluding dividends received from foreign REITs from any treaty participation exemptions.

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