

German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

Court Decisions

Local tax court confirms compatibility of trade tax interest add-back rule with EC Interest and Royalties Directive

Under the previous German trade tax law, taxpayers were required to add back 50% of long-term interest expenses when computing their trade tax base (as from 2008, 25% of all interest expense must be added back). In a recent decision that also may be relevant to the interest deduction limitation rule, the local tax court of Münster held that the trade tax add-back is compatible with the EC Interest and Royalties Directive for the years from 2004, and compatible with the freedom of establishment provision for the years before 2004 (see also GTLN 6/2007).

The Interest and Royalties Directive exempts interest and royalty payments between associated companies from "any taxes imposed" in the source state. However, Member States may opt not to apply the Directive when the debtor and creditor have not been associated companies for an uninterrupted period of two years. When implementing the Directive into domestic tax law, Germany did not make use of this option. Nonetheless, the local tax court argues that companies that have not been associated for two years cannot rely on the immediate application of the Directive. As Member States have an option not to provide the benefits of the Directive during this period, the taxpayer cannot benefit from the minimum rights as defined by the Directive.

The Münster tax court explicitly refrained from answering the question whether the trade tax add-back rule would contradict the Directive if the companies had been associated for more than two years. The court did not refer the case to the European Court of Justice (ECJ), but instead allowed the German Federal Tax Court (BFH) to decide an appeal. The BFH, however, will be obliged to refer the case to the ECJ if the interpretation of the Directive is not entirely obvious and of decisive relevance to its decision. Thus, the ECJ may still get the opportunity to rule on the compatibility of the trade tax add-back of interest payments with the Interest and Royalties Directive and whether a directive can directly be relied upon if a Member State did not make use of an option to grant benefits only after a minimum holding period.

For the years before 2004, i.e. before the Interest and Royalties Directive entered into effect, the tax court rejected an infringement of EC law which the taxpayer had based on the freedom of establishment.

An appeal has been filed with the BFH and therefore the further development of the case should be closely monitored. Taxpayers should seek to keep assessments open until a final decision is reached.



Local tax court rules on change-in-ownership in double-tier partnership structures

The carry-forward of trade tax losses of a partnership is contingent on both the identity of the partnership's business and the identity of the partners. The identity of the partners implies that the partnership may carry forward trade tax losses only to the extent its current partners are identical to the partners at the time the partnership incurred the loss.

A recently published decision of the local tax court of Saxony concerns the identity of the partners of the lower-tier partnership in a double-tier partnership structure. In the case, the partners of the higher-tier partnership were merged, leading to the collapse of the higher-tier partnership into its remaining partner. As a result, after the restructuring, the remaining partner of the former higher-tier partnership became the direct partner of the former lower-tier partnership. The local tax court of Saxony held that, for trade tax purposes, the partner's identity was not affected by the restructuring. Rather, the remaining partner assumes the participation in the former lower-tier partnership from the collapsed higher-tier partnership without negatively affecting the partner's identity for trade tax purposes. Therefore, the partnership was entitled to an unrestricted trade tax loss carry-forward. The case is pending before the BFH.

Local tax courts decide on former change-in-ownership rules

Two local tax courts recently issued decisions that concern the application of the former change-in-ownership rule for corporations generally in effect until 31 December 2007. Although this provision was replaced under the Business Tax Reform 2008, the old rule continues to apply during a transitional period if certain conditions are satisfied and it is still relevant with regard to tax audits covering previous years.

According to the former change-in-ownership rule, a corporation cannot utilize its tax loss carry-forwards if it is no longer legally and economically identical to the loss-incurring corporation. The economic identity of a corporation is no longer existent, if

- a harmful share transfer of more than 50% of the shares in the corporation takes place; and
- predominantly new business assets have been contributed to the corporation within a certain period following the harmful share transfer.

Regarding the point of time when the existing tax loss carry-forwards of a corporation are forfeited, it had been the opinion of the tax authorities that the relevant time is when both requirements, i.e. harmful share transfer and contribution of predominantly new business assets, are cumulatively fulfilled. The local tax court of Münster, however, confirmed a previous decision of the BFH (see GTLN 10/2007), holding that, after both requirements of the former change-in-ownership rules are met, the tax losses that existed at the time of the harmful share transfer are forfeited retroactively.

This retroactive effect can be either beneficial or detrimental for the taxpayer, depending on whether the corporation generated a loss or a profit in the period between the harmful share transfer and the harmful injection of new business assets. Since, based on the local tax court decision, only the existing tax losses at the time of the harmful share transfer are forfeited, any tax losses that are incurred after the harmful share transfer still could be utilized. On the other hand, it would not be possible to offset profits derived in the period between the harmful share transfer and the contribution of predominantly new business assets with the tax loss carry-forwards the corporation incurred before the harmful share transfer. The decision of the tax court of Münster is final.

Another recent decision by the local tax court of Berlin-Brandenburg concerned the loss of the economic identity of a corporation under the former change-in-ownership rule. The tax court ruled that the change of the business purpose of a corporation from an operating business to mere asset management following a harmful share transfer is not sufficient to give rise to a presumption of the loss of economic identity. Rather, the tax court pointed out that the harmful asset contribution requirement was not fulfilled and a loss of economic identity could not be assumed merely based on the general principles of the change-in-ownership rule. This decision is not yet final because an appeal has been filed with the BFH.

Principles for profit adjustments and estimation of tax base established by local tax court

The local tax court of Hamburg recently issued a final decision regarding business relations of a German partnership with nonresident shell companies. While the underlying case is rather specific, some general principles have been established by the court.

Under German procedural tax law, a deduction for business expenses can be disallowed if the taxpayer fails to name the recipient of the corresponding income upon the request of the tax authorities. The local tax court clarified that this rule only can be applied

by the tax authorities if a creditor or recipient of the corresponding income exists. Thus, the rule does not apply if a taxpayer incurs an expense by writing off a claim, since this type of expense does not generate income for another party and is therefore not covered by the intent of the rule.

Generally, the tax authorities can estimate the tax base if the taxpayer cannot sufficiently support the information provided, or does not sufficiently cooperate with the tax authorities in clarifying the facts, or if the bookkeeping is not formally correct. The local tax court confirmed previous case law, holding that the estimation has to be coherent, economically reasonable and feasible. The court also clearly stated that business relations with nonresident shell companies in low-tax jurisdictions usually serve the purpose of reducing the overall tax burden. If, however, a specific structure would lead to a profit dislocation from the low-tax jurisdiction to Germany, as in the case, there is no justification for presuming an abusive structure that might give rise to an estimation of the tax base.

Tax Authorities' Guidance

Treatment of transaction costs incurred in year prior to or following sale of shares

In March 2008, the Federal Ministry of Finance issued official guidance on the treatment of transaction costs in relation to the sale of shares in a corporate subsidiary where these costs were incurred in financial years before or after the year in which the sale was executed.

The guidance states that transaction costs generally have to be considered for the calculation of the (tax-exempt) capital gain and the 5% fictitious non-deductible business expenses in the financial year in which the sale of shares took place. The expenses remain deductible for the calculation of taxable income in the year in which they are actually incurred if this differs from the year of sale.

The same logic applies to subsequent purchase price adjustments in the years following the sale, i.e. the calculation of the (tax-exempt) capital gain has to be adjusted in the financial year in which the shares were actually sold and the relevant tax assessment has to be changed.

In case of a partnership selling shares in a corporate subsidiary, the transaction costs must be separately determined in the financial year in which they are incurred.

Tax authorities apply local tax court decision on payments to nonresident silent partners

Before 2008, remuneration paid to a silent partner was only deductible for trade tax purposes if the payments were subject to trade tax at the level of the recipient. Thus, payments to nonresident silent partners could not be deducted for trade tax purposes because the recipients were not subject to trade tax. In contrast, payments to German silent partners usually could be deducted.

Without referring the case to the ECJ, the local tax court of Münster held in a decision published in 2007 that this rule resulted in an unjustified restriction of the basic freedoms of the EC Treaty and thus constitutes an infringement of EC law.

According to recent guidance issued by the tax authorities, the tax court decision will apply in all similar cases before 2008, where a silent partner participates in a German business and the silent partner is resident in an EU/EEA-country or a third country that has concluded a tax treaty with Germany. Furthermore, the guidance expands the suspension of the trade tax add-back to annuity payments, which are subject to the same trade tax treatment as silent partner remuneration.

The tax authorities' guidance only affects payments made before financial year 2008, as the amended add-back rules in effect from financial year 2008 have abolished the discrimination. They allow for a deduction of 75% of silent partner remuneration and annuities, but apply to all payments, irrespective of whether the recipient is subject to trade tax.

VAT News

German obligations to provide evidence for VAT-exempt intra-community supplies in line with EC Law

In a number of decisions published in April 2008, the BFH ruled that the obligations of a supplier to provide appropriate evidence of the existence of an intra-community supply do not contravene EC law because the 6th VAT Directive does not define such evidence but Member States have an option to set any further requirements and obligations to be met by the supplier.

The obligation to provide appropriate evidence under German VAT law and regulations is not a substantive prerequisite for the application of the VAT exemption of an intra-community supply as such. Rather, the German rules define the content and proposed format of the evidence to be provided in the books and records of the supplier; the taxpayer, however, can provide any other suitable evidence if it is not possible to use the proposed format.

The BFH held that, if the supplier does not fulfil its obligation to provide appropriate evidence at all, it can generally be presumed that the prerequisites for treatment as an intra-community supply are not met. Providing a foreign VAT ID number as the sole proof of a recipient's identity to demonstrate an intra-community supply is insufficient, particularly where the supply is a means of transport which is picked up.

It is therefore recommended, particularly in situations involving a pick-up of a means of transport (or of other goods, in general) from Germany by nonresident recipients, to provide enhanced documentation, e.g. written confirmation from the recipient and/or his forwarding agent that the means of transport (or other goods) are/will be actually moved from Germany to another Member State.

For further information, please contact Sonja Mühleisen (smuehleisen@deloitte.de) in our Indirect Tax Service group or your German indirect tax contact.

Other – Important Deadlines Approaching

31 May deadline to report shareholder status after tax-neutral contributions

The Reorganization Tax Act requires that taxpayers notify the tax authorities annually (i.e. by 31 May) on the status of shareholders if contributions in exchange for shares had been made below fair market value under the new Reorganization Tax Act, which has been in effect since 13 December 2006. If the taxpayer fails to notify the tax authorities within this deadline, the relevant contribution will be subject to retroactive taxation (please see GTLN 3/2007 and GTLN 9/2007 for further information).

Documentation of extraordinary transactions

Extraordinary transactions must be documented on a contemporaneous basis under Germany's transfer pricing documentation requirements in order to avoid potentially severe tax consequences and penalties. Contemporaneous documentation is presumed if it is prepared within six months after the end of the financial year in which the relevant business transaction took place. Therefore, calendar year taxpayers that carried out extraordinary transactions in financial year 2007 need to prepare the transfer pricing documentation by 30 June to meet the contemporaneous documentation requirements.

Legal News

Federal Civil Court denies exemption from rules on effective payment of share capital in cases of "economic union"

In a case decided by the Federal Civil Court (BGH) in December 2007, a GmbH was incorporated to serve as the general partner of a GmbH & Co. KG. The share capital of the GmbH was funded in cash. Shortly after incorporation, the GmbH loaned the cash to the GmbH & Co. KG in which it was the general partner. The loan was never repaid and both the GmbH and the GmbH & Co. KG became insolvent. The insolvency administrator required the shareholders of the GmbH to (again) pay the share capital that, according to the administrator, had not been paid in effectively.

The defendants argued that the GmbH and the GmbH & Co. KG were an economic union, making the loan irrelevant for the effective payment of the share capital of the GmbH at the time of its incorporation. The BGH clarified, however, that the assets of the GmbH and the GmbH & Co. KG must be treated separately and the question of whether the share capital has effectively been paid in needs to be individually examined for each entity. The BGH therefore concluded that the share capital of the GmbH had not been paid in effectively and must be paid in (again).

To avoid double payment obligations, advice should be sought in all cases related to the effective payment of share capital.

This article was supplied by Dr. Tim Luthra (tluthra@raupach-we.de), Raupach & Wollert Elmendorff Rechtsanwalts-gesellschaft mbH.

Deloitte News

Frankfurt Breakfast Briefings

Deloitte Frankfurt hosts regular breakfast meetings on international tax developments. The next breakfast meeting will take place on 4 June 2008 at 8:30 am in Deloitte's Frankfurt offices with the topic still to be determined. If you are interested in attending, or would like to receive invitations for upcoming breakfast meetings, please contact Ms. Ebru Özüaydin (eoezueaydin@deloitte.de).

Berlin Breakfast Briefings

Deloitte Berlin hosts regular breakfast meetings on international tax developments and other relevant topics. The next breakfast meeting on the current financial market crisis will take place on 22 May 2008 at 8:30 am in Deloitte's Berlin offices. If you are interested in attending or would like to receive invitations for upcoming breakfast meetings, please contact Ms. Evelyn Schäfer (eschaefer@deloitte.de).

Königstein International Tax Conference

Deloitte Germany's annual two-day seminar on outbound investment and developments in international tax law will take place in Königstein (near Frankfurt) on 4-5 June 2008. The focus of the seminar will be tax issues and planning opportunities for German companies investing abroad and will include an update on recent tax developments relating to investments in Germany and in major target jurisdictions. A key focus of this year's conference will be changes introduced by the 2008 tax reform. Speakers from the German tax authorities and the German Federal Tax Court will join the conference. If you are interested in attending and would like to receive a detailed program, please contact Ms. Lolita Blankenstein (lblankenstein@deloitte.de). The seminar will be held in German.

IIR International Tax Seminar

From 19–23 May 2008, IIR Ltd. will be hosting an International Tax Seminar in London that addresses current tax practice and planning opportunities in the US, Germany, France and Italy, and provides an overview of European holding and financing regimes. Practitioners of Deloitte Munich will give a full-day presentation on 20 May 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. (kmregistration@informa.com or www.iir-conferences.com/ITS).

Notice

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