

# German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

## Legislative Update

### **German Business Tax Reform 2008 adopted by Upper House**

On 6 July 2007, the German Upper House adopted the Business Tax Reform 2008 without further changes. Once signed by the President, the law will become effective. For a summary of the law changes, see GTLN special editions 2/2007 and 5/2007.

### **Disclosure obligations for international tax planning contemplated**

According to a draft bill being discussed within the Ministry of Finance (MOF), Germany may introduce disclosure obligations for certain types of international tax planning as from 1 January 2008.

Targeted are planning structures where:

- An asset is recorded for tax purposes in several jurisdictions;
- The same income is allocated to several taxpayers or to several PEs of the same taxpayer;
- An entity is classified as a taxpayer by one jurisdiction, but not by the other;
- An entity is treated as a dual resident;
- Tax treaty provisions are interpreted or applied differently by treaty partner countries;
- Payments are characterized differently by different countries; or
- The same expenses can be deducted in different jurisdictions;

if the use of such planning leads to a fiscal shortfall in Germany (i.e. a reduction of income, tax deferral or the creation of credits). The disclosure obligations would apply only to advice or recommendations on such structures given after 31 December 2007.

The "promoter" of the structure would be required to notify the Federal Fiscal Agency (FFA) of the proposed strategy, the expected tax saving, the legal basis and the number of clients advised with respect to the strategy (although not the identity of the clients). The FFA would then assign an identification number to the tax planning strategy and taxpayers using the strategy would have to declare whether they used the strategy in their tax returns.

The disclosure would not necessarily mean that Germany would reject the strategy or that legislative steps would be taken to counteract the effect of the strategy, although it is the lawmaker's clear intention to be able to react more quickly to arbitrage opportunities arising in the international tax planning area.



A promoter is defined as any person who advises on or sells tax planning ideas and generates fees of at least € 250,000 per year from such activity. A promoter need not be a German resident. Failure to disclose by either the promoter or the taxpayer using a listed strategy may trigger penalties of up to € 5m.

It is unclear whether this (early) draft will actually become law, although there likely will be little opposition in the current political environment.

## German draft law for Annual Tax Act 2008 published

In June 2007, the German Ministry of Finance published a draft of an Annual Tax Act for 2008 to implement several tax law changes that were not part of the Business Tax Reform 2008. The changes include the following:

- **Tax effective write-downs of shareholder loans:** Write-downs of loans granted by substantial (i.e. more than 25%) shareholders will no longer be possible with tax effect unless the taxpayer can prove that the loan meets an arm's length test. According to the explanations to the draft, the arm's length test would not be met if the loan is non-interest-bearing, if no securities were issued or if an interest-bearing loan for which securities were issued, is not terminated when the economic situation of the borrowing entity deteriorates substantially. If enacted, the proposed rule puts an end to ongoing discussions on how write-downs of shareholder loans should be treated for tax purposes (see GTLN 4/2007).
- **Previously untaxed profits (EK 02):** Under current law, a distribution that is deemed to be made out of previously untaxed profits (which results from the old imputation tax credit system) and that takes place before 2019 triggers an equalization tax amounting to 3/7 of the distribution. The compatibility of this rule with the EC Parent-Subsidiary Directive is currently questioned before the European Court of Justice (ECJ). The draft law proposes a compulsory flat tax amounting to 3% of previously untaxed profit reserves existing as of 31 December 2006, irrespective of a distribution. The resulting tax payable would have to be paid in 10 equal instalments, starting in 2008 (alternatively, a lump-sum payment of the net present value of the total amount can be made upon the taxpayer's application). The 3% flat tax represents a compromise, taking into account that certain taxpayers would be able to postpone dividend distributions that potentially trigger the equalization tax until 2019 and, therefore, would be able to avoid the tax, which is no longer possible under the draft law. If implemented, the full amount of the resulting tax liability would have to be recognized as a liability in the financial statements for 2007.
- **General anti-abuse provision (s. 42 AO):** The German tax authorities are seeking to significantly extend the scope of the anti-abuse rule. According to the proposed rule, a taxpayer will have to show valid business reasons for any structure that leads to a tax benefit. Such business reasons will be sufficient only if a knowledgeable third party would have implemented the particular structure in the same way regardless of the potential tax benefit ("third party test"). Therefore, the decisive criteria for application of the anti-abuse rule would be whether the taxpayer generates a tax benefit from a particular structure and whether there are other more common structures that would not result in such tax benefits. A taxpayer will be allowed to discuss its business reasons with the tax authorities and ultimately the BMF if there is doubt about the acceptance of the business reasons.
- **Implementation of the ECJ decision in the Cadbury Schweppes case:** The draft law proposes implementing into the German Foreign Tax Act the criteria set forth by the ECJ in Cadbury Schweppes. The proposed rules are similar to the BMF guidance published in January 2007 (see GTLN Special Edition 2/2007). Under the proposal, a taxpayer could avoid application of the German CFC rules if the taxpayer can prove that (1) the CFC is actually established in an EU or EEA member state and carries out a genuine economic activity; (2) the passive income is derived in connection with such activities; and (3) the Mutual Assistance Directive or a similar bilateral agreement applies. Notably, the taxpayer would not be permitted to provide such evidence if the low taxation is caused by a subsidiary or a permanent establishment (PE) in a third country or if the CFCs are subject to the German CFC rules only because they earn low-taxed passive investment income (i.e. where the CFC earns more than 10% passive investment income and German resident shareholders hold less than 50%). The official explanation to the CFC-rule changes suggests that the German tax authorities will take a very strict view as regards "artificial" structures, not benefiting from the Cadbury Schweppes-principles. In effect, they seem to regard the activities of group-internal treasury companies as in many cases "artificial".
- **Wage withholding:** The draft law provides substantial changes to the technical aspects of the wage withholding tax system and will be the final step in replacing the current system with a fully electronic system by 2011. The existing paper wage tax cards of employees on which the key tax attributes of an employee are listed and that form the basis for employee taxation would be replaced by a fully electronic system as from 2011.

The German government is expected to decide on the draft on 8 August 2007, which would formally launch the legislative process.

## German draft law on special rules for venture capital published

Following the MOF position paper outlining its policy strategy for a reform of the tax treatment and regulation of venture capital (see GTLN 5/2007), a draft bill was published to implement the strategy set forth in the position paper.

Venture capital companies would need to apply for recognition by the German Financial Supervisory Authority (BaFin) to benefit from the new law. BaFin would oversee the investment policy restrictions applying to venture capital funds under the new rules.

The regulations in the draft would apply to venture capital funds that invest equity in unlisted EU/EEA resident corporations that are less than 10 years old and that do not operate businesses that are older than the corporation itself or that act as the head of a German tax consolidated group. The equity of the target company could not exceed € 20m and the fund would be allowed to hold the investment for a maximum of 15 years.

The venture capital fund would need to have a minimum equity of € 1m and invest at least 70% of its assets in venture capital shares as defined by the new rules. Under the draft, a trade tax exemption would be granted to German resident venture capital funds organized as partnerships in certain circumstances. Less restrictive change-in-ownership rules would apply to loss carryforwards of target companies if the entity is acquired (and disposed of) by a venture capital fund after a holding period of four years.

As expected after issuance of the MOF position paper, no additional benefits are expected to be granted to the managers of venture capital companies.

## Tax Authority Guidance

### Draft decree law on relocation of functions available

In the course of the Business Tax Reform 2008, substantial changes were made to the transfer pricing rules. To compensate for a reduction in tax revenue resulting from the lower corporate income tax rates, one of the key features of the amendments is the new exit taxation rule for changes in the supply chain (also referred to as a "transfer of functions"). Since the law only includes a general framework, the legislator has authorized the MOF to issue a binding decree law that sets out the details for application of the arm's length principle. The MOF recently issued a draft decree law on the relocation and duplication of functions, which includes definitions of "function," "relocation of functions," "duplication of functions," "transfer package" and "profit potential."

A function is defined as the aggregate of similar operating tasks, including opportunities and risks that are executed by certain departments of an enterprise. Accordingly, a relocation of functions exists if the enterprise relocates, discontinues or reduces a function and another enterprise assumes this function, even if the function is only partially or temporarily relocated. The regulations relating to the relocation of functions also would apply to the duplication of functions. The draft decree law also addresses employee secondments and whether a secondment could qualify as a relocation of a function.

The definition of the "transfer package" in the draft decree is extremely broad as it not only includes intangibles and tangible goods, but also opportunities, risks and other advantages. Under the proposed decree law, a valuation of the transfer package would need to be made. The transfer package would have to be remunerated as a whole package based on the profit potential both of the enterprise that relocates and the enterprise that assumes the function.

The draft decree law likely will include details on the calculation of the profit potential, a provision on retroactive adjustments and the date when the decree law enters into force.

### Fiscal unity not jeopardized by non-interest-bearing loss absorption claim

According to a coordinated decree of the Bavarian State Ministry of Finance dated 13 March 2007, the actual execution of a profit and loss pooling agreement (PLPA) will not be denied for tax purposes if the subsidiary's claim for a loss absorption does not yield (appropriate) interest. Under a PLPA, the claim of the loss-making subsidiary for a loss absorption by the parent company arises as of the respective balance sheet date and is due immediately. Under the German Commercial Code, this claim has to bear interest. However, under the coordinated decree, failure to charge (appropriate) interest in such cases will ultimately not be detrimental to the validity of the fiscal unity. Technically, the lack of interest payments is characterized as an anticipated profit transfer in a fiscal unity and, therefore, does not jeopardize the actual execution of the PLPA, which is a vital prerequisite for the recognition of a fiscal unity for tax purposes.

## Other

### EC law implications of trade tax add-back of long-term interest expense

The EC Interest and Royalties Directive, which has been in effect since 1 January 2004, provides that interest and royalties paid between an EU parent and its direct subsidiary companies (or their EU PEs) or between two EU subsidiaries directly held by the same parent company may not be subject to any taxes in the source country regardless of whether such tax is levied by way of assessment or withholding tax.

Under the current German trade tax rules, 50% of long-term interest (from 2008, 25% of all interest) is added back to the trade tax base of the paying entity. Relying on an ECJ decision dating back to 2001, it has been consistently argued that the Directive prevented Germany from applying the trade tax add-back in situations covered by the Directive. It also has been argued that, even for situations before 2004, taxpayers may rely on the principles of the Marks & Spencer decision to claim that the trade tax add-back violates the freedom of establishment because domestic entities that have formed a tax consolidation are not subject to the add-back if interest is paid between a parent and a subsidiary company in a tax consolidation.

Practical experience with the tax authorities shows that they have followed the taxpayers' declarations in tax returns in a number of cases and issued preliminary assessments, so assessments still may be changed in the course of a future tax audit. Moreover, the Higher Regional Tax Authorities of Muenster have informally indicated that a case is pending before the tax court of Muenster, in which the taxpayer is taking the position that the trade tax add-back violated the freedom of establishment as well as the Interest and Royalties Directive from 2004 and the freedom of establishment for the time before 2004. German taxpayers that pay interest to their direct EU subsidiary, direct EU parent or EU brother/sister entity with the same direct shareholder should carefully review their situations to determine whether it would be covered by the Directive and should consider filing their tax returns on the basis that the Interest and Royalties Directive prevents an add-back of long-term interest for trade tax purposes. If the taxpayer's situation is not covered by the Directive, the taxpayer should determine whether the situation could be covered by the freedom of establishment provision in the EC- or the EEA-treaty.

## Deloitte News

### FIN 48 and 2008 Business Tax Reform

Deloitte is hosting a seminar on the consequences of the 2008 Business Tax Reform on FIN 48 reporting on 17 July 2007 in Munich. The seminar will provide an overview of the fundamentals of the FIN 48 regulations and their practical implementation in the group, together with the potential implications of FIN 48 reporting in the course of tax audits. If you are interested in attending and would like to receive a detailed program, please contact Lolita Blankenstein (lblankenstein@deloitte.de). The seminar will be conducted in German.

### Tax Road Show on 2008 Business Tax Reform

Deloitte Germany tax partners will be present in several locations in the U.S. and the U.K. in July and August to provide an update on the 2008 Business Tax Reform and action needs arising from significant changes to the German tax regime. Individual meetings can be arranged on demand. The current schedule is:

17 July	London
17 July	San Jose
19 July	Atlanta
6/7 August	Minneapolis
8 August	Milwaukee
9/10 August	Chicago
14 August	Detroit

Some events include updates on other jurisdictions as well. If you are interested in attending one of the above events and/or would like to have an individual meeting, please contact Nicola Selack (niselack@deloitte.com) for the U.S., and Emma Brown (emmabrown@deloitte.co.uk) for London.

## Notice

If you are interested in regularly receiving this publication or if you know anyone else interested in receiving a copy, please send his/her information to the following email-address: [gtln@deloitte.de](mailto:gtln@deloitte.de)

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