

German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

Legislative Update

2007 Tax Law Changes

On 23 August 2006, the German government officially agreed on the draft 2007 tax bill (see GTLN 7/2006), which includes a number of anti-abuse rules and which may significantly tighten substance requirements for foreign holding entities. The draft bill, which still must undergo the formal legislative process, only includes minor changes compared to the draft published in July. Most notably, the revised anti-treaty shopping provision (see GTLN 7/2006), which provides for a significant restriction – contrary to recent taxpayer favourable case-law – has not been changed. The rule that would deny the (partial) exemption of certain (deemed) dividends for individuals (50% exemption) and corporations (95% exemption) if the corresponding income did not reduce the tax base of the company paying the dividend also has not been modified.

A significant amendment compared to the first draft is a rule relating to the treatment of hidden contributions. According to the proposed change, a hidden contribution that reduces the income of a parent company would lead to a corresponding adjustment (i.e. increase) of the income at the level of the subsidiary. The broad wording of the law suggests that the German tax authorities may also apply this rule in a cross-border context, i.e. where a nonresident parent company makes a hidden contribution to a German resident company, which is treated as a business expense under foreign law.

The timetable for the further legislative process suggests that the required hearings in the upper and the lower houses of parliament will take place from September to November 2006, with the final law to be adopted in mid-December 2006.

2008 Tax Reform

The 2008 tax reform has been subject to ongoing discussions at a government and interest group level. For detailed coverage of the reform plans, see GTLN 7/2006. The governing coalition parties have apparently now agreed on the following principles:

- The corporate income tax rate should only be reduced to 15% (rather than 12.5% as previously discussed). However, since the trade tax multiplier should be reduced at the same time, the combined overall tax rate still would be between 29% and 30% (as compared to the current 39%).
- A number of different models have been discussed to limit the fiscal shortfalls of the tax reform plans. The models mainly focus on the deductibility of interest (and potentially other expenses) for corporate income tax and trade tax purposes. A "minimum



tax," which limits the amount of taxable income (before interest deductions) that can be reduced by interest expense (to 60%) currently seems to be the preferred option. Excess interest could potentially be carried forward and used to offset income in subsequent fiscal years although this is a controversial point.

The discussions on the various models will have to be monitored with the proposed alternatives likely to change significantly over the next few months. A first draft of the law is currently expected for the end of 2006.

Court Decisions

Solidarity Surcharge is in compliance with the constitution

The „solidarity surcharge“, introduced in 1991 to finance German reunification, was initially limited to a one-year period, but was later reintroduced in 1995. The solidarity surcharge is currently calculated at 5.5% of the amount of (corporate) income tax.

The German Federal Tax Court (BFH) recently held that the solidarity surcharge is in line with German constitutional law. The claimants had argued that the surcharge is an unconstitutional „extraordinary tax“ due to the lack of a temporal limitation and it violates the principle of proportionality. The BFH concluded, however, that simply because the surcharge is not limited in time (a temporal limitation is not a feature of a supplementary duty according to the BFH) does not make the surcharge a supplementary duty. The BFH also rejected the argument that the surcharge imposes a disproportionate tax burden.

The case only involved 2002 and there is no indication about the legitimacy of the solidarity surcharge for subsequent years. Although it is unlikely that the court would reach a different conclusion, the German Association of Taxpayers has filed a constitutional complaint. If the German Supreme Constitutional Court formally accepts the complaint, it will decide whether the solidarity surcharge is compatible with the constitution. The complaint also aims to clarify the constitutional aspects of the application of surcharge for years later than 2002. Therefore, assessments to the solidarity surcharge should be appealed until the Supreme Constitutional Court rules on the case.

BFH rules on trade tax exemption for real estate companies

Under the German Trade Tax Act, a company engaging exclusively in the management of its own real property can enjoy a trade tax exemption for income derived from the real estate management (i.e. rental income). Generally, other business activities performed by the company prevent the company from making use of the trade tax exemption – regardless of the extent of such other activities – unless the activities are explicitly mentioned in the provision as ancillary activities. In practice, especially the leasing of fixtures (which are treated as movable assets for tax purposes, but which are part of real estate from a factual perspective) together with the real estate gives rise to issues, since the income from the leasing of fixtures is treated as business income under German tax law.

The BFH recently issued a decision on whether immaterial income from the leasing of fixtures prevented a company that was engaged in real estate management from relying on the trade tax exemption. The BFH held that even an immaterial portion of business income resulting from the leasing of fixtures (1.8% in the case) was harmful for the trade tax exemption. While the official headline of the case suggests that this should apply in general, the facts of the case and the explanations given by the BFH suggest that the BFH could take a different view in other cases. In the case, the fixtures were not located on real estate that was owned by the real estate management company and leased to their customer, but rather were located on premises not owned by the real estate company itself. This is unusual – in most cases, the fixtures are actually located on real estate owned by a real estate management company and leased to the lessee together with the real estate. The BFH explanation (different to the official headline) suggests that in typical cases, a taxpayer may be able to rely on the trade tax exemption if the leasing of the fixtures is closely connected to the management of the company's own real estate, is located on the real estate and if it constitutes an integral part of the economic use of the property. It remains to be seen whether this view will be confirmed in future case law. Foreign investors using foreign vehicles not having a permanent establishment in Germany do not need to rely on the trade tax exemption because they are not subject to trade tax under current rules.

Local tax court subjects conversion of a partnership into a corporation to RETT

Earlier this year, the local tax court of Munster issued a decision which seems to be the first case dealing with whether a conversion of a partnership into a corporation can trigger real estate transfer tax (RETT) at the level of the shareholder (rather than at the level of the company).

The tax authorities, case law and professional literature unanimously agree that a conversion of a real estate holding company does not trigger RETT at the level of that company. The Munster court decision addresses the question whether a conversion of a real estate holding partnership into a corporation may lead to a so-called unification of shares „in one hand“ at the level of the shareholder. In addition to the direct transfer of real estate, the German RETT Act defines the unification of shares in a real estate holding company as a taxable event. A unification of shares generally occurs if a share transfer results in a 95% shareholding being held by one person, one company or a group of companies. If the real estate holding company has the legal form of a partnership, a 100% threshold must be met (including the 0% participation of the general partner). The tax court of Munster decision now states implicitly that such a transfer of shares can be realized by way of a conversion.

In the case, the interests in the real estate holding partnership were held by two companies, one (A-AG) holding 100% of the profit rights, the other one, a non-affiliated company, with no equity or profit interest but responsible for management. Thus, no unification of shares existed at the level of A-AG according to the RETT Act. In the course of the conversion of the partnership into a GmbH, A-AG became the sole shareholder of the GmbH. Thus, the tax court held that the requirements of a unification of shares were met at the level of A-AG because the required threshold applying to the shareholding in a real estate owning corporation had been met for the first time.

The case is now pending before the BFH. It is expected that the conversion of real estate owning partnerships into corporations will now become a focus of the tax authorities. The decision should, however, not be relevant in case of conversions of real estate holding corporations into partnerships.

New Case law on Extraordinary Depreciation of Fixed Assets

Extraordinary Depreciation of Depreciable Fixed Assets

In a decision dated 14 March 2006, the BFH for the first time addresses the issue of when a „presumably permanent decline in value“ of depreciable fixed assets can be presumed. This requirement must be met since 1999 if assets are to be extraordinarily depreciated to a lower going concern value in the tax balance sheet. The court approves the tax authorities' opinion, according to which a presumably permanent decline in value can be generally presumed if, as of the balance sheet date, a depreciable fixed asset's going concern value is presumably lower than its respective book value for at least 50% of the remaining useful life of the asset. However, the court leaves open whether a different conclusion would apply if it can be demonstrated that the depreciable fixed asset cannot be sold in the future for its respective book value, but only for a lower amount. Therefore, it could be helpful to provide such evidence in the future. As the decision only covers depreciable fixed assets, it remains to be seen how the Federal Tax Court would decide in the case of non-depreciable fixed assets (see below for a Lower Tax Court decision on this issue).

Extraordinary Depreciation of Non-Depreciable Fixed Assets (Shares)

The Lower Tax Court of Cologne recently decided a case regarding a decline in the value of listed shares. The shares were purchased by a GmbH in spring 2001. In the 2001 balance sheet, the shares were treated as a long-term investment and accounted for as fixed assets. As of 31 December 2001, the shares' market value had decreased to nearly 50% of the acquisition cost. Therefore, an extraordinary depreciation was recorded in the statutory and tax accounts. The Lower Tax Court denied the extraordinary depreciation for tax purposes because there was no adequate evidence for a presumably permanent decline in value of the shares. Rather, the court regarded the decline in value as a mere value fluctuation without a permanent character.

The court stated that the extraordinary depreciation of non-depreciable fixed assets is only acceptable for tax purposes if there is a presumably permanent decline in value, i.e. as of the balance sheet date the asset's going concern value is presumably lower than its respective book value for a significant period. Because of the lack of a useful life of non-depreciable fixed assets, the court applied a period of at least five years. As a result, an extraordinary depreciation of shares which qualify as fixed assets would only be possible under the court's decision if there are exceptional facts that justify the presumption of a permanent decline in value as opposed to a mere value fluctuation, typical for listed shares. According to the decision, the burden of proof for a permanent decline in value is on the taxpayer. In cases of doubt, a mere value fluctuation will be presumed. The Lower Tax Court has admitted an appeal to the Federal Tax Court so the decision is not final. The question is relevant for past assessment periods only, because in general since 2001, extraordinary depreciations of shares are nondeductible (50% deductible in the case of individuals) for tax purposes.

Administrative Guidance

Administrative guidance on Reorganization Tax Act

The BFH recently ruled that a taxpayer could step up the tax book values of the assets of a partnership upon conversion into a corporation based on special rules in the German Reorganization Tax Act (see GTLN 2/2006 and GTLN 9/2004). The BFH decision overruled official guidance of the tax authorities, according to which a step-up was not possible because of general principles of German GAAP. In recently published guidance, the BMF now agrees that the BFH decision should be applied on a general basis to conversions of partnerships into corporations and repeals the section in the old guidance which the BFH decision related to. A step-up may be beneficial for taxpayers as it enables them to increase future depreciation/amortization of the assets by stepping up the assets' values, while at the same time allowing the gain from the step-up (at least partially) to be offset against tax loss carryforwards (subject to minimum tax rules).

Interestingly, the guidance only mentions conversions, but not other cases (e.g. mergers) in which a similar issue may arise. Unpublished guidance issued by the tax authorities in Berlin suggests that the tax authorities intend to retain the old guidance for transactions other than conversions, so that a taxpayer cannot elect the tax valuation of assets transferred in a corporate merger independently from the German GAAP valuation. It can be expected that the tax authorities would be unable to uphold this position in future court proceedings. Unfortunately, a case addressing the step-up in cases of a merger was recently decided on other grounds, so that the Federal Tax Court did not have to answer the question.

Federal Ministry of Finance issues guidance regarding MAP

On 13 July 2006, the BMF issued guidance regarding the mutual agreement procedure (MAP) under tax treaties and the EC Arbitration Convention, respectively. The publication will serve as a guideline for taxpayers that intend to apply for a MAP to avoid double taxation.

The first part of the guidance contains general information regarding the legal nature and basis of the MAP, applicable provisions and the procedure's object and purpose. If proceedings fall under the Arbitration Convention, the tax authorities involved are required to reach an agreement, while this obligation is usually absent in tax treaties. The guidance comments on the MAP under a tax treaty and provides detailed information about procedural requirements such as content, timeframe and the competent authorities. Thereafter, the guidance then details the MAP and the subsequent mandatory arbitration procedure under the Convention.

The Federal Ministry of Finance is placing transfer pricing high on its agenda, focusing on enhancing the transfer pricing knowledge of tax auditors to increase the frequency and intensity at which transfers pricing issues are reviewed in tax audits. Where tax audits lead to tax adjustments, taxpayers have the opportunity to apply for a MAP to avoid double taxation. The Federal Ministry of Finance guidance should provide important information and support for taxpayers concerned in their further proceeding.

Deloitte News

Frankfurt Breakfast Series

Deloitte Frankfurt regularly hosts breakfast meetings discussing international tax developments from EU, U.S. and German perspectives. The next breakfast meeting will take place on 4 October 2006 at 8.30 am in Deloitte's Frankfurt offices, with the topic still to be determined. If you are interested in attending and/or would like to receive invitations for upcoming breakfast meetings, please contact Ms. Ebru Özüaydin (eoezueaydin@deloitte.de). The breakfast meetings will be conducted mainly in German.

IIR Corporate Tax Congress 2006

IIR Ltd. will be hosting its Annual Corporate Tax Congress on 26 and 27 September 2006 discussing the major tax developments of the year 2006 in a number of plenary sessions and break-out sessions. Practitioners of Deloitte Munich will give a presentation in the afternoon of 26 September 2006 focusing on tax planning for investments into the EU and the Mutual Agreement Procedures and the EU Arbitration Convention. To register, or for more information, please contact IIR Ltd. (registration@iir-conferences.com or www.iir-conferences.com/taxcongress). For a special discount on all registrations through Deloitte, contact Lolita Blankenstein (lblankenstein@deloitte.de).

Seminar on current developments in international tax planning

Deloitte Germany will host a seminar on risks and opportunities of cross-border investments on 29 September 2006 in Frankfurt discussing current tax developments in a number of countries from both a local and a German perspective. The focus of the seminar will be cross-border tax issues and planning opportunities for German companies investing abroad with an update on current tax developments in a number of EU and non-EU jurisdictions. The seminar will be conducted mainly in English. If you are interested in attending and would like to receive a detailed program, please contact Lolita Blankenstein (lblankenstein@deloitte.de).

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

Editors

Christian Ehlermann
+49 89 29036-8114
cehlermann@deloitte.de

Dr. Andreas Kowallik
+49 89 29036-8684
akowallik@deloitte.de

Katja Nakhai
+49 89 29036-8602
knakhai@deloitte.de

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