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3|2009

German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

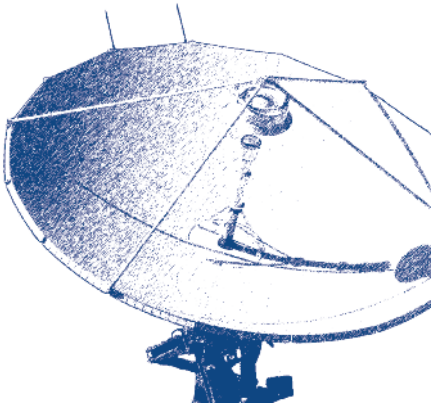
Legislative Update

Change-in-ownership rule and interest deduction limitation rule may be relaxed

The conservative-dominated Finance Committee of Germany's Upper House of Parliament (Bundesrat) passed a proposal on 3 April 2009 asking the German Lower House to consider an amendment to the change-in-ownership and interest deduction limitation rules. Once finalized, these amendments would provide temporary relief to German companies affected by the current economic downturn.

If taken up by the Lower House, under certain (and, in practice, probably limited) circumstances, the proposal would provide an exception to the application of the change-in-ownership rule for share transfers relating to qualifying restructurings of companies in the years 2008 through 2010. The proposal also would provide for an increase in the de minimis threshold under the interest deduction limitation rule from EUR 1 million to EUR 3 million for the same period.

The draft proposal on the change-in-ownership rule, which disallows tax losses, includes the following elements:



- The rule would not apply where the ownership change is related to a "qualifying restructuring" in the years 2008 through 2010.
- A qualifying restructuring would be defined as measures taken to prevent or eliminate a situation of over-indebtedness or illiquidity/insolvency if the measures ensure that the main structural characteristics of the business remain unchanged. A qualifying restructuring would need to meet one of the following requirements:
  - There is an agreement between the works council and the management of the company designed to protect and maintain jobs and the agreement is adhered to by the parties; or
  - Within five years following the restructuring, total wages are not less than 400% of a certain wage amount before the restructuring (i.e. the total per annum must, on average, not have been reduced to less than 80% of a certain annual wage before the restructuring); or
  - Substantial new business assets are injected by way of contributions (with debt waivers regarded as equal to contributions). Substantial new business assets would be considered contributed if, over a 12-month period after the share acquisition, contributions amount to at least 25% of the previous year's tax balance sheet assets.
  - Similar cases of restructurings also could fall within the scope of the rules if they are considered comparable to one of the above examples.

A restructuring would not qualify if the business had ceased its business activities at the time of the change in shareholders or if the line of business is changed within five years following the share transfer.

Details of how these rules would be applied are unclear. Based on the explanatory statements to the proposal, it appears that a qualifying restructuring would only be presumed if a formal restructuring plan (which is normally based on detailed guidelines issued by the German Institute of Certified Public Accountants) has been prepared. The burden of proof would be on the taxpayer to demonstrate that a qualifying restructuring exists. The explanatory statement would also deny the existence of a qualifying restructuring if the restructuring situation is intentionally planned.

Changes to the proposal are still possible, so affected taxpayers should not take any action on the basis of the current proposal, but they should closely monitor the continuing legislative process.

Upper House passes Act on Modernization of Accounting Regulations

After four years of discussion, the Upper House passed the Act on Modernization of Accounting Regulations on 3 April 2009. The final version of the Act includes most of the major amendments included in the draft bill dated 21 May 2008 (see GTLN 8/2008). In general, the rules will take effect for fiscal years beginning after 31 December 2009, although an election for the application of the new rules in the 2009 financial statements also should be possible.

The Act serves three main purposes: deregulating existing accounting rules, modernizing German GAAP as an alternative to IFRS and implementing certain EU directives. For German taxpayers, the most relevant provisions are:

- Book-tax conformity principles are maintained, but further differences between German GAAP and tax accounting are created.
- The concept of reverse book-tax conformity between German GAAP and German tax balance sheet is eliminated. Thus, in the future, taxpayers will be able to select a particular optional tax treatment without the requirement of a corresponding German GAAP treatment (as an example, this amendment will be relevant for certain investment relief reserves). An additional obligation for taxpayers was introduced into the Income Tax Code to keep separate and special accounts for assets and liabilities that are treated differently for tax purposes.
- The proposed mark-to-market valuation rule for financial instruments held for trading was not incorporated into the final version (except for financial institutions).
- The proposed obligation for the capitalization of certain development costs for self-developed intangible fixed assets has been changed to an option right in the final version. If a company elects to capitalize self-developed intangible fixed assets, the resulting equity will not be available for distributions. The tax treatment of the self-development costs remains unchanged.
- Valuation of accruals will be revised to provide a more realistic view of a company's future obligations. The valuation of accruals will take future cost developments into account and must be discounted. This is likely to lead to an increase of accruals (e.g. in pension accruals). Companies will have the option to build up the accrual over a certain time period. The tax treatment of accruals will remain unchanged.
- The practice of offsetting certain assets and corresponding liabilities against each other has been codified in the German commercial code. Contrary to the draft, the accounting units have to be recognized accordingly for tax purposes.
- Deferred tax assets and liabilities will be determined using a balance sheet approach (temporary concept). The capitalization of deferred tax assets will be optional whereby the capitalization of a deferred tax liability will be mandatory.

Several new rules regarding the contents of the balance sheet and income statement have been introduced to increase the informative value of the financial statements. In addition, a corporate governance statement and a description of the main features of the accounting-related internal control and risk management systems were added as a mandatory part of the management report.

A detailed alert on the practical implications of the law change for German tax reporting will follow shortly.

Court Decisions

BFH rules on "held for trading" exception

Dividends and capital gains from the sale of shares in corporations are, in principle, exempt from German corporate income tax. Only 5% of such income is deemed to be nondeductible business expenses, which effectively results in a 95% exemption for dividends and capital gains from the sale of shares for corporate taxpayers. This tax exemption, however, is not applicable to shares held by credit and financial services institutions within the meaning of the German Banking Act (KWG) if the shares are allocated to

the trading book. The same principle applies to financial institutions if the shares are acquired with the objective of realizing short-term profits from trading activities. In these cases, dividends and capital gains are fully taxable (the "held for trading" exception).

The Federal Tax Court (BFH) clarified in a recently published decision that regular holding companies and investment companies also may be deemed to be "financial institutions" within the meaning of the "held for trading" exception and confirmed the view of the court of first instance (see GTLN 8/2008). Further, according to the BFH, the decision to generate short-term profits is taken at the time the shares are acquired. Actions aimed at raising the value of the investment do not influence this classification.

Significantly, the BFH was not obliged to comment in detail on the highly controversial question of what is considered "short-term" for purposes of the rule because the shares were recorded as current assets in the company's financial statements and were sold two months after their acquisition.

German resident holding companies should be prepared to properly document their intention to hold the shares in their subsidiaries for a medium- to long-term period. Failure to do so may result in a 100% taxable (rather than a 95% exempt) capital gain and 100% taxable dividend income. However, should a short-term sale lead to a loss, the loss should be 100% deductible under the "held for trading" exception.

BFH rules on tax-effective write-downs of shareholder loans under pre-2008 rules

The BFH recently published a decision on tax-effective write-downs of shareholder loans under the rules that were in effect until 2007. Under these rules, only write-downs related to shareholdings were nondeductible according to the wording of the law, while write-downs on shareholder loans were not mentioned under the old rules.

After a change in the law effective as from 1 January 2008 (see GTLN Special Edition 11/2007), business expenses/losses resulting from the write-down of loans granted by a substantial (i.e. more than 25%) shareholder or related party are disallowed unless the borrower can demonstrate that it could have obtained the loan under the same conditions from an unrelated third party. Based on the explanatory statements to these new rules, the tax authorities claimed that the rule should apply retroactively to all open cases.

The BFH has rejected the tax authorities' position, deciding that the change in the law does not affect a write-down of shareholder loans effected before 2008 because the explanatory statements to the law are not a valid legal basis for a retroactive application of the new rules to periods preceding the change.

Since a write-down of a shareholder loan could not be compared to a write-down of the shareholding itself under the pre-2008 rules, the shareholder loan receivable could be written down with tax effect in the case before the court. According to the BFH, this rule applies even where the loan was granted by the shareholder during a financial crisis of the company. The BFH stated that, even though the lender's role as a shareholder may have influenced the decision to grant a loan, this was insufficient to qualify the write-down of the loan as a write-down related to a shareholding in a company under the old rules.

BFH rules on free movement of capital in relation to third countries

The BFH recently decided a case relating to the tax treatment of costs incurred in relation to corporate shareholdings in the years prior to 2004. Both foreign and domestic dividends received by German corporations were tax exempt at the time. However, while a lump-sum amount of 5% of gross dividends received was taxable as nondeductible expenses (effectively resulting in a 95% exemption) for foreign dividends, only the actual expenses incurred in relation to the shareholding were nondeductible for domestic dividends. The tax authorities have already accepted that this provision was in conflict with the fundamental freedoms of the EC Treaty in EU and EEA cases (except Liechtenstein).

The BFH's recent decision, however, extended this principle to situations involving shareholdings in third countries. The decision clarifies the BFH's general view on the applicability of the free movement of capital principles in third country cases. Based on ECJ jurisprudence, a taxpayer can only rely on the free movement of capital provision in a third country situation if – in a comparable EU-situation – the situation would not be covered by the freedom of establishment. Contrary to the tax authorities' position, the BFH primarily takes the purpose of the legislation into consideration, when determining whether the situation would be covered by the freedom of establishment in a comparable EU situation, so that even majority shareholders can rely on the free movement of capital provision if the actual rule under review applies irrespective of an ownership percentage and, therefore, does not specifically target situations covered by the freedom of establishment provision. The BFH did not submit the case to the European Court of Jus-

tice (ECJ), holding that the issue was clearly resolved under the ECJ case law, rendering another reference for a preliminary ruling unnecessary.

By applying the free movement of capital provision on a majority shareholding in a third country entity, the BFH clearly contradicted the position of the tax authorities but follows the principles of its earlier decision of August 2006. After the BFH's 2006 decision, the tax authorities issued a decree not to apply the decision to cases other than the one before the court. The BFH confirmed its view in this new decision, which usually means that the court's reasoning must be applied in all similar cases. Although it would be a rather uncommon step, the tax authorities are rumored to be considering another decree not to apply this (second) decision, possibly necessitating yet another court case on this issue. German corporations with third country shareholdings should nevertheless critically review whether they could benefit from the BFH decision for the years prior to 2004.

European Commission refers Germany to ECJ over discriminatory tax treatment of outbound dividends

The European Commission announced in a 19 March 2009 press release that it has decided to refer Germany to the ECJ with respect to the domestic tax provisions governing withholding tax on dividends paid to foreign corporate shareholders.

Under the German tax rules, dividends paid by German corporations are generally subject to a 26.375% statutory withholding tax (including solidarity surcharge), regardless of whether the dividends are paid to a domestic or a foreign shareholder. A German corporation receiving dividends can credit the withholding tax against its own corporate income tax liability, even though the dividends are effectively 95% tax exempt, and the credit may result in a refund if the withholding tax levied exceeds the total corporate income tax due. Except for cases where the EC Parent-Subsidiary Directive applies, the withholding tax (which may be reduced under a tax treaty) on dividends paid to nonresident shareholders will result in a final tax liability unless the shareholder's home country effectively provides for a credit for German withholding tax. The Commission views this different treatment as an infringement of the free movement of capital provision in the EC treaty and the EEA agreement.

The infringement proceedings should mainly have relevance for dividends paid to EU/EEA resident corporate portfolio shareholders, but also may be relevant in other cases where a refund of withholding tax under a tax treaty or the EC Parent-Subsidiary Directive is not available, e.g. certain types of deemed dividends triggered in reorganization transactions, distributions of liquidation proceeds or distributions on certain types of hybrid instruments that qualify as equity for German tax purposes. It may also have relevance for cases where a refund of withholding tax is not granted under the anti-treaty shopping rule because the strict substance requirements are not met, but where the case does not qualify as abuse from an EC law perspective (i.e. it does not constitute a "wholly artificial arrangement" under ECJ case law). This may, for instance, be the case if the shareholder has some substance and a business purpose but fails the additional requirement that 10% of its gross earnings would have to be derived from its own business activities.

EU and EEA (except Liechtenstein) resident shareholders potentially affected by the infringement proceeding should file claims for a refund of withholding taxes. Given the currently unclear procedural situation, claims should be filed as soon as possible with both the Federal Tax Office and the local tax offices competent for the distributing entities. Liechtenstein and third country resident taxpayers should decide whether to file withholding tax claims on a case-by-case basis (see BFH decision on the interpretation of the free movement of capital provision in relation to third countries above).

Administrative Guidance

Hannover tax authority publishes further interpretation on 2003 BMF decree on tax abatements

The regional tax authority in Hannover published additional guidance regarding the 2003 BMF decree on tax abatement in cases of corporate restructurings. According to the BMF guidance, the authorities may grant advantageous tax treatment to companies involved in restructurings to prevent their financial collapse and bankruptcy (e.g. deferral or waiver of tax liabilities resulting from restructuring measures such as debt waivers by third party creditors). The new guidance of the Hannover tax authority seems to be driven by the renewed relevance of the 2003 decree in the current economic downturn and some recent court decisions that added uncertainty regarding the decree's legal basis and, thus, its applicability.

To benefit from the tax abatement regime, taxpayers must demonstrate that (i) they need a restructuring, (ii) they can still be restructured and (iii) the measures are suitable to achieve a restructuring. The recently published interpretation of the regional tax office defines some of the objective circumstances that must be met by a company to qualify for the benefits of the 2003 decree.

According to the decree, the current economic situation of the company must demonstrate an obvious need for reorganization. According to the Hannover tax office, this can be shown by the following factors: the profit situation, the amount of business assets before and after the reorganization, an analysis of the general return on investment, the resources to pay taxes and other debt and, finally, the general performance of the company or group. The need for restructuring will be obvious if the company is insolvent and faces bankruptcy. On the other hand, negative equity (i.e. over-indebtedness) alone is insufficient if insolvency is not imminent and the other circumstances (e.g. turnover, operating margin, etc.) do not indicate a collapse of the company.

Moreover, the company's future situation must allow a recovery. This decision must consider all circumstances that could affect future earnings, such as the overall debt position, waived tax amounts, reasons that led to the company's economic situation and general future earnings. As noted in the 2003 decree, the company must demonstrate that the restructuring measures are a suitable instrument to support a successful reorganization and to prevent bankruptcy. Furthermore, creditors must intend to support the restructuring of the debtor by agreeing to the restructuring measures (e.g. waiver of receivables).

Tax authorities apply BFH decision on write-down of financial assets to lower fair market value within certain limitations

The BFH recently held that a write-down of publicly listed financial assets can be performed with tax effect when the respective share price as of the balance sheet date is lower than the historical acquisition cost and no clear indication for a recovery in value is given (see GTLN 3/2008).

The tax authorities have now decided to apply the decision to the valuation of publicly listed financial assets on a more general basis. However, some arbitrarily defined thresholds have been introduced. Thus, the impairment will only be acknowledged for tax purposes if the share price of the respective financial asset falls short of the historical acquisition cost by more than 40% as of the respective balance sheet date. Alternatively, a decrease in value by more than 25% as of the current and preceding balance sheet dates will be accepted.

Other – Upcoming Deadlines

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 were made below fair market value under the 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 (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 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 2008 need to prepare the transfer pricing documentation by 30 June 2009 to meet the contemporaneous documentation requirements.

Deloitte News

Real Estate Tax News

Deloitte's German Real Estate Tax Service Line recently published a newsletter covering the impact of the Annual Tax Act 2009 on German real estate investments. If you would like to receive a copy, please contact Petra Peffermann (ppeffermann@deloitte.de) or Bettina Lieber (blieber@deloitte.de).

Deloitte European Tax Briefings

Deloitte regularly hosts English language tax webcasts on current European tax developments. The tax briefings, which are free of charge, are designed to bring tax executives up to speed on European tax developments.

Upcoming tax briefings, which will take place at 8.30 am and 12.00 noon (UK time), will address the following:

13 May 2009: An approach to analysing, setting and managing the effective tax rate

Please email taxdeloitteeuropeanbriefing@deloitte.co.uk if you would like to attend the next tax briefing and/or would like to receive an agenda.

IIR International Tax Seminar

From 18-22 May 2009, 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-events.com/ITS).

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