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# German Tax & Legal News

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## Annual Tax Act 2008 Adopted by Lower House – Overview of Major Proposed Tax Law Changes

The German Lower House of Parliament adopted the Annual Tax Act 2008 on 8 November 2007. The Bill is scheduled for discussion in the Upper House on 30 November 2007, although additional significant changes are not expected. The Annual Tax Act 2008 is different from the 2008 Business Tax Reform (which, among other changes, substantially lowered the German tax rates and introduced new rules on interest deductibility, see GTLN Addendum 7/2007) and includes a number of other changes, most of which will be effective from 2008.

The Annual Tax Act 2008 as adopted by the Lower House includes several changes to the first draft of the law (see GTLN 6/2007), some of which, if enacted, could have significant implications for taxpayers. Notably, the highly controversial proposal for a far-reaching disclosure obligation for certain types of international tax planning ideas (see GTLN 6/2007) has apparently been abandoned for the moment.

Even though the legislative process on the Annual Tax Act 2008 has not been finalized, taxpayers should already start examining their tax positions to determine whether any action needs to be taken before year end. In all cases, affected taxpayers should discuss any steps to be taken with their tax counsel.

The following table highlights key proposed changes relevant to foreign investors with German business entities or German source-income and describes possible steps that may be considered to respond to these changes, if enacted.

| Annual Tax Act 2008 – Proposed Changes | Effective Date |
|---|---|
| **1. General anti-abuse rule** | |
| The Annual Tax Act 2008 adopted by the Lower House includes a modified revision of the general anti-abuse rule as compared to the first draft of the law. According to the legislative documents, the modification aims to enhance the precision and effectiveness of the rule. However, the proposed law is still likely to create substantial uncertainty for future tax planning transactions because it considerably expands the current general anti-abuse rule.<br><br>The decisive criteria for application of the proposed new anti-abuse rule would be whether the taxpayer or a third party generates a tax benefit from a particular structure that is not intended by the law. Furthermore, the structure would have to be "inappropriate" (as compared to "unusual" in the first draft). The burden would be on the tax authorities to prove the existence of both factors, but the taxpayer would need to show valid business reasons to justify its chosen structure.<br><br>In addition, the draft law includes a clear ranking order, i.e. specific anti-abuse rules according to applicable tax codes would have to be applied as a first step. If such rules do not apply, the general anti-abuse rule would be relevant. It would appear that, even if certain structures do not fall within the scope of the specific anti-abuse legislation, they still would have to be reviewed in light of the general anti-abuse rule and thus could be still regarded as abusive. | 1 January 2008 |

**Annual Tax Act 2008 – Proposed Changes** | **Effective Date**

If enacted, the new law would become effective 1 January 2008. For calendar years before 1 January 2008, the current general anti-abuse rule would continue to apply. However, it is unclear whether the tax authorities could review the ongoing tax consequences of structures implemented before 2008 in light of the new rules for tax assessments from 2008 if the changes are enacted as currently proposed.

**Potential action step**

Taxpayers should consider implementing tax planning measures with one-time tax effects in 2007 to avoid exposure to uncertainties created by the new anti-abuse rule.

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**2. Tax-effective write-downs of shareholder loans**

Tax assessment period 2008 (Tax assessment period 2008 generally means 1 January 2008 for calendar year taxpayers and FY 2007/2008 for taxpayers with a deviating fiscal year.)

As in the original draft, the proposal includes a rule that disallows business expenses/losses resulting from the write-down or transfer of unsecured loans granted by a substantial (i.e. more than 25%) shareholder or related party in the case of impairment unless the taxpayer can show that it could have obtained the loan under the same conditions from an unrelated third party (i.e. an arm's length test).

With the wording of the current draft remaining essentially unchanged from the previous version, it seems likely that the explanations to the original draft continue to be valid. Consequently, 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.

German shareholders that waive partially impaired receivables against their German subsidiaries or related parties should be aware that there may not be corresponding tax neutral treatment of the waiver at the level of the debtor and the creditor. According to jurisprudence of the Federal Tax Court (BFH), the waiver of a receivable that is partially impaired triggers taxable income at the level of the debtor to the extent the receivable is impaired. Under the new rules, however, the expenses from the waiver at the level of the creditor may not be deductible, which would lead to double taxation. According to the official explanations to the law, taxpayers may apply for equitable tax relief (i.e. a discretionary waiver of the tax) with the tax authorities in such cases.

**Potential action step**

Only limited planning opportunities are possible. One way to realize an existing impairment may be to sell the impaired receivable to a related party at its fair market value in 2007. Benefits of such transactions, however, are uncertain because the German tax authorities have indicated in administrative guidance that they will apply these principles also for years before 2008.

Taxpayers wishing to ensure that a potential future write-down of a loan will be tax effective should review their intercompany loans in light of the arm's length criteria mentioned in the explanations to the law.

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**3. Special balance sheet item for tax purposes in fiscal unity**

Applicable also for tax assessment periods before 2008

In a fiscal unity (Organschaft), deviations between the statutory profit/loss actually transferred to the Organschaft parent under a profit and loss pooling agreement and the profit/loss that is transferred for tax purposes are recognized by special items in the tax balance sheet of the Organschaft parent. This technical procedure was, so far, specified only in the Income Tax Regulations. In a reaction to a recent decision in which the Federal Tax Court rejected the view taken in the regulations, the rules according to the regulations have been proposed for codification.

If enacted, the current technical rules will be retained: a special item will be established in the tax balance sheet of the Organschaft parent in case of deviations between the statutory and tax profit/loss of the subsidiary. Upon sale or reorganization of the subsidiary, the special balance sheet item will be released with income effect to adjust the taxable capital gain (subject to the 95% exemption for capital gains).

For instance, if the statutory profit transferred to the Organschaft parent is higher than the transferred taxable income (e.g. in case of a reorganization at fair market value for statutory purposes which was carried out at book value for tax purposes), the Organschaft parent (tax neutrally) records a special item on the

**Annual Tax Act 2008 – Proposed Changes** | **Effective Date**

liability side of the tax balance sheet to avoid a permanently tax free increase in the value of the subsidiary. Upon the sale of the shares in the subsidiary, the special item will be released, thus increasing the capital gain from the sale of the shares (which would be 95% tax exempt) for the Organschaft parent.

**Potential action step**

The previous technical position will be codified with retroactive effect, thus preventing any planning opportunities.

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**4. Previously untaxed profits (EK 02)**

Tax assessment period 2008

Under current law, a distribution that is deemed to be made from previously untaxed profits (which result 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 currently is being challenged before the European Court of Justice (ECJ).

The first draft of the Annual Tax Act 2008 proposed a compulsory flat tax amounting to 3% of previously untaxed profit reserves existing as of 31 December 2006, irrespective of a distribution. This proposal is retained in the draft law adopted by the Lower House, but with the clarification that the resulting tax is to be paid in 10 equal annual instalments made on 30 September of each year, starting on 30 September 2008 (alternatively, a lump-sum payment of the net present value of the total amount can be made upon the taxpayer's application). If implemented, the full amount of the resulting tax liability should have to be recognized as a liability in the financial statements for 2007.

The draft law includes an option to address the severe consequences of the new system for former publicly owned (non-profit) real estate development companies. According to the draft law, certain real estate companies can opt to remain in the current system by filing an irrevocable application until 30 September 2008. Real estate companies are eligible for the election if they generate a majority of their revenue from the administration of real estate portfolios and if they are directly or indirectly more-than-50%-owned by public corporations, or tax exempt or non-profit corporations or real estate co-operatives.

**Potential action step**

Real estate companies should review their eligibility for the election and determine whether the election would be favorable. All affected taxpayers should compute whether the lump-sum payment of the net present value would be advantageous compared to the annual instalments.

For past distributions under the old system, taxpayers with EU parent companies should consider appealing the assessments in view of the pending proceeding before the ECJ.

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**5. Trade Tax add backs**

Tax assessment period 2008

As a result of the Business Tax Reform 2008, all German trade tax taxpayers will be affected by a new 25% general add-back to the trade tax base of all long- and short-term interest expense from 2008 (in lieu of the current add-back of 50% of interest expense only on long-term debt) (see GTLN Addendum 7/2007).

Affected interest expense items will include the financing element (as defined in the law) of rental or lease payments for immoveable assets. The add-back according to the Business Tax Reform 2008 amounts to 18.75%. The Annual Tax Act 2008 contains a correction of the Business Tax Reform 2008 in that the amount of 18.75% will be reduced to 16.25% under the proposed law.

**Potential action step**

Even though the add-back has been reduced, it is still advisable to avoid future intra-German, intragroup leases outside an Organschaft.

| Annual Tax Act 2008 – Proposed Changes | Effective Date |
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| **6. Implementation of the ECJ decision in the Cadbury Schweppes case** | |
| Changes substantially similar to the tax authorities' guidance issued at the beginning of 2007 will be made to the German CFC rules in response to the ECJ decision in Cadbury Schweppes. Taxpayers that hold more than 50% in an EU or EEA resident corporation that is subject to low taxation and that earns passive income will be given the opportunity to show that the company is both actually established in its country of residence and carries on genuine economic activities there. This "own business activity test" will not be available if the country in which the CFC is established is not covered by the EC Mutual Assistance Directive or an equivalent exchange of information clause under a double tax treaty or if the low taxation is caused by a CFC, partnership or a permanent establishment outside the EU or EEA.<br><br>The threshold for defining low taxation remains at 25% (irrespective of the general rate reduction in Germany).<br><br>**Potential action step**<br><br>Taxpayers should review their structures and determine whether they can meet the own business activity test for their EU/EEA-resident subsidiary in FY 2007 (based on the guidance issued by the tax authorities) or from FY 2008 (based on the change in the law). In future planning, the substance of the CFC will be critical to achieve the desired tax effects. | Imputation of income generated in a CFC after 31 December 2007 |
| **7. Trade Tax on capital gains in certain reorganizations** | |
| Under current law, a claw-back provision for trade tax purposes applies to the business of a partnership or an individual which resulted from a tax neutral reorganization. If the business of the partnership or the individual is sold or abandoned within five years following the reorganization, the respective capital gain is subject to trade tax. As a reaction to recent case law, the Annual Tax Act 2008 contains a provision to clarify that the taxable capital gain comprises not only the business originally transferred by the reorganization, but also the existing business at the respective partnership or individual level.<br><br>**Potential action step**<br><br>Already planned reorganizations into partnerships that would fall under the new rules from 2008 should be filed for registration with the commercial register in 2007 to ensure the application of the favorable case law of the Federal Tax Court and to avoid application of the new law. | Filing of the reorganization for registration with the commercial register after 31 December 2007 |
| **8. Extension of the definition of German-source income** | |
| "German source income" will include income from the generation of renewable energy on the German continental shelf for German corporate income tax and trade tax purposes for nonresidents. The change is aimed primarily at wind parks operating in the waters off Germany.<br><br>**Potential action step**<br><br>No planning opportunities are available, but investors should consider this aspect when planning new facilities. | Tax assessment period 2008 |
| **9. Wage Withholding Tax** | |
| The current paper wage tax card will be replaced by an electronic system. The wage withholding tax attributes will be available electronically from the Federal Tax Office (Bundeszentralamt für Steuern). | Tax assessment period 2011 |

**Annual Tax Act 2008 – Proposed Changes**

**10. Other changes**

- German notaries will be required to notify the tax authorities of the registration of a German branch of a nonresident corporation.
- Recapture rules for foreign permanent establishment losses that were utilized in Germany before a law change in 1999 will be extended indefinitely even though the recapture rules were scheduled to expire at the end of 2008.
- The minimum shareholding needed to benefit from a zero withholding tax on dividends under the EC Parent-Subsidiary Directive will be reduced to 15% retroactively from 1 January 2007 (as required by the Directive).
- For investment income received from 1 January 2008, the withholding tax declaration can only be submitted electronically to the tax office.
- Individuals who are not required to file a tax return but who file on a voluntary basis (e.g. because they expect a tax refund) will no longer be bound by a two-year deadline for the application. The two-year deadline will be eliminated for all assessment periods from 2005.
- The draft also includes changes to the German Investment Tax Act.

## Notice

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