

Draft law proposes additional relief from change-in-ownership rules

Continuation of same business operations would allow use of NOL carryforwards after a harmful change-in-ownership

Germany's Ministry of Finance (MOF) issued a first version of a draft law that would provide an additional opportunity for taxpayers to obtain relief from the general change-in-ownership rules by introducing a new net operating loss (NOL) carryforward category for "business continuation losses."

Under the general change-in-ownership rules, a direct or an indirect transfer of 50% or more of the shares in a company to one new acquirer, related parties or parties acting in concert leads to the forfeiture of NOL carryforwards, interest carryforwards and current year losses of the relevant company. A direct or an indirect transfer of more than 25% of the shares leads to a pro rata forfeiture of the above tax attributes. All ownership transfers within a five-year period are counted together for purposes of the change-in-ownership rules.

There currently are two exceptions to the change-in-ownership rules: the intragroup restructuring exception and the built-in gains exception. Under the intragroup restructuring exception, a share transfer within one group with one common 100% shareholder does not constitute a harmful change in ownership, and under the built-in-gains exception, the above tax attributes continue to be available to the extent there is taxable built-in-gain available in the assets of the loss company.

The MOF now intends to provide an additional relief measure because the two existing exceptions are not sufficient in certain cases.

Under the proposed rule (that would be incorporated in new section 8d of the Corporate Income Tax Code), the general change-in-ownership rules would not be applicable where the business operations of the loss corporation are continued and unchanged from the time of incorporation or at least during the three fiscal years before the change-in-ownership. If these conditions are fulfilled and the taxpayer files an application, the regular NOL carryforward would be transformed into a business continuation NOL carryforward. This business continuation NOL carryforward would be available for use under the general rules for NOL carryforwards, but would be forfeited if one of the following events occurs:

- Temporary or final discontinuation of the business operations;
- Change of the purpose of the business operations;
- Takeover of additional business operations;
- Participation as a partner in a partnership;
- The corporation becomes a controlling parent entity in a tax consolidated group; or
- Assets are transferred to the loss corporation at a value below the fair market value for tax purposes.

However, even if one of the above events occurs, business continuation losses still would be available if the conditions for the built-in-gain exception were fulfilled at the time of the harmful event.

Importance of continuing and unchanged "business operations"

The central criteria of the draft law is the existence of continuing and unchanged business operations of a corporation. The term "business operations" is new in German tax law and would be defined as "sustainable, complementing and supporting activities of the corporation that are based on a holistic intent to generate profits." According to the explanation by the MOF, a business operation would be defined based on qualitative criteria; the infusion of new assets in connection with an ownership change (as it was the case under the loss forfeiture rule before 2008) would not be a relevant criteria.

The MOF also provides limited guidance regarding the criterion of continued and

unchanged business operations. A change of a business would be presumed if a company's purpose in the articles of incorporation is changed or if the actual economic purpose of the business operations is changed. The following criteria would be taken into account in determining whether the business operations have been changed or new business operations have been added to the company:

- Type of services/goods offered by the company;
- Supplier base and customer base;
- Key market areas; and
- Employee base (with the analysis based on the qualification of employees rather than the number of employees).

The MOF also states that a lease of the entire business would qualify as a discontinuation of the business operations at the level of the lessor.

If approved, the new rule would be applicable for ownership transfers that occur after 31 December 2015 and would be applicable for both corporate income tax and trade tax purposes.

The draft law provides a welcome additional relief opportunity from the general change-in-ownership rules. It should be noted, however, that the draft includes several new technical terms that are not defined and where only scant guidance is available. In practice, the application of the business continuation loss rule likely would result in uncertainty in some cases.

Unlike the application of the intragroup restructuring and the built-in-gain exceptions, which apply by operation of law, the application of the business continuation exception would require the taxpayer to submit an application with its tax return for the year in which the ownership change occurred.

For loss carryforwards generated after an application is filed, the taxpayer would have the option to treat such loss carryforwards as regular NOL carryforwards or as business continuation NOL carryforwards. This option effectively would introduce two different categories of NOL carryforwards into German tax law.

Taxpayers that wish to rely on the business continuation exception from the change-in-ownership rules would face an additional compliance burden. The existence of continuing and unchanged business operations of a company would have to be documented and proven from the time the company's operations commenced (or at least for a three-year period in the past), as well as on a go-forward basis without any time limit. Changes in business activities, as well as certain corporate restructurings, could have an impact on the existence of the business continuation NOL carryforward.

It currently is unclear whether the draft law will be finalized, but potentially affected taxpayers should monitor the legislative process. The German government is expected to decide on 14 September whether to formally initiate the legislative process.

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