

The background of the top half of the page is a photograph of the Reichstag dome in Berlin, Germany. The dome is a large, glass and steel structure with a spiral design, illuminated from within, creating a warm glow. The sky is a clear, bright blue.

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2008 Tax Act: Government Draft

On 8 August 2007, the German cabinet adopted the draft of the 2008 Tax Act that it will send to the legislature. The Bundestag and Bundesrat (lower and upper houses of parliament) are expected to begin deliberations on the draft legislation after their summer recess. The enactment of the legislation into law is expected by the end of 2007. The main provisions of the legislation are outlined below.

Recapture Taxation of Carryover EK 02

The equity accounts of many corporations may still contain previously untaxed earnings classified as EK 02 under the old corporation tax credit system in force until 2001. Under current law, a disposition affecting the amount of such carryover EK 02 (e.g. distribution as a dividend) triggers tax in the amount of 3/7ths (42.86%) of the carryover EK 02 deemed used in the transaction. However, this recapture taxation lapses at the end of 2019.

The draft 2008 Tax Act provides for definitive, one-time recapture taxation of carryover EK 02 at an effective tax rate of 3%. This tax would be payable

in ten equal annual installments.

Corporations may instead elect to pay in a single installment, which would then be discounted at a rate of 5.5%. Future distributions of these equity funds would not trigger any further taxation at the level of the corporation.

Application of § 8b (3) KStG to Shareholder Loans

Under § 8b (3) sent. 3 KStG (Corporate Income Tax Law), reductions in profits arising in connection with corporate stockholdings are disregarded in determining taxable income.

The 2008 Tax Act would expand the rule of § 8b (3) KStG to cover shareholder loans in the following general situations:

- reductions in profits in connection with a loan (e.g. writedowns to going concern value, forgiveness of the unrecoverable portion of a debt claim)
- reductions in profits due to the realization of securities and guarantees given for a loan,
- reductions in profits resulting from legal acts that are the economic equivalent of a loan.

As contemplated, the new rule would deny deductions for reductions in profits that result from loans made, or comparable transactions engaged in, by (i) substantial shareholders (shareholders holding more than 25% of share capital either directly or indirectly), (ii) persons related to substantial shareholders under § 1 (2) AStG (Foreign Transactions Tax Law), and (iii) third parties with a right of recourse against the aforementioned persons.

Redesign of general anti-abuse provision

The government draft of new § 42 AO (General Tax Code) would for the first time provide a legal definition of the abusive structures at which the provision is aimed: abuse would be defined as an unusual legal arrangement that results in a tax benefit and for which no valid non-tax reasons exist.

The tax administration would first have to prove that a legal arrangement is unusual. The draft bill stipulates that an arrangement or structure is unusual if it is inconsistent with that which the legislature, in keeping with generally accepted views, assumed would be employed to achieve certain economic objectives.

Should the tax administration meet this evidentiary burden, the new legislation would require the taxpayer to demonstrate the existence of non-tax motives. Borrowing from the case law, the draft statute states that a valid non-tax reason exists where, considering the economic circumstances and objectives, an outside expert would

have structured the transaction in the same way even in the absence of the tax benefit. Under the draft statute, a taxpayer that is unable to establish valid non-tax reasons is liable for the tax that would have accrued under a conventional arrangement.

Subsection 2 of § 42 AO would also be amended to clarify that, being a general provision, § 42 AO is co-equal with specific anti-abuse provisions (such as § 50d (3) EStG – Income Tax Law) and concurrently applicable alongside them.

Further Tax Changes

Exceptions from CFC rules in EU/EEA cases

In its *Cadbury-Schweppes* decision (C-196/04), the European Court of Justice (ECJ) held that the British rules respecting imputational taxation of the income of controlled foreign corporations (CFC rules) infringe the freedom of establishment guaranteed under EU law to the extent they apply to arrangements that are not wholly artificial in nature.

The 2008 Tax Act would amend § 8 (2) AStG (Foreign Transactions Tax Law) to bring German law into line with the ECJ's decision. Under the new draft version of § 8 (2) AStG, imputational CFC taxation would not apply to the income of companies having their registered office or place of management in an EU or EEA country, provided the relevant German resident taxpayer can prove that the foreign company carries on a genuine economic activity in the country in which it is resident. The exception applies only to income related to the foreign company's own economic

activity. The planned CFC exception would not cover cases involving third countries (countries outside the EU / EEA).

Corporate Income Tax Law

The SE Introductory Act allows the creation of an adjusting item to defer taxation on outbound asset transfers within the EU (§ 4g EStG). The 2008 Tax Act would amend § 12 KStG to clarify that corporations are also entitled to establish such adjusting items.

2008 Business Tax Reform Act Promulgated

Like the Bundestag (lower house of parliament), the Bundesrat (upper house) has now also passed the 2008 Business Tax Reform Act. Following signature by Germany's president, the law was promulgated in the Federal Gazette on 17 August 2007. The principal changes made by the legislation are described in *German Tax Monthly* June 2007, page 1. The provisions of the new law will thus take effect as planned, in most cases starting with the 2008 assessment period.

Corporate Change-of-Control Rules

2008 Business Tax Reform Act

The 2008 Business Tax Reform Act establishes new change of control rules that apply as of the 2008 assessment period to transfers of shares on or after 1 January 2008. Acquisition of more than 25 percent of a corporation's shares or voting rights within a five year period by one or more related parties will trigger partial forfeiture of existing loss

carryforwards. The forfeiture of loss carryforwards is total where more than 50 percent of the shares or voting rights are transferred.

Despite the new change of control rules, prior law (§ 8 (4) KStG – Corporate Income Tax Law) will also continue to apply where a detrimental transfer of shares occurs during a five year period that begins prior to 1 January 2008 and is followed by an injection of predominantly new business assets prior to 1 January 2013.

New Guidance from the Federal Ministry of Finance

The previous position of the tax administration regarding the current change-of-control rules of § 8 (4) KStG has been that loss carryforwards are forfeited where a detrimental share transfer and the injection of predominantly new assets take place within a five year period. However, the Federal Tax Court held in 2006 that a causal relationship between a share transfer and the injection of new assets can only be inferred – by reason of mere proximity in time – if both take place within one year of each other.

In response to this high court judgment, new guidance from the Federal Ministry of Finance redefines the controlling period as two years. The new guidance further states that loss forfeiture may occur even where the two pivotal events are separated by more than two years, provided a causal relationship between the share transfer and the injection of new assets can be established.

Proposed Exemption from change of control rules for venture capital companies

Pending legislation would exempt venture capital companies from the change of control rules in certain cases (Act for the Modernization of the Legal Framework for Equity Investments). Certification as a venture capital investment company is obtained by application to the Federal Financial Service Oversight Agency (BaFin). To qualify, a company's business purpose must be to acquire, hold, manage, and sell venture capital investments; its principal place of management and registered office must be in Germany and it must meet certain other requirements.

When a venture capital investment company acquires shares in a target company (venture capital investments), the loss carryforwards of the target company would be preserved (override of the change of control rules) to the extent they are offset by unrealized appreciation (previously unrecognized reserves) in the target company's taxable domestic assets. The same applies when the venture capital company sells the investment to a third party. The preferential treatment is available only where the target company's equity does not exceed € 100 million. Furthermore, if the equity of the target company exceeds € 20 million, the permissible excess of up to € 80 million must derive from the target company's profits of the last four years. Otherwise, the change of control rules apply in unmodified form.

Non-Deductibility of Shareholding Losses Referred to ECJ

The Federal Tax Court has asked the European Court of Justice (ECJ) to decide a question arising under § 8b (3) KStG (Corporate Income Tax Law) as amended by the December 2001 Act for the Further Restructuring of Business Taxation.

At issue is whether Article 56 EC Treaty (free movement of capital) is violated where the tax law of a member state prohibits the deduction of losses arising in connection with shares held in domestic and foreign corporations, but the effective date of the prohibition on deduction of losses from shares in foreign corporations is earlier than that for shares in domestic corporations.

Under the German corporate income tax reforms taking effect (generally) in 2001, profits on the sale of shares in corporations and other corporate entities, domestic and foreign, are exempt from tax irrespective of their amount (§ 8b (2) KStG). A corresponding prohibition was enacted on the deduction of losses related to shareholdings (§ 8b (3) KStG); this applied regardless of the percentage amount of the shareholding to all losses related to the value of the shares (e.g. losses from writedowns to going concern value). However, the effective date of the loss prohibition provision for shares in foreign corporations preceded that for shares in German corporations.

In its referral order, the German Federal Tax Court states that, in its opinion, the less favorable treatment of shares in foreign corporations probably did not

deter German taxpayers from investing in foreign corporations because the disparate treatment was of brief duration and resulted from transition provisions. However, the German high court stresses that the ECJ has, in cases decided under the freedom of establishment clause of the EC Treaty (Article 43), held even "slight or insignificant" restraints to be barred by EU law. The Federal Tax Court also notes that the prohibition on deduction of losses from shares held in foreign corporations was part of the system of exemptions for dividends received and for gains on the sale of shares in corporations (so-called "half-income system") that also went into effect sooner for shares in foreign corporations. This at least in the Federal Tax Courts view

"mitigated" the discrimination resulting from the prohibition on deductions.

EU Commission Contests German Taxation of Foreign Dividends

The EU Commission has formally demanded that Germany revise its rules respecting dividends paid to foreign companies. The Commission believes that Germany in some cases imposes more tax on dividends payable to foreign companies than on those payable to German resident companies. The Commission considers this to violate the freedoms of establishment and movement of capital in the EC Treaty.

The German withholding tax on dividends is the same whether the recipient is domestic or foreign. For foreign recipients, the withholding rate can even be reduced under a tax treaty.

The discrimination to which the Commission objects arises at a different level. The Commission notes that the dividend withholding tax may become definitive for foreign dividend recipients, but is always creditable to German resident taxpayers, and contends that distributions to German residents are subject to a lower final tax rate, so that the excess withholding tax is refunded or credited against other tax liability.

The formal demand is the second step in a treaty infringement proceeding. Should the German legislature not take the requested action, the Commission can take the matter to the European Court of Justice.

Imprint

Responsible*: Dr. Martin Lenz
Head of National Tax

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Marie-Curie-Straße 30
D-60439 Frankfurt am Main

Editorial Team:

Oliver Dörfler

Dr. Markus Oblau

Dr. Gerrit Adrian

Christian Schenk

Oliver Franz

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