

A large, illuminated glass dome structure, likely a modern architectural landmark, is the background for the top half of the page. The dome is made of a grid of metal and glass panels, and it is lit from within, creating a warm glow. The sky is a clear, deep blue.

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Federal Tax Court Adopts Specific Asset Approach under Change-of-Control Rules

Losses incurred by a corporation may be carried forward without time limit provided the corporation retains both its legal and its economic identity (§ 8 (4) of the Corporate Income Tax Law). A transfer of more than 50 % of a corporation's shares coupled with a contemporaneous injection of predominantly new business assets causes the corporation to lose its economic identity and hence forfeit its loss carryforwards. The case decided by the Federal Tax Court in its judgment of 5 June 2007 (case no. I R 106/05) turned on the method by which one measures "predominantly new business assets". The court held that a specific asset approach was required.

New business assets predominate when newly acquired assets exceed the assets that are already present at the time of the detrimental share transfer. To determine what assets have been newly injected, the Federal Tax Court took a specific asset approach, which involves asset-by-asset counting of new assets. It is not permissible to net additions against disposals and

treat merely the numerical excess of additions over disposals as newly injected assets. The court therefore held that the exchange of one asset for another constituted an injection of new assets.

The Federal Tax Court's interpretation of economic identity is thus more restrictive than that of the tax authorities. The tax authorities take the position that only increases in business assets as a whole constitute an injection of assets, not the mere substitution of one asset for another. The tax administration would thus not regard the above example as involving an injection of new business assets.

The recently enacted business tax reforms contain a completely new set of change-of-control rules repealing the business asset test which are in principle applicable as of 1 January 2008. The old rules are last applicable to situations in which more than half of the shares in a corporation are transferred in a 5 year period that begins prior to 1 January 2008 and a loss of economic identity occurs prior to 1 January 2013 (cf. *German Tax Monthly* April 2007 and June 2007).

Beneficial Ownership of Corporate Stock – Prices of Packets of Shares Sold for Different Amounts – Federal Tax Court, 4 July 2007

In its judgment of 4 July 2007 (case no. VIII R 68/05) relating to § 17 EStG (Income Tax Law), the Federal Tax Court held that the grant of an option to purchase stock is generally insufficient to cause beneficial ownership to pass and give rise to a taxable capital gain.

The case involved an option to purchase a closely held German stock corporation (the target corporation). In 1993, the shareholders granted a prospective buyer the option to purchase their stock. The same year, the target corporation's share capital was increased by issuing new shares. The shareholders waived their preemptive rights with respect to these shares, all of which were purchased by a subsidiary of the prospective buyer subject to subsequent conversion into preferred shares without voting rights if the prospective buyer failed to exercise its purchase option. The prospective buyer exercised this option in 1994 and acquired the rest of the target corporation's stock at a price considerably higher than that paid for the newly issued shares the year before.

At issue in the case was whether the target corporation's shareholders realized a capital gain in 1993 that was taxable under § 17 EStG, which taxes the capital gain on sale of stock privately held by individuals with substantial ownership interests in the corporation. In order for the tax to accrue, either legal or beneficial ownership of the stock being sold must pass to the

purchaser. Legal title to the stock owned by the sellers was not transferred until the purchase in 1994. Regarding beneficial ownership, the court held that an option conveys beneficial ownership if, considering all circumstances, the option is likely to be exercised in the future. In the instant case, there were no agreements or circumstances necessitating exercise of the option by the prospective buyer. Accordingly, no capital gain taxable under § 17 EStG occurred in 1993 by reason of the option.

However, under § 17 EStG (1) sent. 3, the transfer of an expectancy interest in stock is also subject to tax. The term "expectancy interest" includes the right to subscribe newly issued stock in a corporation, hence the waiver of such rights constitutes transfer of an expectancy interest. While there was no consideration flowing to the shareholders for this waiver, the Federal Tax Court, noting the difference in the price paid for the newly issued stock in 1993 and the pre-existing stock in 1994, it held that the price paid in 1994 included payment for the 1993 waiver of preemptive rights. Accordingly, the portion of the 1994 purchase price that is allocable to the shares acquired in 1993 represents the price paid in a sale that is taxable in 1993 under § 17 EStG.

Tax Authorities Reject High Court Decision on Reversal of Adjusting Items on Sale of the Shares in a Consolidated Subsidiary

In a directive dated 5 October 2007 (IV B 7 - S-2770 / 07 / 0004), the Federal Ministry of Finance responds to the Federal Tax Court judgment of 7 Feb-

ruary 2007 (case no. I R 5/05) by instructing tax officials not to apply the judgment except in the decided case. At issue are the tax consequences of reversal of liabilities-side adjusting items in connection with tax consolidated groups. The Federal Tax Court held that a liabilities-side adjusting item in the tax balance sheet of the controlling company in a tax consolidated group should be reversed without impacting earnings when the controlling company sells the shares in its controlled subsidiary. This ran counter to the practice of the tax administration in such cases, which was to transfer the adjusting entry to revenue.

Under commercial law, a corporation can undertake to transfer its entire profits to another company. A profit (and loss) pooling agreement of this sort is recognized for tax purposes if certain conditions are met. In this case, the profits of the subsidiary (controlled corporation) are attributed to the parent entity (controlling company). Since the rules of commercial accounting differ from those of tax accounting in certain respects, the income or loss attributable for tax purposes seldom agrees with the positive or negative result actually transferred. Transfers that exceed or fall short of the corresponding figure for tax purposes are accounted for in the tax balance sheet by means of asset-side or liabilities-side adjusting items. The entry of an adjusting item is profit-neutral. If the shares in the controlled subsidiary are later sold, the tax administration insists that the controlling company retransfer asset-side adjusting entries to expense and liabilities-side adjusting entries to

revenue. The Federal Tax Court rejected this approach, holding that it lacked a basis in either statutory or customary law.

The Federal Ministry of Finance considers the judgment inconsistent with the principle of consolidation for corporation tax purposes, by which the generated income and losses are taxed only once and only at the level of the controlling company. The tax administration will accordingly persist in treating the reversal of adjusting items on sale of the shares in a controlled subsidiary as an event impacting taxable income.

Performance in Fact of Profit and Loss Pooling Agreements for Tax Consolidation Purposes: Administrative Guidance

In its directive of 15 October 2007, the Federal Ministry of Finance again addresses the requirement that the profit and loss pooling agreement between the members of a consolidated tax group be performed in fact. In 2005, Germany's highest civil and criminal court, the Federal Court of Justice, held that interest is payable as of the balance sheet date on the receivable resulting under a profit and loss pooling agreement from the right to reimbursement for losses (judgment of 14 April 2005 – case no. II ZR 361/02).

The guidance from the Federal Ministry of Finance states that neither the failure to pay interest nor the waiver of the right to receive interest jeopardizes

the tax consolidation arrangement because the contractual obligation breached is merely ancillary in nature.

German School Tuition Deduction Violates EU Law

In its judgment of 11 September 2007 (case no. C-76/05), the European Court of Justice (ECJ) holds that the German provisions allowing the deduction of school tuition payments only if paid to domestic schools violates fundamental freedoms guaranteed by Community law.

Under § 10 (1) no. 9 of the Income Tax Law, 30 % tuition paid to government certified schools may be deducted as so-called special personal expenses if paid for a child for whom the taxpayer may receive government child support contributions or claim a standard child support deduction. The deduction is currently available only for schools in Germany or for German schools in foreign countries that have received government certification or been approved by the appropriate government office.

The ECJ held that the denial of a deduction for tuition paid to schools in other EU member countries violates the freedom to provide services guaranteed by the EC Treaty if the school in question relies primarily on private financing. The court reasons that the limitation of the deduction to domestic schools deters German taxpayers from sending their children to schools in other EU member countries. It also finds that limitation hinders the offering

of education by foreign schools to the children of taxpayers resident in Germany.

The court furthermore states that the free movement of EU citizens as guaranteed by European law is also violated, even if the services offered by the foreign schools are not provided predominantly in return for payment and hence no infringement of the freedom of establishment is presented. The provisions of German tax law favoring domestic schools are considered to disadvantage EU citizens merely because they have availed themselves of their right to travel to another EU member country. The court finds that this infringes the freedom of movement.

Consequently, the income tax deduction for school tuition now applies for tuition paid to schools in other EU member countries as well.

Imprint

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