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Federal Tax Court Decision on Foreign-Source Income from Interest in Typical Silent Partnership

At issue in the Federal Tax Court judgment of 4 June 2008 was the tax treaty treatment of income derived by a domestic person from an interest as silent partner of a Luxemburg corporate subsidiary.

Under the final protocol to Germany's tax treaty with Luxembourg, income from a silent partner interest in a corporation is treated as a dividend. The right to tax dividend income is assigned by the tax treaty to the country in which the dividend recipient is resident. However, the source country is permitted to impose a limited withholding tax. The avoidance of double taxation is incumbent upon the country of residence and generally takes the form of a credit for the foreign withholding tax. However, for qualifying shareholdings ($\geq 25\%$), the country of residence instead excludes the dividend income from its tax base (so-called tax treaty participation exemption).

In the case here reported on, a German corporation (GmbH) held a direct share of 48 % in a Luxembourg corporation

(S.A.). At the same time, the GmbH held an interest as silent partner in the S.A. The share of profits derived from the silent partnership interest was subject to a 10 % withholding tax in Luxembourg. Taking the position that the tax treaty participation exemption also applied to the income from its silent partner interest, the taxpayer treated this income as tax exempt in Germany.

The Federal Tax Court held that the requirements of the tax treaty participation exemption were not met and that the income from the interest as a silent partner was therefore includible in the GmbH's taxable income, subject merely to a credit for the Luxembourg withholding tax. The court based its judgment on a narrow reading of the tax treaty provision, stating that the participation exemption applied to dividends that derived from a direct shareholding of at least 25 % ("genuine dividends"). While conceding that income from a silent partner interest was deemed to constitute dividend income under the final protocol, the court held that such income did not qualify for the participation exemption because the income did not derive from a direct shareholding.

Corrections and Amendments to the Balance Sheet

This article provides a brief summary of recent developments relating to balance sheet corrections and balance sheet amendments. High court decisions and administrative pronouncements have clarified a number of contested issues in this area.

The permissibility of changes to the balance sheet after its submission to the tax office is governed by § 4 (2) EStG (Income Tax Law). In this context, sentences 1 and 2 of the statute create a distinction between balance sheet corrections and balance sheet amendments. A balance sheet correction serves to rectify a balance sheet entry that was impermissible under commercial or tax law. A balance sheet amendment, on the other hand, replaces one permissible balance sheet entry by another equally permissible entry.

A balance sheet correction is only permissible where the original balance sheet entry violates mandatory provisions of commercial or tax law. In a judgment dated 23 January 2008, the Federal Tax Court confirms that a balance sheet entry is correct where it reflects the knowledge that a reasonable businessperson would possess at the time of preparation of the balance sheet. A high court decision handed down after preparation of the balance sheet does not render the balance sheet entries contained therein incorrect.

Further, the position of the tax authorities used to be that a balance sheet correction was possible only to the extent it related to assets or prepaid and deferred items that should not have been shown at all or that should have been shown in a different amount. This view was rejected by the Federal Tax Court in its judgment of 31 May 2007. The court instead held that changes in the composition of a business's equity due to withdrawals and contributions that are not reflected or improperly reflected in the accounts may also justify balance sheet corrections. In guidance dated 13 August 2008, the Federal Ministry of Finance acquiesces in this decision.

Section 4 (2) sent. 2 EStG permits balance sheet amendments only where they are closely related in time and in subject matter to a balance sheet correction and only to the extent of the impact of the balance sheet correction on profits. The Federal Tax Court stated in a judgment dated 27 September 2006 that no balance sheet amendment was involved where it did not become possible for the taxpayer to exercise an election until submission of the balance sheet. Only where the failure to exercise the election was due to negligence, e.g. to the failure to report a capital gain, might the rules for balance sheet amendments apply. In its May 2007 judgment, the Federal Tax Court agrees with the tax authorities that close relationship in time and subject matter between a balance sheet correction and a balance sheet

amendment is present where the changes relate to the same balance sheet and the amendment is requested without delay following the correction. Finally, in its January 2008 decision, the Federal Tax Court holds that off-balance sheet adjustments to profits do not open the door to balance sheet amendments because they do not affect any balance sheet entry.

Deductibility of Irrecoverable Shareholder Loans

At issue in the decision of the Tax Court of Lower Saxony of 3 April 2008 was the deductibility of losses on irrecoverable loans extended by shareholders to their corporations. The plaintiff corporation (the parent company) held a 100 % share in a subsidiary GmbH. The parent company had repeatedly loaned money to its subsidiary over a period of several years, during which the subsidiary's financial condition had deteriorated. The tax authorities conceded that the value of the parent company's claims for repayment of the loans was impaired as a result.

The parent company accordingly wrote down the value of its irrecoverable loans, thus reducing its taxable profits. But reductions in profits that are related to shares that can be sold tax free may not be deducted for tax purposes. According to official guidance of the Regional Finance Office of Münster dated 15 September 2005 the tax authorities treated the parent company's losses on the loans to its subsidiary as

related to the shares held by the parent in its subsidiary and refused to allow the reduction in profits.

The tax court, however, could discern no connection between the loans and the ownership interest held as business property by the parent company and therefore allowed the losses on the loans to be deducted. The court stressed that an ownership interest in a company and a loan to this company were two separate assets. In the court's view, the prohibition on deduction applied only to reductions in profits that were related to the ownership interest itself. Other assets were not subject to the prohibition, according to the court. Reductions in profits that related to these assets could therefore be deducted under general tax principles.

The decision was based on the prohibition on deduction as in force for the year 2002. However, the lower court stated that the modifications in the prohibition on deduction in following years involved no substantive changes as regards the legal issue decided by the court. Not until enactment of the 2008 Tax Act was the prohibition on deduction expressly widened to include losses on shareholder loans. The lower court's decision has been appealed to the Federal Tax Court.

Lower Court Decision on Unsecured Shareholder Loan

At issue in the (final) judgment of the Cologne Tax Court of 22 August 2007

was whether loan interest paid by a corporation to its shareholder should be treated as a constructive dividend if the underlying loan was unsecured.

A constructive dividend is defined a decrease (or a prevented increase) in corporate net worth that (i) is not based on a declared distribution of profits, (ii) reduces the corporation's profits, and (iii) is induced by the shareholder relationship. Constructive dividends are added back to profits in an off-balance-sheet calculation for purposes of determining taxable income.

In the case here reported on, the tax authorities argued that the lack of security for the loan meant that the interest payments constituted constructive dividends, which it added back to corporate profits. The tax authorities contended that a high risk of default on the loan was evidence that the loan was induced by the shareholder relationship.

The tax court rejected this approach, stating that the mere lack of a security agreement with regard to a loan did not in all cases permit the inference that the interest payments were induced by the shareholder relationship. Security agreements were, in the court's view, not an end in themselves. They could accordingly only be required where an unrelated third party would, under the same circumstances, have demanded security. The court stressed that all facts and circumstances must be considered when deciding whether a constructive dividend has been paid.

Tax Exemption on Sale of Shares

The capital gain realized by a corporate entity on the sale of shares in another corporate entity is generally 95 % tax exempt (§ 8b (2) and (3) KStG – Corporate Income Tax Law). There are, however, exceptions to this rule, one of which applies to sales of shares acquired by a financial business with the goal of deriving a short-term proprietary trading gain (§ 8b (7) sent. 2 KStG).

In a judgment dated 26 January 2008, the Hamburg Tax Court held that holding companies having the acquisition and holding of ownership interests as their principal activity may constitute financial businesses of this sort. Since the entire income of the company in question derived from ownership interests held, the tax court was not obliged to decide precisely what requirements must be met in order to find that the acquisition and holding of ownership interests constitutes an entity's principal activity.

The second requirement to be met under § 8b (7) sent. 2 KStG in order to deny the exemption is acquisition of the shares with the goal of deriving a short-term proprietary trading gain. The tax court stated that the shares need not be marketable on a functioning market in order for this requirement to be met. The determination instead turned on marketability in an abstract sense, according to the court. The case before the court involved the sale of shares in a GmbH. Noting that the shares were legally transferrable and

could be sold on short notice to realize the difference between the purchase and sales price, the court held that the shares were sufficiently marketable. Neither the need for notarial recordation of the sale nor the necessity of consent by the other shareholders were impediments to marketability, in the court's view.

The lower court did not comment on the controversial question as to the length of time that may be regarded as "short-term" for purposes of § 8b (7) sent. 2 KStG.

The lower court's decision has been appealed to the Federal Tax Court. How the high court will decide the various disputed issues surrounding § 8b (7) KStG remains to be seen.

Incentives for Employee Equity Ownership Plans

On 27 August 2008, the German government adopted a draft Tax Act for the Promotion of Employee Equity Ownership. The legislation is intended to make the tax environment more conducive to employee equity participations in the companies they work for. The bill is intended both to permit employees to share in their employer's profits to a greater extent and to strengthen the equity base of business entities. To this end, the bill would increase to € 360 the maximum amount that employees can receive per year free of tax and free of social insurance contributions in the form of direct ownership interests. The bill would also create new employee ownership

funds to permit employees to acquire indirect interests in their companies. This is designed to make the incentives available to the employees of small and medium sized businesses. The preferences are available only where all of a company's employees are included in the relevant plan and only where the plan is not funded by converting wages or salaries into equity benefits.

The changes would take effect on 1 April 2009.

KPMG's 2008 Corporate and Indirect Tax Rate Survey

In global competition, the trend towards lower corporate tax rates continues. By contrast, value added tax rates have remained steady. These are the principal findings of the KPMG 2008 Corporate and Indirect Tax Rate Survey. For the past 16 years, KPMG has tracked tax rates in some 100 countries, including all 27 EU member states.

The average worldwide corporate tax rate was 25.9 % in 2008. The average tax burden on corporations in EU member states is now 23.2 %. Germany reduced the corporate tax rates from 38.4 % to 29.5 % and thus continues to exceed the European and worldwide averages.

The situation as regards value added tax rates is different, however. Here, the worldwide average is 15.7 %. The average VAT rate in the EU is now 19.5 %. Germany's 19 % rate is thus slightly under the European norm.

Readers desiring more information on this subject may download the 2008 Corporate and Indirect Tax Rate Survey from the following link:

http://www.kpmg.de/docs/20080801_KPMGs_Corporate_and_Indirect_Tax_Rate_Survey.pdf

New Edition of KPMG's Investment in Germany

The updated booklet Investment in Germany provides information on a number of subjects important to those contemplating making investments or doing business in Germany.

Readers may download the latest edition of Investment in Germany from the following link:

http://www.kpmg.de/docs/Investment_in_Germany.pdf

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