

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 Decision on the Taxation of the Profits of a U.S.-LLC

The profits of a German resident individual from an interest in a limited liability company (LLC) that was treated as a partnership for U.S. tax purposes were at issue in a case recently decided by the Federal Tax Court (find detailed information on the judgment of the lower court in German Tax Monthly September 2008, p. 5). Germany has no business entity that is equivalent to an LLC. Germany therefore classifies LLCs as partnerships or corporations depending on their degree of similarity to the respective German entities. Under this approach, the classification depends on whether the specific LLC is more similar to a German partnership or a German corporation.

The court of lower instance considered that in case the LLC is treated as a partnership for U.S. tax purposes the German resident member's interest in an LLC to be comparable to an interest held by a German resident in a foreign partnership. Operations of a partnership are attributable pro rata to its German member and treated as his permanent establishment. Following this, the lower court decided that busi-

ness profits which are attributable to the U.S. permanent establishment are taxable in the U.S. and exempt from taxation in Germany, irrespective of the classification as partnership or corporation from a German point of view.

In the case reported hereon the Federal Tax Court disagreed with the lower court decision. It stated that an LLC classified as partnership was not entitled to treaty benefits. Entitled to treaty benefits was the German member. Therefore the classification of the LLC from a German point of view was decisive. Should the LLC considered to be a partnership for German tax purposes its German member earn business profits which are taxable in the U.S. In case of a corporation its German member is also subject to German tax liability, but only with respect to the LLC's distribution.

The Federal Tax Court held that the profit shares of a member of an LLC did not constitute dividend income because the LLC did not qualify as a "company that is a resident of a Contracting State", as required by the dividend article. Since the income did not address the tax treaty the distributions constitute "other income" – a catch-all

provision - for which Germany has the exclusive right of taxation under its tax treaty with the U.S. The Federal Tax Court approved the opinion of the tax authorities issued in official guidance dated 19 March 2004.

ECJ Decision in *Krankenheim Case*

At issue in the European Court of Justice (ECJ) decision of 23 October 2008 was the German tax regime regarding the treatment of losses of foreign permanent establishments applicable prior to 1999. According to that regime a German head office was allowed to take into account losses incurred by a foreign permanent establishment (PE) while calculating its income even though the tax treaty provided for an exemption of PE profits in the home state. However, the company had to provide for a recapture of those losses when the PE made profits again. This recapture did not apply in cases in which the taxpayer was able to demonstrate that the law of the PE state in general does not allow loss carryforwards.

Krankenheim GmbH operated a PE in Austria which made losses until 1990. At request of the GmbH, those losses were taken into account in calculating the taxable amount for that company in Germany. Beginning in 1991, the PE became profitable. The German tax authorities thus retrospectively taxed the losses previously deducted in the context of national taxation, in respect of the losses incurred by the PE in Austria. Krankenheim was charged corporation tax in the years its PE made profits in Austria. The losses previously incurred by that company in the PE

were not taken into account because Austria permitted deduction of losses only in cases where it was not possible to take them into account in the state where the head office was established.

The court held that the recapture restricts the freedom of establishment guaranteed by Article 31 of the EEA Agreement due to the fact that only German companies with a foreign PE are affected by the recapture. In the ECJ's view, the restriction of the freedom of establishment was justified by the coherence of the German tax system since the deduction of the PE losses and their recapture are directly linked to each other.

Since the Austrian tax laws in general allowed for a loss carry forward, but only in the specific case Krankenheim was unable to set off losses in Austria, Germany did not have to apply the exemption from recapture. The court reasoned that in the absence of any harmonized EC laws, member states retain the power to define criteria for income taxation with regard to eliminating double taxation. Therefore, a member state is not required to consider possible negative effects arising from laws in other member states. In case the combined effect of taxation in the state where the principal company of the PE concerned is situated and tax due in the State where that PE is located leads to a restriction of the freedom of establishment, such restriction has to be imputable only to the PE state.

Exit Taxation upon moving to another EU/EEA Country

Under § 6 AStG (Foreign Transactions Tax Law), individuals who have held resident tax status for 10 years or more are in principle required to pay tax on the unrealized appreciation of shares they own if they terminate such status by moving to a foreign jurisdiction. With the amendments of the SE Introductory Act (SEStEG) in 2006 the collection of tax is generally deferred without time limit or payment of interest until the shares are sold or otherwise disposed of where the destination country is a member of the EU or EEA. The deferral is applicable to all income tax assessment notices that have not yet become final.

At issue in the Federal Tax Court's order of 23 September 2008 was the conformity of the exit taxation upon moving to another EU country with European Law. The case involved a taxpayer who owned more than 50 % of the shares of two domestic corporations and moved from Germany to Portugal. The taxpayer objected to the tax assessment and claimed for the stay of execution.

The court held that § 6 AStG as amended by SEStEG does not violate European or constitutional law. The court of lower instance raised considerable doubts as to the compatibility of Germany's exit taxation in case it leads to a taxation of the respective appreciation in both countries. The Federal Tax Court did not affirm these doubts with reference to the ECJ judgment of 7 September 2006 (*N, C-470/04*). In the absence of any harmonized EC laws,

member states shall retain the power to define criteria for income taxation with regard to eliminating double taxation. Therefore, the Community Law allows the taxation of asset appreciation accruing while the taxpayer is resident in Germany at the last possible time. Should the destination country also levy taxes on the respective appreciation (as it claims that based on applicable tax treaties the right to tax capital gains is with the shareholder's country of residence), this state shall be obliged to avoid the double taxation by crediting the German exit tax against the tax liability in that state.

The court further stated that the application of deferral provisions that were enacted after the taxpayer had already moved away did not constitute unconstitutional retroactive taxation (cf. also German Tax Monthly May 2008, p. 4).

Reclassified Constructive Dividends are subject to Withholding Tax

At issue in the Federal Tax Court decision of 8 August 2008, was the question if reclassified constructive dividends are subject to withholding tax under the regime of thin capitalization rules 2002.

Interest expenses incurred with respect to long-term debts owed to substantial shareholders or parties related to substantial shareholders were reclassified as constructive dividends by German thin capitalization rules 2002, if certain conditions were met. The payer of such requalified constructive dividends could no longer deduct these payments as operating expenditures for tax purposes.

The tax authorities treated reclassified constructive dividends as capital income that is subject to withholding tax. Hence, the corporation had to retain the withholding tax on the deemed dividends and remit such tax to the tax authorities.

In the decision reported hereon the interests paid to a silent partner were requalified as constructive dividends according to the thin capitalization rules 2002. The corporation made payments to the silent partner without retaining withholding tax.

The Federal Tax Court agreed with the tax authorities that requalified constructive dividends are subject to withholding tax. A corporation not complying with the obligation to retain withholding tax is liable to this amount.

The thin capitalization rules have been changed essentially by the 2008 Business Tax Reform Act. According to the new earnings stripping rules interest expense in excess of interest is deductible only up to 30 % of tax EDITDA. The non-deductible interest expense is not reclassified and therefore, no withholding tax has to be retained.

Judgment of the Federal Tax Court concerning the Change-of-Control Rules

In a recent decision the Federal Tax Court comments on the change-of-control rules (find detailed information on other judgments on the change-of-control rules in German Tax Monthly November 2007, p. 1 and February 2008, p. 3). Losses incurred by a corporation may be carried forward without time limit provided the corporation

retains both its legal and economic identity with the corporate body causing the loss (change-of-control rules). A transfer of more than 50 % of a corporation's shares coupled with an injection of predominantly new business assets causes the corporation to lose its economic identity and hence forfeit its loss carryforwards.

In the case reported hereon the purpose of business of a corporation changed after a detrimental transfer of shares transfer from an active to a non-trading business. The corporation limits the business activities on tenancy of its assets. Predominantly new assets have not been injected in the considered year. The tax authorities held that irrespective of this any changes in the purpose of business causes the corporation to lose its economic identity.

The Federal Tax Court disagreed with the tax authorities and held that the economic identity of a corporation is determined by the purpose of business and its assets. The loss of economic identity requires the usage of predominantly new assets. The Federal Tax Court denies an extension of the change-of-control rules to any cases of a change of industry sector without a contribution of predominantly new assets. At least in cases where the new activity stands in close relationship to the previous loss causing activity, the loss carryforwards would not be forfeited.

The 2008 Business Tax Reform contains a completely new set of corporate loss limitation rules. The rules considered hereon are last applicable to situations in which more than half of the

shares in a corporation are transferred in a five year period that begins prior to January 2008 and a loss of economic identity occurs prior to 1 January 2013 (cf. German Tax Monthly June 2007).

Legislative Developments

Financial-Market Stabilisation Act

On 18 October 2008 the Financial-Market Stabilisation Act (Finanzmarktstabilisierungsgesetz - FMStG) became effective. The act contains several measures permitting financial institutions to strengthen their equity base and to overcome existing liquidity shortages. Therefore a special federal fund, called "Financial Market Stabilisation Fund" (FMS) was established. Acquisition or reassignment of stabilisation components of the fund inter alia may lead to a transfer of shares to the fund. The Act states, that a detrimental change in ownership in the sense of the new corporate loss limitation rules, § 8c Corporate Income Tax Act (KStG), does not occur in case of utilizing components of the fund. Losses carry forward can therefore be used further on. The exception of the loss limitation rules does not apply to corporations utilizing corresponding funds abroad.

Act on the Implementation of Tax Regulations for the Package of Measures "Employment Guarantee through Growth Incentives"

In addition, on 5 November 2008 the German cabinet enacted a package of measures, called "Employment Guarantee through Growth Incentives" to overcome the economic weakness.

This bill contains in particular the possibility of using the declining balance method of depreciation for movable assets to the amount of at most 25 %. This possibility only applies for movable assets acquired or built in a two year-period, beginning from 1 January 2009 onwards.

Promulgation of the Act for the Modernization of Limited Liability Company Law

The Act for the Modernization of Limited Liability Company Law and the Deterrence of Abuses (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG) was promulgated by publication in the Federal Tax Gazette on 28 October 2008 and hence entered into force on this date.

The law seeks to make the German limited liability company (GmbH) more competitive internationally. One of the main points of the act is the facilitation and acceleration of the corporate formation. In addition the act permits, that the GmbHs' place of management is not identical with that of their registered office; the place of management could therefore be located outside Germany.

Tax treaty with South Africa

On 9 September 2008, Germany and the Republic of South Africa entered into a new convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital. The amendment replaces the first agreement of 1973 and is predominantly based on the OECD model tax treaty.

The withholding tax on dividends to intercompany shareholders holding directly more than 10 % of the capital of the paying company is lowered from 7.5 % to 5 %. An exemption from withholding taxes on dividends for intercompany shareholders – like in most of the German tax treaties – is not implemented. Moreover, both states refrain from deducting withholding taxes on interest payments. The provisions respecting the application of the convention in cases involving tax avoidance and classification conflicts have also been updated.

The new tax treaty between Germany and South Africa does not enter into force until ratified by both countries. It will contractually be applied at the beginning of the year following the ratification. In the interim the 1973 tax treaty remains in force.

Imprint

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