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## German Accounting Law Modernization Act

On 26 March 2009, the Lower House of Parliament passed the German Accounting Law Modernization Act (Bilanzrechtsmodernisierungsgesetz – BilMoG) and the Upper House approved the Act on 3 April 2009. The legislative process will probably be completed in early summer, when the BilMoG is published in the Federal Gazette.

The objective of the reform is to make German commercial accounting law (German GAAP) a fully adequate, yet more economical and simpler alternative to International Financial Reporting Standards (IFRS). A moderate shift towards IFRS is designed to strengthen the informational function of commercial financial statements without abandoning the basic principles and features of existing accounting law. Financial statements prepared in accordance with German GAAP are to remain the basis on which permissible profit distributions are calculated and taxable income is determined.

The new rules apply for the first time to financial statements prepared for the business year beginning after 31 December 2009. They may be applied voluntarily for the previous year, but only as a whole. The exemption for sole proprietors from the requirement of keeping books (§ 241a HGB – Commercial Code) and the increase of the thresholds regarding the size classifications for corporations (§ 267 HGB) apply for the first time for annual financial statements of the business year beginning after 31 December 2007.

In accordance with one of the main aims of the BilMoG - tax neutrality - most of the planned changes in the Commercial Code do not affect the tax balance sheet. However, a separate tax accounting policy gains greater significance because of the changes in the principle of linkage (§ 5 (1) EStG – Income Tax Law).

Due to the increased differences between commercial and tax accounting, deferred taxes gain high importance in the future.

The schedule below gives an overview of the principal changes:

Section	New Regulation	Tax Consequences
5 (1) EStG	Elimination of the <b>principle of reverse linkage</b> . Under § 5 (1) sent. 1 EStG, taxpayers that carry on a trade or business have to report business assets according to German Accounting Principles (GoB), unless a different method was or is used in the context of exercising a tax election ( <b>principle of linkage</b> ).	Due to the elimination of the principle of reverse linkage, in the future tax elections can be exercised independently of the commercial balance sheet. Taxpayers who exercise tax elections are required to record the assets affected thereby in running schedules.
241a HGB	The legislation provides for exemption of sole proprietors from the <b>requirement of keeping books and preparing financial statements</b> if the net income does not exceed € 50,000 and sales revenues do not exceed € 500,000 on the balance sheet dates of two consecutive business years.	For taxpayers that carry on a trade or business, § 141 AO sets out a requirement to keep books of account and to prepare financial statements purely on the grounds of tax accounting. The criteria of § 141 AO do not entirely match the criteria of § 241a HGB. Nevertheless, most sole proprietors who take advantage of the planned exemption for commercial accounting purposes will be able to base their tax returns on cash-basis accounting in the future.
246 (2) sent. 2 HGB and 5 (1a) sent. 1 EStG	In principle, the <b>netting of assets against liabilities</b> and expenses against revenues is still prohibited, except for pension liabilities and the assets covering them; the same applies for the expenses and revenues derived from them.	A general prohibition on netting is included in § 5 (1a) sent. 1 EStG to ensure that assets and liabilities are still reported separately on the tax balance sheet.
248 (2) HGB	The prohibition to capitalize <b>self-created intangible fixed assets</b> is abolished and the capitalization is made optional, except for trademarks, publishing rights, customer lists and similar intangible fixed assets that were not acquired against payment.	Expenses related to self-created intangible fixed assets are still not to be capitalized. The expenses are to be deducted immediately as business expenses (§ 5 (2) EStG).
253 (1) sent. 2 HGB and 6 (1) no. 3a (f) EStG	<b>Provisions</b> are to be stated in the future at their settlement value on the commercial balance sheet, which means that future increases in prices and costs are to be taken into account when valuing the provision. In addition, provisions with a remaining term of more than one year need to be discounted at the average market interest rate of the last seven fiscal years corresponding to their remaining term. Provisions for pension plans and similar long-term liabilities can alternatively be discounted at an average market rate resulting from an assumed remaining term of 15 years.	The valuation of provisions for tax purposes is based on the circumstances prevailing on the balance sheet date without regard to future increases in prices and costs (§ 6 (1) no. 3a (f) EStG). According to § 6a EStG, this applies analogously for pension provisions. The discounting for commercial accounting purposes has no relevance for tax purposes, as separate tax valuation rules already apply for discounting provisions at a rate of generally 5.5% and 6% for pension provisions.
253 (3) and (4) HGB	The option to <b>write down</b> assets to a value which is no longer impacted by fluctuations (§ 253 (3) sent. 3 HGB) and the option to write down assets on the basis of sound business judgment (§ 253 (4) HGB) are removed. Regardless of the legal form of the company, an exceptional write down for fixed assets can only be carried out in cases of a decrease in value that is deemed to be permanent. For financial assets, an option for exceptional depreciation exists regardless of the legal form of the company and also for decreases in value deemed to be non-permanent.	Write downs are only permissible for decreases in value deemed to be permanent (§ 6 (1) no. 1 sent. 2 EStG).
253 (5) HGB	The <b>reversal of prior writedowns</b> when an asset recovers in value becomes mandatory for all business entities. By way of exception, no reversal of a prior writedown is permitted for <b>goodwill</b> .	The reversal of writedowns is already mandatory for all business entities when the asset recovers in value (§ 6 (1) no. 1 sent. 4 EStG).

Section	New Regulation	Tax Consequences
255 (2) HGB	The <b>cost of production</b> must include costs of materials and production costs as well as special costs of production and now also appropriate portions of materials overheads and necessary production overheads as well as the depreciation of fixed assets, to the extent that they result from the manufacturing process, which were optional before. The inclusion of costs of general administration and expenditures for social amenities of the company, for voluntary benefits to personnel and for pensions remains optional. Selling expenses and research costs are excluded from the production costs.	"Cost of production" in commercial accounting is thus harmonized with "cost of production" for tax purposes, which mandatorily include appropriate portions of materials overheads, necessary production overheads and the depreciation of fixed assets, to the extent that they result from the manufacturing process (R 6.3 EStR).
256a HGB	Assets and liabilities denominated in <b>foreign currencies</b> are converted at the mean spot rate (Devisenkassa-Mittelkurs) on the balance sheet date.	According to the principle of linkage, this revision in principle applies for tax purposes as well.
267 HGB	In view of the <b>size classifications for corporations</b> (small, medium-sized and large corporations) the thresholds for the balance sheet total and revenues are increased by about 20% (§ 267 HGB), so that more companies can take advantage of simplified accounting procedures.	
274 HGB	The method of calculating deferred taxes is now based on a balance sheet comparison of commercial and tax accounting assets (so-called temporary concept) instead of the currently applicable timing concept. <b>Deferred tax liabilities</b> remaining after netting are reported on the commercial balance sheet. The capitalization of <b>deferred tax assets</b> remaining after netting is optional. In addition, there is the option of showing deferred tax assets and liabilities on a gross basis without netting.	Due to the fact that the commercial balance sheet will differ to a greater extent from the tax balance sheet, there is an increased importance of drawing up separate tax balance sheets. Because of the implementation of the so-called temporary concept, deferred tax accounting is of even higher importance in the future and a prompt preparation of the tax balance sheet is required.
290 HGB	For the preparation of <b>consolidated financial statements</b> it does not matter anymore if the parent company holds any ownership interest in the enterprise in question. The deciding issue is whether or not a controlling influence can be exercised over a company (either directly or indirectly). Therefore, assets and liabilities of special purpose vehicles have to be consolidated as well.	The scope of consolidation has tax significance with regard to the earnings stripping rules, which limit the tax deductibility of interest as a business expense (§ 4h EStG, § 8a KStG), should the taxpayer take advantage of the so-called escape clause.
340e (3) and (4) HGB and 6 (1) no. 2b EStG	<b>Financial instruments</b> in the trading portfolios of financial institutions are to be valued at fair value minus a discount for risk. Reclassifications out of the trading portfolio are only permissible under extraordinary circumstances. Financial instruments cannot be reclassified to be included in the trading portfolio.	Financial institutions within the meaning of § 340 HGB are obligated to value financial instruments purchased for trading purposes at fair value minus a discount for risk (§ 6 (1) no. 2b EStG).

## Federal Tax Court rules on the Dividend and Capital Gains Exemption

Distributed profits by one corporation to another corporation are, in principle, tax-exempt in the hands of the recipient. Capital gains arising on the sale of shares held by a corporation are also tax-exempt, in principle. Five percent of the distributed profits/ capital gains are treated as a non-deductible business expense and added back to the taxable income. Losses on the sale of shares and write-downs due to impaired value are likewise not tax deductible.

The Federal Tax Court recently ruled in a number of cases on open issues related to the dividend and capital gains exemption.

### Holding Companies and Investment Companies can be Financial Companies

An exception from the dividend and capital gains exemption is provided for financial companies who are not required to keep a trading book, and who acquire shares with the aim of realizing short-term profits for their own account. The tax authorities always assume a profit from short-term, own-account trading if the investments are included under current assets. Until now it was unclear whether holding companies and investment companies are to be defined as financial companies within the meaning of this provision.

In its judgment of 14 January 2009 (I R 36/06), the Federal Tax Court qualified holding companies and investment companies as financial companies. The

court based its decision on the broader definition of the term "financial company". According to the court, this would cover all companies whose main activity inter alia is to acquire and hold shares.

If a holding company or investment company is considered a financial company, and if it holds the shares amongst its current assets, there is the risk that the tax authorities will not apply the dividend and capital gains exemption. Such profits would therefore be treated as fully taxable. On the other hand, losses on the sale of shares and write-downs due to impaired value which are related to the investments are tax deductible.

Corporate groups with relevant structures should examine whether or not their holding companies and investment companies should be considered a financial company, and should take timely measures to ensure that they are not unfavourably treated for tax purposes.

### Write-down to Going-Concern Value of Shareholder Loans

Reductions in profits which are related to shares in corporations (in particular write-downs to the going-concern value) are not tax deductible if the shareholder is a corporation. The 2008 Tax Act (Jahressteuergesetz 2008) extended the prohibition of loss deduction to shareholder loans with effect as of 2008 assessment period. The Act denies any reductions in profits that result from loans by substantial shareholders (direct or indirect holding of at

least 25 % of the shares), persons related to substantial shareholders and third parties with the right to recourse against the aforementioned persons. The denial does not apply if the lender can prove that an unrelated party would have made the loan on the same terms.

In its judgment of 14 January 2009 (I R 52/08), the Federal Tax Court ruled against a broad interpretation of the old provision by the tax authorities, and against the concept that the new provision merely serves as clarification. The wording of the old rule only pertained to profit reductions relating to the shares in a corporation. This refers only to reductions in the value of the substance of the shares. The fact that the loan is granted due to the shareholder relationship is not sufficient to assume a connection between the shareholding and the write-down to going-concern value of the shareholder loan.

The new rule cannot be understood merely as clarification but is constitutive. Therefore, the new rule applies from the 2008 assessment period onward; retroactive application is not possible.

Taxpayers should examine whether or not they have taken such write-downs to the lower going-concern value on shareholder loans in the past. On the basis of the Federal Tax Court judgment, these write-downs should be tax deductible for assessment periods beginning from the year 2000 until 2007.

### Non-Application of the 5% rule for Dividends from Third Countries

Under § 8b (5) KStG 2000, 5% of the generally tax-exempt dividends received by corporate shareholders are treated as a non-deductible business expense so that, in effect, only 95% of the dividends are tax-exempt.

The Federal Court had already decided, in its ruling of 9 August 2006 (I R 95/05) that the fiction of the 5% non-deductible business expenses for dividends from third countries in the assessment periods 1999-2003 violates both the freedom of establishment, as well as the free movement of capital provided by the EC Treaty.

The discrimination results of the fact that such a fiction applies for dividends from third countries from the 1999 assessment period, but only from the 2004 assessment period as regards domestic dividends. This decision was important because it held that the free movement of capital was violated, which also applies to third countries. Thus, the Federal Tax Court held that the 5% rule under § 8b (5) KStG 2000 was also not applicable to dividends paid by third countries. That this provision does not apply to dividends from EU/EEA countries because of the freedom of establishment was already recognized by the tax authorities even prior to the recent court ruling.

The Federal Ministry of Finance reacted to the judgment with a partial non-application decree. According to the decree, freedom of establishment, but not free movement of capital, should apply to holdings of more than 50%. As a consequence, the 5% rule under

§ 8b (5) KStG 2000 in view of the tax administration would continue to apply to dividends from a third country.

In its ruling of 26 November 2008 (I R 7/08), the Federal Tax Court confirmed its earlier decision of 9 August 2006. Section 8b (5) KStG 2000 not only infringes the freedom of establishment, but also the free movement of capital. Because free movement of capital also applies for dividends from third countries, § 8b (5) KStG 2000 is also not applicable for the assessment periods 1999-2003 for all such dividends regardless of their origin and the level of the holding.

The tax authorities have not yet responded to the ruling. Whether or not they will now implement it remains to be seen.

### Write-downs to Going-Concern Value of listed Shares held as Fixed Assets

Assets may be written down to going-concern value only by reason of a decline in value that is expected to be permanent. According to the guidelines contained in the Federal Tax Court's judgment dated 26 September 2007 (I R 58/06, see detailed information on the decision in German Tax Monthly March 2008, p. 3), a reduction in value of publicly traded stocks is deemed to be permanent if the market value at the balance sheet date has fallen below the acquisition costs, and, at the balance sheet date, there are no concrete indications that the price will recover in the near future. The Federal Tax Court left the question open as to whether changes in value within a certain range could be considered tempo-

rary fluctuations for simplification reasons.

In a guidance issued on 26 March 2009, the Federal Ministry of Finance stated that the principles on which the judgment was based are generally applicable. The Federal Ministry of Finance assumes a decline in value to be permanent, if, on the balance sheet date, the market price is more than 40 percent lower than the acquisition price, or if the market price was more than 25 percent below the acquisition price at both on the current and the previous balance sheet date. In other cases, the decline in value is deemed a temporary fluctuation, for which no write-down to going-concern value is possible.

The deduction of write-downs to going-concern value on shares in corporations is subject to restrictions for tax purposes. If the stock is held by an individual as a business asset, a write-down to the going-concern value is possible with tax effect to the extent of 60 % of the impairment. Profit reductions that are related to shares in a corporation are disregarded for tax purposes if the shares are held by corporate entities. There is an exception for shares in corporations that are held by banks, other financial service providers, insurance companies as well as holding companies and investment companies under certain circumstances. Profit reductions that are related to these shares are deductible for tax purposes.

### **European Commission refers Germany to the ECJ over the taxation of outbound dividends**

The European Commission refers Germany to the European Court of Justice (ECJ) for its tax provisions concerning outbound dividend payments. The Commission considers the unequal taxation of outbound dividends to be contrary to the free movement of capital and the freedom of establishment provided in the EC Treaty.

Dividends paid by a German corporation to a domestic or foreign shareholder are both subject to withholding taxes of 25% (plus solidarity surcharge). While for domestic corporate shareholders the withholding tax is fully credited against the domestic corporate tax liability, the withholding tax in principle becomes final for foreign corporate shareholders unless (at least partial) tax exemption is provided by virtue of a tax treaty. The unequal treatment leads to a discrimination of outbound dividends. This holds true for dividends paid to shareholders in EU or EEA countries that are not covered by the Parent-Subsidiary Directive as well as for dividends paid to shareholders in non-member countries.

In the rulings *Denkavit* (ruling of 14 December 2006, C-170/05) and *Amurta* (ruling of 8 November 2007, C-379/05) the ECJ held that outbound dividends may not be subject to higher taxation in the source state than domestic dividends. Since the German tax rules were not amended to comply with these rulings, the Commission decided to refer the case to the ECJ.

Attention should be paid to the fact that despite the Commission referring to the ECJ unjustified withholding tax could become final.

### **Retaining the Economic Identity in the Context of a Change of Control despite an Increase in Current Assets**

According to change-of-control-rules (§ 8 (4) KStG), the economic identity of a corporation is the precondition for the deduction of losses in subsequent years. The economic identity is especially lost in those cases where more than 50% of the shares of a company are transferred, predominantly new business assets are injected, and business operations are continued or recommenced with these new business assets.

According to a 2007 decision of the Federal Tax Court (I R 106/05), when judging whether or not business operations are continued with predominantly new business assets, an increase of the current assets as a result of the company's business activities (so-called internal financing) has to be taken into account, if there is a change of business sector or industry. In the opinion of the court, in case of the change in the business sector, the change in the current assets could also be defining for the company.

In its judgment of 15 October 2008 (12 K 8367/05), the Berlin-Brandenburg Tax Court decided a case in which the current assets had increased as a result of the company's business activities, while the corporation was still active in the same business sector as before the transfer of shares. According to the

Tax Court, in this case the increase in current assets as a consequence of the company's business activities was to be disregarded in the comparison of business assets. Insofar, the Tax Court confirmed its 2008 ruling (see German Tax Monthly January 2009, p. 5). In a similar case, in a judgment dated 12 February 2009 (13 K 787/05), the Tax Court of Cologne voiced the same opinion.

As an appeal was lodged against the Berlin-Brandenburg Tax Court's recent judgment, it remains to be seen how the Federal Tax Court will decide in this kind of case.

### **Commercial Nature of Single Property Business**

In a guidance dated 1 April 2009, the Federal Ministry of Finance has commented – referring to a judgment of the Federal Tax Court dated 26 June 2007 (IV R 46/04) – on the commercial nature of so-called single property businesses. Single property businesses are sole proprietorships or partnerships whose business concept extends to the acquisition, renting out and sale of only a single asset.

These businesses are deemed commercial entities if their activity goes beyond the scope of private asset management. Renting out only constitutes commercial income, if, within the overall picture of the company's activities, the actual granting of the use of the asset is of lesser importance. This would be the case if the rental activity is tied to the purchase of the asset and its sale on the basis of an overall business concept. The tax authorities assume the existence of an overall busi-

ness concept if the plan, from the outset, was to sell the rented-out asset before the end of its statutory or actual useful life and only through this sale an overall profit can be achieved.

The activity of the single property business in such cases covers the acquisition, the renting out and the sale of a single asset. Thus, the profit on the sale is included in the current business activities subject to trade tax, for which the favourable tax treatment (§§ 16, 34 Income Tax Act "EStG") cannot be applied.

#### **Arbitration Proceedings regarding the Tax Treaty with the US and the Advanced Pricing Agreements ("APA")**

The tax authorities of the US and Germany entered into an agreement on the application of the mutual agreement and arbitration proceedings pursuant to Art. 25 of the tax treaty USA/Germany ("DTT"). According to Art. 25 of the DTT, disagreements between the US and German tax authorities regarding the interpretation or application of the DTT can be submitted for arbitration by the taxpayer. Taxpayers submit their applications for a mutual agreement procedure in the treaty state in which they are resident. In allocating the income of associated persons, every affected person must file an application in his country of residence.

If, in the course of the mutual agreement procedure, no agreement can be reached between the US and Germany

with regard to permanent establishments (Art. 5 DTT), business profits (Art. 7 DTT), associated enterprises (Art. 9 DTT), royalties (Art. 12 DTT) or the residence of individuals (Art. 4 DTT), and certain other requirements are met, the question has to be decided in an arbitration proceeding. Unsuccessful attempts to reach agreements between two competent authorities with regard to APA can also be transformed into an arbitration procedure. The agreement of 8 December 2008 encompasses requirements of a procedural and substantive nature of the DTT as well as special rules for the arbitration proceedings for APA.

After the arbitration proceedings begin, the members of the arbitration board are selected by the competent authorities, and a chairman is appointed by agreement. If only one of the competent authorities of a treaty state submits a proposal for a solution within a designated time, this is deemed the decision of the arbitration board. If competent authorities of both treaty states submit a proposal for a solution, a decision has to be taken by accepting one of them. Both authorities are bound by this proposal. If one of the affected taxpayers does not expressly accept the suggestion within a period of 30 days, the decision is deemed completely rejected. In this case, the arbitration proceedings are closed.

Under no circumstances are taxpayers to be burdened with the costs of the arbitration proceedings. The treatment of interest and penalty charges, on the

other hand, is subject to the domestic laws of the US and Germany. During the arbitration proceedings, no further information can be collected for arbitration proceedings purposes from the taxpayers involved. A communication between the members of the arbitration board and the taxpayers involved, both during and after the proceedings, is prohibited.

#### **Promulgation of Tax Act for Continuation of the Commuter Tax Allowance 2006**

The Tax Act for the Continuation of the Commuter Tax Allowance 2006 was promulgated on 23 April 2009 in the Federal Law Gazette and hence entered into force, retroactively, as of 1 January 2007. The Federal Constitutional Court in its judgment of 9 December 2008, held that a change in the commuter tax allowance effective from 2007 was unconstitutional (see German Tax Monthly January 2009, p. 5). The Continuation of the Commuter Tax Allowance 2006 Act rescind that change and rules that a flat rate per working day and kilometer of EUR 0.30 for travelling between home and workplace can be deducted from income subject to income tax as income-related expenses pursuant to § 9 Income Tax Act (EStG) or as business expenses pursuant to § 4 EStG. Expenses for using public transportation which exceed the deductible amount based on flat rate method can also be deducted from income mentioned above.

### **KPMG's 2009 German Tax Card**

KPMG published the current version of the German Tax Card. The German Tax Card offers a short overview of significant changes in the field of taxation and social security regulations for 2009. The current version of the German Tax Card 2009 can be found under the following link:

[http://www.kpmg.de/docs/German\\_Tax\\_Card\\_2009\\_engl.pdf](http://www.kpmg.de/docs/German_Tax_Card_2009_engl.pdf)

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