

# German Tax Monthly

March 2010

## Content

- No Prohibition of the Deduction of Negative Gains on Shares resulting from Investment Funds Holding Foreign Shares in the 2001 Assessment Period
- Taxation of a Former Limited Partner's Pension
- Treatment of Object-Related Transfer Costs Arising in the Course of Reorganizations
- Existing Profit and Loss Pooling Agreements in Tax Group Relationships need not be Modified due to the Accounting Law Modernization Act
- Current Status of Double Tax Treaties

## No Prohibition of the Deduction of Negative Gains on Shares resulting from Investment Funds Holding Foreign Shares in the 2001 Assessment Period

Considering the principles laid down by the ECJ in its "STEKO" decision of 22 January 2009 (C-377/07; cf. GTM March 2009, p. 1) the German Federal Tax Court (BFH) concludes in its judgment of 28 October 2009 (ref. no. I R 27/08) that the restriction on the deduction of negative gains on shares resulting from an investment fund's shareholdings in foreign corporations (§ 40a (1) sent. 2 Investment Companies Law – KAGG – in conjunction with § 8b (3) Corporate Income Tax Law – KStG – in the version of 1999), constituted a violation of the free movement of capital (Art. 64 TFEU, formerly Art. 56 EC Treaty). The BFH reasoned that restricting the prohibition of deductions to shareholdings in foreign corporations in the 2001 assessment period constituted an unjustified unequal treatment of shareholdings in foreign vs. in German-based corporations.

In its judgment the BFH concludes that this opinion of the ECJ applies to shareholdings in foreign corporations

held both directly, and indirectly through the separate assets of an investment fund.

Furthermore, the BFH explains that negative gains on the redemption of such shares are not to be offset against any (tax-exempt) gains on the sale of shares (pursuant to § 8b (2) KStG in the version of 1999) in foreign corporations generated in the year in question, nor against gains resulting from the redemption of interests in the separate assets of investment funds that maintain shareholdings in foreign corporations. In the Court's view there is no legal basis for offsetting such gains against each other. Positive and negative gains resulting from interests in different investment funds and gains on the sale of shareholdings in foreign corporations are each subject to distinct tax rules. The tax exemption of positive gains on shares and the simultaneous deduction of negative gains on shares may lead to a discrimination of corporations with comparable domestic shareholding. Nevertheless this does not justify the restriction of the deduction of negative gains on shares as provided for by Community law in the case of the plaintiff.

It is to be noted that the BFH identified such unequal treatment of shareholdings held in domestic vs. in foreign corporations only for the 2001 assessment period. However, the BFH left the question open whether the same applies for the 2002 assessment period (the Tax Court of Muenster (ref. no. 9 K 5096/07 K) referred the question whether the application of § 8b (3) KStG in 2002 is unconstitutional to the Federal Constitutional Court). Where the full or partial deduction of such negative gains on shares was not allowed, an adjustment of the assessment notices should be pursued to the extent that this is still possible.

### **Taxation of a Former Limited Partner's Pension**

In its judgment dated 9 October 2009 (ref. no. 10 K 3312/08) the Baden-Württemberg Tax Court published its view on the allocation of the right to tax pension payments made to a former partner of a German partnership not resident in Germany under the Double Tax Treaty USA.

Until 1997, the plaintiff had been a limited partner of a German GmbH & Co KG and had served as managing director of the general partner GmbH for many years. In 1984, the plaintiff resigned as managing director of the GmbH and, upon resignation, concluded a consulting agreement with the company lasting until the end of 2000. From 2001 onwards, the plaintiff received a pension from the company that continued the activities of the GmbH & Co KG. The plaintiff is resident of the United States.

According to the view of the Baden-Württemberg Tax Court, pension payments to the plaintiff cannot be taxed in Germany. Examined in isolation, the pension is paid with respect to dependent employment as referred to under Art. 18 Double Tax Treaty USA. Accordingly, the right of taxation is allocated exclusively to the taxpayer's state of residence. According to domestic law, the special partner remunerations are qualified as subsequent income from commercial business activity. However, due to the autonomous interpretation of tax treaties, this qualification under German tax law is not relevant to the qualification of such income for tax treaty purposes. The Court referred to a judgment of the Federal Tax Court (BFH) dated 17 October 2007 (cf. GTM May 2008, p. 1) according to which special partner remunerations are to be qualified by attributing them to the relevant tax treaty articles.

Furthermore, the Baden-Württemberg Tax Court ruled that the provision on the distinct tax treaty attribution of special partner remunerations (§ 50d (10) Income Tax Law – EStG –) was not relevant, because the provision was not applicable to subsequent income. In the Court's view, the wording as well as the purpose and intent of § 50d (10) EStG exclusively relate to current commercial business income. The Court also held that even if § 50d (10) EStG was regarded as applicable, subsequent income would not necessarily have to be qualified as business profits within the meaning of Art. 7 Double Tax Treaty USA, the reason being that taxation by the State

where the permanent establishment is situated would require the remunerations to be attributed to the domestic permanent establishment. In the view of the Court, however, the pension payments are not effectively attributable to the permanent establishment, nor does § 50d (10) EStG allow for a fictitious attribution.

The Court did not consider the question as to whether the application of § 50d (10) EStG to all pending cases and thus the retroactive effect of such provision was in breach of the constitution. In its ruling of 30 July 2009, the Munich Tax Court did not regard the retroactive application as impermissible under constitutional law (cf. GTM December 2009, p. 4).

Since an appeal has been filed with the Federal Tax Court it remains to be seen whether the judgment of the Baden-Württemberg Tax Court will be confirmed.

### **Treatment of Object-Related Transfer Costs Arising in the Course of Reorganizations**

In its guidance dated 18 January 2010 the Federal Ministry of Finance (BMF) published its view on the income tax treatment of object-related costs in the event of asset transfers during reorganizations.

Especially real estate transfer taxes which arise during real estate transfers from the transferring entity to the receiving entity in the course of a reorganization process are deemed object-related costs. Any other costs that might arise during reorganizations due to the transfer of other intangible or

tangible assets are also regarded as object-related costs.

According to the BMF guidance any object-related transfer costs incurred under reorganizations must be qualified as incidental acquisition costs and capitalized by the receiving entity. In the case of reorganizations the BMF thus qualifies an asset transfer as an acquisition process performed by the receiving entity.

In the past the BMF did not regard such asset transfers as acquisition processes. Object-related costs were treated as business expenses that reduced the reorganization result of the absorbing company. However, as reorganization results are tax-exempt for the receiving entity pursuant to § 12 Reorganization Tax Law – UmwStG –, object-related transfer costs included in the reorganization result did not have a mitigating effect on the tax result. On the other hand, object-related costs that are capitalized as incidental acquisition costs may have a profit-reducing effect for tax purposes (e.g. through building write-downs) for the receiving entity when reporting write-downs.

The receiving entity needs to capitalize the object-related transfer costs irrespective of whether the receiving or transferring entity assumes the costs.

The tax authorities already qualified object-related transfer costs as acquisition-related expenses in the case of contributions to corporations. The objective is to treat mergers, split-ups and type I spin-offs also in the same way, irrespective of the legal form of the entities involved in the reorganization

process. Qualifying reorganizations as acquisition processes in the case of contributions appears more obvious, particularly because the contributing entity obtains shares in the receiving entity as consideration, whereas in mergers, split-ups, and type I spin-offs shareholders do not necessarily receive a consideration in the form of a capital increase (e.g. in the case of an upstream-merger). According to the BMF guidance it does not make any difference whether there is a capital increase, or not, when qualifying a reorganization as an acquisition process.

In not yet finally assessed cases of asset transfers from corporations to partnerships or to individuals, or asset transfers from corporations to partnerships through split-ups or type I spin-offs for which the UmwStG of 7 December 2007, as amended, was not yet applicable (legacy cases) the BMF grants two options to the receiving entity. To date the so-called Reorganization Tax Decree – UmwSt-Erlass – stipulated in such cases that object-related costs were to be treated as business expenses. For the cited legacy cases the receiving entity is now able to uniformly deduct as business expenses or capitalize as incidental acquisition costs any object-related transfer costs incurred for the reorganization process.

#### **Existing Profit and Loss Pooling Agreements in Tax Group Relationships need not be Modified due to the Accounting Law Modernization Act**

In its guidance dated 14 January 2010 the Federal Ministry of Finance (BMF)

published its view as to whether existing profit and loss pooling agreements in tax group relationships need to be modified because the accounting rules have changed as a result of the Accounting Law Modernization Act.

Concluding a profit and loss pooling agreement is one of the prerequisites that the controlling entity and the controlled company have to meet for being granted tax recognition as a tax group. Such an agreement obligates the controlled company to transfer its entire profits. Changes in the wake of the Accounting Law Modernization Act, however, also affect the regulation on the maximum amount of profit to be transferred, as the Act also introduced a so-called restriction on profit distribution for certain profits, e.g. profits derived from the capitalization of self-created intangible assets. Accordingly, any profits generated must be reduced by the amount that is subject to a restriction on profit distribution.

The BMF stated in its guidance that the introduction of the restriction on profit distribution will not affect the tax recognition of the tax group and that it is not necessary to modify any profit and loss pooling agreements. Notwithstanding any dissenting contractual provisions, however, the tax group must, in the actual transfer of profits, observe the revised regulations on the maximum amount. Transfers to revenue reserves which are carried out as a result of the transitional arrangements under the Accounting Law Modernization Act do not affect tax recognition either. The guidance of the BMF is important for foreign investors that are

associated with a German tax group. Such associations may exist when their German subsidiary or German branch acts as controlling entity. Foreign partners of a German partnership that acts as controlling entity are also affected.

### **Current Status of Double Tax Treaties**

In a communication dated 12 January 2010, the Federal Ministry of Finance informed about the current status of double tax treaties and negotiations regarding such treaties. At present, Germany maintains double tax treaties on income and capital with approximately 90 states.

Negotiations on the conclusion of a double tax treaty with Taiwan are currently underway. Negotiations on a new Double Tax Treaty with the United Arab Emirates have been concluded, but it is not yet clear when the new Treaty will be signed. This means that no double tax treaty has been in operation since 1 January 2009.

No treaty is in operation at present with the Hong Kong and Macau Special Administrative Regions, either. There are no negotiations planned on the conclusion of a tax treaty. Neither is there an intention to extend the Double Tax Treaty China to cover the two Regions.

On 21 July 2009, the Double Tax Treaty Turkey was terminated (cf. German Tax Monthly September 2009, p. 5). If no new treaty is concluded, no treaty will be in operation as of 1 January 2011.

### **Imprint**

Responsible\*: Dr. Martin Lenz  
Head of National Tax

KPMG AG  
Wirtschaftsprüfungsgesellschaft  
Marie-Curie-Straße 30  
D-60439 Frankfurt/Main  
Editorial Team:

**Oliver Dörfler**

**Julian Fey**

**Dr. Christoph Geeb**

**Meike Groß**

**Eva Handwerker**

\*Responsible according to German Law  
(§ 7 II Berliner PresseG)