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## Coalition Agreement signed – Impact on Business Taxation

On 26 October 2009 the conservative (CDU, CSU) and liberal (FDP) parties have signed a coalition agreement setting out the agenda for the upcoming legislative period. The coalition agreement contains a number of provisions on business taxation, the most important of which are summarized below. The following measures shall be introduced with effect as of 1 January 2010 and form part of an ad hoc economic growth program.

### Corporate Change-of-Control Rules Significantly Eased

Pursuant to § 8c KStG unused tax losses and tax loss carry forwards are forfeited if more than 50% of the shares in a loss corporation are transferred to a (single) acquirer or related parties within a period of five years. If more than 25%, but not more than 50% of the shares in a loss corporation are transferred, tax losses are forfeited on a pro rata basis.

Section 8c KStG in its current form does not contain any exceptions for

share transfers within a group of companies. This has proven to be a major obstacle for reorganizations within a group as the change-of-control rules cover both, direct and indirect share transfers. The coalition agreement now allows for an exception to share transfers within a group of companies.

Furthermore, the coalition agreement provides that § 8c KStG should be modified so that even in case of a detrimental change in ownership tax losses will not be forfeited up to the amount of the built-in gains of the company whose shares were transferred.

Under the turn around exemption clause, which was introduced in summer 2009 with retroactive effect, an acquisition of shares in a loss making company up to and including 31 December 2009 shall not be affected by § 8c KStG if it serves the purpose of turning around the business of the corporation. The coalition agreement provides for an unrestricted application of this exemption clause in terms of time.

### Earnings Stripping Rules to be Revised

The current earnings stripping rules limit the tax deductibility of interest expenses to 30% of tax EBITDA. The 30% limitation does not apply if the annual net interest expenses amount to less than € 3 m (de minimis threshold).

The de minimis threshold has temporarily been increased from € 1 m to € 3 m and the increase was to expire on 31 December 2009. Now the increased de minimis threshold shall become permanent.

In addition, it shall be possible to carry forward unused tax EBITDA (as for example in a given year the net interest expenses may be lower than 30% of tax EBITDA). Such tax EBITDA carry forward shall be limited to a maximum period of five years and shall have retroactive effect as from the introduction of the earnings stripping rules.

Furthermore, the so-called escape clause shall be reviewed and modified to make it applicable for German-based groups of companies.

### Base Shifting Rules To Be Modified

The 2008 Business Tax Reform Act for the first time introduced rules against so-called base shifting (transfer of functions together with associated risks and opportunities). According to the coalition agreement the negative impact of those rules on Germany as a location for R&D work shall be mitigated.

### Trade Tax Add-back of Rental Payments of Immovable Property

In order to determine the trade tax profit the interest element of rental payments for immovable assets is added back to the trade tax base. This interest element amounted to 65% of the payments from 2008 onwards and shall now be reduced to 50%. As only one quarter of the interest element is added back, the effective add-back will be decreased from 16.25% to 12.5%.

### Real Estate Transfer Tax

In case group companies own real estate, the group will often not carry out necessary restructurings as these can trigger real estate transfer tax. The coalition plans to introduce a group exemption provision for real estate transfer tax purposes in order to facilitate the restructuring of companies.

### Medium-term Objectives of Business Taxation

The coalition agreement aims to modernize the company tax law and to make it more competitive. Besides, Germany shall become more attractive for holding companies. Hence, the coalition plans to pursue inter alia the following measures:

- The modification of the loss-offsetting rules
- The cross-border taxation of business profits
- The introduction of a modern group taxation system instead of the current tax-grouping system (Organschaft)

- To retain in principle the exemption method in German double tax treaties
- The introduction of tax incentives for research and development in Germany, especially for small- and medium-sized entities
- A commission shall be appointed in order to reorganize the budgets of the municipalities. This commission shall inter alia discuss the abolition of the German trade tax in connection with the implementation of a community surcharge on the corporate income tax/personal income tax and a share in the value added tax revenues.

### Further Tax Measures

The tax progression for individuals is especially high if the taxpayer earns a medium high income. Therefore, the coalition agreement provides that the progressive tax rate system for individuals shall switch to a flat tax system with three to five steps.

### ECJ Judgment on the "blocked amount" (Sperrbetrag) Provision in the "Glaxo Wellcome" Case

On 17 September 2009, the European Court of Justice (ECJ) issued a preliminary ruling in the Glaxo Wellcome case (C-182/08) on the compatibility of the so-called "blocked amount" provision of § 50c German Income Tax Act (EStG) with Community law.

Section 50c EStG is a provision enacted under the former corporate tax system. It applied where a shareholder entitled to a corporate income tax

credit acquired shares in a resident corporation from a person without such entitlement (typically non-residents or resident taxpayers where the capital gain was tax-exempt) and, for a period of ten years, denied tax effect to write-downs on shares by reason of dividends paid by the acquired corporation to the extent of the blocked amount. The blocked amount is defined as the difference between the purchase price of the shares and their par value. However, when acquiring shares in a resident corporation from a resident shareholder, no "blocked amount" was applicable. This rule which differs between acquisitions from non-resident and resident taxpayers also applies to acquisitions within a merger. This was the case of the ruling reported hereon.

The ECJ decided that, in principle, the blocked amount provision is in breach of the free movement of capital, because the provision makes the acquisition of shares from a non-resident shareholder not entitled to such corporate income tax credit less attractive for tax reasons. The ECJ solely applied the free movement of capital, because regarding its content and purpose, the blocked amount provision does not require a shareholding which allows the shareholder to exercise a certain degree of influence on the decisions of the company. In this specific situation at hand, the free movement of capital replaces the freedom of establishment.

Whilst the ECJ concluded that the blocked amount provision could be justified if and to the extent that it is required to ensure a balanced allocation

of the power to impose taxes between member states, or to prevent abuse, the Court will not decide whether the provision at issue is necessary to attain these objectives, but explicitly leaves this question to be answered by the referring German Federal Tax Court.

### **Parent Subsidiary Directive only applicable to Companies Whose Legal Form is contained in the List of Companies annexed to the Directive**

The Parent Subsidiary Directive (90/435/EEC of 20 August 1990) is part of European Community harmonization measures with regard to direct taxation. The aim of the Directive is to avoid double or multiple taxation of profit distributions received by a EU parent from its EU subsidiary. In particular, the Directive covers distributed profits between associated companies where the parent has a minimum direct holding of 10% (with effect from 2009 – higher participation thresholds applied in previous years) in the capital of the subsidiary and the two legal entities are corporations with registered offices in different EU member states. Finally, both companies have to qualify as "a company of a Member State" in terms of the Directive.

According to German tax law, an EU parent may, for the purpose of the Parent Subsidiary Directive, request a refund of dividend withholding tax on profit distributions received from a German subsidiary, or, if it has obtained a certificate of exemption, the Federal Central Tax Office will refrain from levying withholding tax. Where the parent

is located in Germany dividends are, in principle, tax-exempt. However, 5% of the dividends constitute non-deductible business expenses.

On 1 October 2009, the ECJ issued a preliminary ruling (C-247/08, "Gaz de France") in which it interpreted the term "company of a Member State" for the purpose of the Parent Subsidiary Directive. The case involves a dividend paid by a German company to its parent, a French "société par actions simplifiée" (SAS). The German tax authorities refused to refund withholding tax since a company in the form of an SAS did not fall within the scope of the Parent Subsidiary Directive.

The ECJ held that, prior to 2005, the SAS could not be considered a "company of a Member State" for the purpose of the Parent Subsidiary Directive. Neither was the legal form of an SAS contained in the Annex to the Directive, nor was there a saving clause providing for the inclusion of other companies subject to French corporate tax that might be introduced under French law. Insofar, the list annexed to the Directive was conclusive. It is irrelevant that the SAS legal form has similarities with the "société anonyme" (SA) which is listed in the Annex and that, at the time the Directive came into force, the SAS legal form did not exist.

It was not until the amendment of the Parent Subsidiary Directive (2003/123/EC of 22 December 2003) that the SAS was included in the Annex. Member states were to trans-

pose the Directive into national law by 1 January 2005.

The ECJ's reasoning in this case could have implications for other directives, notably the Merger Directive (90/434/EEC of 23 July 1990) and the Interest and Royalty Directive (2003/49/EC of 3 June 2003). The Interest and Royalty Directive has so far not been amended to include the SAS in its Annex and does not contain any provisions for the inclusion of other companies constituted under French law, so that the SAS is unlikely to fall in the scope of this Directive. Although the Merger Directive has been amended with effect from 1 January 2006, an SAS may probably not rely upon it for periods before that date. The decision could have broader implications for corporate forms introduced by member states since the EU Directive came into force.

#### **Federal Tax Court on the Tax Exemption of Employer Contributions to Social Insurance Schemes for Expatriates**

In its judgment dated 28 May 2009 (VI R 27/06) the Federal Tax Court ruled on the tax exemption conditions to be met for employer contributions to social insurance schemes paid by a German subsidiary for an employee of its Swedish parent seconded to Germany. Pension contributions were paid by the German subsidiary to Dutch and Swedish insurance companies in order to cover for the difference between the pension to be expected from the Ger-

man statutory system and the Swedish company pension commitment.

According to § 3 no. 62 German Income Tax Act (EStG), social insurance expenses for employees paid by the employer are not taxable as wages if their payment is required by law.

In the case at issue, the pension commitment was merely based on a contractual agreement between Swedish employer and employee associations, and thus not required by law. Therefore, the Federal Tax Court denied the tax exemption of the pension contributions.

However, the Federal Tax Court clarified that had such payments been required under the laws of the foreign jurisdiction, they would have been tax-free.

With regard to the fundamental freedoms guaranteed by the EC Treaty, the provision granting tax exemption did not contain conditions which could only be met by German employees or employers. Therefore, the tax exemption did not constitute any indirect or direct discrimination within the meaning of Art. 39 of the EC Treaty on the free movement of workers. Moreover, the Federal Tax Court denied both a breach of the freedom of establishment of the Swedish parent and a violation of the freedom to provide services of the Dutch and Swedish insurance companies.

#### **Denial of Loss Deduction pursuant to the Previous Version of § 8 (4) KStG When an Original Majority Interest is re-acquired**

In a judgment dated 4 June 2009 (I R 57/09), the Schleswig-Holstein Tax Court ruled on the change-of-control rules under the previous version of § 8 (4) KStG that impose limitations on loss deduction. Although the above rules have been replaced by § 8c KStG with effect from 2008, the old rules still apply with regard to changes in ownership that occurred prior to 1 January 2008, but where predominantly new assets are injected until 31 December 2012.

Pursuant to the previous version of § 8 (4) KStG, a company must maintain both its legal and economic identity to qualify for loss deductions. Under this provision, the economic identity is especially lost in those cases where more than 50% of the shares of a company are transferred and predominantly new business assets are injected.

In the case under review, a founder partner owning a 51% share in the company in question at first sold 21% of its shares to the co-partner. Eighteen months later, said shareholder acquired 70% of the shares from the co-partner, thus becoming sole shareholder of the GmbH. The Tax Court considered this a detrimental change in ownership within the meaning of the previous version of § 8 (4) KStG. According to the Tax Court it was irrelevant that the acquirer was an existing shareholder who had even been major-

ity shareholder, albeit with an interruption of 18 months. The deciding factor were that the wording of the previous version of § 8 (4) KStG did not make any distinction between a transfer of shares and the acquisition of additional shares by an existing shareholder.

Despite the fact that the acquisition of shares constituted a retransfer of shares, the acquired shares would still have to be considered when applying the previous version of § 8 (4) KStG.

As it is undisputed that the company continued business operations with predominantly new business assets the second requirement of the change-of-control rules was also fulfilled, resulting in a denial of a loss carryforward. Since the judgment is not final and an appeal has been filed with the Federal Tax Court, it remains to be seen if this judgment will be confirmed.

Considering the changes introduced in § 8c KStG it is to be expected that the acquisition of shares by an existing shareholder as well as the retransfer of shares will also be detrimental under the new provisions.

### **Lower Tax Court of Münster on the Qualification of a U.S. LLC according to German Tax Law**

In a judgment dated 1 October 2009 (8K 4552/04 F), the Lower Tax Court of Münster ruled on the qualification of a U.S. LLC according to German tax law. 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 ("Rechtstypenvergleich", entity comparison method). Under this approach, the classification depends on whether the specific LLC is more similar to a German partnership or a German corporation.

In the case at issue, the German shareholder (a GmbH & Co. KG) qualified the LLC as a corporation. Due to the LLC's constant losses, the interest's going concern value was impaired, which is why the member wrote down the interest to EUR 0 with the loss charged to income. The tax authorities, however, qualified the LLC as a partnership. Since according to the German approach an interest in a partnership does not constitute an asset, such partnership interest cannot be written down. A deduction of losses at the level of the partner (as a consequence of pass-through taxation applicable to partnerships) is in conflict with double tax treaty provisions. The Double Tax Treaty with the United States provides for the exemption method to be applied for profits/losses from interests held in US-partnerships. For the purpose of domestic taxation, losses are to be considered only with regard to the negative progression clause.

In its decision to qualify the LLC as a corporation or partnership, the Münster Court follows the guidance issued by the Federal Ministry of Finance on 19 March 2004. According to the Ministry's guidance, exclusively German legal principles are applicable. It is therefore irrelevant for domestic taxation whether a company has elected to

be taxed as one or the other in the US (Check-the-Box). The entity comparison method must be used for classifying the LLC. According to this approach, an LLC is considered a corporation if an overall consideration of the LLC's jurisdiction's rules and regulations and the provisions in the operating agreement allow for the conclusion that it resembles a German corporation in both legal and business terms.

Since in the case at hand there was no centralized management, interests were not freely transferable, profit allocation was fixed from the start and the member was paid in advance for performing duties as managing director, the LLC had to be regarded as a partnership for German taxation purposes. The only aspect in which the LLC resembles a corporation is limited liability. However, this was not regarded as a decisive aspect in the overall consideration of the case at hand.

Since the LLC had to be considered a partnership in this case, a recognition of the writedown to going concern value in the partner's P&L was not possible. The losses may, however, be considered with regard to the negative progression clause.

The Münster Court denied an infringement of Community law with reference to an ECJ order dated 6 November 2007 in the Ergste Westig case (C-415/06, cf. German Tax Monthly July/August 2008, p 6). For German international tax law purposes, a partnership interest is treated as permanent establishment of the partner.

Therefore, according to the decision of the ECJ in the case at issue, the freedom of establishment is affected, however, this freedom cannot be relied upon in a situation involving an establishment in a non-member state. Since the ECJ denied a violation of the freedom of establishment, a potential breach of the freedom of capital movement did not merit a separate analysis.

Appeal was disallowed by the Lower Tax Court of Münster.

#### **Germany's Right to tax Gains arising from Jouissance Shares pursuant to Art. 11 (2) Double Tax Treaty between Germany and Austria**

In 2003 and 2004, the plaintiff, an Austria-based bank held jouissance shares of a bank resident in Germany. The jouissance shares entitled the plaintiff to an annual distribution relating to the respective financial year. However, if and to the extent that such distribution should result in an accumulated deficit, the entitlement was precluded. The jouissance shares did not grant the plaintiff any right to participate in the liquidation proceed. In 2004 and 2005, the plaintiff submitted a request according to § 50d (1) EStG in conjunction with the Double Tax Treaty Austria to what is today the Federal Central Tax Office in which the plaintiff claimed refunds of the amounts of the distributions that were withheld and remitted as tax. The Federal Central Tax Office denied the request for a refund.

In its ruling of 30 April 2009 (2 K 2375/06) the Tax Court of Cologne

stated that according to Art. 11 (2) Double Tax Treaty Austria, Germany as the Source Country has the unlimited right to tax any income derived by the plaintiff from the jouissance shares. With regard to defining dividends and interest payments, the Court formed the opinion that the plaintiff's income does not constitute dividends referred to in Art. 10 Double Tax Treaty Austria but interest payments within the meaning of Art. 11 of the above treaty, because in the event of a liquidation of the issuer according to the terms of the jouissance shares, the plaintiff's jouissance shares did not grant any right to participate in the liquidation proceeds.

In addition, in the interest article of the Double Tax Treaty Austria a distinction is made between "plain" interest on the one hand, for which Art. 11 (1) Double Tax Treaty Austria precludes any right of imposing withholding tax, and income derived from rights and debt claims with profit participation on the other, on which the Source State may levy tax pursuant to Art. 11 (2) Double Tax Treaty Austria.

The Tax Court qualified the jouissance right of the plaintiff as a so-called profit-related fixed interest payment, for the plaintiff was only entitled to a fixed interest on the nominal amount if the distribution did not result in an accumulated deficit.

Accordingly, the jouissance shares were associated with a profit participation right within the meaning of Art. 11 (2) Double Tax Treaty Austria, and

Germany was therefore entitled to levy tax.

The Court could not take into consideration the plaintiff's objection that no limited tax liability exists in connection with income derived from the jouissance rights in Germany, or that Germany in the plaintiff's case violated the provisions of Art. 56 EC stipulating the free movement of capital by deducting withholding tax. If an exemption procedure and/or refunding procedure under § 50d EStG is adopted, the Federal Central Tax Office will only accept the reasons for relief explicitly stated there (thus in the present case reasons according to the Double Tax Treaty Austria) to be brought forward. Therefore, the plaintiff would have had to submit its objections to the appropriate tax office, if necessary, in a parallel refunding procedure.

The judgment does not have final and binding effect. Since an appeal has been filed with the Federal Tax Court, it remains to be seen if this judgment will be confirmed.

#### **Tax Treatment of Writedowns to Going-Concern Value of Interests in Domestic and Foreign Investment Funds held as Business Assets**

In its guidance dated 8 May 2009, the Highest Regional Tax Office Rheinland published its view on the preconditions under which interests in domestic and foreign investment funds held as business assets may be written down to going-concern value and the extent to which such writedowns may be regarded for tax purposes.

Interests in investment funds may be written down to going-concern value only by reason of a decline in value that is expected to be permanent. The assets that make up the separate assets of the investment fund determine whether a decline in value may be deemed to be permanent (principle of transparency).

Where the separate assets include stock exchange listed shares and where the interests in the investment fund are held as fixed assets the principles detailed by the Federal Ministry of Finance in its guidance issued on 26 March 2009 (see German Tax Monthly May 2009, p. 5) are to be applied with regard to establishing whether a reduction in value can be expected to be permanent. Accordingly, the decline in value should be assumed to be permanent if, on the current balance sheet date, the market price of the interests held as fixed assets is more than 40 percent lower than the acquisition price or if the market price is more than 25 percent below the acquisition price on both the current and the previous balance sheet date. If, on the other hand, the interests in investment funds are held as current assets they may be written down to going-concern value provided that their decline in value continues up to the date when the balance sheet is drawn up (so-called retrospective view). However, the resulting value of the asset may not be lower than the highest redemption price achieved in this period.

According to the Highest Regional Tax Office, the question as to how far writedowns to going-concern value – which are permissible in principle – are regarded for tax purposes depends on whether they relate to interests in domestic or foreign investment funds and whether such interests are held as business property by a corporation, by an individual or by a partnership.

To the extent that they are related to shares in corporations whose payments give rise to tax-exempt income for the recipient (within the meaning of § 20 (1) no. 1 EStG – e.g. dividends), reductions in profits arising after 31 December 2003 are disregarded for tax purposes when interests in domestic investment funds are held as business property by a corporation. According to the Highest Regional Tax Office, where an assessment is still pending, the same should apply for profit reductions arising prior to 1 January 2004 und thus before the relevant provision of § 8b (3) KStG as amended entered into force. However, it remains uncertain whether this would qualify as a genuine retroactive effect impermissible under constitutional law. If that were the case, a writedown to going-concern value would in fact have to be regarded for tax purposes, too. Profit reductions may be regarded for tax purposes where they are related to other assets in the investment fund (e.g. interest-bearing securities).

For interests in domestic investment funds held as business property by an individual, writedowns to going-

concern value under the half-income system become tax effective to the extent of only 50% (40% under the partial-income system introduced in 2009). If the interests are held by a partnership as business property, the legal forms of the entities involved in the partnership determine the tax treatment of the interests.

Writedowns to going-concern value that are permissible on principle are fully regarded for tax purposes if, ceteris paribus, the interests in question are interests in foreign investment funds and if the reductions in profit arose prior to 1 January 2004. However, for profit reductions arising after 31 December 2003 the legal effects are the same as for interests in domestic investment funds.

## Imprint

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