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Citizen Relief Act Health Insurance

The Lower House of the German Parliament has adopted the Citizen Relief Act Health Insurance on 19 June 2009. The approval by the Upper House of the German Parliament is expected for 10 July 2009 and the announcement in the Federal Law Gazette could follow end of July 2009.

Aside from improved tax treatment for social security and similar expenses ("Vorsorgeaufwendungen"), the Act contains reliefs with respect to core regulations of the 2008 Business Tax Reform.

Increase of the de minimis threshold with respect to the earnings stripping rules

Under the earnings stripping rules (§ 4h EStG – German Income Tax Law) the tax-deductibility of interest expenses in excess of the interest income (net interest expense) incurred by business units is restricted to 30% of the tax EBITDA.

The earnings stripping rules do not apply if the net interest expense of the business unit is less than € 1 million

(de minimis threshold). The de minimis threshold shall now be increased to € 3 million. Therefore, the earnings stripping rules are not applicable if the net interest expense of the business unit in the relevant fiscal year is less than € 3 million.

The de minimis threshold is increased only temporarily and shall be effective retroactively for assessment periods 2008 and 2009 (special rules for deviating business years to be observed).

Introduction of a turnaround exemption clause with respect to corporate loss limitations pursuant to § 8c KStG

Under § 8c KStG unused losses are forfeited in total if within a period of five years more than 50% of the share capital, membership rights, ownership rights, or voting rights in a corporate entity are transferred to a (single) acquirer or to his/her related parties. If within a period of five years more than 25% and up to 50% of the share capital (among others) is transferred, unused losses are forfeited pro-rata.

Along with the Citizen Relief Act a turnaround exemption clause constituting

an exception to § 8c KStG shall be introduced (§ 8c (1a) KStG-E – Draft of the German Corporate Income Tax Law). Following this, a change in ownership in a loss making company shall not be affected by § 8c KStG if it serves the purpose of turning around the business of the corporation.

According to the reasoning of the Act an acquisition serves the purpose of turning around the business, if (i) the acquisition takes place at a point in time when illiquidity or over-indebtedness of the corporation is impending or has occurred, (ii) the company show turnaround-capacity at the time of the acquisition according to the obligatory assessment of a neutral third party, and (iii) the planned measures be objectively suitable for leading the company out of the crisis in due course. The prognosis generally requires to be based on a well-documented turn around-plan. There is no requirement as to success resulting from turning around the business.

The application of the turnaround exemption clause is conditional on a further requirement: the essential business structures must be preserved. Following § 8c (1a) sent. 3 KStG-E this requirement is met in each of the following cases:

- **Preservation of jobs:** the decisive annual payroll total of the corporation does not fall below 400% of the initial payroll for a period of five years after the change in ownership.

- **Works council agreement on the preservation of jobs:** the corporation acts in compliance with a works council agreement regulating the preservation of jobs.
- **Injection of material business assets:** within twelve months after the change in ownership material business assets are injected as equity into the corporation. The injection is considered material if it amounts to at least 25% of the assets stated in the tax balance sheet at the end of the previous fiscal year. In case of an acquisition of less than 100% the assets to be injected are reduced accordingly.

The turnaround exemption clause is not applicable, if

- the corporation had largely discontinued its operation at the time of the change in ownership or
- a change of the line of business occurs within five years after the change in ownership.

As a result a change in ownership for the purpose of turning around the business does not affect the application of § 8c (1) KStG. In this respect losses can continue to be used despite of a change in ownership.

The new regulation of § 8c (1a) KStG-E applies retroactively, to the assessment period 2008 for the first time and to changes in ownership after 31 December 2007. Hence the turnaround exemption clause is effective as of the first application of § 8c (1) KStG. However, it is restricted to changes in ownership until 31 December 2009.

[Improved tax treatment for social security and similar expenses](#)

According to the existing law, the premiums for health and long-term care insurance up to a certain maximum amount are eligible for deduction from the tax assessment basis. Thus, health and long-term care premiums along with other social security and similar expenses up to a maximum amount of € 1,500 are effective for tax purposes (€ 2,400 in case of taxpayers paying the premiums on their own, i.e. without employer's contribution).

With effect as of 1 January 2010, tax deductibility of social security expenses such as health and long-term care insurance shall be extended both for privately and for statutorily insured persons. The special expenditure allowance ("Sonderausgabenabzug") is unlimited with respect to health and long-term care premiums insuring a payment level that largely corresponds to that of the statutory health and long-term care insurance (§ 10 (1) no. 3 EStG-E – Draft of the German Income Tax Law).

At the same time the current maximum limit shall be increased by € 400 to € 1,900 (€ 2,800 in case of taxpayers paying the premiums on their own) and only apply for other social security and similar expenses in the future. Within the limits of these maximum amounts, the other social security expenses such as insurance premiums to cover liability, unemployment, occupational disability, or casualty as well as premiums for certain life insurances and the portion of premiums for private health and long-term care insurance insuring a

payment level beyond statutory health and long-term care insurance are effective for tax purposes (§ 10 (1) No. 3a EStG-E). However, tax deduction in these cases is only possible, if the maximum amount has not been used up by deductions for basic health and long-term care premiums. Otherwise, tax deduction for other social security and similar expenses is denied (§ 10 (4) EStG-E).

Write-ups after Write-downs due to Dividend Distributions

In a judgment dated 10 November 2008 (File No. 6-K-392/04), the Tax Court of Baden-Wuerttemberg ruled on the tax effectiveness of a write-up on shares where the initial write-down was disregarded pursuant to § 50c EStG (German Income Tax Law).

According to the previous version of § 50c EStG, if a shareholder entitled to a corporate income tax credit acquired shares in a resident corporation from a person without such entitlement, write-downs resulting from dividends paid by the resident corporation were not tax effective to the extent of a so-called blocking amount (Sperrbetrag).

In the case at issue, the shareholder of a GmbH had made a write-down in 1991 on shares of the GmbH due to a dividend payment. Based on § 50c EStG, a part of this write-down was not tax effective. Pursuant to the mandatory reversal of write-downs in case of a future appreciation in value according to § 6 (1) no. 1 sent. 4 EStG, which was first applicable for fiscal years ending after 31 December 1998, write-downs of earlier years were reversed.

With reference to a guidance of the Federal Ministry of Finance dated 25 February 2000, the tax authorities also considered write-ups as increasing profits if the former write-downs had no tax effect pursuant to § 50c EStG.

The Tax Court of Baden-Wuerttemberg ruled against the opinion of the tax authorities. The court stated that the purpose of the mandatory reversal of write-downs pursuant to § 6 EStG was to neutralize a tax effective write-down. Therefore, the tax effect of a write-up could not exceed the tax effect of the write-down. Otherwise there was a risk of taxing the same amount twice. Due to the fact that an off-balance sheet correction of the write-down under § 50c EStG had to be undertaken, reducing the reversal of the write-down must be done off the balance sheet as well. On the balance sheet, the write-downs have to be reversed to their full extent.

An appeal was filed with the Federal Tax Court against the judgment of the Tax Court of Baden-Wuerttemberg. The ruling is therefore not final.

The previous version of § 50c EStG continues to apply for a transitional period until the assessment period 2011. For corporate shareholders, the ruling is relevant for reversals of write-downs if the reversals occurred prior to 2002. From 2002 onwards, reversals of non-tax effective write-downs are in effect tax-exempt to the extent of 95%.

Guidance from the Federal Ministry of Finance on Giving up the Theory of Final Withdrawal

In its guidance of 20 May 2009, the Federal Ministry of Finance ordered the non-application of the Federal Tax Court judgment of 17 July 2008 (File No. I R 77/06) insofar as the judgment gives up the so-called theory of final withdrawal.

According to this theory, a company has to realize the hidden reserves accumulated in an asset when the asset is transferred from Germany to a foreign permanent establishment which is exempt from domestic taxation on a basis of a tax treaty. In its judgment from 17 July 2008 the Federal Tax Court ruled against the immediate realization of a gain for cases in which a single asset is transferred from a domestic head office to a foreign permanent establishment, even if the profits of the foreign permanent establishment are exempted from domestic taxation on the basis of a tax treaty. The Federal Tax Court thus explicitly gave up the theory of final withdrawal it had previously supported. According to the Federal Tax Court, there is no legal basis for immediate taxation (see German Tax Monthly November 2008, p. 2).

According to the Federal Ministry of Finance guidance of 20 May 2009, the principles of the Federal Tax Court decision are not to be applied beyond the specific case the court decided on. The Federal Ministry of Finance is of the opinion that a legal basis exists for

the time period before 2006 for the realization of gains in case the right to tax hidden reserves is lost because of a transfer to foreign permanent establishments. The Ministry argues that while an explicit provision was enacted in 2006 (§ 4 (1) sent. 3 EStG – German Income Tax Law), this only served to clarify the legal situation existing before 2006.

The Federal Ministry of Finance stated that the loss of the taxation right in these cases triggered the taxation of the hidden reserves. This result followed from the international administrative practice and interpretation of the tax treaty law on the basis of the principles of the OECD. The Federal Tax Court based its ruling of 17 July 2008 on a different interpretation of treaty law. The existing rules on the taxation of hidden reserves in cases of the loss of the right of taxation (§ 4 (1) sent. 3 EStG and § 12 (1) KStG – German Corporate Income Tax Law) were unaffected by the ruling.

In addition, the Federal Ministry of Finance guidance addressed two further points of the Federal Tax Court's ruling. The Court regarded a contribution in kind to a limited partnership, which had been booked in part to a capital account and in part to a reserve account jointly owned by the shareholders, in its entirety as a sale against consideration. The tax authorities had so far treated payments to a jointly owned reserve account as a hidden contribution. The Federal Ministry of Finance wants to apply the court decision in all cases which have not been finally as-

essed. Also, the court had ruled that a 100% interest in a corporation did not constitute a branch of activity of the shareholding company within the meaning of the German Reorganization Tax Law (UmwStG – in the version in force since 1995). According to the Federal Ministry of Finance, the court's ruling should not be applied beyond the specific case decided by the court. In expectation of future statutory regulation, a 100 % interest in a corporation should also be treated as a branch of activity within the meaning of the UmwStG in the future.

Short-sales of Shares via Foreign Parties shortly before the Dividend Record Date

On 5 May 2009, the Federal Ministry of Finance issued a new guidance on the tax treatment of short-sales of shares via parties in other countries. The aim of this guidance is to prevent that the buyer of shares receives a tax credit or a tax refund with regard to the dividend withholding tax despite the fact that no withholding tax had been paid.

In the case of these short-sales, shares are sold to a domestic buyer shortly before the dividend record date, but only delivered after the dividend record date. In these cases, the seller is not able to deliver to the buyer the contractually owed share together with a claim to the dividend, because the distribution of the dividend occurs before the delivery of the shares. To remedy this, the seller has to pay compensation to the buyer. The compensatory amount paid to the purchaser via a third party is

subject to the dividend withholding tax. If the shares are sold through a domestic party, it will withhold the dividend withholding tax on the compensatory amount on behalf of the seller. The domestic party issues a certificate regarding the payment of dividend withholding tax to the buyer which entitles him to a tax credit under the German tax system or a refund of the dividend withholding tax, as the case may be.

If the shares however are sold short through a foreign party and the compensatory amount is also paid via this foreign party, this party will not withhold dividend withholding tax from the compensatory payment. The foreign party does not treat the compensatory payment to the purchaser as investment income. However, a domestic credit institution which disburses this compensatory payment on behalf of the seller to satisfy the seller's compensatory obligation is obligated to issue a certificate for the payment of dividend withholding tax for the compensatory amount regardless of the fact that no tax has been withheld, since the domestic institution did not handle the sale of the shares. In this case there is a danger that the buyer will receive a tax credit or a tax refund of the dividend withholding tax on the compensatory amount despite the fact that no tax has been paid.

The guidance from 5 May 2009 contains measures against sellers and buyers acting in concert to carry out such short-sales. Starting 1 January 2009, the certificates for the payment of dividend withholding tax have to

separately report capital income which arises from shares purchased with a claim to dividends but delivered without the claim. Certificates in which this income is not separately identified have to be returned to the issuer and replaced with new ones.

In the case of dividends arising from shares which were bought with a dividend claim but delivered without it, the refunding or crediting of the dividend withholding tax requires the submission of an additional proof in addition to the certificate for the payment of capital withholding tax. A tax consultant, attorney or auditor has to confirm that on the basis of insight into the circumstances of the company and after questioning the taxpayer, he does not have any knowledge of sellers and buyers acting in concert with regard to the purchase of shares over the dividend record date or of any corresponding short-sales in which no withholding tax has been paid for the compensatory payment.

Cologne Tax Court Requests Preliminary Ruling from ECJ Regarding the Application of the Former Corporate Tax Imputation System on Foreign Dividends

Until the end of the year 2000, the corporate tax imputation system, which is based on the principle of once-only taxation, applied in Germany. Profits made in the assessment period were first subject to corporate income tax at the level of the corporation. In the case of a dividend distribution, the profits were taxed at the level of the

shareholders in accordance with their individual circumstances. The corporate income tax, which had already been paid at the level of the corporation, could be credited against the taxes payable by the shareholder.

However, the corporate income tax could initially only be credited if it was paid on the dividends distributed by a domestic corporation. The European Court of Justice (ECJ) considered this a violation of the free movement of capital (Decision of 6 March 2007 in the matter of Meilicke, C-292/04, see German Tax Monthly April 2007, p. 4). His ruling constitutes the basis for granting tax credits for foreign corporate income tax. However, the ECJ left open how the German corporate tax imputation system could be applied for foreign dividends.

The Cologne Tax Court now had to deal with this issue and decided on 14 May 2009 (File No. 2 K 2241/02) to refer the case to the ECJ for a preliminary ruling again. The substantial problem is that it is for minority shareholders usually factually impossible to determine the exact amount of underlying foreign corporate income tax on the dividends received. Therefore, the Cologne Tax Court asks whether it would violate the free movement of capital in the EU to credit corporate income tax amounting to 3/7 of the gross dividend against the income tax despite the fact that the underlying corporate income tax on the foreign dividend could in reality be higher or lower. In addition, the court inquires which formal requirements have to be met to prove that corporate income tax was paid abroad, in particu-

lar, whether a corporate income tax certificate pursuant to the German Corporate Income Tax Law in the version in force at the time would be necessary, and whether the requirement of such a certificate would violate the free movement of capital.

Since granting corporate income tax credits retroactively requires changing income tax assessment notices which have already become final, the court also submitted two procedural questions to the ECJ relating to § 175 AO (General Tax Code), which regulates changes and rescissions of tax assessment notices and was amended in 2004.

So far, the tax authorities have refused to implement the ECJ's Meilicke ruling of 6 March 2007 with reference to the formal proof of corporate income tax paid abroad and final tax assessment notices. The repeated referral to the ECJ and the decision in the case will therefore be significant for many shareholders of foreign corporations since they may expect future tax refund.

Imprint

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(§ 7 II Berliner PresseG)