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Final Dividend Withholding Tax on Outbound Dividends

In its judgment of 22 April 2009 (file no. I R 53/07), the Federal Tax Court ruled on the discharging effect of dividend withholding tax on the distribution of profits to a foreign parent company.

Distributions of profits from domestic corporations are generally subject to dividend withholding tax, regardless of whether they are paid out to a resident or a non-resident shareholder. However, while profit distributions to a domestic corporate shareholder are tax-exempt pursuant to § 8b (1) Corporate Income Tax Law (KStG) and the withheld tax is refunded or credited against the tax liability of the recipient, the dividend withholding tax is final and definite in the case of non-resident recipients.

In the case at issue, a Swiss corporation received a dividend from a German corporation in 2002, of which a dividend withholding tax of 20% had been withheld. The Swiss corporation received a refund of 5% pursuant to Art. 10 (2) c of the Double Tax Treaty between Germany and Switzerland of

1971. The German tax authorities refused to provide a further refund.

According to the Federal Tax Court, there is no legal basis for refunding dividend withholding tax which has been withheld within the limits of the Double Tax Treaty with Switzerland. The tax exemption of dividends pursuant to § 8b (1) KStG did not preclude the discharging effect of the dividend withholding tax.

In addition, the unequal treatment of outbound dividends was compatible with community law and not in violation of the free movement of capital under Art. 56 et seq. EC Treaty. Referring to various ECJ decisions, the Federal Tax Court reasoned that it was not the primary obligation of the source state to avoid double taxation as from the perspective of the source state a foreign and domestic shareholder should not be treated as being in a comparable situation. Under these circumstances double taxation should be avoided by a bilateral agreement as Germany and Switzerland had entered into stipulating that Switzerland, as the state of residence of the parent company, was obligated to avoid any double taxation by providing tax credits, a

general reduction of Swiss taxes on dividends or a partial or full exemption from Swiss taxation (Art. 24 Double Tax Treaty Switzerland 1971).

The European Commission has started treaty infringement proceedings against Germany due to the unequal treatment of dividends paid to domestic and foreign parent companies and decided in March 2009 to bring the matter before the ECJ. The Commission considers the unequal treatment of outbound dividends to be in violation of the freedom of establishment and the free movement of capital (see German Tax Monthly, May 2009, p. 6).

It remains to be seen how the ECJ will decide on the complaint of the European Commission and what value it will attach to the reference to bilateral agreements in this regard. This question is particularly relevant to cases in which the Parent-Subsidiary Directive does not apply because the parent company holds an ownership interest of less than 10% or the minimum holding period is not met, and in cases where distributions are paid to parent companies in non-EU countries.

Write-ups owing to Exchange-rate Changes for Foreign Currency Liabilities

In its decision of 23 April 2009 (file no. IV R 62/06), the Federal Tax Court ruled on the tax treatment of write-ups owing to exchange-rate changes for long-term foreign currency liabilities.

Liabilities generally have to be disclosed on the balance sheet at the

amount repayable. With regard to foreign currency liabilities, the amount repayable is calculated at the exchange rate prevalent at the time the loan is taken out. Liabilities however have to be restated at a higher going-concern value if their value is deemed to have increased permanently.

In the case at issue, a partnership had taken out a long-term loan in a foreign currency. In 1999 the exchange rate of the foreign currency rose such that the value of the liability increased by approximately 10%. At the end of 1999, the liability had a residual maturity period of ten years. The company restated the liability at the higher going-concern value due to the increase in the exchange rate.

The Federal Tax Court deemed the restatement of the liability at the higher value as inadmissible, since the court considered the change in the value as non-permanent. According to the court, whether a foreign currency liability should be deemed to have permanently increased in value because of a change in the foreign exchange rate depended, to a substantial extent, on the residual maturity period of the liability. For long-term foreign currency liabilities (ten years in the case at issue), it should be assumed that fluctuations in the exchange rate even out over the duration of the liability. This could however be different if a permanent change of the exchange rate is to be expected on the basis of forecasts.

The Federal Tax Court thus applied the comparably restrictive principles for the

capitalization of depreciable fixed assets at a lower going-concern value for tax purposes also for the valuation of long-term foreign currency liabilities. The Federal Tax Court did not address the valuation of short-term liabilities in this judgment.

Offsetting of Losses in Mergers of Corporations

In a judgment of 27 May 2009 (file no. I R 94/08), the Federal Tax Court ruled on the offsetting of losses in mergers of corporations under the Reorganization Tax Law (UmwStG) in force prior to the SE-Introductory Act (SEStEG) which entered into effect as of 13 December 2006.

Under the previous version of § 12 (3) UmwStG, in a merger between corporations, the receiving corporation fully assumed the legal position of the transferring corporation. Therefore, the receiving corporation could offset its own income with loss carryforwards of the transferring corporation provided that the business which had caused the loss had been continued over the following five years to a comparable extent considering all the economic facts and circumstances.

The Federal Tax Court held that the business giving rise to the loss should be deemed to have been continued, even if the business had been transferred to a new entity within the five-year period and this entity had continued the business in an unchanged manner. The possibility of transferring the loss carryforwards to the receiving

entity did not require the receiving entity itself to continue the business.

The Federal Tax Court also affirmed its opinion that a loss carryforward assessed at the level of the transferring entity at the end of the merger year should be tax-effective for the receiving entity already in the merger year.

The judgment has significance for mergers, the registration in the Commercial Register of which was applied for no later than on 12 December 2006, and which are thus subject to the Reorganization Tax Law prior to the amendments implemented through the SEStEG. Under the current Reorganization Tax Law the transfer of loss carryforwards of the transferring entity to the receiving entity is no longer possible.

Statement by the Federal Ministry of Finance on the Treatment of Losses arising from Permanent Establishments in another EU-Member State

Following the ECJ decision of 15 May 2008 in the case *Lidl Belgium* (C-414/06, see *German Tax Monthly*, June 2008, p. 3), the Federal Tax Court had ruled in a judgment of 17 July 2008 that losses arising from a permanent establishment in another EU-Member State were generally not tax-deductible in Germany if the income of the permanent establishment was exempt from domestic taxation based on a Double Tax Treaty. However, the Federal Tax Court considered allowing the deduction of a loss in the same assessment period the loss arose, in so far and to the extent that the taxpayer

is able to furnish proof that a deduction of the losses in the country in which the permanent establishment is located is permanently precluded. The deciding factor for the deduction is therefore the finality of the losses. The requirements the taxpayer has to meet in furnishing proof of such finality have yet to be established in practice. In the case at issue, the Federal Tax Court remitted the case to the court of lower instance to establish the facts.

In a statement issued on 13 July 2009, the Federal Ministry of Finance rejected the application of the principles of the judgment of the Federal Tax Court dated 17 July 2008 beyond the specific court case. The Federal Ministry of Finance opined that the ECJ based its decision in the *Lidl* case only on the legal possibility of deducting the loss in the country of the permanent establishment and not on whether a loss was actually deducted. This very formal legal view would largely limit the possibilities to deduct losses of foreign permanent establishments in Germany.

The Federal Ministry of Finance also rejected drawing any conclusions from the Federal Tax Court judgment regarding the deduction of losses in the same assessment period in which they occurred. As such, even in cases where the finality of losses incurred by permanent establishments has been successfully proven, the point in time of the loss deduction remains uncertain.

If and when losses from permanent establishments in other EU-Member States can be utilized by the head of-

fice in Germany remain uncertain. It is to be expected that only further court decisions will finally settle the issue.

Publication of the Draft Decree on the Transfer of Functions

On 17 July 2009, the Federal Ministry of Finance issued a draft decree on the transfer of functions. The draft refers to provisions for the cross-border transfer of functions between related enterprises which were introduced into the Foreign Transactions Tax Law by the 2008 Business Tax Reform Act. The arm's length price for the transferred function is not determined on the basis of a valuation of the individual transferred assets, but on the basis of the transfer of the function as a whole (transfer package). The transfer package consists of the function as well as the opportunities and risks associated with it, the assets and benefits transferred along with the function and the services rendered in this connection.

Details of the transfer of functions were set out in a regulation of 12 August 2008 (Regulation on Transfer of Functions, see *German Tax Monthly*, July/August 2008, p. 3). The 72 pages of the draft guidance, published on 17 July 2009, on the principles of the transfer of functions contain further explanations, definitions and examples regarding functions themselves, the transfer of functions and the transfer package and its valuation from the perspective of the ministry.

A transfer of function exists if an enterprise transfers, or provides the use of, assets or other benefits together

with the associated opportunities and risks and therefore, the function is restricted or eliminated at the transferring enterprise. The ascertainment as to whether or not a transfer of function has taken place (in particular with regard to the restriction or elimination of the existing function) is based on a period of up to five years. If a domestic parent company for example stops producing a certain product and this product is now produced by a foreign subsidiary, this constitutes a restriction or elimination of the function. According to the Federal Ministry of Finance, this applies even if the parent company ceases the production of a certain product in favor of a successor product which generates higher sales and requires the same amount of labor input. Even if a function is only transferred for a limited time, this constitutes a transfer of functions if it exceeds certain de minimis limits.

If a business function, such as the production of a certain product, is newly initiated in another country, and the same function which already exists domestically is not restricted by the new production in the other country, this merely constitutes a duplication of the existing function and no function transfer within the meaning of the law. However, according to the Federal Ministry of Finance, a decrease in the sales of the domestically manufactured product after the duplication of the function constitutes a restriction of the function. As a result, the guidance qualifies this situation as a transfer of function, even if it is not accompanied

by factors such as cutbacks in the workforce or production. Under such circumstances, the taxpayer has to show credibly that the decrease in sales is not related to the transfer of the function.

According to the draft, the following cases constitute further examples of a transfer of function:

- Relocation of the distribution of a product to a foreign dealer acting in his own name,
- Converting a domestic dealer acting in his own name into a commission agent,
- Converting a foreign company from a contract manufacturer to a producer on its own account, or converting a domestic company from producing on its own account to a contract manufacturer,
- Centralization of purchase at a foreign group company to achieve discounts,
- Transferring research to a foreign affiliated enterprise which carries out the research on its own account.

The draft provides that the arm's length price for the transfer package should generally be determined by means of a hypothetical arm's length comparison, because actual arm's length comparables, on which a price may be based, are usually not available.

The hypothetical arm's length comparison simulates a pricing process for a transfer package between the transferring and the receiving enterprise, whereby both are in possession of all relevant information. The minimum price of the transferring enterprise determined on this basis and the maximum price that the receiving enterprise would be willing to pay form the so-called range of agreement for the determination of the arm's length price. The price in the range of agreement that reflects the arm's length principle with the highest degree of probability is the price that should generally be considered the price for the package. According to the law, if the taxpayer cannot show credibly such a price, the midpoint in the range of agreement should be used.

As stipulated by the ministry, a total value of the transfer package is to be determined on the basis of a net present value oriented method which determines the respective net present value on the basis of the expected net profit after taxes. The expected net profit has to be determined both from the perspective of the transferring and the receiving enterprise. The expected profits of the transferring and the receiving enterprise both before and after the transfer of function have to be determined. In order to determine the net present value, both the capitalization period and the capitalization interest have to be established. According to the ministry, the capitalization period should generally be indefinite.

From the assessment period 2008 onwards, a one-time adjustment of the transfer price is carried out if a significant change in value occurs within a period of ten years. According to the Federal Ministry of Finance, this should also be permissible for assessment periods before 2008 if the resulting adjustment increases tax revenues.

Draft Bill of a Regulation under the Act to Combat Tax Evasion

On 5 August 2009, the Federal Government passed the draft of a regulation under the Act to Combat Tax Evasion. Among other measures, this act provides for the denial of the deduction of business expenses and the denial of exemptions from withholding taxes on dividends if the taxpayer does not meet his obligations to cooperate and to provide evidence on foreign business relations. These special obligations only apply to business relations with persons resident in so-called non-cooperative jurisdictions. This requires that (i) there exists no agreement containing an information exchange clause commensurate with Art. 26 of the OECD Model Tax Convention or (ii) no comparable established practice of providing such information or (iii), no willingness to disclose such relevant information (see German Tax Monthly June 2009, p. 1). The application of these provisions vis-à-vis the taxpayer requires a regulation by the Federal Government which has to be approved by the Federal Council (Bundesrat).

In particular, the regulation issued by the Federal Government on 5 August

2009, which still requires the approval of the Bundesrat, contains detailed provisions regulating the taxpayer's obligations to cooperate and to provide pertinent evidence.

Foreign business relationships with a related person must be documented in a timely manner and such documentation must be provided on short notice to the tax authorities upon request.

The regulation further specifies the cooperation and documentation obligations for foreign business relationships with unrelated parties. The nature and scope of the business relationship, contracts and contract amendments, tangible and intangible assets used, individuals holding an interest in the foreign person, unless such entity is publicly traded, are all subject to the documentation requirement. In addition, the chosen business strategy and the relevant circumstances of the market and the competitive situation must be documented. Documentation has to be carried out in a timely manner and submitted on short notice upon request.

The draft of the regulation contains no provisions with regard to the ascertainment of jurisdictions which are considered non-cooperative (so-called black list). According to the government, the Federal Ministry of Finance will determine the non-cooperative jurisdiction under approval by the state tax authorities and in coordination with the Foreign Ministry and the Ministry of Commerce. Subsequently, the Federal Ministry of Finance will publish the list

of the non-cooperative jurisdictions in a guidance letter.

We expect the Bundesrat to adopt the regulation by mid-September 2009.

Germany terminates Double Tax Treaty with Turkey

On 21 July 2009, Germany unilaterally terminated the Double Tax Treaty with Turkey with effect for assessment periods beginning after 31 December 2010. In the interest of German companies, the treaty was not terminated at shorter notice in order to allow sufficient time for the negotiation of a new treaty. According to the statements by the German government, the reason for the termination was that the government in particular was no longer willing to tolerate tax sparing credits which allowed for the crediting of Turkish tax which was actually not levied against tax liabilities in Germany.

Tax Information Exchange Agreement signed with Gibraltar

On 13 August 2009, representatives of Germany and Gibraltar signed a treaty on the exchange of information for tax purposes. According to the Federal Ministry of Finance, the treaty gives Germany access to information required for purposes of German taxation, including banking information. The access to the information does not depend on criminal proceedings for tax fraud or the suspicion of a tax offense. According to the Federal Ministry of Finance, the treaty also enables the German tax authorities to request information for past assessment periods

when prosecuting tax offenses. The treaty will enter into force after being ratified by the respective legislative bodies in Germany and Gibraltar.

Legislative Process completed

In the last issues of German Tax Monthly we informed you about the changes introduced by the Accounting Law Modernization Act (Edition May 2009), the Act to Combat Tax Evasion (Edition June 2009) and the Citizen Relief Act Health Insurance (Edition July/August 2009). The acts have now been announced in the Federal Gazette without changes.

Imprint

Responsible*: Dr. Martin Lenz
Head of National Tax

KPMG AG
Wirtschaftsprüfungsgesellschaft
Marie-Curie-Straße 30
D-60439 Frankfurt am Main

Editorial Team:

Oliver Dörfler

Dr. Marc Binger

Dr. Christoph Geeb

Eva Handwerker

*Responsible according to German Law
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