

Contents

- Guidances in draft form on 2008 Business Tax Reform Act
- Draft Guidance regarding New Earnings Stripping Rules
- Proposed Guidance on New Corporate Loss Limitation Rules (§ 8c KStG)
- Draft Directive on Trade Tax Addbacks
- Federal Constitutional Court defines limits of Conference Committee Authority
- Transfer of Rollover Reserves from Corporations to Partnerships
- Federal Tax Court Judgment on Repurchase Commitments Undertaken at the Time of Scale
- Federal Tax Court Reverses Stance on Subject-to-tax Clauses
- ECJ Judgment on the Treatment of Currency Losses in Connection with a Permanent Establishment in the EU or EEA

Guidances in draft form on 2008 Business Tax Reform Act

In official guidances in draft form dated 20 February 2008, the Federal Ministry of Finance addresses some of the most important issues raised by the 2008 Business Tax Reform: the earnings stripping rules, the new corporate loss limitation rules and the trade tax addbacks. The draft directives have been provided to business organizations for comment. The final version of the directives is expected to be issued in late April 2008.

Draft Guidance regarding New Earnings Stripping Rules

The deductibility of interest expense is limited by the earnings stripping rules (§ 4h EStG – Income Tax Law and § 8a KStG – Corporate Income Tax Law). Interest expense in excess of interest income is deductible only up to 30 % of tax EBITDA. The law provides exceptions from the application of the earnings stripping rules: (i) de minimis threshold; (ii) non-group businesses; (iii) escape clause (*find detailed information in German Tax Monthly March 2007, page 1 and April 2007, page 1*). The following comments provide an over-

view of the highlights of the proposed guidance.

Interest expense and interest revenue

The draft of the Federal Ministry of Finance clarifies that the earnings stripping rules in principle apply to revenue and expense from the provision of monetary capital. Debt capital is defined as any provision of capital in cash form that may be accounted for as a liability and does not constitute equity to for tax purposes.

Under the draft guidance, the interest portion of lease payments constitutes interest expense and revenue for purposes of the earnings stripping rules if beneficial ownership passes to the lessee, so that it must carry the asset on its balance sheet.

Were beneficial ownership remains with the lessor, the proposed guidance states that the interest portion of lease payments may be treated as interest revenue and expense only where the arrangement constitutes financial leasing (full-pay-out-lease) of real estate in the sense of the relevant official guidance of the Federal Ministry of Finance.

Interest revenue or interest expense results from compounding and discounting liabilities that bear no interest or a pay a low rate of interest.

Under the draft, interest income and interest expense is not taken into account for purposes of the earnings stripping rules when a liability or money claim is valued for the first time. The revenue resulting from discounting a liability on which no interest or a low rate of interest is payable is thus not treated as interest income for purposes of the earnings stripping rules when the liability is first entered in the accounts. However, the expense that results in the following years as the liability is progressively written back up would constitute interest expense for purposes of the earnings stripping rules.

Interest carry-forward

Interest expense that is not deductible in a given period may be carried forward.

Interest expense carried forward will, however, be erased in reorganizations and where the change-of-control rules apply. According to the proposed guidance, the interest carry-forward is forfeited pro rata if a branch of activity is terminated or transferred.

Partnerships

When allocating the non-deductible interest expense of a partnership, the level of the deemed business property (Sonderbetriebsvermögen) and the level of the partnership are distinguished. Non-deductible interest expense at the partnership level is allocated to the partner proportionally.

Non-deductible interest expense at the level of deemed business property is allocated to the particular partner.

Where a partner leaves the partnership, interest carry forward are forfeited in proportion to the partner's interest in the partnership.

Tax groups

The controlling company and the controlled companies are treated as a single entity for purposes of the earnings stripping rules.

Under the draft guidance, interest loss carry-forwards of a controlled company that arose before formation of the tax group cannot be used for corporate income tax purposes as long as the tax group remains in effect. Interest carry-forwards arising while the tax group is in effect are attributable to the controlling company. The termination of the tax group causes a pro rata forfeiture of the interest carry-forward.

Consolidated group

The earnings stripping rules do not apply to entities that are not members of a controlled group or are only proportional members (non-group businesses, § 4h (2) sent.1 (b) EStG). An enterprise is regarded as part of a controlled group if it is or if it may be included in consolidated financial statements in accordance with IFRS, German GAAP, or U.S. GAAP.

The proposed guidance states that special purpose vehicles are members of a controlled group if, under the relevant accounting standard, they must be included in a consolidated financial statement. An exemption is intended

for securitization special purpose vehicles (ABS structures).

Escape clause

Even if the business belongs to a consolidated group, the earnings stripping rules still do not apply if the equity percentage of the business is no more than 1 percentage point less than the equity percentage of the group as a whole (escape clause, § 4h (2) sent. 1 (c) EStG).

The proposed guidance states that existing group financial statements may generally be used for purposes of the escape clause if they give rise to an exemption under §§ 290, 291, and 292 HGB (Commercial Code). Accordingly, it should be possible to rely on existing group financial statements for purposes of the escape clause even though individual companies were not included in the financial statements, e.g. because not material.

Shareholder debt (§ 8a KStG)

The exception for non-group businesses and the escape clause may only be relied on by corporations and by partnerships owned by corporations if no detrimental shareholder debt financing within the meaning of § 8a KStG is present.

Detrimental shareholder debt financing is present where more than 10 % of net interest expense results from payments for debt capital to (i) a substantial shareholder (person holding more than one fourth of share capital), (ii) a person related to such a shareholder or (iii) a third party with a right of recourse against either a substantial shareholder or one of its related parties.

The proposed guidance takes the position that the escape clause is only applicable to an entity belonging to a consolidated group if a showing is made that all (domestic and foreign) group companies comply with the 10 % limit. Under this view, the escape clause could not be relied on if one group company exceeded the 10 % limit. The proposed guidance does not limit this principle to domestic business property.

Proposed Guidance on New Corporate Loss Limitation Rules (§ 8c KStG)

§ 8c KStG limits the deduction of losses by corporations replacing the previous change-of-control rules of § 8 (4) KStG.

Transfers of shares and comparable events

Under § 8c KStG a detrimental change in ownership occurs when more than 25 % of the share capital, membership rights, ownership rights, or voting rights in a corporate entity are transferred directly or indirectly within a period of five years to a (single) acquirer or its related parties or to a group of acquirers with convergent interests, or when a comparable event occurs.

The statute takes an extensive understanding of the indefinite legal concept "comparable event". Especially considered to constitute "comparable events" within the meaning of the statute are:

- Transfers of pre-emptive-rights or profit-sharing rights treated as equity pursuant to German tax law

- Agreements on voting rights (such as agreements to exercise voting rights in a prescribed manner)
- Merger into a loss company
- Share for share exchanges
- Contribution of a business, branch of activity, or interest in a business partnership
- Acquisitions by a corporation of its own shares
- Capital reduction.

The events referred to are only detrimental if they cause an acquirer or its related parties or a group of persons with convergent interests to acquire an (additional) ownership interest of more than 25 %.

The quota of a change in ownership is determined on the basis of the voting rights for common shares and on the basis of the overall nominal capital for preferred shares. Assuming a corporation has two classes of shares consisting of 70 % common shares and 30 % preferred shares, a transfer of 10 % of preferred shares and 14 % common shares triggers a forfeiture of 30 % of the losses ($10/100 + 14/70 = 30/100$).

As to indirect transfers of shares etc. the proposed guidance states, that shortening or lengthening chains of ownership could also trigger a detrimental change in ownership.

Time of transfer

Pursuant to the proposed guidance, the time of the detrimental change in ownership is determined with reference to the passage of beneficial ownership. This date determines both the applica-

bility of the new rules of § 8c KStG to the transaction and the five year period during which share transfers are aggregated. The proposed guidance states, however, that retroactive effect of reorganization measures is not recognized for purposes of the loss limitation rules.

Five year period

All acquisitions by the same acquirer or group of acquirers within a five year period are aggregated in determining whether a detrimental change in ownership has occurred.

The proposed guidance states that, once the relevant limit (more than 25 %) has been exceeded, the next share transfer to follow marks the beginning of a new five year period. For instance, a transfer of 25.1 % of the shares in a loss corporation to an acquirer in assessment period 01 results initially in a pro rata forfeiture of losses. If another 25 % are transferred to the same acquirer in assessment period 03, all unused losses incurred up to the time of the second transfer are forfeited. Should separate share transfers be seen as one transaction under the substance-over-form doctrine, they may nevertheless be aggregated. According to the tax authorities transfers occurring within a one year period shall be aggregated unless the taxpayer proves that there is no nexus (rebuttable presumption).

Draft Directive on Trade Tax Addbacks

The tax authorities have released a draft on the addback rules for trade tax

purposes, which are already in power for trade tax period 2008.

General comments

The addback for trade purposes shall regulate in particular financing charges. If a contract contains agreements on two or more transactional components (multi-element contract), each element, if separable, is analyzed individually for purposes of trade addback rules. If the contractual relationship constitutes a uniform and indivisible whole, characterization of the contract in whole depends on the dominating performance.

Loans granted by the partner to the partnership, nor the distributive share of an atypical silent partner is subject to addback.

Loans inside tax consolidated groups

Expenses resulting from loans inside a tax consolidated group are not subject to addback. This prevents a double taxation caused by addbacks for trade purposes.

Considerations for debt (§ 8 no. 1 (a) GewStG)

In the draft directive opinion in particular following circumstances trigger the addback: pass-through-loans, payments for an interest swap (except interest swap from lending institutions), discount revenue and additional costs in case of forfeited claims, which result from conducted and long-term contracts (ex. letting contracts).

Rental and lease payments for moveable and immovable assets (§ 8 no. 1 (d) and (e) GewStG)

Rental and lease payments must be qualified by existing tax directives if they trigger 65 % addback rule for immovable assets or 20 % addback rule for movable assets.

Expenses for time-limited provision of right (§ 8 no. 1 (f) GewStG)

Addback rules apply also to fees paid for private or public concession, industrial property rights, copyrights license rights, unprotected inventions, know-how, software, customer bases, rights to names and goodwill. Royalty payments are not added back if the license in question entitles the licensee solely to convey rights to third parties that it derives from the license. This exception is accordingly inapplicable to the last link in the "licensing chain".

The fact that rights are provided on a short-term basis only is irrelevant for purposes of the addback. On the other hand the provision of rights must be subject to a time limitation in order for addback rules to apply. A time limitation is to deny if the economic reality of the transaction is such that beneficial ownership has been transferred.

Federal Constitutional Court defines limits of Conference Committee Authority

Article 77 (2) of the the German Constitution provides for a conference committee that mediates between the upper and lower houses of the German parliament (Bundesrat and Bundestag) in an attempt to arrive at a consensus

version of pending legislation where the two houses do not agree. At issue in the Federal Constitutional Court ruling of 15 January 2008 is the formal constitutionality of a provision that the conference committee added in 1997 to its proposed consensus version of the Act for the Further Reform of Business Taxation. The provision had not been the subject of prior legislative proceedings.

The Federal Constitutional Court holds that the provision is unconstitutional because the manner of its adoption was improper (formal unconstitutionality) as the right to initiate legislation is reserved to the lower house, the upper house, and the federal government. However, the court also finds that the constitutional violation was not patent and therefore does not render the provision null and void.

Similar issues are posed by two other cases currently pending before the Federal Constitutional Court. These concern the constitutionality of loss utilization restrictions in § 12 (3) sent. 2 of the 1995 Reorganization Tax Law and § 8 (4) of the 1996 Corporate Income Tax Law. The Federal Constitutional Court's disposition of these cases will thus in all probability mirror that of its ruling of 15 January 2008.

Transfer of Rollover Reserves from Corporations to Partnerships

The March 2008 edition of German Tax Monthly reported on the Federal Ministry of Finance guidance of 15 January 2008 relating to § 6b EStG (Income Tax Law). This guidance addressed the transfer of rollover reserves from cor-

porations to partnerships in which the corporation is a business partner. In response to criticism of the retroactive application of the guidance, the Federal Ministry of Finance issued supplementary guidance on 29 February 2008 addressing this issue. The new guidance states that balance sheets prepared on or before 1 April 2008 in accordance with the previously valid administrative regulations may be carried forward in the following tax assessment periods in accordance with these former regulations.

Federal Tax Court Judgment on Repurchase Commitments Undertaken at the Time of Sale

At the time of sale of motor vehicles to leasing companies and car rental companies, a motor vehicle dealer agreed to repurchase the vehicles at prearranged fixed prices at the end of a stipulated period. In its recently published judgment of 11 October 2007, the Federal Tax Court held that the dealer must establish a provision for the repurchase commitment in the amount of the payment allocable thereto. The provision is charged against expenses and thus reduces taxable income.

The Federal Tax Court viewed the repurchase commitment as a put option granted by the dealer. It thus in effect divided the purchase contract into a sales transaction and an option transaction. At the time of contracting, both components of the agreement were still executory since neither contracting party had as yet rendered performance. The court held that the put option ceased to be executory once the leas-

ing or car rental company had paid the agreed consideration for the grant of the option as a component part of the purchase price. The consideration for the option seller's commitment should therefore be separated from the overall purchase price and accounted for as a liability until the option is exercised or expires.

This was a case of first impression for the Federal Tax Court. It held that a contract ceases to be executory even though the in-kind performance or service has yet to be rendered where, as in the instant case, the party obligated to make a money payment is by way of exception required to perform before the other party.

This is a condition for tax acceptance of the provision because provisions for contingent liabilities are permitted only to reflect obligations of later performance that result from transactions, or discrete parts thereof, that have already been performed and are no longer executory.

Federal Tax Court Reverses Stance on Subject-to-tax Clauses

In a judgment rendered on 17 October 2007 dealing with Germany's tax treaty with Italy, the Federal Tax Court expressly reverses its previous position as to the language needed to create a subject-to-tax clause in tax treaties.

Tax exemptions under tax treaty law generally apply whether or not the exempt income is actually subject to taxation in the source country. Subject-to-tax clauses are intended to make the exemption in the country of residence contingent on actual taxation of the

income in the source country. Germany has as a rule sought to implement subject-to-tax clauses by adding language to its tax treaties stating that income shall be deemed to arise from sources in the other treaty country if it is taxed in this country.

In a 2003 decision on the tax treaty with Canada, the Federal Tax Court held that this wording was not sufficient to constitute a subject-to-tax clause. The court stated at the time that the provision merely allocated income territorially without thereby reestablishing the right of the country of residence to tax the income in question.

In its decision of 17 October 2007 on the tax treaty with Italy, the Federal Tax Court distances itself from its earlier interpretation. The court holds that the provision is to be understood as a subject-to-tax clause, by virtue of which the right of taxation reverts to the country of residence (Germany, in the instant case) where there is no effective taxation of the income in the source country. Explicit language regarding the reversion of the right of taxation is unnecessary in the court's most recent view.

Wording similar to that in the tax treaty with Italy is found in Germany's tax treaties with Denmark, Norway, Sweden, the United States, and Canada.

ECJ Judgment on the Treatment of Currency Losses in Connection with a Permanent Establishment in the EU or EEA

In its decision of 28 February 2008 in the matter of Deutsche Shell (C-

293/06), the European Court of Justice (ECJ) holds that the German head of office is permitted to deduct a currency conversion loss that arises when its foreign permanent establishment repays its dotation capital (quasi-equity funding including start-up capital). We reported on the opinion of the advocate general in the December 2007/January 2008 issue of German Tax Monthly.

The ECJ notes in its judgment that there is no connection between the

depreciation in the value of the foreign currency and the tax-free capital gains of the permanent establishment under the tax treaty. The court held that the prohibition on deduction under § 3c EStG (Income Tax Law) cannot stand if the currency loss would otherwise not be taken into account in any jurisdiction. In such cases, the court stated that the prohibition on deduction was an obstacle to the freedom of establishment under Article 43 EC because

its application would place permanent establishments in other EU and EEA countries at a disadvantage compared with domestic permanent establishments.

The ECJ's judgment bars Germany from denying domestic companies a deduction for currency conversion losses arising in direct connection with permanent establishments located elsewhere in the EU or the European Economic Area.

Imprint

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