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Blocking Amount under § 50c EStG for so-called Double Conversion Structures

Under the tax law in effect until 2001 a tax-free step up in basis of the underlying assets could be obtained upon conversion of a corporation into a partnership provided certain prerequisites were met. The step up amount was determined by the difference between the higher acquisition costs for the shares (outside basis) and the lower equity of the target corporation (inside basis) subject to certain adjustments. In particular, the step up amount was reduced by a so-called blocking amount (Sperrbetrag) according to § 50c EStG (Income Tax Law).

Sec. 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 divi-

dends paid by the acquired corporation to the extent of the blocking amount. The blocking amount is defined as the difference between the purchase price of the shares and their par value.

The purpose of the provision in principle was to avoid a tax deductible expense in connection with share acquisitions where the seller was not taxable with his capital gain.

The Federal Tax Court's judgment of 12 November 2008 (I R 77/07) is the first high court ruling on the so-called double conversion structure. In the case decided, shares in a target company, for which a blocking amount had to be recognized (as the seller was not subject to tax with his capital gain), was transferred to another German resident company of the same group.

After conversion of the target company (second-tier subsidiary) from corporate to partnership form, the same was done with the first-tier subsidiary. For the conversion of the second-tier subsidiary, a blocking amount pursuant to § 50c EStG could not be avoided and

hence, no step up in basis of the underlying assets could be achieved.

The question was whether the result of the second conversion (that of the first-tier subsidiary) is also impacted by the blocking amount. The lower tax court held that there were no legal grounds for the application of a blocking amount in such cases. While there were specific anti-abuse provisions in place (namely § 50c (7) EStG), these were in the opinion of the lower tax court not applicable.

The Federal Tax Court now ruled that a blocking amount pursuant to § 50c (7) EStG also applies in the case of a conversion of the first-tier subsidiary into a partnership and hence, no step up could be obtained. Under § 50c (7) EStG, reductions in profits relating to shares in a corporation that has directly or indirectly acquired shares subject to a blocking amount are disregarded to the extent the reductions in profits are attributable to the fact that profit distributions have been "passed on".

With regard to the question of whether profit distributions are "passed on", the Federal Tax Court takes up on the legal considerations in its 2007 decision on § 50c EStG in a case that involved an upstream merger (see May issue of GTM 2008). In this case the court held that under § 50c (7) EStG the "passing on" of parts of the equity in the course of a merger constituted "passing on" of profit distributions. According to the court, the same considerations apply for the case at hand because the partnership holds all the assets of the cor-

poration following the conversion which included the equity gained in the corporate income tax credit system. A blocking amount therefore applies in the conversion of the first-tier subsidiary into a partnership.

This is regardless of the fact that the transaction giving rise to the blocking amount occurred in May 1997, while § 50 c (11) EStG, which makes § 50c (7) EStG applicable, only entered into force in October 1997. Only recently the Federal Tax Court had held that new laws were limited with regard to past events (e.g. mergers) so that the taxpayer's expectations owing to past dispositions in the relevant assessment period were not disappointed by a tightened taxation.

In the new judgment the court now limited the protection of past dispositions so that the taxpayer who uses tax structures must expect that legislation will counteract this structure in the assessment period the disposition takes place. Therefore, the legislators were not prevented from extending the scope of an anti-abuse provision to cases which already existed at the time the provision was passed, as long as the legal consequences only take effect after the passing of the law.

Priority of the Reversal of Write-downs which are not Tax-Effective

In its judgment from 2 December 2008 (6 K 2726/06), the Düsseldorf Tax Court held that for write-downs on shares to lower going-concern value which were tax-effective in earlier years and subsequent write-downs not being tax-

effective in later years, a later write-up has to reverse the write-downs which were not tax-effective first.

Within the change of the taxation system for corporations the tax treatment of write-downs on interests in other corporations has changed. Write-downs could be deducted in the imputation system up to the assessment period 2001, but since the introduction of the exemption method they are no longer tax-effective from the assessment period 2002. Depending on the previous write-downs, the write-ups are correspondingly tax-effective or not. Consequently, the write-ups are fully taxable if the write-downs occurred within the scope of the imputation system. 5 percent of the write-ups are subject to tax pursuant to § 8b (3) sent. 1 KStG, if the write-downs occurred within the scope of the exemption method.

The plaintiff, a limited liability company (GmbH) made write-downs before as well as after the change of systems. Since the shares appreciated in value a recapture took place. Accordingly the GmbH wanted to reverse the recent write-downs without tax effect first and thus leave the write-ups tax-exempt (except for 5 percent). The tax authorities were of the opinion that all tax-effective write-downs should be reversed first, subjecting all the write-ups to taxation.

The Tax Court ruled in favour of the plaintiff and denied the need for an explicit legal provision, as it stated that the order in which the write-downs are

to be reversed follows from logic. The earlier (tax-effective) write-downs are on higher book values and the recent (not tax-effective) write-downs are on lower book values. Write-ups have to be carried out in the reverse order so that recent write-downs necessarily have to be reversed first. As a result, the write-ups were tax-exempt (except for 5 percent) until the write-downs with no tax effects have been fully reversed.

In principle, the Düsseldorf Tax Court sees no reason to object to the fact that 5 percent of the tax-exempt write-ups are treated as non-deductible business expenses and added to the taxable income pursuant to § 8b (3) sent. 1 KStG. Likewise, the ruling court has no constitutional objections against the provision.

Judgment of the Cologne Tax Court in a Case of Change-of-Control similar to a Qualified Share Transfer

According to the change-of-control rules, it is a condition for a loss deduction that the corporation claiming the loss is identical to the corporation suffering the loss not only in legal but also in economic terms. The law states that the economic identity will in particular change if more than 50 percent of all shares are transferred (so-called qualified share transfer) and the corporation injects predominantly new business assets.

The change-of-control rules were replaced by loss limitation rules (§ 8c KStG) as part of the 2008 Business Tax Reform Act. Nevertheless, the change-

of-control-rules remain applicable alongside § 8c KStG, if the transfer of shares began prior to 1 January 2008 and the injection of predominantly new business assets takes place before 1 January 2013.

The Cologne Tax Court ruled in its judgment of 22 October 2008 (13 K 3113/07) on a case in which only 49 percent of the shares of the corporation had been transferred; the tax authorities nevertheless assumed that this transaction was similar to a qualified share transfer.

Following the consistent holdings of the Federal Tax Court, the Cologne Tax Court ruled that only situations which were analogous to a transfer of a majority interest could qualify as similar to a qualified share transfer. According to the Tax Court, however, such an analogous situation could only be assumed in extreme cases.

In the case reported hereon the managing director, who had been the sole shareholder, was replaced by the acquirer. In addition, the articles of association were amended that a 75 percent majority of the votes was necessary to pass resolutions. In practice, this change resulted in the need for unanimity, and the acquirer could not be outvoted by the majority shareholder.

On the other hand, the acquirer did not have the possibility of controlling the company by means of majority votes, so that the change was not relevant.

The same applies for the position as managing director. While the acquirer

can manage the business of the corporation, his options are limited on important issues due to the required consent of the shareholder's meeting.

In the case at hand in which the acquirer had leased the business premises to the corporation, the court held that, since the lessor was bound to this lease for 5 years, a time during which he could not unilaterally terminate the contract, this could not be used to exercise control over the company and was therefore not relevant.

In summary, the Tax Court found that the transaction did not grant the acquirer of the minority interest a position similar to that of a holder of a majority interest. Thus, the economic identity of the corporation did not change, and the losses could be utilized in later assessment periods. The judgment is final.

Treatment of Gains from Debt-Restructuring

In a decree from 11 February 2009, the financial authorities further elaborated on the tax treatment of gains which arise in the context of debt restructuring.

The Federal Ministry of Finance already set out its basic position regarding this topic in a decree from 2003. If a company's debt is partially or wholly cancelled in the context of a reorganization of the company, this gives rise to a one-time gain for the company (gain from debt-restructuring). This is true both for cases in which the debt is cancelled outright and for cases where the debt can be collected later on sub-

ject to certain conditions (debtor warrant). In principle, the gain is subject to taxation. Under certain conditions, the income tax or corporate income tax on this amount can be deferred or rather abated.

The first condition for the deferment or abatement of the tax on a gain from debt-restructuring is that the company is in need of reorganization and that this reorganization has the prospect of success. Furthermore, the cancelling of debt must be an appropriate reorganization measure and it must be granted by the creditor for the purpose of supporting the reorganization of the company. According to the decree from 2003, these requirements were generally met if a reorganization plan existed. The decree from 11 February 2009 states now that a financial reorganization plan is a necessary requirement.

The fact that a company has an excessive debt burden is not in itself sufficient cause to assume that it is in need of reorganization. If, on the other hand, the company is in danger of going insolvent, this is a sufficient reason to assume such a need. Whether or not a company is capable of being rescued depends on all circumstances which have an impact on the financial situation of the company.

The gain from debt-restructuring is calculated by including loss carryforwards and current negative income regardless of limitations on loss deductibility and limitations on offsetting current negative income. This reduces

the gain from debt-restructuring. A loss in the assessment period following the reorganization is carried back and lowers the gain from the debt-restructuring. Later payments on a debtor warrant of the creditor also lower the gain.

Initially, the tax on the gain from debt-restructuring is deferred. After the final gain from debt-restructuring is determined, the income tax or corporate income tax is abated. The same applies for interest accruing on the abated tax during the deferral.

No Adjustment of Taxable Income in Cases of Cross-Border Intra-Group Suppliers' Credits

In a ruling issued on 1 July 2008 (10 K 1639/06), the Munich Tax Court ruled on the issue of adjustment of taxable income according to § 1 (1) Foreign Transactions Tax Law (AStG) in cases of cross-border intra-group suppliers' credits. It further specified the criteria for assuming a foreign business relationship as a requirement for an income adjustment. If income derived by a taxpayer from a foreign business relationship with a related party is reduced because the terms and conditions differ from arm's length principle, then – without prejudice to other provisions – the taxpayer's income shall be restated to equal that which would have resulted under the terms and conditions as agreed between third parties unrelated to each other (§ 1 (1) AStG).

The decision of the Munich Tax Court from 1 July 2008 involved a domestic

corporation which granted interest-free suppliers' credits to a lower-tier subsidiary located in a foreign country. The foreign lower-tier subsidiary did not have sufficient equity. The foreign company was therefore dependent on economic help from within the group in the form of interest-free suppliers' credits to carry out its business.

The Munich Tax Court held that the interest-free suppliers' credits were granted because the creditor had an indirect ownership interest in the corporation and therefore did not constitute a foreign business relationship. The court referred to cases in which a foreign subsidiary was supplied with equity capital because of legal relationships under company law which are not recognized as a business relationship. If no equity capital is supplied to a corporation and it is instead financed by other means, it should not be treated any differently. In the case at hand, interest-free suppliers' credit was used to replace the otherwise necessary equity capital of the company.

Because the domestic company granting the loan was therefore not involved in a foreign business relationship, the income was not adjusted. An appeal was filed with the Federal Tax Court.

The question of whether financing relationships between affiliated companies can be considered a foreign business relationship is a particularly controversial issue.

For example after Federal Tax Court from 29 November 2000 a guarantee granted without consideration did not

constitute a foreign business relationship if, without the guarantee, the favored company did not have sufficient equity capital to serve as a financing corporation for the rest of the group.

At least the legislature amended the law to specify that every foreign relationship under the law of obligation which is not an agreement under company law constitutes such a foreign business relationship in 2003. But the definition of foreign business relationship rest affected by legislative reactions and judiciary decisions. So in a judgment of 28 April 2004, the Federal Tax Court left the question open whether the granting of interest-free loans to a domestic corporation for the financing of a permanent establishment in a foreign country constituted such foreign business relationships. In the time after this decision, Lower Tax Courts denied a foreign business relationship in cases where a shareholder waived the interest on a loan granted to a foreign subsidiary.

Tax Treaty with the Isle of Man

The Federal Republic of Germany and the Isle of Man have concluded a treaty for the avoidance of double taxation with respect to enterprises operating ships in international traffic. In addition they have concluded a treaty concerning assistance in civil and criminal tax matters through the exchange of information.

The latter treaty enables both countries to request information on tax issues. With regard to Germany, this applies to the income, corporate, trade, capital

(net worth) and inheritance tax, including the supplements levied in these cases. The information that can be requested includes information on the financial situation (e.g. information held by banks) as well as ownership information on companies, partnerships, collective investment schemes, trusts, foundations, and similar. The competent authorities are granted the right to request interviews of individuals and the examination of records on the territory of the other contracting party, if the individuals or other persons concerned have given their prior written consent. In addition, the requested party may allow the competent authorities of the requesting party to send representatives to attend a tax examination on the territory of the requested contracting party.

The agreement for the avoidance of double taxation with respect to enterprises operating ships in international traffic applies for all taxes on income levied within the territory of the parties. In principle, both countries have the right to tax the revenues of the enterprises run by their residents. Similarly, the taxation of remuneration for dependent employment exercised aboard a ship operated in international traffic by an enterprise of a contracting party generally lies with this contracting state. The remuneration may be taxed by the other contracting state if the employee is a resident of the other contracting state with credit for taxes levied in the source state.

In principle, both of these treaties enter into force one month from the date on

which the contracting parties have notified each other that the requirements for the entry into force have been fulfilled. While the treaty for the assistance in civil and criminal tax matters is generally applicable immediately after entering into force, the treaty on the avoidance of double taxation is largely confined to assessment periods starting after 1 January 2010.

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