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Government Finalizes Draft 2009 Tax Act

On 18 June 2008, the German cabinet adopted the version of the 2009 Tax Act that it will send to the legislature. The principal changes contained in the draft are as follows:

Losses with a Foreign Nexus (§ 2a EStG)

The bill would permit in § 2a EStG certain losses arising in EU or EEA countries to be netted against German-source income where the applicable tax treaty avoids double taxation under the credit method. According to the explanation of provisions accompanying the bill, foreign losses would – in compliance with ECJ jurisprudence – be disregarded in Germany where the exemption method applies. As a flanking measure, the provisions under which positive and negative foreign income is taken into account solely to determine the applicable tax rate (positive and negative progression clause) would be limited in EU/EEA cases. Offset and deduction of losses arising in so-called third countries (non-EU/EEA

countries) are subject to stricter regulations. The amended terms of § 2a EStG would apply to all assessments of tax that have not yet become final.

Losses of Foreign Permanent Establishments

Through 1989, foreign permanent establishment losses could be deducted in Germany despite the application of a tax treaty exempting corresponding gains from German taxation (§ 2 (1) sent. 1 and 2 AuslInvG – International Investment Act). Currently, losses so deducted are subject to recapture only to the extent of subsequent profits derived on or before 31 December 2008. Under draft § 8 (5) sent. 2 AuslInvG, recapture would apply without time limit.

Taxation of non-resident Taxpayers

The draft legislation contains many changes in the taxation of non resident taxpayers.

Income from leasing real property for a period of limited duration would in the future constitute German-source commercial business income even in the absence of a domestic permanent es-

establishment. A determination of taxable income according to cash-basis accounting would no longer be possible.

The assessment procedure under § 50 EStG for non-resident taxpayers would be modified to apply the standard progressive rates defined in § 32a EStG without the current minimum tax rate of 25 %. However, no personal exemption (zero-bracket amount) would apply. The draft bill would also abolish, with regard to non-resident taxpayers, the inclusion of income not subject to taxation in Germany for purposes of calculating the tax rate (progression clause).

As under current law, the tax withheld on income from employment or from capital and the tax withheld under § 50a EStG would still constitute satisfaction in full of a non-resident taxpayer's German tax liability. However, the exceptions to this principle would be materially expanded, thus subjecting non-resident taxpayers to the assessment procedure in many cases in the future.

In compliance with the ECJ's *Scorpio* decision, non-resident taxpayers from EU/EEA countries would in the future be able to elect taxation on a net basis with respect to income from artistic, athletic, acrobatic, or similar performances, income from the utilization of such performances, or income from service on a supervisory board. This would permit the deduction of expenses (business expenses, costs of earning non-business income) that are directly related to the receipts. Where

tax is withheld on the net amount, a standard tax rate of 30 % would apply for individuals. The tax rate for non-resident corporate entities would be 15 %.

The new provisions would apply from the 2009 assessment period onwards. The assessment procedure under § 50a EStG would apply to income from capital received on or after 1 January 2009.

[Treaty and Directive Shopping](#)

The withholding tax on certain income from capital (such as dividends) received by foreign corporate entities will be reduced from 25 % to 15 % (§ 44a (9) EStG). The provision intends to adjust the withholding tax rate to the corporate tax rate of 15 %. The reduction is limited to recipients meeting the activity requirements of § 50d (3) EStG.

[Waivers of Withholding on Income from Capital](#)

Effective 1 January 2009, the 2008 Business Tax Reform Act created an exception to withholding on income from capital for certain corporations. The government draft of the 2009 Tax Act expands the withholding exception to include income from capital payable to

- resident corporations and
- other creditors (persons subject to income tax, non-resident entities subject to corporate income tax) where the income from capital constitutes business revenue of a domestic business and the tax-

payer confirms this to the paying agent on the officially prescribed form (draft § 43 (2) sent. 3 EStG).

Assuming the fulfillment of the above prerequisites, no withholding would be required under the new provisions in particular on (i) gain on the sale of shares in a domestic or foreign corporation and (ii) foreign dividends and similar income. The changes would apply to income from capital received on or after 1 January 2009.

[Flat Tax on Income from Capital](#)

The exchange of shares in corporate entities with registered office or place of management in a non-EU/EEA country ("third country") for other shares would not trigger immediate taxation, provided Germany's right of taxation with respect to the gain on sale of the shares received is not restricted. The purpose of this change is to ensure that the flat tax is not triggered in situations where no cash payment is involved.

With regard to the flat rate tax on income from capital, the draft bill also contains separate provisions regulating the credit of foreign withholding taxes (draft § 32d (5) EStG).

[Bookkeeping in a Foreign Country \(draft § 146 \(2a\) AO\)](#)

The draft of the bill contains provisions authorizing the tax authorities to grant a taxpayer request to transfer its computer-based accounting system and other electronic records to another member country of the EU or EEA when certain requirements were met.

A retransfer to the domestic territory has to take place where a prerequisite is no longer met. The new provisions would take effect on the day after promulgation of the 2009 Tax Act.

Input VAT Deduction for Motor Vehicles

The law currently permits deduction of the full amount of input VAT with respect to motor vehicles that are used for both business and non-business purposes. As a consequence, the non-business use is subject to VAT as value conferred without consideration.

The draft bill would permit only half of input VAT to be deducted with respect to expenses on vehicles that are used in part for non-business purposes. Conversely, taxation of the non-business use would be eliminated. Changes would take effect on 1 January 2009 at the earliest.

Outlook

The Bundestag and Bundesrat (lower and upper houses of parliament) are expected to commence deliberations on the bill in the autumn following their summer recess. The legislative process should be completed by the end of 2008; the planned date of entry into force is 1 January 2009.

Draft Regulation on Transfers of Functions

Provisions on transfers of functions were added to the tax code for the first time by the 2008 Business Tax Reform Act (§ 1 (3) AStG – Foreign Transactions Tax Law). Pursuant to a statutory

grant of authority to regulate the application of these and other transfer pricing provisions (§ 1 (3) sent. 13 AStG), a draft regulation on application of the arm's length principle (§ 1 (1) AStG) to transfers of functions was recently submitted to the Bundesrat (upper house of the German parliament) for its approval. Following approval by the Bundesrat, the regulation would take effect retroactive to 1 January 2008 and apply to the tax assessment periods 2008 and following.

The draft regulation defines a function as a business activity consisting of an aggregation of operational tasks of the same kind that are performed by certain units or departments of an enterprise. A transfer of function occurs where an enterprise (the transferring enterprise) conveys assets and other benefits to a related enterprise (the receiving enterprise) together with the associated opportunities and risks or provides these for use by the receiving enterprise so that the receiving enterprise can exercise a function that was previously exercised by the transferring enterprise, thereby restricting the transferring enterprise's exercise of the function in question. Where no restriction in the exercise of the relevant function by the transferring enterprise occurs within five years, no transfer of function occurs even though all other requirements are met. A transfer of function involves the transfer of a so-called transfer package that consists of the function and the opportunities and risks associated with this function as

well as the assets and benefits that the transferring enterprise conveys to the receiving enterprise along with the function, or provides for its use, and the services rendered in this connection.

The draft regulation provides that the price of the transfer package as a whole shall as a matter of priority be determined under the comparable uncontrolled price method, the resale price method, or the cost-plus method (§ 1 (3) sent. 1 - 4 AStG) where fully or partially comparable arm's length values are available. Where arm's length comparables are not available, which is as a rule the case, the price of the transfer package is determined by means of a hypothetical arm's length comparison. The total value of the transfer package is then determined under business administration principles on the basis of the profit potential of the function being transferred. Profit potential refers to the net after tax profits (present value) which, at the time of transfer, the transferred function may be expected to generate, which a reasonable and conscientious business manager acting for the transferring enterprise would not relinquish without consideration, and for which such a business manager acting for the receiving enterprise would be willing to pay consideration. 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. The price in the range

of agreement that reflects the arm's length principle with the highest degree of probability is the price that is actually applied. The midpoint in the range of agreement is used unless a credible showing can be made in favor of another value (§ 1 (3) sent. 5 - 7 AStG).

The profit that a reasonable and conscientious business manager would expect from the transferred function is the basis for determining the profit potential and hence the range of agreement. The respective profit potential shall be determined with due regard to all circumstances of the individual case on the basis of a functional analysis before and after the transfer of function, considering the courses of action that are available in fact and taking account of locational advantages or disadvantages and synergy effects. Discounting takes place at an appropriate capitalization rate arrived at by adding a premium that adequately reflects functions and risks to the interest rate for a risk-free investment. The capitalization period is rebutably presumed to be perpetual.

Under § 1 (3) sent. 10 AStG, transfer pricing may be based on the transfer prices of the individual assets and services involved, instead of on a price for the transfer package as a whole, in either of the following two situations:

- The taxpayer makes a credible showing that no material intangible assets and benefits were transferred with the function. Under the draft regulation, this is pre-

sumed to be the case where the receiving enterprise exercises the function being transferred solely in relation to the transferring enterprise and the consideration payable for so doing is determined under the cost-plus method. In this connection, the draft regulation treats intangible assets and benefits as material where they are necessary to the transferred function and their aggregate arm's length value exceeds 25 percent of the sum of the individual prices of all assets and benefits in the transfer package; or

- The taxpayer makes a credible showing that, considering the price determined for the transfer package as a whole, the sum of the individual transfer prices reflects the arm's length price. This means, that the sum of the transfer prices for the various individual assets and benefits, all of which must be included, is within the range of agreement and corresponds to the arm's length price.

Under § 1 (3) sent. 11 and 12 AStG, an adjustment is made after the fact where a business relationship involves material intangible assets and benefits and the subsequent actual profit performance diverges substantially from that on which a transfer price determination was based, even if the enterprises in question have failed to include an arm's length adjustment clause in their contractual arrangement.

Draft Accounting Law Modernization Act

The Federal Ministry of Justice has released draft legislation that is intended to modernize German accounting law (draft Accounting Law Modernization Act). The basic purpose of the changes is to make German commercial accounting law a fully adequate and simpler alternative to International Financial Reporting Standards (IFRS). The balance sheet according to German domestic commercial law (German GAAP) would remain the basis for fixing the limits of permissible dividend distributions as well as for determining taxable income.

Various capitalization, recognition, and valuation elections would be eliminated in order to bring German GAAP closer to IFRS. The aim is to enhance the informational content of the financial statements while retaining the existing accounting principles of German commercial law. For these purposes, the principle of reverse linkage would be abandoned. Furthermore, internally generated intangible assets would have to be recognized in the commercial balance sheet. Financial instruments that are acquired for trading purposes would have to be valued at fair value on the balance sheet date. The valuation of provisions would be changed so that they are discounted at a market rate and with respect to rises in pricing and costs. Amongst other provisions, several depreciation elections would be eliminated. The planned changes in the Commercial Code would by and large

not affect the tax balance sheet. However, the draft bill would greatly increase the number of situations in which the commercial and tax balance sheets would differ.

The enactment of the Accounting Law Modernization Act is expected by year-end. Most regulations shall apply for annual periods beginning after 31. December 2008.

New Judgements from National Tax Courts

Business Property of a Permanent Establishment under Art. 13 (2) of the Tax Treaty with Switzerland

At issue in the Federal Tax Court judgment of 13 February 2008 was whether the gain realized by an individual resident in Switzerland on the sale of shares in a U.S. corporation was taxable in Germany because the shares constituted deemed business property (*Sonderbetriebsvermögen*) of a German partnership in which the seller was a limited partner.

Under the principles developed in Germany for the taxation of partnerships, shares that a partner owns in a corporation are treated as type II deemed business property of the partnership for tax purposes if the shares are intended to enhance the partner's interest in the partnership and appropriate for this purpose.

In the instant case, the shares sold by the Swiss resident were in a U.S. corporation (Z Inc.) that was a licensee and trading partner of a German limited partnership (KG), in which the taxpayer

owned a 50 % interest. The Federal Tax Court held that the shares in Z Inc. constituted mandatory type II deemed business property of the German partnership.

In the court's view, the classification as deemed business property should apply for tax treaty purposes as well, with the result that the shares in Z Inc. were considered to be business property of the German permanent establishment that was maintained by the partnership and hence pro rata by the taxpayer as a partner. Under Art. 13 (2) of the tax treaty between Germany and Switzerland, gain on the sale of movable property constituting business property of a German permanent establishment is taxable solely in Germany.

The Federal Tax Court sees no contradiction between this treatment of deemed business property and its recent decision regarding separate partner remuneration (*Sondervergütungen* – see *German Tax Monthly*, May 2008). The court reasons that the provisions on capital gains in the Swiss tax treaty, unlike those pertaining to e.g. the subject-to-tax clauses in Art. 10 (5) of the same treaty, require an economic connection between an asset and the permanent establishment, not a factual or effective connection.

Had the functional relationship between the shares in Z Inc. and a foreign permanent establishment of the taxpayer been closer than that between the shares and the German permanent establishment attributable pro rata to the taxpayer through the partnership,

this might have resulted in allocation of the shares to the foreign permanent establishment instead.

By treating deemed business property as forming part of the business property of a permanent establishment, the Federal Tax Court adopts an approach that may result in double taxation. This danger exists because most foreign jurisdictions do not have tax rules analogous to Germany's with regard to business partnerships and would thus treat a sale of shares like that involved in the instant case as a sale of "other property" under Art. 13 (5) of the OECD model convention, for which the seller's country of residence has the right of taxation. The taxpayer's only recourse in such cases would be to seek to avoid double taxation through a mutual agreement procedure.

Extent of Duties of Cooperation in Matters Involving Foreign Jurisdictions

In its judgment of 10 January 2008, which has since become final, the Tax Court of Lower Saxony decided a case that turned on the scope of the taxpayer's duties of cooperation in matters involving foreign jurisdictions.

The facts of the case were as follows:

The plaintiff was a limited company with registered office in Cyprus and a branch in Germany, among other places. In the years in dispute, the branch incurred losses that were covered using funds provided by the principal office in Cyprus. The branch treated the funds provided to it as "loans" having no impact on its profits.

The tax authorities increased the plaintiff's profits by the amounts of the new "loans" made on the grounds that the plaintiff had breached its duties of cooperation.

The tax court held that the tax authorities had erred in treating the amounts paid to the branch by the principal office as revenue in determining the branch profits. In the court's view, the imputation of revenue to the branch was unjustified because the heightened duties of cooperation in matters involving foreign jurisdictions (§ 90 (2) AO – General Tax Code) had not been breached in the first place.

The court reasoned that the heightened duties of cooperation extended only to the clarification of facts that were relevant for German tax purposes. Accordingly, the tax authorities were entitled to require the plaintiff to explain the source of the sums transferred to the accounts of German branch and the circumstances behind the new "loans". However, the court held that the plaintiff was not required to name the persons behind its companies nor need it explain, much less prove, how the principal office acquired the funds in question because this information was irrelevant for domestic tax purposes.

The court said that this was true even if the funds originated from criminal conduct or were the subject of criminal conduct in Germany (such as money laundering) because even such circumstances would not result in any German tax liability.

Foreign Permanent Establishment Losses under the U.S. Tax Treaty

In a decision dated 11 March 2008, the Federal Tax Court reaffirms its prior case law holding that the German home office may not deduct the losses of a permanent establishment located in a foreign jurisdiction where positive income of the permanent establishment would be exempt from German taxation under an applicable tax treaty (symmetry theory). The circumstances of the case decided were, however, unusual in certain respects.

The losses were in fact derived from a business partnership, which under German tax rules was treated pro rata as a permanent establishment of the various partners. The court stated that the symmetry theory applied in this case as well.

The symmetry theory is, with regard to the losses of permanent establishments in EU/EEA countries, subject to the principles of the decision of the European Court of Justice (ECJ) in *Lidl Belgium* (case C-414/06 – see *German Tax Monthly* June 2008 p. 3). However, the ECJ held in *Stahlwerk Ergste Westig GmbH* (C-415/06) that the freedom of establishment and the free movement of capital afforded no protection with regard to foreign losses from third countries such as the United States where a definite influence was exercised on the foreign permanent establishment or the foreign partnership.

The Federal Tax Court concludes that the application of the symmetry theory follows directly from the terms of the tax treaty with the United States, which applied in the instant case, and hence does not depend on rules of domestic tax law.

Imprint

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