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### Non-deductibility of EU permanent establishment losses

At issue in the case *Lidl Belgium* (C-414/06), currently pending before the European Court of Justice (ECJ), is whether the freedom of establishment guaranteed under EU law permits Germany to deny a German company a deduction for losses arising in its permanent establishment situated in Luxembourg.

According to the German Federal Tax Court, the tax treaty exemption for permanent establishment income applies to both positive and negative income.

In her recent opinion of 14 February 2008, the Advocate General argues that the disparate treatment of losses from domestic and foreign permanent establishments is incompatible with the freedom of establishment.

Drawing an analogy between the ability of a company to deduct the losses of its foreign permanent establishment and the ability to deduct the losses of a foreign subsidiary, the Advocate General analyzes the case in terms of three loss denial justifications that were ar-

ticulated by the ECJ in its 2005 *Marks & Spencer* decision (C-446/03).

With respect to the first justification cited in *Marks & Spencer*, the Advocate General notes that to oblige Germany to permit the deduction of losses even though it has waived its right to tax the corresponding income would breach the symmetrical allocation of rights of taxation in the tax treaty. She further notes that there is the risk of double deduction of the same losses (second justification). She states that the danger of tax avoidance (third justification), while existing in the case of foreign subsidiaries, is not posed by foreign permanent establishments. However, she sees nothing in *Marks & Spencer* to indicate that all three grounds of justification must be cumulatively fulfilled.

The Advocate General nevertheless reaches the conclusion that the denial of a deduction for permanent establishment losses is incompatible with the freedom of establishment in the instant case because the means used to preserve a balanced allocation of the taxing power and to avoid double deduction of the same losses are, in her opinion, unreasonably restrictive. She

argues that the objectives in question could be attained under a system by which the country of the head office allows a temporary deduction of losses subject to later recapture and notes that such a system was in fact in force in Germany through 1998.

The Advocate General's recommendations to the ECJ are an important step forward for the taxpayer. As they are of an advisory nature, the ultimate decision by the ECJ needs to be awaited.

### **Hamburg Tax Court considers 5% rule unconstitutional**

Under § 8b (1) and (2) KStG (Corporate Income Tax Law), income from dividends and from gains on the sale of shares in a corporate entity or association are in principle derived tax free by the receiving corporation. However, 5 % of the dividend income and capital gains is deemed to constitute expenses that may not be deducted as business expenses.

The Hamburg Tax Court in its decision of 7 November 2007 considers the 5% rule to be unconstitutional as the rule does not permit the taxpayer to prove that its actual business expenses were lower. In its ruling, the court therefore refers the case to the Federal Constitutional Court for decision whether the statute violates the principles of equal application of the tax laws and taxation in accordance with ability to pay (Art. 3 (1) of the German constitution).

In the case at issue, the business expenses actually incurred were considerably less than those deemed to be non-deductible under § 8b (3) and (5) KStG.

The court acknowledges that the legislature is in principle free to simplify administration of the tax laws by enacting provisions under which transactions are taxed based on their typical characteristics or general nature. However, in the court's opinion, it is only permissible to deny the taxpayer the right to present proof to the contrary where the number of taxpayers affected is small and the infringement of the principle of equal application of the tax laws is not severe.

The court argues that, in reality, business expenses are not infrequently less than 5 % of dividends received or capital gains realized. This is the case, says the court, above all for corporations that have funded their holdings in their subsidiaries out of equity and thus incur no interest expense. The court concludes that the generalizations on which § 8b (3) and (5) KStG are based exceed the limit of what is justifiable on the grounds of simplified administration of the tax laws.

In order to withstand constitutional muster, the statute must therefore, in the lower court's opinion, at least permit the taxpayer to prove that its actual expenses were lower than those deemed by the statute.

### **Treaty infringement proceeding for tax discrimination of non-resident taxpayers**

In a reasoned opinion of 31 January 2008, the EU Commission has called upon Germany to change what the Commission considers to be discriminatory withholding tax procedures with regard to non-resident taxpayers (above

all performers, athletes, and journalists).

Germany imposes a withholding tax of up to 25 % on the income of performers, athletes, and journalists who are not resident in the German domestic territory. In official guidance dated 5 April 2007, the Federal Ministry of Finance created a limited possibility to deduct business expenses from gross earnings. A deduction of business expenses is now possible where they exceed 50 % of the relevant income. In this case, the withholding tax rate is increased to 40 %. By contrast, the taxation of resident taxpayers involves an annual income tax assessment procedure in which account is taken of business expenses.

The EU Commission contends that the limitation on the deduction of business expenses in conjunction with the increased withholding tax rate frequently results in higher taxation of non-resident taxpayers for which there is no objective justification. The Commission regards this as a substantial restriction on the cross-border rendering of services as guaranteed by Article 49 of the EC Treaty. In support of its position, the Commission cites the decisions of the European Court of Justice in *Scorpio* (case C-290/04) and *Gerritse* (case C-234/01).

### **No interest paid on refunds of withholding taxes – relationship of Community law and domestic law**

The Federal Tax Court has handed down a new judgment (18 Sept. 2007 – I R 15/05) addressing Germany's implementation of the requirements es-

established by the European Court of Justice (ECJ) in its *Scorpio* decision. The issue before the Federal Tax Court was whether Community law requires interest to be paid on refunded withholding tax amounts.

Non-resident performers and their foreign event organizers are liable to German tax on a non-resident basis with respect to their domestic appearances. Their domestic tax liability with respect to their fees is satisfied by a tax which event organizers resident in Germany must withhold and remit to the German tax authorities. The taxpayer may obtain a full or partial refund of the amount withheld by filing an application under a refund procedure. Under German domestic law, the refund is paid without interest (§ 233a (1) sent. 2 Tax Procedure Law).

The Federal Tax Court holds that there is no right to payment of interest with respect to the refund amount under the case law of the ECJ. In its *Scorpio* decision, the ECJ requires withholding tax procedures to conform the requirements of Community law. Consequently, the business expenses of performers and foreign event organizers that are directly related to their work must be taken into account for tax purposes, if necessary in a refund procedure. However, the Federal Tax Court finds that no right to payment of interest on the refund amount results from this decision. Impairments of liquidity that result from the withholding procedure are thus acceptable under EU law, in the opinion of the German high court.

### **Writedowns to going concern value of listed shares held as fixed assets**

Assets may be written down to going concern value only by reason of a decline in value that is expected to be permanent. In its judgment of 26 September 2007 (docket no. I R 58/06), the Federal Tax Court addressed the conditions under which the value of stock exchange listed shares that are held as financial assets is impaired in a manner that is expected to be permanent within the meaning of § 6 (1) no. 2 sent. 2 EStG (Income Tax Law).

The Federal Tax Court treats a decline in the stock exchange value as lasting where, from the perspective of the balance sheet date, the case for permanent impairment is stronger than the case against. The stock exchange price of listed securities reflects the views of a large number of market participants. The list price also reflects their assessment of future risks and opportunities. The Federal Tax Court therefore holds that a permanent impairment exists where the stock exchange price on the balance sheet date is below the purchase price and there are no concrete indications that the list price will recover in the near future.

The case was decided on the basis of the laws in effect in 2001. At the time, shares in corporations could be written down to going concern value with full tax effect. After introduction of § 8b (3) KStG, reductions in profits that are related to shares in a corporation are disregarded for tax purposes if the shares are held by corporate entities. There is an exception for shares in corporations that are held by banks, other financial

service providers, and insurance companies within the meaning of § 8b (7) and (8) KStG. Reductions in profits that are related to these shares are still deductible for tax purposes. If the corporate shares are held by an individual, a writedown to going concern value is possible with tax effect to the extent of 50 % of the impairment (from 2009 on to the extent of 60 %), provided the shares are held as business property.

### **Guidance on the accounting treatment of corporate income tax credits**

Many corporations are still entitled to corporate income tax credits that arose under the old corporation tax credit system in force until 2001.

Initially, the credit was available only upon distribution of retained earnings that were taxed under the old system. The SE Introductory Act replaced this with an arrangement by which the total credit available with respect to such earnings is paid in installments. As a rule, the corporate income tax credit amount is assessed definitively as of 31 December 2006 and paid out in ten equal installments, beginning in 2008 and ending in 2017. A claim to payment of the credit amount thus arises on 31 December 2006 in most cases.

In official guidance dated 14 January 2008, the Federal Ministry of Finance comments on the accounting treatment of the corporate income tax credit amount.

The tax authorities state that the claim for payment must be capitalized on the commercial and tax balance sheets when it arises (for calendar year tax-

payers on 31 December 2006), thus increasing income by this amount. The claim is discounted to its present value, to be calculated using a market rate of interest on the balance sheet date.

The income resulting from capitalizing the claim for repayment is excluded from taxable income under § 37 (7) KStG. Reductions in income in connection with the corporate income tax credit amount are likewise excluded.

By its terms, the application of § 37 (7) KStG is limited to corporate entities with respect to which the claim for repayment has been fixed by assessment. The new guidance states that § 37 (7) KStG is also applicable to successors in interest that take by universal succession (e.g. mergers), provided a corporate entity is the receiving entity.

If the credit repayment claims are acquired by other means (that is, not by operation of law), the tax authorities require the claim to be capitalized at its purchase cost. The interest component results in taxable income.

### **Transfer of rollover reserves from corporations to partnerships**

In guidance dated 15 January 2008, the Federal Ministry of Finance comments on the possibilities for transferring rollover reserves under § 6b EStG (Income Tax Law) from a corporation to a partnership in which the corporation is a business partner.

Under § 6b EStG, taxpayers can avoid recognizing gain on the sale of certain assets by deducting the gain from their tax basis in qualifying assets purchased

or produced in the same year or by placing the gain in a reserve and reducing income by the same amount. The reserve is personal to the taxpayer and may be transferred by individuals and corporations to assets of partnerships in which they hold an interest as a business partner (*Mitunternehmer*). For instance, the capital gains of corporations can be transferred to the assets of a partnership without triggering gain.

The ability of a corporation to transfer gains held in abeyance to a partnership constitutes a tax election. Tax elections are subject to the principle of reverse linkage of the commercial balance sheet to the tax balance sheet. On the tax balance sheet of the transferring corporation, the carrying value of the corporation's interest in the partnership is reduced by the rollover amount transferred. On the tax balance sheet of the partnership, its basis in the qualifying asset is reduced by the same amount. The transfer is flanked by reducing the capital account of the transferring business partner in the tax balance sheet of the business partnership.

The guidance issued by the Federal Ministry of Finance states that the rollover reserve on the liabilities side of the corporation's commercial balance sheet must be released upon transfer of the gain held in abeyance. However, no reduction is made in the carrying value of the interest in the partnership on the asset side of the commercial balance sheet. To this extent, the principle of reverse linkage does not apply. The new guidance now permits transfer of gain held in abeyance in any amount.

The new guidance applies retroactively. It may thus apply to tax assessment periods in which corporations accounted for the transfer of gains held in abeyance to partnership assets by reducing the carrying value of their partnership interest on their commercial balance sheet and entering an adjusting item on the liabilities side.

### **Guidance in draft form on 2008 Business Tax Reform Act**

In official guidance 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. You will be informed about this draft in detail in the next edition of German Tax Monthly.

### **Imprint**

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