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Guidance on the Treatment of Business Expenses Related to Foreign Dividends

In its *Keller Holding* judgment of 23 February 2006 (Case C-471/04), the European Court of Justice (ECJ) held that the denial of a deduction for business expenses related to indirect foreign-source dividends violated the freedom of establishment guaranteed by Community law. In response to this judgment and the subsequent related Federal Tax Court decisions of 13 June 2006 and 9 August 2006, the Federal Ministry of Finance recently published guidance on the tax treatment of business expenses related to dividends paid by EU and EEA companies. Since only tax assessment periods from 1993 to 2003 are affected, the new administrative guidance applies as a practical matter only where the tax assessment notices for these years have not yet become final.

In defining the tax treatment of business expenses related to dividends paid by EU and EEA companies, the tax authorities distinguish between four time periods.

From 1993 to 1998, business expenses related to tax-free foreign-source dividends are deductible in full.

From 1999 to 2000/2001, the provisions by which 5 % of tax-free foreign-source dividends is deemed to constitute non-deductible business expense are not applied, and actual business expense directly related to tax-free dividends with a foreign nexus is deductible in full.

In the period 2001/2002 to 2003, the provisions deeming 5 % of tax-free foreign-source dividends to constitute non-deductible business expense are not applied where the actual amount of related business expenses is less than 5 %. In such cases the actual related business expenses are not deductible, as according to the general rule business-expenses related to tax-exempt income are not deductible. If the actual business expenses directly related to the dividends exceed 5 % of the dividend amount, the 5 % deemed non-deductibility rule remains applicable.

From 2004 onwards, the 5 % deemed non-deductibility rule applies equally to domestic-source and foreign-source

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dividends and thus seems to be in line with Community law.

Transfer of Assets to a Foreign Business Operation

At issue in the Federal Tax Court judgment of 17 July 2008 was the transfer of shares in a corporation to a foreign business operation.

A German partnership contributed shares that it held in a U.S. corporation to a downstream Austrian partnership in return for an interest in this partnership.

The Federal Tax Court regarded the in-kind contribution as a quasi-exchange transaction and hence as a disposition. The approach of the Federal Tax Court contradicts the views expressed by the tax authorities in the Federal Ministry of Finance guidance of 26 November 2004. The Federal Tax Court also held that that the election under § 24 UmwStG 1995 (Reorganization Tax Law) to state the contributed property at book value (carryover basis) was not available in the instant case. The court reasoned that the election was available only where a business or branch of activity was contributed. Since shares in a corporation did not represent an organizational unit of a business, the court found that the requirements of § 24 UmwStG 1995 were not fulfilled. The Federal Tax Court's holding is contrary to the decision of the lower court, the position of the tax authorities, and the prevailing view in the literature, all of which advocate that a 100 % interest in a corporation is deemed to constitute a branch of activity.

In the year in dispute (1995), the transfer of individual assets from one business operation to another had not yet been regulated by statute. However, the case law permits the election of a carryover basis where an asset held by a partner as business property is contributed to a partnership in return for an interest therein. The Federal Tax Court ruled that this election may not be denied merely because the shares were contributed to a foreign business operation. The court reasoned that unequal treatment of contributions to domestic and foreign business operations within the EU would violate the freedom of establishment under Community law.

The court further held that no taxation is triggered at the time of transfer of individual assets to a foreign business operation even if the profits of the foreign permanent establishment are exempt from taxation in Germany under a tax treaty. The court thus overrules a long line of cases resting on the teleological definition of withdrawals of assets from business operations. In support of this shift in the case law, the court states that the transfer of an asset to the foreign permanent establishment of the same taxpayer is not a taxable event because the previous functional relationship continues unbroken. The old line of cases was based on the premise that the unrealized appreciation inherent in an asset should not be permitted to escape German taxation definitively. The court now regards this argument as outdated, stating that, under the current interpretation of tax treaties, the tax treaty exemption for permanent establishment income does not preclude later taxation of the asset appreciation that took place in the domestic territory. Only the asset appreciation accruing in the foreign permanent establishment is shielded from German taxation. The court furthermore says that the functional separate entity approach favored by the OECD cannot be used to justify the teleological definition of withdrawals.

In 2006, general provisions governing the taxation of outbound asset transfers were added to the tax code by the SE Introductory Act (§ 4 (1) sent. 3 EStG and § 12 (1) KStG). The new rules deem an asset to have been withdrawn when Germany's right to tax the profits from the asset's sale or use are precluded or restricted. Applying the reasoning of the instant Federal Tax Court decision to the statutory rules would lead to the conclusion that the transfer of assets from the domestic head office to a foreign permanent establishment does not preclude or restrict Germany's right of taxation, so that consequently no taxation of unrealized appreciation at the time of the transfer would be possible. Application of the principles of the judgment to the Reorganization Tax Law also may have implications as regards cross-border mergers within the EU. While such mergers can be generally carried out at book value on the basis of the EU Merger Directive, this requires inter alia that all assets transferred can still be allocated to a permanent establishment in the country where the transferring company is resident. Assets that may have to be allocated to the foreign absorbing entity (such as e.g. goodwill or

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other intangibles) would trigger an exit tax under current German tax law. Also these provisions seem not to be in line with the judgment of 17 July 2008 so that Germany would be precluded to impose an exit tax at the time of the merger.

Cologne Tax Court: Priority of Tax Treaties when Categorizing Income

At issue in the Cologne Tax Court's judgment of 20 March 2008 was the relationship of tax treaties to rules of ordinary domestic tax law when assigning income to an income category.

The case before the court involved a non-resident Swiss national who held an ownership interest in a German limited liability company (GmbH). The GmbH was converted into a limited partnership (KG), requiring the determination of the gain or loss on conversion (takeover gain or loss). The takeover gain or loss is the difference between the value at which the transferred assets are taken and the value of the contributed shares. Under the prior version of § 5 (2) UmwStG, shares not held as business property on the transfer record date were deemed to be contributed at cost and included in calculating the takeover gain. This deemed contribution has the effect of reducing the takeover gain or increasing the takeover loss.

For the Swiss shareholder, whose shares were indisputably non-business property prior to the reorganization, the deemed contribution would have resulted in a takeover loss.

The tax court held, however, that the deemed contribution was overridden by the rules of the tax treaty. The court concluded that the deemed contribution under § 5 (2) UmwStG was not decisive for classification of the shareholder's shares as business or non-business property. The court instead found that classification depended solely on the terms of the tax treaty. The re-classification from non-business to business property (due to the deemed contribution) was therefore irrelevant at the tax treaty level. The court reasoned that to decide otherwise would mean that Germany could unilaterally deprive the country of residence of its right of taxation as a result of the re-classification.

Consequently, the court found that Swiss shareholder's shares in the GmbH remained his non-business property and were governed by Art. 13 (3) of the Swiss tax treaty. The shares consequently had no impact on the limited partnership's takeover gain or loss.

The judgment is not yet final.

Federal Tax Court Affirms Treatment of the Corporate Income Tax Credits

In a ruling dated 15 July 2008, the Federal Tax Court has upheld the views of the Federal Ministry of Finance with regard to the future accounting treatment of corporate income tax credit amounts that accrued under the corporate income tax system in effect through 2001 and have not yet been used up (see *German Tax Monthly*, March 2008, p. 3 ff.). The corporate income tax credit amount separately assessed for the last time as at 31 December 2006 will be paid out in ten equal annual installments from 2008 to 2017. A non-interest bearing claim for payment is reflected by capitalizing a discounted receivable, thus giving rise to revenue. Both initial capitalization of the claim for payment of the corporate tax credit amount in ten equal annual installments and the subsequent adjustments in the value of the claim are then eliminated in the process of determining taxable income.

Swiss Tax Treaty: Mutual Agreement on Article 15 (4) of the Swiss Tax Treaty ("Senior Executives")

A mutual agreement reached with regard to Article 15 (4) of the Swiss tax treaty has been published by the Federal Ministry of Finance in guidance dated 30 September 2008.

Article 15 (4) deals with situations in which an individual is resident in one treaty country, but works as the senior executive of a company resident in the other treaty country. By way of exception, the tax treaty assigns the right of taxation for senior executives to the country in which the corporation has its registered office, regardless of where the work is actually exercised.

Under an earlier accord reached in 1997, it was agreed that the term "senior executives" would include deputy directors, vice directors, and general directors, in addition to the "directors" referred to in Article 15 (4) of the tax treaty. The term was in particular to include persons whose entry in the Commercial Register was not mandatory.

Due to practical difficulties in identifying senior executives, the new mutual agreement provides that, beginning

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with the 2009 assessment period, Article 15 (4) of the Swiss tax treaty is applicable only to the persons named in the earlier accord whose general power of attorney (*Prokura*) or function referred to in treaty Article 15 (4) is entered in the Commercial Register.

Amendments to German Tax Treaties

Tax Treaty with Mexico

On 9 July 2008, Germany and the United Mexican States entered into a new convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital. Compared with the 1993 treaty, there are changes particularly with regard to the taxation of pensions, income from government service, and the income of visiting professors. The provisions respecting mutual assistance in the collection of taxes and the application of the convention in cases involving tax avoidance and classification conflicts have also been overhauled.

The new tax treaty between Germany and Mexico does not enter into force until ratified by both countries. The 1993 tax treaty remains in force in the interim.

Tax Treaty with Russia

On 23 September 2008, the German federal government released a draft bill implementing the amendment protocol of 15 October 2007 to the tax treaty with Russia. The bill would update the 1996 tax treaty with Russia. Among the primary goals are improving cooperation between the tax administrations and achieving equal treatment of Russian and German investment funds. Russia would be entitled in the future to impose a withholding tax on the distributions of investment funds. This puts the Russian taxation of the distributions of Russian investment funds on a par with the German right to tax the distributions of German investment funds.

Tax Treaty with the United Arab Emirates

Germany's tax treaty with the United Arab Emirates expired on 10 August 2006. In June 2006, the two countries agreed to extend the treaty for two years until 9 August 2008. However, the treaty remains in effect until 31 December 2008.

Despite several rounds of negotiations, Germany and the United Arab Emirates remain unable to agree on the text of a new treaty for the avoidance of double taxation. There are currently no plans for further negotiations. Such negotiations could nevertheless come about if written exchanges indicated a realistic possibility of agreement. Otherwise, both treaty countries understand that a treatyless situation will commence as of 1 January 2009.

Imprint

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