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Guidances on 2008 Business Tax Reform Act

After the issue of draft directives in February 2008 (*see German Tax Monthly April 2008, p. 1)* the Federal Ministry of Finance has recently released official guidances addressing some of the most important issues raised by the 2008 Business Tax Reform: the earnings stripping rules, the corporate loss limitation rules and the trade tax addbacks.

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; *find detailed information in German Tax Monthly March 2007, p. 1 and April 2007, p. 1*). 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. The following comments provide an overview of the highlights of the official guidance.

Interest expense and interest revenue

The guidance 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 for tax purposes. Hence, the provision of capital in kind (for example leasing) does not fall under the earnings stripping rules.

Under the official guidance, the interest portion of lease payments however constitutes interest expense and revenue for purposes of the earnings stripping rules if beneficial ownership passes to the lessee, so that the lessee must carry the asset on its balance sheet. Where beneficial ownership remains with the lessor, the guidance states that upon application the interest portion of lease payments may be treated as interest revenue and expense for reasons of equity where the arrangement constitutes financial leasing of real estate in the sense of the relevant official guidance of the Federal Ministry of Finance.

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Interest expense (or revenue) may result from compounding and discounting liabilities that bear no interest or a pay a low rate of interest. Under the guidance of the Federal Ministry, 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 loss limitation rules (§ 8c KStG, see below) apply. According to the 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 partnership level as well as at the level of the partners is allocated to all partners proportionally.

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

Non-group businesses

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). A business 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. Under certain circumstances also GAAP of a EU-member state or U.S. GAAP can be used.

A consolidated group is also considered to exist where the financial and business policy of the business can be uniformly determined together with that of one or more businesses.

The 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 applies 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).

The 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 German GAAP (§§ 290, 291 and 292 Commercial Code). Accordingly, it should be possible to rely on existing group financial statements for purpose 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

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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. Also debt financing by the head of a consolidated group may be detrimental where the head is not included in the consolidated financial statements.

The 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 guidance does not limit this principle to domestic business property.

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. Application of the new rules is triggered by a detrimental change in the ownership of the loss corporation.

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 guidance gives examples of what it considers to constitute "comparable events" within the meaning of the statute:

- Transfers of hybrid instruments 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
- Contribution of a business, branch of activity, or interest in a business partnership
- Acquisitions by a corporation of its own shares
- Capital reductions.

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.

As to indirect transfers of shares the guidance states, that shortening or lengthening chains of ownership could also trigger a detrimental change in ownership. However, a reorganisation under the change-of-legal form concept (Formwechsel) or comparable reorganisations under foreign law within the chain of ownership do not result in an indirect change in ownership.

Time of transfer

Pursuant to the guidance, the time of the detrimental change in ownership is determined with reference to the passage of beneficial ownership. This date determines both the applicability of the new rules of § 8c KStG to the transaction and the five year period during which share transfers are aggregated. The 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 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

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that there is no nexus (rebuttable presumption).

Forfeiture of losses

A detrimental share transfer results in forfeiture of losses pro rata (transfers exceeding 25 %) or in toto (transfers exceeding 50 %).

The loss forfeiture relates to all losses or negative income not yet offset against income of the same period or deducted from losses of another period.

Where a detrimental change in ownership occurs in the course of a fiscal year, losses incurred in the year in progress up to the time of the detrimental change in ownership are also subject to the loss limitation rules of § 8c KStG. In principle, the loss forfeiture is determined pro rata temporis. However, another proportioning may be possible if it is economically justified.

According to the guidance it shall not be possible to carry back a loss incurred in the year in which the detrimental change in ownership takes place to previous years. In addition, it shall also not be possible to use existing loss carry forwards against a profit made in the year in which the detrimental change in ownership occurs.

Coordinated all-State Directive on Trade Tax Addbacks

Under § 8 no. 1 GewStG (Trade Tax Act) a portion of one-fourth of the following financing charges is added back to the trade tax base:

- loan remuneration (e.g. interest)
- recurring payments
- profit shares of a silent partner
- 25 percent of payments to license rights for a limited time period, except for licenses that merely confer entitlement to license to third parties the rights derived thereunder
- 20 percent of rental and leasing payments for movable fixed assets
- 65 percent of rental and leasing payments for immovable fixed assets

The addback occurs only to the extent an exemption for financial charges of € 100.000 is exceeded.

Compared with the draft directive *(see German Tax Monthly April 2008, p. 3)* the official directive contains only a few principal changes and clarifications.

According to the directive, the term "rights" includes concessions, industrial property rights, copyrights, license rights and rights to names. In the draft directive the term included in addition unprotected inventions, know-how, software, customer bases and goodwill. As these terms are not included any longer, they do not underlie the application range of the provision.

In addition the directive clarifies that vessels and aircrafts are treated as movable assets for purposes of the trade tax addbacks.

ECJ Upholds Tax on Distributing Corporation under Old German Corporation Tax System

At issue in the judgment handed down by the European Court of Justice (ECJ) on 26 June 2008 in the *Burda* case (C-284/06) was whether Germany's taxation of distributions paid out of tax exempt retained earnings under the old corporate income tax credit system was compatible with Art. 5 (1) of the EU Parent-Subsidiary Directive and the freedom of establishment clause of the EC Treaty. Specifically, the case involved a distribution from a category known as EK 02 under the corporate income tax credit system in force until 2001.

The case involved profits distributed by a German corporation (Burda) to its two 50 % shareholders, a German corporation and a corporation resident in the Netherlands. The amount distributed exceeded the distributing corporation's taxable income and was deemed to have been paid in part out of tax exempt retained earnings (EK 02) under the ordering rules then in effect. This triggered a recapture tax at the level of the distributing corporation. A corporate income tax credit in the same amount was available in Germany for the domestic dividend recipient, but not for the foreign shareholder.

The ECJ began by deciding that the arrangement did not involve a withholding tax within the meaning of the EU Parent-Subsidiary Directive and hence was not barred by Art. 5 (1) of the Directive because the taxpayer (the dis-

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tributing corporation) did not hold the relevant shares. The court thus construed the EU Parent-Subsidiary Directive along strictly formal lines and declined to broaden the scope of the directive's protection by adopting the economic interpretation favored by the European Commission.

The ECJ then went on to hold that there was no violation of a fundamental freedom guaranteed by the EC Treaty. Because of the size of the stake held by the non-resident parent company (50 %), the court analyzed the case solely from the perspective of the freedom of establishment, concluding that there was nothing discriminatory in the tax treatment of the foreign parent company. In the court's view, the same rule was not being improperly applied to different situations because the provision in question operated solely to adjust the tax paid by the distributing subsidiary. The upward adjustment in the tax paid by the distributing subsidiary took place regardless of the place of residence (domestic or foreign) of the receiving parent company. The ECJ stated that it was up to the member state in which the parent company was resident to avoid an economic double taxation of dividends, e.g. by means of a tax credit like that granted to the domestic parent company under German law. The court accordingly held that foreign shareholders were not subjected to unequal treatment.

Activity Requirements for the International Trade Tax Participation Exemption

Profits from shares held in a foreign subsidiary corporation are exempt from trade tax where an ownership interest of at least 15 % has been held since the beginning of the collection period and the subsidiary's earnings are derived exclusively or almost exclusively from the conduct of an active business. The minimum ownership percentage is reduced to 10 % where the shares are held in a company that meets the requirements of the EU Parent-Subsidiary Directive. No activity requirements apply in this case.

In a judgment dated 13 August 2008, the Federal Tax Court addressed the requirements for the international trade tax participation exemption in situations involving multi-tier partnership structures.

If the subsidiary holds interests in business partnerships, the gross earnings of such partnerships are, in the opinion of the Federal Tax Court, attributable to the subsidiary with regard to both their type and their amount. The court held this rule to be applicable even to multi-tier partnerships. This means, in effect, that the gross earnings of the downstream partnerships from the conduct of an active business are attributed to the subsidiary as its own earnings.

While addressed to the trade tax exemption under the statute as in effect for the year 1991, the judgment applies as well to the law in its current form, since the basic features of the international trade tax participation exemption have not changed in the interim.

Lower Court Decision on the Taxation of the Profits of a U.S. Limited Liability Company (LLC)

The profits of a German resident individual from an interest in a limited liability company that was treated as a partnership for U.S. tax purposes were at issue in a case recently decided by the Tax Court of Baden-Württemberg. Germany has no business entity that is equivalent to an LLC. Germany therefore classifies LLCs as partnerships or corporations depending on their degree of similarity to the respective German entities. Under this approach, the classification depends on whether the specific LLC is more similar to a German partnership or a German corporation.

The Federal Ministry of Finance issued official guidance dated 19 March 2004 on the German tax treatment of LLCs. In this guidance, the German tax authorities take the following positions: If the United States classifies an LLC as a partnership, its members are taxable in the United States. Should the LLC considered to be a corporate entity for German tax purposes its German members are also subject to German tax liability, but in this case only with respect to the LLC's distributions. From a tax treaty perspective, the distributions constitute "other income," for which Germany has the exclusive right of taxation under its tax treaty with the United States.

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In the case here reported on, the Lower Tax Court disagreed with the tax authorities. It stated that the article on "other income" was a catch-all provision that governed the right to tax only those types of income that the tax treaty failed to address. The court concurred with the tax authorities that the profit shares of a member of an LLC did not constitute dividend income because the LLC did not qualify as "a company that is a resident of a Contracting State," as required by the dividends article. However, the court considered the German resident member's interest in an LLC to be comparable to an interest held by a German resident in a foreign partnership. The court stated that the LLC was an enterprise engaged in a business and as such derived business profits. Since the enterprise was not itself entitled to treaty benefits, its operations were attributable pro rata to its German member and treated as his permanent establishment. Since the right to tax business profits was assigned to the United States to the extent such profits were attributable to the U.S. permanent establishment, the respective income was, in the court's view, exempt from German taxation.

The classification of the income as business profits precluded their taxation in Germany as "other income."

The tax authorities have appealed the lower court ruling.

Act for Modernizing the Legal Framework for Investments in Corporations Promulgated

The Act for the Modernization of the Legal Framework for Equity Investments *(Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungen – MoRaKG)* has been promulgated in the Federal Gazette on 18 August 2008. In order to promote private investments in new businesses and in small and medium-sized companies, the law improves the legal framework for venture capital investment companies and equity investment companies and also, among other things, creates tax preferences for such companies, establishes requirements for their business activities, and provides for their oversight.

For taking effect certain rules requires the acceptance of the European Commission.

General Administrative Order Rejecting Appeals Challenging the Solidarity Surcharge

The 2007 Tax Act authorized the Federal Ministry of Finance to issue general administrative orders rejecting administrative appeals that pose legal issues that have been decided by the European Court of Justice, the Federal Constitutional Court, or the Federal Tax Court.

This obviates the necessity of sending an appeals decision notice to each and every appellant.

Taxpayers have constructive notice of a general administrative order as of the day following its publication in the Federal Gazette. From this date runs a one year deadline for filing a court action, after the expiration of which the relevant assessment becomes final.

A ruling dated 11 February 2008 by which the Federal Constitutional Court declined to hear a constitutional complaint challenging the solidarity surcharge has prompted the Federal Ministry of Finance to exercise its right to issue general administrative orders. By general administrative order of 22 July 2008, it rejects all pending administrative appeals alleging the unconstitutionality of solidarity surcharge assessments.

Government Finalizes Draft 2010 Investment Subsidies Act

On 23 July 2008, the German cabinet adopted a bill that would extend investment subsidies for business investments in East Germany through 2013. The subsidies would otherwise have terminated in 2009.

Investment subsidies are available in the new German States and the City of Berlin for qualifying investments in businesses that engage in manufacturing, render certain production-related services, or are part of the hotel trade. Resident and non-resident taxpayers for purposes of the personal and corporate income tax laws are entitled to receive subsidies.

The investment subsidy is calculated on the basis of the total cost (cost of purchase and production) of qualifying investments completed in a particular fiscal or calendar year. The current subsidy rates (12.5 % for large busi-

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nesses, 25 % for small and medium-sized businesses) would decline from 2010 to 2013 by 2.5 percentage points per year for large businesses and 5 percentage points per year for small and medium-sized businesses.

Investments extending over several years are subsidized at the rate in force in the year in which the investment is commenced. Companies that commence investment projects by the end of 2009 can thus benefit from the subsidy rates currently in effect.

Reduction of Tax Bureaucracy

On 23 July 2008, the German cabinet adopted the draft Act for the Modernization and De-Bureaucratization of the Tax Process (Tax Bureaucracy Reduction Act) as recommended by the Federal Ministry of Finance. This legislation is intended to benefit individuals, businesses, and the government by reducing bureaucratic burdens and simplifying tax collection procedures.

Paper-based processes would be replaced in the future by electronic communications. For instance, the electronic transmission of business tax returns, balance sheets, and income statements would be made standard for fiscal years beginning after 31 December 2010.

The draft legislation would also introduce targeted simplification and de-bureaucratization measures. A modest increase in the thresholds at which monthly (as opposed to quarterly) reports are required for VAT and wage tax purposes is one such measure. Furthermore, the corporate income tax credit amount separately assessed under § 37 KStG would be disbursed in a single payment where it does not exceed EUR 1,000.

The act is expected to pass the Bundestag *(lower house of the German parliament)* in the autumn of this year and to take effect as of 1 January 2009.

Imprint

Responsible*: Dr. Martin Lenz
Head of National Tax

KPMG Deutsche Treuhand-Gesellschaft
Aktiengesellschaft
Wirtschaftsprüfungsgesellschaft
Marie-Curie-Straße 30
D-60439 Frankfurt am Main

Editorial Team:

Oliver Dörfler

Oliver Franz, LL.M.

Dr. Christoph Geeb

Eva Handwerker

Christian Schenk

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