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## Draft 2009 Tax Act Released

The Federal Ministry of Finance released a draft version of the 2009 Tax Act. The principal changes contained in the legislation with particular impact on the Income Tax Law and the Corporate Income Tax Law are described below.

### Changes in the Flat Tax for Investment Income and Capital Gains

The 2008 Business Tax Reform Act introduced a flat rate tax of 25 % with effect from 1 January 2009 for non-business investment income derived by individuals. The draft 2009 Tax Act would make a number of changes in this area.

Under the draft legislation, an exchange of shares in corporate entities with place of management or registered office outside of the EU and the EEA would not trigger tax provided Germany's right of taxation is preserved with respect to the shares received in the transaction. The purpose of this change is to ensure that the flat tax is not triggered in situations where no cash payment is involved.

The draft legislation would add a provision to the tax code addressing the

credit of foreign withholding taxes imposed on income subject to the flat rate tax (draft § 32d (5) EStG – Income Tax Law). The so-called per-country limitation, which limits the creditable tax depending on the income derived from each respective foreign jurisdiction, would not apply for purposes of the flat rate tax.

The new provisions regarding the flat tax on income from capital would apply to income from capital received by obligees on or after 1 January 2009.

### Changes in the Taxation of Non-Resident Taxpayers

Persons having neither a domicile nor their habitual abode in Germany are subject to tax on a non-resident basis with regard to their German-source income.

The draft legislation would expand the catalogue of German-source income (§ 49 (1) EStG – Income Tax Code) to include payments from pension funds, and direct insurance plans to the extent based on contributions benefiting from a domestic tax exemption.

The current 25 % minimum tax rate for non-resident taxpayers would be re-

placed by the standard progressive rates, however without application of the personal exemption (zero-bracket amount). Under a related provision in the draft bill, income not subject to taxation in Germany would no longer be included for purposes of calculating the tax rate.

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

Non-resident taxpayers from EU and EEA countries would be able to elect withholding on a net basis for certain income. This would permit the deduction of business expenses or costs of earning non-business income that are directly related to the receipts, so that tax is withheld only on the net amount. Where tax is withheld on the net amount, a minimum tax rate of 30 % would apply for individuals. The tax rate for non-resident corporate entities would be 15 %.

All changes regarding the taxation of non-resident taxpayers would apply beginning with the 2009 tax assessment period.

#### Losses of Foreign Permanent Establishments

Until 1989, the losses of foreign permanent establishments could be deducted in Germany. These losses were subject to recapture to the extent of subsequent profits in the respective

foreign country in the period ending on 31 December 2008. Under the draft bill, the recapture provision would apply without time limit.

#### Treaty and Directive Shopping

The withholding tax on certain income from capital received by foreign corporate entities on or after 1 January 2009 is reduced from 25 % to 15 %. The draft 2009 Tax Act would limit the reduction to recipients meeting the activity requirements of § 50d (3) EStG. This means that § 50d (3) EStG, which is intended to combat treaty and directive shopping, would also apply for purposes of the 15 % withholding tax rate for foreign corporations.

#### Bookkeeping in a Foreign Country

Under the draft bill, the tax authorities may upon request permit bookkeeping records generated by a data processing system and other electronic records to be transferred to another member country of the EU or EEA if certain requirements are met. In case the bookkeeping function is being transferred to an EEA country, an agreement regarding bilateral administrative assistance must also be in place with the country in question.

The new provisions would take effect on the day after promulgation of the 2009 Tax Act.

#### Changes in the Foreign Transactions Tax Law

Under § 15 AStG (Foreign Transactions Tax Law), the assets and income of foreign family foundations are attributable pro rata to German resident founders or to resident current or remainder

beneficiaries and subject to German tax in their hands.

Under the draft 2009 Tax Act this provision would be amended so that it is effectively inapplicable where the family foundation has its place of management or registered office in the EU or EEA. This would be contingent on the founder's having relinquished control over the foundation's property as a legal and practical matter and on application of the EU mutual assistance directive.

In guidance dated 14 May 2008, the Federal Ministry of Finance suspends the application of § 15 AStG with regard to family foundations in EU and EEA member countries in all open cases pending enactment of above legislation.

This action is necessary to avoid possible violations of EU law. The EU Commission had initiated a treaty infringement proceeding against Germany in 2007 with respect to the provision in question, § 15 AStG, contending that it violated the rights of free movement of capital and of persons.

#### Outlook

The Federal Ministry of Finance has requested that the business community submit comments by 16 May 2008. The government is expected to finalize its draft of the bill in June 2008. Enactment into law could then take place in the autumn of this year.

### **ECJ Rules on Non-Deductibility of Permanent Establishment Losses**

At issue in the European Court of Justice (ECJ) judgment of 15 May 2008 regarding *Lidl Belgium* (C-414/06) was the permissibility under European Community law of denying a deduction to the German head office for losses incurred by its foreign permanent establishment, the income of which was exempt from tax in Germany under a tax treaty.

In the case before the court, a deduction for the losses of a Luxembourg permanent establishment was denied in determining the taxable income of the German head office on the grounds that the income of the permanent establishment was exempt from German taxation under the tax treaty between Germany and Luxembourg.

The ECJ held that the denial of a deduction for such losses at the level of the German home office violates the freedom of establishment only where the losses are definitively non-deductible in the foreign jurisdiction in which the permanent establishment is located (so-called definitive losses). The court thus applies the principles of its *Marks & Spencer* decision (C-446/03, see *German Tax Monthly* 2/2006) to the losses of foreign permanent establishments. Accordingly, the court held in *Lidl Belgium* that a restriction of the freedom of establishment was justified by the need to preserve the balanced allocation of the power to impose taxes between the member countries and the need to prevent the double deduction of the same losses. The court furthermore held that the provisions in

question did not go beyond what was necessary to attain the objectives pursued since the losses could be deducted at the level of the permanent establishment in future tax years.

In her Opinion (see *German Tax Monthly* 3/2008), the Advocate General had argued that the freedom of establishment was unjustifiably restricted because the permanent establishment was exposed to a cash-flow disadvantage that she considered incompatible with Article 43 EC Treaty even where the losses were carried forward to later years.

### **Federal Tax Court Requests Ruling from ECJ on § 50c EStG**

By order of 23 January 2008, the Federal Tax Court has requested a preliminary ruling from the ECJ as to whether § 50c EStG (Income Tax Law) violates the freedom of establishment or the free movement of capital.

Section 50c EStG was enacted under the corporate income tax credit system that was phased out in 2000/2001. The statute applied where a person entitled to a corporate income tax credit acquired shares in a resident corporation from a shareholder without such entitlement. For a period of ten years, the statute denied tax effect to writedowns by reason of dividends paid by the acquired corporation to the extent of a so-called blocking amount. The blocking amount is defined as the difference between the purchase cost of the shares and their par value. The purpose of the statute was to prevent circumvention of the provisions denying a corporation tax credit to the (typically non-resident) seller of the shares.

The order for reference pertains to a case similar to that reported on in the May 2008 edition of *German Tax Monthly* (Federal Tax Court decision of 7 November 2007). Unlike the November 2007 case, the matter referred to the ECJ involves a company resident in the EU as the selling shareholder not entitled to the corporate income tax credit.

In its order for reference, the Federal Tax Court cites the ECJ's decision in *Meilicke* (C-292/04) in expressing doubt as to the compatibility of the statute's blocking amount with European law. In *Meilicke*, the ECJ held that the arrangement under Germany's since-terminated corporate income tax credit system by which resident taxpayers were entitled to a tax credit only with respect to the distributions of domestic corporations was incompatible with the free movement of capital.

The Federal Tax Court states that the principles of the *Meilicke* decision may apply to all provisions connected with the previous corporate income tax credit system and hence to § 50c EStG as well.

Action should therefore be taken to prevent assessments from becoming final in potentially affected cases.

### **Tax Treaty Classification of Dividends Received through a Foreign Partnership**

The Federal Tax Court ruling of 19 December 2007 involves the classification of third country dividends for tax treaty purposes where the dividends are received indirectly through an intermediate foreign partnership.

The decision relates to a Netherlands marketing partnership (A-C.V.) that held stakes in several corporations based in third countries. The sole limited partner of the Netherlands partnership was a German corporation (A-GmbH). The German tax authorities attributed the dividends paid by the third country corporations directly to A-GmbH and treated them as "other income" within the meaning of Article 16 of Germany's tax treaty with the Netherlands, for which Germany had the right of taxation.

Since the partnership maintained a permanent establishment in the Netherlands, the dividends might also constitute business profits subject to Article 5 (1) of the tax treaty. This approach is premised, however, on allocation of the respective shareholdings to the intermediate marketing partnership. In this case, the Netherlands would have the right of taxation, and Germany would be required to exclude the income from its tax base (Articles 5 (1) and 20 (2) sent. 1 of the tax treaty respectively).

Instead of basing its decision on legal ownership of the shares by the partnership, the Federal Tax Court requires a functional relationship with the permanent establishment's immediate business activity such that the dividend income constitutes income incidental to such activity. In its decision, the court states that the required functional relationship exists with regard to marketing permanent establishments where the shareholding has positive consequences for the marketing operations engaged in or where certain functions of managing holding companies

(such as business management authority) are assigned to the permanent establishment by the head office. In the instant case, the court found that the requisite functional relationship between the shareholdings and the Netherlands permanent establishment was not present. It therefore held that the income was attributable directly to the partner (A-GmbH) despite the interposition of the foreign partnership (A-C.V.).

For international tax planning, the decision is significant above all because of the guidance it provides as to the meaning of the indefinite legal concept "functional relationship". The grounds of the decision apply in relation to a large number of countries besides the Netherlands with which Germany has entered into tax treaties.

#### **No Corporate Tax Exemption for Gain on the Sale of Subscription Rights**

Gains realized by a corporate entity on the sale of shares in a domestic or foreign corporation are excluded for purposes of determining taxable income (§ 8b (2) sent. 1 KStG – Corporate Income Tax Law). However, 5 % of the gain on sale is deemed to constitute non-deductible business expense, resulting in taxability to this extent (§ 8b (3) sent. 1 KStG). In effect, the selling corporation's gain on the sale of shares in other corporations is 95 % exempt from corporate income tax.

At issue in the Federal Tax Court ruling of 23 January 2008 was whether the term "shares in a corporate entity" as used in § 8b (2) sent. 1 KStG includes the right to subscribe to shares in a stock corporation or a limited liability

company (subscription rights). The court stated that § 8b (2) sent. 1 KStG must be narrowly construed. It therefore held that only the sale of the shares themselves, not the sale of subscription rights, was covered by the exemption. The court based its decision primarily on the wording of the statute ("shares"), but stated that the same conclusion was supported by the purpose and logic of the statute.

#### **Increase in Current Assets and Asset Test under Change of Control Rules**

Under § 8 (4) KStG, a corporation is permitted to deduct losses only if it is legally and economically identical to the corporation that incurred the loss (loss limitation rules, change-of-control rules). A transfer of more than 50 % of a corporation's shares coupled with an injection of predominantly new business assets causes the corporation to lose its economic identity and hence forfeit its loss carryforwards.

The Federal Tax Court has previously held that an increase in current assets can constitute predominantly new business assets and hence trigger the loss of economic identity at least in cases that involve a change in the industry sector or trade (judgment of 5 June 2007, see *German Tax Monthly* 2/2007).

At issue in a judgment handed down by the Tax Court of Berlin-Brandenburg on 16 January 2008, which has since become final, was whether an increase in current assets, but not in fixed assets, is sufficient to constitute predominantly new business assets for purposes of § 8 (4) KStG. In the decided case, the business was continued after an inter-

ruption, but without changing the industry sector or trade. The increase in business assets resulted primarily from an increase in bank balances and trade receivables, which constitute current assets.

The Tax Court of Berlin-Brandenburg held that an increase in current assets resulting from a corporation's own economic activity does not constitute an injection of new business assets for purposes of the loss limitation rules where no change in the industry sector or trade occurs. The fact that the corporation's business assets were increased by its own economic activity and not by an injection of outside assets was critical from the court's perspective. Under these circumstances, the court stated that the increase in current assets did not change the character of the corporation's assets and hence did cause it to lose its economic identity.

The recently enacted business tax reforms contain a completely new set of corporate loss limitation rules. Regarding concurrent application of both sets of rules, see *German Tax Monthly* 11/2007.

### **Guidance on Flat Rate Taxation of In-Kind Gratuities under § 37b EStG**

Under § 37b EStG, a taxpayer is permitted to assume the income tax liability associated with in-kind gratuities that it provides to its employees or other persons to the extent that no specific tax regulations must be applied; it remits tax at a 30 % flat rate in such cases.

In recently issued guidance, the Federal Ministry of Finance states that any domestic or foreign natural or legal person may elect to provide in-kind gratuities on this basis and thereby become the taxpayer for purposes of the statute. The recipients may be the taxpayer's own employees or third parties, whether individuals or entities. In-kind gratuities include both the gifts referred to in § 4 (5) sent. 1 no. 1 EStG and in-kind benefits within the meaning of § 8 (2) sent. 1 EStG that are provided in addition to the otherwise agreed performance, or in addition to the wages or salaries otherwise owing, and are not motivated by a company law relationship. The gratuities are valued at the expenses actually incurred by the taxpayer including VAT or, in the alternative, at their fair market value.

The flat rate tax under § 37b EStG is elective, but the election must be exercised uniformly for all gratuities provided in a given fiscal year. The election may, however, be limited to gratuities provided to one's own employees or to third persons. The election may also be exercised in the course of the year in progress; it is irrevocable.

The flat rate taxation is unavailable to the extent the expenditure including value added tax per recipient and fiscal year exceeds Euro 10,000 (standard allowance) or when the expenditure for a single gratuity exceeds Euro 10,000 (threshold amount). In-kind benefits provided in the clearly predominant business interest of the employer and tax-exempt in-kind benefits are not covered by § 37b EStG.

Where in-kind gratuities are provided by a domestic taxpayer, the related expenditure including flat rate tax constitutes business expense deductible either in full or subject to the limitations of § 4 (5) EStG. If subject to flat rate taxation, the in-kind gratuity is excluded from the recipient's taxable income.

### **Imprint**

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