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# German Tax News

## Summary of important tax law changes in Germany during the last months

Various changes in German tax law have become effective in 2008 or will or are expected to become effective in 2009 due to the German Business Tax Reform 2008 and the Annual Tax Act 2008 or the Draft Annual Tax Act 2009. In the following, we would like to give an overview of some of the most important rules which might impact foreign investors.

### Index of contents


- Tax rates
- Earnings stripping rules
- Loss trafficking rules
- Reduction of withholding taxes
- Trade tax add-backs
- Participation exemption
- Revision of anti-abuse rules
- Transfer of business functions abroad
- Relocation of bookkeeping functions
- Reclassification from rental income to trading income

## Tax rates

The corporate income tax rate has been significantly reduced from 25% to 15%. The average trade tax rate is also approx. 15% (depending on the municipality). The average tax rate is therefore 30% from 2008 onwards.

In turn, trade tax is no longer a tax deductible expense. Further, several amendments in trade tax add-back, interest deduction limitation and loss utilization have been enacted (see below for details).

## Earnings stripping rules

The new rules concerning interest limitation generally apply from 2008 onwards. One of the most important changes is that all loans – irrespective whether shareholder or third party loans – will fall under the new rules. Short-term loans and unsecured third party loans are also covered.

Interest deduction is generally possible for net interest (interest expense less interest income) not exceeding 30% of “EBITDA” (which is a figure calculated under special tax rules).

The limitation does not apply if the net interest expense is less than EUR 1 million or where the taxpayer is not part of a corporate group. Further, there is an “escape” clause under which the taxpayer can prove that the equity ratio (ratio of equity to balance sheet total) of the German borrower is at least equal to or higher than the equity ratio of the whole group (a tolerance of 1% being allowed).

Disallowance of interest deduction under the earnings stripping rules will no longer trigger withholding tax. Non-deductible interest expense can be carried-forward and can be deducted in future years under consideration of the 30% EBITDA rule. Interest carry forwards will be lost in the event of harmful shareholder changes (similar to the loss forfeiture in the course of the loss trafficking rules, see below).

## Loss trafficking rules

Under the “old” loss trafficking rules, a direct shareholder change of more than 50% and an injection of predominantly new business assets during a two-year monitoring period led to the forfeiture of loss carry forwards in a loss company.

German loss trafficking rules have now been significantly tightened. From 2008 onwards, the direct or indirect transfer of more than 25%/50% of the shares in a loss company to any one shareholder or a group of shareholders with similar objectives will lead to a partial/complete forfeiture of all tax loss carry forwards in the company. As under the old rules, no group exception is envisaged in the law.

There is an interim period up to 2013 in which the old and new loss trafficking rules apply simultaneously depending on when the harmful shareholder change took place.

## Reduction of withholding taxes

Withholding tax on dividend payments will be increased from 20% to 25% plus solidarity surcharge for payments made after January 1, 2009. Non-resident taxpayers can apply for a 40% reduction, leading to an effective withholding tax rate of 15.825% including solidarity surcharge. Further reductions under the parent/subsidiary directive or a double tax treaty are possible.

It should be noted that according to the current wording of the tax law the possibility of a reduction is not conditional upon the existence of substance in the parent company but that this is a point which is currently under discussion. The Draft 2009 Tax Act limits the reduction to those recipients that meet the strict substance requirements of the German anti-treaty and directive shopping provisions that were introduced in 2007. In structures where the corporate shareholder of the German company does not meet these requirements and the upper-tier shareholder is an individual residing in a non-treaty country, the reduced withholding tax rate is not applicable and the domestic rate actually remains at 25% (plus the solidarity surcharge of 5.5%, leading to an overall tax burden of 26.375%).

## Trade tax add-backs

From 2008 onwards, German trade taxpayers will be affected by the new 25% general add-back of all long-term and short-term interest expense to the trade tax base. This will also include the financing element of rental or the lease of movable assets (add-back of 5%), immovable assets (add-back of 16.25%) and royalty payments (add-back of 6.25%). There is an allowance of EUR 100,000 and exceptions for payments made within a German tax consolidation group.

## Participation exemption

The threshold in the trade tax law to qualify for the participation exemption for domestic and foreign dividends for trade tax purposes is increased from 10% to 15% from 2008 onwards.

Although it is not included in an updated Draft published on June 18, discussions are also in progress to introduce a provision whereby all dividends and capital gains from the disposal of shares will be subject to corporate income tax if the company holds less than 10% of the shares at the beginning of the tax assessment period (“widespread shareholding”). This means that contrary to current law, dividends and capital gains from the disposal of shares received by corporate entities which only own such widespread shareholdings would no longer be 95% exempt under the participation exemption. A number of methods for calculating the shareholding percentage (e.g. in case of tax groups, security lending, etc.) would be required. Moreover, expenses in connection with widespread shareholdings would be limited to income from these shareholdings.

## Revision of anti-abuse rules

The anti-abuse rules are extended. According to the wording of the law, an abusive structure will be presumed if a tax benefit is achieved by implementing an inadequate structure, provided that an adequate structure would not have led to that benefit. No abuse is assumed if considerable non-tax reasons can be proven. It should be noted that the discussed disclosure requirement has not been enacted. The new anti-abuse rules are applicable from 2008 onwards.

## Transfer of business functions abroad

The transfer of so-called business functions from a German entity abroad becomes subject to an exit taxation. Business functions include chances and risks and tangible and intangible assets connected to such function. The required remuneration for a transfer subject to taxation in Germany is based on a so-called “transfer package” reflecting a compensation for expected future gain potential connected to the relocated business function. Furthermore, obligations for the determination of transfer prices and transfer pricing documentation for internationally affiliated companies are tightened once again.

The new rules apply from the assessment period 2008.

## Relocation of bookkeeping functions

The current law prohibits German companies or German permanent establishments of foreign companies from locating their bookkeeping function outside Germany, except in the case of foreign permanent establishments. Under the Draft 2009 Tax Act, these companies may produce electronic bookkeeping records in other EU Member States and in certain cases in EEA countries, provided they have met certain requirements and received permission from the tax authorities. No bookkeeping activities must be carried on in "third countries". The draft contains harsh penalties of up to EUR 250,000 if the taxpayer does not immediately relocate its electronic bookkeeping back to Germany in case it is considered to have failed to meet the necessary conditions precedent for establishing its bookkeeping in a foreign country.

## Re-classification from rental income to trading income

As from the 2009 tax assessment period, it is scheduled that foreign corporate entities renting German properties will no longer generate rental income but trade income.

Consequently, income will have to be determined on an accruals basis rather than on a cash basis, as is presently the case. The positive impact of this reclassification will be a yearly depreciation charge for the building of 3% instead of 2%.

The proposed change should not have an impact on the trade tax position of foreign special purpose vehicles deriving income from renting German real property. Neither should it affect the position of these vehicles with respect to the recently introduced German “interest barrier” limiting the tax deductibility of interest expenses (see above), given that the barrier is already applicable to foreign corporations earning rental income in Germany.

**Imprint**
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