CLIFFORD CHANCE

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German Business Taxation: Annual Tax Act 2010

1. Changes in business taxation under the Annual Tax Act 2010

The German Annual Tax Act 2010 of 8 December 2010 provides for a number of changes affecting the taxation of German companies and German permanent establishments of non-German companies. The changes relate particularly to the transfer of business establishments abroad, tighter CFC-rules and changes regarding loss utilisation.

2. Loss utilisation

Changes regarding preservation of losses in the amount of hidden reserves

In the event of a share purchase between more than 25% and 50%, tax losses and tax loss carry-forwards are generally written-off on a pro-rata basis; the entire tax losses and tax loss carry-forwards are generally written off in the event of a purchase of more than 50% of the shares (Sec. 8c Corporate Income Tax Act). The same applies to trade tax losses and interest carry forwards within the meaning of the interest barrier rules.

In the case of the harmful acquisition of shares, the utilisation of tax losses and tax loss carry-forwards remains nonetheless possible in the amount of the hidden reserves (unrealised profits) of the company acquired. Tax losses and tax loss carry-forwards will not be forfeited provided that, in the event of a harmful acquisition of more than 25%, but less than 50% of the shares, they do not exceed the *hidden reserves on a pro-rata basis*, or, in the event of a harmful acquisition of more than 50% of the shares, the *entire hidden reserves* of the company are not exceeded. Tax losses and tax loss carry-forwards that exceed the hidden reserves will be forfeited.

2.1 Changed definition of the relevant business assets

According to the legal status so far, only hidden reserves in German business assets were taken into consideration for loss preservation purposes. Hidden reserves in business assets of non-German permanent establishments, or in real estate located abroad, were left out of consideration. This restriction to domestic operating assets, which was very likely not compatible with EU law, has now been abolished. As of now, any hidden reserves that are included in operating assets and that are taxable in Germany will be fully considered for the preservation of losses. This new rule also covers foreign business assets that are subject to German taxation.

2.2 Modified calculation of the amount of hidden reserves in the case of a negative taxable equity capital

In general, the amount of hidden reserves corresponds to the difference between the fair market value of the acquired shares and the taxable equity capital that relates to the acquired shares. In the case of a purchase, the fair market value of the shares corresponds to the remuneration.

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If the taxable equity is negative, the amount of hidden reserves henceforth corresponds to the difference between the fair market value of the business assets (instead of the fair market value of the acquired shares) and the (negative) taxable equity capital that relates to the acquired shares. As a disadvantage of the modified calculation, the determination of the fair market value of the business assets generally requires a valuation.

The changes in Sec. 8c Corporate Income Tax Act are applicable as of the tax assessment period 2010.

3. International Transactions

3.1 Realisation of hidden reserves when assets are transferred abroad

It is a statutory requirement that hidden reserves accumulated in an asset must be realised if Germany's taxation right with regard to capital gains from the sale of the asset is restricted or excluded. However, in view of recent case law it was unclear whether the transfer of an asset from Germany to a non-German permanent establishment triggers the taxation of all hidden reserves accumulated in such asset.

The Annual Tax Act 2010 now explicitly stipulates that hidden reserves must be realised if a business asset previously allocated to a German permanent establishment is transferred to a non-German permanent establishment maintained by the same taxpayer. It is of no relevance whether the profits of the non-German permanent establishment fall under the tax exemption method or the tax credit method provided for in the relevant double tax treaty. If a business asset is transferred to a non-German permanent establishment of the same taxpayer within the EU, it is possible to create a special balancing item in order to spread any taxable profit that may thus arise over a period of up to five years.

The obligation to realise hidden reserves also arises if operating units, interests in a partnership or individual business assets are allocated to a non-German permanent establishment in the context of a split up of a partnership.

In principle, the new provisions have retroactive effect and apply to all fiscal years ending after 31 December 2005. In certain cases these new provisions also apply to fiscal years that ended prior to 1 January 2006. However, it still remains to be clarified whether it is legally permissible to introduce such legislation with retroactive effect. Given that this matter will most likely be decided by the courts, it is advisable to ensure by appeal that any relevant tax assessment notices do not become final before such final clarification.

3.2 Realisation of hidden reserves when business establishments are transferred abroad

If an entrepreneur transfers his business establishment in its entirety from Germany to another country (without retaining any presence in Germany), any hidden reserves that may exist in connection with such business must be realised (as if the entire business establishment were fully wound up and closed down) and such hidden reserves are then fully taxable. Here again the problem of such new legislation being intended to have retroactive effect arises. If a business establishment is relocated within the EU or the EEA, a special balancing item can be created in order to spread any taxable profit that may thus arise over a period of up to five years.

3.3 Tightening of CFC rules (prevention of the so-called "Malta Tax Scheme")

The German CFC rules (Sec. 7 et seq. Foreign Tax Act) apply if "detrimental passive income" is actually taxed at a low rate only. This is the case if income of a foreign company is taxed at a rate of less than 25%. Up to now, the relevant provisions referred only to the taxes payable at the level of the foreign company, while tax refunds at the level of the foreign company's shareholders were ignored. However, the Annual Tax Act 2010 contains a new, tighter definition of what is to be understood by the term "low tax burden" (Sec. 8 subsec. 3 Foreign Tax Act). In future, any tax refunds or tax credits that may accrue to any direct or indirect shareholders of a foreign company are taken into account for determining whether a company is subject to a low tax rate.

Certain structuring options were possible under the provisions up to now. One example is the so-called "Malta Tax Scheme": In principle, a corporation established in Malta is subject to corporate income tax levied at a global rate of 35%. However, if and to the extent that a Maltese corporation distributes profits, up to 6/7th of the tax paid by the corporation (i.e. up to 30% of the tax liability) will be refunded to its shareholders. This means that the ultimate tax burden on the corporation's income is around 5%. However, the income tax payable by the corporation (35%) was relevant and thus, the CFC rules did not apply. The new legislation provides for an economically oriented approach, taking into consideration not only the company, but also its shareholders. Therefore, as of now, the Malta Tax Scheme will result in a low taxation (5%).

In addition, any tax credits and tax refunds obtained abroad are taken into consideration when determining the amount of the CFC profits. Therefore, only taxes that are effectively incurred are deductible when determining this amount. In the case of the Malta Tax Scheme, only 5% (instead of 35%) are deductible.

These newly introduced provisions shall apply to foreign intermediate companies with effect as of their first fiscal year beginning after 31 December 2010.

3.4 Restrictions of the switch-over clause (Sec. 20 subsec. 2 Foreign Tax Act)

The German tax law provides that, in certain cases, profits of a foreign permanent establishment fall under the tax credit method instead of the tax exemption method contained in the relevant double tax treaty (so-called switch-over clause, Sec. 20 subsec. 2 Foreign Tax Act). This provision applies in cases where a permanent establishment has income which, if such permanent establishment were a foreign intermediate company, would be subject to the CFC taxation (Sec. 8 subsec. 1 Foreign Tax Act). The Annual Tax Act 2010 abolishes an unintended application of the switch-over-clause. This is the case where a permanent establishment obtains income from the provision of services and, in this respect, collaborates with a shareholder subject to unlimited tax liability in Germany (or a party affiliated to such a shareholder). As of now, such collaboration will no longer fall within the scope of the switch-over clause. This new legislation will be applied in all cases that are still pending (Sec. 21 subsec. 19 sentence 2 Foreign Tax Act).