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Tax News.

Government Draft on the German Annual Tax Act 2009

1 Introduction

The Federal Government (*Bundesregierung*) passed the government draft on the German Annual Tax Act 2009 on 18 June 2008. According to the present planning of the legislative procedure, the 1st reading of the government draft shall not take place until after the summer break, on 25 September 2008. The 2nd and 3rd reading shall follow on 14 November 2008 and the approval by the Federal Council (*Bundesrat*) is expected on 19 December 2008.

In the following, we have summarised the most important amendments concerning company taxation and capital investments.

2 Amendments to the German Income Tax Act (Einkommensteuergesetz - EStG)

2.1 Offset of Foreign Source Losses (section 2a German Income Tax Act-Draft)

The present wording of section 2a of the German Income Tax Act provides for a general limitation of the offset and deduction of losses for specific losses sustained in foreign countries without making a differentiation according to the country of origin of the losses. These losses can only be offset against positive income of the same type from the same country; they may also not be deducted according to section 10d of the German Income Tax Act.

In particular, the new wording of section 2a of the German Income Tax Act now planned is a reaction to the treaty infringement procedures which the EU Commission initiated against the Federal Republic of Germany. According to the opinion of the Commission, Germany violates its obligations

Contents

under the EC Treaty by subjecting foreign source losses to the limitations set forth in section 2a of the German Income Tax Act, whereas losses sustained in Germany can be made use of without these limitations.

Therefore, according to section 2a of the German Income Tax Act-Draft, the limitations of the offset and deduction of losses only apply in future to losses sustained in non-EEA states and no longer to losses sustained in the EU and the European Economic Area (EEA).

According to the new regulation, in future, losses sustained in member states of the EU to which the tax credit method can be applied, can be asserted in Germany. If the exemption method applies, according to the view of the Federal Republic of Germany, it is also possible that losses sustained in a member state of the EU are not taken into consideration.

Initial application: In all tax assessments which are not final and absolute (section 52 para. 3 sentence 2 German Income Tax Act-Draft).

2.2 Limitation of the Progressivity Proviso for EU Profits and Losses (section 32b para. 1 German Income Tax Act-Draft)

Foreign source losses or profits, which are not subject to taxation due to the exemption method, have an effect within the scope of the progressivity proviso on the applicable tax rate for the other taxable income. In future, profits and losses from member states of the EU shall, to the extent that the exemption method applies, no longer be taken into consideration in the determination of the tax rate to be applied (discontinuation of a positive and/or negative progressivity proviso).

According to the opinion of the federal government, the new regulation supplements the intended change of section 2a of the German Income Tax Act whereby the federal government again invokes the plea of symmetry of profits and losses in relation to conformity with European law: to the extent that profits cannot be taken into account within the scope of the progressivity proviso, also losses from member states of the EU could be excluded from the progressivity proviso.

Initial application: As of tax assessment period 2008 (section 52 para. 43a sentences 2 and 3 German Income Tax Act-Draft)

2.3 Limitation of the Offset of a Loss of a Limited Partner in the event of Subsequent Contributions (section 15a para. 1a German Income Tax Act-Draft)

Losses of a limited partner may not be offset against other income or deducted according to section 10d of the German Income Tax Act to the extent that the loss causes a negative balance on the capital account or the negative balance is increased (section 15a para. 1 sentence 1 German Income Tax Act). In connection with contributions made after completion of the financial year in which a loss has occurred that is not able to be offset or deducted (so-called “subsequent contributions“), on the one hand, the new regulation shall enable present case law and administrative practice to be codified by legislation, however, on the other hand, the offset of losses shall be considerably limited, contrary to the case law of the Federal Finance Court (*Bundesfinanzhof*).

According to section 15a para. 1a first half of the sentence of the German Income Tax Act-Draft, subsequent contributions do not permit offsetting and deducting an existing loss that is able to be offset. This statutory regulation codifies present case law and administrative practice according to which subsequent contributions cannot have the effect that existing losses, which are not able to be retroactively offset or deducted, are then able to be offset and deducted (cf. e.g. Federal Finance Court (BFH) of 14 December 1995, IV R 106/94, BStBl. (*Federal Tax Gazette*) II 1996, 226; H 15a EStH, heading “Contributions“).

In addition to this, pursuant to section 15a para. 1a 2nd half of the sentence of the German Income Tax Act-Draft, subsequent contributions shall also not permit an offset or deduction of future losses if the loss causes a negative balance on the capital account or the negative balance is increased. According to established case law of the Federal Finance Court on section 15a of the German Income Tax Act, an adjustment item shall be set up in the amount of the contributions which were made in order to offset a negative balance on the capital account and which are not depleted by losses that can be offset in the year the contribution is made. Losses sustained in subsequent financial years can be offset up to the amount of this adjustment item; this also applies if a negative balance on the capital account occurs or is increased (again) (cf. e.g. BFH of 26 June 2007, IV R 28/06, DStR, 2007, 1620; contrary to its original opinion (cf. BMF (*Federal Ministry of Finance*) of 14 April 2004, BStBl. I 2004, 463). With circular letter of 19 November 2007 (BStBl. I 2007, 823), the tax authority has adopted the opinion of the Federal Finance Court. With the regulation set forth in section 15a para. 1a second half of the sentence of the German Income Tax Act-Draft, it is now obviously intended to codify the tax authority’s earlier opinion into legislation, whereby contributions, which are made in order to offset a negative balance on the capital account and which are not depleted by losses that can be offset in the year the contribution is made, will also not be taken into account in respect of future losses if a negative balance on the capital account occurs or is increased. It is certainly open to doubt whether this “law on non-application“ will hold up against the constitutional-law concerns voiced by the

Federal Finance Court against subsequent contributions not being taken into account.

Initial application: The new regulation shall apply to contributions which are made after the date of the pronouncement of the German Annual Tax Act 2009 in the Federal Law Gazette (*Bundesgesetzblatt)* (section 52 para. 33 German Income Tax Act-Draft).

2.4 Amendments in respect of Final Withholding Tax (Abgeltungsteuer)

Continuation of the book value for specific capital measures concerning private assets (section 20 para. 4a German Income Tax Act-Draft): Section 20 para. 4a of the German Income Tax Act–Draft envisages a determination of profits in deviation from section 20 para. 4 of the German Income Tax Act for certain capital measures. In specific cases where income is not achieved in the form of monetary payments, the final withholding tax and the associated withholding of taxes on capital gains for the parties obliged to withhold the taxes shall be structured in a more practical manner. For certain capital measures, no profit realisation shall take place in future but instead, the present acquisition costs shall be continued. The following cases are affected by the new regulation:

– **Share Exchange**

  If shares in corporations, conglomerations of property or associations of persons that have their seat outside of the EU, respectively the EEA, are exchanged for shares in another corporation, conglomeration of property or association of persons, the acquisition costs of the shares being given are deemed to be the selling price and the acquisition costs of the shares received as long as Germany's taxation right remains in existence for the shares received (exception: the transaction falls within the scope of section 12 para. 2 of the German Corporate Income Tax Act (*Körperschaftsteuergesetz – KStG*)).

  Contrary to general principles, the new legislative regulation makes a tax-neutral exchange of shares possible also outside of the German Reorganisation Tax Act (*Umwandlungssteuergesetz*) in respect of shares in private assets (lower than 1%). However please note in this context that – notwithstanding the tax-neutral status of the exchange – the shares received are newly acquired. Accordingly, for exchange transactions which take place as of 1 January 2009 and concern shares which were acquired before this point in time, subsequent capital gains are subject to final withholding tax and are not covered by the grandfathering rules for old shares (i.e. acquisition up to 31 December 2008).

- **Exchange of Capital Claims into Shares**

  For other capital claims in terms of section 20 para. 1 no. 7 of the German Income Tax Act as amended on 1 January 2009, whereby instead of the repayment of the nominal amount, either the holder of the capital claim can demand the delivery of a determined number of shares or the issuer can offer a determined number of shares for sale (in particular reverse convertible bonds and/or exchangeable bonds), the remuneration for the acquisition of the capital claim is deemed to be the selling price for the claim and the acquisition costs for the shares received. Therefore, the share exchange and/or the offer of the sale of shares have a neutral effect on income tax. For reverse convertible bonds, the possibility of taking a possible loss into account is also ruled out by law. A separate regulation for the conversion of convertible bonds in terms of section 221 of the German Stock Corporation Act (*Aktiengesetz - AktG*) is not required because already up to now, the conversion has not been deemed to be a fact of realisation.

- **Subscription Rights**

  For subscription rights within the scope of a capital increase pursuant to section 186 of the German Stock Corporation Act, section 55 of the German Act on Limited Liability Companies (*GmbH-Gesetz*) or a claim to the conclusion of a subscription agreement according to a comparable foreign law, that part of the acquisition costs of the old shares attributable to the subscription rights is set at 0 for the establishment, sale and exercise of subscription rights. This regulation is also based on considerations of feasibility in order to avoid a determination of the value of the subscription right especially in relation to non-trading subscription rights.

Initial application: The regulation shall be applied for the first time to capital gains which accrue to the taxpayer after 31 December 2008 (section 52a para. 10 sentence 10 German Income Tax Act).

Ability to Offset Losses from Writing Options: According to applicable legislation, income from writing options (e.g., option premiums received) is subject to taxation pursuant to section 22 no. 3 of the German Income Tax Act. However, based on the German Corporate Tax Reform Act 2008 (*Unternehmensteuerreformgesetz 2008*), as of 2009, this income will be considered to be income from capital investments according to section 20 para. 1 no. 11 of the German Income Tax Act. Until now, for income according to section 22 no. 3 of the German Income Tax Act, an offset of losses is only possible within this income category. Therefore, losses from writing options, which have not yet been offset by 31 December 2008, may no longer be offset.

This shall be changed by the German Annual Tax Act 2009: in future, “old losses“ that are realised from writing options up to 31 December 2008 can be offset for a transitional period up to 2013 against writing option premiums according to section 20 para. 1 no. 11 of the German Income Tax Act–Draft (section 22 no. 3 sentence 4 German Income Tax Act-Draft).

First and last application: As of tax assessment period 2009 (section 52a para. 10a German Income Tax Act-Draft) up to and including tax assessment period 2013 (section 52a para. 10a German Income Tax Act-Draft).

Tax Credit of Withholding Tax (*Quellensteuer*) for Foreign Capital Gains: In order to minimise or prevent double taxation for taxpayers with unlimited tax liability, in principle, the foreign tax levied on foreign income can be credited against the German income tax (section 34c German Income Tax Act). Usually the credit takes place according to the so-called “per country limitation“, i.e., the credit of taxes shall be carried out separately for every state.

For foreign capital gains subject to final withholding tax in Germany, section 32d para. 5 of the German Income Tax Act-Draft provides a separate regulation which takes the credit of foreign withholding tax into account without the application of the so-called “per country limitation“. The foreign tax credit (as the case may be including notional withholding tax) is limited to the amount of German tax attributable during the respective tax assessment period to the derived related foreign capital gains, i.e., to a maximum of 25% or a lower income tax based on the tax assessment requested by the taxpayer.

Correspondent to the implementation of a separate tax credit regulation for foreign capital gains subject to withholding tax, this income is consequently excluded from the general foreign tax credit and deduction procedure under section 34c of the German Income Tax Act (section 34c para. 1 sentences 1 and 3 German Income Tax Act-Draft, section 34 para. 6 sentence 2 German Income Tax Act-Draft).

Initial application: As of tax assessment period 2009 (section 52 para. 49 sentence 1 respectively section 52a para. 15 German Income Tax Act-Draft).

Transitional Regulation for Financial Innovations (section 52a para. 10 sentence 7 German Income Tax Act-Draft): The reason for the new wording is the case law of the Federal Finance Court which states that certain components of the income from financial innovations are possibly not covered by section 20 para. 2 sentence 1 no. 4 of the German Income Tax Act. Thus, for example, a profit from the sale of a financial innovation without issuing yield (*Emissionsrendite*) is also not taxed according to the market yield but instead only according to the profit component even if the definition of the profit and asset level is possible without a great amount of effort; also a profit from the sale of a certificate with partial capital protection is only subject to taxation according to section 20 para. 2 sentence 1 no. 4 of the German Income Tax Act in the partial amount of the capital protection.

The new wording of section 52a para. 10 sentence 7 of the German Income Tax Act-Draft, shall ensure that the case law of the Federal Finance Court does not affect the scope of protection of vested rights for financial innovations which were acquired up to 31 December 2008. Accordingly, profits from capital claims, which according to the wording of section 20 para. 2 sentence 1 no. 4 of the German Income Tax Act shall be deemed to be financial innovations, shall also be entirely subject to final withholding tax as of 1 January 2009 even if, based on the case law of the Federal Finance Court, certain profit components would not be subject to taxation according to this regulation.

2.5 Amendments for Tax payers with Limited Tax Liability

Taxpayers with limited tax liability are persons who are not resident in Germany or do not have their habitual abode in Germany and who receive income in Germany within the meaning of section 49 para. 1 of the German Income Tax Act. Likewise, corporations not having their management or seat in Germany are parties with limited tax liability. The German Annual Tax Act 2009 sets forth some amendments in the area of limited tax liability of which the following shall be pointed out in particular:

Commercial Nature of Rental Income Received by Parties with Limited Tax Liability: Up to now, income which a party with limited tax liability (e.g., a foreign stock corporation) realises from renting and leasing real estate situated in Germany or from rights exploited in Germany within the scope of its commercial activities, is only considered to be income from trade or business if the income can be attributed to a permanent establishment in Germany or a permanent representative has been appointed in Germany (section 49 para. 1 no. 2 letter a German Income Tax Act). Otherwise it realises income from leases according to section 21 of the German Income Tax Act in conjunction with section 49 para. 1 no. 6 of the German Income Tax Act.

Through the amendments in the German Annual Tax Act 2009, such rental income – the same as up to now the income from the sale of German real estate – irrespective of the existence of a German permanent establishment or a permanent representative in Germany, shall be re-classified as commercial domestic income to the extent that the income can be attributed to the commercial activities of the party with limited tax liability (section 49 para. 1 no. 2 letter f German Income Tax Act-Draft). With this, as in the past, regular rental income and also sales proceeds are subject to the regulations on the determination of profit according to sections 4 et seq. of the German Income Tax Act.

This can lead to disadvantages, in particular due to a limited deduction of interest expenses according to section 4h of the German Income Tax Act (so-called interest ceiling). Up to now, the interest ceiling has only applied to foreign property corporations (*Objektkapitalgesellschaften*) which realise rental income in Germany (section 8a para. 1 sentence 4 German Corporate Income Tax Act). Through the new wording of section 49 para. 1 no. 2 letter f of the German Income Tax Act–Draft, now the interest ceiling also applies to other foreign corporate bodies (co-operatives, foundations).

Initial application: As of tax assessment period 2009 (section 52 para. 1 German Income Tax Act-Draft).

Discontinuation of the Minimum Tax Rate for Parties with Limited Tax Liability: The regulation set forth under section 50 of the German Income Tax Act contains special provisions for the determination of the taxable income and the amount of income tax and/or corporate income tax for parties with limited tax liability. This regulation is being reworded, primarily, due to the large number of concerns based on European law. Of particular note here is the discontinuation of the minimum tax rate of 25% for parties with limited tax liability.

The European Court of Justice (cf. decision of 12 June 2003, Rs. C-234/01, Gerritse, BStBl II 2003, p. 859) has complained about the use of the minimum tax rate in those cases where the application of the progressive tax rate which applies to the party with limited tax liability (entry-level tax rate of presently 15%) in fact leads to a lower tax rate. The new statutory regulation envisaged by the German Annual Tax Act 2009 essentially follows the practice of the tax authorities for citizens of the EU and the EEA according to the decision handed down by the European Court of Justice (cf. BMF of 10 September 2004, BStBl I 2004, p. 860) and calculates the income tax consistently according to the tax rate for parties with unlimited tax liability (section 32a para. 1 German Income Tax Act), whereby however the basic personal allowance is not taken into consideration (section 50 para. 1 sentence 2 German Income Tax Act-Draft). The new statutory regulation is not limited to EU and EEA cases but also applies to parties with limited tax liability from non-EEA states.

Initial application: As of tax assessment period 2009 (section 52 para. 1 German Income Tax Act-Draft).

Aggravation of Withholding Tax Reduction to 15% for Foreign Corporations: According to the German Corporate Tax Reform 2008 (final withholding tax), in principle, the capital gains tax, respectively withholding tax for certain domestic capital gains (e.g., dividends earned from interests in a German corporation) amounts to 25% (section 43 para. 1 sentence 1 no. 1-4 in conjunction with section 43a para. 1 no. 1 German Income Tax Act). If the creditor is a corporation with limited tax liability, the withholding tax of 25% is reduced to the tax rate according to the tariff for corporate income tax of 15%. Upon application, the difference of 10% is reimbursed by the Federal Central Tax Office (*Bundeszentralamt für Steuern*) (section 44a para. 9 sentence 1 German Income Tax Act); section 50d para. 1 sentence 3-9 of the German Income Tax Act applies for the procedure respectively.

According to the German Annual Tax Act 2009, also the requirements for the reimbursement of the difference of 10% are that the foreign corporation submits a certificate of residence for tax purposes (*Ansässigkeits-bescheinigung*) (section 50d para. 4 German Income Tax Act) and that there is no improper intermediate vehicle in the form of a shell company with no function (section 50d para. 3 German Income Tax Act) (section 44a para. 9 sentence 2 German Income Tax Act-Draft) *(Cf. Newsletter of 21 July 2006, para. 2), on the government draft regarding the German Annual Tax Act 2007 in respect of the tightening of section 50d para. 3.)*.

Initial application: For capital gains accruing after 31 December 2008 (section 52a para. 16 sentence 3 German Income Tax Act-Draft).

2.6 Overview of Other Income Tax Amendments

– Discontinuation of the special regulations for parties with limited tax liability concerning deduction of losses according to section 10d of the German Income Tax Act by way of deletion of the present section 50 para. 1 sentence 2 of the German Income Tax Act (i.e. storage of the records documenting the loss is no longer required in Germany).

– Replacement of the present tax reimbursement procedure by a tax assessment option for parties with limited tax liability from EU/EEA states (section 50 para. 2 no. 5 German Income Tax Act-Draft, section 32 para. 2 no. 2 German Corporate Income Tax Act-Draft).

– Reduction of the tax deduction of 20% to 15% for income from (i) cultural, sports, artistic and similar performances in Germany which serve the purpose of entertaining the public, (ii) the exploitation of such performances in Germany as well as (iii) the granting of rights (section 50a para. 2 German Income Tax Act-Draft).

– Consideration of operating costs or income-related expenses in the tax deduction procedure for parties with limited tax liability, however with an increase of the tax rate for natural persons from 15% to 30% (section 50a para. 3 sentence 3 no. 1 German Income Tax Act-Draft).

3 Amendments to the German Corporate Income Tax Act (Körperschaftsteuergesetz - KStG)

Amendments concerning Securities Lending: The scope of application of section 8b para. 10 of the German Corporate Income Tax Act-Draft (refusal of deductibility of manufactured dividends for certain securities lending transactions) will be extended to investment units insofar as these result in income to which section 8b of the German Corporate Income Tax Act shall be applied.

4 Amendments to the German Trade Tax Act (Gewerbesteuergesetz - GewStG)

Reduction of trade tax according to section 9 no. 1 of the German Income Tax Act for co-entrepreneurships managing real estate (section 9 no. 1 sentence 5 no. 1a German Trade Tax Act-Draft): Pursuant to section 9 no. 1, sentence 2 of the German Trade Tax Act, upon application, real estate companies may reduce the profit attributable to the management and use of their own real estate when determining the trade income. Through section 9 no. 1 sentence 5 no. 1a of the German Trade Tax Act-Draft, the extended reduction according to section 9 no. 1 sentences 2 to 4 of the German Trade Tax Act is limited for co-entrepreneurships managing real estate.

In future, the extended reduction will only apply to special payments to co-entrepreneurs if they are paid for providing real estate. The extended reduction is excluded insofar as special payments are paid by the company for other services performed by the co-entrepreneur, such as the granting of a loan or provision of consultancy services.

Initial application: The limitation of the extended reduction for real estate (*Grundstückskürzung*) shall apply for the first time for collection period (*Erhebungszeitraum*) 2009 (section 36 para. 1 German Trade Tax Act-Draft).

5 Amendments to the German Reorganisation Tax Act (Umwandlungssteuergesetz - UmwStG)

Retroactive taxation of the exchange of shares (section 22 para. 2 sentence 1 German Income Tax Act-Draft): Section 22 para. 1 sentence 1 of the German Reorganisation Tax Act provides that within the scope of a contribution in kind and/or a share exchange, a retroactive taxation of the market value of the contribution takes place if the contributed share is sold by the receiving company within seven years of the contribution.

Retroactive taxation shall not take place if the sales proceeds are given preferential treatment according to section 8b para. 2 of the German Corporate Income Tax Act anyway to the benefit of the contributing party. In the present version of the legislation, this requirement was provided for with a regulation specifying that "the contributing party is not a party being benefited by section 8b para. 2". This wording is obviously not clear enough for the Federal Government.

The new regulation set forth in section 22 para. 2 sentence 1 of the German Reorganisation Tax Act-Draft, provides a clarification that a retroactive taxation requires that "the shares are not tax-exempt according to section 8b para. 2 of the German Corporate Income Tax Act at this point in time for the contributing party".

Initial application: On the day after the pronouncement of the German Annual Tax Act 2009.

6 Amendments to the German VAT Act (Umsatzsteuergesetz - UStG)

Taxation of mixed-use vehicles (section 15 para. 1b German VAT Act): According to the current legislation, in regards to vehicles which are used for both enterpreneurial and non-entrepreneurial purposes, the entrepreneur shall pay taxes on the non-entrepreneurial use as a provision of services free of charge (gratuitous release of value) (*unentgeltliche Wertabgabe*) pursuant to section 3 para. 9a of the German VAT Act.

Pursuant to section 15 para. 1b of the German VAT Act-Draft, in future, this taxation shall be replaced by a lump-sum limitation of the input tax deduction for mixed-use vehicles. According to the new regulation, only 50% of the input tax amounts attributable to the acquisition or production, the import, the intra-community acquisition, the renting, the leasing or the operation of the vehicles within the meaning of section 1b para. 2 of the German VAT Act may be deducted if the vehicles are also used for the private purposes of the entrepreneur or for other purposes not associated with the business activities.

The required consequential amendments concerning the lump-sum input tax deduction ban under section 15 para. 1b of the German VAT Act-Draft are set forth in section 15a para. 6a and para. 8 sentence 2 of the German VAT Act-Draft. Section 15a para. 6a of the German VAT Act-Draft supplements the correction rule set forth in section 15a of the German VAT Act. According to this, the input tax deduction shall be corrected on a *pro rata temporis* basis if within five years of the first use of the vehicle, the use changes from exclusively entrepreneurial use to partially non-entrepreneurial use, respectively changes from a mixed use to an exclusively entrepreneurial use. According to section 15a para. 8 sentence 2 of the German VAT Act-Draft, if the vehicle is sold or withdrawn from the business within five years, this is also considered to be a change of use. A double burdening with VAT is prevented by the correction because the full amount of VAT is levied on the withdrawal and the sale of the vehicle.

Initial application: Because the new regulation deviates from the regulations under community law, it requires an authorisation by the Council pursuant to Art. 395 of the VAT Directive. Therefore, section 15 para. 1b of the German VAT Act-Draft shall be applied to all vehicles which are acquired, produced, imported, purchased within the community, rented or leased after 31 December 2008, however not before the expiration of the calendar month which follows the month in which the decision of the Council on the authorisation of the Federal Republic of Germany is published in the Official Journal of the European Union.

7 Amendments to the German Foreign Tax Act (Außensteuergesetz - AStG)

Attribution of income according to the German Foreign Tax Act for foreign foundations as well as determination of income (section 15 para. 6, 7 German Foreign Tax Act-Draft): The new regulation set forth in **section 15 para. 6 of the German Foreign Tax Act-Draft** shall accommodate for the criticism voiced according to European law of the allocation of income according to the German Foreign Tax Act for foreign foundations.

An attribution of the income of the foreign foundation to the founder, respectively the beneficiaries, shall be excluded if the foundation has its seat or its headquarters in a member state of the EU respectively the EEA and the founder, respectively the beneficiaries can prove that they are legally and factually not authorised to dispose over the foundation assets. The proof requires that the tax authorities have a possibility of verifying this proof by way of inter-governmental administrative assistance through an exchange of information. According to the reasoning for the government draft, it is adequate in this respect that such regulations exist, their effective application is not required.

Initial application: The new regulation applies as of tax assessment period 2009 (section 21 para. 18 sentence 1 German Foreign Tax Act-Draft). Until this new regulation takes effect, the tax authorities are already applying these principles on the basis of the notice from the BMF of 14 May 2008 (DStR 2008, 1094) for all tax assessments which are not absolute and final.

According to **section 15 para. 7 sentence 1 of the German Foreign Tax Act-Draft**, income to be attributed according to section 15 para. 1 of the German Foreign Tax Act shall be determined according to German tax law; this regulation corresponds with the case law of the BFH and administrative practice and is therefore only a clarification (cf. BFH, decision of 5 November 1992, BStBl. II 1993, p. 388; BMF, notice of 2 December 1994, BStBl. I 1995, special issue 1, p. 3, margin no. 15.1.1). Furthermore, it is now provided by legislation that the attribution does not apply to negative income and section 10d of the German Income Tax Act shall be applied accordingly (section 15 para. 7 sentences 2 and 3 German Foreign Tax Act-Draft). As is stated in the legislative reasoning, also these regulations shall only be a clarification and not an actual amendment; however it is doubtful whether this is in fact the case.

Initial application: The regulation shall be applied to all tax assessments which are not final and absolute (section 21 para. 18 sentence 2 German Foreign Tax Act-Draft). It is doubtful whether the associated real retroactive effect for tax assessment periods before 2008 is constitutional, in particular, in view of the unclear nature (clarification or actual amendment) of the new regulation.

8 Amendments to the German Investment Tax Act (Investmentsteuergesetz - InvStG)

The government draft on the German Annual Tax Act 2009 also contains important amendments for the taxation of units in investments funds. In particular this concerns the expansion of the scope of deemed distributions, and the accrual-based accounting of interest.

8.1 Expansion of the Scope of Deemed Distributions (section 1 para. 3 sentence 3 German Investment Tax Act-Draft)

According to the German Investment Tax Act, not only the distributed profits of an investment fund are taxed at investor level but also the so-called deemed distributions (section 2 para. 1 sentence 1 German Investment Tax Act). Deemed distributions are proceeds of an investment fund which are attributed to the investor and for which the investor must pay taxes although they are retained by the investment fund.

Change of the Definition of Deemed Distributions: The government draft on the German Annual Tax Act 2009 contains an expansion of the definition of deemed distributions in section 1 para. 3 sentence 3 no. 1 of the German Investment Tax Act-Draft in respect of capital income capital . As was the case up to now, basically all capital income in terms of section 20 of the German Income Tax Act shall constitute deemed distributions. However, specific types of capital income are explicitly excluded from deemed distributions. This has the result that there is no regular taxation of this income at investor level (so-called fund privilege). On the contrary, with continuous profit retention, this income increases the value of the investment unit with the consequence that this is not taxed until the sale, respectively return of the investment unit by the investor.

According to the government draft on the German Annual Tax Act 2009, the following income is not defined as deemed distributions:

- income from option writer/seller premiums,
- profits from options, futures, and forwards,
- profits from the sale of shares in corporations, equity-style profit participation rights and similar investments as well as vested rights to such instruments and
- profits from the sale or redemption of other capital claims with fixed interest rates, respectively, issuing yield.

Whereas already according to presently applicable law, income from option writer/seller premiums and profits from options, futures and forwards, in this form, are not considered to be deemed distributions, the regulation on profits from the sale of shares in corporations and other equity-style instruments as well profits from the sale and/or redemption of other capital claims with fixed interest rates, respectively issuing yield, results in an expansion of the definition of deemed distributions:

- According to the definition of deemed distributions, which has been applicable since the German Tax Reform Act 2008 became effective, "**securities sales transactions**" are not considered to be deemed distributions. This has the consequence that neither the profits from the sale of shares in corporations and other equity-style instruments nor profits from the sale of other securities (e.g. profits from the sale of interest coupons, accrued interest and full-risk certificates) constitute deemed distributions. Therefore, these profits cannot be taxed as capital gains at investor level. With the planned change implemented by the government draft on the German Annual Tax Act 2009, the legislator limits the group of privileged sales profits. According to this, only the profits from the sale of **shares in corporations** and other equity-style instruments shall still be privileged. In comparison, the profits from the sale of other capital claims shall lead to deemed distributions and therewith, also in the event ongoing profit retention, also be subject to regular taxation at investor level.
- Besides this expansion of the definition of deemed distributions to profits from the sale of securities that are not shares in corporations, respectively other equity-style instruments, the definition of deemed distributions shall be adapted more precisely to the final withholding tax which is applicable as of 1 January 2009. For this reason, all proceeds from capital claims will basically constitute deemed distributions. This applies irrespective of whether or not they are capital protected (in whole or in part). In particular, the so-called **full-risk certificates** are included in the deemed distributions. Only profits from the sale and/or redemption of capital claims with **fixed interest rates**, respectively an **issuing yield** shall not be included in the deemed distributions and therewith, in the event of retention of profits, shall not be subject to regular taxation at investor level. In our opinion, this exception also includes all the other capital claims for which at least a fixed or variable (possibly lower) interest rate is also paid to the extent that this is calculated on the basis of a fractional amount of the capital.

No Affect on the Taxation of the Sale and/or Return of Investment Units by a so-called Fund-of-Funds: In our opinion, the change of the definition of deemed distributions has no effect on the taxation of the sale and/or return of investment units by a so-called fund-of-funds. The fund-of-funds, in our view, does not realise deemed distributions through the sale and/or return of the units in the target fund because according to section 8 para. 5 sentence 1 of the German Investment Tax Act, the profits from the sale and/or return of the investment units shall be classified as profits from the sale of shares in corporations and other equity-style instruments. According to the clear regulation set forth in section 1 para. 3 sentence 3 no. 1 of the

German Investment Tax Act-Draft, such profits do not constitute deemed distributions.

Initial application: The new determination of the definition of deemed distributions shall apply to income which accrues to the investor as of 1 January 2009 (section 18 para. 12 sentence 1 German Investment Tax Act-Draft). In deviation from this, the new regulation shall only apply to income from full-risk certificates if these are acquired after 31 December 2008. In our opinion, if full-risk certificates are acquired before this date, the profits from the sale of such certificates do not constitute deemed distributions even if they are achieved after 31 December 2008.

8.2 Accrual-based Accounting of Interest (section 3 para. 2 sentence 1 no. 2 German Investment Tax Act-Draft)

Section 3 para. 2 sentence 1 no. 2 of the German Investment Tax Act-Draft contains a further change. According to this regulation, interest, in particular income from other capital claims with issuing yield, shall be accounted on an accrual basis at investment fund level. The interest accounted on an accrual basis is included in the distributed profits or the deemed distributions; in the event of retained profits, the interest is deemed to have accrued. This regulation corresponds with the old legislation because the definition of “interest“ has been very widely understood up to now.

This regulation shall also be initially applied to income which is deemed to have accrued after 31 December 2008.

9 Amendments to the German General Fiscal Code (Abgabenordnung - AO)

Accounting in Foreign Countries (section 146 paras. 2a, 2b of the German General Fiscal Code–Draft): According to the current legislation (section 146 para. 2 sentence 1 of the German General Fiscal Code), it is compulsory that the accounts and other records required are maintained and retained in Germany. By inserting the new paragraphs 2a and 2b into section 146 of the German General Fiscal Code-Draft, a relocation of the accounting prepared by a data processing system to the headquarters or centralised accounting departments in other EU or EEA countries will be possible upon a corresponding application by the taxpayer. Pursuant to section 146 para. 2a sentence 3 nos. 1-4 of the German General Fiscal Code–Draft, the requirements for a relocation are as follows:

- The taxpayer proves that the state to which the accounting shall be relocated agrees to the German tax authorities having access to electronic books and other records required;
- the taxpayer notifies its local tax office (*Finanzamt*) of the location of the data processing system;
- the taxpayer has so far properly complied with its various obligations to co-operate (sections 90, 93, 97, 140 to 147, 200 paras. 1 and 2 of the German General Fiscal Code);
- the access to the data pursuant to section 147 para. 6 of the German General Fiscal Code is guaranteed for the German tax authorities.

In case of non-compliance with the above requirements, violation of the obligations to co-operate or, if required, to reverse the relocation, the tax authorities shall determine a so-called default fee (*Verzögerungsgeld*) in the amount of €2,500 to €250,000 (section 146 para. 2b of the German General Fiscal Code-Draft).

At first sight, the provision seems to be a relief for international groups and entities relocating their IT department to other European countries for financial reasons. However, a practical implementation is hardly possible due to the very restrictive requirements, in particular the consent of the foreign authorities to the access. Furthermore, a relocation to non-EEA states, such as the United States or India, should be possible.

Initial application: The day after the pronouncement of the German Annual Tax Act 2009 (Art. 22 para. 1 of the German Annual Tax Act 2009).

10 Amendments resulting from the German Act on the Modernisation of Accounting Law (Bilanzrechtsmodernisierungsgesetz - BilMoG)

In addition to the government draft on the German Annual Tax Act 2009, the government draft on the German Act on the Modernisation of Accounting Law dated 23 May 2008 is also part of the legislative procedure. The exact schedule regarding such Act is yet to be determined. It is planned that it will be adopted in the second half of 2008.

According to the German Act on the Modernisation of Accounting Law, the balance sheet prepared in accordance with the German Commercial Code will remain the basis for the determination of profits (section 5 para. 1 sentence 1 clause 1 of the German Income Tax Act-Draft). The Act on the Modernisation of Accounting Law causes amendments to the German Commercial Code which, in particular, lead to an approximation to the IFRS accounting rules and place more emphasis on the informative function of the annual accounts for the capital markets. The following **amendments to the German Commercial Code** have to be pointed out in particular:

- **Renunciation of options to report certain items:** Obligation to capitalise derivatively acquired goodwill, prohibition to capitalise deferred charges for customs duties, consumption taxes and VAT on prepayments, prohibition to capitalise expenses for the start-up and expansion of the business,
- **renunciation of prohibitions to report certain items:** Obligation to capitalise self-created assets forming part of the fixed assets in relation to production costs during the development stage,
- **renunciation of historical cost principle** when evaluating financial instruments acquired for trading, adoption of a valuation at fair value.

In principle, the amendments to the German Commercial Code affect profit determination unless specific tax-law capitalisation rules or the tax valuation proviso (*steuerlicher Bewertungsvorbehalt*) set out in section 5 para. 6 of the German Income Tax Act have to be taken into account. The latter is basically the case in view of the amendments referred to above (e.g. section 5 para. 5 sentence 2 of the German Income Tax Act in relation to the obligation to capitalise certain consumption taxes paid in advance or section 6 para. 1 sentence 1 no. 2 of the German Income Tax Act concerning the historical cost principle when evaluating current assets). Therefore, the commercial law amendments resulting from the German Act on the Modernisation of Accounting Law do not affect the tax balance sheet. However, overall they lead to a larger divergence between the tax balance sheet and the commercial balance sheet.

A substantial amendment resulting from the German Act on the Modernisation of Accounting Law concerns the **removal of the reverse authority** (deletion of section 5 para. 1 sentence 2 of the German Income Tax Act), due to the fact that more emphasis is placed on the informative function of the annual accounts. In this context, the exception clauses under commercial law will also be deleted (sections 247 para. 3, 254, 273, 279 para. 2, 280 para. 1, 281, 285 sentence 1 no. 5 of the German Commercial Code). It is clarified in section 5 para. 1 sentence 1 clause 2 of the German Income Tax Act–Draft that the exercise of tax options deviating from the accounting rules stipulated by commercial law no longer have to be reproduced in the annual accounts prepared in accordance with commercial law. In case of a deviation from the commercial law valuation, these assets are to be included in a separate register in order to be able to prove the date of acquisition or production, the costs of acquisition or production, the corresponding tax provision as well as the depreciations effected (section 6 para. 1 sentences 2, 3 of the German Income Tax Act–Draft). The renunciation of the reverse authority results in a larger divergence between commercial law accounting and tax law accounting.

Initial application: As of tax assessment period 2009 (section 52 para. 12e of the German Income Tax Act-Draft).

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