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Tax News.

German Annual Tax Act 2009

1 Introduction

On 28 November 2008 the German Parliament (*Bundestag*) adopted the German Annual Tax Act 2009 ("**ATA 2009**") in the second and third readings, and in doing so followed the recommendations of its Tax Committee on the amendment of the government proposal. The consent of the Federal Council *(Bundesrat)* is expected at its sitting on 19 December 2008. Compared to the government's draft ATA 2009 discussed in our June 2008 Newsletter, this Act contains substantial changes in the area of taxation of companies and capital investments, which we shall explain in the following.

We first point out that certain important amendments that were discussed in the preliminaries have **not** been adopted in the ATA 2009. In this regard we especially point out the following:

– No introduction of full corporate tax liability for dividends and profits from the divestiture of so-called **portfolio participations** (Section 8b of the German Corporation Tax Act (*Körperschaftsteuergesetz - KStG*)).

– No general new provision and/or targeted amendment of the so-called **interest barrier** (*Zinsschranke*) and no cancellation of the proposed curtailing of the investment book value in the framework of the so-called Escape Clause.

– No protection from final withholding tax (*Abgeltungssteuer*) for fund savings plans that were concluded before 2009.

Contents

2 Amendments to the German Income Tax Act (*Einkommensteuergesetz*)

2.1 Taxation of life insurance policies and/or life insurance shells (*Lebensversicherungsmäntel*), section 20 para. 1 no. 6 of the German Income Tax Act – Draft (*Einkommensteuergesetzes-entwurf - EStG-E*)

Investment income that accrues within an insurance policy as defined by section 20 para. 1 no. 6 of the German Income Tax Act is only subject to tax upon insurance payout in case of survival or upon buy-back (cancellation). Revenues flowing to the insurance company in the form of interest, dividends or capital gains from the divestiture of asset items remain, unlike direct investments, untaxed during the term. Furthermore, at maturity revenues are only taxed at half the individual tax rate if the insurance payment is paid after a term of 12 years and the insured party has turned 60. This privilege is to be maintained generally, however, only for traditional term life insurance policies or pension plans.

Two types of agreements will, however, be subject to a significant tightening of tax rules:

– **Life insurance shells** (section 20 para. 1 no. 6 sentence 5 of the German Income Tax Act – Draft): Asset-managing life insurance policies (*vermögensverwaltende Versicherungsverträge*) are excepted from the taxation rules for insurance contracts and are subject to transparent taxation. An asset-managing insurance policy as defined by the new provision is an individual capital investment that is not limited to the acquisition of publicly marketed investment funds or index-linked assets, and in which the asset items are directly or indirectly at the disposal of, and the reinvestment of the revenues made by, the beneficiary. In future, revenues accruing to the insurance company shall be directly attributed to the beneficiary. He shall then be subject to taxation according to the rules applicable for the respective asset item.

– **Minimum tax standards for insurance benefits** (section 20 para. 1 no. 6 sentence 6 of the German Income Tax Act – Draft): New minimum standards for insurance benefits are introduced by the provisions under the new sentence 6; if these conditions are not fulfilled, such contracts will not be eligible for half-rate taxation of the revenues.

  – Term life insurance policies featuring ongoing premium payment must provide, until payout in case of survival, a minimum death benefit of at least 50% of the premiums to be paid in over the term.

– For term life insurance policies featuring one-time premium payment or shortened payment terms, as well as payments under fund-linked life insurances, the conditions for minimum death benefits will be linked to the respective coverage capital or the contract's present value. A death benefit is generally considered sufficient if it exceeds the coverage capital or the present value by 10%.

Initial application: Transparent taxation of asset-managing insurance contracts will be applicable to all investment revenue received by the insurance company after 31 December 2008. The requirements for appreciable risk and minimum death benefits will be applicable to insurance contracts that are concluded after 31 March 2009 or the premium payment of which is due after 31 March 2009 (section 52 para. 36 sentences 10 and 11 of the German Income Tax Act – Draft).

2.2 Simplification of taxation of certain equity measures, section 20 para. 4a of the German Income Tax Act – Draft

The government proposal already provided for a section 20 para. 4a of the German Income Tax Act – Draft envisaging a determination of profits in deviation from section 20 para. 4 of the German Income Tax Act, for certain capital measures. The final withholding tax, and the associated withholding of tax for a person obliged to withhold shall be more practicably designed in certain cases in which the revenues are not received in the form of monetary payments. For certain capital measures, no profit realisation (*Gewinnrealisierung*) takes place in future, but instead the present acquisition costs will be continued. The provision covers share exchanges, the conversion of capital claims into shares as well as subscription rights (see our Newsletter dated June 2008 for details).

The following amendments have been made to the government's proposal, with regard to the specific capital measures:

– **Share exchanges**

With regard to share exchanges, the previous restriction of the scope of application to the exchange of shares in companies outside the EU/EEA, is dropped. In non EU/EEA cases German credit institutions are also generally unable to recognize in short time whether the transaction is subject to taxation in the foreign country. The new provision is subject to the restriction that the share exchange must be transacted under corporate law measures (e.g. mergers or divisions). The new provision continues to stipulate that the shares received shall be considered in place of the shares parted with for tax purposes. Thus the new shares also are considered as exempt from tax jurisdiction (i.e. continuation of grandfathering), to the extent that the divestiture of the old shares would already have been exempt due to a holding period of more than one year at the time of the exchange (section 20 para. 4a sentence 1 of the German Income Tax Act – Draft).

According to section 20 para. 4a sentence 2 of the German Income Tax Act – Draft, however, compensation that is paid in the framework of a share exchange, in addition to the shares received, shall be considered as revenue subject to withholding tax.

– **Conversion of capital claims into securities**

With regard to the conversion of capital claims, the scope of application of the new provision is generally extended to include the conversion of capital claims into securities. The government's proposal, on the other hand, had originally been limited to a conversion into shares.

In order to reliably determine the tax reference date, to the extent that the date is relevant, the simplification rule for all capital measures is to use the booking date onto the taxpayer's securities account as a basis (section 20 para. 4a sentence 6 of the German Income Tax Act – Draft).

Unlike the government proposal, the new provision provides, regardless of whether there is a relevant capital measure, that in cases of attribution of shares as defined by section 20 para. 2 sentence 1 no. 1 of the German Income Tax Act without specific compensation payment, the revenue and the asset costs of these shares are to be assessed at € 0, if it is not possible to determine the amount of the revenue (section 20 para. 4a sentence 5 of the German Income Tax Act – Draft). The new provision shall particularly apply to foreign transactions for which the credit institutions are unable to calculate the applicable amount upon attribution of the shares. On the other hand, domestic transactions shall not fall within the scope of the new provision, since it is assumed in such cases that the amount can be determined from corresponding information from the issuer. This provision shall not apply if shares are attributed against compensation by the taxpayer or in the framework of the conversion of a capital claim.

2.3 Procedural provisions in the framework of section 34a of the German Income Tax Act

The amendment to section 34a of the German Income Tax Act contains various procedural additions to this provision with an income tax privilege for retained profits, implemented by the German Corporate Tax Reform Act of 2008 (*Unternehmenssteuerreformgesetz 2008*).

Section 34a of the German Income Tax Act provides for the possibility to have retained profits taxed at a special income tax rate of 28.25%. The taxpayer may withdraw a filed application, wholly or in part, anytime before the income tax assessment for the following assessment period

(*Veranlagungszeitraum*) becomes final and non-appealable. Under the new provision, an already issued income tax assessment must be correspondingly amended if an application is withdrawn (section 34a para. 1 sentence 4 second half-sentence of the German Income Tax Act – Draft). In this regard, the assessment deadline (*Festsetzungsfrist*) shall not expire before the expiry of the assessment deadline for the following assessment period (section 43a para. 1 sentence 5 of German Income Tax Act – Draft).

In case of a uniform and separate determination of profits (*einheitliche und gesonderte Gewinnfeststellung*) as per section 180 para. 1 no. 2 a or b of the German Tax Code (*Abgabenordnung - AO*) (particularly for co-entrepreneurships (*Mitunternehmer*) the relevant data for taxation under section 34a of the German Tax Code may also be determined in this procedure. The assessment deadline shall not end before the expiry of the assessment deadline under section 180 para. 1 no. 2 of the German Tax Code. The Tax Office competent under section 180 para. 1 no. 2 of the German Tax Code is also competent for this assessment (section 34a para. 10 of the German Income Tax Act – Draft).

According to section 34a para. 3 of the German Income Tax Act, the tax-privileged retained profits may be subject to a later recapture taxation. To the extent that the taxpayer files or withdraws an application for the retained profits tax privilege under section 34a para. 1 of the German Income Tax Act, a corresponding notice on the separate determination of the recapture amount is to be issued, revoked, or amended, to the extent that the filing or withdrawal of the application by the taxpayer changes the basis of taxation with regard to the recapture amount (section 34a para. 11 sentence 1 of the German Income Tax Act – Draft). An assessment deadline will not end before the expiry of the assessment deadline for the period at the end of which the recapture amount of the company or co-entrepreneurship share is to be determined separately (section 34a para. 11 sentence 3 of the German Income Tax Act – Draft).

2.4 Final withholding tax in certain restructuring cases, section 43 of the German Income Tax Act – Draft

The new provision adjusts the withholding tax in accordance with the substantive provisions of the German Corporate Restructuring Tax Act (*Umwandlungssteuergesetz - UmwStG*) for certain types of restructurings.

In cases of mergers and divisions, notwithstanding section 13 of the German Corporate Restructuring Tax Act, the shares in the company taking over are considered in place of the shares of the company taken over, for purposes of the investment withholding tax (section 43 para. 1a sentence 1 of the German Income Tax Act – Draft). This enables the shares received in the framework of a divestiture to remain exempt even from withholding tax, to the extent that the old shares were not subject to tax at the time of the restructuring, based on the shares' holding period. Thus, in the framework of a tax-free divestiture of new shares, it is no longer necessary to wait for reimbursement of the withholding tax via assessment proceedings.

2.5 Capital gains under limited tax liability, section 49 para. 1 no. 5d of the German Income Tax Act

In the framework of the 2008 German Corporate Tax Reform Act, the types of domestic investment income subject to limited tax liability under section 49 para. 1 no. 5d of the German Income Tax Act were extended beyond OTC transactions to generally include all divestiture transactions subject to withholding tax. The proposed change would again cut back the limited tax liability in cases of divestiture transactions subject to withholding tax.

Thus, investment income from the divestiture of securities will in future only be subject to limited tax liability if paid out or credited against handing over of the security, and such securities are neither held nor administered by the credit institution (such in 49 para. 1 no. 5d bb of the German Income Tax Act – Draft).

2.6 Deemed qualification of special remuneration (Sondervergütung) in cases of Double Taxation Treaties, section 50 d para. 10 of the German Income Tax Act – Draft

A new paragraph 10 shall be added to section 50d of the German Income Tax Act; according to this paragraph, **special remuneration** (section 15 para. 1 sentence 1 nos. 2 sentence 1, half-sentence 2, and 3 half-sentence 2 of the German Income Tax Act) shall be deemed exclusively as **business profits for the purposes of the application of Double Taxation Treaties (DTTs)**, if the applicable DTT does not contain a specific provision for such remuneration. Section 50d para. 10 of the German Income Tax Act – Draft shall apply to **all open income and corporate tax assessments** (section 52 para. 59a sentence 8 of the German Income Tax Act – Draft) and shall be applied accordingly for the determination of trade revenue (section 7 sentence 6, section 36 para. 5 of the German Trade Tax Act – Draft).

The new provision intends to prevent a **loss of tax base** and the **circumvention of the interest barrier**. The provision is in response to case law of the Federal Finance Court (*Bundesfinanzhof - BFH*) on the application of DTT provisions to special remuneration.

Under German tax law, special remuneration by a partnership to its partners (for example loan interest) is treated as business profit for the partners and is, as trade income, subject to trade tax at the level of the partnership. A similar qualification of special remuneration as trade income can only be found in a few other countries (e.g. in Austria and Switzerland). If the other country, on the contrary, treats the special remuneration according to civil law for the purposes of the application of a DTT, a **qualification conflict** may occur if Germany applies its domestic approach.

In cases of **foreign partnerships** that pay interest to a domestic partner, double non-taxation may occur, if the other country applies to the interest payments, according the civil law approach, the DTT's interest clause, which generally attributes the right of taxation to the partner's state of residence, and Germany as the state of residence attributes the interest, according to its qualification approach, to business profits, for which the German DTTs generally provide tax exemption. In order to prevent such a double exemption in these cases, among others, the legislator implemented section 50d para. 9 sentence 1 no. 1 of the German Income Tax Act in the 2007 ATA (w*ith retroactive application*) providing that the tax exemption under the DTT is refused via a *treaty override*. This provision is not affected by the new proposal (section 50d para. 10 sentence 2 of the German Income Tax – Draft).

In the opposite case, namely of a **domestic partnership** that pays interest to a partner in a DTT-country, double taxation may occur if Germany, according to its approach, considers the interest as business profits, for which Germany has the right to tax, and the partner's state of residence, following the civil law evaluation, also claims its right to tax the interest payments under the interest clause of the DTT. However, according to consistent case law of the Federal Finance Court on the treatment of special remuneration under DTTs, loan interest payments also in these constellations are considered – subject to deviating DTT provisions (for example in the DTT with Austria and the DTT with Switzerland) – to be interest in terms of the DTT (and thus not subject to tax in Germany), even if the German domestic law considers them as trade income (decision dated 17 October 2007 – IR5/06, DStR 2008, 659 with further references). As result thereof, the legislator fears a stripping of profits via interest payments that goes beyond **the effects on the interest barrier** and will lead to a **loss of German tax base**, as well as an application of the judgement to royalties and other special remuneration as well.

According to the legislator's reasoning behind the Act, section 50d para. 10 of the German Income Tax – Draft is not a *treaty override*, but rather a mandatory domestic interpretation – contrary to that of the Federal Finance Courts – of the DTT concept of "business profits" that the DTTs themselves do not define. According to the legislator, the risk of double taxation has to be prevented by application of the credit method in the partner's state of residence.

The **retroactive application** of section 50d para. 10 of the German Income Tax – Draft to all still open tax assessments is justified by the legislator as ensuring equal legal and factual tax treatment for all, required by the constitution. Nonetheless, doubts remain as to the legality of this retroactive effect.

3 Changes in the German Corporation Tax Act (*Körperschaftsteuergesetz*)

3.1 Abrogation of the prohibition of fiscal unity (*Organschaft*) with regard to insurance companies

According to previous legislation, it was not possible for life and health insurers to be a dependent entity within a unity for tax purposes called a fiscal unity (*Organschaft*). The prohibition of fiscal unity applying to life and health insurance companies, introduced in 2002, will now be abrogated without replacement as a result of the deletion of former section 14 para. 2 of the German Corporation Tax Act. Basically, section 14 para. 2 of the German Corporation Tax Act will be applicable for the last time if the fiscal year of a dependent entity ends prior to 1 January 2009 (section 34 para. 9 sentence 1 no. 6 of the German Income Tax Act – Draft).

3.2 No "gross method" with regard to credit institutions, finance companies, financial services companies as well as life and health insurers

The amendment of section 15 sentence 1 no. 2 of the German Corporation Tax Act through the newly introduced 3rd sentence is a clarifying modification. Basically, the so-called gross method (*Bruttomethode*) is applicable in the event of a fiscal unity, i.e., section 8b of the German Corporation Tax Act does not apply at the level of a dependent entity, having the consequence that income from shares in corporations benefiting from section 8b of the German Corporation Tax Act will be allocated to the dominant entity within the scope of income allocation. At the level of the dominant entity, section 8b of the German Corporation Tax Act or – if the dominant entity is an individual – the half-income taxation (*Halbeinkünfteverfahren*) / partial income taxation method (*Teileinkünfteverfahren*) will basically be applicable in respect of the allocated income from participating interests. The new section 15 sentence 1 no. 2 sentence 3 of the German Income Tax Act – Draft makes it now clear that section 8b of the German Corporation Tax Act will not be applicable at the level of the dominant entity, if (i) the dependent entity is a credit institution, a financial services institution or a finance company and the interests are allocable to the trading book or have been acquired with the aim of generating a short-term gain from proprietary trading or if (ii) the dependent entity is a life/health insurer and the participating interests are allocable to capital investments.

3.3 Revision of the so-called "tax unity across entities" (*Querverbund*)

With the ATA 2009, the German legislator prescribes that losses of business enterprises or corporations organised under public law will not be treated as a hidden profit distribution if they result from so-called continuous loss transactions (*Dauerverlustgeschäft*) (section 8 para. 7 of the German Income Tax Act – Draft). A continuous loss transaction means an economic activity undertaken due to reasons set out by law (e.g. social, cultural or education policy reasons). Corresponding losses may be carried forward. They may not be set off against profits of other public law business, even if they are combined.

4 Changes in the German Trade Tax Act (*Gewerbesteuer-gesetz*)

4.1 Prevention of structures with regard to the use of loss and interest carried forward

– **Losses carried forward for trade tax purposes**

A new restriction for setting off losses (section 8c of the German Corporate Income Tax Act) has been introduced in the context of the company tax reform 2008. Section 8c of the German Corporate Income Tax Act also applies to trade tax losses due to a reference in section 10a sentence 9 of the German Trade Tax Act. According to section 8c of the German Corporate Income Tax Act, losses carried forward or current losses/deficits at the level of an entity will perish for corporate income tax and trade tax purposes in the event of a detrimental change of shareholder as defined in section 8c of the German Corporate Income Tax Act (as of 25% proportionally; as of 50% completely).

Under previous legislation, it was possible to avoid at least the loss of the losses carried forward for trade tax purposes by transferring the "loss-making business" to a partnership prior to transferring the shares in the corporate entity. By way of the transfer, a loss carry forward for trade tax purposes was passed on to the partnership together with the business. Under previous legislation, a subsequent detrimental change of shareholder at the level of the corporate entity did not affect the loss carry forward for trade tax purposes at the level of the partnership.

By adding a clause to section 10a sentence 10 of the German Trade Tax Act – Draft (previously: section 10a sentence 9 of the German Trade Tax Act), the legislator intends to prevent such structures in the future. Due to the new clause, the provisions of section 8c of the German Corporate Income Tax Act are supposed to be accordingly applicable to a loss carry forward for trade tax purposes of a co-entrepreneurship (*Mitunternehmerschaft*) to the extent it is (i) directly allocable to a corporate entity or (ii) allocable to a co-entrepreneurship insofar as a corporate entity holds a direct or indirect share in the co-entrepreneurship via one or more partnerships. As a consequence, a detrimental change of shareholder at the level of a corporate entity will in future lead to a non-deductibility of a loss carry forward for trade tax purposes at the level of the partnership to the extent the corporate entity holds a direct or indirect share in the partnership via (commercial) partnerships.

Initial application: shares transferred after 28 November 2008.

– **Interest carried forward**

With this amendment, the legislator wants to prevent that an interest carry forward according to section 4h para. 1 sentence 2 of the German Income Tax Act remains intact at the level of a partnership if a corporate entity holds a share, as co-entrepreneur, in such partnership and a detrimental change of shareholder occurs at the level of the corporate entity. A commercial partnership represents an operation (*Betrieb*) for the purposes of the interest barrier rule and thus also for the allocation of an interest carry forward. According to a new section 4h para. 5 sentence 3 of the German Income Tax Act – Draft, section 8c of the German Corporate Income Tax Act will be applicable accordingly to the interest carry forward of a partnership to the extent a corporate entity holds a direct or indirect share, as co-entrepreneur, in such partnership. As a consequence, an interest carry forward at the level of the partnership will be lost in the event of a detrimental change of shareholder at the level of the corporate entity to the extent the corporate entity holds a direct or indirect share in the partnership.

Initial application: shares transferred after 28 November 2008.

4.2 Extension of the banking privilege to leasing and factoring companies, section 19 of the German Trade Tax Implementation Regulation – Draft (*GewStDV-E*)

Section 19 of the German Trade Tax Implementation Regulation – Draft contains special provisions for credit institutions, pawnbrokers and securitisation companies and limits the debts to be taken into account in the calculation of the additions for trade tax purposes. This regulation excludes the refinancing of typical banking transactions from the addition for trade tax purposes (so-called “banking privilege”).

It is intended to introduce those sector-specific exceptional rules also with regard to leasing and factoring companies (section 19 para. 3 no. 4 of the German Trade Tax Implementation Regulation – Draft) to the extent those companies will in future also be subject to the financial supervision under the German Banking Act. For those purposes, factoring and finance leasing will also be considered as financial services pursuant to section 1 para. 1a sentence 2 of the German Banking Act – Draft. The so-called “banking privilege” will also apply to leasing companies if they exclusively and demonstrably undertake finance leasing transactions. Operating leasing will not be privileged.

Leasing and factoring companies providing financial services as defined in section 1 para. 1a sentence 2 of the German Banking Act will therefore be subject to a limited credit supervision by the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin*). With regard to special purpose leasing companies prevented from making their own business decisions, it is made sure in section 2 para. 6 no. 17 of the German Banking Act – Draft that the parent companies behind the special purpose vehicles are subject to regulatory supervision. The second-tier special purpose vehicles will also fall within the scope of application of section 19 of the German Trade Tax Implementation Regulation – Draft.

Initial application: the inclusion of financial services companies under the so-called “banking privilege” pursuant to section 19 of the German Trade Tax Implementation Regulation – Draft will be applicable for the first time with regard to the imposition period 2008. Leasing and factoring companies will be subject to limited credit supervision if they notify their business to the German Financial Supervisory Authority by 31 January 2009 or 31 December 2009 at the latest.

5 Changes in the German Restructuring Tax Act (*Umwandlungssteuergesetz*)

5.1 Restrictions of the fictitious retroactivity for the purposes of corporate restructuring taxation provided for in section 2 of the German Restructuring Tax Act

The legislator has added a fourth paragraph to section 2 of the German Restructuring Tax Act in order to avoid structures to circumvent the restrictions applying to losses and interest carried forward by way of corporate reorganisations having retroactive effect.

Such a structure could consist in a corporate reorganisation carried out after a detrimental change of shareholder within the meaning of section 8c of the German Corporate Income Tax Act, which has retroactive effect as of a date prior to the detrimental change of shareholder in accordance with section 1 para. 1 of the German Restructuring Tax Act and leads to a gain resulting from the transfer due to a realisation of hidden reserves. This transfer gain could be balanced with, or set off against, losses carried forward or an interest carried forward pursuant to section 4h para. 1 sentence 2 of the German Income Tax Act.

According to the new provision in section 2 para. 4 sentence 1 of the German Restructuring Tax Act Draft, it is intended that it would only be possible to benefit from a loss as mentioned above if this were also possible without the reorganisation having retroactive effect.

It will also not be possible to offset negative income generated during the period of retroactive effect against gains if this is not possible without the reorganisation (section 2 para. 4 sentence 2 of the German Restructuring Tax Act Draft).

Initial application: reorganisations that are entered into the commercial register after 28 November 2008.

5.2 Adjustment of section 4 paras. 6 and 7 of the German Restructuring Tax Act to the partial income taxation method

Section 4 para. 6 of the German Restructuring Tax Act Draft regulates the treatment of a loss resulting from an acquisition suffered by the acquiring entity within the scope of a merger of a corporate entity into a partnership or a natural person, or a change of legal form from a corporate entity into a partnership. Previously, the provision had not been adjusted to the partial income taxation method applying as of 2009. Henceforth, according to section 4 para. 6 sentence 4 of the German Income Tax Act – Draft, a loss resulting from an acquisition will be deductible in an amount of 60%, but limited to a maximum of 60% of the income as defined in section 7 of the German Restructuring Tax Act (taxation of disclosed reserves), provided that it is subject to taxation at the level of a natural person within the scope of the transformations mentioned above.

If the shares in the transferring entity are shares that would be allocable to the trading book in the event of credit and financial services institutions, or shares acquired by finance companies with the aim of generating a short-term gain from proprietary trading, it will be possible to deduct a loss from acquisition in the full amount of the income defined in section 7 of the German Restructuring Tax Act (section 4 para. 6 sentence 5 of the German Income Tax Act – Draft). Corresponding to this new regulation, the gain resulting from an acquisition will also be fully subject to taxation in those cases (section 4 para. 7 sentence 2 of the German Income Tax Act – Draft).

5.3 Changes in section 22 para. 2 sentence 1 of the German Restructuring Tax Act

The government proposal concerning the ATA 2009 already contained a change in section 22 para. 2 sentence 1 of the German Restructuring Tax Act – Draft. According thereto, there will be no retroactive taxation of a contribution if shares are contributed within the scope of a contribution in kind or an exchange of shares (in the event of a sale of the shares contributed within a period of seven years after the contribution by the acquiring entity), provided that a gain resulting from the sale of the shares would have been tax-exempt at the level of the contributor at the time of the contribution according to section 8b para. 2 of the German Corporate Income Tax Act.

Additionally, section 22 para. 2 sentence 1 of the German Restructuring Tax Act – Draft now provides that a contribution will also be subject to retroactive taxation if the shares are only sold indirectly, for example if a contributed co-entrepreneurship share (*Mitunternehmeranteil*), which also comprises shares in corporations, is sold by the acquiring entity.

6 Amendments to the German VAT Act (*Umsatz-steuergesetz*)

German VAT is experiencing substantial amendments in the area of the place of supply of services (see 6.1) and the input VAT refund procedure (see 6.2), which however do not come into effect until 2010.

In addition, with effect as of 2009, the **VAT exemption for out-patient and in-patient medical care** as well as for care and nursing services provided to persons in need set forth in section 4 no. 14 and 16 of the German VAT Act is comprehensively revised because in some areas the exemption fell short of the requirements of European Community Law and, in other areas, went beyond this.

Different as was contemplated in the government proposal, **no limitation of the input VAT deduction for vehicles which are used for both entre-preneurial and non-entrepreneurial purposes** shall be implemented; not only in the *Bundesrat* were systematic concerns (violation of the principle of proportionality) voiced against this intention and the simplification effects and alleviation of work which were expected with this were assessed to be very doubtful.

6.1 Place of Supply of Services

According to the requirements of European Community Law, the place of supply of services, in particular in the business-to-business area (B2B), shall be revised by 2010. This also includes additional obligations of notification and declaration. Thus, significant amendments will be incorporated into sections 3a, 3b, 3e, 18a, 18b of the German VAT Act.

According to section 3a para. 2 of the German VAT Act – Draft, in future in the **B2B area**, principally the **place of establishment of the recipient of the services** – for services provided to a permanent establishment, the location of the permanent establishment – will apply as the place of supply of services. For the determination of the place of supply of services, non-taxable legal persons identified with a VAT Id No. are assimilated to taxable persons as recipients of services. Section 3a para. 2 of the German VAT Act – Draft is applicable as a fallback provision if the subsequent paragraphs of section 3a as well as sections 3b, 3e, 3f of the German VAT Act – Draft do not contain any overriding determination of the place of supply of services. In particular, the following services lead to a **place of supply of services deviating from the general rule**:

– Immovable property transactions (section 3a para. 3 no. 1 of the German VAT Act – Draft): For services connected with immovable property, the situs-of-property principle applies as before (section 3a para. 2 no. 1 of the German VAT Act) and in the same scope.

– Short-term leasing of means of transport (section 3a para. 3 no. 2 of the German VAT Act – Draft): For this new service category, the service is supplied at the place where this means of transport is actually put at the disposal of the recipient (this rule also applies in the business to consumer (B2C) area). Presently, the leasing of transport means takes place where the service provider is established (section 3a para. 1 of the German VAT Act).

– Cultural, artistic, etc. services, fairs/exhibitions, services of organisers and connected services (section 3a para. 3 no. 3 letter a of the German VAT Act – Draft): As has been the case up to now (section 3a para. 2 no. 3 letter a German VAT Act), the place of activity is decisive for these services.

– Restaurant and catering services (provision of food and drinks for consumption on the premises), if the services are not provided on board ships, aircrafts or trains during an intra-Community transportation (section 3a para. 3 no. 3 letter b of the German VAT Act – Draft): For this also new service category, the place of supply is the place where the services are physically carried out (this rule also applies to the B2C area). Up to now, for these services, the place of supply is where the service provider is established (section 3a para. 1 of the German VAT Act).

- Restaurant and catering services on board ships, aircrafts or trains during an intra-Community transportation (section 3e of the German VAT Act – Draft): For these services, the point of departure of the means of transport in the territory of the Community is the place of supply of services (as was already the case for the supply of goods).
- Passenger transport (section 3b para. 1 sentence 1 of the German VAT Act – Draft): For passenger transport, the place of supply of services continues to be determined by the actual performance of the transport (taxation proportionate to the distance covered).
- Special cases relating to third countries(section 3a para. 6 and 7 of the German VAT Act – Draft): For so-called intangible services and the leasing of transport means, the place of supply is shifted from abroad to Germany (or vice versa) according to the effective enjoyment or use; this provision was taken over from section 1 of the German VAT Implementation Regulation (*Umsatzsteuer-Durchführungsverordnung*), which therefore is cancelled.

The possibility of shifting the place of supply of services by using a deviating VAT Id No. for certain services (for work on tangible property and its valuation, for intermediary services, for intra-Community transport of goods and independent ancillary activities as well as intermediary services relating thereto) ceases to apply in the B2B area.

With the principal application of the place of the recipient in the B2B area, a delimitation using the list of the so-called intangible services within the Community is no longer necessary.

The determination of the place of supply of services in the B2B area according to section 3a para. 2 of the German VAT Act – Draft leads to a shifting of the tax liability, i.e. **Reverse Charge,** if the recipient of the services is established in another Member State of the Community. If the recipient of the services is established in Germany, he is liable to pay the VAT accrued (section 13b para. 1 sentence 1 no. 1, para. 2 sentence 1 of the German VAT Act); in this case, according to section 14a para. 1 of the German VAT Act – Draft, the taxable person providing the services is obliged to issue an invoice on which the VAT Id numbers of both the service provider and the recipient of the services have to be indicated.

In order to verify the correct and complete declaration of the *reverse charge* services by the recipient of the services, the Community-wide system of the **recapitulative statement**, which was implemented in 1993 by the single market rules for intra-Community movement of goods, is expanded in general to services for which the recipient of the services in another Member State is liable for VAT. According to section 18a of the German VAT Act – Draft, for the r*everse charge* services supplied to other Member States, the VAT Id No. of every recipient and the taxable amount of the services supplied have to be entered on the recapitulative statement. According to section 18b of the German VAT Act – Draft, these *reverse charge* services have to be declared separately (as already today the intra-Community supply of goods).

In the **B2C area**, the general rule of the place of supply of services being the place where the supplier is established and the overriding rules for specific services remain as before. The special provisions for short-term leasing of means of transport (section 3a para. 3 no. 2 of the German VAT Act – Draft) and for restaurant/catering services (section 3a para. 3 no. 3 letter b, section 3e of the German VAT Act – Draft) have been added; these determinations of the place of supply of services apply to both non-entrepreneurial and entrepreneurial recipients (see above). However, in the B2C area, the list of so-called intangible services continues to be of importance for non-entrepreneurial recipients in third countries (section 3a para. 4 of the German VAT Act – Draft).

The amendments concerning the place of supply of services shall take effect on 1 January 2010.

6.2 Input VAT Refund Procedure

According to the requirements of European Community Law, the input VAT refund procedure for **taxable persons established in the Community** shall be revised by 2010. The following points shall be emphasised concerning the new input VAT refund procedure which applies Community-wide:

In future, the refund application is no longer to be submitted on paper (according to the officially prescribed pre-printed form) but in electronic form (according to the officially prescribed data record by way of data transmission). The refund assessment notice is also transmitted in electronic form.

The refund application is no longer to be submitted in the Member State of refund, but in the Member State of residence of the taxable person. For taxable persons resident in Germany, the Federal Central Tax Office (*Bundeszentralamt für Steuern – BZSt*)) is the responsible agency (section 18g of the German VAT Act – Draft), which forwards the application to the authority in the Member State of refund after verification that the application is complete and admissible (in particular, the status of the applicant as taxable person).

Applications of taxable persons resident in another Member State of the Community are forwarded to the German Federal Central Tax Office by the competent authority in the respective state (section 61 para. 1 of the German VAT Implementation Regulation – Draft). The application has to be submitted by 30 September (up to now 30 June) of the following calendar year (section 61 para. 2 of the German VAT Implementation Regulation – Draft). Electronic copies of invoices and import documents have to be enclosed with the application where the single taxable amount is € 1,000 (for fuels € 250) or more; in cases of doubt, the German Federal Central Tax Office may request the submission of the originals.

The refund amount is limited (other than according to the rules of the German VAT Act) to the *pro-rata* rate applicable in the Member State of residence for applicants not entitled to full input VAT deduction (section 18 para. 9 sentence 3 of the German VAT Act – Draft). The provision on interest on the refund amount is new (section 61 para. 5 and 6 of the German VAT Implementation Regulation – Draft). At the earliest, the interest period begins to run 4 months and 10 business days after receipt of the application by the German Federal Central Tax Office, respectively later in the event of late submission of copies of the invoices. In the event of queries by the German Federal Central Tax Office, the processing time is prolonged up to 8 months and 10 business days. The interest period ends with the payment. The interest rate is 0.5% per month pursuant to section 238 of the German Tax Code which is also applicable for the calculation. Interest is not paid if the applicant does not comply with his duty to cooperate within one month.

The **input VAT refund procedure for taxable persons established inthird countries** mainly remains unchanged (section 61a of the German VAT Implementation Regulation – Draft). However, the application can also be submitted in electronic form.

The new rules for the refund procedure shall be applied to refund applications which are submitted after 31 December 2009.

7 Amendments to the German Foreign Tax Act (*Außensteuergesetz*)

The regulations on the so-called extended limited tax liability according to section 2 of the German Foreign Tax Act will be supplemented. A natural person, after moving out of Germany under the conditions contained in section 2 para. 1 sentence 1 of the German Foreign Tax Act, is subject to taxation for ten years for such income in Germany which, in the event of an unlimited tax liability in Germany, is not foreign income within the meaning of section 34d of the German Income Tax Act (so-called extended domestic source income).

According to section 34d no. 2 letter a of the German Income Tax Act, trade or business income is foreign income in this sense if it is earned by a permanent establishment located in a foreign country or by a permanent representative working in the foreign country. Up to now, the tax authorities proceeded on the assumption that also trade or business income which is unable to be attributed to either a German or a foreign permanent establishment belongs to the extended domestic source income (note 2.5.0.1 of the special decree issued by the tax authorities on the German Foreign Tax Act). The Federal Finance Court opposed this with its decision of 19 December 2007 (I R 19/06) and decided that, in principle, there is no "floating income". In the opinion of the Federal Finance Court, to the extent that trade or business income of a natural person cannot be attributed to a permanent establishment located in Germany, in case of doubt, this income shall be attributed to a place of management of the natural person in the state of residence which, as the case may be, can be located in the apartment of the natural person. Therefore, such income would not be subject to the extended limited tax liability in Germany.

The legislator has reacted to this case law by incorporating a fiction into section 2 para. 1 sentence 2 of the German Foreign Tax Act – Draft. According to this, income of a natural person shall be attributable to a notional place of management in Germany, if this income is not earned by a foreign permanent establishment or a permanent representative working in the foreign country. This has the consequence that such income is not foreign income within the meaning of section 34d of the German Income Tax Act and therefore is subject to the extended limited tax liability. In our view, the regulation should still not lead to the extended limited tax liability of trade or business income in Germany if this income shall be functionally attributed to a permanent establishment located in a foreign country. In our view, such a permanent establishment can – as in the Federal Finance Court case – also be a place of management located in the apartment of the natural person. After the new regulation has come into effect, one will however not – the same as the Federal Finance Court – be able to assume that "in case of doubt" a place of management exists in the foreign country; but instead in this concrete case one will have to make this determination according to the standards set forth in the general rules.

As documented in the legislative intent, the fiction set forth in section 2 para. 1 sentence 2 of the German Foreign Tax Act – Draft shall only apply for purposes of section 2 of the German Foreign Tax Act due to the very clear wording.

Initial application: 2009 Assessment period.

8 Amendments to the German Investment Tax Act (*Investmentsteuergesetz*)

The ATA 2009 contains important amendments to provisions on the taxation of units in investment funds. Such amendments refer to the extension of the scope of dividend-equivalent income, the recording of interest on an accruals basis as well as stricter transitional provisions applying to certain tax-optimised money market funds in particular.

8.1 Redefining dividend-equivalent income section 1 para. 3 sentence 3 of the German Investment Tax Act – Draft (InvStG-E)

Dividend-equivalent income is income from an investment fund attributed to the investor, who is subject to taxation, although such income is retained by the investment fund. On the basis of the legal position hitherto in force, dividend-equivalent income does not include, *inter alia*, any income received by the fund from option writer premiums, any income from options, futures and forwards as well as, generally, capital gains from the disposal of securities.

While income from option writer premiums and profits from options, futures and forwards are not included in dividend-equivalent income in this form under applicable law anyway, the provisions stipulated in ATA 2009, in the final analysis, result in an extension of the notion of dividend-equivalent income.

The extension of the notion of dividend-equivalent income contained in the ATA 2009 government proposal has been thoroughly revised in the process of legislation; this is due to, in particular, applications and review requests on the part of the *Bundesrat*.

Accordingly, the following income or profits, respectively, are **not** defined as dividend-equivalent income:

- income from option writer premiums,
- profits from options, futures and forwards,
- profits from the disposal of shareholdings in companies, equity profit participation rights (*EK-Genussrechte*) and comparable participations as well as vested rights to such instruments and
- profits from the disposal of other capital claims, if such capital claims
  - have an issuing yield (section 1 para. 3 sentence 3 no. 1 letter a of the German Investment Tax Act – Draft); in this regard, a recording pursuant to section 3 para. 2 of the German Investment Tax Act is required, and the interest recorded on an accruals basis is deemed to

have accrued; any additional recording of the profits from the disposal of such capital claims is not deemed to be required;

- have a fixed or floating interest rate determined according to the portion of the capital, and repayment of the capital is agreed or effected in the amount in which it had been made available (section 1 para. 3 sentence 3 no. 1 letter b of the German Investment Tax Act – Draft); this includes, in particular, “normal” bonds and non-certificated receivables (*unverbriefte Forderungen*) with a fixed coupon, down-rating bonds, floaters and also reverse floaters; any exchange profit is not a revenue element for these bonds, but rather a capital gain from the disposal of securities, which remains tax-free at investor level if it is retained by the fund;
- are certificates that entail the risk of full loss of the invested capital, whose value depends on the performance of either an individual share or a published index applying to various shares and which reflect this performance at a ratio of 1:1 (section 1 para. 3 sentence 3 no. 1 letter c of the German Investment Tax Act – Draft); such share certificates entailing the risk of full loss of the invested capital may still be disposed of by the fund, without any taxable income being attributable to the investor;
- qualify as reverse convertible bonds, exchangeable bonds or convertible bonds (section 1 para. 3 sentence 3 no. 1 letter d of the German Investment Tax Act – Draft);
- qualify as income bonds or profit participation rights within the meaning of section 43 para. 1 sentence 1 no. 2 of the German Income Tax Act (section 1 para. 3 sentence 3 no. 1 letter e of the German Investment Tax Act – Draft); this includes, in particular, income bonds traded flat, i.e., without a separate recording of the accrued interest as well as debt profit participation rights (*Fremdkapital-Genussrechte*);
- are cum-warrant bonds (section 1 para. 3 sentence 3 no. 1 letter f of the German Investment Tax Act – Draft), i.e., whose acquisition cost is attributable in part to detachable warrants and a separately tradable bond; this is supposed to be a provision for the purpose of simplification.

Inital application: The redefinition of the notion of dividend-equivalent income pursuant to section 1 para. 3 sentence 3 of the German Investment Tax Act – Draft shall be uniformly deemed to be income, which accrues, or is deemed to have accrued, to the investment fund after 31 December 2008.

Certificates entailing the risk of full loss of the invested capital which are not the share certificates at a ratio of 1:1 described above and which are acquired prior to 31 December 2008 are subject to grandfather protection.

Any income from such existing certificates will not be deemed to be dividend-equivalent income even from 2009 (section 18 para. 12 sentence 2 of the German Investment Tax Act – Draft).

8.2 Recording of interest on an accruals basis section 3 para. 2 sentence 1 no. 2 of the German Investment Tax Act – Draft

As a consequence of the revision of the notion of dividend-equivalent income, also the provision on the recording of interest on an accruals basis pursuant to section 3 para. 2 sentence 1 no. 2 of the German Investment Tax Act – Draft will be defined and adjusted accordingly.

According to this provision, any interest or any accrued claims from other capital claims with issuing yields shall be recorded on an accruals basis at the level of the fund; the accrued claims shall be recorded at their issue yield, to the extent easily and clearly determined, or, if this is not the case, at market yield. This income recorded on an accruals basis is to be included as distributed or dividend-equivalent income. As regards cum-warrant bonds within the meaning of section 1 para. 3 sentence 3 no. 1 letter f of the German Investment Tax Act – Draft, for reasons of simplification, only the interest and not the claims accrued shall be recorded on an accruals basis.

These provisions on the recording of interest on an accruals basis will apply to any imputed interest accruing from 31 December 2008. Capital claims which did not have to be recorded at an accruals basis under the law applicable to the present date are deemed to be abolished with effect from 1 January 2009.

8.3 Stricter transitional provisions in respect of withholding tax applying to certain tax-optimised investment funds

The transitional provision pursuant to section 18 para. 2b of the German Investment Tax Act – Draft is a response to tax-optimised money market funds whose investment policy aims at achieving a money market yield and in whose case interest is reflected in the form of capital gains from the disposal of options, futures and forwards or securities, respectively (i.e. without any dividend-equivalent income being generated). As regards products of this type, it might be possible, by way of a packaging together of financial instruments, to achieve a tax-exempt interest-like yield. This is corrected in a twofold manner:

– money market funds whose extraordinary income is higher than their ordinary income (i.e. in particular, those generating capital gains from the disposal of options, futures and forwards or securities, respectively), shall cease to benefit from the so-called grandfathering (in principle, any gains generated from the disposal and redemption of units acquired prior to 1 January 2009 are not falling within the scope of tax outside a 1-year-holding-period). This means that any capital gains from the disposal or redemption of such units will be subject to withholding tax from 1 January 2009, even if these units were acquired prior to 1 January 2009. Exempt from this are, in turn, any units acquired prior to 19 September 2008.

– As regards units in such money market funds acquired prior to 19 September 2008 which will be continued to be held after 10 January 2011, however, these units shall be deemed to be disposed of and acquired on 10 January 2011, for the purposes of the taxation of profits from the disposal of units, and the relevant capital appreciation achieved after 10 January 2011 shall be subject to taxation in the event of a subsequent redemption or disposal of the units.

9 Amendments to the German Tax Code (*Abgabenordnung*)

Accounting in foreign countries (section 146 para. 2a, 2b of the German Tax Code – Draft (AO-E)

Section 146 para. 2a of the German Income Tax Act – Draft as provided for in the government proposal already stipulated the possibility that companies keeping electronic accounts and other electronic records in Germany, which, under applicable legal requirements (section 146 para. 2 sentence 1 of the German Tax Code) must be kept and stored in Germany, may be relocated, subject to meeting certain requirements, to other member states of the EU/EEA (cf. in this regard our newsletter dated June 2008).

According to the redefinition, as provided for in the version of the Act that has been passed, the fiscal authorities may consent to the keeping and storing of electronic accounts and other electronic records in order to avoid hardships in individual cases – even if not all the requirements of section 146 para. 2a of the German Income Tax Act – Draft are met in detail and a taxation is not put at risk by this (section 146 para. 2a sentence 5 of the German Income Tax Act – Draft). Other than in the event of a relocation in accordance with statutory provisions, in the event of a consent granted in an individual case, there is, in particular, the possibility of a relocation to non-member states of the EU/EEA area as well. In addition, the consent to access the electronic accounts and other records by the competent body in the country in which such electronic accounts and other records are stored may be waived.

The duty of the fiscal authorities to impose a delaying fee if the person subject to taxation fails to comply with certain duties within the scope of a relocation of electronic accounts and other records contained in section 146 para. 2b of the German Income Tax Act – Draft as provided for in the government proposal has henceforth been watered down to a "discretionary decision on whether to act or not on the part of the competent authorities (*Erschließungsermessen*)" in the version of the Act passed.

Linklaters

Berlin
Linklaters LLP
Potsdamer Platz 5
10785 Berlin
Postfach 30 18 50
10746 Berlin
Tel: (+49) 30 21496-0
Fax: (+49) 30 21496-100

Düsseldorf
Linklaters LLP
Königsallee 49-51
40212 Düsseldorf
Postfach 10 35 41
40026 Düsseldorf
Tel: (+49) 211 22977-0
Fax: (+49) 211 22977-435

Frankfurt am Main
Linklaters LLP
Mainzer Landstraße 16
60325 Frankfurt am Main
Postfach 17 01 11
60075 Frankfurt am Main
Tel: (+49) 69 71003-0
Fax: (+49) 69 71003-333

München
Linklaters LLP
Prinzregentenplatz 10
81675 München
Postfach 80 15 20
81615 München
Tel: (+49) 89 41808-0
Fax: (+49) 89 41808-100

Editor: **Dr Thomas Elser** Email: **thomas.elser@linklaters.com**
Dr Martin Lausterer Email: **martin.lausterer@linklaters.com**