Overview of Business Tax Reform 2008 and Other Proposed Changes

The German Business Tax Reform 2008 has been adopted by both houses of parliament and was signed by the President without any changes on 14 August 2007. The legislative process was finalized on 17 August 2007 with the official publication of the law.

Some of the changes included in the reform could have far-reaching and negative implications for taxpayers, so taxpayers should immediately begin to examine their tax positions to determine whether action should be taken before year-end. In all cases, affected taxpayers should discuss any steps to be taken with their tax counsel.

The following highlights key changes relevant to foreign investors with German business entities or German source-income and describes typical actions that may be taken to respond to these changes.

Business Tax Reform 2008

Tax Rates

*Effective for calendar year taxpayers: 1 January 2008*
*Effective for deviating fiscal year: FY 2007/2008*

The corporate income tax rate will be reduced from 25% to 15%. Taken together with changes to the trade tax rules, the combined German tax rate (corporate income tax, trade tax and solidarity surcharge) will come down to approximately 29.8% from approximately 38.65%. The most important technical change for trade tax purposes is that trade tax is no longer deductible for corporate income tax purposes. Depending on the effects of the new trade tax add-back items (see below), the effective rate may, however, be higher than 29.8% for a number of taxpayers.

**Potential action step:** Explore income deferral possibilities and
consider valuation impacts on deferred taxes.

**Interest Deduction Limitation**

*Effective for calendar year taxpayers: 1 January 2008*

*Effective for deviating fiscal year: FY 2007/2008 (if FY starts after 25 May 2007)*

A taxpayer will only be able to immediately deduct (net) interest expense up to 30% of annual pre-interest, pre-loss carryforward profits for tax purposes, increased by the tax depreciation incurred (taxable EBITDA). The 30% limitation will apply to all interest, regardless of whether the debt is granted by a shareholder, related party or third party.

Excess interest can be carried forward. Unlike under the existing thin capitalization rules, interest expense disallowed under the interest deduction limitation will not trigger withholding taxes.

The 30% limitation will not apply where the annual (net) interest burden is less than Euro 1 million, where the taxpayer is not part of a group of companies or where, under the “escape clause”, the taxpayer demonstrates that the equity ratio of the German borrower does not deviate by more than 1 percentage point from the worldwide group’s equity ratio.

**Potential action step:** In particular, the EBITDA projections for the year 2008 should be critically reviewed and, if interest expense exceeds the 30% threshold, it should be determined whether the escape clause is applicable to ensure interest deductibility in 2008. Potential planning still needs to be implemented in 2007 to be effective for 2008. Profitable taxpayers that do not reach the 30% ceiling should consider pushing additional debt into Germany to improve their financing position from a tax perspective.

**Change-in-Ownership Rule**

*Effective for calendar year taxpayers and for deviating fiscal years for share transfers taking place after 31 December 2007*

Under the revised rule, a direct or indirect ownership change of more than 25%/50% to one shareholder will result in a partial/complete forfeiture of all tax loss carryforwards. No exception will be made for intragroup transfers. Special rules will apply if a group of persons together acquires a share of less than 25% each.

Share transfers taking place up to 31 December 2007 will be subject to the old rule, which includes an “anti-stuffing” provision. The monitoring period for the anti-stuffing period is unclear; recent guidance issued by the tax authorities (taking into account decisions of the Federal Tax Court) suggests a two-year-period, but the wording of the new rules suggests a five-year period.
**Potential action step:** If share transfers are currently contemplated for 2008 or later, consider a transfer in 2007. Taxpayers that still need to react to the revised anti-treaty shopping rule (e.g. by transferring their German entity to a different holding company) should do so before year end. Taxpayers should consider loss refresher strategies to reduce the impact of the new rules for share transfers from 2008.

**Transfer Pricing Changes**

*Effective for calendar year taxpayers: From 1 January 2008*
*Effective for deviating fiscal year: FY 2007/2008*

The question of whether or not the tax authorities may levy exit tax charges when functions are transferred in cross-border intragroup transactions based on general transfer pricing principles has been controversial.

Multinational groups with German subsidiaries need to be aware that, as from 2008, specific transfer pricing rules will apply that should result in an exit charge on such transfers. The exit tax will be determined based on the “profit potential” that is deemed to be transferred based on the discounted cash flow value of the subsidiary before and after the restructuring of the German entity.

A transfer of functions will be presumed if a company shifts operating functions (such as production or distribution) to a foreign company; when functions/risks are reduced (e.g. a German fully-fledged distributor is stripped to a commission agent); or when other advantages (goodwill) are transferred to a foreign company.

**Potential action step:** It is possible that the tax authorities will attempt to impose an exit charge on a cross-border transfer of functions in 2007 based on general transfer pricing principles. Affected taxpayers should determine whether it is feasible to undertake restructuring measures before year-end.

**Depreciation Methods**

*Effective for calendar year taxpayers and for deviating fiscal years for asset acquisitions after 31 December 2007*

The declining balance depreciation for moveable assets will be abolished. The general threshold for the immediate expensing of low value assets will be reduced from Euro 410 to Euro 150. A pool of assets with acquisition costs between Euro 150 and Euro 1000 will be created, which will be depreciated over five years.

**Potential action step:** Consider acquiring movable assets in 2007 to benefit from the current rules.
Stock-Lending Transactions

*Effective for calendar year taxpayers: 1 January 2007*
*Effective for deviating fiscal year: FY 2006/2007*

With retroactive effect for tax year 2007, lending fees incurred in connection with stock-lending transactions will no longer be deductible for tax purposes for corporate taxpayers that enjoy the 95% exemption for dividends.

Trade Tax Add-Backs

*Effective for calendar year taxpayers: 1 January 2008*
*Effective for deviating fiscal year: FY 2007/2008*

Basically, all German trade taxpayers will be affected by a new 25% general add-back of all long- and short-term interest expense to the trade tax base (in lieu of the current add-back of 50% of interest expense only on long-term debt). This will also include the financing element (as defined in the law) of the rental or lease of moveable assets (add-back of 5%), immovable assets (add-back of 18.75%) and royalty payments (add-back of 6.25%, although an exception for certain flow-through royalties applies). An exception applies for payments made within an *Organschaft*.

The threshold to qualify for the participation exemption for domestic and foreign dividends for trade tax purposes will be increased from 10% to 15% as from 2008 (unless an applicable tax treaty provides for a lower threshold).

**Potential action step:** Avoid intra-German, intragroup leases/royalties outside an *Organschaft* in the future.

If shareholdings below 15% are currently held by a German entity, consider selling such shareholdings to another non-German group entity that enjoys a full exemption on dividends received.

Reduction of Withholding Taxes

*Effective for calendar year taxpayers and for deviating fiscal years for payments after 1 January 2009*

The withholding tax on dividends will remain at 20% (21.1%, including the solidarity surcharge) in 2008 but will be increased to 25% as from 1 January 2009, with a potential for a 40% refund for nonresident corporations (not subject to anti-treaty shopping rules), which should result in an effective withholding tax rate of 15.825% on dividends for nonresident corporations in non-treaty/non-EC Directive situations.

*Effective for calendar year taxpayers: Payments after 1 January 2008*
*Effective for deviating fiscal year: Payments in fiscal year 2007/2008*
In addition, the withholding tax on certain types of other remuneration (e.g. royalty payments or lease payments on movable property) paid to nonresident corporations will be reduced to 15% (15.825%, including the solidarity surcharge) as from 2008.

Changes Not Yet Enacted

A number of other changes are included in the Annual Tax Act 2008, a draft of which was published by the Federal Cabinet on 8 August 2007. The draft still must be passed by both houses of parliament and, therefore, may still be subject to changes.

The Annual Tax Act 2008 includes a revision of the general anti-abuse rule, which will likely add substantial uncertainty for future tax planning transactions because the proposed rule would substantially expand the current rule. The decisive criteria for application of the anti-abuse rule would be whether the taxpayer generates a tax benefit from a particular structure and whether that structure is “unusual”. The burden would be on the tax authorities to prove the existence of both factors, but the taxpayer would need to show valid business reasons to justify its chosen structure. If enacted, the new law would become effective 1 January 2008. It is unclear whether the tax authorities could review the current tax consequences of structures implemented before 2008 in light of the new provisions for tax assessments from 2008 if the changes are enacted as currently proposed.

The law proposes the disallowance of business expenses/losses resulting from the write-down or transfer of unsecured loans granted by a substantial (i.e. more than 25%) shareholder or related party in the case of impairment. It also includes a number of changes to the CFC rules, which are substantially similar to the tax authorities’ guidance issued in January 2007 regarding the implementation of the ECJ’s decision in the Cadbury Schweppes case into German law.

Finally, a proposed far-reaching disclosure obligation for certain types of international tax planning ideas is currently under discussion in the Ministry of Finance. This proposal can be expected to be incorporated in the Annual Tax Act 2008.

Taxpayers should closely monitor the Annual Tax Act 2008 as it proceeds through the legislative process to determine whether any action will be required to respond to the changes.