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Update on German Corporate Taxation

The purpose of this newsletter is to give an overview of the most important features of the corporate tax regime for foreign investment in Germany following the Corporate Tax Reform 2008 (see below A.) and the Draft Annual Tax Act 2008 (see below B.). Furthermore this article provides investors a brief update on the status and serves as a reminder about the taxation of German REITs (see below C.).

Although the cut in tax rates resulting from the Corporate Tax Reform 2008 is eagerly marketed by the Federal Government, foreign investors should be aware that those cuts will be paid for by a substantial broadening of the tax base. In particular, the new *interest ceiling* will shift the key tax issue for foreign investors to financing. Also the new rules for the use of losses upon change of ownership, add-backs for Trade Tax purposes and transfer pricing demonstrate that taxation in Germany has not been simplified.

The Draft Annual Tax Act 2008 proposes more than 200 changes and is particularly aimed at reducing bureaucracy as well as at modernising and simplifying the law (e.g. electronic procedures for withholding taxes, wage tax and tax on social security compensations). However, it also contains some major alterations; for example, the non-deductibility of losses related to shareholder loans and the tightening of the general anti-abuse provision which will need to be continually borne in mind.

A. Corporate Tax Reform 2008

As already reported in the media, on 6 July 2007 the German Federal Council of States approved the Corporate Tax Reform 2008. The new rules have entered into force on 18 August 2007.

1. Reduced tax rates

For the tax year 2008, the Corporate Income Tax (CIT) rate is reduced from the current rate of 25 % to 15 % for corporations (plus the Solidarity Surcharge). Profits of partnerships or individual businesses, which are not withdrawn but retained in the company, are to be taxed at a reduced rate of 28.25% (instead of the individual progressive tax rate of the respective partner or individual entrepreneur) plus the Solidarity Surcharge where certain conditions are fulfilled and subject to a recapture clause.

At the same time, the base rate for Municipal Trade Tax (TT) is to be reduced from the current 5 % to a uniform 3.5 % (for corporations as well as for partnerships and individual entrepreneurs). The result of these changes is an average combined effective tax rate (CIT and Solidarity Surcharge plus TT) of 29.83 % for corporations.

Depending on the individual TT factor of each municipality, this combined effective tax rate for corporations can vary substantially (especially for the larger cities), as is demonstrated by the following table:

	Average	Berlin	Stuttgart	Düsseldorf	Frankfurt	Hamburg	Munich
TT factor 07	400,00%	410,00%	420,00%	445,00%	460,00%	470,00%	490,00%
Tax rate 07	38,65%	38,90%	39,15%	39,78%	40,14%	40,38%	40,86%
Tax rate 08	29,83%	30,18%	30,53%	31,40%	31,93%	32,28%	32,98%



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These new effective tax rates also reflect the fact that TT will no longer be treated as deductible. Partnerships and individual businesses will be relieved from this burden at least partially by a higher TT credit granted for income tax purposes.

2. Thin capitalisation: introduction of an "interest ceiling"

A new thin capitalisation rule, the so-called "interest ceiling", has been introduced. The interest ceiling is one of the measures taken by the legislative bodies to ensure that the above-mentioned reduction in tax rates will not lead to an erosion of tax revenue. It is a complex new provision which will keep all parties - taxpayers, their consultants, the tax authorities and tax courts - busy in the future. For foreign investors it will mean that financing is the key tax issue.

The interest ceiling restricts the amount of interest deductions based on taxable income. Contrary to the current thin capitalisation rules, it is not limited to loans granted by shareholders or by related parties, but includes all (short and long term) debt financing, particularly bank loans. Moreover, it applies to all businesses in a group (as defined under IFRS), irrespective of their legal form, whereas the old thin cap rules only applied to corporations. The main contents of the interest ceiling are as follows:

Interest incurred is deductible without limitation up to the amount of the interest income earned in the same fiscal year. Any resulting net interest incurred below one million EUR (threshold) is also fully deductible. Where the interest incurred exceeds the interest earned by 1 million EUR or more, then the entire net interest deficit is only deductible up to 30 % of the taxable income. For these purposes the taxable income is defined as pre-tax profits before interest and normal depreciation - including the write off of small items, but excluding extraordinary write-offs - this effectively being "EBITDA" of the same fiscal year.

Non-deductible interest of one fiscal year can be carried forward to the following years and can then be deducted within the above limits ("interest carry forward"). The interest carry forward increases the interest expenditure but not the EBITDA of the following fiscal year. If the enterprise is closed down, reorganised or transferred, the interest carry forward can no longer be used. Where there is a partnership and one of the partners ceases to be a member of the partnership, then a proportion of the interest carried forward is lost pro rata to the partner's share. For a corporation if its share capital is transferred, then the interest carry forward expires because of the rules contained in anti-avoidance provisions governing share transfers, losses and the changes in ownership of the corporation (see below A.3.).

Under an "escape clause", enterprises within a group are not subject to the interest ceiling if they can prove that the equity ratio (see below) of the enterprise according to its own financial statements is not more than one percentage point below the equity ratio of the group as shown in its consolidated financial statements.

The equity ratio is determined by reference to the balance sheet date of the preceding fiscal year preferably prepared under IFRS, or, alternatively under the commercial laws of a Member State of the European Union, or, subject to further restrictions, under US-GAAP. A reconciliation statement needs to be prepared where the individual enterprise's and the consolidated financial statements are prepared under different financial reporting standards. The individual financial statement and any adjusted statement



must in any case be "inspected" by an auditor, but the tax authorities may even request that the financial statements be audited.

The equity ratio is defined as the ratio of equity to the balance sheet total. When determining the equity ratio, the equity is to be increased by:

- the goodwill of the business as included in the consolidated financial statements and
- half of the special reserve according to Sec. 273 HGB (German Commercial Code) and reduced by:

- equity without voting rights – except for preferential shares in stock corporations,
- the book value of the shares in subsidiaries and
- capital contributions within the last six months preceding the balance sheet date if these are withdrawn or distributed within six months after the balance sheet date.

The balance sheet total is to be reduced by intra group debt of other group companies not included in the consolidated financial statement.

For corporations, the following additional rules apply:

Corporations participating in a fiscal unity (*Organschaft*) are considered as one single business, so that financing transactions between such corporations are not affected by the interest ceiling.

The relevant taxable income for EBITDA excludes tax-free earned capital gains and dividends, which reduces the scope for tax allowable interest deductions within the 30% threshold. However, the relevant taxable income includes "paid constructive dividends". This increases the scope for tax allowable interest.

The principles of the interest ceiling also apply to foreign corporations who have a tax presence or obligation in Germany, irrespective of the type of income they earn. This can particularly impact on foreign special purpose companies earning rental income from German real estate.

In terms of "harmful shareholder debt financing", there are more rigid rules applying the interest ceiling for corporations and partnerships which are subsidiaries of a corporation. This results in fewer opportunities to avoid the provisions:

- Even if the borrowing company does not belong to a group, an unrestricted deduction of interest expenditure is only possible if it can prove that no more than 10% of the net interest incurred relates to financing provided by a shareholder with a (direct or indirect) participation of more than 25%, by a person related to such shareholder or by a third party with a right of recourse against such shareholder or related person. The legislator's interpretation of "right of recourse" is wide - even a mere "de facto recourse" is sufficient.
- If the borrowing company belongs to a group, it must adhere to both the escape clause regarding the equity ratio and the above-mentioned 10% threshold for interest arising from "harmful shareholder debt financing". In this respect, the harmful shareholder debt financing of any legal entity in the group undermines all other entities within the group. However, interest is only considered as harmful in this context if it is attributable to liabilities accounted for in the consolidated financial statement, i.e. interest on intra group liabilities is not relevant for this purpose.



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As the interest ceiling will apply for the first time for fiscal years beginning after 25 May 2007 and ending after 31 December 2007 (i.e. where the fiscal year corresponds to the calendar year: for 2008), special attention should be paid to the equity ratio of this fiscal year's balance sheet which in many cases will be the basis for calculating the tax deductible interest for the next fiscal year.

3. New change-in-ownership provisions for loss carrying companies

The change in ownership provisions which were meant to prevent a market for loss-bearing shell companies have been rewritten as the previous rules were frequently disputed and difficult to apply in practice. The new approach - which applies from the tax year 2008 and for share transfers after 31 December 2007 - is more straightforward, but disallows the transfer of losses in nearly all mergers and acquisitions:

Losses for both Corporate Income Tax (CIT) and Trade Tax (TT) purposes will expire upon the change in ownership and "comparable situations". This would be the case if one acquirer or a group of related acquirers or even various unrelated acquirers with "similar interests" purchase directly or indirectly more than 25% of the shares in the loss-bearing corporation. This percentage threshold is aggregated for transactions within any five year period (so-called "harmful transfers"). A capital increase resulting in a change in the participation ratios is also considered a change in ownership. There are no exceptions for groups of companies so that share transfers within groups of companies also fall within this legislation.

The new restriction for losses takes effect in two ways:

- "Harmful transfers" of more than 25% and up to 50% within five years result in a proportional expiry of losses to the extent of the change in ownership percentage.
- "Harmful transfers" of more than 50% within five years result in a complete expiry of the losses.

In this context "losses" mean loss carry-forwards as well as the current period's losses incurred up to the date of transfer.

These new rules will be extremely important for foreign investors, because young innovative companies could remain excluded from a considerable part of the capital markets. The Federal Government has responded to these concerns and, subject to certain conditions, has included an exception for venture capitalist investment within the proposed provisions of its Draft Act on the Modernisation of the General Framework for Capital Investment (Draft MoRaKG of 15 August 2007).

4. Changes in the taxable base for Trade Tax

Even if an interest deduction is not affected by the interest ceiling for income tax purposes (see above A.2.), it could still be restricted for TT purposes. The current 50 percent add-back of long-term interest expense was replaced by a general add-back of 25 % of all interest payable including the following items, to the extent that their total exceeds 100,000 EUR:

- interest for (short or long term) debt (including discounts or comparable advantages, to the extent that they are not customary),
- annuities and permanent charges,
- profit shares of a (typical) silent partner,
- the notional financing share of rent and lease payments deemed as:



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- 20% of the relevant rent/lease for movable property (i.e. 25% of 20% = 5%)
- 75% of the relevant rent/lease for immovable property (i.e. 25% of 75% = 18.75%);
- the notional financing share of licensing payments deemed as 25% lump sum (i.e. 25% of 25% = 6.25%); this does not include licences carrying merely the right to sell rights derived there from (so-called sales licences) and certain fees paid to artists and authors.

In addition to the above add-backs, the taxable base for TT purposes will be further broadened to include dividend income. The participation exemption is limited to dividend income from participations in corporations of at least 15% (currently 10%).

5. Transfer Pricing (Documentation) and Transfer of Functions

The legislation regarding transfer pricing is (again) tightened significantly for the tax year 2008 onwards. For the first time, basic definitions and concepts from the tax authorities' guidelines are introduced into written law. Moreover, the rules on the submission of relevant documentation become more rigid. In summary, foreign investors need to be aware of the following:

Transfer prices are to be determined primarily by the comparable uncontrolled price method, the resale price method or the cost plus method. For comparable uncontrolled pricing arm's length prices need to be available and should be compared under these methods using functional analysis. If there are no comparable arm's length prices then pricing must be based on a price under another valid method. If several different arms' length prices exist, the final margin is to be refined in accordance with the tax authorities' administrative principles.

Transfers of corporate functions are included within the legislation for the first time. They are defined as the transfer of a business activity including the attached opportunities and risks. The value attributable to the transfer will be determined as a whole, i.e. as a "transfer package". This is based on the combined forecasted profit potential of the two parties involved. If substantial intangible assets or benefits are transferred as part of a business relationship, or, there is a transfer of functions and actual performance exceeds forecasted performance, then a further price-adjustment will have to be agreed. Without such price-adjustment agreement the tax authorities can make a one off adjustment up to 10 years after the transaction. Further administrative details relating to the arm's length principle (in particular for transfers of functions) have been announced.

The time limit for the submission of documentation on extraordinary transactions has been reduced from 60 to 30 days. Moreover, the definition of transfers of functions in the context of extraordinary transactions has been further explained.

Under the new rules, the tax authorities will have further powers to assess additional income upon taxpayers if there is evidence that the transfer price is too low or where clarification is impossible because of a lack of information from a foreign related party. By this means, foreign parent companies are to be forced to cooperate with the German tax authorities.



6. Further changes in corporate taxation

The immediate write off for low-value assets is limited to assets with acquisition or creation costs of 150 EUR maximum. Assets with acquisition or production costs exceeding 150 but not 1,000 EUR will be pooled and amortised at 20% over five years.

The provisions for depreciation on the reducing balance basis are abolished for assets acquired or created after 31 December 2007.

The rules for the so-called "savings amortisation" for SMEs are improved, enabling SMEs within certain limits to deduct 40% of the acquisition costs for movable assets in the year prior to the actual acquisition.

B. Draft Annual Tax Act 2008

Even after passing the Corporate Tax Reform 2008, the German legislative bodies remain busy and intend to make further changes. In early August 2007 the Federal Government issued a Draft Annual Tax Act 2008. The legislative process resumes in September with its finalisation anticipated by the end of November 2007.

As to corporate taxation and foreign investment into Germany, we consider the following to be the most important proposed changes:

1. No deduction of losses relating to shareholder loans

Currently, losses incurred by a corporate taxpayer upon their shareholdings in subsidiaries (e.g. due to write downs upon revaluation) are non-deductible for tax purposes.

The Draft Act proposes to extend this rule to losses incurred on loans or under loan guarantees given by the shareholder. The new provision shall apply if the shareholder granting the loan or the guarantee holds (directly or indirectly) more than 25% of the shares in the capital of its subsidiary (a substantial shareholder). The same shall apply if the loan or guarantee has been granted by a related person of a substantial shareholder (e.g. parent or associated company). Conversely, profits from the reversal of previous and disallowable write downs of a debt shall not be taxable.

There is an escape clause if the taxpayer can demonstrate that an unrelated third party would have granted or not claimed back the loan under similar circumstances. However, the explanatory statement to the Draft Act excludes from this third party test any loan which is interest-free, unsecured or (even in case it is interest bearing and secured) is not claimed when the subsidiary is in financial difficulty.



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2. Dissolution and taxation of EK 02

Under current tax law, the distribution of certain reserves earned tax-free under the former imputation system which applied until 2000 ("EK 02") triggers a deferred corporate income tax charge at 3/7 of the distribution payment plus the Solidarity Surcharge. This EK 02 recapture taxation shall cease as of 2019.

The Draft Act provides for an obligatory one off tax charge on the EK 02 reserves (irrespective of whether a dividend is paid out or not). This tax charge would amount to 3% of EK 02 determined as at 31 December 2006. However it is proposed to cap the tax to the amount which would be payable if the entire (tax) equity of the company (as at 31 December 2006) were distributed under the above-mentioned current 3/7-rule.

The lump sum tax shall accrue on 1 January 2007 and shall be paid in ten equal (interest-free) instalments from 2008 to 2017. The taxpayer has until 30 September 2015 to opt to make a single payment of any outstanding CIT amount. In this case the remaining instalments will be discounted by a factor of 5.5% p.a. (which can reduce the payment to approx. 80% of the nominal amount - the maximum discount available).

An exemption from the above is proposed for certain public housing companies which may opt for the ongoing application of the current 3/7-rule.

3. Tightening of the general anti tax abuse provision

The German general anti tax abuse provision is to be tightened. Under current tax law, the anti tax abuse provision is applied to unreasonable tax structures whose sole purpose is to achieve tax advantages (without any other commercial purpose) by avoiding other specific tax provisions which were intended to prevent such advantages. These current general anti tax abuse provisions only operate where there is no specific anti abuse rules in other parts of the tax legislation.

The new general anti abuse rule is intended to apply as of 2008

- to all *unusual* (instead of unreasonable) tax structures which have no substantial other commercial purpose (apart from the avoidance of tax)
- *together with* (instead of subordinated to) other specific provisions in other parts of the tax legislation.

Structures will be considered unusual, if they are not envisaged by the legislative body as being conventional and recognised by prevailing public opinion for the achievement of certain economic aims.

The burden of proof will remain unchanged, but will have more weight:

1. As a first step the tax authorities would have to prove that the chosen structure is unusual, i.e. that the legislator has provided for another structure and that this other structure is in accordance with the prevailing public opinion.
2. If the tax authorities succeed at point 1, then the taxpayer will be required to prove that there were substantial non-tax related commercial reasons for choosing the particular structure.

Due to the lack of clarity of the definitions of prevailing public opinion and unusual tax structures, it is doubtful whether this draft new anti tax abuse provision is compatible with German constitutional law. Nevertheless, it shows that the climate for tax structuring in Germany is becoming more unfavourable and that the German legislator is adopting similar anti tax abuse concepts as enforced in other jurisdictions.

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C. REIT Update

A couple of months ago, there was much publicity about the new REIT legislation in Germany introduced in 2007. We would like to take this opportunity to give an update.

To date, the market has not significantly responded to the new legislation. Few cases of stock-listed REITs have been reported. However it is expected, that the number of REITs will increase before the end of 2007 or during the first half of 2008. We wish to remind you about the key tax advantages of such structures:

- REITs are completely exempt from CIT and TT to the extent that 90% of profit is, in fact, distributed to the shareholders.
- Correspondingly, such distributions are in turn fully taxable at shareholder level.
- Upon the sale of corporate real estate properties to a REIT, any existing hidden reserves will be subject to taxation ("exit tax").
- Until 2009, only 50% of such gains will be taxed, provided the real estate was part of the business assets for at least five years.

These tax advantages mean that REITs can be a favourable source of financing and accessing hidden reserves so that they can be invested in innovative projects. In this context, sale-and-lease-back structures may be an attractive alternative for investors with German real estate on their books who could use the additional funding more effectively.

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