

**Bill for the
Reduction of Tax Allowances and Exemptions**

***(Steuervergünstigungsabbaugesetz,
Tax Allowance Reduction Act,
StVergAbG)***

April 24, 2003

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List of defined Terms

Abgabenordnung, AO	General Tax Act
Auslandsinvestmentgesetz	Foreign Investment Fund Act
Außensteuergesetz, AStG	Foreign Tax Act
Bundesamt für Finanzen	Federal Tax Office
Bundesfinanzhof, BFH	German Supreme Tax Court
Bundeskabinett	German Federal Cabinet
Bundesländer	Federal States
Bundesrat	Upper House of the German Parliament
Bundestag	Lower House of the German Parliament
Bundesregierung	German Federal Government
Bundesverfassungsgericht	Federal Constitutional Court
Eigenheimzulagegesetz	Private Home Allowance Act
Einkommensteuer – Durchführungsverordnung	Income Tax Implementation Ordinance
Einkommensteuergesetz, EStG	Income Tax Act
Finanzministerium	German Federal Ministry of Finance
Finanzminister	German Federal Finance Minister
Gesetz über Kapitalanlagegesellschaften	German Investment Fund Act
Gewerbsteuer – Durchführungsverordnung	Trade Tax Implementation Ordinance
Gewerbsteuergesetz, GewStG	Trade Tax Act
Halbeinkünfteverfahren	Half-Income-Procedure
Körperschaftsteuergesetz, KStG	Corporation Tax Act
Landtag	Parliament of the Federal States

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Steuerentlastungsgesetz

Steuersenkungsgesetz

Steuerergänzungsgesetz

Tax Relief Act

Tax Reduction Act

Tax Reduction Amending Act

Umsatzsteuer –

Durchführungsverordnung

Value Added Tax Implementation

Ordinance

Umsatzsteuergesetz, UStG

Value Added Tax Act

Umwandlungsteuergesetz, UmwStG

Reorganization Tax Act

Unternehmenssteuerfort-

Entwicklungsgesetz

Business Tax Development Act

Vermittlungsausschuss

Mediation committee

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I. Preliminary Remarks

On April 11, 2003, the *Bundestag* and the *Bundesrat* passed and approved the Tax Benefits Reduction Act (*Steuervergünstigungsabbaugesetz – StVergAbG*). Initially, the law was introduced into the legislative process as a bill of the *Bundesregierung* on November 20, 2002. On February 21, 2003, the *Bundestag* passed the bill. Subsequent to a *Bundesrat* majority voting against the law on March 14, 2003, the *Vermittlungsausschuss* came up with a mediation result on April 9, 2003 which was approved by both the *Bundestag* and the *Bundesrat* on April 11, 2003.

The adopted *StVergAbG* consists almost exclusively of regulations pertaining to corporations. The extensive changes that had originally been planned with respect to general taxation, e.g. the introduction of a general capital gains tax, changes concerning company cars and owner-occupied home allowance, to name but a few, were thus not implemented.

The *StVergAbG* comprises fiscal changes which are intended to generate additional tax revenues of approximately Euro 4.4 billion. The extra revenue for the year 2003 alone is expected to amount to Euro 1 billion, of which Euro 535 million will go to the Federal State. The original version of the bill was intended to generate additional tax revenues of approximately Euro 15.5 billion.

In addition to its proposal, the *Vermittlungsausschuss* passed an additional declaration on April 9, 2003, announcing further needs for changes to tax law which are to be implemented by January 1, 2004 at the latest. These changes relate to, for example, thin capitalization rules, the abolition of dividend/capital gains tax exemption granted to life and health insurance companies, the introduction of a 15 % lump-sum tax on capital gains and additional measures in the context of the Foreign Tax Act.

Consequently, after the *Bundestag's* decision, there has been talk that the adopted tax increases represent only a first step. Further tax increases are to be expected. The issue of planning security, which companies have been asking for repeatedly in the past, has once again been relegated to the distant future. The *StVergAbG* also failed to make any progress in the direction of the badly needed simplification of German tax law.

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II. General Changes to the Corporate Income Tax Law

1. Introduction of a Three-Year-Moratorium

The recent reduction in the corporate income tax revenue has led to critical reactions among the public. In this context, the proposal of the *Vermittlungsausschuss* states that “big business ... no longer made an adequate contribution to public financing“. It was argued that the drop in corporate income tax was due to the fact that corporations had distributed their reserves on a large scale during the last two years, thereby mobilizing a substantial corporate income tax reduction potential. As a consequence, the corporate income tax refund volume was, in part, larger than the actual corporate income tax received. In 2001, tax authorities were obliged to refund approx. Euro 400 million in corporate income tax; until June 2002, the figure even amounted to approx. Euro 1.3 billion.

At a press conference on November 13, 2002, the *Finanzministerium* stated that the corporate income tax revenue was, admittedly, still lower than expected. However, this development was not due, as generally claimed, to the last tax reform and even less to the fact that capital gains generated from corporations' sale of shares held in corporations have been exempted from taxation. Instead, the low 2002 corporate income tax revenue was a result of the negative profit development during the years 2001 and 2002. As early as 2000, major companies active in those economic sectors in which profits had slumped not only due to the general economic decline but also due to industry-specific problems, had already received millions in refunds of corporate income tax prepayments in the context of the 2000 and 2001 tax assessment. Consequently, the *Bundesfinanzministerium* is of the opinion that the decisive reason for the drop of the corporate income tax is the general economic climate. Despite this insight, attempts are now being made to stabilize or increase corporate income tax revenue by changing the corporate income tax law.

According to the *KStG* version, which was applicable before the implementation of the *StVergAbG*, the corporate income tax credit, which arose at the time of the imputation system, reduces the corporate income tax applicable for the year, insofar as a distribution takes place during said year. The reduction amount is 1/6 of the distribution. If, for example, the corporate income tax amounts to 100 and the distribution amounts to 60, the corporate income tax would be reduced by 1/6 of the distribution amount, i.e. by 10.

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The *StVergAbG* initially provided for a decrease in the reduction amount to 1/7. In addition, the total corporate income tax reduction was to amount to no more than half the assessed corporate income tax. However, this provision was dropped.

Instead, a three-year moratorium is introduced with the aim of avoiding a further drop in the corporate income tax revenue. The moratorium is intended to act as a "re-adjustment" of the recent major corporate tax reform, which presents a system change from the corporate imputation method to the *Halbeinkünfteverfahren*.

2. The changes in detail

The corporate income tax credit resulting from the old imputation system amounts to 1/6th of the final partial amount subject to a 40 % corporate income tax.

Example 1 (simplified):

Profit	100
Corporate income tax	<u>-40</u>
Final amount (partial amount subject to 40 % corporate tax = EK 40)	60
Corporate income tax credit, 1/6th of the final amount	<u>10</u>
Final corporate income tax on "old profits"	30

The combination of the corporate income tax credit of 1/6th of the final amount subject to a 40 % corporate income tax rate leads to a final 30 % tax rate on the old profits made during the former tax imputation system. In the case of a distribution, old profits realized during the old tax system thus remain subject to a 30 % corporate income tax rate while new profits are subject to a 25 % corporate income tax rate.

The corporate income tax credit is realized via distributions. The respective reduction amount is 1/6th of the profit distribution, insofar as the profit distribution is based on a regular resolution.

Example 2:

Corporate income tax	100
Distribution	600
Reduction amount, 1/6th of 600 =	- <u>100</u>
Corporate income tax	0

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According to the newly added § 37 para. 2a KStG, the corporate income tax reduction in the case of a distribution will be suspended for a three-year period. This means that, during these three years, the corporate income tax credit of 1/6th of the final amounts that have been determined in accordance with § 37 para. 1 KStG may not be mobilized despite the fact that profit distributions take place.

Example 3:

Corporate income tax	100
Distribution	600
Three-year suspension of the reduction amount (moratorium)	<u>0</u>
Corporate income tax	100

The moratorium applies to profit distributions that take place between April 12, 2003 and December 31, 2005. This refers to all profit distributions taking place after the *Bundestag* and *Bundesrat* decisions. Also excepted from this moratorium are profit distributions that took place after April 11, 2003 and before January 1, 2006 but were resolved before November 21, 2002. November 21, 2002 is the decisive date with respect to the profit distribution resolution since the *Bundeskabinett* took the *StVergAbG* decision on November 20, 2002. Thus, the new regulation does not apply to resolutions taken after November 21, 2002, which led to a distribution before April 11, 2003.

<u>Resolution</u>	<u>Distribution</u>	<u>Prior law</u>	<u>Moratorium</u>
Before Nov. 21, 2002	by Apr. 11, 2003	x	
Before Nov. 21, 2002	after Apr. 11, 2003	x	
Nov. 21, 2001 and after	by Apr. 11, 2003	x	
Nov. 21, 2001 and after	between Apr. 11, 2003 and Dec. 31, 2005		x

Coinciding with the introduction of the three-year moratorium, the transition period during which the distribution of prior profits generated during the time of the old corporate tax system may lead to a tax relief was extended by three years. According to prior law, the transition period during which the corporate income tax credit may be

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raised by way of distributions amounted to 15 years. In the case of financial years corresponding to the calendar year, the respective date would be the end of the year 2016. The 15-year transition period was now extended by three years. Consequently, in the case of financial years corresponding to the calendar year, a corporate income tax reduction will be allowed, for the last time, in the year 2019.

Subsequent to the expiry of the moratorium, the corporate income tax reduction potential will again amount to 1/6th of the distribution as a matter of principle. However, the reduction potential is subject to the further limitation that, in each year, only that amount of a tax reduction will be granted, that represents 1/14, 1/13 etc. of the remaining tax credit for the transition period.

After the expiry of the moratorium on December 31, 2005, another 14 financial years remain until the end of the transition period (until the year 2019). Accordingly, during the first year after the moratorium, no more than 1/14 of the residual credit can be refunded and during the second year no more than 1/13, etc. During the last year of the transition period, companies may realize the entire residual amount that was not utilized previously.

Example 4:

Corporate income tax		100
Final amount (EK 40)	600	
Distribution	600	
Reduction, 1/6 of 600	100	
Limitation of tax reduction to 1/14 of 100		<u>-7,14</u>
Corporate income tax		92,86

The extension of the transition period in conjunction with the linear limitation of the refundable volume is a further substantial tightening of fiscal regulations at the expense of the companies.

The limitations of the corporate income tax credit realization as described above apply neither in the case of liquidation nor in the case of a corporation converting to a partnership (merger or change in legal form). In these cases both the moratorium and the linear distribution of the corporate income tax credit do not apply and there is an immediate and full refund of the tax credit

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In parallel with the three-year extension of the transition period applying to the realization of the corporate income tax credit, the transition period applying to the final EK 02 equity capital amounts (which will lead to an increase of corporate income tax in the case of distribution) was also extended by three years.

3. Evaluation of the changes

The new provisions are fiscally motivated and have nothing to do with a reduction of either tax benefits or exemption rules. The legislature is using these provisions in order to correct a system it had created only recently. This course of action cannot lead to planning security. The linear distribution of the corporate income tax credit over the residual term of the transition period certainly does not represent a simplification of tax law. The three-year moratorium and the subsequent distribution restrictions represent a compulsory loan granted to fiscal authorities. The limitations that have now been introduced can hardly be justified, in particular given the Federal Finance Ministry's opinion that the drastic drop in corporate income tax revenue was caused by the general economic situation. After all, the new provisions not only affect big business but also those small and medium-sized companies that are organized as corporations.

4. Alternative strategies

The increase in the corporate income tax credit will become fact with respect to all distribution resolutions that were not taken before November 21, 2002 and all distributions that did not take place before April 11, 2003.

Some companies may be able to convert to or merge into a partnership. In both cases, the limitations applying to corporate income tax credit realization do not apply. Larger companies, in particular those listed at the stock exchange, do not have this option.

Furthermore, in future, structures should be assessed in terms of their effects on profits. During the three-year-moratorium, for example, a shift of the income subject to corporation tax to other company units or to a period subsequent to the expiry of the moratorium could mitigate the restrictions applicable to the availability of the corporate income tax credit.

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III. Profit and Loss Pooling Agreements

The new statute provides for the following changes to the current legal situation:

- Profit and loss pooling agreements only become effective with the beginning of the fiscal year current at the time of their recording in the commercial register of the subsidiary (see below 1.)
- No pooling agreements are possible in all cases of statutory divisional accounting (see below 2.)
- Profit and loss pooling agreements are no longer possible in case of a multi-parent Organschaft (see below 3.)

1. Abolition of Retroactive Installation of Organschaft

Under the previous law, the profit and loss pooling agreement (and thus the effective Organschaft for tax purposes) became effective with the beginning of the fiscal year at the start of which there was financial control between parent and subsidiary. The profit and loss pooling agreement had to be concluded during the course of this year and it had to be recorded in the commercial register before the end of the second fiscal year of the subsidiary.

The new law moves the effectiveness of the profit and loss pooling agreement and thus the beginning of the tax Organschaft to the beginning of the fiscal year of the subsidiary current at the time when the profit and loss pooling agreement is recorded in its commercial register (provided there was financial control from its beginning).

In many cases this does not result in a substantial burden for the taxpayer. Given proper planning, the profit and loss pooling agreement can be filed in good time with the commercial register so that, assuming corresponding co-operation of the commercial register, it may be recorded in time before the current fiscal year ends.

This is more of a challenge in an acquisition when the profit and loss pooling agreement is to become effective as early as possible. This can be achieved - although by accepting some delay - by adjusting the fiscal year of the subsidiary. The fiscal year of the subsidiary can be changed (by shareholder resolution and recording in the commercial register) to commence at an early date following the acquisition. Given appro-

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appropriate structure and recording in the register, the profit and loss pooling agreement becomes effective with the beginning of the altered fiscal year. It has to be observed that the change of a fiscal year requires the consent by the tax administration, unless it is changed to coincide with the calendar year. In all other cases the tax administration is as a rule prepared (and according to the corporate income tax ordinance also obliged) to grant its consent, if the purpose of the change of the fiscal year is to commence an Organschaft.

Particular problems will be caused by the new rules for listed stock corporations, which are always exposed to the usual greenmail by wayward shareholders. In these cases, it is the simple objection to the protocol in the AGM, which will delay the recording of the profit and loss pooling agreement in a manner, which is beyond planning. As a result, the corporation may possibly suffer substantial additional taxes.

Merging the subsidiary into the parent could create a possible escape. The merger is less subject to challenges in many areas because the recording can be accelerated by reliance on specific rules in the Reorganisation Tax Act.

It is not apparent at all what specific purpose these new rules seek to achieve beyond tax increase purposes. In other cases (e.g. merger, conversion etc.) there is no problem in accepting for tax purposes the time when the recording application is filed with the register – as opposed to its recording. The legislator accepted in these cases that the recording process with the commercial register (e.g. flu epidemic in the typing pool) cannot be influenced by the taxpayer. The same is obviously true for the commercial register recording of the profit and loss pooling agreement. The proposed amendment thus contradicts the view of the legislator itself and it must - absent other justification - simply be described as hostile to commercial activities.

2. No Pooling Agreements in all cases of statutory divisional accounting

Under present law, the agreement on profit and loss pooling agreements was not permissible for companies, which were subject to regulations requiring divisional accounting. This exclusion used to be limited to life and health insurance companies. The new statute extends this exclusion to all cases where there is statutory divisional accounting. In addition to the abovementioned insurance companies, this also applies especially to specialised banks, such as mortgage institutes.

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3. Abolition of Multi-Parent Organschaft

Under both old and new law it is a requirement for the conclusion of a profit and loss pooling agreement that the parent holds a majority of the shares (giving financial control) in the subsidiary. In case of a joint venture between two partners this could result in a 50:50 participation with the result that none of the participating enterprises holds the required majority. In order to facilitate the conclusion of a profit and loss pooling agreement in these cases reflecting the governance of the subsidiary by its jointly acting parents, it was standard procedure to combine the interests of the parent companies in a partnership, which would hold all shares in the subsidiary. The profit and loss pooling agreement was concluded between the subsidiary and the partnership combining the interests of the joint parent companies.

The new law tries to bar this so-called multi-parent Organschaft.

In future, only a trading partnership – apart from a corporate entity - can function as parent in an Organschaft. As a result, the traditionally used common law partnership is no longer available.

To the extent that corporate entities should be used as Organschaft parent in joint ventures, the interests of the parent companies could be structured as “tracking stock”. In this way, the results obtained from various parts of the joint venture can be separately shown and channelled to the respective joint venture parent. This structure could also eliminate controversies about the valuation of certain elements of the joint venture.

This change should not result in a substantial tightening of tax rules applicable to Organschaft. In future, the multi-parent Organschaft will be structured as trading partnerships. This should also apply to current multi-parent Organschaft currently structured as common law partnerships. On the other hand, the new rules will pose new questions as to the type and extent of the qualifying trading activity.

It has to be taken into account that according to case law of the European Court, holding companies qualify for VAT input refund provided they themselves render value added activities, including toward their own subsidiaries. For this reason, there is an interest in the majority of cases to establish a trading partnership for purposes of forming a multi-parent Organschaft, anyway.

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4. Evaluation of Changes and what is to be Expected

German law does not operate group taxation. There are extensive rules concerning group accounting, but these rules are limited to financial accounts. The consolidated accounts are a pure information instrument; they have no relevance for tax purposes (and also not for dividend distributions). Yet, the consolidated accounts supply an instructive operating number for the tax optimisation of the group in the form of the group tax quota. A group, which is not optimised from a tax view point could, for example, show a domestic pre-tax result of +200 and a foreign loss of ./100, thus a consolidated result of 100. Yet, the domestic tax rate of e.g. 40% is only charged on the domestic result of 200 with the consequence of taxes of 80 on a consolidated result of 100, thus a tax quota of 80%. Comparably unacceptable tax quotas could also result between domestic enterprises in case of deficient group structuring.

It should also be noted that profit and loss pooling under Organschaft does not amount to full consolidation. Instead, the unconsolidated results of subsidiary and parent are simply added on an unsophisticated basis but without eliminating intra-group transactions (profit realisations from group internal sales etc.). For this reason, Organschaft is merely a second best instrument on the path to group taxation, which would be highly necessary.

For as long as group taxation is a thing of the future (present planning envisage group taxation plans at the time when the European Stock Corporation comes on stream from October 8th, 2004), companies would do well to structure their group results with more attention to detail, more planning and more long-term insistence in line with value added considerations. As noted, this will become more important not only for domestic group companies, but in particular for the allocation of the group result between domestic and foreign operations. The main emphasis will be on the avoidance of losses with some group members when simultaneously other group members show profits so as to avoid any distortion of the group tax quota.

IV. Limitation of Loss Utilization regarding Silent Partnerships

1. Current statute

Losses derived from a typical silent partnership interest held as business assets used to be available for set-off purposes provided that the prerequisites of a depreciation to the lower going concern value ("*Teilwertabschreibung*", § 6 para 1 no. 1 clause 2 *EStG*) were met. Furthermore, academic commentary held that losses incurred by a typical

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silent partner would lead to a simultaneous book value reduction, even if the prerequisites for a depreciation to a lower going concern value ("presumably permanent reduction in value") were not met (cf. e.g. Behrens/Karkowski, DB 2001, 1059; Glanegger in: L. Schmidt, Sec.6 annot. 260, "*Stille Gesellschaft*"). The deduction of losses derived from an atypical silent partnership interest from positive earnings from other sources of income had, up to now, not been subject to any restrictions.

2. New Provision under the Tax Benefits Reduction Act (StVergAbG)

The new provision does not affect the current legal situation of typical silent partnerships.

As regards atypical silent partnership interests held by a corporation in another corporation, losses within the meaning of § 15 para 4 clause 6 of the *EStG* can, in the future, only be deducted subject to the prerequisites stipulated in § 10d *EStG* from profits derived from the same entity in the year preceding the year in which the losses were incurred, or generated in later assessment periods. This will apply accordingly to sub-participations and other undisclosed partnerships (*Innengesellschaften*) in which the partner or interest holder has a status similar to that of a partner in a commercial partnership ("*Mitunternehmer*").

3. Application of new Provision

The new provisions are applicable for fiscal years ending after December 31, 2002 and thus apply to losses already incurred and existing loss-carry forwards. The new provisions result in a substantial restriction of the utilization of losses from atypical silent partnership interests and similar arrangements in which the shareholder has a status similar to that of a partner in a commercial partnership and, as a rule, require profits earned by the same entity in the preceding year or later assessment periods.

V. Changes in Tax Law with respect to Outbound-Transactions and Cross Border Business Relations

With respect to outbound transactions and cross-border business relations the *StVergAbG* provides for major changes with respect to the provisions of the *AStG* and the *AO*. The tax changes include, in particular:

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- Abolition of the treaty protection for profits reallocated according to the provisions of the *AStG* (abolition of § 10 para. 5 *AStG*)
- Abolition of tax privileges for certain passive investment income (abolition of § 10 para. 7 *AStG*)
- Redrafting of the definition for „active trading business“ (§ 8 para. 1 No. 4 *AStG*)
- Extension of the application of the tax credit method instead of the tax exemption method with respect to specific foreign branch income (redrafting of § 20 para. 2 *AStG*)
- Definition of „business relationship“ (§ 1 para. 4 *AStG*)
- Introduction of new transfer pricing documentation requirements and penalties (extension of §§ 90, 162 *AO*).

1. Changes with respect to the *AStG*

a. Abolition of the Treaty Protection for Profits Reallocated (Abolition of § 10 para. 5 *AStG*)

aa. Current Law and Changes by the *StVergAbG*

Certain Foreign Corporations are deemed to be transparent for tax purposes according to the provision of the *AStG* (so called „*Zwischengesellschaften*“). The respective income of such foreign company is allocated to the German shareholder as fictitious dividend („*Hinzurechnungsbetrag*“). In the past, it had been possible in a number of cases to avoid the taxation of profits reallocated according to § 10 para. 5 *AStG*. According to this provision, the treaty provisions for dividends are to be applied to the fictitious dividend („*Hinzurechnungsbetrag*“). If the foreign company was resident in a country which had concluded a tax treaty with Germany that provided for a tax exemption of dividends received irrespective of the nature of the profits (so-called „*Schachtelprivileg ohne Aktivitätsvorbehalt*“) this led also to a tax exemption of the fictitious dividend. For example, the tax treaties with Luxemburg, Ireland and the Netherlands contain for such provisions.

§ 10 para. 5 *AStG* is now abolished completely.

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bb. Evaluation and Alternative Strategies

In the past, this provision avoided the taxation of a fictitious dividend at the level of the German parent company for example with respect to profits realized by an Irish group finance company although the conditions of § 8 para. 1 No. 7 *AStG* for an active financing business were not met by the Irish company. Such exception, however, no longer exists. Special care must therefore be taken that the requirements of § 8 para. 1 *AStG* with respect to an “active” business activity of the foreign company are fulfilled. In the case of a group finance company this means that such company must raise its capital exclusively on foreign capital markets and not from related companies. Should such finance company grant loan capital to foreign affiliates, such affiliates must themselves perform “active” business activities within the meaning of § 8 para. 1 No. 1 – 6 *AStG* to retain the dividend exemption from Ireland.

b. Abolition of Tax Privileges for Certain Passive Investment Income

aa. Current Law and Changes by *StVergAbG*

The current tax privileges for certain passive investment income according to § 10 para. 6 – 7 *AStG* were abolished. The specific definition of passive investment income according to the *AStG* is now to be found in a newly inserted paragraph 6a of § 7 *AStG*. The definition of passive investment income is to remain the same. This specific form of passive income shall in future only be relevant for determining the relevant participation quota, which will determine the application of the provisions of the *AStG*. Should a foreign corporation derive such passive investment income, a participation of at least 1% of the German shareholder shall continue to be sufficient for the reallocation of the income attributed to such participation to the German shareholder.

With the abolition of these provisions, the tax privileges for income from group financing activities no longer exist. Originally, according to § 10 para. 7 *AStG* only 60% of the income from the group financing activities was included in the amount of fictitious dividend provided that such income was derived from financing foreign branches or foreign affiliates, which realize almost only “active” income. In future, such income is fully included in the fictitious dividend.

bb. Alternative Strategies

To the extent that foreign group companies located in low tax jurisdictions perform finance activities for the group, a restructuring of the financing activities should be

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taken into consideration. For example, it may be possible to bundle all financing activities into one group company, which meets all requirements for “active” financing business within the meaning of § 8 para. 1 No. 7 *AStG*.

It may also be considered under specific circumstances for finance purposes to replace a loan by equity, thereby realizing dividend income which is deemed active income according to § 8 para. 1 No. 8 *AStG*.

c. Redrafting the Definition for „Active” Trading Business (§ 8 para. 1 No. 4 *AStG*)

aa. Current Law and Changes by *StVergAbG*

The requirements for the recognition of an „active“ trading business within the meaning of § 8 para. 1 No. 4 *AStG* were redrafted. The previous wording requires an export delivery of commodities or goods from Germany or an import delivery. The requirement “delivery” is replaced by the requirement “assignment of the right of disposal” with respect to commodities or goods to a German resident taxpayer or by a German resident taxpayer (including German permanent establishments of foreign corporations) regardless of an actual delivery. The redrafting is designed to avoid its the circumvention of this provision.

The intermediate trading business within a group is particularly affected by this redrafting of § 8 para. 1 No. 4 *AStG* whenever no delivery takes place or the commodities or goods are delivered directly to the end consumer which involves related persons who are subject to tax in Germany.

bb. Alternative Strategies

Whenever such trading transactions exist within a group of companies, particular attention must be paid to equipping the foreign company in such way that it maintains a business establishment equipped for such commercial transactions, carries out trading transactions with third parties and performs the activities without the assistance of the German shareholder or of other affiliates subject to resident tax in Germany.

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d. Extension of the Application of the Tax Credit Method instead of the Tax Exemption Method with respect to Specific Branch Income (Redrafting of § 20 para. 2 *AStG*)

The redraft of § 20 para. 2 *AStG* abolishes the treaty protection for specific income of a foreign permanent establishment. According to the revised provision, the double taxation of the income of a foreign permanent establishment is now to be avoided by crediting the foreign tax imposed on such income rather than by exempting such income from German taxation. This change affects all income of foreign permanent establishments which does not result from „active“ business activities or which is not to be considered „active“ income within the meaning of § 8 para. 1 *AStG*. By this provision, the tax burden on the respective passive income of a foreign permanent establishment is brought up to the German level.

e. Definition of “Business Relationship” (§ 1 para. 4 *AStG*)

aa. Current Law and changes by *StVergAbG*

The amendment of this provision is for clarification purposes only. § 1 para. 4 *AStG* provides for an adjustment of income with respect to all business relationships between the resident taxpayer and a related person, which are based upon a contractual agreement. For the existence of a business relationship as such it is irrelevant whether it is based on business or a corporate relationship.

With the redrafting of § 1 para. 4 *AStG* the previous opinion with respect to the meaning of the term “business relationship” becomes standardized. This became necessary as the *Bundesfinanzhof* in its judgment dated November 29, 2000 held a dissenting opinion with respect to the interpretation of § 1 *AStG*.¹

bb. Alternative Strategies

As far as business relationships between a resident company and its subsidiary are based on corporate reasons, e.g. an interest-free loan to replace missing equity, the respective activities are to be put on a formal corporate legal basis e.g. by providing for a respective obligation in the articles of incorporation.

¹ BFH, Federal Tax Gazette 2002 II, p. 720; Letter ruling with respect to the non-application of the judgment dated 17.12.2002, Federal Tax Gazette 2002 I, p. 1025

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f. Application Rules

The redrafting of § 1 para. 4 *ASiG* shall become effective for the first time for fiscal years starting after December 31, 2002.

The other amendments with respect to the *ASiG* shall become effective for fiscal years of the *Zwischengesellschaft* resp. a permanent establishment commencing after December 31, 2002.

2. Introduction of New Transfer Pricing Documentation Requirements and Penalties

a. Current Law and Changes by *StVergAbG*

The exchange of goods and services between related companies is carried out on the basis of transfer prices. In order to determine the appropriate transfer price, the arm's length principle is to be applied, e.g. in case a related company sells goods or merchandise to another related company, only such price is to be owed for such goods or services which would have been agreed when dealing with third parties. Should the goods or services rendered not be available on the market, no comparable fair market price is available. In the past, in these cases it had been difficult for the German tax authorities to review the adequacy of the transfer prices as German taxpayers had not been obliged to prepare and maintain verifiable and detailed documentation. This legal position was explicitly confirmed by the *Bundesfinanzhof* decision from October 17, 2001². The Court stated that the German subsidiary does not violate its tax obligations when failing to document transfer pricing practice. Consequently, the failure of providing such documentation does not justify a penalty. On the contrary, the failure to submit such information would only lead to the presumption that the transfer prices were influenced by the corporate relationship. The burden of proof for the determination of the appropriate transfer prices would nevertheless rest with the German tax authorities.

In order to improve the disadvantages from this legal position for the tax authorities, a new paragraph 3 is added to § 90 *AO*. This new provision provides for extended transfer pricing documentation requirements. For business transactions related to foreign countries, the taxpayer has to compile records of the type and contents of his business transactions with related companies. This transfer pricing documentation requirement

² BB 2001, page 2451

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shall comprise in particular the economic and legal basis that is of importance for determining the adequate transfer prices and other agreed business conditions. The submission of such documentation is due within a term of 60 days which may, however, be extended in special cases.

The Federal Ministry of Finance will be authorized to determine the nature, scope and content of the documentation requirements by way of ordinance which is currently being drafted.

If a taxpayer fails to submit the documentation as requested by § 90 para. 3 *AO* German tax authorities may presume pursuant to § 162 para. 3 *AO* that the income derived from these business relationships is under-declared. This presumption applies not only if the taxpayer fails to submit such information but also if the documents submitted are essentially unfit for the purpose or - as it may occur in the case of extraordinary business transactions – were not recorded in time. In such cases, the German tax authorities are entitled to estimate the income derived from these business relationships. If in such case the income can be estimated only within a certain range, e.g. because of profit and trade margins, such potential can be fully exploited to the disadvantage of the taxpayer when estimating his income. The burden of proof that the declared income and not the income estimated by the tax authorities was correct will rest with the German resident taxpayer.

If a taxpayer fails to submit the documentation or if the documentation submitted turns out to be unfit for the purpose, according to § 162 para. 4 *AO*, the tax authorities are allowed to assess a penalty of at minimum 5% and at maximum 10% of the increase of income, which had been adjusted according to § 162 para. 3 *AO*, in any case, however, a minimum of 5,000 Euro. In addition, a penalty of up to 1 Million Euro is to be assessed in case of a delay in submitting the requested documentation, and of a minimum of 100 Euro for each day in excess of the time limit. No penalty will be assessed, if the failure to comply with the respective obligations is excusable or if the failure turns out to be insignificant. Generally, the penalty is to be determined after completion of the tax audit.

b. Evaluation

According to the new provisions, all that is needed is insufficient documentation of all information and circumstances which are of influence for determining the transfer prices and other terms and conditions to result in the assumption that the income derived from business transactions with foreign affiliates was under-declared due to the

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corporate relationship. In other words, it is assumed that the agreed transfer prices do not comply with the arm's length principle because of the corporate relationship. As a result, a mere violation of the documentation obligation, entitles tax authorities to presume all criteria for a constructive dividend without the obligation to produce supporting facts. In contrast to current law, it will be the taxpayer who has to bear the burden of proof that the transfer prices comply with the arm's length principle. As the failure to provide sufficient documentation leads to the presumption of a constructive dividend, the tax authorities are entitled to estimate the amount of taxpayer's income absent such a constructive dividend. In determining the appropriate fair market price, a potential range for the appropriate transfer price can be fully utilized to the disadvantage of the taxpayer. The exercise of such discretion when estimating the appropriate transfer price already leads to increased taxes due to the range involved in the estimate. § 162 para. 4 AO increases the tax burden even more as it provides for an additional penalty. In addition, the mere delay in submitting the requested documentation triggers a considerable penalty. The burden of such legal consequence carries even more weight for the taxpayer as the 60 days period for submitting the requested documents becomes too short if documents are to be requested from abroad. Such transfer pricing penalties had been unknown by German tax law.

c. Alternative Strategies

It is recommended that taxpayers prepare all transfer pricing documentation on a contemporaneous basis even though the wording of the law obliges taxpayers to create such timely documentation only with regard to extraordinary business operations. In case the foreign parent company is not willing to disclose its transfer pricing policy for the respective production and distribution stages vis-à-vis the German subsidiary, an increased German taxation by estimating the appropriate income and by assessing a penalty for the German subsidiary pursuant to the new provisions is inevitable. In order, however, to avoid such increased tax burden it is recommended to provide sufficient information to the German subsidiary, in particular with regard to transfer pricing documentation that may already exist. To the extent a transfer pricing documentation already exists for other jurisdictions such documentation has to be verified with respect to its usefulness for German tax purposes.

In order to obtain sufficient legal certainty, it may be considered to enter into Advance Pricing Agreements (APA) between companies within the European Union. Such agreements represent a binding undertaking of the countries vis-à-vis the participating taxpayers with respect to the chosen transfer prices and the terms and conditions of the contractual agreement. In Germany such agreement can only be entered into within the

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framework of a binding ruling request. The *Federal Ministry of Finance* is currently in the process of setting up guidelines for such ruling requests. Such binding ruling request is thought to avoid the risk of double taxation and as such it needs to be coordinated with the respective foreign fiscal authorities. It remains to be seen whether such corresponding guidelines are issued within the near future. The particular need of protection of German taxpayers is obvious in view of the drastic consequences, in particular with regard to the substantial penalties being introduced into German tax law for the first time.

d. Scope of Application

Section 90 para. 3 *AO* applies for the first time to business years commencing after December 31, 2002. In the case of long term contractual agreements which were entered into before this point in time and which are still valid, the documentation with respect to the relevant commercial data has to be prepared at the latest six months following the effective date of the ordinance governing the details within the meaning of § 90 para. 3 *AO*.

Section 162 para. 3 and 4 *AO* is to be applied for the first time to business years commencing after December 31, 2003 but at the earliest 6 months following the effective date of the ordinance within the meaning of Section 90 para. 3 *AO*.

VI. Changes in the UStG Regarding Electronic Services

1. Overview Regarding the New Regulations

Adopting Council Directive 2002/38/EC of May 7, 2002, electronically supplied services provided by non-resident entrepreneurs to non-taxable persons shall, according to the new regulations under the *StVergAbG*, be made subject to *UStG* in Germany if this is where the non-taxable entrepreneurs is established, has his residence or usually resides. In order to facilitate compliance with these fiscal obligations by non-resident entrepreneurs providing electronically supplied services, a special scheme shall be established allowing the non-resident entrepreneurs to register only in one EU Member State for VAT purposes, even if services are provided in various member states. However, irrespective of the member state of registration, the VAT rate applicable for the services provided by the non-resident entrepreneurs is Germany's standard VAT rate of 16 %, as long as the services are supplied in Germany. The new regulations shall come into effect on July 1, 2003 in accordance with the respective EU directives.

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2. The New Regulations in Detail

a. The Place of Supply

According to the new § 3 a para. 3a in connection with para. 4 No. 14 *UStG*, electronically supplied services provided by a non-resident entrepreneur to a non-taxable person shall be deemed rendered where the non-taxable person is a resident, has his residence or usually resides.

Example:

An entrepreneur residing in the USA provides software via download to a non-taxable person with his residence in Germany.

Current place of service: USA

Place of service after *StVergAbG*: Germany

The place where the service is deemed rendered will not be shifted as a result of the *StVergAbG* if the provider of the service to a non-taxable person is located within the EU or has a permanent establishment within the EU which he uses to effect the service.

Example:

An entrepreneur residing in France provides software via download to a non-taxable entrepreneur with his residence in Germany.

The place where the service is rendered is before and after the *StVergAbG*: France.

According to the new § 3 a para. 3 *UStG* in connection with § 3 a para. 4 No. 14 *UStG*, the place where a service is deemed rendered may also be shifted in cases where a non-resident entrepreneur provides an electronically supplied service to a taxable entrepreneur within the EU. This is the case where such a service could not yet be qualified under § 3 a para. 4 *UStG*.

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Example:

An entrepreneur residing in the USA provides web-site services to an entrepreneur with his seat in Germany.

Current place of service: USA

Place of service after *StVergAbG*: Germany

As a result of the German reverse charge rules according to § 13 b *UStG*, such shift of the place of services, however, does not affect the non-resident entrepreneur providing the service. The entrepreneurial recipient, however, may be affected by this shift of the place of the service, if such recipient is not entitled to a full VAT refund. In this case, the entrepreneurial recipient will be burdened with VAT for the electronically supplied service received from a non-resident entrepreneur. In contrast to cases where services are provided to non-taxable customers, such shift of the place of services will also occur in cases where the entrepreneur providing the service is located in the EU, e.g. France. The effect in this case is, however, limited to the fact that the VAT on that service will be owed in the future in Germany rather than in France.

The term “electronically supplied services” shall comprise services where the genuine service is provided electronically via a network. According to the commentaries added to the proposal of the new VAT legislation, web-site supply, web-hosting, remote maintenance of programs and equipment, supply of software and updating thereof, supply of images, text and information, and making data bases available, supply of music, films and games (including games of chance and gambling games) and political, cultural, artistic, sporting, scientific and entertainment broadcasts and events, and e-teaching as well, among others, shall qualify as electronically supplied services.

b. Taxation Procedure

A non-resident entrepreneur whose only taxable supplied services rendered in Germany are electronically supplied services shall have three possibilities to observe the taxation procedure in Germany and possibly in other EU Member States. First, he shall be entitled to make use of the ordinary taxation procedure according to Sections 16 and 18 *UStG*. Second, the entrepreneur shall be entitled to make use of the new “single point of registration” procedure according to Sec. 18 para. 4c *UStG*. Within the framework of the single point of registration procedure the entrepreneur must decide whether he wants to register solely in Germany or solely in another EU Member State. If he chooses the single point of registration in another EU Member State, he is ex-

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empt from filing VAT returns in Germany. The new single point of registration procedure is solely electronic, from the application to file under this procedure to the filing of the VAT returns. It does not, however, include VAT refunds. Instead German input VAT will continue to be refunded by way of the special VAT refund procedure to be applied for with the Federal Tax Office in Bonn, Germany.

3. Consequences following the New VAT Legislation

Predominantly, the new § 3 a para. 3 a and para. 4 No. 14 UStG shall result in a shift of the place of supply of electronically supplied services provided by non-resident entrepreneurs to non-taxable persons in Germany. These new regulations shall therefore result in a value added taxation of electronically supplied services within the EU Member States. The new regulations will therefore result in an increase of the value added tax collections among the EU Member States. Entrepreneurs qualifying as non-resident entrepreneurs will probably pass these additional value added taxes on to their customers via an increase of their service fees. Whether or not the market will allow for such increases in the service fees remains to be seen. If and in so far as the non-resident entrepreneurs will not be able to pass the VAT on to their customers, it will once again be evident that VAT is very often not cost-neutral for entrepreneurs.

Taking a closer look at the new regulations, it becomes obvious that not only entrepreneurs qualifying as non-EU resident entrepreneurs will be affected by these new VAT regulations. Not only services electronically supplied to non-taxable persons are subject to the new VAT regulations, but also electronically supplied services provided to entrepreneurial recipients within the EU (§ 3 a para. 3 UStG in connection with § 3 a para. 4 No. 14 UStG). However, this is only true regarding services which were not already included in the list of services according to § 3 a para. 4 UStG. The amendment of the list of services of Sec. 3a para. 4 UStG will in any case increase the reporting obligations of the entrepreneurial recipients (reverse charge rules). Entrepreneurial recipients not entitled to a complete input VAT refund will even be burdened with additional value added taxes regarding electronically delivered services which have previously not been subject to taxation in Germany (e.g. web-sites). EU-resident entrepreneurs are therefore affected by the new VAT legislation as well.

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4. Alternatives

a. Non-EU Resident Entrepreneurs

Entrepreneurs residing outside of the EU should carefully consider whether or not the special registration procedure according to § 18 para. 4 c *UStG* is indeed advantageous for them. The simplification in regard to filing only one VAT return in only one single EU Member State must be weighed against the disadvantage of a postponed refund of input VAT which is possibly charged to the non-resident entrepreneur. This is because the special VAT refund procedure to be filed with the Federal Tax Office take always longer than the refund of input VAT included in an ordinary VAT filing procedure.

In any case, non-resident entrepreneurs must in the future, i.e. starting from July 1, 2003, ensure that they pay VAT regarding their services provided to non-taxable EU customers. In addition, non-resident entrepreneurs must ensure that they properly account for their activities in Germany and the other EU Member States in order to be able to undertake the necessary VAT filing procedures. Neglecting these new regulations is, as usual, punishable as tax fraud or gross negligent tax evasion. However, in many cases it will be difficult for the respective entrepreneur to determine whether services have been supplied to business or to private customers. Apparently, it is neither planned on a German nor on a European level to provide the entrepreneurs with some kind of support (e.g. efficient and sufficiently accurate access to VAT ID databases) in this regard.

b. Recipient of the Services

Electronically supplied services will in future be subject to value added taxation in Germany and the other EU Member States if they are supplied to EU-resident recipients, irrespective of where these services are actually supplied. Possible alternative strategies in order to avoid such taxation must thus focus on a possible shift of the place where the service is actually received. For non-taxable persons tax planning alternatives are thus rather limited. VAT minimizing strategies applicable to a broad number of cases are not possible. However, entrepreneurs resident in Germany or in other EU Member States will have to consider in the future whether or not it is possible for them not to receive such service in Germany or another EU Member State, but rather outside of the EU territory, provided that such entrepreneur is not entitled to a full refund of input VAT. Such considerations will, however, have to address the transfer functions within the entrepreneurial group structure as well.

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VII. Changes of Trade Tax Law / Trade Tax Imputation

Over the last years, the trade tax revenues of the German municipalities have decreased significantly. This was not only caused by the decline of the economic environment, but also by an increasing tax competition between the different municipalities (which levy the trade tax). Especially the small village Norderfriedrichskoog in Schleswig-Holstein, which levies no trade tax at all, took center stage in this regard. In order to limit the tax competition between the municipalities, the new tax bill provides – factually – for a minimum trade tax rate. In cases of "low" trade taxation, i.e. if the trade tax collection rate (“*Gewerbesteuerhebesatz*”) of the respective municipality is less than 200 %, the trade taxation will be “made up” at the level of the shareholder/interest holder in the respective entity (details see below). As a consequence, the respective municipalities will be forced to increase their trade tax collection rate to at least 200 %.

In detail, the new tax bill provides for the following trade tax changes:

- The deemed trade tax imputation for income tax purposes (see § 35 *EStG*) which should avoid a double taxation of income with both Income and Trade Tax will not be available, if the respective income has been subject to "low" trade taxation.
- The new § 8a *GewStG* provides for such entities (being subject to trade tax), which hold an interest in a German corporation being subject to "low" trade taxation, an addition of the trade tax income (“*Gewerbeertrag*”) of the respective corporation to its own trade tax income. Such addition of the trade tax income of the subsidiary applies, if
 - the corporation (GmbH, AG or KGaA) has its seat and its general management in Germany,
 - the interest in the statutory capital amounts to 10 % or more and
 - the respective interest has been held without any interruption since the beginning of the respective calendar year.

The addition of the trade tax income of the "low-taxed" corporation will be made in the amount of the proportionate participation.

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- If an entity (which is subject to trade tax) holds an interest in a trade partnership, the trade tax exemption of the income derived from such partnership according to § 9 No. 2 *GewStG* will not apply if the income of the respective partnership is subject to "low" trade taxation. In such case, the income of the partnership will be subject to additional trade taxation at the level of the relevant entity holding the interest in the (for trade tax purposes) "low-taxed" partnership.
- In case of an *Organschaft* (and also in cases of permanent establishments) usually the amount of trade tax income of the parent company (respectively the company) "owning" the permanent establishment will be divided between the different municipalities where the member companies of the *Organschaft* (respectively the permanent establishments) are domiciled. The new tax law provides that such municipalities with a "low" trade tax collection rate ("*Gewerbesteuerhebesatz*") in future will not earn a proportionate part in the trade tax income of the *Organschaft*, respectively the company, and therefore will not earn any trade tax at all.

The new provisions will apply for fiscal year 2003 and, to this extent, have some retroactive effect. They should only in the rather rare cases, in which the trade tax collection amount of the respective municipality is less than 200 %, trigger a higher tax burden. Considering that the new trade tax provisions cover only a limited number of municipalities, the new provisions should not contradict constitutional law. It should also be noted that the *GewStG* will be subject to a substantial revision in the context of the intended reform of the trade tax system in 2004 (see below VIII.1). The consequences of the new provisions therefore will be rather limited.

VIII. Expected New Tax Legislation

1. Trade Tax Reform 2004

The reform of German trade taxation has been the subject of intense and near permanent discussion over the last few years. However, motivated by the decrease of the trade tax revenues in the last years and by the distressed budget of most municipalities, in 2002 a working group was formed with the mandate to develop the draft of a new trade tax system. Currently, a multitude of different proposals are submitted for discussion, which are drafted either by some of the Federal States ("*Bundesländer*"), by associations of the municipalities or by third party experts. All proposals focus on

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making trade tax revenues more steady but intend to continue the character of the trade tax as a tax relating to the income of the relevant taxpayer. Some of the proposals provide an extension of the trade taxation also to such taxpayers deriving income from independent services ("*Einkünfte aus selbständiger Tätigkeit*"). This would, combined with the deemed imputation of trade tax for income tax purposes (see VII. above) lead to a redistribution of tax revenues between the German Federal government and Federal States budgets and the municipalities.

It is currently unclear which of the different proposals the working group will reach an agreement and whether new trade tax law will really apply as of January 1, 2004. It is not unlikely that the reform will be postponed to 2005.

2. New German Thin Capitalization Rules

In its court decision dated December 12, 2002 ("Langhorst – Hohorst"), the European Court of Justice ruled that § 8a para 1 No. 2 *KStG* for the years 1996 to 1998 violates European law. § 8a *KStG* provides a limitation of the debt financing of German corporation by non-German shareholders ("German Thin Capitalization Rules"). German tax authorities have not yet published a public letter ruling with regard to the consequences of the court decision for § 8a *KStG* in its current form. Especially, no binding ruling by German tax authorities has been published whether § 8a *KStG* applies for purposes of the corporate income tax assessment 2002.

It is expected that the German legislator will react to the decision of the European Court of Justice as early as 2003 to expand the application of § 8a *KStG* to German shareholders of German corporations. In a protocol of the Lower and Upper House of German Parliament (following an initiative of the mediation committee ("*Vermittlungsausschuss*")), the German legislator was requested to consider new legislation for shareholder debt financing which extends the application of § 8a *KStG* to German shareholders. The protocol contains no proposal with regard to the technical framework of such new provision. In particular, the proposal of the Federal States Hessen and Nordrhein-Westfalen for a new version of § 8a *KStG* (application of § 8a *KStG* in its current form to German shareholders, but exemption of interest payments up to an amount of EUR 50,000) was not repeated in the protocol.

The intended extension of the application of § 8a *KStG* to loans granted by German shareholders to German corporations will have a substantial impact on the financing of German entities. For reasons of safe planning, the presently employed strategies developed with regard to § 8a *KStG* should be considered also in case of pure domestic

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shareholdings until a first draft of the new German Thin Capitalization Rules is available.

3. New Legislation on Interest Income

On March 18, 2003, the German Federal Ministry of Finance published the first draft of the new tax legislation with regard to interest income. On the one hand, the draft provides for a reform of the interest income taxation as of 2004, according to which certain interest income will be subject to a flat-rate taxation of 25 % to be withheld directly at the source of the interest payments. The new legislation will apply especially to interest payments made by (German) banks. In the event of payments made by non-German banks, the taxpayer will be able to file for the taxation of the respective interest income at the 25 % tax rate. In case the personal income tax rate of a taxpayer is lower than 25 %, he will be able to include the interest income in his "normal" income tax assessment.

In addition to this new flat-rate taxation for interest income, the draft dated March 18, 2003 provides for a tax amnesty in case of the supplementary declaration of income previously untaxed in Germany. The German government expects to repatriate a part of the capital of German taxpayers previously untaxed and held in deposit abroad. The tax amnesty will only apply, if the supplementary declaration of the untaxed income will be made by June 30, 2004, at the latest. If the income is declared by January 1, 2004, 25 % of the income declared will be payable as a flat-rate tax. If the declaration is filed between January 1, 2004, and June 30, 2004, 35 % of the declared income will be payable as flat-rate tax.

As a consequence of the tax amnesty, the German legislator expects additional revenues in 2003 of EUR 5 billion. On the other hand, the proposed flat-rate taxation for interest income will decrease tax revenues by approximately EUR 3 billion for years 2004 to 2006. According to some deliberations, the new legislation regarding interest income and the tax amnesty shall be put before the Lower and Upper House of German Parliament in early summer 2003. It should be noted that the opposition against the intended new tax legislation has increased over the last months due to alleged social deficits of the draft tax bill.

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4. New Tax Laws regarding Investment Funds

On March 6, 2003, the German Finance Ministry published its Finance Market Plan 2006, which contains, inter alia, a fundamental new structure for German investment fund taxation. Currently, the taxation of German investment funds is governed by the provisions of the German Investment Fund Act (“KAGG”) and the taxation of non-German investment funds by the Foreign Investment Fund Act (“AusInvestmG”). With regard to the tax provisions of the Foreign Investment Fund Act, the European Commission currently investigates, whether these tax provisions discriminate against non-German investment funds and therefore violate European law.

The German legislator intends to introduce a unified investment fund taxation act, applying as of January 1, 2004. The new investment fund taxation act shall apply both to German and non-German investment funds. Furthermore, the (currently) extremely complicated concept of German fund taxation should be simplified by this new legislation. It is intended (as already done with regard to the regulatory framework for investment funds) to closely link the tax provisions with the rules of the so-called UCITS Directive of the European Union (Directive 85/611/EWG).

The German Ministry of Finance has not yet published a first draft of the new investment fund taxation act. It is therefore unclear which way the legislator intends to define the scope of the new tax law with regard to non-German investment vehicles. This is especially of relevance for alternative asset funds (like private equity funds etc.).

Considering that the German legislator also intends to reform the regulatory provisions of the German Investment Fund Act, the new investment fund taxation act will have substantial influence on the German capital markets. New legislation might have a positive effect especially for alternative asset funds, which suffered in the past under the uncertainty with regard to the tax and regulatory framework in Germany. It should be noted that the German legislator intends to admit the registration of German hedge funds as regulated investment funds in the future. This action should support the development of the German finance markets over the next years.
