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1) Business tax reform: German Bundestag passes bill following amendment in parliamentary proceedings

As previously reported in our December issue of German Tax News, the German government has been discussing necessary measures for a business tax reform for months. In February 2007 a draft was published summarizing the planned amendments. A lively discussion regarding the proposed changes ended in an amended draft which passed the Bundestag (Lower House of Parliament) on May 25, 2007.

The following is a summary of the most important measures of this bill which will become effective on January 1, 2008:

- The corporate tax rate will be reduced to 15 %.
- Taxes will be reduced for sole proprietors and partners in business partnerships in regard to profits that are retained.
- The deduction of interest payments will be limited in that only interest payments which do not exceed 30 % of a company's annual profit may be deducted in the year of payment. Any excessive amounts can be carried forward to the following years. Up to EUR 1 million of interest payments may be deducted without limitation.

Note: Unlike in the draft bill, under the bill passed, depreciation will not be considered for the purpose of calculating the 30 % annual profit base.

- Under the trade tax, the tax assessment factor (Steuermesszahl) will be reduced from 5% to 3,5%.

Note: The base for the calculation of trade tax will be increased by including 25 % of all interest payments (regardless of whether the payments are made in regard to long-term or short-term financing) as well as 25 % of a so-called "financing rate", a fictitious financing portion of paid rental fees and royalties. An allowance of EUR 100,000 is intended to provide some relief for small and medium-sized businesses.

- The losses of a corporation acquired in a share purchase are only deductible by the new shareholders under strictly limited conditions. These conditions will be tightened by the business tax reform in that if between 25 % and 50 % of the shares are purchased, the losses may only be deducted on a pro-rata basis. If more than 50 % of the shares are purchased, the loss deduction will not be allowed at all.
- The declining balance method of depreciation will be abandoned.
- In regard to the depreciation of low-value assets, in the future only small or medium-sized enterprises will be allowed to depreciate assets up to EUR 410 in the year of purchase. For all other types of enterprises, only those assets costing up to EUR 150 may be directly depreciated (the first draft provided for a EUR 100 limit).
- Low-value assets with purchase prices between EUR 150 and EUR 1,000 must be accumulated in a "pool" and depreciated over 5 years. The pool will not changed, even if an asset is sold or becomes obsolete during the 5-year period.
- Enterprises with working capital of up to EUR 235,000 (first draft: EUR 210,000) will be allowed to set aside pre-tax up to 40 % of planned investments (in movable assets only). The reserve must be liquidated and will increase the taxable profit of the year in question, if no investment is actually made prior to the end of a three-year period beginning with the creation of the reserve.
- Section 1 of the International Tax Relations Law (Aussensteuergesetz, hereinafter "AStG") will be amended in regard to the transfer of functions from or to Germany. In such cases, a "transfer packet" will be calculated including all hidden reserves resulting from tangible and intangible assets, such as international business opportunities. For foreign corporations which transfer functions to Germany this could be advantageous, since it would enable them to depreciate intangible assets.
- A uniform withholding tax of 25% on all types of capital income will be introduced starting January 1, 2009.

Note: The adopted draft provides that losses from the sale of shares may only be charged against profits from the sale of shares and not against any other type of income.

2) European Court of Justice: The German legislation limiting the deductibility of losses incurred in book-value write-downs of foreign shareholdings restricts the freedom of establishment

The European Court of Justice (ECJ) was again called upon to review a German regulation which restricts the deductibility of losses simply because they originate from a subsidiary domiciled outside of Germany. The German tax law under review provides that a parent company estab-

lished in Germany may deduct from its taxable profit the losses it incurs in regard to the book-value write-downs of shareholdings in subsidiaries only if such companies are also established in Germany. The law further provides that losses of the same kind stemming from shareholdings in subsidiaries established in other Member States are deductible only if those subsidiaries subsequently generate positive income of the same kind or if they carry on an activity of a commercial nature.

A German company which owned a subsidiary in the Netherlands nevertheless made write-downs to the book value of its participation in that subsidiary which it wished to take into account as losses in the calculation of its taxable profit in Germany. Since the local tax authority disallowed the losses stemming from such write-downs, the company brought an action before the relevant German tax court which referred the question to the ECJ for review.

In its judgement delivered on March 29, 2007, the ECJ first held that the German legislation constitutes a restriction on the freedom of establishment since the legislation applies a different tax treatment to parent companies depending on whether their losses stem from write-downs regarding resident or non-resident subsidiaries. The ECJ further noted that simply because a company decides to carry on economic activities in another member state of the European Community in which Germany cannot exercise its taxing powers is not adequate justification for the different treatment. Furthermore, the Court did not see any danger that losses incurred abroad will be taken into account twice.

The German Ministry of Finance reacted to the decision by issuing a decree on June 11, 2007 stating that Section 2a (1)1 No. 3a Income Tax Code, which restricts the deductibility of losses stemming from the book value write-downs of shareholdings in subsidiaries located in other Member States, is no longer applicable and that such losses may now be deducted under the same conditions as losses stemming from Germany subsidiaries.

An exception was made, however, for Liechtenstein subsidiaries and losses that result from write-downs originating from circumstances existing outside of the European Union.

3) Tax Court Münster / ECJ: Compatibility of various sections of the AStG with the EU law to be reviewed.

A case was brought before the tax court of Münster by Columbus Container Services B.V.B.A. & Co, a Belgian commercial partnership, which was taxed as a coordination center at a reduced tax rate of 30 % in Belgium. In regard to a German member of the partnership, the X-KG, the German tax authorities treated the partnership income as taxable business income and credited against the German taxes only those taxes actually paid in Belgium.

The German tax authorities based this treatment on sections 20 (2) and (3) AStG. This provision states that in regard to the passive income of a foreign permanent establishment (or partnership) of a party subject to unlimited German tax liability, which would be liable to tax as a

controlled-foreign-corporation (CFC) if the permanent establishment were a foreign corporation, double taxation is to be avoided through a tax crediting rather than through exemption.

Income from a permanent establishment is generally exempted from taxation in Germany if the resident state concludes a double taxation treaty with Germany. For foreign subsidiaries in the form of a corporation, however, the AStG for many years contained anti-deferral clauses. Sections 20 (2) and (3) AStG were adopted in order to prevent the misuse of permanent establishments and partnerships in such situations.

The Belgian partnership appealed against the German tax authority's treatment and argued that the German tax law violates EC law since Sections 20 (2) and (3) AStG make an unjustified differentiation between foreign permanent establishments (and partnerships) and those located within Germany and therefore violates the freedom of establishment laid down in Article 52 of the EC Treaty (now Article 43 EC).

The tax court of Münster submitted the case to the ECJ, the decision of which is still pending. While the Attorney General of the ECJ, in his final application, took the position that Sections 20 (2) and (3) AStG generally violate EC law, he has noted that they nevertheless may be justified in certain cases in order to avoid abuse.

Similarly situated taxpayers, whose foreign income has not been exempted from taxation but rather made subject to a tax-credit method under Sections 20 (2) and (3) AStG, should appeal against these tax assessments with reference to the case C-298/05 Columbus Container Services BVBA & Co.

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