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German Tax News

September 2007

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1) Ministry of Finance: Decree regarding the taxation of financial innovations

Income from capital investments is taxable in Germany in two different manners. Remuneration received for the commitment of capital (interest, for example) is always taxable as a general principle, whereas income arising from the increase in the value of the capital itself (capital gains) remains tax free if the capital cannot be regarded as business assets and was held for a period of not less than one year.

Given these general principles, banks and financial service providers have been eager in the last few years to create innovative investment schemes which allow investors to generate tax free capital gains income rather than income from capital commitment such as interest.

The German tax authorities, however, in reacting to this development amended Section 20(2) No. 4(2) of the German Income Tax Code (Einkommensteuergesetz hereinafter "EStG") in 1994. Since then, the issue yield – in cases where an issue yield cannot be evaluated the market rate of return - is subject to taxation.

This regulation was accepted as consistent with the German Constitution by the Federal German Tax Court in its decision from December 13, 2006, but only under certain conditions. These conditions were discussed in a second Federal Tax Court decision, also from December 13, 2006, which pointed out that the taxation of a market rate of return is not allowable in cases in which income from capital commitment and from capital growth is clearly definable and calculable.

On July 18, 2007, the Federal Ministry of Finance issued a decree responding to the above-mentioned decisions in which it clarifies that the decisions have no relevance for the calculation of withholding tax but only within the tax assessment procedure. The tax authorities are urged to follow the taxpayer's statement regarding the amount of taxable income from a financial investment, even if he is no longer able to choose between the declaration of the issue

yield and the market rate of return. In cases of greater financial interest, the taxpayer can be requested to prove the issue yield.

As a general rule, however, Section 20 (2), No. 4(2) EStG is no longer applicable to bonds for which income from capital commitment and from capital growth is clearly definable and calculable.

2) Federal Tax Court: Interest payments on a loan used to finance the acquisition of shares in a corporation can be deductible under certain conditions even after the shares are contributed into another corporation

On March 27, 2007, the German Federal Tax Court heard a case regarding the deduction of interest payments as capital income-related expenses. In the case under consideration, a taxpayer originally held 50% of the shares of a corporation (GmbH 1). The taxpayer provided a guarantee for GmbH 1 which later drew on the guarantee. In order to finance the guarantee payment, the taxpayer took out a loan of 700,000 EUR.

The taxpayer was also shareholder of another corporation (GmbH 2), into which he contributed the shares of GmbH 1. In return for the contribution he received approximately 30,000 EUR which were charged against existing loans.

In his income tax return, the taxpayer claimed a deduction for the interest payments on the loan. The tax authorities denied the deduction arguing that there was no direct connection between the interest payments and any kind of income. The loan had originally been taken out in order to finance the guarantee for GmbH 1 but after contributing the shares of GmbH 1 to GmbH 2, the taxpayer no longer had direct income from it but rather this income flowed to GmbH 2.

The Federal Supreme Tax Court basically agreed with the tax authorities but referred to prevailing case law stating that in the case of the sale of an asset which has been used to achieve taxable income, interest payments arising on the financing of the assets remain deductible if the sale profits are reinvested into another asset which also generates taxable income.

The new aspect of the case considered was that the shares were contributed to another GmbH rather than being sold. The Court regarded this process as comparable to an exchange and therefore as in return for payment stating that it made no difference that there was no cash payment but only the charging against loans.

According to the Court, however, the deduction of interest payments is restricted to the amount which corresponds to the reinvested profit. Since the taxpayer received only 30,000 EUR which he could reinvest, but paid interest on a loan of 700,000 EUR, the interest payment could only be deducted proportionately.

3) Federal Tax Court: A deferred item must be dissolved if within a tax group the controlling company sells its shares of the subsidiary company

With its decision from February 7, 2007, the Federal Tax Court contradicted the tax authority's long standing approach and stated that the regulation contained in section R 63

(3) of the Corporate Tax Guidelines (Körperschaftsteuerrichtlinien; hereinafter "KStR") is no longer applicable.
The Court was called on to decide the case of a holding company H which held shares of a subsidiary company S which incurred losses from participation in another company. Since H and S formed a tax group for German tax purposes, the losses of S were attributed to the H's taxable income and resulted in reducing the H's tax burden. Since the losses were calculated differently for tax and commercial law purposes, H had to show a deferral in its balance sheet representing the resulting difference.

Since H sold the shares of S, the question arose as to how the deferred item should be treated. The tax authorities, referring to section R 63 (3) KStR, dissolved the deferral while simultaneously increasing H´s taxable income.

The Federal Tax Court, on the other hand, was of the opinion that there is no legal basis for any treatment other than a dissolution without any influence on taxable income. The Court noted that there is no legal justification for the fact that the tax authorities have acted according to the Corporate Tax Guidelines and that, since the regulation has been discussed among tax experts for many years without consensus, it cannot be regarded as a general principle. The Court held, therefore, that a deferred item must be dissolved without any effect on income if the shares of a subsidiary company are sold by the controlling company of a tax group.

4) Federal Tax Court: The transfer of capital to a Liechtenstein foundation is not taxable under the Gift Tax Code if the foundation is not allowed to freely dispose of the foundation assets

In a case addressed by the German Federal Tax Court, a German taxpayer authorized a Liechtenstein lawyer to manage the establishment of a Liechtenstein foundation with an initial capital donation of 30,000 SFr and an additional contribution of 1,000,000 SFr at a later date.

Under German law, a foundation is generally regarded as an independent legal entity. In the case decided, however, the Court noted that the foundation was restricted by its charter and additional agreements in its decisions regarding the management of its capital and that the German benefactor had the actual authority to make such decisions. This being the case, the Court held in its decision from June 28, 2007 that the transfer of the 1,000,000 SFr was not a gift since, under Section 7(1) of the Gift Tax Code (Schenkungssteuergesetz) the grant of capital is only taxable if the beneficiary is able to freely dispose of the capital.

5) Value added tax: A short outline of the latest developments

Federal Tax Court Decision:

In a decision from March 21, 2007, the Court held that an entrepreneur whose turnover is taxable under Section 1(1) no. 4 UStG (on the import of goods) but tax free under Section 5 UStG (regulating the exemption from VAT in special import cases) is considered a debtor of import turnover tax in accordance with Section 3(8) of the German VAT Act (Umsatzsteuergesetz, hereinafter "UStG").

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Decree of the Federal Ministry of Finance:

1) In a decree from May 22, 2007, the Federal Ministry of Finance noted that input VAT from the purchase or construction of a building which is intended to be used to generate turnover both exempt from as well as subject to VAT, need not be apportioned in accordance with the rules laid down in a former decree from November 24, 2004. The decree also points out that the differentiation between expenses for the construction of the building and mere maintenance costs -- as favored by the German Federal Tax Court in a decision from September 28, 2006 -- is not generally applicable. According to the Ministry of Finance, the method that will lead to an adequate result in most cases is the apportionment of the input VAT in proportion to floor space that is used to generate taxable or non-taxable turnover, respectively.

2) A decree of the Ministry of Finance from May 31, 2007 sets forth and illustrates the following criteria which will lead to a VAT duty in regard to turnover generated between a company and the members of the company.

   - the company member acts as an independent person and not as an employee,

   - a corporation acting as a company member is always regarded as independent other than in cases of a VAT group,

   - services performed by a company member in order to fulfill the duties of the company agreement do not lead to VAT; only services beyond such agreement are taxable,

   - examples of particular cases including the withdrawal of assets or capital, remuneration for the assumption of liability and cases of mixed remuneration.

VAT Act:

Section 13b (3) no. 4 UStG has been amended effective from fiscal year 2007. Under the so-called reverse-charge procedure set forth by this provision, VAT liability is shifted to the recipient if he is domiciled outside Germany. This regulation has been restricted in cases of trade fairs, congresses and exhibitions organized by a foreign entrepreneur in Germany with the effect that stand fees in such cases are no longer subject to a reverse-charge procedure. The participants of the event receive invoices including VAT and only the organizer must pay VAT on his turnover.

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