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Recent tax developments for companies in Germany and French-German tax convergence

François Hellio, Stéphane Austry, Daniel Gutmann, Angelika Thies, Heino Büsching, Thomas Link, Jesko Nobiling

Current status of the tax convergence between France and Germany

– Main steps up to now :

- March 2011 : Following a request from the President of the French Republic, delivery of a report on « social and tax levies in France and Germany » (Court of Accounts)
- 16 August 2011 : French-German Summit ; joint statement by N. Sarkozy and A. Merkel
- February 2012 : Green Paper on French-German Cooperation focusing on possible convergence points in the field of taxation of companies

France has already started the process

- Tax treatment of deficits

- VAT reforms
  - Lower rate increased
  - « Social VAT »

- However, recent reforms are not always coherent with the objective of convergence

What to expect from the Green Paper of February 2012 ?

Germany as a source of inspiration for France	France as a source of inspiration for Germany	Convergence on mutual standards	No convergence necessary
Deductibility of interest	Parent-subsidiary regime	Deficit carry-forward/back	Territoriality
Deductibility of local taxes	Group consolidation		Provisions
Depreciation rules			R&D
Corporate income tax rate			Capital gains on participations
Partnership taxation			

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General Overview:
Company Taxation in Germany
- applicable interest deduction rules

Prof. Dr. Angelika Thies
CMS Hasche Sigle, Munich

Agenda

I. Background: French-German tax convergence

II. Company taxation in Germany

III. Interest deduction rules

    1. General principles

    2. Case study

    3. Interest barrier rule

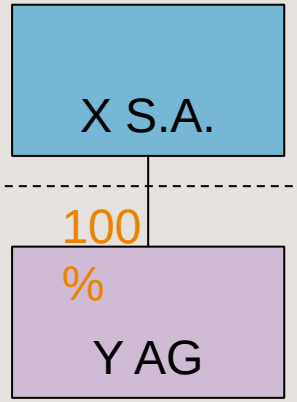
IV. Loss deduction rules

I. Background

– the Green Book on French-German co-operation on company taxation, released on
6 February 2012, identifies as potential fields for tax convergence:
  - tax rates
  - group tax regimes
  - taxation of dividends and interest
  - loss deductions
  - depreciation and amortization
  - partnership taxation

– current status: plans for implementation of proposed changes in Germany

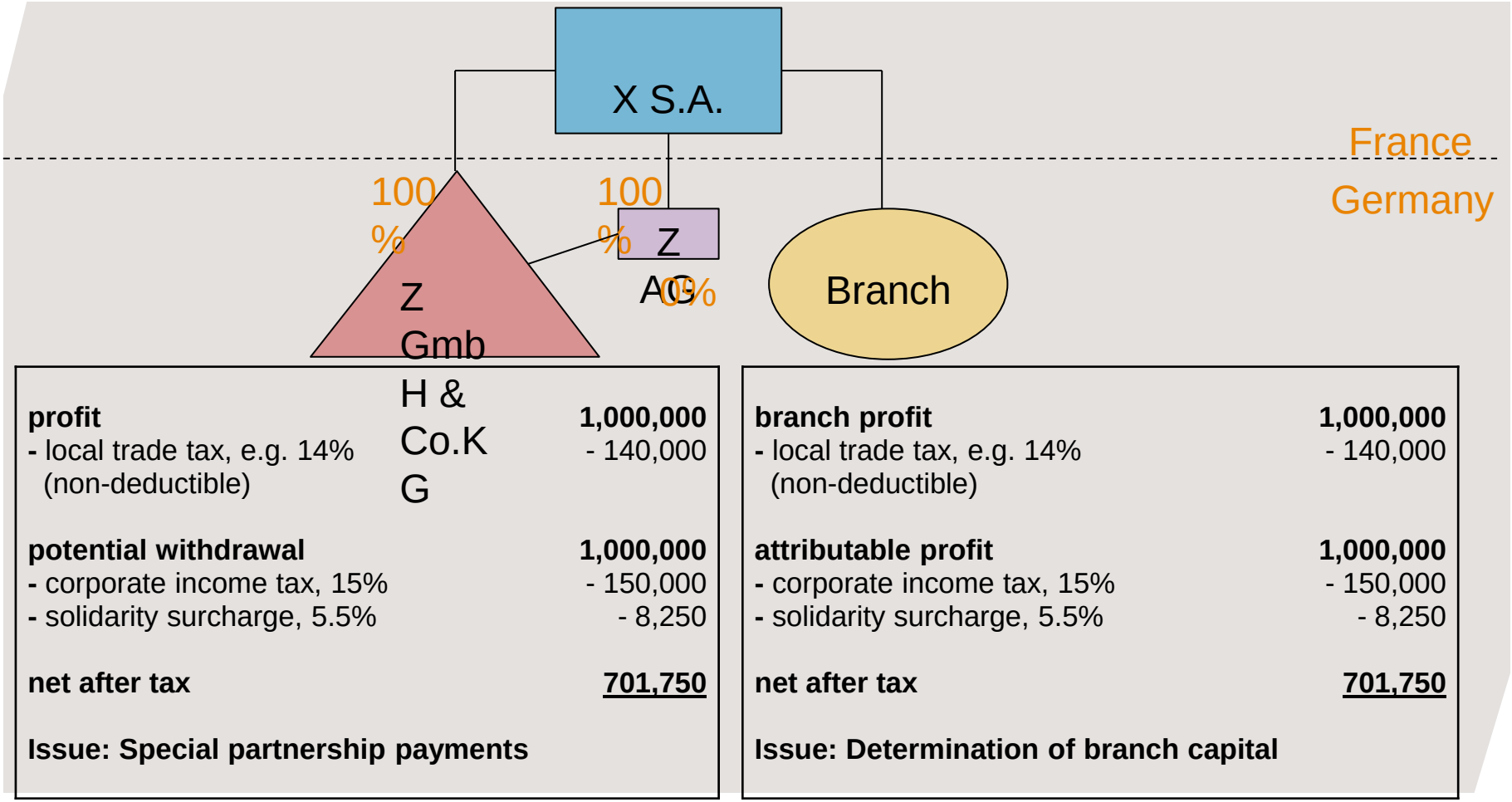
II. Company taxation in Germany (1)



profit	**1,000,000**
- local trade tax, e.g. 14% (non-deductible)	- 140,000
- corporate income tax, 15%	- 150,000
- solidarity surcharge, 5.5%	- 8,250
net after tax	**701,750**

witholding tax:	
dividend	**701,750**
- standard rate, 26.375%	- 185,087
- local reduction, 15.825%	- 111,052
- DTT, 15%	- 105,263
- DTT, 5%	- 35,088
- EU (>10%;>12 months), 0% (limitation: § 50d (3) EStG)	0
net after witholding tax	
DTT (15%) / DTT (5%) / EU	**596,487 / 666,662 / 701,750**

II. Company taxation in Germany (2)



profit	**1,000,000**
- local trade tax, e.g. 14% (non-deductible)	- 140,000
potential withdrawal	**1,000,000**
- corporate income tax, 15%	- 150,000
- solidarity surcharge, 5.5%	- 8,250
net after tax	**701,750**

Issue: Special partnership payments

branch profit	**1,000,000**
- local trade tax, e.g. 14% (non-deductible)	- 140,000
attributable profit	**1,000,000**
- corporate income tax, 15%	- 150,000
- solidarity surcharge, 5.5%	- 8,250
net after tax	**701,750**

Issue: Determination of branch capital

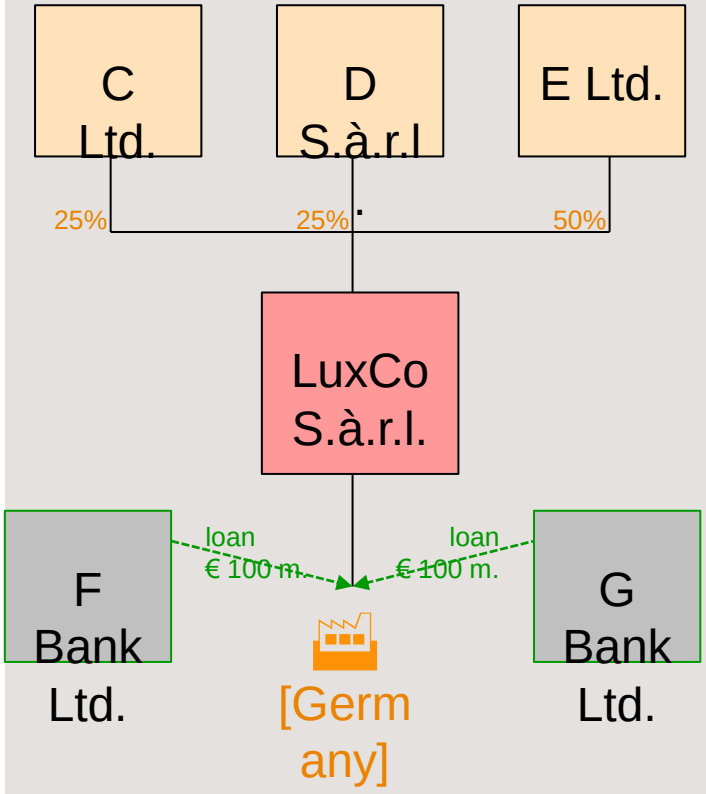
III. Interest deduction rules (1)

- general rule
  - interest deductible up to an amount of 30% of tax EBITDA
  - exceeding interest amount to be carried forward indefinitely
  - EBITDA can be carried forward to the extent not used
- exemptions
  - threshold of € 3 m.
  - no group of related companies
  - escape clause (debt-to-equity ratio)
- limitation of interest deduction applicable to
  - all interest (inter-company + third party)
  - German and non-German corporations and partnerships
  - ongoing financing + acquisition financing

III. Interest deduction rules (2)

Case study:

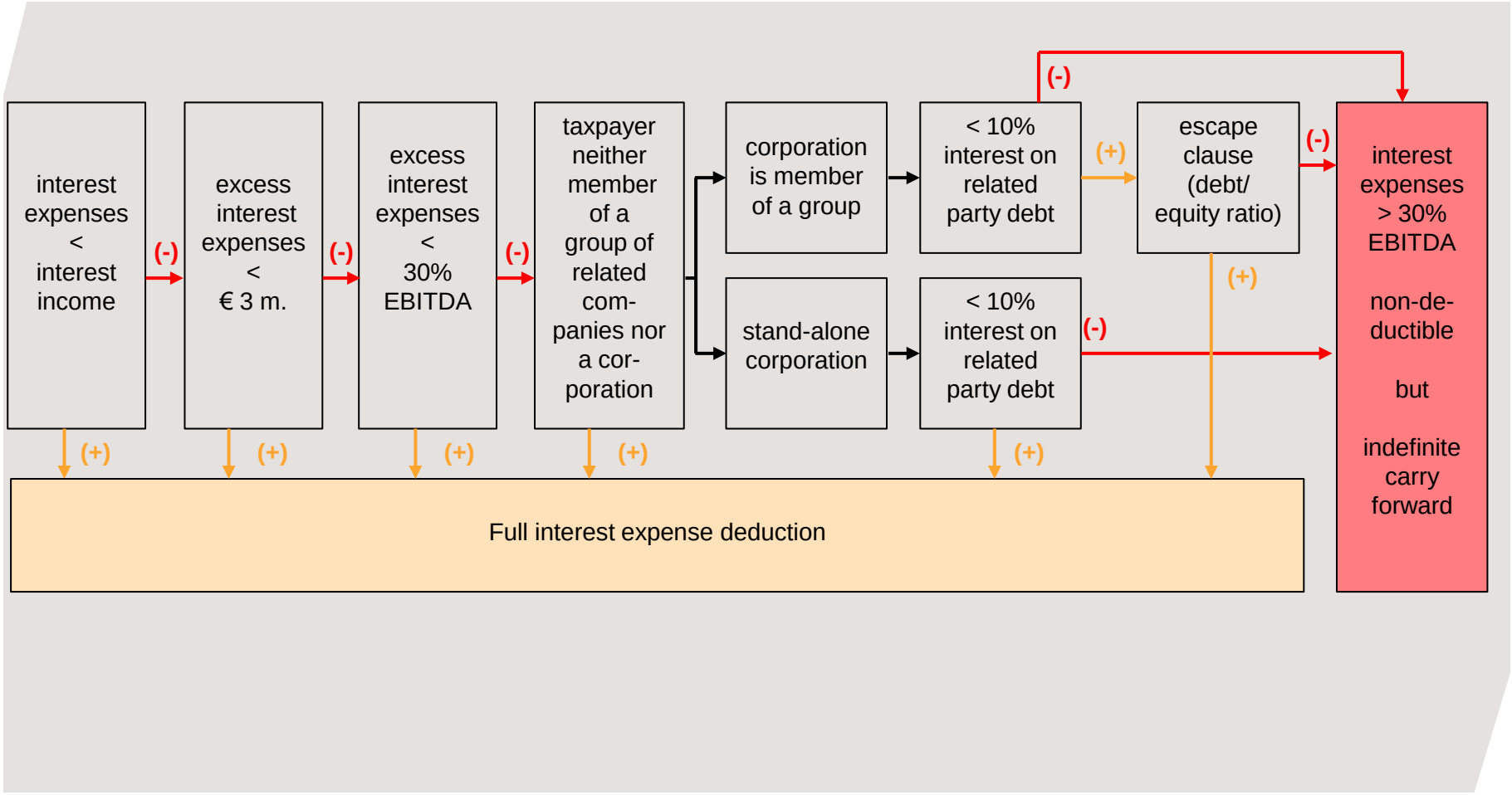
(FG Berlin-Brandenburg, 13 October 2011)



- fiscal year 2008 (LuxCo):
  - Loss € 543,000
  - Interest € 8.8 m.
  - EBITDA € 11.9 m.
- tax assessment
  - Annual taxable income € 4.7 m.
  - Losses carried forward € 2.0 m.
  - Remaining taxable income € 2.7 m.

- limitation of interest deduction deemed unconstitutional
- at least 5 cases pending

III. Interest deduction rules (3)



IV. Loss deduction rules

- change-of-control provision deemed unconstitutional
- Constitutional court proceedings pending

1. General principle
   - losses can be carried forward indefinitely
   - losses can be carried back to preceding year (limited to € 511.500)
2. Minimum taxation
   - losses carried forward can be fully set off against € 1m. net income per year and up to 60% against the net income exceeding this limit
3. Change-of-control provision for corporations
   - loss forfeiture if within 5 years more than 50% of the capital or voting rights are directly or indirectly transferred
   - pro-rata loss forfeiture if 25–50% of the capital or voting rights are transferred
   - exemptions:
     – intragroup reorganizations (100% ownership required)
     – to the extent of existing hidden reserves

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General Overview: "Group" Taxation in Germany

Dr. Heino Büsching
CMS Hasche Sigle, Frankfurt

Agenda

I. Overview – Group Taxation in Germany (*Organschaft*)

II. Preconditions for a group taxation (CIT; TT)

III. (Tax) Consequences

IV. Current Status-Analysis

V. Developments – Cross Border Group Taxation?

I. Overview - Group Taxation in Germany (*Organschaft*)

"Group Taxation" for

– Corporate Income Tax (CIT)

– Trade Tax (TT)

– VAT

II. Preconditions for a group taxation (CIT, TT)

- Mother company (HoldCo) – any legal entity active in business
- Subsidiary (SubCo) – only corporate entities
- Financial integration
  - Participation of more than 50 %
  - From the beginning of a fiscal year
- Profit and loss transfer agreement/profit and loss transfer and control agreement (PLTA)
  - PLTA must be concluded for at least 5 years and be enforced during such period
  - Termination only for good cause

III. (Tax) consequences

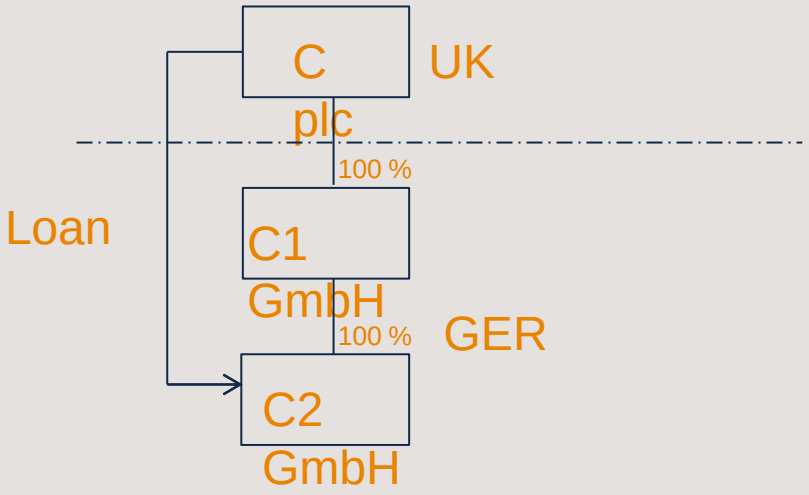
- Income of SubCo to be allocated to HoldCo
- No consolidation of income!
- HoldCo and SubCo are seen as <u>one</u> entity for the application of interest barrier rule

IV. Current Status - Analysis

- Group taxation requires PLTA
  → full liability of HoldCo for losses of SubCo/transfer of earnings
  → Compensation for minority shareholders (if any) required
- Strict interpretation of preconditions

V. Developments – Cross Border Group Taxation

- Decision 2011: Supreme Tax Court holds cross border TT group as possible for financial years until 2001!
  - The case



- Reaction of
  - Tax administration – No general acceptance
  - Government – No new law yet
- From 2002 onwards:
  - Requirement of a PLTA!?

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Modified German Substance Requirements

Dr. Thomas Link
CMS Hasche Sigle, Hamburg

I. Problem

Interposition of corporate entities to achieve indirect tax relief for persons who do not qualify for such relief (Treaty of Directive Shopping)

II. Historic Concepts

- Until 1993 only abuse of legal form concept (→ did not apply to non-tax residents)
- From 1990 ban on purely artificial structures (foreign entity did not have offices or personnel nor communication means or entity did not participate in general business)
- From 1994 relief was refused if interposition of foreign entity was not justified by economic or other significant (e.g. legal) reasons and entity did not conduct economic activities

III. 2007 Rules Challenged by Commission

– From 2007 treaty and directive benefits are refused for a foreign corporation if and to the extent its shareholders are not entitled to the tax relief if the income is received by the shareholders directly

and

- the use of the intermediate corporation does not have economic or other important reasons

or

- the foreign corporation does not generate more than 10% of its gross income from own active business

or

- the foreign corporation is not adequately equipped for carrying out its business

– EU-commission has started infringement procedure on 18 March 2010 with respect to the 10% own business rule.

IV. Legislative Response

– From 2012 treaty and directive benefits are not available for a foreign corporation if and to the extent its shareholder(s) are not entitled to the tax relief if the income is received by the shareholders directly

and

- the foreign corporation does not generate its gross income of the relevant fiscal year from own active business

and

- with respect to such non-active income there is no economic or other important reason to interpose the foreign corporation

or

- the foreign corporation is not adequately equipped for carrying out its business.

V. Legislative Response (cont'd)

– This test does not apply to foreign listed corporations with regular and substantial trading activities or if the foreign corporation falls within the scope of the German Investment Tax Act.

VI. Changes Analysed

- 10% own business activity test repealed
- Factual qualification for tax relief is now available if and to the extent the gross revenues are derived from own business activity
  → The percentage of revenues from own business will always secure a corresponding percentage of relief.

VII. Details of New Rules Analysed

Shareholders without personal tax relief

– Shareholder is an individual
(→ special treatment for French SCSs!).
– Shareholder is not an EU-corporation qualifying for PSD benefits.
– Shareholder does not qualify for treaty benefits.

VIII. Details of New Rules Analysed (cont'd)

Own business activity

- Corporation participates in general trade beyond pure asset holding activities and takes part in market activities in a constant and sustained manner.
- Includes services rendered to group companies on arm's length basis.
- Active management of at least two (?) group companies of a certain significance
  - Active management means business policy decisions of long-term nature, fundamental importance and relevance for the controlled company.
  - Significance is related to the intensity of the management.
  - Shareholding of more than 25% indicates management influence.
  - No management contract required.
  - Single functions such as IP-management or cash management is not sufficient.
  - Active business includes dividends, interest and royalties from managed subsidiaries.
  - Written documentation required.

IX. Details of New Rules Analysed (cont'd) (1)

Economic or other important reasons for interposing foreign corporation

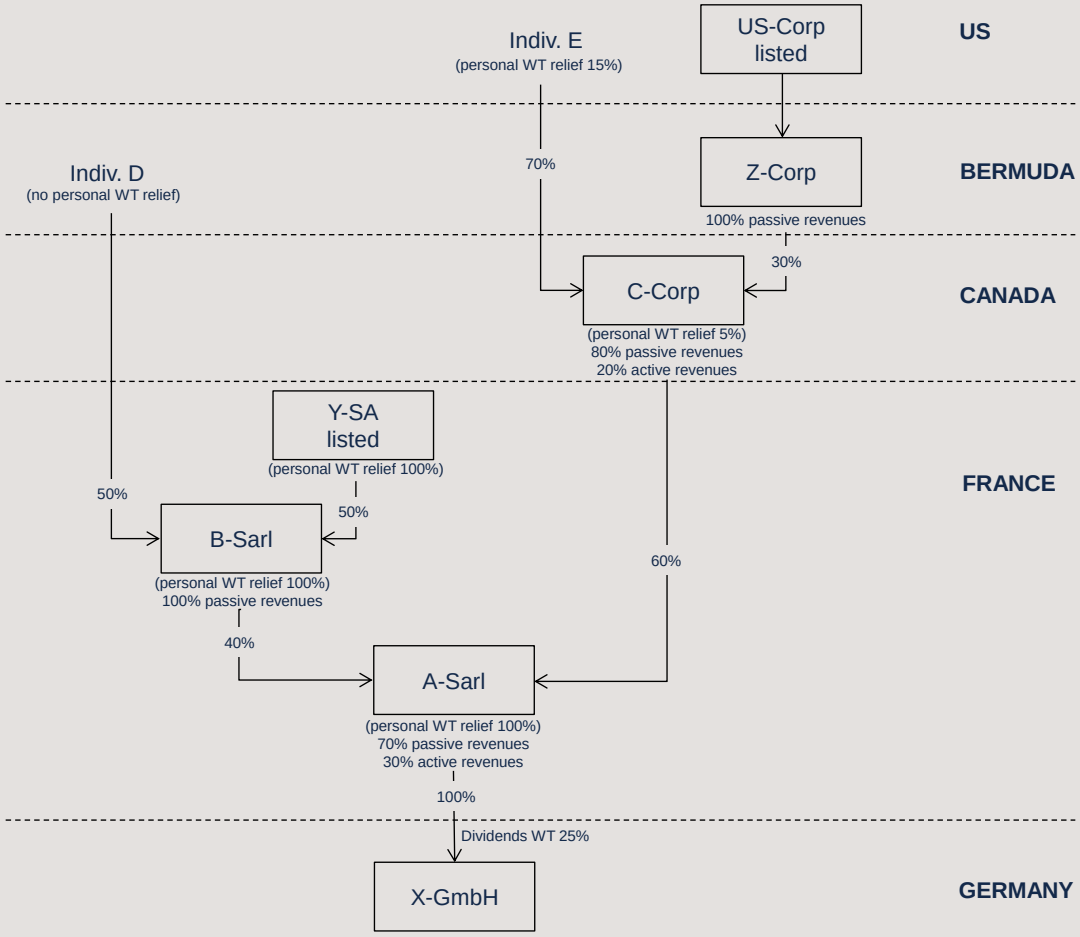
- Only refers to reasons set by the foreign corporation.
- Considerations on group level (e.g. co-ordination, strategy, costs, local preferences) are not relevant.
- Economic: Foreign corporation has or intends to have own active business.
- Other reasons: Legal, political or religious reasons.

IX. Details of New Rules Analysed (cont'd) (2)

Adequate business equipment

- Business equipment must be adequate for functions carried out by foreign corporation (e.g. own personnel, office, technical communication equipment)
- "Physical existence" of business equipment requires:
  - Managing and supporting personnel must be hired
  - Personnel must have qualification to perform functions by itself
  - Arm's length principles observed for intra-group dealings.

Example


US-Corp
listed
US
Indiv. E
(personal WT relief 15%)
70%
Indiv. D
(no personal WT relief)
Z-Corp
BERMUDA
100% passive revenues
30%
C-Corp
CANADA
(personal WT relief 5%)
80% passive revenues
20% active revenues
Y-SA
listed
(personal WT relief 100%)
FRANCE
50%
50%
B-Sarl
(personal WT relief 100%)
100% passive revenues
60%
40%
A-Sarl
(personal WT relief 100%)
70% passive revenues
30% active revenues
100%
Dividends WT 25%
X-GmbH
GERMANY

Example (cont'd)

Calculation of relief

1. Factual test: A-Sarl

Relief for 30% of dividends because of own acitivities 30

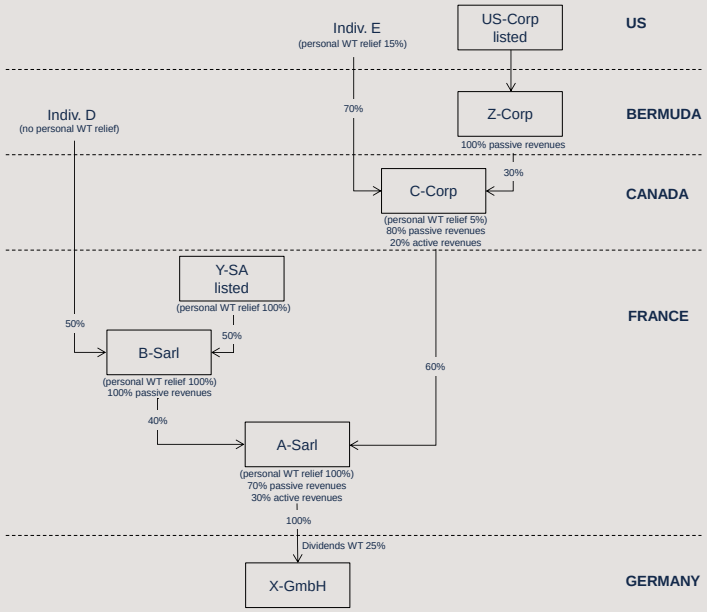
2. Personal test: A-Sarl

Relief for 70% of dividends depends on potential relief for shareholders

B: - personal relief (+)
- factual relief (–)
→ shareholders of B
- D personal relief (–)
- Y personal relief (+)
factual relief (+): (70% x 40% x 50%) 14

C: - personal relief (+)
- factual relief: → 20% (+) (70% x 60% x 20% x $\frac{20}{25}$) 6,72
→ 80% (–)
→ shareholders of C:
- E personal relief (+)
(70% x 60% x 80% x 70% x $\frac{10}{25}$) 9,41
- Z personal relief (-)
(active US-Corp is not relevant)

Total relief (30% + 14% + 6,72% + 9,41%) 60,12



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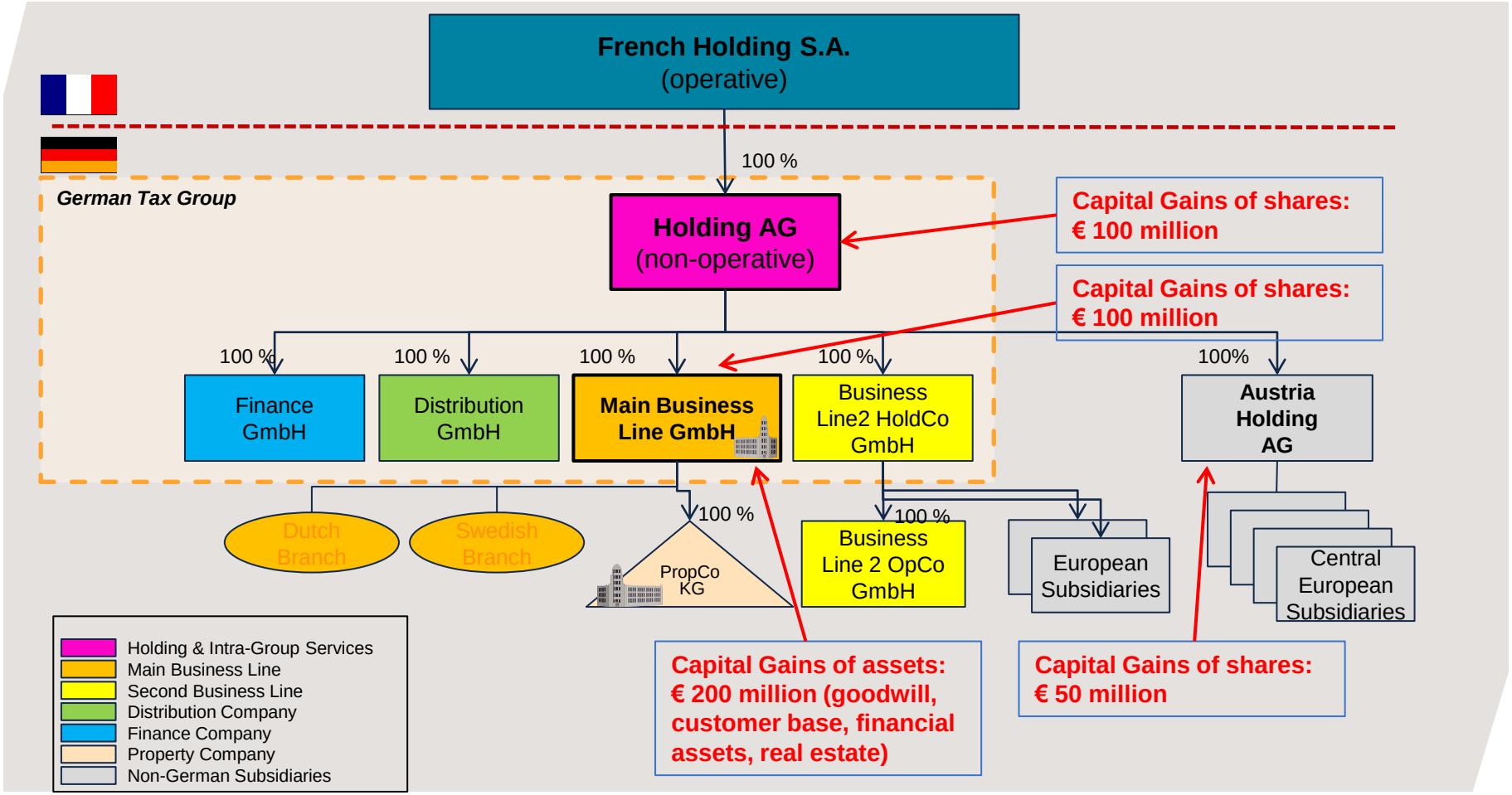
Cross-Border Mergers
German Tax Pitfalls & Case Study

Jesko Nobiling
CMS Hasche Sigle, Berlin

I. Case Study – Initial Structure (simplified)



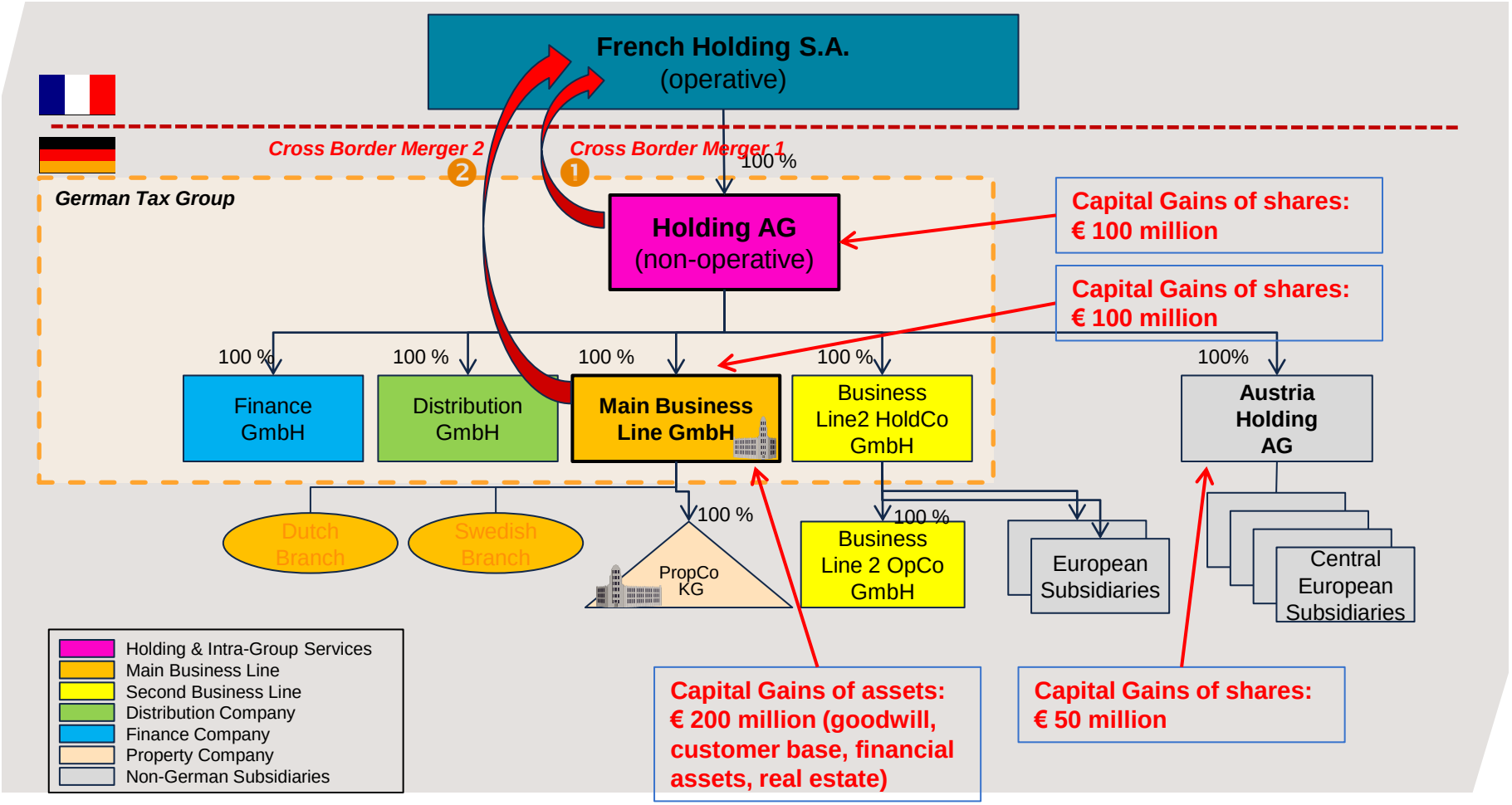
II. Case Study – Facts

- Facts
  - French Holding Company (with own operational business)
  - German Holding Company (no own business activities)
  - German HoldCo holds (*inter alia*) the following subsidiaries
    - German OpCo 1 (representing the main business line), highly profitalbe
      - amount of latent capital gains of assets: € 200 million (goodwill; client relationship; financial assets);
      - amount of latent capital gains of the shares in OpCo 1: € 100 million
    - German SubHoldco, holding all shares in German OpCo 2 (German OpCo 2 is also highly profitable)
    - Austrian HoldCo, acting as the head of the Central European Platform (latent capital gains: €50 million); shares are held by German HoldCo as financial asset
  - German companies have close business relationships to each other

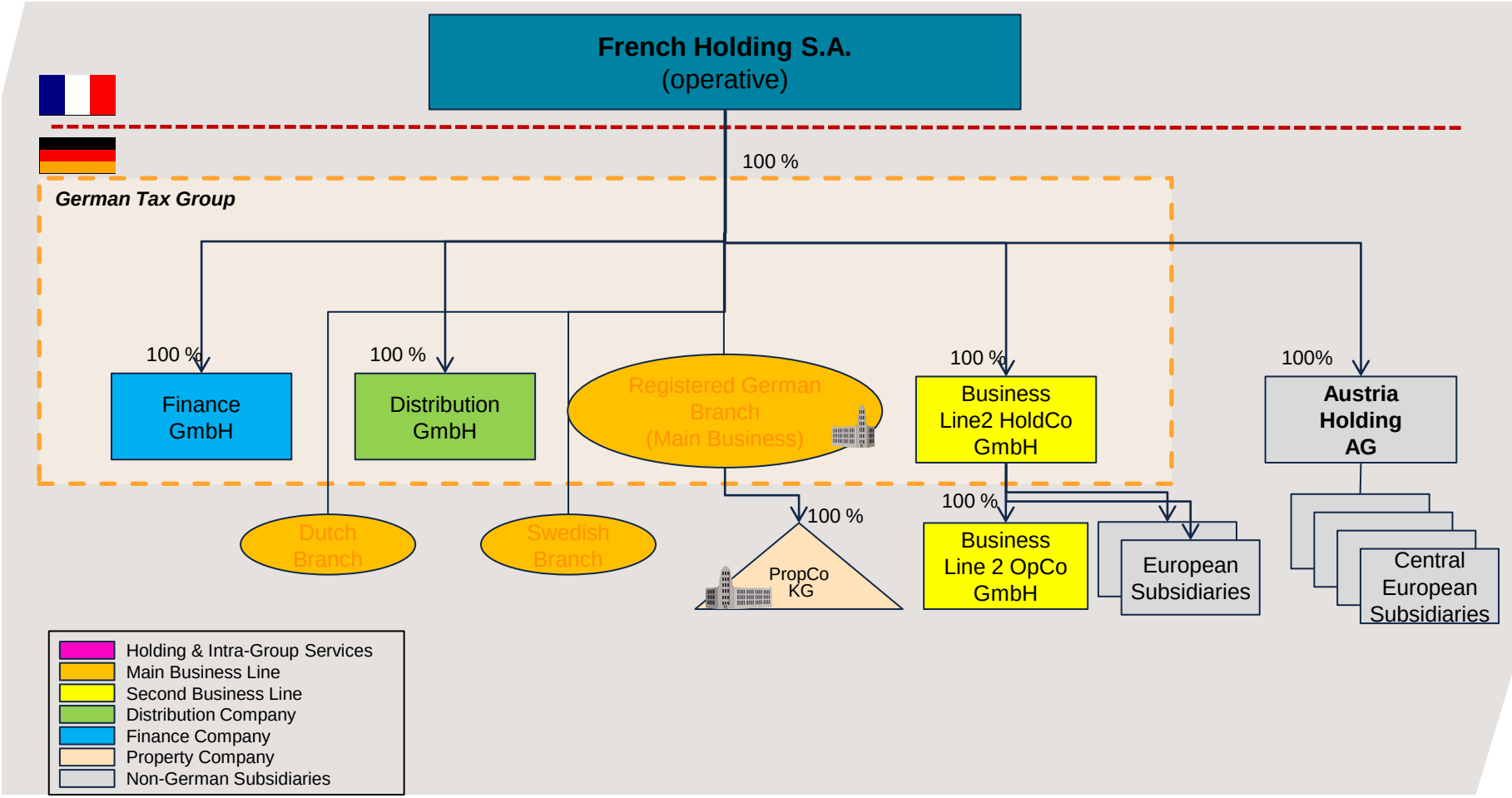
III. Case Study – Goals of Restructuring

- Goals of the German restructuring:
  - German HoldCo shall be merged into French HoldCo
  - German OpCo 1 shall be merged into French HoldCo immediately after effectiveness of merger 1
  - German business of OpCo 1 shall be continued in Germany as a German branch of French HoldCo
  - Merger shall be carried out on a tax-neutral basis (in accordance with the European Merger Directive)
  - German tax group (fiscal unity) shall be maintained after the merger

IV. Case Study – Proposed Restructuring



V. Case Study – Final Structure



VI. European Merger Directive (90/434/EEC)

- European Merger Directive (90/434/EEC):
  - Principle of Tax Neutrality of Mergers:
    - Art. 4: "*A merger (…) shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes."*
    - Art. 7: "*Where the receiving company has a holding in the capital of the transferring company, any gains accruing to the receiving company on the cancellation of its holding shall not be liable to any taxation."*
    - Art. 8: "*On a merger (…), the allotment of securities representing the capital of the receiving (…) company to a shareholder of the transferring (…) company in exchange for securities representing the capital of the latter company shall not, of itself, give rise to any taxation of the income, profits or capital gains of that shareholder.*"

VII. Case Study – General German Rules

- General rules:
  - Tax treatment of the transfer of assets:
    - Upon application, mergers can be carried out at book values (= tax neutral) if and to the extent that the German taxation rights for the assets of the merged companies is neither excluded nor restricted
  - Tax treatment of capital gains of the shares of the merged Company:
    - No taxation of capital gains, but 5% of such profits are regarded as non-tax-deductible business expenses (= are taxable)
- Decree of the German tax administration:
  - A cross border merger does not result in a different allocation of assets (and thus not in a taxable capital gain), "**but the general principles for the allocation of assets to a branch or the head office apply**".

VIII. Case Study – German Tax Pitfalls (1)

- German tax authorities: General Doctrine of "centralised function of the headoffice" applies after a merger
  - This doctrine means that assets which have no direct and functional link to the surviving branch, must be allocated to the headoffice (no "option right" for the management to allocate these assets to the PE on an voluntary basis or by accounting.
  - This general tax doctrine is relevant for:
    - shares in subsidiaries (unless the shares functionally belong to a German PE)
    - goodwill of the merged company
    - IP-rights and other intangible assets
    - financial assets
  - Consequences of an allocation of German assets to a foreign PE:
    - **immediate taxation of capital gains (Exit taxation)!**

VIII. Case Study – German Tax Pitfalls (2)

- German Tax Consequences (selected aspects):
  - **Decisive Question: Can the assets of the merged company be functionally allocated to a German PE after the merger???**
  - Merger of German HoldCo into French HoldCo SA:
    - Shares in Austria HoldCo qualify as financial assets and must be allocated to French HoldCo from a German tax perspective
      - 5% of the capital gains of € 50 million are taxable at approx. 30%
    - Can the shares in the German subsidiaries be allocated to a German PE???
      - according to the doctrine: shares are typically deemed to belong the headoffice unless they are integral part of a German PE
    - No German taxation of the termination of the shares in German HoldCo possible (due to Art. 7 (1) of the German/French double tax treaty)

VIII. Case Study – German Tax Pitfalls (3)

- German Tax Consequences (selected aspects - cont'd):
  - Merger of German OpCo1 into French HoldCo:
    - latent capital gains of German real estate are not taxed
    - latent capital gains of the goodwill: Allocation to a German PE (branch) or to the French headoffice?
    - latent capital gains of financial assets: Allocation to a German PE???
    - taxation of a merger profit resulting from the dissolution of the shares in German OpCo1 (5 % of € 100 million are taxable at approx. 30%)
  - Survival of the German tax group?
    - Can the requirements for a German fiscal unity be met if the head of the tax group is French company (assumption and/or conclusion of profit and loss pooling agreement between a French HoldCo and German subsidiaries)?
    - Additional formal requirements under German tax law to be met!

IV. Case Study – Possible Solutions

- Possible Solutions / Recommendations:
  - Appropriate tax structuring prior to the merger
    - e.g. creation an operational German PE in due time before the merger is concluded (or even simultaneously)
  - Application for a binding ruling in order to get legal certainty
    - but limited effects of a positive ruling, as the effectiveness of such binding ruling depends on the compliance with the described facts
  - European Law: application of the ECJ-decision in the "National Grind Indus"-case (C-371/10)?

Questions