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The German government on May 4 approved two draft tax bills, the Improvement of Tax Conditions Act and the Protection of the Succession in Businesses Act. The drafts now must be adopted by both the government-controlled lower house of Parliament and the opposition-controlled upper house. However, the opposition has already indicated that it will reject some of the proposed tax law amendments, so some changes likely will be made to the draft bills during the legislative procedure.

Corporate Income Tax Rate

The corporate income tax rate would be cut from 25 percent to 19 percent. Although the opposition has voiced concerns about the refinancing of the tax breaks, it supports the proposal in general. As a recommendation for the refinancing, the opposition has suggested an increase in dividend taxation from 50 percent to 57 percent. However, that proposal has not been incorporated into the above-mentioned draft laws as yet.

CFC Rules

In conjunction with the proposed decrease of the corporate income tax rate, the tax rate that is deemed "low taxation" under the Foreign Tax Act in terms of controlled foreign corporation tax rules also would be reduced from 25 percent to 19 percent. Furthermore, in the future, a tax regime also would be deemed low-tax if the foreign corporation's income is subject to tax of at least 19 percent, but that tax regime is based on foreign provisions that enable the foreign corporation to opt for a tax burden of at least 19 percent. The new definition of low taxation in terms of CFC tax rules is designed to discourage so-called designer (low) tax rates and the use of tax haven countries. Moreover, administrative practice would be adopted into statutory law so that only the actually paid taxes, and not those statutorily provided, are decisive in determining low taxation in terms of the CFC tax rules.

Trade Tax Credit

The lump sum factor for crediting the trade tax against the income tax due would be increased from 1.8 to 2.0. The result would be full trade tax relief if municipal trade tax multipliers of up to approximately 380 percent apply. Therefore, the actual limit would be a multiplier of about 340 percent. However, the opposition has concerns about the financial feasibility of this proposal.

Business Real Property Sales

The disposition of real property owned by businesses would, in principle, be exempted from tax by 50 percent, if the assets are fixed assets that have been held by domestic businesses for more than 10 years. That favorable tax treatment would apply to sales from January 1, 2006, through December 31, 2008.

However, the opposition strongly disagrees with this plan, arguing that any preferential treatment of real property is unreasonable. It has suggested that Germany instead adopt real estate investment trust provisions similar to those in the United States, but many issues remain unsolved.

Minimum Taxation

The so-called minimum taxation applicable since 2004 for income tax, corporate income tax, and trade tax purposes would be tightened. Currently, any loss carryforward exceeding a base rate of €1 million reduces the taxpayer's income by 60 percent. The draft provides that a deduction of 50 percent would be allowed. However, the base rate and the rules for loss carrybacks would remain unchanged. The opposition has already indicated that it will vote against any tightening of the minimum taxation rules.

Losses Derived From Tax Deferral Models

A new section 15(b), "Losses in Connection With Tax Deferral Models," would be incorporated into the German Income Tax Act. The new provision mainly would affect closely held funds (for example, special-purpose media funds and bond-trading funds) with start-up losses for tax purposes. Neither the deduction of losses arising from those tax deferral models from other income during the same year, nor a carryforward or carryback of those losses to be deducted from other income would be allowed. In the future, those losses could be deducted, with subsequent gains arising from the same income source (that is, the same fund). The new rules would apply only if the expected losses exceed 10 percent of the total capital invested.

A further prerequisite for the application of section 15(b) would be the tax deferral model's status as a tax scheme, along the lines of the provision in section 2(b) of the Income Tax Act. The new rules would not apply to any structuring that is not considered to be a tax scheme (for example, the foundation of a new business) or to private equity funds and venture capital funds. With the adoption of the new rules, section 2(b) would become superfluous and would therefore be abolished. In principle, the opposition agrees with the adoption of section 15(b), but it generally objects to all fund structures that are designed to create initial losses for tax purposes.

Inheritance Tax

The Protection of the Succession in Businesses Act, which would amend the Inheritance Tax Act, is based on a draft submitted by the Bavarian Ministry of Finance. Because the draft measure is accepted by most of the political parties, it could be passed as a law before the parliamentary summer break.

Most importantly under the measure, when "productive business assets" worth up to €100 million are transferred, the inheritance tax would be waived completely if the favored assets are held by the heirs and the donees, respectively, for a period of at least 10 years without any substantial disposition of the assets. The tax would be reduced by one-tenth each year for a period of 10 years. And as long as the heirs and the donees continue to carry on the business, the inheritance tax would be deferred. Should the business assets be worth more than €100 million, the current privileges (a tax allowance in the amount of €225,000 and a reduction of the tax base to 35 percent) would apply to the amount in excess of €100 million. Although the new provisions would apply to transfers of productive business assets to any person, the most typical cases would be successions of family-owned businesses.

The determination of what kind of assets are productive business assets in accordance with the meaning of this legislation will be of practical importance. According to the draft, bonds, shareholdings in corporations of 25 percent or less of share capital, rented real estate, ships, planes, concessions, industrial property rights and similar rights, and licensing rights are not deemed to be productive. ◆

♦ *Frank Schoenherr and Claus Lemaitre are certified tax advisers and partners with Richter & Partners, LLP in Munich.*