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1. **Federal Ministry of Finance: Decree regarding the deduction of costs arising in connection with the tax-free sale of shares**

An amended law was enacted in 2001 which generally made the sale of shares by corporations tax free. The amended law also included a provision, however, that 5% of the tax-free profit from the sale of shares must be regarded as non-deductible expenses with the result that this 5% amount is taxable.

On March 13, 2008, the Federal Ministry of Finance issued a decree in order to clarify frequently asked questions which have arisen since the amendment's enactment. Specifically, the decree addresses the treatment of costs arising in regard to a share sale other than in the year of sale as well as the

treatment of a rescinded sale. The ministry uses the following example to illustrate the issues and the proposed taxation.

In year 1, a German GmbH (corporation) pays Euro 20,000 for legal advice in connection with an intended sale of shares of a subsidiary corporation. In year 2, the GmbH sells the shares, which have a book value of Euro 100,000, for Euro 500,000 but the payment of the purchase price is deferred. In year 4 it becomes obvious that the acquirer of the shares will never pay the purchase price with the result that the share sale is rescinded and the receivable claim must be written off.

Year 1 Taxation

The Euro 20,000 of legal costs can be deducted from the GmbH's taxable income.

Year 2 Taxation

The profit resulting from the sale of the shares amounts to Euro 380,000 (Euro 500,000 sale price less Euro 100,000 book value less Euro 20,000 legal costs), 95% of which (Euro 361,000) is tax free. The remaining 5% (Euro 19,000) is taxable in year 2. Additionally taxable income must be increased by the Euro 20,000 which were deducted to determine taxable income since these costs were already deducted in year 1 to determine that year's income. The taxable amount resulting from the sale of shares in year 2 is therefore Euro 39,000 or a total of 19,000 from years 1 and 2 (see table below).

Year 4 Taxation

Once it becomes clear in year 4 that the purchase price will not be paid and that the share sale must be rescinded, the calculation of income in year 2 must be adjusted to negate the results of the transaction as calculated in that year. Since the loss of the Euro 500,000 claim reduces income in year 4, income in year 2 must be increased by Euro 500,000 plus Euro 20,000 in legal costs to neutralize the effects of the income calculation in year 2. The overall result of the transaction at the end of year 4 is therefore zero (see table below).

	Year 1	Year 2	Year 4	Total
Income (expense) – before sale rescission	(20,000)	39,000	0	19,000
Income (expense) – after sale rescission	(20,000)	520,000	(500,000)	0

2. **German Federal Tax Court: Dividends received by a German-owned Dutch partnership from holdings in third countries are not exempt from German taxation if the third-country interest has no actual connection with the partnership's business activities**

In the case decided by the German Federal Tax Court (hereinafter "the Court") on

December 19, 2007, a German GmbH was a limited partner of a Dutch partnership (CV) which acted as distribution company for the A-Group, to which both GmbH and CV belonged. CV itself was involved only in distribution activities in the Netherlands, but held shares of other distribution corporations which were active in Italy, Spain, Canada, Great Britain, Belgium and Switzer-

land. Dividends received by CV from these distribution corporations remained free of taxation in the Netherlands. The German tax authorities, however, were of the opinion that the double taxation convention (hereinafter "DTC") between Germany and the Netherlands allowed the taxation of the dividends in Germany because CV was seen as a pass-through entity.

The Court supported this point of view and made clear that dividends received by a distribution company have no direct connection with its business activities, even if the dividends also result from income earned by distribution activities. For this reason the dividends do not qualify as business income earned by a permanent establishment and are therefore not subject to tax only in the country where the permanent establishment is situated but are also taxable in other relevant countries. Furthermore, the court noted that the dividends do not fall within the scope of the "Dividend Article" of the DTC, since this provision is only applicable to dividends paid between contracting states, not to third-country dividends. Finally, the Court looked to Article 16 of the DTC (Other Income), which is applicable if the income concerned cannot be allocated to one of the categories dealt with in previous provisions and gives the state of domicile the right to tax the in-

come in question.

The only real problem which the Court had to address was the fact that the Germany-Netherlands DTC, contrary to the OECD Model Convention and several other DTCs, does not contain a regulation regarding the priority of Article 5 (Business Income) and Article 16 (Other Income). In this regard, the Court referred to previous decisions concerning other DTCs and noted that, to the extent that the DTC provides no priority rule for these two articles, the question must be addressed as to whether the income is connected to the main business activity of the permanent establishment (in which case it would be business income) or has no such connection (in which case it would be other income). As noted above, the Court concluded that the dividend income had no connection to CV's main business activity and therefore defined the dividends as "other income" falling under Article 16 of the DTC.

3. Federal Ministry of Finance: Decree addresses recent Federal Tax Court decisions on the taxation of a corporation in liquidation

On April 4, 2008, the Minister of Finance felt obliged to comment on two German Federal Tax Court decisions, one from February 22, 2006 and the other from September 18, 2007, in both of which the

Court reached a result contrary to the administrative provisions enacted by the tax authorities in regard to the liquidation taxation of a corporation.

The 2006 case dealt with special problems arising from the change of the corporate tax system from the tax credit method to the so-called half-income system in 2001. In principle, the last tax assessment of a corporation in liquidation covers three years. The 2006 decision and now the decree both address the question of how to deal with the liquidation of a corporation which falls partly under the tax-credit method and partly under the half-income system. Since this issue concerns only a very few special cases, the details will not be discussed here and companies potentially affected by the clarified provisions are invited to contact us for further information..

Commenting on the second decision, from September 2007, the Finance Minister pointed out that the tax assessment for trade tax purposes in the case of a liquidation will take place at the end of the three-year liquidation period. The income calculated at that time must then be allocated equally to the three years, regardless of whether those years fall under the old system or the new.

4. Regional Tax Office Frankfurt: Administrative rules regarding the taxation of stock capital increases from the company's own resources

On November 23, 2007, the Frankfurt regional tax office (hereinafter "RTO") issued administrative principles regarding the tax treatment of a company's share capital increase out of its own reserves. First, the RTO made clear that such a capital increase will not give rise to deemed dividends or other deemed distributions at the time of the increase but will potentially produce tax effects if and when the shares are eventually sold.

The RTO further noted that no special considerations are required to the extent that only existing ownership interests are increased in proportion to each shareholder's interest in the company before the increase and no additional contributions are required in regard to the company's hidden reserves.

To the extent that these conditions are not fulfilled, however, e.g. if new shareholders are admitted or the interests of the existing shareholders are not increased proportionately, the hidden reserves will be deemed transferred to the new shares at the time of the capital increase. The RTO points out that, in such cases, it may be difficult to ensure the full taxation of the hidden reserves when the shares are

later sold. Therefore, the main purpose of the RTO's administrative principles is to point out this danger to the various tax authorities within its jurisdiction in order to assure taxation of the full amount of capital gains at the time of sale.

Up to December 31, 2006 the General Tax Code (Abgabenordnung; hereinafter "AO") contained a provision allowing for the documentation of such a capital increase and its effects on the company's hidden reserves in order to ensure the taxation in case of a future sale of shares. As a result of amendments to the AO, which were actually intended only to react to changes in the Reorganization Tax Act, however, the provision for fiscal years beginning after December 31, 2006 only allows for documentation in cases where a reorganization occurred in accordance with the Reorganization Tax Act. The increase of share capital as described above, however, in many cases falls within the scope of the Income Tax Act which does not require the documentation of such share capital increases.

From the taxpayer perspective, such capital increases should be adequately documented in order to ensure that the tax authorities only assess tax on the actual gain realized on a sale of shares and not on a fictitious gain

determined on the basis of a capital increase which occurred many years previously. Only by such means can a taxpayer ensure that, in the case of a future sale, taxes will only be payable on the difference between the sales price and the shareholder's actual acquisition costs.

5. German Federal Tax Court: Sponsoring of a non-profit organization is taxable if the sponsor is granted consideration

In Germany, organizations which pursue charitable purposes are generally freed from taxation. However, the sponsorship of such organizations may have unintended tax consequences as shown by a case decided by the Federal German Tax Court on November 7, 2007.

This case involved a local sports club which allowed a sponsor to advertise in its club magazine and to provide information about the sponsor's business activities (insurance) during club meetings. The Court ruled that the non-profit sports club became comparable to a business entity by "selling" advertising space and time for marketing during club meetings. As a consequence, the sports club was assessed corporate taxes on the deemed income from the sponsoring and was qualified as an entrepreneur for VAT purposes and therefore subject to the full amount of VAT.

This disadvantageous result for the sports club might, on the other hand, be advantageous for the sponsor which can reduce its taxable income by the amount sponsored. While a sponsor can generally deduct donated amounts regardless of whether they are regarded as charitable contributions or business expenses, a sponsor might prefer the latter since charitable contributions are subject to deduction limitations while business expenses generally are not. Indeed, if both parties consider the possibilities, in coordination with their tax advisors, and reach an agreement prior to the payment of any contributions, sponsoring for consideration could be a viable alternative to purely charitable donations

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