



# International Tax Alert

**BDO Seidman, LLP**  
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## ISSUE:

NEW GERMAN TAX LAW CHANGES TO SEVERELY IMPACT BUSINESSES

## DATE/TIMING:

Officially published and enacted on December 27, 2003. Many of the changes are effective for German taxpayers with fiscal years ending in 2004.

## AFFECTING:

U.S. Taxpayers owning direct or indirect investments in German operations.

## DETAILS:

The new law contains many changes for German corporate and individual taxpayers. Summarized here are some of the major corporate changes including: 1) Net Operating Loss Utilization; 2) Thin Capitalization; 3) Capital Gains/Dividend Taxation; and 4) Trade Tax.

### Net Operating Loss Utilization (Minimum Taxation)

German corporations will now be subject to limitation on the utilization of loss carryforwards for corporation tax. This so-called minimum tax is computed by allowing the first €1 million of net operating loss carryforwards to offset taxable income. Any utilization above that threshold will generally be limited to 60% of taxable income. There is no expiration date for the net operating loss carryforward. Under the prior law, German corporations were able to offset 100% of their income with loss carryforwards. This change will significantly impact German companies with large start-up losses.

### Thin Capitalization

In order to conform with EU Law, changes were made to eliminate the distinction between how the thin capitalization rules were applied to non-resident and domestic shareholders of German entities. The new law applies to all German entities regardless of owner's residence. It applies only to annual interest expense in excess of €250,000. The new rules also apply to non-resident entities that are taxable in Germany (i.e., German branches or other flow-through entities). The debt/equity safe harbor for operating entities remains at 1.5:1. The debt/equity safe harbor for holding companies had previously been 3:1. Under the new rules, this safe harbor is lowered to 1.5:1.

The ability of a company to access third party borrowing (without considering any related party's financial position) continues to be a safe-harbor to allow a higher debt/equity ratio, provided it is properly documented.

The Tax Practice at

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## DETAILS ...(continued)

Interest expense relating to financing of an intragroup share purchase will not be deductible if the lender is related to the borrower. This can apply to third party loans as well if the loan is recourse.

### Capital Gains/Dividend Taxation

German corporations receiving dividends from domestic companies will now be subject to tax on 5% of the dividend. Previously, 100% of the domestic dividend qualified for the participation exemption. As a result, the expenses allocable to domestic dividend income will now be fully deductible since it no longer relates to generating tax-free income. This is important for German groups where there is no *organschaft* agreement in place. Moreover, 5% of the capital gain arising from the sale of German and non-German corporate shares will now be subject to corporate tax.

### Trade Tax

Several previous versions of the tax bills considered significant changes to the trade tax regime, but these were ultimately not made. However, the above changes also significantly affect the trade tax calculation. The loss disallowance rules work the same way to determine how much net operating losses can be utilized in the trade tax calculation. If under the thin capitalization provisions the interest is disallowed for corporate tax purposes, the same amount will not be treated as interest expense for trade tax purposes. This is a change from previous law where the corporate disallowance did not generally affect what was subject to the 50% addback for trade tax purposes. However, any interest deduction allowed for corporate tax purposes will be subject to a 50% disallowance when computing trade tax.

The 5% inclusion for dividends/capital gains will be subject to trade tax too. Likewise, the expenses attributable to generating domestic dividends will now be deductible for trade tax purposes.

### Going Forward

In certain circumstances and with careful implementation, strategic tax planning can still work to successfully minimize German tax.

The international tax group of BDO Seidman, LLP is committed to monitoring the guidance issued under these new rules to identify new opportunities as well as associated risks.

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