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Subject:

German Government Approves Draft Tax Reform 2008

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International Tax Alert

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For more information, please contact:

Jack Frame
BDO Seidman, LLP
330 Madison Ave
New York, NY 10017
Phone: 212-885-8125
jframe@bdo.com

On March 14 the German cabinet approved the draft bill for the planned 2008 corporate tax reform. The two houses of the German legislature are expected to pass the bill this summer. The following is a summary of some key provisions of the draft.

Corporate and Trade Tax Rate Reduction

The draft bill provides for a reduction of the corporate tax rate from currently 25% to 15%. The solidarity surcharge rate of 5.5% of the corporate tax will remain unchanged. In addition, the trade tax base rate will be reduced from 5% to 3.5%, and trade tax will no longer be deductible for corporate or trade tax purposes. All these measures will reduce the overall tax rate on corporate income from about 40% to slightly below 30% (assuming an applicable local trade tax levy rate of 400% or lower).

Interest Barrier Rule

The thin capitalization rule will be entirely replaced by an "interest barrier rule" which will generally impose a limit on the deductibility of all kinds of interest expense. Rather than focusing on interest expense relating to shareholder loans or shareholder secured third party loans, the new limitations will apply to interest expense relating to "normal" third party loans.

Where the annual interest expense of a corporation or partnership does not exceed its interest income by more than EUR 1,000,000, the deduction of the interest expense will not be limited.

However, where the total interest expense exceeds the total interest income by more than EUR 1,000,000 the deduction of the balance between interest expense and revenues will be limited to 30% of the profit before interest expense and income if the company claiming the deduction belongs to a group of companies as defined by the interest barrier rule.

Insofar as the balance in a given tax year exceeds the limit, the balance can be carried forward to future tax years.

The limitation will not apply where the corporation or partnership can establish that the ratio of equity to total assets of the company is equal or higher than the same ratio for the group ("escape clause").

Add-back of Interest Expense for Trade Tax Purposes

The current trade tax add-back rule, whereby 50% of interest expense relating to long term debt is disallowed as a deduction, will be replaced by a broader rule. Under the new rule, 25% of the direct interest expense relating to all forms of indebtedness (long term and short term) will be disallowed for trade tax purposes.

Furthermore, under the new rule 25% of the financing portion of leasing, rent & royalty expenses will generally be disallowed as a deduction. According to the draft bill, a 20% financing portion will be attributed to leasing & rental expenses relating to movable property. The financing portion will be 75% if attributable to immovable property and 25% if attributable to licenses. However, an add-back only occurs where the sum of this direct and indirect interest exceeds €100,000 in total during the assessment period (tax-free amount).

Loss Carry-forwards in Case of Ownership Changes

The current (rather complex) change of ownership rules for corporations which restrict under certain prerequisites the utilization of carry-forwards of tax losses will probably be replaced by the following simpler but less favourable rules:

- the loss carry-forward will be disallowed pro rata for transfers of 25% to 50% of the shares (measured by vote or value) within 5 years; and
- in cases where more than 50% of shares (vote or value) are transferred, the loss carry-forward will be disallowed completely.

Introduction of a Flat Income Tax Rate

From 1 January 2009 interest, dividends and capital gains of individuals who are residents of Germany will be subject to a flat income tax rate of 25% or perhaps a lower graduated rate.

Currently, capital gains recognized by individual residents of Germany are only subject to tax in Germany if the capital gain relates to a shareholding representing more than 1% of the share capital or if the shares were not held for more than one year. From 1 January 2009 all capital gains recognized by individual residents of Germany will be subject to the flat income tax rate of 25%.

The flat income tax rate will not be applicable if shares are held as business assets by sole proprietors, partnerships and corporations. Instead, 60% of the interest, dividend and capital gain income of such taxpayers will be taxed at regular income tax rates (currently 50%). The 95% tax exemption for dividend and capital gain income earned by corporations will remain unchanged.

Other Issues

- The declining-balance method of depreciation will be abolished. Only straight-line depreciation will be available for business assets purchased or manufactured after 31 December 2007.
- The threshold for immediate depreciation of low-value business assets will be decreased from EUR 410 to EUR 100 except for small and medium sized sole proprietors and partnerships. Assets valued between EUR 100 and EUR 1,000 may be booked on a pooling account and depreciated over a five-year-period.

- Provisions stipulating the valuation and documentation of transactions which entail a shift of functions and, thus, profit potential from Germany to a foreign country are being implemented. If there is an indication that internal transfer prices are too low, the tax authorities may be entitled to detrimentally assess a taxpayer's income.
- Current tax planning opportunities in relation to share lending transactions will be abolished.
- Partnerships will have the option to apply for taxation of their retained earnings in the same manner as corporations. The retained income will initially be taxed at a rate of about 28%. On distribution, any excess of withdrawals over contributions (to the extent it exceeds the profits of the partnership) will then be taxed at 25% plus solidarity surcharge at the level of the receiving partner. The option will, however, only be granted to the partners of a partnership who hold a participation of more than 10% or whose profit share exceeds €10,000.

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