Germany:  
More changes proposed to Annual Tax Act

The German Upper House of Parliament made recommendations for various amendments to the draft Annual Tax Act 2013 on 6 July 2012. The government will review and then forward the recommendations of the Upper House and its own comments to the Lower House of Parliament. Given the provisional stage of the legislative procedure, it is unclear which of the recommendations will lead to actual law changes, but it can be reasonably expected that some will be enacted. The following main measures are relevant for corporate investors.

**Corporate Income Tax Act**

- The most significant change concerns the possible elimination of the 95% exemption for dividends and capital gains derived from portfolio investments (i.e. less-than-10% shareholdings in subsidiaries). The proposed change is combined with proposed changes to the loss carryforward rules and the calculation of EBITDA for purposes of the interest deduction limitation relating to dividends that are taxable under the new rule. According to these proposals, taxable dividends received from less-than-10% shareholdings would not increase the relevant tax EBITDA for purposes of the interest deduction limitation, and any expenses and losses resulting from a less-than-10% shareholding could be offset only against income from other portfolio investments.

- A general principle of corresponding treatment is proposed for all dividends, i.e. dividends generally eligible for the 95% exemption would enjoy the exemption only if they were not treated as deductible expenses at the level of the payer subsidiary. This would result in an extension of the scope of the current principle, which only provides for corresponding treatment in the case of deemed distributions.

- The Upper House proposes to limit the application of the “held-for-trading” exception to banks and financial institutions within the meaning of the Banking Act. Under this exception, dividends and capital gains realized by a financial institution are not entitled to the 95% exemption if the participation is held with the intention to engage in short-term trading activities (and losses are fully deductible in these situations). According to recent jurisprudence of the German courts, regular holding companies also fall within the scope of this rule, which is why the Upper House decided to propose restricting the scope of the rule.

- The Upper House is requesting a review of the rules on tax groups to make their application less prone to formal errors in practice. Other requests for review include the tax treatment of final losses incurred in an EU/EEA permanent establishment as well as changes to the German domestic subject-to-tax-rules.

**Other proposals/requests for review**

- The Upper House has formally asked the government to review the Real Estate Transfer Tax (RETT) rules and propose an amendment to eliminate “RETT blocker structures,” which are used by taxpayers to minimize their RETT liability in share acquisitions.

- Following the postponement of a major reform to the Investment Tax Act by the Finance Ministers of the federal states at their conference on 1 June 2012, the Upper House has proposed changes to the act, including changes to reflect the amendments to the participation exemption in the Corporate Income Tax Act.

- The Upper House favors the introduction of regulations to ensure Germany’s ability to levy income tax and withholding tax on German-source dividends received via investment funds. Dividend taxation currently can be avoided for certain investor groups by redemption of the investment fund units. Although the recommendations do not propose any specific wording, the new regulation may correspond to the taxation of interim profits for untaxed interest income. Undistributed dividends (i.e. dividends that have not been subject to deemed distributed income taxation at the investor level in previous financial years) would become taxable upon the redemption of the fund units.

- The Upper House has requested new regulations to prevent certain structures involving the change-in-ownership rules, known as “bond-stripping structures.” In essence, these structures have been used to generate taxable income from the disposal of stripped interest coupons at the fund level, which can be used as deemed distributed income to be offset against other taxable income of the investor. Future losses from the disposal of the fund units can be offset against other taxable income and, hence, circumvent the full or partial forfeiture of the investor’s tax losses in the event of a harmful change in ownership.

- The Upper House recommends changing the withholding tax system on German-source dividends distributed to investment funds to mitigate the risk that Germany will be obliged to refund the withholding tax in the future. This recommendation is a direct reaction to the European Court of Justice decision in Santander, in which the court...
held that French withholding tax levied on French-source dividends paid to nonresident investment funds violates the EU fundamental freedoms of both EU resident and nonresident funds.

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