



# Taxation of cross-border mergers and acquisitions

**Germany**

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# Germany

## Introduction

Germany has not seen major changes to its tax rules since the 2008 tax reform. Since then, the reform's new earnings-stripping rules and further restrictions on the use of tax loss carry forwards have been established without significant changes. The Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) initiative is not expected to lead to significant changes in German tax law, as many of the OECD's proposals (general anti-avoidance rules (GAAR)), anti-hybrid rules, controlled foreign company (CFC) rules, earnings-stripping rules) have been in place in Germany for many years.

The following outline of German commercial and tax law is designed to inform foreign investors about their general tax options on the acquisition of a business in Germany. Unless otherwise stated, the commentary ignores Germany's solidarity surcharge of 5.5 percent on corporate and individual income tax.

## Recent developments

### Suspension of turnaround exemption

On 26 January 2011, the European Union (EU) Commission ruled that the exemption from the forfeiture of tax losses in the course of a detrimental transfer of shares in turnaround situations constitutes illegal state aid and infringes with EU freedoms providing for the European common market. The German government appealed this ruling before the General Court of the EU. The proceedings of the German government were dismissed as inadmissible on 18 December 2012 (EGC-Ruling T-205/11) as the period for filing an action had already expired. Numerous taxpayers have brought individual actions before the General Court. These cases are still pending.

In view of a potential decision of the EU Commission against the German government and resultant need to collect the granted tax benefits from taxpayers that took advantage of the turnaround exemption, the German tax authorities suspended application of this clause and stayed all appeals against assessments not applying the turnaround exemption as of April 2010, subject to the final decision of the Court of Justice of the EU.

## Reform of investment taxation

On 18 December 2015, the Federal Ministry for Finance published the latest draft bill on a reform of investment taxation. The proposed reform would significantly change the tax treatment of investment funds, moving from a transparent system, with tax only levied on the investors, to a non-transparent system, with taxation at the fund level. The new rules are expected to be implemented as of 1 January 2018. A provision on taxation of capital gains on portfolio investments contained in earlier drafts is no longer included. Thus, the currently applicable portfolio exemption for corporate tax (effectively 95 percent) is expected to remain applicable.

## Extension of the group exemption for losses carried forward

The Tax Amendment Act 2015, dated 16 October 2015, extends the so-called 'group exemption' provision of § 8c CTA (change-of-control rule). The previous version of the rule did not cover transfers to and from the top holding company in otherwise privileged groups, leading to a forfeiture of losses brought forward on transfers of shares to the ultimate parent. The new law now contains an exemption from change-of-control rules where shares are moved either by or from the ultimate parent.

## Other consideration in exchange for contributions

A further amendment to German reorganization tax law implemented with the Tax Amendment Act 2015 imposes a new restriction on tax-neutral transfers of assets by way of contributions to corporations and partnership. Under the previous law, such contributions could be performed tax-neutrally, even if other consideration in addition to equity was granted in exchange, to the extent such other consideration did not exceed the net book value of assets contributed. Under the new rules, such consideration must not exceed 500,000 euros (EUR) or 25 percent of the net book value of assets contributed. Any excess consideration will render these transactions partially taxable. The new rules impose a considerable restriction on the ability to transfer liabilities and, thus, push down debt through the transfer of going concern businesses.

## Real estate transfer tax

New rules affect the real estate transfer tax (RETT) implications of indirect changes in the composition of partnerships. Changes in partnership interests in multi-layer partnership structures that own real estate will follow a

transparency regime. For investments of corporations in real estate-owning partnerships, any change of more than 95 percent of shares will be viewed as a taxable event. The new rules establish an existing administrative opinion that the Federal Tax Court had overruled.

In addition, the German Federal Constitutional Court ruled that the auxiliary basis of assessment for RETT on reorganizations was unconstitutional. The new assessment rules follow the valuation principles established in inheritance tax law and are expected to produce results closer to market value than the earlier assessment basis.

## Replacement assets

In the past, domestic taxpayers were allowed to shelter or prolong the taxation of capital gains on the sale of certain fixed assets if they were replaced with other assets (replacement assets) in a German business. These rules were in breach of the EU Treaty and have been amended such that investments in replacement assets in EU branches of the taxpayer also qualify for the benefit.

## Asset purchase or share purchase

The form of an acquisition is often motivated by tax but also driven by other commercial and legal factors. The buyer's main preference, from a tax perspective, is to get a step-up in the acquired assets along with a corresponding depreciation base to reduce the future effective tax rate, which is achievable in assets deals or other taxable transactions, e.g. under German reorganization tax law. The seller's primary interest is to minimize capital gains tax or, ideally, to obtain a tax exemption. Share deals are generally more tax-efficient for all types of owners, whether corporates or individuals.

The transfer of ownership interests is legally simpler than the transfer of numerous scattered assets. It is easier to specify the interests or shares being disposed of than to identify individual assets. Contracts and licenses held by the purchased entity remain effective and may not need to be assumed (requiring the other parties' consent) or renegotiated. By contrast, assets deals allow an individual determination of the assets and liabilities transferred and therefore can provide more flexibility in carving out risk areas, etc. More complex transactions under the reorganization tax law allow for the combination of the legal benefits of a universal succession into a business' assets with a step-up in assets. This can especially be favorable in regulated industries if licenses need to be transferred.

## Purchase of assets

In an asset purchase, the purchased assets are accorded a new cost base for the buyer, and the selling entity realizes a gain/loss amounting to the excess/shortfall of the purchase price over the book value of the assets. A deferral of capital gains may apply to certain fixed assets (replacement assets) in the case of reinvestments in either German or EU-based permanent establishments (PE). Generally, the allocation of

any step-up/step-down is performed on an asset-by-asset basis. Goodwill generally is calculated as the difference between the purchase price and the sum of the stepped-up market values of the other assets and is capitalized at this value. An asset deal provides the purchaser with the opportunity to buy only those assets actually desired and leave unwanted assets (e.g. environmentally contaminated real estate) and, in many cases, unwanted liabilities behind.

However, under German law, some liabilities cannot be avoided and pass to the buyer in an asset deal except under certain circumstances. For example, liabilities with respect to existing employment contracts (German Civil Code [*Bürgerliches Gesetzbuch* — BGB], section 613a) and several tax liabilities (*General Tax Act [Abgabenordnung* — AO], section 75) cannot be disclaimed. Although certain liabilities are taken over where the acquired commercial business is continued under the same name (German Commercial Code [*Handelsgesetzbuch* — HGB], section 25), such liabilities could be disclaimed under certain conditions.

From a purchaser's tax perspective, the acquisition of a partnership interest is treated as a pro rata acquisition of the partnership's assets. Consequently, the buyer can step-up the basis in their pro rata share of partnership assets acquired to equal the full purchase price.

## Purchase price

Where assets are purchased, the buyer should attempt to persuade the seller to agree to a detailed allocation of the purchase price to the assets. Such an allocation is not binding for tax purposes but provides a useful starting point. Non-competition agreements in connection with asset purchases are generally viewed as part of goodwill and do not constitute independent assets, unless a separate price is determined and allocated in the purchase agreement. The value added tax (VAT) implications of such separate agreements need to be taken into account.

## Goodwill

The acquired tangible and intangible assets, including goodwill, are to be capitalized at their fair market values. For tax purposes, goodwill is amortized over a 15-year period, independent of the International Financial Reporting Standards (IFRS) or statutory accounting treatment. Consequently, deferred tax implications apply.

## Depreciation

All other assets are depreciable over their useful lives. The tax authorities have published depreciation tables listing the relevant periods for almost every type of asset.

## Contingent losses

The acquisition of liabilities that are not recognized in full in the tax balance sheet of the seller due to certain restrictions for tax accounting purposes results in a post-acquisition profit of the purchaser in the business year of the acquisition as

the purchaser must apply the original accounting restrictions. The resulting profit may be spread over a period of 15 years, which may avoid taxation of the post-acquisition profit to some extent where the contingent tax loss is correspondingly realized in the same periods.

#### **Tax attributes**

Tax losses, interest and earnings before interest, taxes, depreciation and amortization (EBITDA) carried forward and other attributes are not transferred in an asset deal. They remain with the seller or are eliminated.

#### **Value added tax**

Asset purchases of a business or division (branch of activity) are generally not subject to German VAT law [USTG], section 1 par. 1a). Purchases of shares in a corporation or interests in a partnership are tax-exempt under USTG, section 4 par. 8 (f).

#### **Transfer taxes**

There is no stamp duty in Germany. However, the acquisition of property in an asset purchase is subject to RETT on the purchase price allocated to the property. The RETT rate is between 3.5 and 6.5 percent (depending on the German state in which the real estate is located). If an asset deal triggers RETT, the purchaser and seller are generally liable. Typically, an asset purchase agreement allocates the RETT as a transaction cost to the purchaser.

RETT is also triggered when at least 95 percent of the shares in a company or partnership owning real estate located in Germany are transferred, directly or indirectly. This also applies where less than 95 percent is transferred but, after the transfer, at least 95 percent of the entity is directly or indirectly owned by one taxpayer or a consolidated tax group. Different methods for calculating the 95 percent threshold apply for partnerships and corporations as of 2016. Further, a transaction triggers RETT where a person or company acquires an economic participation of at least 95 percent in a real estate-owning company. Such participation equals the sum of direct and indirect participations in the capital or assets of the company. In the case of indirect participations, the participations in the capital or assets must be multiplied on each participation level.

For partnerships, any direct or indirect share transfers within a 5-year period are added together for this 95 percent test. Previously, where RETT was triggered by the acquisition of shares in a company or partnership, the RETT was based on a special valuation of the real estate for tax purposes, which amounted to roughly 70 to 80 percent of the fair market value. This valuation method was overruled as unconstitutional in 2015. The valuation methodology of German Inheritance Tax Law applies retroactively as of 2009, leading to transfer values closer to fair market value. The purchaser or direct or indirect owner of at least 95 percent in a real estate-owning corporation is liable for RETT.

There is an exemption of RETT for certain reorganizations within a group, including mergers, de-mergers (split-up, spin-off, carve-out) and certain other transfers of property. Similar reorganizations under the law of another EU or European Economic Area (EEA) member state are also privileged. According to the recently amended group exemption clause, contributions and other transactions on the basis of the articles of association also may be exempt from RETT. However, according to guidance from the tax authorities, the group exemption applies only to the transfer of real estate where the transaction allows for universal succession of the receiving entity in the position of the transferring entity.

Further, the group exemption only applies where a company and a controlled company are involved in the reorganization. A company is deemed controlled where the controlling company holds (directly or indirectly) an interest of at least 95 percent within a period of 5 years before and 5 years after the reorganization.

#### **Purchase of shares**

A share deal does not offer the buyer a step-up of the assets (capitalization of assets at fair market value) of the purchased company to increase the depreciation base. The scope for achieving such a step-up by post-acquisition restructuring is limited. VAT and RETT implications are discussed earlier in this report.

#### **Legal form of businesses**

When buying a business, it is necessary to understand the legal form in which it is conducted. Most business activity in Germany is carried out through one of the following:

- sole proprietorship (*Einzelunternehmen*)
- general partnership (*offene Handelsgesellschaft* — oHG)
- limited partnership (*Kommanditgesellschaft* — KG)
- limited partnership with corporate general partner (GmbH and Co. KG)
- limited liability company (*Gesellschaft mit beschränkter Haftung* — GmbH)
- entrepreneurial company with limited liability (*Unternehmergesellschaft (haftungsbeschränkt)* — UG)
- stock corporation (*Aktiengesellschaft* — AG).

The federal German law governs these enterprises. A corporation (AG, GmbH, UG) is subject to corporate income tax (since 2008, 15 percent), solidarity surcharge (5.5 percent of the corporate tax), trade tax (approximately 14 percent), and VAT (19 percent standard rate). A partnership (oHG, KG, GmbH and Co. KG) is transparent for corporate income tax purposes (i.e. partnership income is attributed to and taxed in the hands of the partners) but not for trade tax purposes. An election to treat a partnership as a corporation is not possible for German tax purposes.

Of these legal forms, the GmbH and Co. KG, GmbH, UG and AG allow a limitation of the owners' liability to the agreed capital contribution. In the case of the GmbH and Co. KG, this applies, strictly speaking, only to the limited partners. The general partner, the GmbH, does not need to make any capital contribution or be entitled to any share of profits. The management of the GmbH and Co. KG usually rests with its general partner, the GmbH, but this is not mandatory.

### **Limited liability company: *Gesellschaft mit beschränkter Haftung* (GmbH)**

The GmbH is the most common form of business association. It is a corporate entity with its own legal identity, one or more shareholders and share capital of at least EUR25,000. Shares in GmbHs are not certified. The purchase and transfer of shares in an existing GmbH requires an agreement, which must be recorded in the presence of a qualified German notary. Except for some cases in which Swiss notaries are considered as qualified, a transfer of GmbH shares before a foreign notary is generally not possible. The management of a GmbH rests with one or more managing directors appointed by the shareholders. The managing directors are subject to close supervision and control by the shareholders and are generally obliged to respect instructions given to them at the shareholders' meeting. Where a GmbH has at least 500 employees, a supervisory board must be established according to provisions applicable to AGs. The shareholders control the distribution of net earnings.

### **Entrepreneurial company with limited liability: *Unternehmergesellschaft (haftungsbeschränkt)* (UG)**

The legal form of the UG was established by the German Act to Modernize the Law Governing Limited Liability Companies and to Combat Abuses (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen [MoMiG]), dated 1 November 2008.

The UG is not an independent legal form but a subtype of the limited liability company. It may be formed with a share capital of EUR1 to EUR24,999, but is subject to specific statutory restrictions (e.g. contributions in kind may not be performed by an entrepreneurial company; mandatory allocation of one-quarter of the annual surplus into the capital reserve).

The UG generally is treated like a GmbH for tax purposes. By increasing the capital to at least EUR25,000, an UG can become a GmbH.

### **Stock corporation: *Aktiengesellschaft* (AG)**

The AG is also a corporate entity with its own legal identity. The minimum share capital is EUR50,000. The management structure invariably consists of a management board and a supervisory board.

The management board is in charge of the management and representation of the AG. The members of the management board are appointed and removed by the supervisory board. The supervisory board only monitors the management board and represents the AG in relation to the management board.

The articles of association must stipulate that specific actions of the management board require the prior approval of the supervisory board.

The supervisory board must consist of at least three members or a higher number divisible by three. The shareholders elect the members. Where the AG has more than 500 employees, one-third of the members of the supervisory board must be elected by the employees. In AGs with more than 2,000 employees, employees have the right to elect one-half of the supervisory board members. Generally, the shares in AGs are certified.

In contrast to the GmbH, AG shares need not be transferred in notarized form and can be traded on the stock exchanges. The shareholders control the distribution of at least 50 percent of net earnings.

### **General partnership (*oHG*), limited partnership (*KG*), limited partnership with corporate general partner (*GmbH & Co. KG*)**

In an oHG, no minimum capital is required and all partners are fully liable for the partnership's debts. In contrast, in a KG, there are general partners (*Komplementär*) with unlimited liability and limited partners (*Kommanditisten*) whose liability is restricted to their fixed contributions to the partnership. Although a partnership itself is not a corporate body, it may acquire rights and incur liabilities, acquire title to real estate and sue or be sued. Generally, all partners that are fully liable for the partnership's debts act as managing directors in contrast to the partners subject to limited liability. From a legal perspective, the transfer of shares in a partnership generally does not need to be recorded in the presence of a qualified notary.

The GmbH and Co. KG is a limited partnership in which the sole general partner is typically a GmbH, combining the advantages of a partnership with those of a limited liability corporation.

### **Other forms**

The following, less common forms of association may also be encountered:

- private association (*Verein*)
- cooperative (*Genossenschaft*)
- foundation (*Stiftung*)
- partnership limited by shares (*Kommanditgesellschaft auf Aktien* — KGaA).

Associations and cooperatives can be useful in structuring cooperation among several independent parties. Foundations resemble common-law trusts to some degree. These three organizations are popular for non-profit activities but are not widely used for business purposes.

The partnership limited by shares is still rare but is becoming more popular.

## Commercial and non-commercial activity

German company and tax laws distinguish between trade and business activities (commercial activity) and other activities. Generally, the tax law assumes commercial activity where a company exercises a trade (which is not related to self-employment or passive asset management) for the purposes of making a profit. Capital gains generally are taxable where the property is sold as part of a commercial activity or is held by companies that are, by virtue of the law, trading companies.

Apart from a tax liability for capital gains, the main tax consequence of commercial activity is the liability for trade tax, which is imposed only on commercial enterprises. By virtue of their corporate legal form, company law and tax law deem the AG, the GmbH and the UG to be engaged in commercial activity.

## Tax indemnities and warranties

In a share acquisition, the purchaser is taking over the target company together with all related liabilities, including contingent liabilities. Therefore, the purchaser normally requires more extensive indemnities and warranties than in the case of an asset acquisition.

Unlike the United States/Anglo-Saxon legal principle of *caveat emptor* (let the buyer beware), German law generally does not require the purchaser to examine an entity they intend to purchase in advance. However, according to the German Civil Code (*Bürgerliches Gesetzbuch*), a purchaser forfeits their rights and guarantee claims regarding a defect they are unaware of where gross negligence is involved. The non-performance of due diligence prior to the acquisition of an entity generally does not result in the purchaser being grossly negligent. This is only the case where the purchaser did not perform due diligence despite obvious defects of the target or suspicious facts. The purchaser's decision on whether or not to perform a due diligence thus depends on an assessment of the individual circumstances.

By contrast, the vendor may have a pre-contractual duty to inform the purchaser about certain defects of the target according to the German law principle of '*culpa in contrahendo*'. This principle implies that a party with important information to which the other party does not have access must share it with the other party so that it can contract with sufficient knowledge of the facts. The extent of this obligation again depends on the individual case, particularly the value or significance of the transaction.

## Tax losses

### Use of pre-acquisition losses

In Germany, tax losses may be carried forward indefinitely for trade tax on income and personal or corporate income tax purposes. Personal or corporate income tax losses may also be carried back to the previous fiscal year, up to a maximum of EUR1 million.

The use of tax loss carry forwards is restricted by a minimum taxation scheme. Only EUR1 million plus 60 percent of the taxpayer's current year income in excess of EUR1 million can be offset against tax loss carry forwards. The restriction applies to both corporate income tax and trade tax.

The use of pre-acquisition losses is restricted by the general change of control rules. These rules lead to a partial forfeiture of loss carry forwards where more than 25 percent of the shares in a corporation are acquired by a purchaser, a purchasing group or related parties within a period of 5 years. Where more than 50 percent of the shares are acquired, all loss carry forwards are forfeited. The rules apply to any direct or indirect change in the shareholder structure, so the acquisition of a multinational group at the top holding level may also lead to a forfeiture of losses in a German group company.

The forfeiture of losses on a change of control, however, does not apply up to the amount of the domestic built-in gains of the loss company transferred. Therefore, tax loss carry forwards are only forfeited to the extent the losses carried forward exceed the transferee's domestic built-in gains in the business assets at the time of the detrimental change of control.

This provision covers share acquisitions from third parties as well as related parties. The latter case may become relevant where the criteria under the group exemption clause are not met (as discussed later in this report). The built-in gains of the corporation's domestic (i.e. fully taxable) business assets prevent the forfeiture of current-year tax losses as well as tax losses carried forward. The built-in gains are determined by comparing the equity according to the tax accounts and the fair value of the shares of the loss company (which generally equals the purchase price). A determination on a pro rata basis applies where not more than 50 percent of the shares in a loss-making corporation are transferred. Built-in gains not subject to tax in Germany must be deducted (in particular, shares in corporations for which a capital gains exemption applies). A 2010 amendment to the exemption relating to taxable built-in gains eliminated the restriction to domestic business assets only so that foreign business assets subject to German taxation are taken into account as well. Moreover, where the equity of a loss-making entity is negative, the built-in gains are determined by comparing the equity according to tax accounts and the fair market value of the business assets (instead of the fair market value of the shares) to exclude built-in gains calculated in the shares that pertain to tax assets only.

An internal reorganization before 1 January 2010, such as the interposition of a new holding entity, could also trigger the general change of control rules. For reorganizations after 1 January 2010, the change of control rules for corporations have been eased by a new exception for share transfers within a group of companies. Under this exception, a change of ownership is not viewed as detrimental where 100 percent of the shares in the transferee or the transferor are held directly or

indirectly by the same person (i.e. wholly owned subsidiaries of a common parent) or the transferor or transferee itself. In a change from earlier legislation, the exemption also applies to trading partnerships as qualifying holding companies. A group exemption provision is not applicable where the transferring and acquiring entity belong to a group of companies but shares in the transferring and/or acquiring entity are held by outside (minority) shareholders.

A turnaround exemption clause, introduced in 2009, states that the acquisition of shares in a loss-making company is not affected by the change of control rules if it serves the purpose of turning around the company's business. The turnaround (*Sanierung*) refers to a measure that aims to:

- prevent or abolish illiquidity or over-indebtedness
- preserve the essential business structures at the same time.

According to the rationale for the law, an acquisition serves the purpose of turning around the business where the acquisition takes place when the company in question faces potential or actual illiquidity or over-indebtedness. Further, to be considered an acquisition of shares for the purpose of turning around the business under the act, the company must show turnaround potential at the time of the acquisition.

The turnaround exemption does not apply where:

- the corporation had largely discontinued its operation at the time of the change in ownership
- a change in the line of business occurs within 5 years after the change in ownership.

The exemption clause was initially introduced as a temporary measure for share transfers taking place until 31 December 2009. This time limitation was later removed.

On 26 January 2011, the EU Commission ruled that this measure constitutes illegal state aid and therefore not in line with the requirements of the Common Market. While the proceedings of the German government against the ruling were dismissed as inadmissible by the General Court of the EU (EGC, 18 December 2012, t-205/11), numerous taxpayers have brought individual actions before the court that are still pending. In view of the potential ruling of the EU Commission, the German tax authorities had already suspended the application of the turnaround exemption and stayed all appeals against assessments not applying the turnaround exemption since April 2010, subject to a final court decision. The suspension was also implemented by the German legislator in December 2011.

Note that these change of control rules also apply to excess interest carried forward under the new earnings-stripping rules.

For partnerships, a direct acquisition of interests in a partnership limits the utilization of the trade tax loss carry forwards of the partnership or even triggers their partial or

complete forfeiture. This can only be avoided by acquiring the partnership interest indirectly. However, where the partners are corporate entities, even an indirect share transfer may lead to a forfeiture of tax losses.

Finally, the transfer of tax losses carried forward on mergers under the German Mergers and Reorganizations Tax Act has been abolished, so that all losses disappear in a corporate reorganization. Therefore, a step-up to the fair market or an interim value may be implemented to optimize loss utilization.

In addition, certain restrictions apply with regard to offsetting losses of the transferring entity and the receiving entity where a reorganization is implemented with retroactive effect.

Generally, the income and business assets of the transferring corporate entity and the receiving entity are determined as if the business assets of the corporate entity had been transferred to the receiving entity at midnight on the date of the reorganization balance sheet. The restrictions on the offsetting of losses of the transferring entity at the level of the receiving entity were expanded to cover the offset of losses of the receiving entity. For reorganizations and contributions implemented after 6 June 2013, it is no longer permissible for the receiving entity to offset its losses or interest carried forward against income of the transferring entity generated in the period of retroactivity. Therefore, the income attributed to the receiving entity is fully taxed. The limit on offsetting losses does not apply where the transferring entity and the receiving entity are affiliated companies pursuant to Sec. 271 para. 2 German Commercial Code (*Handelsgesetzbuch* — HGB) before midnight on the date of transfer ('group clause').

## Transfer taxes

See transfer taxes in this report's purchase of assets section.

## Tax clearances

Tax clearances are recommended, especially in cases of complex acquisition structures, such as under the German reorganization law. A taxpayer can apply for a so-called 'binding ruling' with the competent tax authority regarding the application of tax laws to certain specific facts but not on the existence of certain facts. While the tax authorities have discretion to issue a tax ruling, they can only decline to issue a ruling in limited circumstances. The tax authorities are bound by binding rulings granted to the taxpayer where the taxpayer has executed the transaction as described in its application for the ruling.

The taxpayer must pay a fee with the application of the binding ruling unless the value of the dispute does not exceed EUR10,000. The maximum fee is currently capped at EUR109,736, which equals a value of dispute of EUR30 million.

## Choice of acquisition vehicle

A foreign purchaser may invest in a German target through different vehicles. The tax implications of each vehicle may

influence the choice. Germany does not levy stamp tax or capital duty on funding a German company or branch.

### **Local holding company**

A German holding company is typically used when the purchaser wishes to ensure that tax relief for interest (e.g. resulting from a debt pushdown) is available to offset the target's taxable profits (see choice of acquisition funding) or taxable profits of other German companies already owned by the purchaser within a tax-consolidation scheme (see group relief/consolidation).

Capital gains derived by a resident corporate shareholder are essentially 95 percent exempt from corporate income tax irrespective of the participation quota, holding period and source (domestic or foreign).

As of 1 March 2013, the 95 percent exemption only applies to dividend income of the resident corporate shareholder where the investment accounts for at least 10 percent of the share capital at the beginning of the respective calendar year. The abolition of the exemption from capital gains for respective minority shareholdings has been discussed as well but will stay in force for the time being.

For trade tax purposes, the 95 percent exemption of dividend income only applies where the investment accounts for at least 15 percent of the share capital or an equivalent participation quota in the assets at the beginning of the respective fiscal year.

### **Foreign parent company**

A foreign purchaser may choose to perform the acquisition itself, perhaps to shelter its own taxable profits with the financing costs related to the investment in the German target. Where the German target is a trading partnership, the financing costs of the foreign parent company in connection with the acquisition of the partnership interest are generally tax-deductible at the level of the German partnership, subject to restrictions of the German earnings-stripping rules and a 25 percent add-back for trade tax purposes.

Thus, investments in German partnerships by a foreign parent company may potentially provide a double interest deduction opportunity where debt financing is taken out at the level of the foreign parent company. However, dual consolidated loss rules may apply, and these rules are likely to be expanded with the OECD BEPS initiative.

For a German corporate subsidiary, dividend distributions are subject to withholding tax (WHT) at a rate of 25 percent, increased to 26.375 percent by a 5.5 percent solidarity surcharge. The dividend WHT may be reduced to 15.825 percent where the foreign parent company is not domiciled in a country that has a tax treaty with Germany. If there is a tax treaty or the EU Parent-Subsidiary Directive applies, the WHT may be reduced to tax treaty rates or to zero under German domestic tax law, provided the foreign parent company meets

the requirements of the German anti-treaty shopping rules (see anti-treaty shopping rules).

Where the foreign parent company invests through a German trading partnership, generally, the parent has a limited tax liability in Germany on its income from the partnership. A withdrawal of capital from the trading partnership is not subject to WHT.

In principle, a capital gain on disposal of the investment in the German company is subject to tax in Germany under German domestic tax law. Capital gains tax is mitigated by the German participation exemption rules for corporate shareholders, which principally provide for a 95 percent tax exemption, or by the partial income system for individual shareholders, which provides for a 40 percent tax exemption (previously 50 percent) where the German company is a corporate entity. Where individual shareholders hold less than 1 percent of the share capital as private property, a flat tax rate of 25 percent plus solidarity surcharge applies. A full capital gains tax exemption may be available on the disposal of shares in a company if the tax treaty allocates the right to tax capital gains to the foreign parent company's country of residence.

### **Non-resident intermediate holding company**

Interposing an intermediate holding company generally implies an additional layer of taxation on funds repatriated to the investor. A non-resident intermediate holding company may be an option where the investor's country of residence taxes capital gains and dividends received from abroad. An intermediate holding company resident in another territory could be used to defer this tax and take advantage of a more favorable tax treaty with Germany.

The same German tax implications set out earlier for foreign parent companies apply to non-resident intermediate holding companies.

In terms of WHT relief, using a non-resident intermediate holding company is only more tax-efficient than a direct investment where the intermediate holding company meets the requirements of the German anti-treaty shopping rules. To the extent that the non-resident intermediate holding company does not derive its income from own business activities and lacks sufficient substance, the German anti-treaty shopping rules look through to its shareholder (see anti-treaty shopping rules).

Where the shareholder meets the requirements, the intermediate holding company may claim the benefits of a tax treaty or German domestic tax law implementing the EU Parent-Subsidiary Directive. Where sufficient substance is not demonstrated, the benefits are limited to the extent that the ultimate shareholder could have claimed them.

### **Anti-treaty shopping rules**

According to the German anti-treaty shopping rules, a foreign company has no right to complete or partial reduction of WHT

pursuant to a tax treaty and the German Income Tax Act to the extent its shareholders would not be entitled to the refund or exemption if (a) they derived the income directly; and (b) the foreign company's gross earnings for the respective fiscal year are not derived from its own business activities and

- with regard to these earnings, there are no economic or other valid reasons for the interposition of the foreign company, or
- the foreign company does not participate in general commerce by means of a business organization with resources appropriate to its business purpose.

## Local branch

As an alternative to directly acquiring the target's trade and assets, a foreign purchaser may structure the acquisition through a German branch. Germany does not impose additional taxes (such as WHT) on branch profits remitted to an overseas head office. The foreign enterprise is taxable as a non-resident taxpayer on income derived from the PE in Germany. Thus, the branch's income is subject to German tax at normal corporate and trade tax rates. Where the German operation is initially expected to make losses, a branch may be advantageous, because, subject to the tax treatment applicable in the head office's country, a timing benefit could arise from the ability to consolidate losses with the profits of the head office.

Unlike the disposal of a German subsidiary by a non-resident, which is 95 percent or 100 percent tax-exempt, a disposal of a German branch to a third party triggers capital gains tax, other than on capital gains relating to shares in corporations, which are in principle 95 percent tax-exempt.

## Joint venture

Joint ventures can either operate through a corporate entity (with the joint venture partners holding shares in a German company) or an unincorporated entity (usually a German limited partnership — *Kommanditgesellschaft*).

Partnerships are generally considered to provide greater tax flexibility. For example, where the joint venture is expected to make initial losses, the partners should be able to use their shares of corporate income tax losses against their existing German profits. However, trade tax losses cannot be transferred and remain at the level of the partnership. Profits of a partnership can be repatriated free of German WHT. Further, financing costs for acquiring a partnership are tax-deductible at the level of the partnership, which allows a debt pushdown without moving the debt itself to the joint venture or partnership level. However, any payments to the partners (e.g. management fees) are not tax-deductible at the partnership level. German real estate investments held by foreigners are often structured using partnerships because no German trade tax arises, provided the business qualifies as non-trading for tax purposes.

## Choice of acquisition funding

A purchaser needs to decide whether to fund the acquisition with debt or equity. The main concern is often to ensure that interest on funding can be set off against the target's profits to reduce the German effective tax rate. Tax-deductibility depends on the acquisition vehicle's legal form and place of residence, as well as the legal form of the target.

### Debt

The advantage of debt is the potential tax-deductibility of interest (see deductibility of interest), because the payment of a dividend is not tax-deductible at the level of the distributing entity. Where debt is used, the purchaser must decide which company should borrow and how the acquisition should be structured. To allocate the cost of debt efficiently, there must be sufficient taxable profit against which interest payments can be offset. The following comments assume that the purchaser wishes to set off the interest payments against the German target's taxable profits. However, consideration should be given to whether relief would be available at a higher rate in another jurisdiction.

Usually, a German corporation is used as the acquisition vehicle for a share acquisition, funding the purchase price with debt either from a related party (e.g. shareholder loan) or directly from a bank. Dividends received from domestic shareholdings are generally tax-exempt for trade tax purposes if the investment exceeds 15 percent and is held from the beginning of the fiscal year. A respective exemption applies for corporate income tax purposes if the investment accounts for at least 10 percent of the share capital at the beginning of the respective calendar year. However, 5 percent of any dividend received is treated as non-tax-deductible, which effectively reduces the dividend exemption to 95 percent. On the other hand, any business expenses, particularly interest expenses related to German-sourced dividend income, are fully tax-deductible for corporate income tax purposes (for discussion of restrictions on interest expenses and the add-back rules for trade tax purposes, see deductibility of interest).

The most common way to deduct interest expenses and offset them against the target's taxable income is an acquisition through a leveraged acquisition vehicle, followed by the establishment of a tax-consolidation scheme (*Organschaft*). A debt pushdown into the target directly may be achieved by merging the target into the acquisition vehicle or vice versa. Otherwise, interest expenses would remain structurally non-deductible because of the acquisition vehicle's lack of taxable income. In an asset deal, such an offset is automatically achieved where the acquirer of the assets/going concern is provided with the acquisition funding.

Due to the fiscal transparency of partnerships for German corporate income tax purposes, any interest on debt taken out to acquire an interest in a German partnership is tax-deductible at the level of the target, rather than at the level of

the acquisition vehicle. Thus, the acquisition of a partnership often results in an automatic debt pushdown for German tax purposes.

If the interest cannot be offset immediately (i.e. there are insufficient taxable profits), the resulting losses can be carried forward for German corporate income and trade tax purposes. In addition, it is possible to carry back losses of up to EUR1 million for German corporate income tax purposes.

Depending on the existing structures of the purchaser and target groups, it may be possible to introduce leverage into Germany after (rather than at the time of) the acquisition, such as by way of a recapitalization.

### **Deductibility of interest**

Tax-efficient debt-funding of acquisitions in Germany is restricted by earnings-stripping rules.

These rules generally limit the deductibility of net interest expenses (interest expense in excess of interest income) to 30 percent of EBITDA for tax purposes. Unlike traditional thin capitalization or transfer pricing restrictions applicable in many European countries, this restriction applies to any kind of interest expense, irrespective of whether it is derived from intercompany financing or third-party debt. The rules only apply to net interest expense exceeding EUR3 million in the assessment period.

To assess whether the earnings-stripping rules result in a restriction on interest deductions, the EBITDA for tax purposes must be accurately modelled in each case. The German generally accepted accounting principles (GAAP) results need to be decreased by tax-free income, such as dividends, capital gains and exempt foreign-sourced profits, to determine the allowable amount of interest.

Any interest in excess of the 30 percent threshold is non-deductible. Excess interest may be carried forward to future tax years but is subject to change of control restrictions, which may lead to a (full or partial) forfeiture of interest carry forwards on a transfer of shares in the respective company (as further discussed under tax losses in the purchase of assets section earlier in this report).

Companies wishing to deduct more interest expense than allowed under these restrictions may be able to take advantage of the so-called 'escape clause'. To qualify, the taxpayer must be able to demonstrate to the German tax authorities that the equity ratio (equity/balance sheet total) of the company is not more than 2 percent (increased from 1 percent by the Economic Growth Acceleration Act for 2010 and later assessment periods) lower than the equity ratio of the consolidated group of which the company is a member. In other words, debt financing must not exceed that of the group as a whole. Specific rules apply to the calculation of the equity ratio for this purpose, and there is a restriction on the use of debt granted or secured by related parties from outside the

consolidated group (tainted debt). The interest on such debt must not exceed 10 percent of the total net interest expense for each entity in the group. Interest expense in excess of 10 percent on tainted debt is subject to the 30 percent EBITDA restriction.

Although the German tax authorities issued a decree in July 2008 on the application of the earnings-stripping rules, the rules are difficult to apply because it is not clear how to determine the correct consolidation level, the applicable accounting principles, or the equity ratio for tax purposes, taking into account certain adjustments and add-backs. Structuring a transaction with a borrowing ratio that leads to interest expenses in excess of the 30 percent EBITDA rule requires careful analysis of whether the conditions of the escape clause can be met.

Where the net interest expenses are subject to the 30 percent EBITDA threshold but less than 30 percent of the tax EBITDA, the unused tax EBITDA provides for an additional interest deduction in future years in which the net interest expenses exceed 30 percent of the current tax EBITDA. Such EBITDA carry forwards are limited to a period of 5 years and must be assessed separately. An EBITDA carry forward is not allowed in years in which an exemption from the earnings-stripping rules applies. Taxable EBITDA is subject to full or pro rata forfeiture where the business of that company is transferred as a whole or, in certain cases of group reorganizations, according to German reorganization tax law. EBITDA carried forward is not forfeited on a detrimental change of control (i.e. a purchase of more than 25 percent of the shares in a company). Generally, the provision applies for business years ending after 31 December 2009.

For trade tax purposes, the deductibility of interest is further limited by an add-back of 25 percent of any deductible interest expense that exceeds EUR100,000 (together with certain other add-backs).

### **Withholding tax on debt and methods to reduce or eliminate it**

Generally, interest payments to lenders are not subject to German WHT. However, non-resident lenders are subject to non-resident taxation in Germany where the debt provided is secured by, for example, land charges on German real estate owned by the borrower/ target group and no relief can be claimed under the relevant tax treaty. Where a lender fails to qualify for relief, all interest income is subject to corporate income tax in Germany at a rate of 15.825 percent (including solidarity surcharge).

### **Checklist for debt funding**

- Consider whether the level of taxable profits of the German entities would allow effective tax relief for interest payments and whether a tax deduction may be available at higher rates in other jurisdictions.

- Analyze the debt capacity of the German (target) entities based on projections of EBITDA for tax purposes. Explore the potential applicability of the so-called ‘escape clause’ under the earnings-stripping rules.
- Explore whether a debt pushdown should be completed by a tax group scheme (*Organschaft*) or by way of a merger or other measures.

## Equity

An acquirer may use equity to fund the acquisition. German tax law imposes no capital or stamp duty.

However, Germany would levy 26.375 percent WHT (including solidarity surcharge) on dividends paid by a German company. The WHT may be avoided through the EU Parent-Subsidiary Directive or reduced under a tax treaty or domestic law, provided applicable conditions are met, particularly the minimum participation, holding period and substance requirements. Dividend payments are not tax-deductible in Germany.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, the use of equity may be more appropriate than debt in some situations, particularly where the target (group) is loss-making or the deductibility of interest expenses has already reached its limit under the earnings-stripping rules. Therefore, a tax-efficient structure normally requires an appropriate mix of debt and equity so that the interest expense remains deductible under the earnings-stripping rules. In addition, there may be non-tax reasons for using equity.

## Reorganizations

The discussion thus far has focused on the purchase of an entire business for cash. Where only part of a business is targeted and the seller refuses to agree to an asset sale, the provisions of the new German Reorganization Law, discussed later in the report, may permit a hive-down of the targeted assets into a subsidiary, the shares of which can then be sold. Accordingly, where two businesses are to be combined, the merger provisions may permit the combination to be structured as a share-for-share exchange without triggering an immediate tax liability. Due to several anti-avoidance rules, a tax-exempt reorganization followed by a disposal of shares in the company involved may lead to adverse tax consequences if the disposal date is close to the reorganization date. The reorganization may become retroactively subject to tax as a result.

German reorganization tax law was amended to facilitate cross-border reorganizations within the EU. Now the act covers not only reorganizations carried out under German reorganization law but also reorganizations in other EU jurisdictions that are comparable to reorganizations under German law. Transactions involving companies from non-EU and non-EEA countries usually still lead to immediate taxation of the transaction at both company and/or shareholder/partner level.

Generally, the reorganization tax law provides for all reorganizations to be carried out at fair market value, leading

to the taxation of hidden reserves. Where Germany has the right to tax the transferred assets, reorganizations can only be effected at book value on written application. In such cases, an interim value (below fair market value) may be chosen in order to utilize existing tax losses carried forward, subject to the minimum taxation rules, by offsetting them against any profits on reorganization.

One of the most significant privileges of reorganizations under the reorganization tax law is that most reorganizations can be carried out with a retroactive effect of up to 8 months for tax purposes. For example, the legal procedures of the reorganization can be carried out up to 31 August 2014, if the effective date of the reorganization for tax purposes was 31 December 2013.

## Merger of a German corporation into a German partnership

A merger of a corporation into a partnership can be carried out at book value so that no gain is recorded at the level of the transferring corporation, but the German tax authorities retain their right to tax any hidden reserves in the assets of the transferring corporation.

At the shareholder level of the transferring corporation, different effects should be considered:

- Any tax-effective depreciation on the shares in the transferring corporation is reversed, leading to a taxable profit. Such profit is 95 percent tax-exempt for corporate shareholders and 40 percent tax-exempt (50 percent before 2009) for individual shareholders.
- Retained earnings of the transferring corporation are treated as deemed dividend distributions and taxed at the shareholder level. Such dividends are 95 percent tax-exempt for corporate shareholders. They are also subject to 26.375 percent WHT (including 5.5 percent solidarity surcharge), which is generally creditable by domestic shareholders.
- For tax purposes, the shares in the transferring corporation generally are deemed to be contributed to the partnership. The replacement of the shares in the transferring corporation with the assets of the corporation due to the merger may then lead to a profit or loss on merger. Transaction costs and the deemed dividend distribution also may be deducted when calculating the merger profit or loss. A merger profit is 95 percent tax-exempt at the level of a corporate partner in the assuming partnership, but any loss on takeover is not tax-deductible.

Since a partnership is transparent for German income tax purposes, Germany’s right of taxation could be restricted on some mergers, for example, where the assuming partnership has non-resident partners that are only subject to a limited tax liability in Germany. Following the merger, any operating profit or capital gain is taxable at the level of the non-resident partner, so a tax treaty could restrict the right of taxation.

However, in most cases, the right of taxation remains with Germany to the extent the business assets constitute a PE.

Tax losses, interest and EBITDA carried forward, as well as current-year losses, are not transferred to the receiving partnership. Thus, such losses may only be offset against any merger profit resulting from a transfer of the assets at fair market value or an interim value. Normally, the tax losses carried forward are not entirely used since the tax losses carried forward for corporate income tax and trade tax purposes usually differ. Moreover, the set-off of tax losses carried forward is further restricted by the minimum taxation rules. In addition, any interest carried forward resulting from the limitations of the earnings-stripping rules is not transferred to the receiving entity.

### **Merger of a German corporation into another German corporation**

A corporation can be merged into another by compensating the shareholder(s) of the transferring entity with new shares in the receiving entity or, in exceptional cases, without any compensation. A formal liquidation of the transferring entity is not required. On the merger, the transferring entity can increase the cost base of its assets, including self-created intellectual property. The increase in the cost base triggers taxable income at the level of the transferring entity and increases the depreciation base at the level of the receiving entity. In most cases, a merger gain (i.e. a gain resulting from an excess of the value of assets received over the shares held in the transferring entity) at the level of the receiving entity is tax-free. However, in the case of an upstream merger where a subsidiary merges into the parent company, the merger gain is only 95 percent tax-exempt. In all cases, a merger loss is not tax-deductible.

Any previous write-downs of shares in the transferring company must be reversed. Where these write-downs were tax-deductible (i.e. for write-downs prior to 2002), the reversal is subject to corporate income and trade taxes in full. Write-downs occurring after 2001 are not tax-deductible, so the reversal is 95 percent tax-exempt for corporate income and trade tax purposes.

Tax losses, interest and EBITDA carried forward (earnings-stripping rules) by the transferring entity are forfeited on the merger (see merger of a German corporation into a German partnership).

### **Contribution of assets into a German corporation in return for new shares**

When the transferring entity receives new shares in the receiving entity, the following assets can be transferred to a German corporation under the German Mergers and Reorganizations Tax Act:

- assets and liabilities that constitute a branch of activity (*Betrieb or Teilbetrieb*), which can be categorized as such where they have a certain degree of independence and are potentially capable of functioning as an independent business

- an interest in a partnership
- a stake in a corporation.

Such a transfer is generally performed at fair market value, triggering a taxable gain or loss. However, the contribution of a branch or a partnership interest can be done at cost. This does not trigger additional tax costs where the following requirements are met:

- The contributed assets are subject to German corporate income tax at the level of the receiving entity.
- For contributions effected before 2015, the liabilities contributed do not exceed the assets contributed. For contributions effected or agreed in 2015 and later years, the liabilities contributed or any compensation other than shares does not exceed EUR500,000 or 25 percent of the book value of assets contributed
- Germany's taxation rights on the contributed assets are not excluded or limited as a result of the contribution.

The contribution of a stake in a corporation may be effected tax-neutrally if the receiving entity owns the majority of the voting rights in the contributed corporation after the contribution. Any existing shareholding is included when considering this condition.

A tax-free contribution may be later subject to partial, retroactive taxation where, within 7 years following the contribution, either the shares granted in exchange for the contributed assets or the contributed shares themselves are sold. However, the sale of the contributed shares does not lead to retroactive taxation where the contributing entity is a corporation that could have disposed of the shares tax-free anyway.

The taxable gain is decreased pro rata by one-seventh for each year that elapses from the time of the contribution to the time of the sale. The taxpayer must demonstrate to the tax authorities by 31 May of each year that the shares were not sold during the past year. A failure to provide such evidence to the tax authorities in good time leads to a deemed share transfer and retroactive taxation on a pro rata basis.

### **Demerger**

In addition to the aforementioned contributions, a branch of activity, interest in a partnership or a 100 percent stake in a corporation can be contributed in return for new shares in the transferee or, in exceptional cases, without any compensation. The main differences between this and the previously discussed contribution are that new shares can be granted to the shareholder of the transferring entity and this scheme is solely applicable to corporations. Generally, three models are possible:

- In a split-up, an entity transfers all of its assets and liabilities to two or more receiving entities, either pre-existing or created for this purpose. The transferring entity is dissolved without being liquidated, and the owners of the transferring entity take ownership interests in the receiving entities in return for their dissolved interests.

- In a split-off, an entity transfers part of its assets and liabilities to one or more receiving entities, either pre-existing or created for this purpose. The transferring entity is not dissolved. The owners of the transferring entity take shares in the receiving entity in return for surrendering their indirect ownership rights in the property transferred. Split-offs include transactions in which the owners of the transferring entity all receive pro rata ownership rights in the receiving entity (sometimes called spin-off). Split-offs also include transactions in which certain owners of the transferring entity surrender all or part of their interest in this entity in return for an increased interest in the receiving entity.
- In a hive-down, an entity transfers part of its assets and liabilities to one or more receiving entities, either pre-existing or created for this purpose, and in return takes ownership rights in the receiving entities.

These types of transaction are generally carried out at fair market value but can also be achieved tax-free subject to certain conditions. For split-offs, both the assets and liabilities retained and those transferred must constitute self-contained businesses, interests in trading partnerships, or 100 percent ownership of corporations to ensure that the split-off is performed tax-neutrally at book value. The split-off of other assets must be carried out at fair market value, leading to a capital gain. For split-ups and hive-downs, the same applies to the assets transferred. However, where shares in a corporation are being hived down to another corporation, it is enough that the receiving corporation holds a majority of the first corporation's voting shares after the reorganization (see contribution of assets into a German corporation in return for new shares).

Complete continuity of ownership between the transferring corporation and the receiving entity (i.e. no separation of shareholder groups) is a condition of tax-free treatment in split-offs and split-ups, unless the shareholders in the transferring corporation have held their shares for at least 5 years. However, it is not necessary for all shareholders of the transferring corporation to take pro rata ownership interests in the receiving entity. The interest retained in the transferring entity can be reduced in return for an increased interest in the receiving entity and vice versa. Unanimous shareholder approval is required.

Where, within 5 years of a split-up or split-off, interests in the entities representing more than 20 percent of the value of the original interests in the transferring entity are conveyed to third parties, the entire reorganization is retroactively subject to tax.

Where a corporation is divided by a split-up, all loss carry forwards are forfeited. In a split-off, tax losses carried forward are not transferred to the receiving entities and some existing tax losses are forfeited.

## Contribution of assets into a German partnership

Under German reorganization tax law, all the shares in a corporation, self-contained businesses or interest in a partnership can be contributed tax-free, provided Germany's taxation rights in relation to these assets is not removed or limited. While the contribution of shares into a corporation can be tax-neutral, provided the receiving entity owns the majority of the voting shares following the contribution, the contribution of shares into a partnership is eligible for tax-neutral treatment under this regime only if all the shares are transferred.

As of 31 December 2014, the same restrictions that apply on the contribution of assets into a corporation apply where the contributor receives compensation other than an equity interest in the receiving partnership. Such additional compensation must not exceed EUR500,000 or 25 percent of the book value of assets contributed.

Outside the scope of the reorganization tax law, a transfer of single assets (including individual non-qualifying shares in a corporation) between two businesses owned by the same taxpayer or the attribution of assets to a partnership for tax purposes (*Sonderbetriebsvermögen*) is possible according to the Income Tax Act, section 6(5). According to German tax law, a transfer of shares by a partner to the partnership of which they are a member is also possible at tax book values. Other than the reorganization schemes described earlier, such a transaction is ineligible for retroactive application and the legal benefit of universal succession is not available. Consequently, contracts and licenses, etc., can only be transferred with the consent of the counterpart or regulator.

## Change of legal form

The German Reorganization Act and Reorganization Tax Act allow for the conversion of a corporation into a partnership and vice versa. From a tax perspective, the conversion of a corporation into a partnership triggers the same tax consequences as the merger of a corporation into a partnership, as described earlier. The conversion of a partnership into a corporation is treated as a contribution of a branch of activity into a corporation in return for new shares, as noted earlier.

## Hybrids

Consideration may be given to hybrid financing — that is, using instruments treated as equity for tax purposes for one party and as debt (giving rise to tax-deductible interest) for the other. Various hybrid instruments and structures were devised to achieve an interest deduction for the borrower with no income inclusion for the lender. However, legislative changes made in 2013 deny the tax-effectiveness of certain double dip structures, particularly hybrid financing structures. Further restrictions are expected to apply with the implementation of the OECD BEPS initiative.

## Discounted securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment. As a result, the issuer should be able to obtain a tax deduction for the discount accruing over the life of the security. An advantage of discounted securities is that discount, unlike interest, does not give rise to WHT.

## Deferred settlement

An acquisition often involves an element of deferred consideration, the amount of which is based on the business's post-acquisition performance and can only be determined at a later date. Under German tax law, the right to receive an unknown future amount is not regarded as an asset that must be valued upfront for German tax purposes. Instead, any consideration is treated as a retroactive adjustment of the initial consideration paid, and the tax calculation of both seller and buyer is amended retroactively for the deferred consideration received.

## Other considerations

### Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. Due to differences in the tax treatment of asset and share sales, owners of corporate target entities generally are less inclined to sell the entity's assets than its shares.

### Asset deal

The taxation of capital gains depends on the legal form of the seller and the type of asset disposed.

Where the seller is an individual who sells their whole business, the capital gain may be subject to a favorable tax regime. For a corporation, capital gains are generally fully taxable; however, where the business assets include shares, the 95 percent participation exemption applies on the sale of the shares.

The new provisions on the transfer of contingent losses allow the seller to realize built-in losses subject to certain limitations. While immediate deduction of realized built-in losses is allowed on the transfer of an entire business or partnership interest, built-in losses that are realized due to the transfer of a liability in other cases generally may not be fully deducted in the year of transfer but must be spread over a period of 15 years. These rules are especially relevant if, within a business transfer, existing pension obligations are transferred.

### Disposal of a partnership

The taxation of a capital gain incurred on the disposal of a partnership interest depends on the type of partner concerned, that is, whether the partner is an individual or a corporate entity and, in the case of a disposal by an individual, whether their interest is sold fully or partly.

Where a partner sells their whole interest in the partnership, the resulting capital gain is not subject to trade tax if the seller is an individual. Additionally, an individual can apply for the same tax relief as described earlier with respect to the transfer of a going concern business by means of an asset deal. If only part of the partnership interest is sold, trade tax becomes due. In addition, none of the tax reliefs granted on the disposal of the whole interest are usually available when disposing of part of an interest (i.e. neither the limited tax exemption nor the reduced average tax rate apply).

For corporate partners, the capital gain is subject to corporate income tax and trade tax, irrespective of whether the participation is sold in whole or in part.

For corporate members, the part of the capital gain from the disposal of a partnership interest attributable to a participation in shares held by the partnership is taxed in the same way as if the shares were held directly by the seller (see next section).

### Disposal of shares

German taxpayers enjoy certain tax exemptions on capital gains realized on the sale of shares in a corporation:

- Sellers who are resident or non-resident individuals can exclude 40 percent (50 percent pre-2009) of the gain realized for income tax purposes and, if applicable, for trade tax purposes (40 percent exemption).
- Individual sellers holding less than 1 percent of the shares in the company as private property are subject to a flat tax rate of 25 percent plus solidarity surcharge.
- Resident and non-resident corporate sellers can generally exclude their entire gains for corporate income and trade tax purposes (100 percent exemption). The same applies where the shares are held by a German branch of a foreign company or a German partnership with a corporate partner.

Generally, a minimum interest, holding period or tax treaty protection is not required to qualify for these exemptions. However, within a 7-year holding period following a tax-free reorganization, a sale may have adverse tax consequences under German reorganization tax law (see earlier in the report). Banks and other financial institutions that sell stocks held for short-term trading purposes cannot benefit from the capital gains exemptions because receipts are considered trading income. Recent developments suggest this short-term trading rule may also apply to non-financial institutions.

As of 2004, 5 percent of the capital gain is deemed to be a non-deductible business expense for corporate sellers, thus effectively reducing the 100 percent exemption to a 95 percent exemption. While current expenses, such as financing costs, are tax-deductible, expenses incurred on the sale of shares reduce the amount of the capital gain, so they are only 5 percent tax-deductible.

The capital gains tax exemption does not apply to the disposal of shares held by life and health insurance companies.

## Company law and accounting

Under German commercial law, International Financial Reporting Standards (IFRS) can be substituted for German GAAP as reporting standards for listed and non-listed companies. However, German GAAP are mandatory for statutory financial statements, particularly as the basis for the distribution of dividends, for insolvency law and for tax reasons. German reorganization law is mainly laid out in the so-called '*Umwandlungsgesetz*' (UmwG), which sets out the rules for commercial law and the accounting treatment for mergers (*Verschmelzungen*) as well as demergers (spin-offs, split-offs, carve-outs) and conversions.

As for M&A transactions, a business combination (which, under IFRS, is defined as the bringing together of separate entities or businesses into one reporting entity) may be categorized as either a merger or an acquisition. In essence, a combination is regarded as a merger where it effects a pooling of business interests (i.e. where one company's equity is exchanged for equity in another company) or where shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for the equity, with both sides receiving little or no consideration in the form of cash or other assets.

German company law and accounting standards allow for various M&A methods. Generally, for mergers, companies have the choice of keeping current book values or changing to fair values according to German reorganization law in their statutory financial statements. Acquisitions are accounted for based on the contribution made in exchange for economic control over the company or over assets and liabilities that constitute a branch of activity. In contrast to German GAAP, merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated (share deal) or statutory (asset deal) balance sheet at their fair values, and goodwill arises to the extent that the consideration paid exceeds the sum of these values. Under IFRS, goodwill is not amortized over its useful economic life (impairment-only approach). Under German GAAP, goodwill in the consolidated financial statements is amortized on a systematic basis over its estimated useful life. For practical reasons, a useful life of 15 years, as defined by German tax law, is usually applied to amortize goodwill in both statutory financial statements under German GAAP and the tax balance sheets. Acquisition accounting principles also apply to purchases of trade and assets, with any goodwill and fair value adjustments appearing on the acquirer's own balance sheet. In merger accounting, goodwill does not arise. Any remaining difference is treated as a capital contribution or as a merger gain or loss, depending on the shareholder resolution.

Another important feature of German company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable equity under German GAAP (e.g. retained earnings or available capital reserves). Thus, for groups, the distributable equity reserves must be determined by aggregating the corresponding statutory German GAAP accounts of the holding company and its subsidiaries separately, rather than by simply looking at the equity reserves of the group at consolidated level. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the distribution of pre-acquisition profits of the acquired company may be restricted.

Additionally, distributions recorded in the company's accounts must meet certain legal capital maintenance rules. Violation of these rules triggers a personal liability for management and shareholders. In particular, these rules may need to be applied where simple upstream loans are made to the parent company instead of dividend payments. Previously, the scope of these rules was much wider. Even now, it remains important that upstream loans are not impaired at grant date and that management continuously monitors the credit-worthiness of the borrower. Share capital increases, particularly payments in kind rather than cash, must also meet legal requirements for capital maintenance. Otherwise, the management and shareholders may become personally liable.

Germany does not generally impose government controls or restrictions on investments in assets and business entities or on capital movements into or out of Germany. However, the German foreign trade act (*Außenwirtschaftsgesetz*) allows for a prohibition of acquisitions regarding more than 25 percent of voting rights by non-European investors if public order or security are endangered. Due to a restrictive application, the majority of transactions is not affected by such prohibitions. Foreign investors can obtain legal certainty by obtaining a clearance certificate before a relevant acquisition. Further restrictions exist for investments in military weapons, including dual-use technologies.

In addition, foreign trade regulations (*Außenwirtschaftsverordnung*) require reporting certain flows of capital for statistical purposes.

Germany has anti-trust legislation to safeguard free competition. M&A transactions above a certain size (essentially, involving companies or corporate groups with a joint worldwide turnover exceeding EUR500 million) and including at least one entity with a turnover exceeding EUR25 million in Germany and another with a turnover exceeding EUR5 million in Germany must be registered with the federal cartel authority regardless of the nature of the business. The federal cartel office can prohibit or restrict such transactions if it considers them to be detrimental to competition. EU anti-trust laws may pre-empt German anti-trust laws or add to them, depending on the transaction.

When planning an M&A transaction, labor law considerations should be taken into account. Under a provision in force in one form or another throughout the EU, the purchaser of a business automatically takes over all employment contracts associated with it. It makes no difference in this respect whether shares or assets are purchased, although difficult questions arise when not all assets of a business are acquired, such as the acquisition of one of several business divisions (branches of activity). Continuation of the employment contracts does not in itself prevent immediate downsizing following the acquisition, but this must be conducted in accordance with general German labor law legislation, which, compared with that of many countries, favors employees.

Further, Germany has an employee codetermination/participation system for virtually all businesses. At the business level, in companies with at least five employees, employees can elect a works council (*Betriebsrat*). The works council has a variety of rights to be informed and heard on personnel and other intracompany matters. If a works council exists, some decisions, such as terminations, may also require prior consent of the works council.

At the company level, employee co-determination provisions require companies with 500 or more employees to establish a supervisory board if they do not already have one according to their articles of association. The employees have the right to elect one-third of the supervisory board members, or 50 percent of the supervisory board members in companies with more than 2000 employees. Advocates of this system regard it as at least partially responsible for the traditionally good German management-labor relations and relatively low level of strike activity. Foreign owners unfamiliar with supervisory boards sometimes consider this practice to be unusual.

### **Group relief/consolidation**

Generally, each entity is taxed on a standalone basis, unless the entities constitute a consolidated tax group. Entities that are part of such a consolidated group are taxed together as a single body (*Organschaft*).

There are three types of tax consolidation in Germany: VAT consolidation, trade tax consolidation and corporate income tax consolidation. In all three cases, group members (controlled entities) are consolidated under a group leader (controlling entity). All types of consolidation require the financial integration of the group members.

Financial integration requires at least a direct or indirect majority of the voting rights of the controlling entity in the controlled company.

Only European stock corporations (*societas Europaea*), stock corporations, partnerships limited by shares and, subject to certain requirements, other corporations (particularly GmbH) established in an EU/EEA member state whose place of management and control is in Germany qualify as potential group subsidiaries. Due to the transparency of a partnership

for corporate income tax purposes, the partnership's income is attributed to its partners and taxed in their hands. Therefore, for a partnership, corporate income is effectively consolidated.

Corporate income tax and trade tax consolidation require only the financial integration from the beginning of the fiscal year and a signed profit and loss pooling agreement between the group member and the group leader. This agreement is subject to various formal requirements and must actually be performed. Further, the agreement is enforceable by creditors (e.g. to force the group leader to transfer funds to a group member to cover its losses).

The group leader can be any person, corporation or partnership engaged in a commercial enterprise with a PE in Germany. However, the shares in the controlled subsidiary have to be allocated to the German PE for the tax group to be recognized.

Losses sustained by group members after the effective date of consolidation are attributed to the group leader for trade and corporation tax purposes. Pre-consolidation corporate income tax losses and, since 2004, trade tax losses are not affected by the consolidation and remain within the particular group member for use after the tax consolidation is terminated (e.g. by termination of the profit and loss assumption agreement).

For VAT purposes, consolidation requires the financial, organizational and economic integration of the group members into the group leader:

- Organizational integration requires the controlling entity to be able to assert management influence on a group member (e.g. where the same persons manage both companies or the group member contractually yields management authority to the group leader).
- Economic integration requires a substantial economic relationship between the activities of the group members and the group leader, ideally such that the group member functions economically like a branch of the group leader. This is often the most difficult of the three requirements to meet, especially where the intended group leader is a pure holding company.

For VAT purposes, the tax consolidation automatically becomes effective when these requirements are met.

### **Transfer pricing**

Where an intercompany balance arises between the purchaser and the target after the acquisition, failure to charge interest on the balance may give rise to transfer pricing problems in the relevant jurisdiction. For example, where the balance is owed to the target, the tax authorities could impute interest on the balance if interest is not charged at an arm's length rate. Failure to charge fees, such as for cross-guarantees provided where the German target is the guarantor, may give rise to transfer pricing adjustments.

## Dual residency

There may be advantages in seeking to establish a dual resident company, such as by benefitting from rules that are not followed in other jurisdictions (e.g. special business expenses in the case of partnerships).

## Foreign investments of a local target company

The CFC anti-avoidance legislation is designed to prevent German companies from accumulating profits offshore in low-tax countries. Unless the offshore lower-tier company is carrying out certain acceptable activities or meets other specific conditions, its profits are apportioned and allocated to the German parent company and are subject to German tax.

Therefore, the structure of the potential target should be reviewed for CFC risks in advance.

## Comparison of asset and share purchases

### Advantages of asset purchases

- Direct allocation of the transaction financing to the acquired assets.
- Step-up to a higher depreciation base and goodwill amortization.
- Assumption of business-related liabilities only, although certain liabilities are unavoidable under the German Civil Code (BGB), section 613a, the German Commercial Code (HGB), section 25, and the General Tax Act (AO), section 75.
- Easy integration of profitable target operations into the loss-making company in the purchaser's group, permitting future offset of profits and losses.
- Selective acquisition of only those assets that are desired; debt-free acquisition of the business.

### Disadvantages of asset purchases

- Approval of partners/shareholders possibly required.
- Legally more complicated due to the need to specify assets acquired, regulate delivery, arrange for continuation or renegotiate contractual relationships, etc.
- Possible difficulties in transferring certain pension obligations to the buyer.
- Need to renew licenses and permits associated with the business.

- Higher capital outlay if purchased debt-free.
- Potentially higher capital gains tax for the seller.
- Likely to be subject to VAT unless the whole business is transferred.
- Real estate transfer tax base may be higher.

### Advantages of share purchases

- Greater legal simplicity; no need to assume contracts or re-apply for licenses and permits.
- Potential 95 percent capital gains tax exemption for the seller.
- Potential integration of target corporation into existing tax-consolidated group.
- For partnership interests, double dips may be possible. Also, step-up for tax purposes available.

### Disadvantages of share purchases

- Target business in a corporation form (i.e. where the target is a form of tax-transparent partnership, an interest purchase generally is treated as an asset deal for tax purposes).
- Tax depreciation is unaffected by the value of the purchase price (unchanged historical asset depreciation values).
- Acquisition of all business-related liabilities.



## KPMG in Germany

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