# GERMANY

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## INTERNATIONAL DEVELOPMENTS

### 1. WHAT ARE RECENT TAX DEVELOPMENTS IN YOUR COUNTRY WHICH ARE RELEVANT FOR M&A DEALS AND PRIVATE EQUITY?

Germany has recently seen some legislative developments with relevance for M&A deals and private equity.

Regarding the tax loss forfeiture rules for harmful transfers of more than 25% or 50% of the shares in a target entity (change-of-control), the tax legislation introduced an additional rule which, at the taxpayer's request, is applied instead of the general rules to allow – under very strict conditions – the preservation of losses in the case of a continuation of business (see no. 9 below).

Another important development was that the German Federal Constitutional Court (*Bundesverfassungsgericht*) in its decision of 29 March 2017 declared the proportional loss forfeiture for the transfer of more than 25% up to 50% in the years 2008 to 2015 unconstitutional unless the legislature creates a constitutional and retroactively applicable new regulation. According to the draft Annual Tax Act 2018 the loss forfeiture shall not apply to such changes in ownership of up to 50% that have occurred in the years 2008 to 2015. The question as to whether the complete loss forfeiture for a transfer of more than 50% of the shares is unconstitutional is currently pending.

A third significant development with respect to tax loss forfeiture rules was the European Court of Justice (ECJ) decision of 28 June 2018 in which the ECJ annulled a decision by the European Commission in 2011 on the state aid status of the restructuring clause (*Sanierungsklausel*), arguing that the European commission applied an incorrect reference system for purposes of the selectivity analysis. This restructuring clause, under certain conditions, allows to prevent the application of the loss forfeiture rules in spite of a harmful change in ownership. The draft Annual Tax Act 2018 includes a provision that reinstates the restructuring clause retroactively to 2008. However, it is unclear whether the ECJ confirmed that the restructuring clause is not an unlawful state aid.

The tax legislation also adopted a license barrier which, as of 1 January 2018, restricts the tax deductibility of license fees and royalties paid by German taxpayers to related parties if at the recipient's level such payments are subject to low taxation (see no. 18 below).

The German Federal Tax Court (*Bundesfinanzhof*) ruled on 31 May 2017 that a capital gain realised by a corporation from the sale of shares in another corporation is 100% tax-exempt if the selling corporation is non-domestic and does not have a permanent establishment or representative in Germany (see no. 14 below).

In the past, financial restructurings were facilitated by the tax authorities' restructuring decree (*Sanierungserlass*) dated 27 March 2013 declaring that subject to certain conditions a debt waiver gain is not taxed. In its resolution of 28 November 2016, the Grand Senate of the German Federal Tax Court abolished this restructuring decree because it had no statutory basis. The German legislature then basically converted the restructuring decree into statutory law. This new law applies retrospectively for all debt waivers effected after 8 February 2017 but is currently subject to notification by the European Commission in order to avoid potential state aid risks. For any debt waivers effected up to and including 8 February 2017, the German Federal Ministry of Finance (*Bundesfinanzministerium*) stated in a circular that the restructuring decree continues to be applicable. However, the German Federal Tax Court recently also abolished this circular with the effect that for such "old" debt waivers taxpayers generally cannot rely on the applicability of the restructuring decree.

M&A deals could also be affected by possible amendments of the Real Estate Transfer Tax (RETT) Act. The Ministers of Finance of the Federal States agreed on new RETT rules for share deals. Firstly, it is proposed to lower the harmful threshold of direct and indirect share transfers in real estate holding companies from 95% to 90%. Secondly, an additional RETT event for corporations holding real estate shall be implemented, where (similarly to the existing rules for partnerships) the transfer of at least 90% of the shares in a corporation within a period of ten years will be subject to RETT, i.e. also the transfer to two or more unrelated investors would trigger RETT. Thirdly, the holding periods, e.g. for the seller regarding its minority interest in a partnership holding real estate as well as for certain RETT exemptions, shall be extended from five to ten years. Certain consequential amendments to the RETT Act are possible. However, no draft law on the new RETT rules has been published yet. Against this background, especially in cases where a share transfer of more than 90% of the shares or interests is currently envisaged, the legislative process should be monitored closely.

Finally, it is important to note that the envisaged tightening of the rules dealing with the tax-exemption of capital gains deriving from the disposal of shares in corporations by corporations (i.e. a 10% minimum shareholding criteria) has not been introduced yet and is currently not included in any tax bill. However, it cannot be ruled out that the restriction will be enacted at a later stage.

## 2. WHAT IS THE GENERAL APPROACH OF YOUR JURISDICTION REGARDING THE IMPLEMENTATION OF OECD BEPS ACTIONS (ACTION PLANS 6 AND 15 SPECIFICALLY) AND, IF APPLICABLE, THE AMENDMENTS TO THE EU PARENT-SUBSIDIARY DIRECTIVE AND ANTI-TAX AVOIDANCE DIRECTIVES?

### OECD BEPS

Germany generally supports the BEPS actions. German tax law already covers many aspects of the BEPS action plan (e.g. interest barrier rules, CFC rules). With effect from 2017 and 2018 respectively, Germany implemented provisions reflecting BEPS Actions 5 and 13. With regard to Action 5, Germany introduced a limitation rule for license fees and royalties (see no. 18 below). Furthermore, in order to implement Action 13, Germany changed its General Tax Act so that multinational enterprises are now required to submit master and local files as well as country-by-country reporting. In addition, several existing tax rules have been changed in order to challenge treaty shopping. It is not unlikely that further provisions, in particular regarding hybrid mismatches (Action 2),
will be introduced in future.

On 7 June 2017, Germany signed the OECD Multilateral Instrument, a convention to modify existing double tax treaties under BEPS Action 15 with the aim of reducing opportunities for tax avoidance by multinational enterprises.

### Parent-Subsidiary Directive

The amendments of the Parent-Subsidiary Directive in July 2014 (introducing subject-to-tax clause and correspondence principle) and January 2015 (introducing a general anti-abuse clause) were in principle enacted in German tax law.

### Anti-Tax Avoidance Directive

Most of the rules of the Anti-Tax Avoidance Directive (e.g. interest barrier rule, exit taxation) are already included in German tax law. Therefore, no significant amendments are expected in this respect. However, the German legislature might take the opportunity to modernise the German CFC rules in light of Article 7 of the Directive.

### Mutual Assistance Directive

In connection with BEPS Action 5, the European Commission – with its proposal dated June 2017 – intends to amend Council Directive 2011/16/EU on administrative co-operation in the field of taxation and repeal Directive 77/799/EEC (Mutual Assistance Directive) by introducing special disclosure obligations for potentially aggressive tax planning arrangements with cross-border implications. In its corresponding recommendations, the German Federal Council (Bundesrat) proposes to extend such reporting obligations to national tax planning arrangements.

## GENERAL

### 3. WHAT ARE THE MAIN DIFFERENCES BETWEEN AN ACQUISITION OF SHARES AND AN ASSET DEAL IN YOUR COUNTRY?

**A) Share deal**

In a share deal, no step-up of the book value of the assets in the target company is possible for the buyer. Instead, the (high) acquisition costs are only reflected in the book value of the acquired shares and will thereby only reduce a potential future capital gain (which in the case of a corporate seller is 95% tax exempt) provided that the future exit takes place at this level. Further, the buyer acquires all tax risks from prior years associated with the company's shares and therefore should request tax guarantees/indemnity from the seller. If the target company owns German real estate with considerable value, a share deal might enable the buyer to mitigate or even avoid RETT (regarding potential changes of the law see no. 1 above). Various options are available for the buyer to achieve a debt-push down (e.g. down-stream merger, implementation of fiscal unity). Whether arm's-length interest expense is deductible for tax purposes depends on the requirements of the interest barrier rule (see no. 6 below).

From a corporate seller's perspective, the main advantage of a share deal is that the capital gain deriving from the disposal of shares is in principle 95% tax-exempt. However, capital losses from share deals are not tax-deductible at all. At the level of the target corporation (and its subsidiaries), losses carried forward and current losses up to the transfer date might be forfeited under the loss forfeiture rules (unless certain exceptions are fulfilled). Share transfers are generally VAT-exempt. Depending on the VAT situation of the seller and the purchaser, the seller can opt for regular VAT in order to improve the deductibility of input VAT on transaction costs.

**B) Asset deal**

An asset deal gives the buyer the possibility to step up the book values of the acquired assets, including goodwill, up to the acquisition price. The subsequent depreciation results in lower tax burdens for the buyer in the future. In an asset deal, most of the tax risks from former years remain with the seller. However, if the asset deal qualifies as a transfer of a going concern (meaning the transfer of the whole business or separate business unit), there is a special regulation that the buyer could be subject to a secondary liability for certain business taxes of the seller resulting from the pre-acquisition period.

A debt push-down is not required as financing can be easily provided to the acquiring company. The deductibility of interest expense depends on the requirements of the interest barrier rule (see no. 6 below). Furthermore, the acquisition of assets is generally not exempt from VAT (unless the assets qualify as a going concern). This has to be carefully considered if the input VAT is not fully deductible for the buyer (e.g. in the event of a VAT-exempt turnover).

Please note that the acquisition of a partnership interest is treated like an asset deal (and not like a share deal) for German tax purposes. Therefore, there is a step-up of the value of the assets for the buyer when acquiring partnership interests. For (corporate) income tax purposes, depreciation of the stepped-up assets (shown in a supplementary tax balance sheet) is allocated directly to the acquiring partner. For trade tax purposes, an allocation of the stepped-up assets would need to be contractually agreed as in this case, not the respective partner but the partnership itself is the taxpayer.

For the seller, the asset deal is in principle a taxable event, except for a potential tax-neutral roll-over regarding land, buildings or vessels if the corresponding proceeds are reinvested (see no. 21). Capital gains could be offset against existing losses and loss carry-forwards of the seller. In this context the seller has to take into account Germany's minimum taxation rules. These rules limit the deduction of loss carry-forwards in a fiscal year to the amount of €1 million plus 60% of the income exceeding €1 million. The seller usually retains all tax risks from prior years associated with the business assets. Capital losses from an asset deal are in principle tax-deductible.

## BUY-SIDE

### 4. WHAT STRATEGIES ARE IN PLACE, IF ANY, TO STEP UP THE VALUE OF THE TANGIBLE AND INTANGIBLE ASSETS IN CASE OF SHARE DEALS?

German tax law in principle does not provide for a tax-neutral step-up of the value of tangible or intangible assets in a share deal. Various options (e.g. sale, merger) are available to achieve a taxable step-up of the assets after the share deal. In this context a tax benefit could be achieved only if existing losses or loss carry-forwards can neutralise the taxable capital gain. However, the minimum taxation rules have to be considered in cases where the taxable profit from the contribution exceeds €1 million and no sufficient losses of the current year are available (see no. 3b) above).

### 5. WHAT ARE THE PARTICULAR RULES OF AMORTISATION OF GOODWILL AND SIMILAR INTANGIBLE ASSETS IN YOUR COUNTRY?

German tax law allows straight-line depreciation of goodwill over 15 years. For German GAAP purposes, however, the depreciation period of goodwill is generally 5 years.

Acquired intangible fixed assets are depreciated straight-line over their estimated useful lives (the costs of self-created intangible fixed assets must not be capitalised).

### 6. WHAT ARE THE LIMITATIONS ON THE DEDUCTIBILITY OF INTEREST EXPENSE? ARE THERE SPECIAL INTEREST LIMITATIONS IN THE CASES OF ACQUISITION OF SHARES AND ASSETS?

The general limitations on the deductibility of interest expenses also apply to share and asset acquisitions.

- **Arm's length principle**

  The interest rate on borrowings from shareholders or related persons must comply with arm's length principles. This also requires that financing agreements are concluded beforehand and preferably in writing in order to prevent the tax authorities from denying the interest deductibility.

- **Interest barrier rules**

  According to the German interest barrier rules, a taxpayer is able to immediately deduct net interest expenses (interest expenses minus interest income) only up to 30% of the taxable earnings before interest, taxes, depreciation and amortisation (tax EBITDA). The tax EBITDA only includes taxable income and thus does not necessarily match with the GAAP EBITDA. The interest barrier rules apply to all interest and not only to interest on intra-group loans. The interest barrier rules allow EBITDA carry-forwards (broadly speaking, unused EBITDA in one year can be used to achieve an interest deduction in future years) and interest carry-forwards (non-deductible interest might be deductible in future years if there is sufficient EBITDA in such a year). Interest carry-forwards are subject to the change-of-ownership rules (see no. 9); EBITDA carry-forwards lapse after five years.

  The interest barrier rules do not apply if one of the following conditions is met:

  - The net interest expenses of the respective fiscal year (based on the tax authorities' view including any interest carry-forwards) are less than €3 million (exemption limit, no allowance),
  - The taxpayer is not part of a group of companies and the interest expense paid to a material shareholder or a related party or a back-to-back lender does not exceed 10% of the company's total net interest expense, or

- The taxpayer proves that the borrower's equity ratio is at least as high as the world-wide group's equity ratio. It is acceptable if the German entity's equity ratio is 2 percentage points below the group's ratio. This escape clause applies only if the taxpayer or any other group company is not shareholder-financed to a harmful extent; that is, if the taxpayer or any group company pays no more than 10% of its interest expense to a material shareholder or related party outside the group or to a third party secured by the material shareholder or related party.

**Add-back for trade tax purposes**

25% of the interest expense must be added back for trade tax purposes (to the extent an allowance for interest and certain other expenses in the overall amount of €100,000 is exceeded).

## 7. WHAT ARE COMMON STRATEGIES TO PUSH-DOWN DEBT ON ACQUISITIONS?

Various options are available to achieve a debt push-down. One is to implement a tax group (fiscal unity, "*Organschaft*") between the debt-financed German acquisition vehicle and the target company. Such a tax group, which requires (i) that the acquisition vehicle holds the majority in the voting rights of the target company, and (ii) the conclusion of a profit and loss transfer agreement, allows for a consolidation of the interest expense of the acquisition vehicle, resulting from the financing, with the profits of the target company. Alternatively, the acquisition vehicle and the target company can be merged. Leveraged distributions or repayments of (free) capital reserves of the target company are other potential options. When determining the level of debt financing, the German interest barrier rules have to be considered (see no. 6). The German capital maintenance rules also have to be kept in mind.

## 8. ARE THERE ANY TAX INCENTIVES FOR EQUITY FINANCING?

German tax law does not provide for specific tax incentives for equity financing.

## 9. ARE LOSSES OF A TARGET COMPANY AVAILABLE AFTER AN ACQUISITION IS MADE? ARE THERE ANY RESTRICTIONS ON THE USE OF SUCH LOSSES?

The direct or indirect transfer (or a similar transaction, such as a capital increase or an internal group restructuring) of more than 25% or 50% of the shares in a loss company to any shareholder or a group of shareholders with similar objectives within a 5-year period leads in principle to a partial or complete forfeiture of current tax losses and tax loss carry-forwards. The law provides for several options to avoid the forfeiture of losses and loss carry-forwards:

**Intra-group escape**

The acquisition of shares in principle no longer results in the loss (or partial loss) of losses and loss carry-forwards if the same taxpayer indirectly or directly holds 100% of the shares in both the transferring and the acquiring entity, the acquirer indirectly or directly holds 100% in the shares of the transferring entity, or the seller indirectly or directly holds 100% in the acquiring entity. Intra-group reorganisations that fulfill these (strict) requirements can therefore be carried out without the forfeiture of losses and loss carry-forwards.

**Hidden-reserve escape**

In addition, a corporation's unused tax losses are preserved to the extent they are compensated for by hidden reserves that have been built into those business assets of the corporation and that are subject to German taxation. If only between 25% and 50% of shares in the corporation are sold, the corresponding portion of hidden reserves is considered. The hidden reserves are evaluated by comparing the portion of the equity of the shareholder(s) that corresponds to the portion of the transferred shares with the fair market value of these shares. In a sale of more than 50% of the shares, the entire hidden reserves can be taken into account and be compared with the fair value of all shares.

- **Continued-business escape (implemented in 2017)**

  A new exemption came into effect on January 1, 2016. This rule allows for losses to be carried forward if the relevant company carried on its business for the three fiscal years prior to the year of the harmful transaction. However, certain transactions during those three years (e.g. being partner in a partnership or controlled company in a tax group) will prevent the application of the escape.

## 10. ARE THERE ANY ITEMS THAT SHOULD BE INCLUDED IN THE SCOPE OF A TAX DUE DILIGENCE THAT ARE VERY SPECIFIC TO YOUR COUNTRY?

A number of specific items should be considered in a tax due diligence in Germany. They include (i) the validity of tax groups (fiscal unities) for income tax (e.g. actual execution of the profit and loss transfer agreement) and VAT purposes, (ii) the forfeiture of tax losses on the basis of the forfeiture rules and the applicability of exceptions (see no. 9), (iii) previous reorganisations and the existence of specific holding periods (to be observed in order to avoid a (retroactive) capital gains taxation of the initial tax-neutral transactions), and (iv) the limitation of interest deductibility due to the interest barrier rule (see no. 6) as well as the deductibility of license fees due to license barrier (since 2018, see no. 18). Further, it should be reviewed whether the target company could be liable for German RETT due to transactions with German real estate holding companies. Additionally, Germany applies a very specific tax regime to (German and foreign) partnerships which are considered as transparent for income tax purposes so that the respective partner of the partnership is liable to (corporate) income tax. However, for trade tax purposes, the partnership itself is liable to tax, which means that the partnership is liable for the capital gain triggered by the sale of a partnership interest.

With respect to repatriation of cash, German tax law includes an anti-treaty/directive-shopping provision. This rule requires the beneficiary of a distribution (dividends or royalties) to have sufficient substance and activities. This substance has to be proven to the Federal Central Tax Office in order to receive either a refund for WHT or an exemption certificate so that no WHT is due on future distributions. The ECJ recently held that the previous version of the rule was in violation of EU law (see ECJ of 20 December 2017, C-504/16 and C-616/16). Based thereon, the German Federal Ministry of Finance takes the position that (i) the old version of the anti-treaty/directive-shopping is basically no longer applicable and (ii) the new version is handled in a more favorable way for the taxpayer with respect to the substance and activities test (cf. decree of the Federal Ministry of Finance of 4 April 2018).

## 11. IS THERE ANY INDIRECT TAX ON TRANSFER OF SHARES (STAMP DUTY, TRANSFER TAX, ETC.)?

Germany does not impose any stamp duties or transfer tax on share transfers. However, if the target company (corporation or partnership) owns German real estate, under certain circumstances Germany levies RETT on a specially assessed property value (see no. 16).

The transfer of shares and partnership interests is in principle exempt from VAT. However, the supplier can opt to waive this VAT exemption (which in practice is usually not done).

## 12. ARE THERE ANY RESTRICTIONS ON THE CORPORATE TAX DEDUCTIBILITY OF ACQUISITION COSTS?

Acquisition costs are generally not deductible but have to be capitalised and depreciated over the average useful life of the respective asset (if applicable; e.g. land and shares in corporations are not subject to depreciation). Incidental acquisition costs (e.g. for legal/tax advice) usually have to be allocated to the acquired assets and are – in principle – not immediately deductible but part of the pro rata depreciation (if applicable). An immediate deduction of such costs is possible if it can be proven that there is no economic connection between the acquired assets/shares and the corresponding costs. Financing-related costs (e.g. commitment fees or advisory costs in connection with the financing) or costs for a W&I insurance (insurance premium, insurance tax) are only indirectly connected with the acquisition and, thus, immediately deductible. From a timing perspective, costs can only be classified as incidental acquisition costs if they incur after the purchase decision is basically made. In this respect, particularly the treatment of due diligence costs is controversial. Costs in regard to failed acquisitions are in principle immediately deductible. RETT paid in an asset deal has to be capitalised, whereas RETT triggered in a share deal transaction is in principle immediately deductible.

## 13. CAN VAT (IF APPLICABLE) BE RECOVERED ON ACQUISITION COSTS?

A VAT recovery requires that the person that wants to claim input VAT has to qualify as an entrepreneur for VAT purposes. It is further required that the acquired assets will be used for transactions subject to VAT. If VAT cannot be recovered on acquisition costs, it would increase the acquisition costs and be part of the pro rata depreciation (if applicable).

## 14. ARE THERE ANY PARTICULAR TAX ISSUES TO CONSIDER IN THE ACQUISITION OF A DOMESTIC COMPANY BY A FOREIGN COMPANY?

A foreign (non-German) acquiring company is subject to limited tax liability in Germany if it generates income from German sources. Income from German sources arises, for instance, if (i) shares or interest in a German entity with registered seat and/or place of management in Germany, (ii) real estate located in Germany, or (iii) assets belonging to a German permanent establishment, are acquired.

When a foreign company holds shares in a German corporation, withholding tax (WHT) of 25% (26.375% including solidarity surcharge of 5.5%) is generally levied on, for example, dividend or royalty payments by the German entity to its foreign shareholder. An applicable double tax treaty (DTT) or EU directive (e.g. Interest and License Fee Directive, Parent-Subsidiary Directive) might fully or partially reduce the German WHT burden. The German entity may abstain from WHT deduction only if an exemption certificate is issued by the German Federal Central Tax Office prior to the relevant payment. A reduction or refund (without a prior exemption certificate) of German WHT is subject to the fulfillment of certain requirements concerning the activity and substance of the direct or indirect foreign shareholder of the German entity (see also no. 10).

Please be aware that Germany's 95% tax exemption for dividend income is available for German and foreign shareholders only if the shareholding in the German company amounts to at least 10% for corporate income tax purposes and 15% for trade tax purposes (at the beginning of the fiscal year of the subsidiary in question).

Under most double tax treaties concluded by Germany, the taxation right for capital gains from the sale of shares in a corporation is attributed to the seller's state of residence (with the exception of shares in a German real estate company if more than 50% or 75% of that company's value consists of real estate located in Germany, for example, under the treaties with Luxembourg, the Netherlands, Poland or the UK), unless the shares are held through a German permanent establishment. In a case where Germany's taxation right was not excluded, the German Federal Tax Court recently ruled that capital gains from the sale of shares in a corporation realised by a non-domestic seller without a permanent establishment or permanent representative in Germany shall be 100% tax exempt.

## 15. CAN THE GROUP REORGANISE AFTER THE ACQUISITION IN A TAX NEUTRAL MANNER THROUGH MERGERS OR A TAX GROUPING?

- **Options for tax-neutral reorganisation measures**

  In particular the Reorganisation Tax Act provides for tax-neutral reorganisations such as mergers, spin-offs, hive-downs, conversions, contributions of shares or specific business assets. The full or partial tax neutrality for the transferring entity in principle requires that (i) Germany retains the right to tax a capital gain regarding the assets transferred, (ii) the transferring entity receives only new shares in the receiving entity (or limited other consideration, see above), and (iii) the relevant entity files an application for tax neutrality with the competent tax office. If these requirements are met, the transferring entity may recognise the assets at tax book value, thereby avoiding a capital gain. These rules also apply to cross-border reorganisation measures.

German tax law also provides for structuring options outside the Reorganisation Tax Act. For instance, the assets of a partnership can be transferred to its sole remaining partner in a tax-neutral way.

- **Tax group**

Tax groups (fiscal unities) can be beneficial in reorganisations (see no. 17). In particular in M&A deals with controlled entities a clear termination of the profit and loss transfer agreement has to be ensured. The SPA should provide for a reasonable allocation of tax risks before the transfer date. An acquisition can be structured in a way that the tax group with the selling controlling entity exists until the transfer date and a new tax group with the buyer starts as of the transfer date (e.g. by implementing short fiscal years).

## 16. ARE THERE ANY PARTICULAR ISSUES TO CONSIDER IN THE CASE OF A TARGET COMPANY THAT HAS SIGNIFICANT REAL ESTATE ASSETS?

The main issue to consider when acquiring companies whose main assets consist of German real estate is that Germany levies RETT on the direct or indirect transfer of such real estate. The tax rates vary between 3.5% and 6.5% depending on the federal state in which the real estate is located. In an asset deal, RETT is always triggered (the purchase price is the assessment base; no avoidance strategies are available).

In a transfer of interests in a partnership, RETT is basically levied if at least 95% of the partnership interests are transferred within a period of five years. A transfer of shares in corporations triggers RETT only if a buyer (or a RETT group) acquires at least 95% of the shares. The tax base is in principle the fair value of the real estate. RETT could be avoided by, for example, selling only 94.9% to a single purchaser and having the shareholder or a third party retain the remaining 5.1% shareholding. In this respect it is to be considered that (ongoing) M&A deals could be affected by possible amendments of the RETT Act (see no. 1). RETT relief might be available for certain reorganisation measures (e.g. mergers, spin-offs, hive-downs or contributions and share-for-share exchanges). This requires, among other things, that the controlling company directly or indirectly holds at least 95% of the shares in the controlled company involved in the reorganisation within the five years prior to the relevant transaction and for at least five years after it.

An increasing number of German DTTs allocate the right to tax a capital gain deriving from the disposal of shares to the state of residence of the target company if most of its assets comprise real estate (see also Art. 13(4) of the OECD Model Convention).

## 17. IS FISCAL UNITY/TAX GROUPING ALLOWED IN YOUR JURISDICTION AND IF SO, WHAT BENEFITS DOES IT GRANT?

German tax law provides for tax groups (fiscal unity, “Organschaft”) for corporate income tax (CIT) and trade tax (TT) purposes as well as for VAT purposes.

- **CIT and TT group**

The main benefit of a tax group is that all profits and losses of the tax group members are pooled at the level of the controlling parent company. In principle, only the parent company has to pay CIT and TT. Nevertheless, the subsidiary (controlled entity) still qualifies as a taxable entity and has to file tax returns. One further tax benefit is that profit transfers of the subsidiary to the parent company are only taxed at the level of the parent company whereas, without a tax group, 5% of a dividend distribution would be subject to CIT and TT at the level of the parent company although the underlying profits were already taxed at the level of the subsidiary.

Moreover, the tax group allows for a debt push-down (see no. 7). Further benefits might be available (e.g. regarding the interest barrier rules, no trade tax addition for interest expenses, royalties or rental expenses).

An income tax group requires the following:

- The parent company must hold the majority of the voting rights in the subsidiary from the beginning of the subsidiary's fiscal year
- The parent company and the subsidiary must enter into a profit and loss transfer agreement for at least five entire years
- The agreement must be consistently carried out throughout the term of the agreement
- The subsidiary must be a corporation. The parent company can also be a trading partnership or sole trader
- The investment in the subsidiary must be functionally attributable to a German permanent establishment of the controlling entity and the income of the permanent establishment be subject to German tax and not be exempt under a DTT

**VAT group**

A VAT group is also possible under German tax law. This requires that the subsidiary is financially, economically and organisationally integrated into the parent company. Only the parent company is liable to VAT for transactions of the group. Unlike for a CIT and TT group, no profit and loss transfer agreement is required and the subsidiary does not have to file a tax return. However, the parent company itself has to be considered an entrepreneur (i.e. a taxable person) for VAT purposes; otherwise the VAT group is invalid.

## 18. DOES YOUR COUNTRY HAVE ANY SPECIAL TAX STATUS SUCH AS A PATENT BOX FOR COMPANIES THAT HOLD INTANGIBLE ASSETS?

Germany does not have a patent box or similar special tax status for companies that hold intangible assets. Also, Germany currently offers no R&D tax incentives with the mere exception of a prohibition to capitalise costs for self-created intangible fixed assets which as a consequence are immediately tax-deductible. According to the German coalition agreement published on 7 February 2018, however, the three governing parties (CDU, CSU and SPD) envisage introducing an R&D tax incentive for small and medium-sized entities.

In connection with action point 5 of the OECD's BEPS project, Germany unilaterally adopted an "anti-patent box". As of 2018, this license barrier restricts the tax deductibility of license fees or royalties paid by German taxpayers to related parties if at the recipient's level such payments are subject to low taxation (i.e. below 25%) based upon a preferential tax regime for intellectual property. In order to prevent avoidance structures, the license barrier also applies in "interposed cases" or licensing/sub-licensing structures, e.g. if a domestic licensee pays the license fees to an interposed company in a high-tax jurisdiction which passes on this income to a preferentially taxed company in a low-tax jurisdiction (instead of directly paying it to the latter entity). An exception applies for preferential tax regimes which – in line with the "nexus approach" described in BEPS action point 5 – require that the intellectual property was predominantly self-developed by the recipient of the license fees or royalties. If the requirements of the license barrier are met, the non-deductible portion of the license fees or royalties is calculated based on the assumed tax benefit of the recipient:

$$\frac{25\% - \text{recipient's effective tax rate}}{25\%}$$

## 19. DOES YOUR COUNTRY IMPOSE ADVERSE TAX CONSEQUENCES IF OWNERSHIP OF INTANGIBLES IS TRANSFERRED OUT OF THE COUNTRY?

The disposal of an intangible asset triggers an immediate realisation of profits from the transfer which are subject to (corporate) income tax and trade tax. If the transaction is carried out between related parties, the purchase price must comply with the arm's length price to be recognised for tax purposes. In practice, German tax authorities accept a purchase price/valuation of intangible assets which is in line with principles contained in the German Standard for Chartered Accountants S5 (IDW S 5). Based on these principles, a valuation of intangible assets (e.g. brands) should consider the future benefit that a potential purchaser will derive from using the asset in question. For instance, the income approach is preferred for the valuation of brands. It is based on future economic benefits derived from the use of a brand. Accordingly, the value of brands is determined by totaling the discounted future financial surpluses.

Where an intangible asset is allocated to a foreign permanent establishment of the same company with the result that the German right to tax that asset is excluded or limited, the allocation is deemed to occur at fair market value for (corporate) income tax and trade tax purposes. To that effect, any hidden reserves in such asset are immediately taxed even though they have not been realised in the market. Under certain conditions the taxation of such deemed profit can effectively be spread over a period of five years through setting up a tax adjustment item that subsequently is released by one-fifth in the fiscal year in which it was formed and the following four fiscal years. The formation of the tax adjustment item requires that the asset is transferred to a permanent establishment in another EU member state and that the transferor is subject to unlimited tax liability in Germany (i.e. a company with German tax residency that transfers the asset to its foreign permanent establishment but not vice versa).

If business functions and risks in conjunction with intangible assets are transferred to a foreign group entity or permanent establishment, the transfer generally qualifies as a taxable relocation of functions. As a consequence, the value of the "transfer package" as a whole has to be determined instead of the value of the individual assets. To that effect, not only the hidden reserves in intangible assets but also the earning potentials that are not substantiated in a manner concrete enough to qualify as an asset are subject to (corporate) income and trade tax based on a sound business valuation. As an exception from the overall valuation of the transfer package, an individual valuation is allowed if, for example, the taxpayer demonstrates that either no material assets and other advantages are included in the transfer package or at least one material – and precisely defined – asset is included in the transfer package. A taxable relocation of functions is not applicable in cases where a function is only duplicated across borders and the duplication does not lead to a limitation of the function performed locally. In practice, the triggering of immediate exit taxation can be avoided by licensing the transfer package.

# SELL-SIDE

## 20. HOW ARE CAPITAL GAINS TAXED IN YOUR COUNTRY? WHAT, IF ANY, GAINS ARISING IN AN M&A CONTEXT ARE ELIGIBLE FOR SPECIAL TREATMENT?

In principle, capital gains from the disposal of German assets (including partnership interests) are subject to German income taxation without any special treatment except for a potential tax-neutral roll-over regarding land, buildings or vessels if the corresponding proceeds are reinvested (see no. 21).

An important exception is the capital gain derived from the disposal of shares in a corporation by a corporation. Under German tax law, 95% of such a capital gain is in principle tax-exempt irrespective of any minimum shareholding or holding period. In the case of an individual person, the taxation of the capital gain from the disposal of shares depends on (i) the shareholding percentage, and (ii) whether the share is held as private property or as business property. For shareholdings of 1% or more, 40% of the capital gain is tax-exempt and 60% is taxable at the individual income rate (this ratio also applies to expenses in connection with the transaction). The same treatment applies (irrespective of the holding percentage) if the shares belong to a business or trade of the individual. In all other cases a capital gain is taxed at a beneficial lump-sum tax rate of 26.375% (costs are not tax-deductible at all). If a partnership generates a capital gain from the disposal of shares, the applicable tax rule basically depends on the tax status of the partner (being a corporation or an individual person).

## 21. IS THERE ANY FISCAL ADVANTAGE IF THE PROCEEDS FROM THE SALE OF SHARES OR ASSETS ARE REINVESTED?

Under certain conditions, there are some tax advantages to reinvesting proceeds from an asset sale in cases where land, buildings or vessels are sold and new assets of such categories are (intended to be) acquired. The capital gain from the sale is not immediately subject to income taxation but can be deducted from the acquisition costs of newly acquired assets. As a result, the depreciation base of the newly acquired assets is reduced. If no new assets are to be immediately acquired, the capital gain can be parked tax-free as reserve and deducted from new acquisitions within the next four or, or in the case of new buildings, six years. However, if no new acquisitions take place in the relevant period of time, the reserve has to be dissolved, leading to a retroactive taxation of the release amount (increased by 6% p.a.). Individuals selling shares can benefit from rules similar to those described for real estate (applicable to capital gains of up to €500,000). There is no tax advantage to reinvesting sale proceeds from a share deal made by corporations.

## 22. ARE THERE ANY LOCAL SUBSTANCE REQUIREMENTS FOR HOLDING COMPANIES?

Foreign holding companies need to prove certain substance requirements in order to benefit from WHT relief under a DTT or German tax rules (see nos. 10 and 14).

Holding companies do not qualify as entrepreneurs (i.e. taxable persons) for VAT purposes if they are mere financial holdings. In this case no (full) input VAT deduction would be available. A different VAT treatment would apply if a holding company carries out certain management services with regard to its subsidiaries for which it receives an arm's length remuneration.

## 23. ARE THERE ANY SPECIAL TAX CONSIDERATIONS REGARDING MERGERS/SPIN-OFFS?

German law provides for various forms of transferring assets, including mergers and spin-offs. The Reorganisation Act deals with many of these forms, including mergers and spin-offs. The Reorganisation Tax Act basically refers to the reorganisation forms of the Reorganisation Act. In general, mergers and spin-offs are considered as taxable events. However, under certain circumstances (see no. 15) mergers/spin-offs can be structured in a tax-neutral manner.

# MANAGEMENT INCENTIVES

## 24. WHAT ARE THE TAX CONSIDERATIONS IN YOUR JURISDICTION FOR MANAGEMENT INCENTIVES IN CONNECTION WITH SELLING OR BUYING A COMPANY?

Various types of management incentives are available in Germany including shares, sub-participations, stock options, phantom stocks and bonuses. The three most common schemes are shareholdings via a management partnership structure, exit bonuses, and direct shareholdings.

In the case of shareholdings, a manager's potential capital gain from a future exit in principle qualifies for the preferential capital gains tax rate of 26.4%. In practice, such equity participation is often implemented via a management partnership structure where the managers' shares are pooled in a specific investment vehicle in the legal form of a partnership (e.g. GmbH & Co. KG) whose general partner is regularly controlled by the investor. Alternatively, the shares can be held directly by the managers, which is structurally less complex but provides for no pooling element and only limited control by the investor.

An exit bonus is simple in structure. From the manager's perspective, however, an exit bonus actually received qualifies as employment income subject to the personal tax rate of up to 47.5%. At the same time the exit bonus is a tax-deductible business expense at the level of the employer.

No specific tax benefits exist for those schemes. In particular, within management equity participations the shares are regularly acquired at an arm's length price to prevent the receipt of shares from being treated as employment income. As the German tax authorities tend to reclassify the potential gains derived from management equity participations as employment income, it is vital that the scheme is structured in a way that the proceeds can be classified as capital gains.

## FOR MORE INFORMATION CONTACT:

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