To Our Clients and Friends

Memorandum

German Tax Reform Act 2018 – A Speed Read on Tax Implications for Corporates with German Operations

On November 23, 2018, the German Federal Council (*Bundesrat*) approved the Tax Reform Act of 2018 (the "**Tax Reform Act**"; *Gesetz zur Vermeidung von Umsatzsteuerausfällen beim Handel mit Waren im Internet und zur Änderung weiterer steuerlicher Vorschriften*), which was passed by the German Parliament (*Bundestag*) on November 8, 2018.

The Tax Reform Act implements necessary amendments to the German tax law, to reflect the relevant decisions of the European Court of Justice, the EU Commission, the German Constitutional Court and the German Federal Tax Court. The Tax Reform Act has an impact on German corporates and international corporates with German operations. Particularly welcome is the softening of the German loss forfeiture rules (sec. 8c CITA), which limits adverse tax consequences in the case of a change of control in corporations. In addition, the clarification on the treatment of variable compensation payments to minority shareholders under a profit and loss pooling agreement should be favorable to taxpayers.

- **Limitation of loss forfeiture rule for corporations - Sec. 8c para. 1 sent. 1 CITA**

  Pursuant to sec. 8c para. 1 sent. 1 Corporate Income Tax Act (**CITA**), tax loss carry forwards and interest carry forwards cease to exist on a pro-rata basis if more than 25% and up to 50% of the shares in a corporation are transferred to an acquirer within a period of five years. Under the Tax Reform Act, sec. 8c para. 1 sent. 1 CITA is abolished, with retroactive effect for share transfers between January 1, 2008 to December 31, 2015 based on the decision of the Constitutional Court from March 29, 2017 (2 BvL 6/11).

  Tax assessment notices for fiscal years 2008 to 2015 should be reviewed to assess whether taxpayers can benefit from the abolition of the provision.

  Also, tax assessment notices for fiscal year 2008 and onwards should be kept open to amendments with respect to the application of sec. 8c para. 1 sent. 2 CITA. The case on the application of sec. 8c para. 1 sent. 2 CITA, under which the transfer of more than 50% of the shares in a corporation leads to the full forfeiture of any loss and interest carry forwards, is still pending with the Constitutional Court (2 BvL 19/17).

- **Reinstatement of Restructuring Exception (Sanierungsklausel) - Sec. 8c para. 1a CITA**

  Pursuant to sec. 8c para. 1a CITA, existing tax loss and interest carry forwards do not cease to exist in the case of a transfer of shares if such transfer occurs in order to restructure the business of an ailing corporation (the "**Restructuring Exception**"; *Sanierungsklausel*). The provision became

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effective for share transfers that took place after December 31, 2007. However, the effectiveness of the provison was suspended due to a state aid resolution (*Beilhilfebeschluss*) from the EU Commission in January 2011. The European Court of Justice reversed the EU Commission's resolution on June 28, 2018. Consequently, the Restructuring Exception is reinstated, with the Tax Reform Law effective retroactively for share transfers after December 31, 2007.

To the extent that tax assessment notices for the respective years are not yet time-barred, it should be reviewed if the Restructuring Exception can be applied.

- **Confirmation of eligibility of variable compensation payments to minority shareholders in fiscal unity - Sec. 14 para. 2 CITA**

  In cases where a shareholder holds a minority stake of the shares in a controlled entity (*Organgesellschaft*), the minority shareholder is entitled to a fixed compensation payment (*Ausgleichszahlung*) under the profit and loss pooling agreement pursuant to sec. 304 para. 2 sent. 1 German Stock Corporation Act (**SCA**; *Aktiengesetz*). In the past, it was disputed whether a fiscal unity is accepted if the minority shareholder of the controlled entity receives any variable payments (based on the actual profit of the controlled entity).

  Pursuant to sec. 14 para. 2 CITA, which is newly incorporated into the law, the fiscal unity should not be disallowed if the minority shareholder receives a compensation payment that has a variable element and exceeds the amount pursuant to sec. 304 para. 2 sent. 1 SCA. However, this is only the case if the overall compensation payment does not exceed the amount that would have been paid to the minority shareholder if no profit and loss pooling agreement were in place.

  Existing profit and loss pooling agreements should be reviewed as to whether an amendment of the agreement under the new provision is economically beneficial. New profit and loss pooling agreements can be entered into in a manner such that a minority shareholder is entitled to variable compensation payments.

- **Introduction of legal provisions on treatment of restructuring gains - Sec. 3a ITA**

  Pursuant to sec. 3a Income Tax Act (**ITA**) and sec. 7b Trade Tax Act (**TTA**), gains from debt relief are exempt from German (corporate) income and trade taxation if the relief is granted to recapitalize and restructure the ailing business. The provisions were already introduced with law of June 27, 2017, but the effectiveness of the provisions was conditional upon the confirmation of the EU Commission that the rules do not constitute unlawful state aid. The EU Commission issued the confirmation in August 2018.

  The Tax Reform Act sets sec. 3a ITA and sec. 7b TTA into force, with a retroactive effect of July 5, 2017. The rules apply for the first time to debt that was fully or partially waived after February 8, 2017.

  Tax returns and tax assessment notices from fiscal year 2017 onwards should be reviewed if the tax exemption can be applied.

Also, the Tax Reform Act also comprises extensive amendments of the German Value Added Tax Act which mainly concern the VAT treatment of services and deliveries of goods on the electronic market place.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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