



MERGERS AND ACQUISITIONS

Germany

Taxation of Cross-Border
Mergers and Acquisitions

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TAX

Germany

Introduction

Germany's 2008 tax reform effected major changes in the corporate income tax system by replacing thin-capitalization rules with new earnings-stripping rules and by further restricting the use of tax loss carry-forwards. In 2009 these rules were adjusted by the Economic Growth Acceleration Act. The changes have important implications for purchasers of German businesses. 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

Accounting Law Modernization Act (BilMoG)

On 3 April 2009, the Upper House of the German Parliament passed the German Accounting Law Modernization Act (Bilanzrechtsmodernisierungsgesetz – BilMoG). The objective of the reform is to make German commercial accounting law (German GAAP) a fully adequate, yet simpler and more economical alternative to International Financial Reporting Standards (IFRS). A moderate shift towards IFRS is designed to strengthen the informational function of the financial statements without abandoning the basic principles and features of the existing accounting law. Financial statements prepared in accordance with German GAAP are to remain the basis on which permissible profit distributions are calculated and taxable income is determined. The new rules only apply to individual and group financial statements prepared for fiscal years beginning after 31 December 31 2009. As such, if the financial year is the same as the calendar year, the new rules will first apply to the financial statements to 31 December 2010. The new rules may be applied voluntarily for the previous year, but only in their entirety.

The main changes that affect mergers and acquisitions (M&A) tax law are the changes to the principle of linkage. Under previous law, taxpayers that carry on a trade or business and have bookkeeping requirements had to use the German GAAP financial statements as

the basis for the tax balance sheet. This so-called principle of linkage is preserved under the BilMoG. In addition, the existing laws enforced the principle of reverse linkage, which states that tax elections have to be exercised in correspondence with the balance sheet in the financial statements (commercial balance sheet). Examples of consequences of the reverse linkage principle are the recognition of higher write-downs on the basis of special tax provisions, as well as the transfer of hidden reserves to replacement assets. Under this principle, elections made for tax purposes must also be recognized on the commercial balance sheet to become tax effective. The act has now abolished this principle of reverse linkage. Taxpayers that carry on a trade or business have to report business assets in line with German Accounting Principles (Grundsätze ordnungsmäßiger Buchführung – GoB), unless a different method was or is used in the context of exercising a tax election. Thus, tax elections can be exercised independently of the commercial balance sheet in future. However, taxpayers who exercise tax elections are required to record the assets affected in running schedules. Furthermore, the BilMoG changes several capitalization and valuation rules. The elimination of certain capitalization and valuation options is intended to bring German GAAP closer to International Financial Reporting Standards (IFRS).

The new act has also introduced some changes to the scope of consolidation under German GAAP. The legal committee of the Lower House of the German Parliament referred to the new scope of consolidation as potential control. Therefore, assets and liabilities of special purpose vehicles must be consolidated as well. This constitutes a harmonization with IAS 27. The scope of consolidation under German GAAP may have an impact on the earnings-stripping rules (which limit the tax deductibility of interest as a business expense), in case the equity quota test under the escape clause is applied (see later in the chapter).

Relief with Respect to the Regulations of the 2008 Business Tax Reform – Citizen Relief Act Health Insurance

Other than improved tax treatment for social security and similar expenses (Vorsorgeaufwendungen), the

Citizen Relief Act contains reliefs with respect to core regulations of the 2008 Business Tax Reform.

Both the earnings-stripping and change of control rules (see later in the chapter) on loss limitation have a damaging effect on businesses in the financial crisis. Therefore, the de minimus threshold for the earnings-stripping rules has been increased from EUR 1 million to EUR 3 million with retroactive effect as of the assessment period 2008. A turn-around exemption clause (Sanierungsklausel) has been introduced to the change of control rules. Under the existing rules, unused losses are forfeited up to the date of the detrimental change in ownership. The turn-around exemption clause will preserve the forfeiture of tax losses within a detrimental change of ownership in special cases (see Tax Losses in the Purchase of Assets section).

Economic Growth Acceleration Act (Wachstumsbeschleunigungsgesetz)

On 18 December 2009 the so-called Economic Growth Acceleration Act has passed the Upper House of the German Parliament, designed to stimulate economic activity by significantly modifying the German business taxation rules. The new act became effective as of 1 January 2010. One of the most important aspects of the new law is the significant easing of the corporate change of control rules. A group exemption clause and a built-in gains exemption provision will result in a full or partial preservation of tax losses carried forward in case of a change in ownership of a company. Furthermore the earnings-stripping rules have been reviewed to extend the deductibility of interest expenses. In addition, the abovementioned temporary threshold extension to EUR 3 million became permanent. For certain business reorganizations the new law also provides for an exemption from real estate transfer tax (Gründerwerbsteuer) to facilitate such transactions within a group (for further explanations of the new regulations see relevant sections below).

Asset Purchase or Share Purchase

The form of an acquisition is often motivated by tax or other commercial factors. The buyer's main preference is to get a step-up in the acquired assets along with a corresponding depreciation base to reduce the future effective tax rate. The seller's primary interest is to minimize capital gains tax or, ideally, to obtain a tax exemption. Under the current law, however, 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.

Purchase of Assets

In an asset purchase the purchased assets are accorded a new base cost in the hands of 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. The allocation of such step-up/step-down is generally performed on an asset-by-asset basis. Goodwill is generally 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, for example environmentally contaminated real estate, and, in many cases, unwanted liabilities, behind.

However, under German law there are some liabilities that cannot be avoided and pass to the buyer in an asset deal – except under certain circumstances – at an asset transfer. 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 if 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 his/her basis in his/her pro rata share of partnership assets acquired to equal the full purchase price.

Purchase Price

If an asset purchase is made, the buyer should attempt to persuade the seller to agree to a detailed allocation of the purchase price to the assets purchased. Such an allocation will not be 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.

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.

Depreciation

All other assets are depreciable over their useful life. The tax authorities have published a depreciation table listing the relevant periods for almost any type of asset.

Tax Attributes

Tax losses and other attributes are not transferred in an asset deal. They remain with the seller or are eliminated.

Value-Added Tax (VAT)

Asset purchases of a business or a division (branch of activity) are generally not subject to German VAT (Value Added Tax 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 real estate transfer tax on the purchase price allocated to the property. The real estate transfer tax rate is 3.5 percent (4.5 percent for real estate located in Berlin and Hamburg), based on a special valuation of the real estate for tax purposes, which amounts to roughly 70 percent to 80 percent of the fair market value. However, the standard assessed value is expected to increase for real estate in the near future.

Real estate transfer tax 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 if less than 95 percent is transferred, but after the transfer at least 95 percent of the entity is owned by one taxpayer, or a consolidated tax group. For partnerships, any direct or indirect share transfers within a five-year period are added together for this 95 percent test.

With effect as of 1 January 2010 the Economic Growth Acceleration Act, provides for an exemption of real estate transfer tax for certain reorganizations within a group. Real estate transfer tax triggering transactions such as mergers, divisions (split-up, spin-off, carve-out),

or transfers of property will obtain an exemption from real estate transfer tax. Similar reorganizations due to the law of another European Union (EU) Member State or European Economic Area (EEA) Member State are also privileged. However, contributions by way of singular succession are excluded from the tax exemption, according to the wording of the law. This provision will only apply if a company and a controlled company are involved in the reorganization. A company will be deemed controlled if the controlling company held (directly or indirectly) an interest of at least 95 percent within a period of five years preceding and following 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 very limited. For VAT and real estate transfer tax implications see earlier in the chapter.

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 trader (Einzelunternehmen)
- General partnership (Offene Handelsgesellschaft, oHG)
- Limited partnership (Kommanditgesellschaft, KG)
- Limited partnership with corporate general partner (GmbH and Co. KG)
- Limited liability company (GmbH)
- Stock corporation (Aktiengesellschaft, AG)

The federal German law governs these enterprises. A corporation (AG, GmbH) is subject to corporate income tax (2008, 15 percent), solidarity surcharge (5.5 percent of the corporate tax), trade tax (approximately 14 percent), and value-added tax (VAT; 19-percent standard rate). A partnership (oHG, KG, GmbH, or Co. KG) is transparent for corporate income tax purposes (that is, 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 the above legal forms, the GmbH and Co. KG, GmbH, 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, need not 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 limited liability company (GmbH) is the most common form of business association. It is a corporate entity with its own legal identity, has one or more shareholders, and share capital of at least EUR 25,000. 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 notary. 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. When a GmbH has at least 500 employees, a supervisory board has to be established according to provisions applicable to AGs. The shareholders control the distribution of net earnings.

Stock Corporation: Aktiengesellschaft (AG)

The stock corporation (AG) is also a corporate entity with its own legal identity. The minimum share capital is EUR 50,000. 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 may 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. If the AG has more than 500 employees, one third of the members of the supervisory board have to be elected by the employees. 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 a general partnership (OHG) no minimum capital is required and all partners are fully liable for the partnership's debts. In contrast in a limited partnership (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. Regularly, all partners being fully liable for the partnership's debts are acting as managing directors in contrast to the partners subject to limited liability. From a legal perspective the transfer of shares in a partnership do not generally need to be recorded in the presence of a qualified notary.

The GmbH & Co. KG is a limited partnership with, typically, the sole general partner being a limited liability company. It can thus combine the advantages of a partnership with those of the limited liability of a corporation.

Other Forms

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

- Private association (Verein)
- Cooperative (Genossenschaft)
- Foundation (Stiftung)
- Partnership limited by shares (Kommanditgesellschaft auf Aktien, or 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 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 law distinguishes between trade, business activities (commercial activity), and other activities. In general, tax law will assume

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 in the hands of non-trading individuals. Capital gains are, as a rule, taxable only if the property is sold as part of a commercial activity or is held by companies, which, by virtue of the law, are 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 stock limited partnership, and the GmbH 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. The purchaser will, therefore, normally require more extensive indemnities and warranties than in the case of an asset acquisition.

Unlike the US/Anglo-Saxon legal principle of *caveat emptor* (let the purchaser beware), in general German law does not require the purchaser to examine an entity he/she intends to purchase in advance. However, according to the German Civil Code (*Bürgerliches Gesetzbuch*) a purchaser forfeits his/her rights and guarantee claims with respect to a defect he is unaware of if gross negligence is involved. The non-performance of a due diligence prior to the acquisition of an entity does, however, not generally result in the purchaser being grossly negligent. This would only be the case if the purchaser were not to perform a 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.

In 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 such information duty again depends on the individual case, in particular the value or significance of the transaction.

Tax Losses

Use of Pre-Acquisition Losses

In Germany, tax losses may be carried forward indefinitely for both 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 EUR 511,500.

Since 2004, the use of tax loss carry-forwards is restricted by a minimum taxation scheme. Only EUR 1 million plus 60 percent of the taxpayer's current year income in excess of EUR 1 million can be offset against tax loss carry-forwards. The restriction applies to both corporate income tax and trade tax.

As of 2008 the use of pre-acquisition losses was virtually excluded by the general change of control rules. These rules lead to a partial forfeiture of loss carry-forwards if more than 25 percent of the shares in a corporation are acquired. If more than 50 percent of 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.

However, certain exemptions to this general rule have been implemented recently. For share transfers after 31 December 2009 the Economic Growth Acceleration Act provides that – as a general rule – unused tax losses of a corporation shall not be forfeited on a share transfer up to the amount of the domestic built-in gains of the loss company. Therefore, tax loss carry forwards would only be 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 from related parties. The latter case may become relevant if the criteria under the newly-introduced group exemption are not met (see later in the chapter). The built-in gains of the corporation's domestic (that is, fully taxable) business assets will prevent the forfeiture of current year tax losses as well as tax losses carried forward. The built-in gains shall be determined by comparison of 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 will be applicable if not more than 50 percent of the shares in a loss-making corporation are transferred. Built-in gains

not subject to tax in Germany have to be deducted (in particular, shares in corporations for which a capital gains exemption applies).

An internal reorganization before 1 January 2010, such as the interposition of the new holding entity, could also trigger the general change of control rules. Under the Economic Growth Acceleration Act (Wachstumsbeschleunigungsgesetz) the change of control rules for corporations have also been eased by the introduction of an exception applying to share transfers within a group of companies. A change of ownership will not be viewed as detrimental if 100 percent of the shares in the transferee and transferor are held directly or indirectly by the same person (that is, wholly-owned subsidiaries of a common parent). Hence, a group exemption provision is not applicable if 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.

In addition, a turn-around exemption clause was introduced in 2009. This clause states that the acquisition of shares in a loss-making company is not be affected by the change of control rules if it serves the purpose of turning round the company's business. The turn-around (Sanierung) refers to a measure that aims at:

- preventing or abolishing illiquidity or over-indebtedness; and
- preserving the essential business structures at the same time.

According to the rationale for the new law, an acquisition serves the purpose of turning round the business if 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 purposes of turning round the business under the Act, the company must show turn round potential at the time of the acquisition. This must be confirmed by the assessment of a neutral third party, and the planned measures must be objectively suitable for leading the company out of the crisis in due course. Following the rationale for the new law, this assessment must be based on a well-documented turn-around plan. The ultimate success of turn-around is not required. The application of the turn-around exemption clause is conditional on a further requirement: the key business structures must be preserved. Following the new rule this requirement is met in each of the following cases:

Works council agreement on the preservation of jobs: the corporation acts in compliance with a works council agreement regulating the preservation of jobs (see later in the chapter). The fact that a crisis may often only be overcome if costs are also contained by a reduction in workforce is thereby accounted for, according to the reasoning of the new law.

Preservation of jobs: the accumulated payroll for a five-year period following the transfer does not fall below 400 percent of the initial annual payroll.

Injection of material business assets: within 12 months after the change in ownership, material business assets are injected as equity into the corporation. The injection is considered material if it amounts to at least 25 percent of the assets stated in the tax balance sheet at the end of the previous fiscal year. For an acquisition of less than 100 percent, this is reduced proportionally. For instance, for an acquisition of 50 percent, only 12.5 percent new business assets need to be injected for the injection to be material. The waiver of debts (debt-for-equity swap) is equivalent to an injection of new assets amounting to the fair market value of the receivables waived. According to the new rules, paying out the injected business assets to shareholders should be prevented. Therefore, payments made by the corporation between 1 January 2009 and 31 December 2011 lead to a reduction in value of the injected business assets. This may result in a situation where the required injection of business assets cannot be effected when the change of control rules remain applicable.

The turn-around exemption clause is not applicable, if

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

The turn-around exemption clause applies retroactively beginning from the 2008 assessment period and to transfers of ownership after 31 December 2007. Hence the exemption clause is effective from the first application of the new change of control rules. The time limitation of the turn-around exemption clause has been modified. The clause was initially introduced as a temporary measure and, therefore, only applicable to share transfers taking place until 31 December 2009. The Economic Growth Acceleration Act now provides for non time-limited application.

It is important to 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 destroys the partnership trade tax loss carry-forwards. This can only be avoided if the partnership interest is indirectly acquired. However, if the partners are corporate entities, even an indirect share transfer may lead to a forfeiture of tax losses.

Finally, the transfer of carried forward losses on mergers under the German Mergers and Reorganizations Tax Act has also been abolished, so that all losses disappear in a corporate reorganization.

Transfer Taxes

See Transfer Taxes in the Purchase of Assets section.

Tax Clearances

Tax clearances are recommended especially in cases of complex acquisition structures, such as under the German reorganization law.

Choice of Acquisition Vehicle

A foreign purchaser may invest into a German target through different various 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 (such as resulting from a debt push-down) 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).

Dividends and capital gains derived by a resident corporate shareholder are essentially 95 percent exempt from corporate income tax irrespective of the participation quota, the holding period, and the source (domestic or foreign). For trade tax purposes the 95 percent exemption of dividend income only applies if the investment accounts for at least 15 percent of the share capital or an equivalent participation quota in the assets from the beginning of the respective calendar 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 into 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.

Investments into German partnerships by a foreign parent company may, therefore, potentially provide a double-dipping opportunity if debt financing is taken out at the level of the foreign parent company.

For a German corporate subsidiary, dividend distributions are subject to withholding tax (WHT) at a rate of 25 percent, increased to 26.38 percent by a 5.5 percent solidarity surcharge. The dividend WHT may be reduced to 15.83 percent if the foreign parent company is not domiciled in a country that has a tax treaty with Germany. If there is a double tax treaty (DTT) or the EU-Parent-subsidiary Directive (EU-PSD) 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 which include a motive test, an income test, and a substance test. Should the foreign parent company invest through a German trading partnership, it would generally have a limited tax liability in Germany on its income derived 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 provide for a 40-percent tax exemption (previously 50 percent) if the German company is a corporate entity. A full capital gains tax exemption may be available on the disposal of shares in a company if the DTT gives 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 if the country of residence of the investor 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 above 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 if the intermediate holding company meets the requirements under the German anti-treaty shopping rules. If the non-resident intermediate holding company lacks sufficient substance, the German anti-treaty shopping rules look through to its shareholder. If the shareholder meets the substance requirements, the intermediate holding company may claim the benefits of a DTT or German domestic tax law implementing the EU-PSD. However, in this case the benefits are limited to the extent that they could have been claimed by the ultimate shareholder.

Local Branch

As an alternative to the direct acquisition of 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 permanent establishment in Germany. Thus, the branch's income will be subject to German tax at the normal corporate and trade tax rate. If 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, there could be a timing benefit arising from the ability to consolidate losses with the profits of the head office.

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

Joint Ventures

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, when 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. Furthermore, financing costs for the acquisition of a partnership are tax deductible at the level of the partnership, which allows a debt push-down. However, any payments to the partners (such as management fees) are not tax deductible at the level of the partnership. German real estate investments held by foreigners are often structured using partnerships, because this avoids German trade tax if the business qualifies as non-trading for tax purposes.

Choice of Acquisition Funding

A purchaser will need to decide whether he/she wishes to fund the acquisition by means of debt or equity. The main concern will often be 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 the 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. If debt is used, a decision must be made on 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 (such as a shareholder loan) or directly from a bank. Dividends received from domestic shareholdings are generally tax exempt for trade tax (TT) purposes if the investment exceeds 15 percent and is held from the beginning of the calendar year. The exemption generally applies for corporate income tax purposes (CIT) without a minimum participation or minimum holding period. However, 5 percent of any dividend received is treated as a non-tax deductible item, which effectively reduces the dividend exemption to 95 percent. On the other hand, any

business expenses, in particular interest expenses related to German-sourced dividend income, are fully tax-deductible for CIT purposes (for restrictions with respect to interest expenses and the add-back rules for trade tax purposes, see Deductibility of Interest).

The most common way to deduct interest expenses and to 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 push-down into the target directly may be achieved through a merger of 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 could be automatically achieved if the acquirer of the assets/going concern is provided with the acquisition funding.

Due to the fiscal transparency of partnerships for German CIT purposes, any interest on debt taken out to acquire an interest in a German partnership would be tax-deductible at the level of the target, rather than at the level of the acquisition vehicle. The acquisition of a partnership, therefore, often results in an automatic debt push-down for German tax purposes.

If the interest cannot be offset immediately (that is, there are insufficient taxable profits), the resulting losses can be carried forward for German CIT and TT purposes. In addition, it is possible to carry back losses of up to EUR 511,500 for German CIT purposes.

Depending on the existing structures of the purchaser and target groups, it may also 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

As of 1 January 2008 generally, the German thin-capitalization rules were abolished and replaced 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 earnings before interest, depreciation, and amortization (EBITDA) for tax purposes. Other than traditional thin-capitalization or transfer pricing restrictions applicable in many European countries, this restriction applies to any kind of interest expense, irrespective of whether derived from inter-company financing or third-party debt. Initially, the rules applied to the net interest expense exceeding EUR 1 million in the assessment period. The Economic Growth

Acceleration Act modified the rules and permanently increased this de minimus threshold to EUR 3 million with retroactive effect as of the tax assessment period 2008.

To assess whether the new rules result in a restriction on interest deductions, the EBITDA for tax purposes must be accurately modeled in each case. The German GAAP results need to be decreased by tax free income, such as dividends, capital gains, or 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 (for further explanations please see Tax Losses in the Purchase of Assets section).

If companies wish to deduct more interest expense than allowed under these restrictions, they can 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 assessment periods from 2010 onwards) 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. The interest on such debt must not exceed 10 percent of the total net interest expense for each entity in the group.

Although the German tax authorities issued a decree in July 2008 on the application of the earnings-stripping rules, the new rules are difficult to apply, because it is not clear how to determine the correct consolidation level, the applicable accounting principles, and 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 a very careful analysis of whether the conditions of the escape clause can be met.

Under the Economic Growth Acceleration Act an EBITDA carry-forward was introduced. If the net interest expenses will be less than 30 percent of the tax EBITDA. This unused tax EBITDA will provide for an

additional interest deduction in future years if in these years the net interest expenses exceed 30 percent of the current tax EBITDA. Such EBITDA carry-forwards are limited to a period of five years and must be assessed separately. An EBITDA carry-forward will not be allowed in years in which an exemption from the earnings-stripping rules apply. Like tax loss carried-forwards the EBITDA carry-forwards will be forfeit within detrimental changes of ownership under certain circumstances (for further explanations please see Tax Losses in the Purchase of Assets section). In general, the provision is applicable for business years ending after 31 December 2009.

Additionally, it should be noted that for TT purposes, the deductibility of interest is further limited by an add-back of 25 percent of any deductible interest expense that exceeds (together with certain other add-backs) a threshold of EUR 100,000.

Withholding Tax on Debt and Methods to Reduce or Eliminate

Generally, interest payments to lenders are not subject to German WHT. However, non-resident lenders will be subject to non-resident taxation in Germany if 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 DTT. If lenders fail to qualify for a relief, all interest income is subject to CIT 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. Might 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 push-down 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-PSD, or reduced under a DTT or under domestic law provided the applicable conditions, in particular the minimum participation, holding periods, and substance requirements, are fulfilled. Dividend payments are not tax-deductible in Germany.

There may be situations where use of equity, although offering less flexibility should the parent subsequently wish to recover the funds it has injected, may be more appropriate than debt, in particular if 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. If 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 chapter, may permit a drop-down of the targeted assets into a subsidiary, the shares of which can then be sold. Accordingly, if two businesses are to be combined, the merger provisions may permit this 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 that of the reorganization. This may result in the reorganization retroactively becoming subject to tax.

Reorganization

The German Reorganization Tax Act was amended to facilitate cross-border reorganizations within the European Union. These amendments were required following the SEVIC judgment of the European Court of Justice (ECJ), the Council Directive 2005/56/EC on cross-border mergers of limited liability companies, and the Merger Directive, which had until then been ignored by the German legislation.

For the first time, the Reorganization Tax Act relates not only to reorganizations carried out under the German Reorganization Act, but also to 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 company at both shareholder and/or partner level.

As a general rule, the Reorganization Tax Act provides for all reorganizations to be carried out at fair market value leading to the taxation of hidden reserves. If 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, which would enable any profits on reorganization to be offset against existing tax losses carried forward, subject to the minimum taxation rules.

The choice of an interim value is more important now, because any reorganization leads to a forfeiture of tax losses carried forward (and interest carried forward under the limitation of the earnings-stripping rules).

The new rules apply to all reorganizations for which a registration with a commercial registrar was filed after 12 December 2006.

One of the most significant privileges of reorganizations under the Reorganization Tax Act is the fact that most reorganizations can be carried out with a retroactive effect of up to eight months for tax purposes. For example, the legal procedures of the reorganization can be carried out up to 31 August 2010, if the effective date of the reorganization for tax purposes was 31 December 2009.

Merger of a German Corporation into a German Partnership

According to the German reorganization tax act, a corporate entity can be merged into a German partnership or a German corporation. 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 have to be considered:

- Any tax-effective depreciation on the shares in the transferring corporation has to be reversed, leading to a taxable profit. Such profit is 95 percent tax-exempt for corporate shareholders and 50-percent tax exempt (up from 40 percent from 2009 onwards) for individual shareholders.
- Open reserves of the transferring corporation are treated as deemed dividend distributions and taxed at 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.

- The replacement of the shares in the transferring corporation with the assets of the corporation (upstream merger) may lead to a profit or loss on takeover. Transaction costs and the deemed dividend distribution may also be deducted when calculating the takeover profit or loss. A takeover 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, if the assuming partnership has non-resident partners who/which are only subject to a limited tax liability in Germany on their domestic income. Following the merger, any operating profit or capital gain would be taxable at the level of the non-resident partner, so the right of taxation could be restricted by a DTT. However, in most cases the right of taxation will remain with the country where there is a permanent establishment.

Tax losses 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. However, the tax losses carried forward will normally not be 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 will not be transferred to the receiving entity.

Merger of a German Corporation into a Second 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 base cost of its assets, including self-created intellectual property. The increase in the cost base would trigger taxable income at the level of the transferring entity on the one hand, and increase the depreciation base at the level of the receiving entity on the other hand. In most cases, a merger gain (that is, a gain resulting from an excess of the value of assets received over the shares

issued) at the level of the receiving entity is tax free. However, in the case of an upstream merger, that is, 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 have to be reversed. Where these write-downs were tax deductible (that is, for write-downs prior to 2001), the reversal is subject to CIT and TT in full. However any write-downs occurring after 2001 are not tax deductible, and as such the reversal is 95-percent tax exempt for CIT and TT purposes. Tax losses carried forward and interest carried forward (earnings-stripping rules) of the transferring entity will be forfeited on the merger and cannot be used by the receiving entity.

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, which constitute a branch of activity (Betrieb or Teilbetrieb). These can be categorized as such if 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 will generally be 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 if the following requirements are met:

- the contributed assets are subject to German CIT at the level of the receiving entity;
- the liabilities contributed do not exceed the assets contributed; and
- Germany's taxation rights on the contributed assets will not be excluded or limited as a result of the contribution.

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

A tax-free contribution may later be subject to partial, retroactive taxation if, within seven years following the contribution, either (a) the shares granted in exchange for the contributed assets or (b) the contributed shares themselves, are sold. The taxable gain will be decreased pro-rata by one-seventh for each year that elapses from the time of the contribution to the time of the sale. It is up to the taxpayer to demonstrate to the tax authorities by 31 May of each year that the shares have not been sold during the past year. A failure to provide such evidence to the tax authorities in good time will lead to a deemed share transfer and trigger retroactive taxation on a pro-rata basis.

However, the sale of the contributed shares will not lead to retroactive taxation if the contributing entity is a corporation which could have disposed of the shares tax-free anyway.

De-Mergers

In addition to the above-mentioned 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 that this scheme is solely applicable to corporations. Generally three models are possible:

- A split-up is a transaction in which an entity transfers its entire 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.
- A split-off is a transaction in which 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. A split-off includes both transactions in which the owners of the transferring entity all receive pro rata ownership rights in the receiving entity (sometimes called spin-off) and 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.

- A hive-down is a transaction in which 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 must be 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 drop-downs, the same applies to the assets transferred. However, if shares in a corporation are being dropped down into 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 (that is, 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 five years. It is, however, not necessary for all shareholders of the transferring corporation to take pro rata ownership interests in the receiving entity. In other words, the interest retained in the transferring entity can be reduced in return for an increased interest in the receiving entity and vice-versa. However this requires unanimous shareholder approval.

If, within five 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, this will lead to retroactive taxation on the entire reorganization.

When a corporation is divided by a split-up, all loss carry-forwards will be forfeited. In the case of a split-off, tax losses carried forward will not be transferred to the receiving entities and some of the existing tax losses will be 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 right 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. However, 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 Income Tax Law, a transfer of shares by a partner to the partnership in which he/she is a member is also possible at tax written down values. Other than the reorganization schemes described above, such a transaction is, however, ineligible for application with retro-active effects.

Change of Legal Form

According to the German Reorganization Act and Reorganization Tax Act, the conversion of a corporation into a partnership and vice-versa is allowed. 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 above. The reverse case, 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 above.

Hybrids

Consideration may be given to hybrid financing – that is, using instruments treated as equity for tax purposes in the hands of one party and as debt (giving rise to tax-deductible interest) in the other. Various hybrid instruments and structures were devised to achieve an interest deduction for the borrower with no income pick-up for the lender. However, legislative changes made in 2009 seek to deny the tax-effectiveness of such double-dip structures, particularly hybrid financing structures.

Discounted Securities

The tax treatment of securities issued at a discount to third parties normally follows the accounting treatment, with the result that 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' post-acquisition performance and, therefore, 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 up-front 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 have a significant influence on any transaction. Since 2002, German taxpayers have enjoyed 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); and
- resident and non-resident corporate sellers can generally exclude their entire gains for CIT and TT purposes (100 percent exemption).

A minimum interest or holding period, or tax treaty protection is not generally required to qualify for these exemptions. However, within a seven-year holding period following a tax-free reorganization, a sale may have adverse tax consequences under German Reorganization Tax Law (see earlier in the chapter). 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 to be trading income. Recent developments suggest this short-term trading rule may also apply to non-financial institutions.

Since 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. Expenses incurred on the sale reduce the amount of the capital gain and are, therefore, only 5 percent deductible.

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

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 his/her interest is sold fully or partly. (See Disposal of a Partnership.)

The differences in the tax treatment of assets and share sales clearly make owners of corporate target entities less inclined to sell the entity's assets, rather than its shares.

Asset Deal

The taxation of capital gains depends on the legal form of the seller and the type of the disposed asset. For the taxation of the disposal of shares and partnership interests, refer to the comments later in the chapter.

If the seller is an individual and sells his/her whole business, the capital gain may be subject to a favorable tax regime if certain requirements are met. In the hands of a corporation, capital gains will generally be subject to the 95-percent participation exemption on the sale of shares and be fully taxable for any other assets.

Disposal of a Partnership

If the partner sells his/her whole interest in the partnership, any 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 above with respect to the transfer of the total business by means of an asset deal. If only part of the partnership share is sold, TT 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 (that is, neither the limited tax exemption nor the halved partner's average tax rate apply).

In the case of a corporate partner, the capital gain is subject to corporate income tax and trade tax, irrespective of whether the participation is sold as a whole or in part.

For corporate members, the part of the capital gain attributable to interests 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). For individuals, new rules applied from 2009.

Disposal of Shares

Under current laws, the disposal of shares in corporations by resident or non-resident corporate entities is generally tax exempt except for the disposal of shares held by life and health insurance companies.

The same applies if the shares are held by a German branch of a foreign company or a German partnership with a corporate partner. Although related expenses are generally deductible, 5 percent of the capital gain is deemed to be a non-deductible business expense for corporate shareholders, thus reducing the 100-percent tax exemption to effectively 95 percent.

Resident or non-resident individual shareholders benefit from a 50-percent tax exemption (40 percent from 2009 onwards).

Company Law and Accounting

Under German commercial law, IFRS can be substituted for German GAAP as reporting standards for listed and non-listed companies, but German GAAP are mandatory for statutory financial statements, in particular as the basis for the distribution of dividends, insolvency, law, and for tax reasons. German Reorganization Law is mainly laid out in the so-called Umwandlungsgesetz (UmwG) and sets out the rules for commercial law and the accounting treatment for mergers (Verschmelzungen) as well as carve-outs and contributions of assets and liabilities, which constitute a separate branch of activity (such as Ausgliederung or Einbringungen; see also the tax explanation in the section Reorganizations).

As for M&A, 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 when it effects a pooling of business interests (that is, where one company's equity is exchanged for equity in another company), or 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. In general, 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 the assets and liabilities, which 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 arising on acquisition. 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. As long as IFRS is adopted, 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. An amortization period exceeding 20 years may be used in some cases, but must be justified. In the statutory financial statements of the company, goodwill must also be amortized over its 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 (such as retained earnings or available capital reserves). For groups, this means that the distributable equity reserves have to be determined by aggregating the corresponding statutory German GAAP accounts of the holding company and its subsidiaries separately, rather than 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 will trigger a personal liability for management and for shareholders. In particular these rules may need to be applied in the case of simple upstream loans to the parent company instead of a payment of dividends. The scope of these rules was previously much wider. Even so, it is still important that upstream loans are not impaired at grant date and that management continuously monitors the credit-worthiness of the borrower. Share capital increases, in particular payments in-kind rather than

cash, must also meet the legal requirements for capital maintenance. Otherwise the management and the shareholder may become personally liable.

In Germany there are generally no government controls or restrictions on investments in assets and business entities, or on capital movements into or out of Germany. There are, however, requirements under the Foreign Trade Regulations (Außenwirtschaftsverordnung) to report certain flows of capital for statistical purposes. The Foreign Trade Act (Außenwirtschaftsgesetz) also empowers the government to restrict the acquisition of interests in German companies and real estate by foreign persons. Currently, no such restrictions are in force and there is no reason to expect that they will be imposed in the foreseeable future.

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 EUR 500 million) and including at least one German entity with a turnover exceeding EUR 25 million must be registered with the Federal Cartel Authority and can be prohibited by this authority if considered to be detrimental to competition. EU anti-trust laws may pre-empt German anti-trust laws or add to it, depending on the transaction.

When planning an M&A transaction labor law considerations should also be taken into account. Under a provision in force in one form or another throughout the European Union, 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 one of several business divisions (branches of activity). Continuation of the employment contracts does not ipso facto 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.

Furthermore, Germany has an employee co-determination system for virtually all businesses. The system has several variants, the simplest, which involves election by employees, is the works council (Betriebsrat). The works council has a variety of rights to be informed and to be heard on personnel and other intra-company matters, and co-determination rights (where their consent is required).

Employees must make up a third of the supervisory board at companies with 500 or more employees. Limited liability companies exceeding the threshold of 500 employees must establish a supervisory board, if they do not already have one according to their articles of association. 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, but foreign owners unfamiliar with supervisory boards sometimes consider this to be unusual.

Group Relief/Consolidation

Generally, each entity is taxed on a stand-alone 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, TT consolidation, and CIT 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 corporations qualify as potential group subsidiaries. Due to the transparency of a partnership for CIT purposes, the partnership's income is attributed to its partners and taxed in their hands. Therefore, in the case of a partnership share, corporate income is de facto consolidated.

CIT and TT consolidation require only the financial integration from the beginning of the fiscal year and a signed profit and loss assumption agreement between the group member and the group leader. This agreement is subject to various formal requirements and must actually be performed. Furthermore, it is enforceable by creditors (for example, to force the group leader to transfer funds to a group member to cover its losses).

The group leader can be any German resident person or entity engaged in a commercial enterprise (such as a trading partnership or a registered branch of a non-German entity) with its place of management located in Germany. 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 CIT losses and, since 2004, TT losses are not affected by the consolidation and remain within

the particular group member for use after the tax consolidation is terminated (such as 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 (for example if the same persons manage both companies, or the group member has contractually yielded management authority to the group leader).
- Economic integration requires a substantial economic relationship between the activities of the group members and those of 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 if the intended group leader is a pure holding company.

For VAT purposes, the tax consolidation automatically becomes effective when the above-mentioned requirements are met.

Transfer Pricing

If, following acquisition, an inter-company balance arises between the purchaser and the target, 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. Furthermore, failure to charge fees for such as 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 which are not known in other jurisdictions, such as special business expenses in the case of partnerships.

Foreign Investments of a Local Target Company

The controlled foreign companies (CFC) anti-avoidance legislation is designed to prevent German companies 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 will be apportioned to the German parent company, and will be 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

- Assumption of business-related liabilities only, although certain liabilities are unavoidable under the German Civil Code (BGB), sections 419 and 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, need to specify assets acquired, regulate delivery, arrange for continuation, or re-negotiation of 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 at the seller's level.
- Likely to be subject to VAT unless 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 at seller's level.
- Potential integration of target corporation into existing tax consolidated group.
- For partnership interest, double dips may be possible. Also, step-up for tax purposes available.

Disadvantages of Share Purchases

- Target business in a corporation form (if target is of a tax transparent partnership form, the interest purchase is generally 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.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends ¹		Interest ²	Royalties
	Individuals, Companies (%)	Qualifying Companies ³ (%)		
Algeria	15	5 ⁴	10	10
Argentina	15	15	10/15 ^{5,6,*}	15/- ⁷
Armenia ⁸	15	15	5 [*]	0
Australia	15	15	10	10
Austria	15	5 ⁴	0	0
Azerbaijan	15	5 ⁹	10 [*]	5/10 ¹⁰
Bangladesh	15	15	10	10
Belarus	15	5 ¹¹	5	3/5 ¹⁰
Belgium	15	15	0/15 ¹²	0
Bolivia	10	10	15	15
Bosnia and Herzegovina ¹³	15	15	0 [*]	10
Bulgaria	15	15	0 [*]	5
Canada	15	5 ⁴	0/10 ^{14,*}	0/10 ¹⁵
China (People's Rep.) ¹⁶	10	10	10 [*]	7/10 ¹⁷
Croatia	15	5 ⁴	0 [*]	0
Cyprus	15	10	10	0/5 ¹⁸
Czech Republic	15	5	0	5
Denmark	15	5	0/25 ¹⁹	0
Ecuador	15	15	10/15 ⁵	15
Egypt	15	15	15 [*]	15/25 ²⁰
Estonia	15	5	10 [*]	5/10 ¹⁷
Finland	15	10	0	0/5 ²¹
France	15	5	0	0
Georgia	10	0/5 ²²	0 [*]	0
Ghana	15	5	0/10 [*]	8
Greece	25	25	10	0
Hungary	15	5	0	0
Iceland	15	5	0	0
India	10	10	10 [*]	10
Indonesia	15	10	10 [*]	7.5/10/15 ²³
Iran	20	15	15	10
Ireland	10	10	0	0
Israel	25	25	15	0/5 ¹⁵
Italy	15	15	0/10 ^{14,*}	0/5 ²¹
Ivory Coast	15	15	15 [*]	10
Jamaica	15	10	10/12.5 ⁶	10
Japan	15	15	10	10
Kazakhstan	15	5	10	10
Kenya	15	15	15	15
Korea (Rep.)	15	5	10/25 ¹⁹	2/10 ¹⁷
Kuwait	15	5	0 [*]	10
Kyrgyzstan	15	5	5 [*]	10
Latvia	15	5	10 [*]	5/10 ¹⁷
Liberia	15	10	10/20 ⁶	10/20 ²⁴
Lithuania	15	5	10 [*]	5/10 ¹⁷
Luxembourg ²⁵	15	10	0	5
Macedonia ¹³	15	15	0 [*]	10
Malaysia	15	5	15	10/- ²⁶
Malta	15	5 ⁴	0 [*]	0
Mauritius	15	5	0/- ²⁷	15
Mexico	15	5	0/10/15 ²⁸	10
Moldova ⁸	15	15	5 [*]	0
Mongolia	10	5	10 [*]	10

Country	Dividends ¹		Interest ²	Royalties
	Individuals, Companies (%)	Qualifying Companies ³ (%)		
Montenegro ¹³	15	15	0*	10
Morocco	15	5	10	10
Namibia	15	10	0*	10
Netherlands	15	10	0/15 ¹⁹	0
New Zealand	15	15	10	10
Norway	15	0	0	0
Pakistan	15	10	10/20 ^{6,*}	10
Philippines	15	10	0/10/15 ^{29,*}	10/15 ¹⁰
Poland	15	5 ⁴	5*	5
Portugal	15	15	10/15 ^{6,*}	10
Romania	15	5 ⁴	0/3 ^{30,*}	3
Russia	15	5 ³¹	0*	0
Serbia ¹³	15	15	0*	10
Singapore	15	5 ⁴	8	8
Slovak Republic	15	5	0	5
Slovenia	15	5	5*	5
South Africa	15	7.5	10/- ³²	0
Spain	15	10	10	5
Sri Lanka	15	15	10*	10
Sweden	15	0	0*	0
Switzerland	15	0 ³³	0*	0
Tajikistan	15	5 ⁴	0*	5
Thailand	20	15	0/10/25 ²⁸	5/15 ¹⁵
Trinidad and Tobago	20	10	10/15 ⁶	0/10 ¹⁵
Tunisia	15	10	10	10/15 ³⁴
Turkey	20	15	15*	10
Turkmenistan ⁸	15	15	5*	0
Ukraine	10	5 ³³	2/5 ^{5,*}	0/5 ¹⁰
United Kingdom	15	15	0	0
United States	15	0/5 ³⁵	0*	0
Uruguay	15	15	15*	10/15 ³⁶
Uzbekistan	15	5	5*	3/5 ¹⁰
Venezuela	15	5	5*	5
Vietnam	15	5/10 ³⁷	5*	7.5/10 ³⁶
Zambia	15	5	10	10
Zimbabwe	20	10	10*	7.5

Notes

- * This treaty does not limit the taxation of profit-dependent interest, such as interest on profit-sharing bonds; thus, the domestic rate applies to such interest.
- The dividend rates apply, under a number of treaties, also to the income of silent (or sleeping) partners from their partnership share and to payments on jouissance rights that do not entitle the owner to participation in the liquidation surplus. Other treaties, however, provide for no restriction or, in exceptional cases, for another rate. The individual tax treaty should be consulted.
 - Many treaties provide for an exemption for certain types of interest, such as interest paid to public bodies and institutions or in relation to sales on credit. These exemptions are not indicated in the column. Although interest on loans secured by German immovable property (mortgage loans) is taxed by assessment rather than by withholding, a treaty can exclude German taxation or reduce the rate.
 - Unless otherwise indicated, the rates in this column apply if the holding is at least 25 percent of the capital or voting power of the German company, as the case may be.
 - The rate applies if the recipient company owns at least 10 percent of the capital or the voting power of the German company, as the case may be.
 - The lower rate applies to interest payments in connection with the sale on credit of equipment.
 - The lower rate applies to interest paid to a bank; conditions may apply.
 - The domestic rate applies to copyright royalties, including films, unless the beneficial owner is the author or his/her heir, and to equipment rentals; there is no reduction under the treaty.
 - The treaty concluded between Germany and the former USSR.
 - The rate applies if the Azerbaijani company owns directly at least 25 percent of the capital with a value of at least EUR 150,000 in the German company.
 - The higher rate applies to copyright royalties for literary and artistic works, including films, etc.
 - The rate applies if the Belarusian company holds at least 20 percent of the capital of the German company and the value of the holding is at least EUR 81,806.70.
 - The zero rate applies if the recipient is an enterprise; this does not apply to (a) interest on bonds and (b) interest paid by a company to a company owning at least 25 percent of the paying company's voting power or shares.
 - The treaty concluded between Germany and the former Yugoslavia. It remains applicable in relations between Serbia and Germany. Montenegro has declared that it will honor all tax treaties that applied with respect to Serbia and Montenegro. However, application of the treaty with Montenegro has to be confirmed by Germany.
 - The lower rate applies to interest on public bonds.
 - The lower rate applies to copyright royalties for literary and artistic works, excluding films, etc.
 - The treaty does not apply to Hong Kong and Macau.
 - The lower rate applies to equipment rentals.
 - The higher rate applies to royalties for films, etc.
 - The higher rate applies to profit-dependent interest, such as interest on profit-sharing bonds.
 - The higher rate applies to trademarks.
 - The lower rate applies to copyright royalties for literary, artistic, and scientific works, including films, etc.
 - The zero rate applies if the Georgian company holds at least 50 percent of the capital of the German company and the value of the holding is more than EUR 3 million; the 5-percent rate applies if the Georgian company holds at least 10 percent of the capital of the German company and the value of the holding is more than EUR 100,000.
 - The 7.5-percent rate applies to fees for technical services. The 10-percent rate applies to equipment rentals and to know-how.
 - The higher rate applies to copyright royalties, excluding films, etc., and to trademarks.
 - The treaty does not apply to income paid to exempt Luxembourg holding companies.
 - The domestic rate applies to copyright royalties, including films, etc.; there is no reduction under the treaty.
 - The zero rate applies to interest paid to a bank. Otherwise, the domestic rate applies; there is no reduction under the treaty.
 - The zero rate applies to interest on public bonds. The 10-percent rate applies to interest paid to a bank; conditions may apply.
 - The zero rate applies to interest on public bonds. The 10-percent rate applies to interest payments in connection with the sale on credit of equipment.

30. The lower rate applies if and as long as Germany under its domestic law does not levy WHT on interest paid to a resident of Romania.
31. The rate applies if the Russian company holds at least 10 percent of the capital of the German company and the value of the holding is at least EUR 81,806.70 (DEM 160,000).
32. The 10-percent rate applies if the interest is subject to tax in South Africa. Otherwise, the domestic rate applies; there is no reduction under the treaty.
33. The rate applies if the recipient company owns at least 20 percent of the capital of the German company.
34. The lower rate applies to copyright royalties, excluding films, etc., and to know-how.
35. The zero rate applies if the corporate shareholder owns 80 percent or more of the voting stock of the U.S. corporation for the 12-month period ending on the date on which entitlement to the dividend is determined and qualifies under certain provisions of the limitation on benefits article of the treaty.
36. The lower rate applies to fees for technical services.
37. The lower rate applies if the Vietnamese company owns at least 70 percent of the share capital in the German company.

KPMG in Germany

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