Introduction to tax optimized acquisitions in Germany

Introduction

Despite the euro crisis, Germany has remained economically stable over the past years. It is still Europe's largest national economy, with a lot of innovative and pioneering companies. The surging German Stock Index DAX is a good indicator that the German economy is performing very well and is developing a great potential. A lot of companies still have not reached their limits with regard to their profits increase.

Thus, different studies mention that in the years ahead inbound investments in Germany will continue to increase. In particular, experts expect a rapid growth of specific branches, e.g. life sciences.

The tax overview 2018 focuses mainly on tax issues arising in M&A and provides practical advice on the relevant acquisition structures.

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Content

1. Optimized acquisition structures

A foreign corporate investor ("investor") has a range of legal possibilities of doing business in Germany. The investor could start its business in Germany through a subsidiary, a partnership or a German branch. It cannot be said without a detailed analysis of all relevant factors which of these alternatives is tax-favorable in the specific situation for the investor.

In the following we have outlined potential tax consequences in Germany concerning different legal set-ups and the most important, applicable German taxes which have to be considered.

Mostly, the investor starts its business through an asset deal or share deal due to the fact that the investor generally does not start its business from scratch in Germany.

The acquisition of assets of a German corporation can be structured as an asset deal or a share deal. Depending on the circumstances, a seller's preference normally will be a share deal as this generally offers the opportunity to realize a 95% tax exemption (if the seller is a corporation) or at least a 40% tax exemption on capital gains (if the seller is an individual). In contrast, an asset deal is fully taxable at seller's level.

In contrast, the acquiring investor aims to achieve a step-up on basis of the acquired assets resulting in depreciations and amortizations of the tangible and intangible assets. This result can only be achieved by way of an asset deal in case no further steps (i.e. merger with another German corporation) are envisaged.

Please note that the acquisition of a partnership interest is treated – from a tax perspective – like an asset deal and not as a share deal.

General legal aspects

From a German corporate law perspective, the following steps and decisions might be considered in a potential investor-starts-from-scratch scenario:

The investor should generally consider the selection of the right location. The selection of the location is very different and several aspects have to be considered, in particular an investor should consider:

- the infrastructure,
- nearby clients, and
- other factual criteria.

Moreover, the selection of the location is an important tax decision due to the fact that each municipality has a different trade tax multiplier (at least 200% / see *Appendix 4.1*). This could be a relevant decision from an overall German tax rate perspective.

For example, the municipality Frankfurt am Main has a local trade tax multiplier of 460% which results into a trade tax rate of 16,10% (total tax rate combining CIT: 31,925%). In contrast, the neighbouring municipality Eschborn has a local trade tax multiplier of 280% which results into a trade tax rate of 9,80% (total tax rate combining CIT: 25,625%).

In addition, every business is obligated to register for trade purposes (*Gewerbe-Anmeldung*). Responsible for this registration is the local trade authority. Under certain circumstances qualifications have to be confirmed. Some branches need a trade license, so please be aware of this possibility (e.g. real-estate agents). The acquisition of a business requires the transcription of the trade registration. In case a trade license is required, the investor has to submit the requested qualifications.

1.1 Acquisition of German branches or partnerships

1.1.1 Legal steps

If the target entity qualifies as a limited partnership (*Kommanditgesellschaft*), the following aspects need be taken into account:

- Shareholders in a partnership are at least one general partner (*Komplementär*) and one limited partner (*Kommanditist*).

- Agreements on the sale and transfer of limited partnerships interest (*Kommanditanteil*) generally do not require notarization under German law principles. If the general partner is a limited liability company (*GmbH & Co. KG*) and in addition to the partnership interest also the shares in the general partner shall be sold, notarization also in relation to the sale of the limited partnership interest may under certain circumstances also become necessary.

- Please note that the legal title to holding property remains unchanged at the level of the partnership.

  [For further information refer to our pocket guide on German tax optimized inbound real estate transactions.]

- The asset purchase agreement (APA) finalizes the acquisition of assets of a company.

1.1.2 Tax aspects

Certain tax aspect should be taken into account concerning the disposal of German branches or partnerships at seller's level.

a. Sale of partnership interest

From a tax perspective the sale of the whole partnership interest and a disposal of assets by a partnership are treated in the same way. Please note that only the sale of the entire interest by a partner leads to a termination of business which is subject to a privileged tax regime in case the seller is an individual. The partially disposal of interests is taxed as an ongoing profit, which has also consequences for trade tax purposes.

b. Additional balance sheets

Under certain requirements additional balance sheets (*Ergänzungsbilanzen*) have to be set up for the acquiring partners. This is the case if a profit or loss has to be allocated to an individual partner, e.g. the investor pays an exceeding amount compared to the book values of the partnership interest. This individual discrepancy cannot be reflected in the balance sheet of the partnership with respect to the share capital of each partner. Thus, additional balance sheets have to reflect this difference, which is only relevant for tax purposes. These hidden reserves (*stille Reserven*) have to be allocated to the assets and are subject to depreciations.

Annually, the additional balance sheet has to be carried forward. It is important to mention the depreciation of the assets. Following the Income Tax Act, for instance the firm's goodwill has a straight-line depreciation over 15 years.

In contrast to the acquisition of a corporation (*see below*), there are no tax privileges in this case. The regular tax rates are levied.

c. Liability regarding operating taxes

The acquirer of a branch or partnership is subject to secondary tax liability under section 75 Fiscal Code (*Abgabenordnung*). The tax liability concerns the operating taxes (e.g. TT, VAT and WHT). It is irrelevant if a whole business or a qualified business unit of an enterprise as a going concern (*Teilbetrieb*) is subject of the acquisition. The liability is limited to operating taxes accrued in the last year before the acquisition. Further, the liability is limited in amount to the purchased assets.

Due to the fact that the liability cannot be excluded, it is recommended that the acquirer should demand warranties of the shareholder or obligate the seller (purchase agreement) to indemnify in case a tax liability is triggered. Risks in this context can be mitigated by a tax due diligence.

d. Loss carried forward

As partnerships are transparent for tax purposes, income tax losses cannot be carried forward.

They belong to the partner / vendor and cannot be transferred to the acquirer. The forfeiture of loss carry forwards comprises CIT as well as TT.

e. Real estate transfer tax

The acquisition of German real estate in a course of an asset deal is subject to real estate transfer tax (RETT).

The acquisition of interest in a partnership owning German real estate is subject to RETT only if the investor acquires interest of at least 95% in such partnership within a period of five years. When acquiring interest in a German real estate owning partnership, the tax base is not taken from the purchase price for the acquisition of interest (or a portion of it). Instead, a special valuation procedure is applicable. This procedure contains a simplified discount cash flow model which also takes the age of the building into account. This valuation procedure usually leads to a so called requirement value (*Bedarfswert*) between 60% and 80% of the market value of the German real property.

Practical advice

Concerning the possibilities of RETT planning, please refer to our pocket guide to German tax optimized inbound real estate transactions.

1.2 Acquisition of a German corporate entity (GmbH)

An investor needs to plan the structuring of the acquisition of a German corporate entity carefully in order to achieve tax efficiencies.

In the following we have outlined the major facts which should be considered in the acquisition of a German corporation from a legal and tax perspective.

1.2.1. Legal steps

Before closing the acquisition buyer and seller have to negotiate the price and other circumstances concerning the disposal. This conclusion is recorded in a sales and purchase agreement (SPA / *Unternehmenskaufvertrag*).

By acquiring shares in a German corporate entity, the purchaser buys the whole corporation including all assets, liabilities, employees and risk / opportunities.

Important to note is the requirement of notarizing the acquisition of shares of a German GmbH by way of a share purchase agreement.

1.2.2. Tax aspects

Corporations are not transparent for tax purposes. They are subject to corporate income tax and trade tax.

a. Tax-exemption on share disposals

The acquisition of corporations is tax privileged. The capital gain from a transfer of shares is nearly tax-exempt, only 5% of this gain is relevant for tax purposes for corporate sellers. This rule avoids a double taxation of hidden reserves of the sold corporation.

In scenarios where the acquirer buys shares and not assets, the buyer cannot profit from tax depreciation rates (*Absetzung für Abnutzung*).

b. Loss carried forward

The German change-in-ownership rules ("CIO rules") regarding income tax losses and trade tax losses are – partially – forfeited in case the investor acquires (directly or indirectly) more than 25% or 50% (*schädlicher Beteiligungserwerb*) of the company's shares within a period of five years. The same result can be achieved with a capital increase.

It is important to mention that under certain requirements the losses can be carried forward and used for future profits. This takes place if the taxation of the hidden reserves, difference between equity capital and purchase price, is ensured in Germany (*stille Reserven Klausel*).

The CIO tax rules initially did not provide for an explicit intra-group reorganization privilege. Thus, regular intra-group share acquisitions or restructurings, taking place in Germany or abroad, could eliminate German tax loss carry-forwards.

Even if a chain of shareholding is eliminated, e.g. by way of upstream or downstream-merger of group company, the rules on harmful CIO may apply.

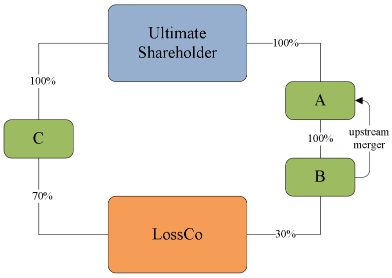
However, due to the financial crisis and following heavy criticism in respect of the width of the new rules' exceptions and limitations to the forfeiture of loss carry-forwards, new rules already have been introduced.

These exceptions cover certain intra-group restructurings, restructurings of companies in crisis, and finally a limitation of the expiring loss carry-forwards equalling the amount of hidden reserves of the company.

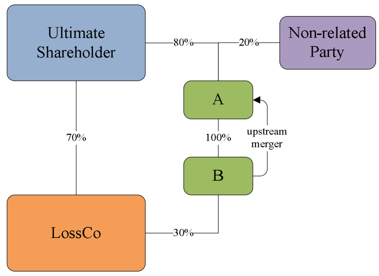
Under the intra-group exception, tax loss carry-forwards can continue to be available following a share transfer of a German loss entity provided that the company transferring the shares and the recipient / acquiring company are both wholly owned, directly or indirectly, by the same ultimate shareholder.

Please see the diagram example below. The requirements for the application of this exception are, however, very narrow. For example, a transaction whereby shares are transferred or received by the ultimate shareholder should not obtain relief.

Tax relief:



Tax relief is not applicable:



An additional relief has been introduced to enable the preservation of tax loss carry-forwards following a share transfer of a German loss entity, if and to the extent that hidden reserves exist at the level of such a German company which, if realised, is taxable in Germany.

In effect, this means that losses can be preserved if and to the extent that they do not exceed the difference between the fair market value of the shares transferred and the German company's tax balance sheet equity (the so-called "hidden reserves" of the company).

However, hidden reserves attributable to assets or shares which would not be taxable in Germany when realised are not taken into account (i.e. assets attributable to foreign branches, or unrealised gains relating to shareholdings which on disposal would be tax exempt in Germany).

c. Liability for tax risks

Generally, the risk for a purchaser of assuming unexpected liabilities is far higher compared to an asset deal. It is therefore advisable to conduct a far more in-depths due diligence regarding the assumed company.

Practical advice

Please mention in this context the following tax-clauses:

- Tax indemnification obligation:

  "The Sellers shall indemnify and hold harmless the Purchaser, or the Company if so requested by the Purchaser, from any Taxes which result in a tax liability of the Company or in a reduction of any loss carry forward (Verlustvorträge), and relate to the periods ending on or before the Closing Date except to the extent that such Taxes are accrued for in the Financial Statements (*) or are related to the income (Jahresüberschuss) according to German GAAP until Closing Date.

  The Sellers shall file all tax returns which are due to be filed by the Company on or before the Closing Date on its own expense and the Purchaser shall fully cooperate with the Sellers and its advisers in connection with any tax matter that could give rise to any liability of the Sellers under this Agreement, including the conduct of any inquiry, audit, investigation, dispute, appeal or litigation with respect to any relevant tax matter.

  The Purchaser shall, after he is informed by an official notice of, or in any other way by, a tax authority about a tax procedure concerning the Company, give notice in writing to the Seller, without undue delay, including copies of the tax authority's notice, if in writing, or other *documents received together with the notice to the extent the tax procedure could give rise to any liability of the Sellers under this Agreement. The Sellers may request the Purchaser to dispute, resist, appeal, compromise or defend any claim and any adjudication in respect thereof, if reasonable, and shall be involved in such disputes."*

- Tax Disputes and Audits:

  "The party responsible under this Section [*] for filing the Tax Returns applicable to the relevant Tax shall control any audits, disputes, administrative, judicial or other proceedings related to Taxes with respect to which either party may incur Liability hereunder. Subject to the preceding sentence, if an adverse determination may result in each party having responsibility for an amount of Taxes under this Section [*] each party shall be entitled to fully participate in that portion of the proceedings relating to the Taxes with respect to which it may incur liability hereunder. For purposes of this Section [*] the term "participation" shall include (i) participation in conferences, meetings or proceedings with any Taxing Authority, the subject matter of which includes an item for which such party may have liability hereunder, (ii) participation in appearances before any court or tribunal, the subject matter of which includes an item for which a party may have liability hereunder, and (iii) with respect to the matters described in the preceding clauses (i) and (ii), participation in the submission and determination of the content of the documentation, protests, memorandum of fact and law, briefs, and the conduct of oral arguments and presentations."

1.3 Tax-driven acquisition finance structures

Due to the fact that acquisitions generally are at least practically debt-financed, it is important for companies to lower the tax burden with the deduction of interests. Please note that in Germany several rules limit the possibility of such deductions. Thus, we have outlined relevant tax guidelines concerning acquisition finance structures.

1.3.1 Limited partnership

If the investment in a partnership is debt financed by a financing loan by the direct partner, this loan is qualified as a special business asset, a German tax law specification (*Sonderbetriebsvermögen*). This specific tax regime results in the fact that the loan interest is not deductible. Therefore, the acquisition finance of a partnership interest has to be made by an affiliate entity not directly acquiring the partnership interest.

1.3.2 GmbH

If the acquisition of a corporation by a corporation is debt financed, there is no limit levied – despite of the interest barrier rules – concerning the depreciation of interests.

1.3.3 NewCo target structure

Generally, in the acquisition practice a common structure is the interposition of a local corporation (NewCo, *Akquisitions-GmbH*). In this scenario the local NewCo buys the shares in the target corporation by debt.

After the acquisition tax benefits can be achieved by integrating the NewCo in the buyer's corporation by way of an upstream or downstream merger (*Verschmelzung*).

Please note that certain requirements have to be observed to make sure that the tax relevant losses can be carried forward.

Tax consolidation (Organschaft)

As an alternative to a merger, a fiscal unity could be installed between NewCo and TargetCo for CIT, TT as well as for VAT purposes.

A tax consolidation for German CIT purposes means that the taxable income of the consolidated subsidiary will be allocated to the parent company for German tax purposes only. However, the tax consolidated subsidiary is still obliged to draw up its own financial statement and must also determine its income.

In principle, the same is true with regard to a TT consolidation. The parent and the consolidated subsidiary are still considered as two separate entities but for TT purposes the consolidated subsidiary is treated like a branch of the parent and the TT income has to be allocated on a standalone basis.

However, usually a German tax group cannot have foreign group members and does not allow cross-border use of losses as losses from foreign subsidiaries cannot be offset within the German tax group. This is the reason for using a local corporate vehicle in order to consolidate the debt payments at NewCo level with the operating profits at TargetCo level.

With regard to a tax consolidation for German VAT purposes (please see below remarks on the German VAT system) the participating companies will be treated as one single company. However, a tax consolidation for German VAT purposes is limited in Germany.

The consolidated subsidiary's turnover will be aggregated with the parent's turnover in the value added tax return. Any supply of goods or services between the participating companies will not be subject to German VAT.

1.3.4 German interest barrier rule

As mentioned above, German tax law provides for a limitation on the deductibility of interest expenses (*Zinsschranke*).

Under the interest barrier rule, interest expenses are tax-deductible provided that the net interest expense (interest expenses minus interest income) does not exceed 30% of the taxable EBITDA ("30% test"). EBITDA is defined as taxable income before application of tax deductions for depreciation and amortization, plus interest expense less interest earnings.

Generally, the 30% test is applied to each legal entity. That means each subsidiary has to be tested whether the interest expenses exceed 30% of the taxable EBITDA. There are three exceptions under which the interest barrier rules are not applicable (i.e. interest expenses are fully deductible) to German or foreign investors with domestic real estate activities:

a. De minimis tax threshold

Under this exception the interest barrier rule is not applicable to the extent that the annual net interest expenses (per taxable entity) amount to less than € 3 m. If the threshold is exceeded by only one single Euro, the full interest expenses fall under the interest barrier rules. The legislator has enacted new legislation to increase the interest deduction limitation for taxpayers.

b. Non-group entities

If the borrower and potential buyer of a debt financing is not a member of a consolidated group were also creditor is a member of the interest barrier, provision is, as a rule, not applicable provided that there is no “harmful debt financing” as described below. The borrowing company is part of a consolidated group if it is included in that group’s consolidated financial statements prepared according to IFRS, local GAAP or US GAAP.

c. Escape clause

An escape clause is applicable if the “equity ratio” of the tested borrower is not less than the “equity ratio” of the consolidated group (2% tolerance) provided that none of the entities in the consolidated group is “debt financed harmfully” according to the interest barrier rules.

The equity ratio is the ratio of equity (calculated under the applicable GAAP) to its balance sheet total. Certain adjustments, such as elimination of interests held in other group companies, have to be considered in determining the equity percentage of the company at borrower’s level. Generally, the determination of the equity ratio is based on the financial statements provided under IFRS or, in default of such information, under local GAAP.

The escape clause is only applicable if the borrowing company can demonstrate that there is no “harmful debt financing” for German tax purposes. This can be assumed if no more than 10% of a group company’s net interest expenses (i.e. not only the interest expense of the German tax payer) is paid to a related party outside the consolidated group.

d. Practical advice

Certain structures allow avoiding – or at least mitigating – the non-deductibility of business expenses, in particular if certain structures exist:

- Interest payments can be allocated to entities which are not subject to the German interest barrier rule. A German company may be financed by equity injections of a foreign group company. The company abroad is not subject to the German interest barrier rule. Thus, the financing of this foreign company by credits abroad (i.e. in order to make equity payments) should be tax optimized. Further tax optimized structures can apply between group companies. Bond loans may be subscribed or interest-bearing loans granted to affiliated foreign companies.

- Injection of supplemental equity through capital increase and profit retention may improve the equity ratio of the whole group or the German entity. This offers the possibility to benefit from the escape clause. In this context mezzanine financing instruments and restructuring of shareholder loans into equity should also be contemplated.

- A tax optimized utilisation of the taxable EBITDA can be achieved by restructuring fixed interest loans in variable interest-bearing loans. Further possibilities are the splitting of operating units and the spin-off of business activities. This allows a multiple utilisation of the German interest barrier rule threshold.

1.3.5 Trade tax add-backs and deductions

Generally, the profits of the corporation are subject to trade taxes.

The tax base may be different from tax base for (corporate) income tax purposes due to specific add-backs and deductions (e.g. add-backs of interests, rent and leasing expenses). For instance, interest payments exceeding a tax free amount of € 100,000 are not fully deductible for trade tax purposes.

2. Tax aspects of operational business

2.1 Ongoing tax obligations

In the following, we have outlined the most relevant taxes and tax obligations concerning the operational business of companies in Germany.

2.1.1 Corporate income tax

A German corporation is – from a German tax law perspective – not transparent for tax purposes. In general, a German corporation (such as a GmbH or AG) is subject to CIT with its taxable profit. The triggered tax rate is 15% plus the levied solidarity surcharge at a rate of 5,5%. The overall tax rate therefore is 15,825%.

2.1.2 Trade tax

A German corporation, commercial partnership or branch is also subject to German TT if it either performs as a business or qualifies as a deemed business.

Please note that a German commercial partnership is regarded as a taxpayer for the purposes of imposing German TT. However, in some cases tax exemptions apply. The tax exemption depends on the business which will run or is running through the German branch or partnership.

In case the business only relates to the rent of offices it might be possible to apply for a TT exemption.

Concerning the tax rate for TT purposes, please see *Appendix 4.1*.

2.1.3 Value added tax

In general, VAT is imposed on deliveries and services at a general tax rate of 19%, whereas the reduced rate is set at 7%. The reduced rate only applies to certain provisions.

2.1.4 General tax procedures

Companies located in Germany have certain formal obligations for tax procedures.

CIT and TT are assessed on an annual basis, referring to a 12-month-period. Depending on a company's decision, the period may refer to the calendar year or fiscal year. VAT is triggered at each stage of production and distribution of products. Companies have to file advanced tax returns monthly in order to assess the VAT payable.

In addition, German subsidiaries or German branches generally are obligated to prepayments of CIT and TT in a prospective 3-month-period based on an estimated profit of the current year's due tax amount.

2.2 Repatriation of profits

2.2.1 Withholding taxes

Germany applies a 25% withholding tax plus 5.5% solidarity surcharge on the gross dividend. Concerning an overview of the total tax amount in case of a dividend distribution, please see *Appendix 4.2*.

In case of a corporate shareholder, German CIT provides for a 95% tax exemption of capital gains received from German or foreign corporations. Capital gains received by individuals, with shares exceeding 1% of the shareholders capital or shares which belong to a business of the individual, are taxes with the usual rate, but 40%-exempt (*Teileinkünfteverfahren*).

2.2.2 Double taxation treaties / EU parent-subsidiary directive

It is important to mention certain circumstances in relation to cross-border participations.

Generally, Germany imposes withholding taxes on dividends at a rate of 25% irrespectively whether such dividends are exempt from German taxation due to the EU-Parent Subsidiary Directive or a double tax treaty.

a. Double taxation treaties

Some investors choose to establish a European holding entity in order to manage their European and German based companies. Traditionally, Luxembourg has been a popular jurisdiction for establishing such holding company due to its favourable double tax treaty protections.

Furthermore, according to the general anti-treaty shopping rules it is important to point out that certain significant substance requirements have to be met for foreign entities to benefit from withholding tax reductions and exemptions under an applicable Double Taxation Treaty or the EU-Parent Subsidiary Directive when repatriating profits from a real estate owning German company to its foreign shareholder. In order to be entitled to such tax reliefs, certain requirements have to be met:

- Relevant economic reasons for the interposition of the foreign entity.
- Engagements in commercial transactions through a business organization appropriate to the business purpose.

b. EU parent subsidiary directive

The EU parent-subsidiary directive (*Mutter-Tochter-Richtlinie* 90/435/EWG) provides that in certain cases no withholding tax will be triggered. It is necessary that the parent company and the subsidiary company are both located in different states of the EU. The parent company must have held a minimum share of at least 10% of the subsidiary company within the last twelve months.

c. Anti-treaty / abuse shopping rules

According to the specific anti-treaty shopping rules significant substance requirements have to be met for foreign entities which intend to benefit from withholding tax reductions/exemptions (with respect to dividends, interests or royalties) under an applicable DTT or the EU-Parent Subsidiary Directive.

A foreign entity does not qualify for a tax relief under a DTT or EU-Parent Subsidiary Directive to the extent it is owned by shareholders who would not be entitled to such tax relief if they derived the income directly unless all of the following requirements are met:

- There are relevant economic motives or other valid reasons for the interposition of the foreign entity ("business purpose test"). Business purpose test: The Ministry of Finance has issued a circular regarding the interpretation of the new legislation. According to the circular of the tax authorities' the business purpose test is met if the holding is interposed for legal, political or religious reasons. Mere organisational reasons (i.e. integration into a group-wide structure) are generally not sufficient to meet the business purpose test. However, the execution of management functions should generally be a valid reason. A legal reason could likely also be the implementation of a stock option plan at the level of the holding company.

- The foreign entity engages in general commercial transactions through a business organisation appropriate to its business purpose ("commercial activity test"). Commercial activity test: According to the circular holding companies (i.e. without own business activity) do generally not meet the commercial activity test. However, the circular states one exception of the rule if the holding company qualifies as a "management holding company".

If the foregoing requirements are not met, the tax payer will be treated as if the dividend was distributed to the direct shareholder of the tested holding company (next shareholder in the chain). In case the direct shareholder in the tested holding company is entitled to treaty benefits these benefits will be granted.

Please note that Germany has introduced strict substance rules according to which any withholding tax relief can only be granted if the company is regarded as an active business company. Due to the underlying official circular dealing with withholding tax relief for holding companies, the following criteria have to be considered.

Management holding companies are companies that engage in the active management of their subsidiaries. In this context, the tax authorities apply rather high standards. Only minor management functions should not be sufficient. Moreover, it is not sufficient if the management functions are outsourced to law firms or management entities. Also, a mere financing or licensing function is not satisfactory. Instead it is necessary that the management holding has at least two participations and that the holding company actively influences the business of the subsidiaries. In this context it is material that strategic and fundamental decisions with respect to the business of the subsidiaries are taken at the level of the management holding and only the day-to-day business takes place at the level of the subsidiary.

Management functions of a holding company should be demonstrated towards the tax officials if the activities of the holding comprise, inter alia (i) coordination of all group companies: e.g. strategic planning and coordination at the level of the holding in respect of all intercompany activities between sister companies; (ii) support concerning HR department: e.g. management holding is involved when hiring key employees, implementing guidelines for all group employees, group-wide personnel administration; (iii) accounting and finance: e.g. preparation of book-keeping for the group, group-wide budgeting, preparation of group financial statements, administrative audit, preparation of costs and price analysis; (iv) legal, tax and consulting: e.g. preparation of group-wide master agreements, legal and tax department for group-wide legal aspects towards customer, protection of trademarks, group-wide insurance agreements; (v) marketing, sales and distributions: e.g. strategic overall planning of the group, monitoring of market develop, assisting of group-wide sales promotion, assisting of the corporate identity; (vi) intercompany relationship, shareholder financing: e.g. surrender of goods, intercompany loan agreements, licence agreements, group-wide guarantees. Please note that the foregoing activities have to be recorded, put into writing and have to be done by the holding company itself (i.e., outsourcing of substantial activities to third parties will lead to the disqualification of the management holding status).

3. Optimized sale structures

3.1 Sale structures – optimizing of losses

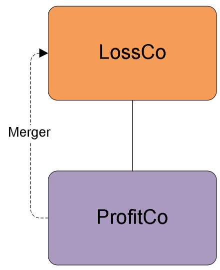
The ability to safeguard against the forfeiture of tax loss and interest carry-forwards has become significant in Germany because of the economic climate and the new developments described above.

In the following, we provide a brief overview of possible structures which may enable relief from a forfeiture of tax losses and interest carry-forwards in a German corporation or group. Investors in Germany and German taxpayers should carefully review whether the CIO rules affect their tax position in Germany.

In principle, capital gains are included in the tax base of Corporate Income Tax and Trade Tax. However, the German Corporate Income Tax Act provides for a 95% tax exemption of capital gains received by corporations on the disposition of shares in German or foreign corporations. The tax exemption applies irrespective of a minimum shareholding or a minimum holding period. In return, losses from the sale of such stakes are disregarded for tax purposes and not deductible from the tax base.

Capital gains received by individuals on the sale of shares in corporations are taxable if the shares belonged to a business or if the individual's participation in the corporation exceeded a threshold of 1% of the capital. As of 2009, 40% of such capital gains are tax exempt. Capital gains received by individuals from the sale of shares (<1%) which were held as private assets are subject to a flat tax of 25% as, irrespective of the holding period.

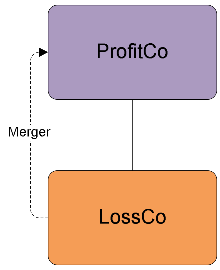
3.1.1. Up-stream merger of profitable subsidiary to parent company ("LossCo")



In a case where LossCo has a profitable subsidiary, an option is to up-stream merger, ProfitCo into LossCo.

The merger should be performed on a tax neutral basis at book value. As a consequence, any taxable income derived from ProfitCo could be offset against current losses and loss carry-forwards of LossCo.

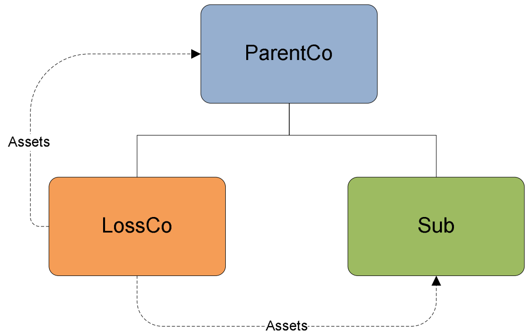
3.1.2 Up-stream merger of a loss-making company to a parent company



This merger should be performed at fair market value. This may lead to a taxable realisation of built-in gains, which could include internally-generated IP rights.

It should be noted that this type of merger can lead to a forfeiture of tax losses and interest carry forwards at the level of LossCo under the CIO rules. Therefore, the merger should only be performed if current tax losses are substantial and tax loss carry-forwards do not exceed the threshold of € 1 m; otherwise Germany's "minimum taxation" rules might diminish any tax benefits of such merger.

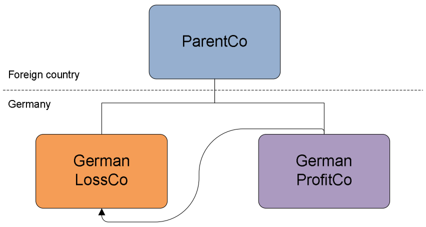
3.1.3 Step-up by way of an asset deal

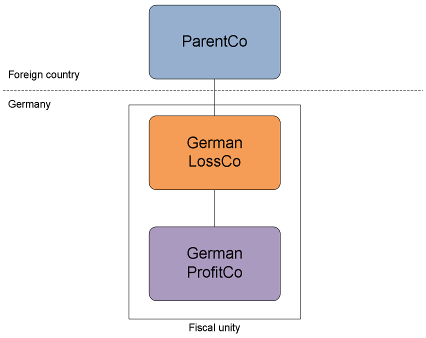


Assets which have potential hidden profits and can be amortized over a specific period of time can be sold within a group. The profit realised can be set off against available loss and interest carry-forwards, subject to the minimum taxation rules in Germany.

If on-going use of assets is required in the company currently owning them, a sale and lease back transaction could be contemplated, though it would be important to take special tax rules for leasing into account.

3.1.4 Fiscal unity





A fiscal unity ("*Organschaft*") of German companies leads to a consolidation / pooling of current profits and losses of the pool members, in this way reducing the overall tax payable (at the level of the German parent company) of the pooling members compared to separate taxation of pool members.

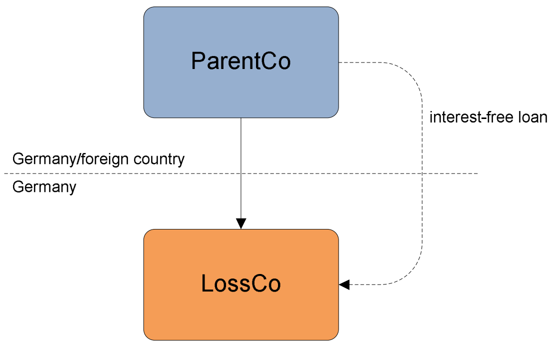
The creation of fiscal unities between German ProfitCo and German LossCo can be achieved by transferring the shares in German ProfitCo on a tax-neutral basis to German LossCo. If possible, the head / parent of the fiscal unity (beneath ParentCo) should be German LossCo, being the company with the highest amount of tax loss carry-forwards, given that the loss carry-forwards of other members of the fiscal unity are “frozen” for the duration of the fiscal unity period.

For tax purposes, fiscal unity contracts have to be entered into and carried out for a minimum period of 5 years. Subsequently, the companies involved should enter into a profit and loss pooling agreement.

The downside of fiscal unity is that the fiscal unity parent (German LossCo) is obliged to commercially assume the losses of its fiscal unity members.

It is worth remembering that following recent case decisions by the European Court of Justice, the possibility of cross-border fiscal unities is highly controversial in Germany.

3.1.5 Granting of a non-interest bearing loan



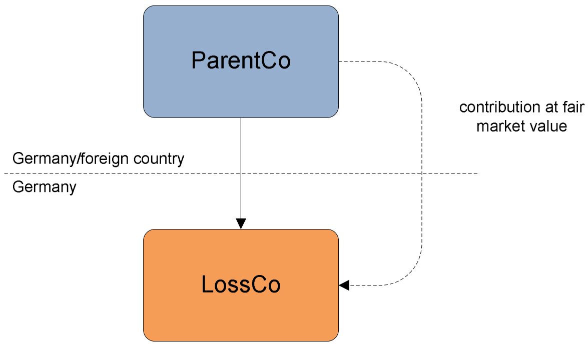
If LossCo expects losses in the current fiscal year but profits in future years, tax loss carry-forwards can only be used for the future within the “minimum taxation” rules.

In order to mitigate such "minimum taxation", LossCo may obtain a loan which is non-interest bearing for a term of more than 12 months.

Under German tax rules, a non-interest bearing loan has to be treated as issued at a discount which leads to taxable profits in LossCo (subject to any set-off of existing loss carry-forwards).

As nil interest earnings would be booked at the level of the lender (ParentCo), this may preclude the creation of new tax loss carry-forwards in LossCo exceeding the € 1 m threshold.

3.1.6 Loan subject to a profit-related repayment obligation



As mentioned above, existing loss carry-forwards can only be used for future profits or other financing measures within the "minimum taxation" rules.

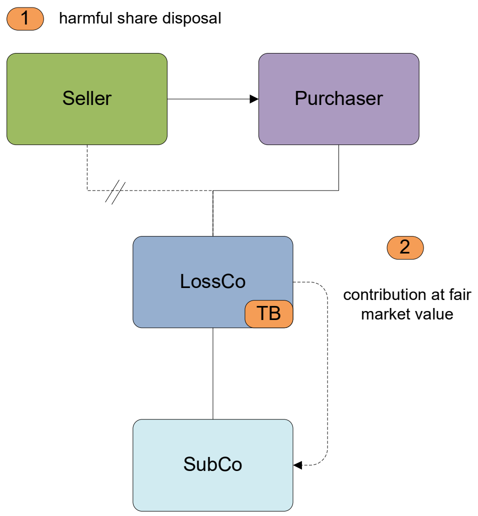
To mitigate such rules, an alternative for ParentCo might be to grant a profit-related loan to LossCo assuming that LossCo would generate profits in future fiscal years. Any repayments under such loan should be subject to any profit for German GAAP purposes in the future.

As the loan repayments will be subject to future profits / earnings being recognised, the loan itself can initially be removed from the balance sheet.

This non-recognition of the loan will create further taxable profits at the level of LossCo, which can be offset by on-going losses.

Subject to future profits being earned at the level of LossCo, the loan then will be booked and can create future losses. This structure would result in a deferral of accumulating (limited use) tax loss carry-forwards.

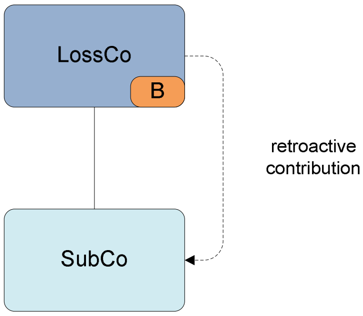
3.1.7 Creation of hidden reserves during the loss-making fiscal year



Where a shareholder is contemplating selling more than 25% of its shareholding in a German LossCo, any existing loss carry-forwards as well as net operating losses will partially be forfeited / disallowed (cf. above), unless the company has “hidden reserves” relating to existing assets which may be realised.

Hidden reserves may be realised by selling or contributing part of the business into a subsidiary at fair market value, the profits of which can be offset against the net operating losses.

3.1.8 Retroactive contribution

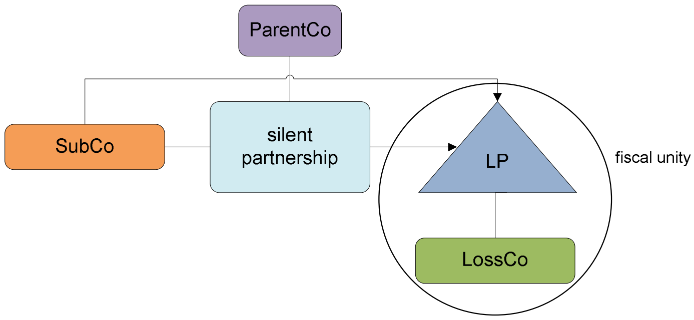


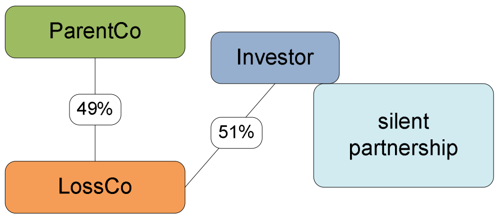
Existing loss carry-forwards can also be preserved following a retroactive contribution by LossCo of part as its business into a new company (SubCo) at fair market value.

Such contributions can create an extraordinary profit of the previous fiscal year at the level of LossCo, which can be offset by existing loss carry-forwards.

The contribution at fair market value will create a step-up in value of costs at the level of SubCo which can be used for tax depreciation purposes (the expenses of which are not subject to the “minimum taxation” rules).

3.1.9 Use of losses through a silent partnership





Finally, by establishing an atypical silent partnership, profits at the level of a company or head of a consolidated group can be allocated via the profit participation share the silent partnership has in the company.

In contrast, any losses at the company / head of the consolidated group can be set off as the equity contribution of the silent partnership will be reduced in proportion to the allocated losses. Any allocation of losses and profits of a silent partnership are not subject to the CIO rules.

3.1.10 Final remarks

German taxpayers and investors should carefully review whether the change of ownership legislation affects their tax positions. Tax planning strategies in order to safeguard such losses and loss carry-forwards are becoming even more important.

3.2 Transfer taxes

3.2.1 Value Added Tax

Generally, the disposal of assets levies VAT. The acquisition of a business includes the transfer of many assets (e.g. commodities, right and allowances). In order to simplify the taxation of acquisitions and to protect the companies from a high VAT debt, the transfer of an entire business (*Geschäftsveräußerung im Ganzen*) is not subject to VAT. In this case it is required that the sold assets are available to the buyer for long-term use after the acquisition. The long-term continuation of the business must be ensured. The purchaser replaces the seller after the transfer. Please note that this also applies to the acquisition of rented property.

Practical advice

Concerning the transfer of real estate, the following clause should ensure the VAT position:

> "The purchase price is meant to be a net amount that does not include any VAT. The Seller and the Purchaser unanimously assume that the sale and transfer of the Properties under the Agreement qualifies as a non-taxable transfer of a business as a going concern within the meaning of Sec. 1 para 1a German Value Added Tax Act (*Umsatzsteuergesetz* – "UStG") which is not subject to

> VAT. The Parties will disclose the contractual stipulation as well as any further information required to determine the VAT treatment to their respective competent Tax authority within the VAT declaration period of the execution of this Agreement."

3.2.2 Real Estate Transfer Tax

Real estate transfer tax is levied if at least 95% of a partnership / corporation are sold. For further information's please see above (1.1.2.e.) and refer to our pocket guide on German tax optimized inbound real estate transactions.

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4. Appendix

4.1 Local trade tax multiplier (minimum 200%) -

State	Min.	Max.	Max. tax rates
Baden-Wurttemberg	265	430	15.05%
Bavaria	230	490	17.15%
Berlin	410	410	14.35%
Brandenburg	200	450	15.75%
Bremen	395	440	15.40%
Hamburg	470	470	16.45%
Hesse	250	460	16.10%
Mecklenburg-Western Pomerania	200	465	16.28%
Lower Saxony	280	460	16.10%
North Rhine-Westphalia	300	520	18.20%
Rhineland-Palatinate	300	900	31.50%

Saarland	360	450	15.75%
Saxony	275	460	16.10%
Saxony-Anhalt	233	450	15.75%
Schleswig-Holstein	235	350	12.25%
Thuringia	200	500	17.50%

4.2 Taxation of dividend distribution

		Corporation (shareholder: corporation*)	Branch (corporate partner)	Partnership (corporate partner)
Profit		**100.00**	**100.00**	**100.00**
Trade Tax (sample rate: 14%)	./.	14.00	14.00	14.00
Corporate income tax, "CIT" (15%)	./.	15.00	15.00	15.00
Solidarity surcharge	./.	0.83	0.83	0.83
Available for distribution		**70.17**	**70.17**	**70.17**
Statutory WHT rate of 26.38% of dividend (distribution of 70.17)	./.	18.51	No WHT	No WHT
WHT refund (upon application)*		18.51*	No WHT	No WHT
Available to shareholder / parent / partner		**70.17**	**70.17**	**70.17**
Total tax burden		**29.83**	**29.83**	**29.83**

* Reduction according to the EU Directive requiring (i) a minimum holding period of 12 months, (ii) a shareholding of at least 10% and (iii) the shareholder being a EU resident corporation.

This simplified scenario may vary depending also on the tax residence of the corporate shareholder (double tax treaty situation) and the local trade tax rate. Foreign tax credits should be taken into account.

Shareholders being individuals will not have the right to claim the full refund as laid down under the EU Directive.