Germany Dr Joachim Englisch*

Reform of the Reorganization Tax Act and Related Changes

Contents

1. Introduction

Until recently, cross-border reorganizations have not been facilitated in German corporate law. This began to change when the Council Regulation on the Statute for a European company (*Societas Europaea*, SE) entered into force on 8 October 2004.[1] In addition, in October 2005, the Council enacted a Directive on the cross-border mergers of limited liability companies.[2] The German government has already initiated the legislative process so as to conform the Reorganization Act (*Umwandlungsgesetz*) to the Directive's requirements.[3] The government has also been encouraged to do so as a result of the *SEVIC* judgment of the European Court of Justice (ECJ), according to which a general refusal to register inbound cross-border mergers constitutes a violation of the freedom of establishment set out in Art. 43 of the EC Treaty.[4] The general terms adopted by the ECJ to support its findings suggest that outbound mergers must be facilitated under the same conditions as for comparable internal transactions,[5] even though this might imply overruling the earlier *Daily Mail*[6] judgment.

These developments have finally given practical relevance to the EC Merger Directive,[7] which provides for the deferred taxation of capital gains arising from cross-border company restructuring carried out by way of mergers, divisions, transfers of assets or exchanges of shares. Prior to this, the most of this EC law framework for the taxation of trans-frontier restructuring operations within the European Union had been ignored by the German legislator due to a legally inherent lack of materialization regarding most transactions. In view of the advances in the corporate law environment, the German government, however, acknowledged a genuine requirement to adapt the isolationist perspective of the relevant tax rules to the challenges of the Internal Market. The government, therefore, suggested a reform bill, even in advance of the proposed Reorganization Act.[8] In December 2006, after a little more than half a year of parliamentary debate and expert hearings, the SEStEG[9] (hereinafter: the SE Tax Act) was adopted. This Act is intended to reconcile the German system for taxing company restructurings with EC law requirements and to increase Germany's attractiveness as a company location, whilst, at the same time securing the entitlement to tax as yet unrealized appreciations in the value of assets.[10]

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1. Council Regulation (EC) No. 2157/2001 of 8 October 2001, Official Journal (EC), L 294, 10 November 2001, p. 1. The Regulation provides for the formation of an SE by means of, inter alia, a cross-border merger and features the possibility to transfer the registered office of an SE between Member States without the SE being dissolved. Since 18 August 2006, the parallel Council Regulation on the Statute for a European Cooperative Society also applies. See Art. 80 of Council Regulation (EC) No. 1435/2003 of 22 July 2003, Official Journal (EC), L 207, 18 August.2003, p. 1.
2. Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005, Official Journal (EC), L 310, 25 November 2005, p. 1. The Directive permits the cross-border merger of a national limited liability company with a limited liability company from another Member State. It must be complied with by 15 December 2007.
3. Draft of the Second Act amending the Reorganization Act (*Entwurf eines Zweiten Gesetzes zur Änderung des Umwandlungsgesetzes*) of 12 October 2006, BT-Drs. 16/2919.
4. ECJ, 13 December 2005, Case C-411/03, *SEVIC Systems AG*, Para. 20 et seq. If domestic companies may merge and, therefore, transfer their assets by dissolution without liquidation, foreign corporations must, in principle, have the same opportunity, notwithstanding the present absence of directly applicable Community harmonization rules.
5. See C.P. Schindler, "Cross-Border Mergers in Europe – Company Law is catching up!", 3 *European Company & Financial Law Review* (2006), p. 117.
6. See ECJ, 27 September1988, Case 81/87, *The Queen v. H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc*, Para. 18 et seq., as confirmed in ECJ, 5 November 2002, Case C-208/00, *Überseering BV v. Nordic Construction Company Baumanagement GmbH (NCC)*, Para. 65 et seq.
7. Council Directive 90/434/EEC of 23 July 1990, Official Journal (EC), L 225, 20 August 1990, p. 1, as amended by Council Directive 2005/19/EC of 17 February 2005, Official Journal (EC), L 58, 4 March 2005, p. 19. For more on the changes introduced by Directive 2005/19/EC, see R. Russo and R. Offermanns, "The 2005 Amendments to the EC Merger Directive", 46 *European Taxation* 6 (2006), pp. 250-257.
8. This Act contemplates forms of reorganization that imply the universal succession of the receiving company, i.e. a merger, a division or a change in legal form.
9. *Gesetz über steuerliche Begleitmaßnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerrechtlicher Vorschriften vom 7.12.2006*, BGBl. I 2006, 12 December 2006, p. 2782.
10. See the introductory remarks of the government draft, BR-Drs. 542/06, p. 1. Another stated objective was the simplification of taxation, which is a promise that the final legislation does not really live up to.

2. Reform of the Reorganization Tax Act

2.1. Introductory remarks

Most, but not all of the provisions regarding fiscally neutral company restructuring are contained in the Reorganization Tax Act (*Umwandlungssteuergesetz*, UmwStG).[11] The Reorganization Tax Act covers direct taxes on mergers, divisions, the transfer of qualifying assets by way of singular succession, an exchange of shares and a change in legal form if the latter has fiscal implications.[12] The personal scope of the Reorganization Tax Act extends to both corporations and fiscally transparent companies[13] as well as to sole proprietors. A transfer of assets, a division or a partial division can, however, only benefit from fiscal neutrality if the assets transferred and, eventually, also the remaining assets, form an "operational unit", i.e. a qualifying business unit capable of sustaining organizationally independent business activities. An exception is made solely in respect of the transfer of a partnership right in a fiscally transparent entity.

2.2. Extension of territorial scope

2.2.1. Background and overall effect

Prior to the adoption of the SE Tax Act, only a few provisions permitted a tax deferral in restructuring operations that involved non-resident corporations.[14] In general, only resident corporations could benefit from the rules permitting fiscally neutral reorganizations with regard to federal income or corporate income tax, on the one hand, and local business tax on the other. The reform has considerably extended the territorial scope of the Reorganization Tax Act. It has, however, resulted in the "Europeanization" rather than the globalization of the tax system in respect of company restructurings. This is because transactions involving companies from third countries usually still result in immediate taxation both at company and at shareholder and/or partner level.[15]

2.2.2. Foreign entities

For a restructuring operation to qualify for a tax deferral, it is now sufficient that both the transferring and the receiving entity are companies that fall within the meaning of Art. 48 of the EC Treaty or Art. 34 of the European Economic Area (EEA) Treaty, which have been created in accordance with the law of an EEA Member State and which have their registered office as well as their principal place of business in one of these Member States. An SE or a European Cooperative Society (*Societas Cooperativa Europaea*, SCE) is deemed to satisfy these requirements if its office is registered in a Member State. If a natural person is directly involved in the reorganization, he must be a resident of a Member State for tax purposes. Fiscally transparent companies are also included, but, if they are the transferring or acquired company, the direct or indirect partners who are subject to tax must also normally meet the aforementioned criteria with regard to their seat or place of residence.[16]

2.2.3. Foreign reorganizations

In addition to a wider personal scope, the types of formal reorganizations that can benefit from a tax deferral are no longer restricted to the national operations provided for in the Reorganization Act. Instead, the Reorganization Tax Act now extends to "comparable" cross-border or foreign reorganizations governed by the commercial law of any other country, as well as to mergers that result in the creation of an SE or SCE as set out in Art. 2(1)(17) of the SE Regulation and Art. 2(1)(19) of the SCE Regulation, respectively. The preparatory documents specify that a foreign reorganization may be classified as comparable if the entities involved feature the typical characteristics of a national company that would qualify for the relevant procedure under the Reorganization Act and if the operation essentially has the same consequences in substance.

In particular, the government draft referred to dissolution without going into liquidation in respect of a merger or split-up, universal succession and comparable limits for additional cash payments. Remarkably, these prerequisites are somewhat stricter than the definitions of mergers and divisions regarding the substantial scope of Art. 2(a), (b) and (b)(a) of the EC Merger Directive, which do not contemplate singular or universal succession. In effect, there should be no relevant lacunae, though, as the law regarding mergers and divisions is already harmonized within the European Union. In bor-

11. This legislation can, broadly, be subdivided into four parts. The first part is concerned with the scope of the application and general aspects of all the operations covered (Sec. 1 and Sec. 2 of the UmwStG), the second addresses the reorganization of corporations in one of the forms provided for in the Reorganization Act (Sec. 3 to Sec. 19 of the UmwStG), the third contemplates the corresponding operations by individuals or fiscally transparent entities as well as informal restructuring by way of a transfer of qualified assets or an exchange of shares (Sec. 20 to Sec. 25 of the UmwStG), and the final part administers the relatively complex issue of temporal applicability (Sec. 27 of the UmwStG). Parts 2 and 3 are subdivided according to the fiscal category of the receiving company and, subsequently, the specific operation carried out. It should be noted that the official system is less sophisticated, as the law only refers to sub-parts.

12. Indirect taxes are charged if the general conditions for their levy are satisfied by the characteristics of the individual restructuring operation. Accordingly, a transfer of ownership of real estate in the course of a reorganization gives rise to real estate transfer tax (an exception exists for a change in legal form) and the transfer of assets in exchange for shares or partnership rights by way of singular succession may be liable to VAT. The latter administrative practice is disputed and could be relinquished following recent ECJ decisions.

13. In Germany, the following companies are treated as fiscally transparent: a limited commercial partnership (*Kommanditgesellschaft*, KG), a general commercial partnership (*Offene Handelsgesellschaft*, OHG), a partnership for professional service providers (*Partnerschaftsgesellschaft*, PartG) and a "civil law association" (*Gesellschaft bürgerlichen Rechts*, GbR).

14. Most notably, a commercial establishment or an operational unit of a resident corporation could be transferred to a company from a Member State within the meaning of Art. 3 of the EC Merger Directive without capital gains taxation if the corresponding assets were then attributed to a PE of the latter that was situated in Germany or created there in the process. Along the same lines, taxation could be avoided if the assets transferred had already related to a German PE of a transferring non-resident company from a Member State. A fiscally neutral exchange of shares of companies from a Member State to establish or create a majority holding position of the receiving corporation was also possible if the shares granted to the transferring company were still liable to tax in Germany.

15. For some exceptions, see the subsequent detailed analysis in 2.3.

16. Details are provided in the course of the subsequent analysis in 2.3.

derline cases, the comparability criterion must be interpreted in conformity with the EC Merger Directive.[17]

2.3. Privileged restructuring operations

2.3.1. Mergers, divisions and changes of legal form

The tax treatment of potentially privileged mergers or divisions that involve the transfer of assets of a corporation liable to corporate income tax depends in a large part on the valuation of these assets on the tax balance sheet, which the transferring corporation has to prepare in respect of the restructuring operation. In general, all the assets transferred in the course of a merger or division by the transferring corporation, including any as yet uncapitalized intangibles, must be accounted for at their fair market value in the tax balance sheet to be prepared in respect of the reorganization. The previously relevant going concern value is, therefore, replaced. This reflects an underlying change in the fiscal perception of the reorganization as a full or partial liquidation of an entity that has to date been subject to tax. The transferring corporation may, however, opt for assessment using the present book value or an intermediate value in as far as the following conditions are satisfied:[18] i.e. that any eventual capital gain resulting from the sale of the assets is taxable in Germany to the same extent as before the reorganization and the consideration, if any, consists of shares in the receiving company.[19]

Any accounting profits of the transferring company arising from an eventual step-up may be set off against current losses or losses carried over from prior assessment periods within the limits of the general minimum taxation rules.[20] The remaining profits are deemed to be capital gains and are taxed accordingly. The assets transferred become the business assets of the receiving company, with the latter being bound by the evaluation of the transferred assets for the purpose of its own tax accounting. The receiving company also assumes the position of the transferring company in all aspects relating to the assets transferred, such as the depreciation method adopted. Given the territorial scope of these provisions, they fully comply with Art. 4 of the EC Merger Directive. In addition, a special provision deals with the transfer of assets effectively connected to a foreign permanent establishment (PE) situated within the European Union in accordance with Art. 10(2) of the EC Merger Directive, i.e. a tax credit is granted for fictitious foreign tax on the capital gain that would have arisen had the assets of the PE been sold at fair market value.[21]

If the corporation merges or splits into a fiscally transparent company, the law now states that all or a corresponding part[22] of its disclosed reserves are then taxed as if they were distributed to the shareholders on a pro rata basis as dividends. For non-resident shareholders, this means that Germany applies treaty provisions resembling those in Art. 10 of the OECD Model Convention (hereinafter: the OECD Model) and exercises its right to levy a withholding tax up to a maximum of 20%. As, in reality there is no cash flow, this newly introduced feature that is designed to secure source state entitlement to what would have been prospective profit distributions could significantly adversely affect the liquidity of the shareholders and amount to a serious obstacle for company restructuring. Notwithstanding this, a violation of the EC Merger Directive cannot arise, since, as a fiscally transparent company, the receiving entity is not entitled to the tax exemptions contemplated in Art. 7 and Art. 8.[23] Whilst, however, resident shareholders can often reclaim all, or, at least, most of the withholding tax, in a later tax assessment or ultimately pay only 1.25% if they are corporations, due to a shareholder relief,[24] the ensuing tax burden for non-resident shareholders is significantly higher, as they are ineligible for the relief, unless a treaty inter-corporate dividend exemption applies.[25] In the

17. See the landmark decision ECJ, 10 April 1984, Case 14/83, *Sabine von Colson and Elisabeth Kamann v. Land Nordrhein-Westfalen*, Para. 26.
18. A special rule provides for the mandatory carry-over of book values under these conditions if both the merging and the receiving company are corporations subject to German corporate income tax and resident of the same third country outside the EEA. Apart from this peculiarity, third country involvement results in the denial of any tax deferral.
19. If the receiving company is considered to be fiscally transparent, the second requirement must be satisfied for each corporation or physical person who, directly or indirectly, (i.e. via other transparent entities) holds partnership rights. This implies that the option may be exercised only partially, but uniformly in respect of all the assets affected, if only some but not all of the relevant partners are residents or domiciled in a state that permits unrestricted German taxation to the extent possible before the reorganization.
20. Current losses and a loss carry-over of up to EUR 1 million may be fully set off. In excess of this threshold, only 60% of the remaining profits may be set off against the remaining loss carry-over. The possibility for a loss set-off is the main incentive for the choice of an assessment with a certain intermediate value that partially discloses hidden reserves. It must, however, be remembered that the reserves thereby disclosed could be taxed in the hands of the shareholders, as demonstrated in the next paragraph of the main text.
21. No such tax deferral is available for the assets attributable to a PE located in a third county, which is an EEA Member State. This unequal treatment is inherent in Art. 10(2) of the EC Merger Directive, but is, nevertheless, hard to reconcile with the prohibition of any discrimination included in the freedom of establishment as set out in Art. 31 of the EEA Agreement. Anyway, the entitlement to subsequent taxation in Art. 10(2) of the EC Merger Directive is of little importance for Germany, which usually agrees on the exemption method in the tax treaties it concludes. This may, however, have effect mainly in respect of PE activity clauses.
22. In respect of a split-off, the reserves are allocated pro rata, based on the relationship between the fair market value of the assets transferred, on the one hand, and the fair market value of the corporation's entire assets, on the other.
23. If the receiving fiscally transparent company is non-resident, Germany may derogate from Art. 8(1) to (3) of the EC Merger Directive and apply the same treatment as it would if the receiving company had been resident by virtue of Art. 10a(3) and (4). Fiscally transparent companies resident in Germany for tax purposes, in turn, do not usually fall within the personal scope of the EC Merger Directive as specified in Art. 3(a), as Germany has listed only non-transparent corporations in the Annex. In the exceptional case of a qualifying partnership that has been formed in another Member State and has later moved its registered office to Germany, it is, at least, not considered in itself to be resident in any Member State and, therefore, fails to satisfy the requirements of Art. 3(b) of the EC Merger Directive.
24. Individual shareholders are assessed at their personal income tax rate only on half of the dividend, which can also be set off against negative income, in particular, against an eventual "transactional loss" discussed in the next paragraph of the main text. Corporate shareholders benefit from an inter-corporate dividend exemption and only 5% of the gross amount is deemed to be non-deductible business expenses, which are subject to corporate income tax at 25% (plus local business tax, in respect of which no withholding tax applies).
25. The exemption from withholding tax contemplated in Sec. 43b of the Income Tax Act (*Einkommensteuergesetz*), which implements Art. 5 of the EC Parent-Subsidiary Directive, does not provide any relief, as it has been amended to exclude explicitly fictitious dividends of the kind discussed above. Whilst this does not violate the EC Parent-Subsidiary Directive, as the latter also only covers a real rather than a fictitious cash flow, the exclusion is, nevertheless, contrary to the spirit of the reform. The new rule is intended to secure an *existing* source state entitlement, but, had the disclosed reserves

light of recent ECJ rulings regarding the discriminatory denial of dividend exemptions to non-resident shareholders,[26] an appeal should be filed against any such treatment.

In addition, with regard to an upstream merger or division,[27] the receiving company is attributed a "transactional profit", the tax-relevant part of which consists of the difference between the book value of its holding in the capital of the transferring company, on the one hand, and the final balance sheet value of the assets transferred pro rata of this holding, on the other. Any expenses relating to the reorganization are deductible. If the receiving company is considered to be fiscally transparent, the same applies to any shares held separately by its partners, unless they are not liable to capital gains taxation.[28] Two exceptions have been introduced for such companies. First, the undisclosed reserves of the transferring corporation that are deemed to be distributed to its shareholders must be deducted from the above, which often results in the assessment of a transactional loss rather than a profit. Second, assets must now be assessed at their fair market value for the purpose of calculating the transactional profit if their sale has not been subject to corporate income tax before the merger or division into a fiscally transparent company.[29]

Transactional profits are treated like a capital gain that would have resulted from a sale of the shares. Accordingly, if the profit is attributable to a corporation, either as the receiving company or as a direct or indirect partner of a fiscally transparent company that receives the assets, it is formally exempt from corporate income tax.[30] An eventual transactional loss is, therefore, generally disregarded for tax purposes.[31] Five per cent of any gain is regarded as non-deductible charges, though, which means that, to this extent, the transactional profit is effectively liable to both corporate income tax and local business tax, which is a total tax burden of approximately 2%. It appears to be highly questionable whether or not this form of covert taxation of the gains accruing on the cancellation of the holding implemented by way of the SE Tax Act is compatible with Art. 7(1) of the EC Merger Directive.[32] Remarkably, an explicit permission similar to that set out in Art. 4(2)(2) of the EC Parent-Subsidiary Directive is lacking in the EC Merger Directive.

In arrangements other than an upstream merger, as a general rule, the issuing of the shares of the receiving corporation to the shareholders of the transferring company is equated to a sale of the former at their fair market value and an acquisition of the latter at this cost. Shareholders may, however, opt for an assessment at book value and, therefore, for a deferral of capital gains taxation if Germany may tax the newly issued shares to the same extent as the shares of the transferring company. A tax deferral is also granted with explicit reference to Art. 8 of the EC Merger Directive, even if the German entitlement to taxation is affected by the reorganization. The German treasury has, however, reserved the right under Art. 8(6) of the EC Merger Directive to tax any gain arising on a subsequent transfer of the new shares, even if this implies a treaty override.

Prior to the recent reform, a merger or division resulted in the full or partial attribution of a remaining loss carry-over of the transferring company to the receiving company if both were corporations liable to corporate income tax. This attractive feature has been completely abolished following the extension of the territorial scope of the Reorganization Tax Act, as the legislator wanted to avoid the import of foreign losses by a resident receiving corporation, but did not feel free to discriminate accordingly.

Admittedly, Art. 6 of the EC Merger Directive only addresses outbound mergers and requires the Member State of the *transferring* corporation to permit a loss carry-over on an equal footing with internal reorganizations. The fundamental freedoms in the EC Treaty, as interpreted by the ECJ, would also not impede the initial confinement of those losses to the PE created in that Member State's territory on the part of the receiving company's Member State of residence as a result of the territoriality principle.[33] The situation could, however, be different if the loss could no longer be used for tax purposes abroad. That is, a foreign affiliated company might not satisfy the strict requirements for an intra-

actually been distributed, Art. 5 of the EC Parent-Subsidiary Directive would have prevented taxation. Accordingly, Germany would not be entitled to a withholding tax in the first place.

26. See ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, Para. 68 and ECJ, 14 December 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, Para. 34 et seq.

27. If the receiving company is fiscally transparent, the Reorganization Tax Act treats all restructuring operations involving universal succession like an upstream merger or division. The transformation of a corporation liable to corporate income tax into a fiscally transparent company through a change of legal form or a comparable change of status under foreign commercial law is also treated analogously to a corresponding upstream merger.

28. At present, privately held shares are liable to capital gains taxation only if they have totalled at least a 1% holding for the previous five years or if they have been held for less than one year. These will probably become fully liable to tax after the enactment of the fundamental company tax reform bill currently being debated in the parliament.

29. This rule is aimed at assets attributable to a foreign PE situated in a state with which Germany has signed a tax treaty applying the exemption method. The reason for this exception is that an alternative sale of the shares of the transferring corporation would have yielded a capital gain, including the reserves hidden in the pre-transfer book value of these assets.

30. In as far as the transactional profit accrues to physical persons or can be attributed to them, personal income tax is levied on one half, whilst the charges relating to the reorganization are not deductible.

31. Half may, however, be set off against the positive income of natural persons who are the direct or indirect partners of a transparent company receiving the assets, but only up to a maximum of half of the fictitious distribution of undisclosed reserves attributed to these persons. The law thereby guarantees a fiscally neutral treatment of these deemed dividends, which themselves are only 50% liable to taxation, at least if the natural person is a resident with access to a tax assessment that permits the setting off of losses and deemed dividends.

32. It should be noted that the question only arises if the receiving company is a corporation that is not considered to be fiscally transparent for the purpose of direct German taxation, as otherwise the EC Merger Directive would not apply.

33. This can be deduced from *Marks & Spencer*. See ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 55, which expressly addresses the transfer of losses within the jurisdiction in which they arose.

group transfer of losses[34] to make it comparable to a resident affiliate as required for a cross-border loss transfer based on *Marks & Spencer*.[35] This could be different if the foreign business only forms a branch in which loss consolidation with the head office is not dependent on any specific criteria in its internal arrangements.[36] In these circumstances, if the consolidation of foreign losses is desired, an alternative would now be to transfer the office or effective place of management to Germany together with a subsequent downstream merger.

2.3.2. *Reorganization of transparent entities and singular succession asset transfers*

In addition to the operations discussed in 2.3.1., the Reorganization Tax Act also contemplates the transfer of an independently operational business unit (which is a concept similar but not necessarily identical to that of a "branch" as defined in Art. 2(i) of the EC Merger Directive) to a corporation in exchange for newly issued shares following a corresponding capital increase.[37] For tax purposes, it is irrelevant whether the business unit is transferred because a fiscally transparent entity merges, splits or transforms into the receiving corporation or if the transfer is performed through singular succession. In respect of a transferring or acquired fiscally transparent company, its direct or indirect partners must, in general, all be residents of an EEA Member State to qualify the operation for a tax deferral.[38] There is a special rule for similar operations if the receiving company is fiscally transparent and the transfer takes place in exchange for partnership rights. In this case, the tax treatment follows a similar, albeit less complex pattern, even though there are no limitations whatsoever with regard to territorial and personal scope. The two categories are, therefore, analysed together.

In contrast to the rules that apply to a merger or division of a corporation, it is the assessment of the transferred assets in the tax balance sheet of the *receiving* company that determines how these restructuring operations are taxed. Nevertheless, the law again prescribes that, as a general rule, all the assets must be accounted for at their fair market value. Here, too, the receiving company may opt for an assessment using the present book value or an intermediate value, but only in as far as the German treasury is still entitled to tax the assets transferred to the same degree before the operation. Even then, a consideration other than shares or partnership rights in the receiving company entails a corresponding step-up in value in as far as this exceeds the book value of the assets transferred. If an option is exercised, the receiving company assumes the position of the transferring company in all the tax aspects relating to the assets transferred. Finally, the total value assigned to the assets determines the eventual capital gain of the transferring company or, if it is considered to be fiscally transparent, of its direct or indirect partners subject to tax. If new shares are issued in exchange, they are deemed to have been acquired for this amount, less any additional consideration.

Apart from those characteristics that are common to all types of transfer of a business unit, there are special provisions if the receiving company is a corporation. The most remarkable taxpayer-friendly provision is a credit for fictitious foreign taxes, which is granted in as far as taxes are levied on a capital gain resulting from the transfer of a foreign PE, or from the reorganization of a non-resident transparent company, in accordance with the conditions set out in Art. 10(2) and 10a(2) of the EC Merger Directive. Conversely, as well as establishing certain additional criteria for the assessment of the assets transferred with no specific importance in an international setting, special attention is paid to the exclusion of what is perceived to be an abuse of the tax deferral. Specifically, the law seeks to avoid favouring restructuring operations that are primarily aimed at the conversion of fully taxable built-in gains attributable to the transferred assets into fully or partially exempt share deals after the reorganization,[39] as well as other forms of avoidance of a German tax burden. Accordingly, if the assets transferred have been assessed below their fair market value and the new shares issued in exchange are sold or otherwise disposed of within seven years of the reorganization, any tax deferral is reversed.[40]

The transfer of assets is then taxed retroactively, assuming their sale at fair market values (which is complicated by the passing of time and, therefore, prone to litigation), and the capital gain resulting from the actual share deal, as well as the balance sheet of the receiving corporation, is adjusted accordingly.[41] The transferring company or

34. The German system of group taxation (*Organschaft*) permits a loss transfer from a subsidiary to its parent only if the latter has entered into a legally binding obligation to compensate for any of the former's losses for a period of at least five years.

35. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 38.

36. The ECJ will have to consider this issue in ECJ, Pending Cases C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronn* and ECJ, Pending Case C-415/06, *Stahlwerk Ergste Westig GmbH v. Finanzamt Düsseldorf-Mettmann*.

37. The transfer of a partnership right in a transparent entity is regarded as an equivalent, which is treated in the same way.

38. By exception, the personal scope extends to companies with non-EEA Member State resident partners who are fully liable to capital gains taxation in Germany in respect of the new shares received in exchange for the assets transferred and attributable in part to them, provided that no foreign tax has to be credited against the prospective tax.

39. The new German corporate tax system features a full or partial participation exemption available for capital gains as a result of the sale of shares by corporations or natural persons, respectively, without any minimum holding requirement.

40. The law provides for an extensive list of alternative events presumed to give rise to the realization of reserves as if there had been an alienation of the shares, or otherwise indicating abuse, including the subsequent loss of personal eligibility of the transferring company or, in respect of fiscal transparency, its partners with regard to the tax deferral granted. This means that the transfer of residence of a single partner of the transferring company to a country that is not a Member State of the European Union, for example, Switzerland, results in the reversal of the privileged tax treatment if the entitlement of the German treasury to tax a capital gains resulting from the sale of the newly issued shares is lost or reduced.

41. Before the reform, the benefit of a full or partial participation exemption for the share deal would have been denied. This implied the double taxation of the transferred hidden reserves both in the hands of the transferring company (or its partners) selling the newly issued shares in which these reserves are reflected and at the level of the receiving company when it actually sells the corresponding assets. The new system avoids this at the cost of increased complexity.

its partners must also annually report the current shareholders to the tax administration. For every year following the reorganization, the retroactively taxable capital gain is reduced by one seventh to reflect the reduced potential for abuse. The compatibility of these rigid anti-abuse provisions with Art. 11(1)(a) of the EC Merger Directive must, however, be seriously doubted, as they do not permit a case-by-case analysis of fraudulent intent.[42]

Finally, a tax deferral is also available for a qualified exchange of shares within the meaning of Art. 2(d) of the EC Merger Directive. Specifically, if a holding in the capital of a corporation is transferred to another corporation in exchange for newly issued shares of the latter and the acquiring corporation obtains or increases a direct majority of the voting rights in the corporation the shares of which are transferred, the exchange may be treated as fiscally neutral.[43] The receiving company may opt for an assessment at the present book value or an intermediate value below the fair market value, regardless of any unrestricted entitlement to taxation by the German treasury. To this effect, it does not matter in which country the corporation whose shares are transferred or the transferor is resident. Only the receiving corporation must be subject to corporate income tax in an EEA Member State. A consideration other than new shares does not preclude the application of the relevant provisions, but, instead, results in the mandatory step up in value in as far as the former exceeds the book value of the acquired shares.

In principle, the former shareholder is then taxed, or exempt from taxation, as if he had sold the transferred shares and acquired the new shares at a price equivalent to the value attributed to them by the acquiring corporation. For the purpose of taxation, the shares must, however, be assessed at their fair market value if the newly issued shares are no longer liable to tax in Germany to the same extent as those transferred to the acquiring company. Even then, a tax deferral is exceptionally granted if required by Art. 8 of the EC Merger Directive. Any capital gain is then liable to tax on the subsequent transfer of the new shares.

In consideration of these rules regarding a qualified exchange of shares, yet another set of anti-abuse provisions has been created. In as far as the transferring company or, in respect of a fiscally transparent partnership, its partners are not incorporated, it could not have benefited from the general participation exemption for the alienation of shares, which is, however, available for the receiving corporation. Accordingly, if the latter sells the transferred shares within seven years of their acquisition, an eventual tax deferral on the initial transfer is retroactively reversed.[44] The specific preconditions and the procedures are similar to those for the transfer of business units in exchange for new shares.[45]

3. Related Changes

3.1. Introductory remarks

The SE Tax Act has not only led to a fundamental overhaul of the Reorganization Tax Act, but has also modified and amended other laws with regard to cross-border restructuring operations. The most important innovations affect the levying of exit taxes on the transfer of business assets (see 3.2.) and the tax implications of a change in a corporation's residence for fiscal purposes (see 3.3.).

3.2. Exit taxes

For the first time in the history of the German taxation of income, the reform has introduced an explicit and general clause to guarantee an exit taxation of business assets on their complete or partial departure from the German tax system.[46] Accordingly, if for whatsoever reason the German treasury's entitlement to tax capital gains on the sale of a business asset is impaired, any unrealized gains are taxed on the basis of the asset's fair market value.[47]

The main focus of the clause is on the transfer of assets situated in the German head office to a PE situated in another state, as this entails a unilateral or bilateral obligation on the part of the German treasury to credit foreign taxes levied on a subsequent alienation of these assets or even the application of the exemption method if so required by a tax treaty.[48] This also covers the repa-

42. Such an individual examination of each particular case has been required by the ECJ in its interpretation of Art. 11 of the EC Merger Directive, See ECJ, 17 July 1997, Case C-28/95, *A. Leur-Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2*, Para. 41.

43. It should be noted that the relevant provisions only apply if neither the acquired company nor the acquiring company is considered to be fiscally transparent by German standards. Otherwise, if the acquired company is classified as fiscally transparent, the restructuring operation is classified as the transfer of partnership rights, which is governed by the aforementioned rules applying to the transfer of a business unit to a corporation. If the receiving company is regarded as fiscally transparent, there is a mandatory carry-over of book values if Germany is still entitled to tax later the built-in gains. Otherwise, realization at fair market value is assumed.

44. An exception is made if the transferor has already sold the new shares received in exchange, so that the effect of the tax deferral has already been removed.

45. This anti-abuse clause also applies to shares acquired as part of the assets of a transferred business unit if the transfer benefited from a (full or partial) tax deferral as outlined in the second paragraph of 2.3.2. This overrides any other anti-abuse clause if the German treasury's entitlement to tax the newly issued shares is not impaired compared to the transferred shares.

46. Before the reform, exit taxes were levied on the basis of an administrative instruction sanctioned by case law, which was, however, less extensive in scope and more generous in granting a tax deferral.

47. Symmetrical to this general rule, any assets that have for the first time become liable to German taxation regarding potential capital gains are assessed at their going concern value for tax accounting purposes.

48. There is some controversy amongst tax scholars as to whether or not this would be the consequence of such a transfer of assets if a tax treaty has been concluded with the state of destination. Some argue that any hidden reserves accrued before the transfer may not be taxed in that state under Art. 7(1)(2) of the OECD Model, but only in the state of the head office in which the assets were formerly located. In practice, the contrary jurisprudence of the German tax courts and the adherence to this by the tax administration are the relevant tax planning factors. In this context, these consider a PE to be a functionally separate entity, so that any gain resulting from the difference between the book value and the market price of an asset attributable to the PE is taxable in the state in which the latter is situated. This approach is now also endorsed by

triation of assets from a German PE to the foreign head office or their transfer to a PE in another state. The new provision is, however, not limited to the removal of assets from Germany. For example, it would apply to assets already attributable to a foreign PE in a state in respect to which the credit method applies if the latter was substituted for the exemption method by a new tax treaty or if the assets were moved to a PE situated in another state and thereby placed under such a tax treaty.

The tax burden resulting from the ensuing de facto capital gains taxation can be spread over a period of five years at the taxpayer's request if the asset is a non-current one and is transferred from Germany to a PE situated in a Member State.[49] The tax deferral is only available to resident taxpayers who are natural persons subject to income tax. Altogether, this concession contrasts sharply with the new system of exit taxes on unrealized gains of private shareholdings liable to tax, which permits an infinite deferment of the tax without interest if the resident shareholder moves to an EEA Member State. In the light of the ECJ's judgments in *Lasteyrie du Saillant*[50] and "*N*",[51] it appears already to be highly unlikely that the ECJ would accept the less generous rules for "privileged" transfers of business assets only on the grounds of the generic arguments of administrative difficulties advanced by the German government.[52] And the ECJ will almost certainly not accept the inherent discrimination against other transfers that are also protected by the freedom of establishment in Art. 43 of the EC Treaty or Art. 31 of the EEA Agreement, which are not covered by the deferment provision.

In addition, the temporary transfer for use of a business asset, which does not result in a change in its location for tax purposes, is now taxed according to the arm's length standard if the proceeds of the use are not liable to German taxation to the same degree as before the transfer. As with the genuine exit tax, this new rule probably applies both to capitalized items and non-capitalizable assets created by own work and internal expenditure.[53] Accordingly, this has far-reaching consequences, especially for the taxation of intangibles, such as patents and know-how. It is not altogether clear, however, whether or not the legislator intended a treaty override in this respect. Consequently, any taxation contrary to Art. 7 of the relevant tax treaty should be appealed.[54]

3.3. Transfer of registered office or place of management

Finally, the reform pays special attention to the cross-frontier transfer of the registered office or the place of management, in as far as it results in a change in the tax residence status of a company subject to corporate income tax.[55] In this respect, it is necessary to decide on the tax consequences at company level, on the one hand, and at shareholder level, on the other. With regard to the former, the fiscal hurdles created by the Corporate Income Tax Law (*Körperschaftsteuergesetz*) have been considerably reduced in an EU ambit. When a transfer of an office or place of management is facilitated by the relevant commercial law,[56] it is only equated to a liquidation on the subsequent sale of all assets at their fair market value for tax purposes if it entails a loss of fiscal residence within the EEA.[57] Otherwise, the operation only gives rise to capital gains taxation, subject to the conditions set out in 3.2. in respect of the levying of exit taxes, especially in as far as certain assets are effectively connected to the head office and, therefore, leave German tax jurisdiction along with it.

With regard to shareholders, the general rule introduced by the SE Tax Act is that they are taxed as if they have sold their shares at fair market value where the transfer of the seat impairs the German treasury's entitlement subsequently to tax an eventual capital gain. There is an exception for the transfer of seat of an SE or an SCE to another Member State.[58] In this case, taxation is postponed until the subsequent sale of the shares. Even though the German legislator is empowered to effect such a possible treaty override by Art. 10d(2) of the EC Merger Directive, its potential for the double taxation of

the OECD (see OECD, "Report of the Attribution of Profits to Permanent Establishments", December 2006, p. 27). Accordingly, an exit tax can only be avoided if the exemption method does not apply with regard to the state of destination and the asset is accounted for at its fair market value on its entry in the books of the PE.

49. If the built-in gains are realized abroad before the expiry of this period, transferred outside the European Union or disconnected from business activities, immediate taxation ensues. If the assets are returned within the five-year-period, any taxes still deferred are abated and the remaining uncovered reserves are reconverted into built-in gains.

50. ECJ, 11 March 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*.

51. ECJ, 7 September 2006, Case C-470/04, *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*.

52. The ECJ, as a general rule, does not accept such arguments as proportional justification, pointing to the Directive on Mutual Assistance (77/799/EEC of 19 December 1977), which requires an exchange of information between the tax authorities of all Member States. See ECJ, 7 September 2004, Case C-319/02, *Petri Manninen*, Para. 50 et seq.

53. The law is not clear on the inclusion of non-capitalized assets. This interpretation may, however, be deducted from prior jurisprudence with regard to similar rules as well as from the teleology of the reform, which is intended to secure German source state entitlement.

54. In the last decade, tax courts have tended to acknowledge a treaty override only if it could be deduced from the text or context of the law with sufficient clarity. It should be noted, however, that the government has recently proposed that any kind of research and development expenditure should be charged to tax subsequently on the transfer of their benefits to a foreign tax jurisdiction.

55. No specific rules exist for the transfer of seat of a fiscally transparent company, as it as such does not affect the right to tax its assets in the hands of its partners. If the transfer implies the attribution of individual assets to another jurisdiction, exit taxes may be levied in accordance with the provisions discussed in 3.2.

56. At present, only corporations that have been founded in another Member State and subsequently move their head office to Germany by virtue of the freedom of establishment and an SE or SCE may transfer their place of management to another Member State without a mandatory winding up. A bill that would also enable German corporations to move their seat abroad without being liquidated has now, however, been proposed to the parliament.

57. If the transfer of seat results in dual residence for tax purposes, the same applies where a tax treaty allocates the entitlement to tax the company as with a resident of a state outside the EEA.

58. Shares in other types of corporations whose transfer of seat is not covered by Art. 10d of the EC Merger Direct benefit from this privilege only if they are privately owned and liable to capital gains taxation. In this case, the discrimination against EEA Member States that do not belong to the European Union is particularly questionable with a view to the freedom of establishment enshrined in Art. 31 of the EEA Agreement.

unrealized gains accrued only after the transfer is obvious.[59]

4. Entry into Force

In general, the reform affects all reorganizations that have been reported for registration in the Commercial Register (*Handelsregister*) after 12 December 2006. If the restructuring operation need not or cannot be registered, in particular in respect of a transfer of assets by way of singular succession, the transfer of beneficial ownership replaces the reporting date. The new exit tax regime (see 3.2.), however, applies retroactively from 1 January 2006.

5. Conclusions

The recent reform of the Reorganization Tax Act has considerably broadened the possibilities of a fiscally neutral cross-border company restructuring, at least within the EEA. The German national legal framework now complies with the requirements of the EC Merger Directive and even goes beyond them in some regards, even though the system still falls short of the global approach, which had been envisaged in the blueprints for the reform. It is necessary to be aware, though, that this positive development has been accompanied by some changes in the general tax treatment of reorganizations to the detriment of the taxpayer, as well as an extension of exit taxes levied on the cross-border movement or use of single business assets. Altogether, the reform can, nevertheless, be seen as another step towards improving the international competitiveness of the German tax system, which will be further enhanced by the overall reform of company taxation that is currently being debated in the parliament.

59. According to a recent, questionable, ECJ ruling, such double taxation does not, however, violate the fundamental freedoms. See ECJ, 14 November 2006, Case C-513/04, *Mark Kerckhaert, Bernadette Morres v. Belgian State*, Para. 17 et seq.

