Utilisation of German tax losses – change of ownership legislation & new tax reliefs

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As of January 2008, new rules came into force concerning the disallowance/forfeiture of tax loss carry-forwards in a German company following a change in ownership of that company (hereafter the "CIO rules"). Broadly, under the CIO rules, if more than 50% of shares in a German company with loss carry-forwards (a "loss entity") are transferred (to a single buyer or to affiliates of the buyer) within a five year period, 100% of loss carry-forwards will be lost. For transfers of more than 25% but not more than 50% of shares within a five year period, loss carry-forwards will be lost equal to the percentage of shares transferred (e.g. so if 40% of the shares are transferred, 40% of the loss carry-forwards would be forfeited).

Historic issues with the CIO rules

There was no exception to the CIO rules in the context of an intra-group reorganisation. Accordingly, intra-group share acquisitions or restructurings, taking place in Germany or abroad, could eliminate the availability of tax loss carry-forwards in a German entity. For example, the CIO rules could be triggered if a group company which held the German loss entity was merged into its parent company, as such upstream merger could be construed as an indirect transfer of shares in the German loss entity.

Also in 2008, an interest barrier provision was introduced, limiting the deductibility of interest expenses. Under that provision, annual net interest expenses were only tax deductible up to 30% of taxable EBITDA, though the expenses were fully deductible if they were below a threshold of EUR 1 million. The interest barrier also did not apply if a German group company could show that its debt: equity ratio was equal to, or was not less than (up to a 1% tolerance threshold), the debt: equity ratio of its global/consolidated group.

Due to the financial crisis, and following heavy criticism of the wide scope of the CIO rules, some exceptions/limitations to the CIO rules have been introduced in Germany, effective as of 1 January 2010. These cover certain intra-group restructurings, restructurings of companies in crisis, and retention of loss carry-forwards which equal the amount of "hidden reserves" of a German company. In addition, changes have been made to the interest barrier provision: the threshold of EUR 1 million has been increased to EUR 3 million; the tolerance threshold has increased from 1% to 2%; and unused taxable EBITDA may now be carried forward for up to five years (though such carry-forward entitlement will be subject to the amended CIO rules).

The purpose of this article is to highlight the new reliefs/privileges to the CIO rules and briefly outline how they may be available in certain corporate reorganisations.

Intra-group privilege

Under the new intra-group exception, tax loss carry-forwards (and interest carry-forwards) can continue to be available following a share transfer of a German loss entity provided the company transferring the shares and the recipient/acquiring company are both wholly owned, directly or indirectly, by the same ultimate shareholder. See example diagram below. The requirements for the application of this new exception are, however, very narrow. For example, a transaction whereby shares are transferred or received by the ultimate shareholder should not obtain relief.
Restructuring that is necessary to avoid the current or expected illiquidity/insolvency of the acquiree. The company must be in crisis for German insolvency laws (and documented as such by investors). The restructuring exception is therefore aimed at retaining or preserving material parts of a company's business which have the potential for an economic turn-around and to encourage new injection of capital by investors.

The restructuring exception was introduced in July 2009 with retroactive effect for share transfers within the CIO rules as from 1 January 2008. It was initially introduced for a transitional period only, but was made permanent in December 2009 by the Law to Accelerate Economic Growth, effective 1 January 2010.

More recently, the European Commission has started a formal investigation into the compatibility of the new exception with EU law and whether it constitutes a state aid measure which had not been previously approved by the Commission. In particular, the Commission is examining whether the exception confers a selective tax advantage on certain restructurings that cannot be justified under general German tax law principles, the main criticism being that only companies in difficulty (and not healthy companies) may preserve the loss carryforwards under this new restructuring exception.

Consequently, a decision by the Commission that the new exception constitutes state aid could mean that any tax advantage already granted under it would have to be disallowed. Taxpayers making use of the provision following the change of ownership, face a reassessment of tax if they have already set off all or part of their loss carryforwards against profits, and/or a retrospective loss of their tax loss carryforwards, irrespective of any good faith in complying with domestic German tax laws.

A decision of the Commission is not expected earlier than in 2011. Meanwhile, the German Federal Ministry of Finance has issued a circular according to which the restructuring exception is not to be applied (including where rulings have been issued) until the Commission has made a binding decision in this respect.

**Hidden reserve privilege**

A new relief has been introduced to enable the preservation of tax loss carryforwards (and interest carryforwards) following a share transfer of a German loss entity, if and to the extent that unrealised gains exist at the level of such German company which, if realised, would be taxable in Germany. In effect, the losses can be preserved if and to the extent that they do not exceed the difference between the fair 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 are not taken into account (i.e. assets attributable to foreign permanent establishments, or unrealised relating to shareholdings which on disposal would be tax exempt in Germany).

**Utilisation of losses**

The ability to safeguard against the forfeiture of tax loss and interest carryforwards 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 loss.
carry-forwards in a German corporation or group. Investors in Germany and German taxpayers should carefully review whether the new CIO rules affect their tax position in Germany.

**Up-stream merger of profitable subsidiary ("ProfitCo") to loss-making parent company ("LossCo")**

In a case where LossCo has a profitable subsidiary, an option could be an up-stream merger of 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.

**Up-stream merger of LossCo to profitable parent company, ProfitCo**

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 loss 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 EUR 1 million; otherwise Germany's "minimum taxation" rules might diminish any tax benefits of such merger.

The "minimum taxation" rules are in addition to the restrictions on use of tax loss carry-forwards under the CIO rules. Under the "minimum taxation" rules, available tax loss carry-forwards can be set off against taxable profits/income up to EUR 1 million without limitation. However, where taxable income exceeds EUR 1 million, losses may only be set off against a maximum of 60% of such taxable income, i.e. 40% of such excess income would remain taxable in Germany.

**Step-up by way of an asset deal**
Assets which have potential hidden profits and can be amortised 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.

**Fiscal unity**

A “fiscal unity” ("Organschaft") of German companies leads to a consolidation/pooling of current profits and losses of the pool members, thus 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 unity 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 at least five 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 would also need to be noted that following recent case decisions by the European Court of Justice, the possibility of cross-border fiscal unities is highly controversial in Germany.

**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 EUR 1 million threshold.

**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 could be for ParentCo 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 would be subject to future profits/earnings being recognised, the loan itself should initially be removed from the balance sheet. This non-recognition of the loan would create further taxable profits at the level of LossCo, which could be offset by on-going losses. Subject to future profits being earned at the level of LossCo, the loan would then be booked and could create future losses. This structure would result in a deferral of accumulating (limited use) tax loss carry-forwards.

**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 would 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.

**Retroactive contribution**

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

Such contribution could 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 would 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).

**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 that company. In contrast, any losses at the company/head of the consolidated group can be off-set 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.

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