

## Selected changes in tax law for the corporate sector as of 1.1.2002

Even the names of the new laws are monstrous: the

Unternehmenssteuerfortentwicklungsgesetz (UntStFG) - "Act on Development of Corporate Taxation" - an Steuerverkürzungsbekämpfungsgesetz (StVBG) - "Act to Combat Tax Evasion" accompany the Steueränderungsgesetz - "Tax Amendment Act" - and the Gesetz zur Eindämmung illegaler Beschäftigung im Baugewerbe - "Act to Stem Illegal Employment in the Construction Industry" - containing new regulations in tax law which came into force on 1.1.2002. The changes implemented by these laws are so extensive that only a small excerpt can be present here. All entrepreneurs are however urgently recommended to review the changes with great care and, where appropriate, seek professional assistance to develop a tax strategy.

Following the previous adjustments initiated by the Act on Reduction of Tax Rates and the Act on Reform of Corporate Taxation from the year 2000, further steps in the reform of corporate taxation were considered necessary. The Act on Development of Corporate Taxation develops existing approaches and regulates problem aspects, particularly in the taxation of dividends and profits from the sale of companies, in co-proprietorship and in the relationship between controlled and controlling companies.

The Act to Combat Tax Evasion focuses on combating abuse of the deduction of input tax (the so-called VAT roundabout). An amendment in the applicable criminal law is also worthy of note. The introduction of Article 370a of the Fiscal Code has created a drastic ruling whose final effects can as yet only be guessed at. The Tax Amendment Act of 2001 is an omnium-gatherum, amending a series of laws and regulations, but these are primarily in the non-corporate area.

With the Act to Stem Illegal Employment in the Construction Industry, the legislature is once again trying to bring this problem under control. For that purpose, a "construction industry deduction tax" obliges employers to retain 15% of sums owing to contractors.

Let us now pick a number of aspects out of this flood and consider them in greater detail.

For all limited companies with business years identical to the calendar year, the procedure for corporation tax changed as at 01.01.2002 from the tax credit system to the fifty percent earnings taxability system, and for all other such companies the change will be effected in the 2002 assessment period. This change provides for a transitional period of 15 years. Sceptics maintain that no tax law has ever lasted as long as that transitional period. These changes, which were made law by a Social Democratic (i.e. left-wing) government, lead to shareholders with a personal tax rate of under 40% being worse off than in the previous tax credit system, whereas shareholders with higher rates of personal tax enjoy benefits. The corporation tax rate is to be reduced in the coming years from the present peak of 48,5% through 47% in 2003 and 2004 to 42% in the year 2005 and thereafter. At present, -therefore, it is advisable to postpone the payment of dividends until the year 2005, and provide loans to cover any capital required by the shareholders in the meantime. The interest paid to the company on those loans will then also be available for distribution. It remains to be noted, however, that the tax burden in the case of distribution of profits is always greater than if those profits are retained, and this lock-in effect was intended by the government.

Opposing interests with regard to dividend policy on the part of many shareholders are therefore to be expected. One solution could be that of incongruent distribution. The Federal Fiscal Court has in principle accepted this possible configuration, but the fiscal authorities are attempting to oppose it with a non-applicability regulation.

An sensitive ruling affecting the outside financing of companies, and in particular the financing of German companies as the subsidiaries of foreign shareholders, has been established in the amendment of Article 8a, para. 1 sentence 3 of the Vorporation Tax Act. In sentence three of that text, the words "not liable for taxation" have been replaced by "not covered by an assessment". Preciosly, remuneration for borrowed capital provided by a (foreign) person or company associated with the shareholder did not constitute a sonstructive dividend if this remunderation was subject to taxation in Germany. Up to now, foreign subsidiaries or a third party that may take recourse could be used as financing companies provided that the interest payments were liable to taxation in Germany. This was ensured by subjecting the interest payment to capital gains tax deductions, in the same manner as for example interest on profit participating loans or income from a typical dormant partnership under the terms of Article 43 para. 4 clause 3 of the Income Tax Act. The use of these sonstructs also ensured that the "safe haven" remained untouched. With the new rulings, such constructs disappear, as the application of the Act would acoided if the remuneration were covered by an assessment in Germany, but such an assessment does not take place on account of the compensatory effect oft Article 50 para. 5 of the Income Tax Act. This ruling has direct impact, and will therefore trigger off demand for immediate professional advice, at least in the case of cmpanies financed from abroad.

With an amendment to the Vorpaortaion Tax Act, the legislature is reacting to a change in the practice of the Federal Fiscal Court with regard to multiple parent cmapies in a controlled/controlling comapny relationship. Under to 1999, the Fiscal Court concurred with the opinion of the fiscal administration that for tax purposes there could only be one parent company. From 1999 onward, however, the court expressed a contrary opinion in several verdicts, allowing a direct involvement in the controlled/controlling relationship by the shareholders in the parent company, i.e. by those companies involved. By sondierably tightening the coditions uder which a controlled an controlling company relationship is allowed to exist, the government has de facto cancelled these verdicts.