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# *Featured Perspectives*

# Losing the Losses — The New German Change-of-Ownership Rule

*by Wolfgang Kessler and Rolf Eicke*

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All good comes at a price. The German corporate tax reform is good overall,[1] but the major benefit, the tax rate cut, comes with a tightened and highly detrimental change of ownership rule. The German term *Mantelkauf*, literally translated as "coat purchase," is deceiving — it sounds and looks as calm and innocuous as a wolf in sheep's clothing, but there are some merits to this simile. The change-of-ownership rule is nothing but a special antiavoidance rule, since the trade with loss carryforwards for tax purposes can be a worthwhile venture, if not limited by law, even though it might in the end increase everything but welfare.

By severely tightening the provision, Germany follows the international tax policy trend of the hour: cutting tax rates while simultaneously tightening or introducing antiavoidance rules. Other protagonists are the United Kingdom (controlled foreign corporation rules) and Denmark (CFC and thin cap rules). Germany's tax reform is made up of an entire package of stricter antiavoidance rules, such as the *Zinsschranke* (thin cap rule)[2] and a regime addressing function shifting.[3] The unpleasant outcome of the change-of-ownership reform beats them all. From now on, it must be considered a technical loss eliminator.

## Legal Framework

The new rule in section 8(c) KStG (Corporate Income Tax Act) will replace the current regime of section 8(4) KStG and constitutes nothing less than a severe tightening of the change-of-ownership provisions along with a policy change.

The new rules apply:

- in the case of a direct or indirect transfer of 25 percent of stocks, membership rights, participation rights, voting rights of a corporation, or a similar transaction;
- within five years, computed retroactively after the last acquisition; and
- to an acquirer or a related person, regardless of whether the acquirer is already a shareholder.

[1]Kessler and Eicke, "Germany's Corporate Tax Reform — The Road Not Taken," *Tax Notes Int'l*, June 11, 2007, p. 1135.

[2]Kessler and Eicke, "New German Thin Cap Rules — Too Thin the Cap," *Tax Notes Int'l*, July 16, 2007, p. 263.

[3]Kessler and Eicke, "Out of Germany: The New Function Shifting Regime," *Tax Notes Int'l*, Oct. 1, 2007, p. 53.

An increase of capital stock is deemed to be a transfer if it alters the participation quota.

The legal consequences are twofold: First, an elimination of corporate income tax and trade tax loss carryforwards on a pro rata basis in case of a change of ownership between 25 percent and 50 percent. Beyond 50 percent all carryforwards are lost. Once the 50 percent threshold is triggered, a new five-year time period begins. Second, an elimination of the interest carryforward that will be introduced with the new thin cap rule (*Zinsschranke*).

The new rule introduces an acquirer perspective, meaning the rule focuses not on the transfer of shares but solely on the acquirer and any related persons. Moreover, a group of acquirers with equal interests is deemed to be a sole acquirer. A signal for "equal interests" is the "joint control" of the corporation. Thereby, the legislature wants to prevent an avoidance of the new rule by several shareholders acting in concert. What is most striking is that the rule can be triggered twice or more when the very same share was acquired from a shareholder that had already triggered the provision. This makes sense because of the new focus on the acquisition.

Under the current provision, the carryforwards are eliminated in case of a change of "business identity." A 50 percent transfer of shares along with a contribution of new assets constitutes a change of "business identity." Contrary to the upcoming rule, the current rule provides for a restructuring exception. According to the official legislative explanation on the new rule, in the case of a restructuring, there might only be room for an administrative relief on the basis of equity. However, this is vague. Also, the legislature argues that there is no need for any restructuring exception because restructuring gains can be set off with loss carryforwards.

Also detrimental is the fact that the new regime does not contain any group exception for the transfer of participations within a group of companies. As a result, any intragroup reorganization might lead to a loss of carryforward credits. The legislature argues that such a group exception would be too hard to administer and would create too many loopholes for tax planning.

The new regime will be applied in the accounting period of 2008. However, there will be a considerable time overlap with the current regime if a 50 percent share is transferred within five years before January 1, 2008, and the loss of business identity occurs before January 1, 2013. (See figure.)

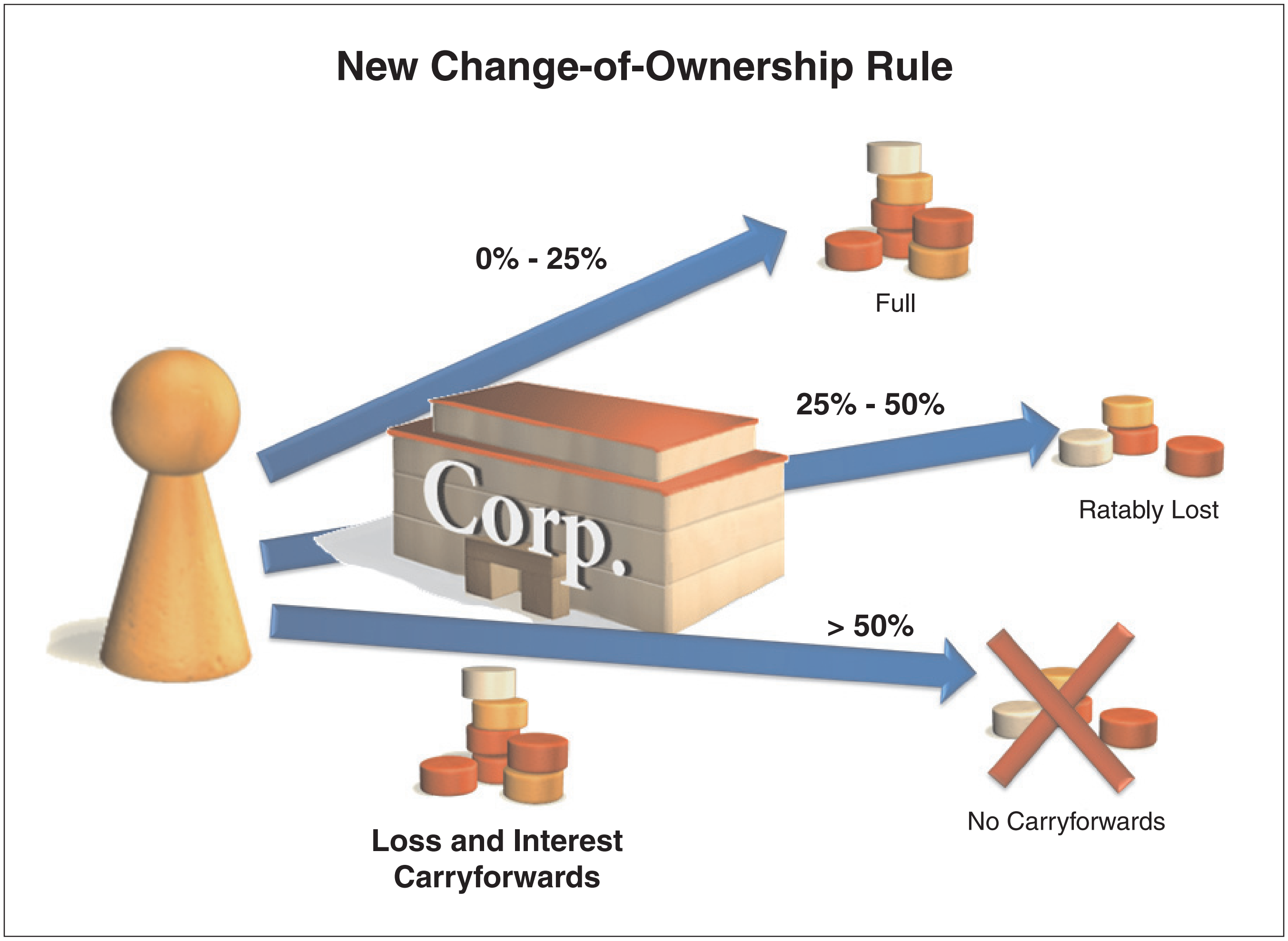
## Analysis

"Simplify our tax system" was one of the driving forces behind the reform of the change-of-ownership rule. One goal was to remove the term "contribution of predominantly new assets," which has been an inexhaustible source for debates. However, the new technical simplicity cannot justify a severe violation of the principle of separation and the principle of net income taxation, the former because the existence of corporations is independent from the existence of their shareholders and the latter because only a clear-cut abusive behavior can justify the nondeduction of losses.

Contrary to the underlying purpose of the current rule to eliminate or at least reduce abusive behavior, the new regime is not primarily targeting abuse. Even though the rule addresses a change of the business identity, the rule's main purpose is to raise funds to finance the major corporate income tax cut from 25 percent to 15 percent. This background is one reason why the new provision is so hard to grasp and to deal with. Another obstacle is that the application leads to inconsistencies or even arbitrary results. Because of the new focus on the acquirer of a share, other shareholders and the corporation will face some negative side effects in terms of the corporation losing the losses, without any measure to counteract for the other shareholders. Imagine you are the shareholder of a company of which 30 percent of the shares change hands, but the company does not receive any new funds or assets and is modified in any other way. Because there is a new shareholder, it might turn out to be a very costly event. Note that this example deals with a direct change of ownership. The most arbitrary, uncertain, and unforeseeable results occur with indirect acquisitions of shares. Groups of companies will likely feel the most detrimental effects due to the lack of a group exception. Any reorganization within a group involves a considerable risk of losing the loss carryforwards. Legislative history reveals that proposals to limit the potential consequences of indirect acquisitions were rejected. After all, the inclusion of indirect transfers severely tightens the new regime compared with the rule that is currently in force.

## Last Resort Venture Capital Act?

The legislature is aware that the new change-of-ownership rule causes some detrimental effect. In the course of the legislative process, the legislature has been resorting to improvements for venture capital companies in the upcoming Venture Capital Act (*Wagniskapitalbeteiligungsgesetz*). The intention is to promote young start-up companies. The act itself is worth a closer look and will be the subject of another column, but for now it is crucial to know that another paragraph will be introduced to the change-of-ownership rule (section 8c(2) KStG). The legislature will soon pass the entire act and will provide that a domestic venture capital company that buys a target company in the sense of section 2 of the Venture Capital Act can use the losses of the target company split over five years.




However, this rule is not applicable for most cases. Therefore, it would be necessary to not only provide exceptions for a limited scope of cases, but for other cases in which a change of ownership causes detrimental effects that cannot be justified (for example, in times of crisis and in group reorganization situations).

## Tax Planning Measures

To avoid triggering the new rule, one should consider an investment via hybrid instruments like silent partnerships or profit certificates. Moreover, the corporation in question should try to generate profits before the acquisition; for instance, via sale and leaseback arrangements, interest-free loans, or the sale of assets to a group company.

## Comparison With IRC Section 382

The U.S. tax system, with IRC section 382, holds a similar provision in store. Just like the current German rule, IRC section 382 applies a single threshold of 50 percent change of ownership. In the case of a more than 50 percent ownership shift, not all loss carryforwards are eliminated according to IRC section 382. Instead, the U.S. rule places an annual cap on the amount of post-change-year income that may be offset by pre-change-year losses. The annual cap is the product of the fair market value of the loss corporation's stock multiplied by the long-term tax exempt rate. Unlike both German versions, the U.S. rule involves a two-year "continuity of business requirement" in any case. The current German rule sets forth a five-year "continuity of business requirement" only if the restructuring exception applies. Since only ownership shifts of 5 percent shareholders are relevant and since the testing period is only three years, the U.S. rule is more generous than the current German rule and much more generous than the upcoming German provision. (See table.)

## Conclusion

The new German change-of-ownership rule follows an international trend to tighten or introduce antiavoidance rules. In the case of the German rule,

| | Section 382 IRC | Section 8(c) KStG 2008 | Section 8(4) KStG 2007 |
|---|---|---|---|
| **Transfer between 25%-50%** | — | Ratable loss of carryforwards. | — |
| **Transfer > 50 percent** | "5 percent shareholders" shifts are relevant; above 50% ratable elimination according to business value multiplied by "long-term tax-exempt rate"; continuity of business requirement (two years). | Complete elimination of loss carryforwards. | Complete elimination of loss carryforwards if predominantly new assets are contributed. |
| **Focus** | Owner shift of *all* "5 percent shareholders" or equity structure shift; continuity of business. | Direct and indirect transfer to an acquirer. | Only direct transfer of shares and "contribution of predominantly new assets." |
| **Testing Period** | Three years. | Five years. | Five years. |
| **Relevance of Multiple Transfer of the Same Shares Within Testing Period** | Yes (testing period shortened). | Yes. | No. |
| **Application on Intragroup Ownership Shifts** | Yes. | Yes. | In general: yes (disputed);<br>in specific cases: no (circular). |
| **Restructuring Exception** | For some types of reorganizations. | No. | Yes; continuity of business requirement (five years). |

all loss carryforwards will be lost if 50 percent of the shares change owner within five years. Below this mark, the loss carryforward is successively limited.

The new regime is a technical loss carryforward eliminator in the disguise of a simplified antiavoidance rule. The lack of any group clause and reorganization clause deters both owners and potential investors from economically desirable actions.

There will be a relief for small private equity investments introduced by the German Private Equity and Venture Capital Act. We think this upcoming relief should be extended to all companies in need of equity or restructurings.

Moreover, the indirect impact of the new change-of-ownership rule leads to absurd consequences. Imagine a 50 percent change of ownership on the 10th tier of a group of companies, resulting in a loss of carryforwards for the parent company. Such a consequence does not only severely violate the principle of separation between corporations, but also the principle of net profit taxation.

Because international investors do not tend to buy in a poke, but rather after a sophisticated tax due diligence, the perspective of a nonuse of the targets' loss carryforward for tax purposes will hover over the acquisition like the sword of Damocles and could eventually lead not to a change of ownership, but to a change of mind. ◆