

BRITISH INVESTMENTS IN GERMANY – THE HURDLES SET BY THE GERMAN TAX AUTHORITIES

Germany – at least in horse racing terms – has become the Grand National of tax legislation, with significant hurdles to be overcome before reaching the winning post. Due to the 30% corporation tax rate in the UK, any tax in excess of 30% in Germany represents a real cost to a UK corporate investor. Depending on the trade tax rate, a corporate investor has an average tax rate of approximately 40% in Germany. The effective taxes can, however, be reduced by introducing group debt into Germany, by the application of transfer pricing techniques, and by ensuring that losses are available for future utilization.

The task of getting round the race course of German tax law has become notoriously difficult for foreign investors. The new thin capitalisation rules are now the Becher's Brook of German tax law. Together with the regular and increasingly lengthy tax audits carried out by the German tax authorities, a foreign investor must plan his tax affairs meticulously in order to have a chance of reaching the winning post.

In addition, the stakes are raised by the fact that new hurdles are announced, withdrawn, re-introduced and amended just before the race begins each year, so that tax payers bear the risk of not making it past the starting post.

The new thin capitalisation rules are proving to be the biggest stumbling block in the current tax period. They were eventually passed by the German Parliament after a lengthy committee phase, which failed to iron out most of the problems that had been identified along the legislative process. The myriad of unanswered questions in this area has left many tax payers in the starting gate as far as their debt/equity ratio is concerned for

2004. Guidance from the German tax authorities on the new rules is expected by this summer (a draft release is expected shortly), however, those tax payers left in the starting gate at the beginning of 2004 will probably only be able to remount as of 1 January 2005.

The German loss-trafficking rules are another hurdle that can unseat a rider. Ensuring that losses incurred are available to set off future years' profits can be as risky as jumping over Becher's Brook. The rules relating to a harmful change in shareholder include intra-group changes in shareholder without a "real" change of the ultimate shareholder in the UK. Furthermore, the anti-stuffing rules, according to which the addition of predominantly new assets to a company (coupled with a harmful change in share-



holder) can lead to the loss of the tax loss carry forwards, are unclear and in practice difficult to apply.

The consequences of the new documentation requirements in the area of transfer pricing, which came into force in 2003, are to be awaited, and could, in practice, prove to be a further Becher's Brook on the tax race course. The documentation requirements are now expressly prescribed by the German tax authorities and hefty penalties for nonconformity can be imposed from 2004 onwards.

Obviously, the areas of thin capitalisation, loss-trafficking and transfer pricing are just three of the fences the tax payer has to over-

come in order to complete the course. Whether the tax payer will turn out to be a winner, fall at the first fence, or even fail to make it out of the starting gate, will be decided once the tax auditor has placed his bet. Thankfully, the German Supreme Tax Court (Bundesfinanzhof) has a tendency to bet on outsiders, so all is not lost on the German tax race course, even if the tax office is currently the odds-on favourite.

About the author:

With over fourteen years' experience in German tax law, Susan Pitter is a partner in the Frankfurt tax department of Ernst & Young, specializing in inbound international tax. Due to her English mother-tongue and fluent German, she advises mainly English-speaking clients on their inbound investments into Germany. Her client base comprises mainly UK and US companies in the advertising industry and in the automotive industry sectors. Susan is a frequent speaker at internal and external seminars, in particular in relation to foreign investors in Germany.



Susan Pitter
Tax Partner Ernst & Young AG
Wirtschaftsprüfungsgesellschaft