



## Proposed cancellation of German participation exemption in relation to capital gains derived from shareholdings below 10%

**On July 22, 2015, the German Federal Ministry of Finance ("MoF") presented a new draft legislation aimed at reforming the taxation of collective investment schemes (the "Discussion Draft"). The Discussion Draft also includes a proposal to cancel the German participation exemption effective January 1, 2018 in relation to capital gains derived by corporate shareholders from the disposal of shares in subsidiary corporate entities where the corporate shareholder holds a participation of less than 10%. Certain tax reductions shall apply in relation to capital gains realized by venture capital investors (Business Angels), if specific requirements are met.**

In the course of a fundamental change of the German tax system in the year 2001/2002, the German legislator introduced a domestic participation exemption in relation to dividend income and capital gains derived by corporate taxpayers from the disposal of shares in their corporate subsidiaries. Under the German participation exemption, corporate shareholders for long enjoyed an effective 95% tax exemption irrespective of their shareholding quota. The 95% exemption was achieved by treating income from dividends and/or capital gains as fully tax-exempt and by adding 5% of such income back to the tax base as a non-deductible business expense.

Foreign corporate shareholders, on the other hand, benefitted from the German participation exemption only with respect to income derived from capital gains. Their German-source dividend income was generally subject to German withholding tax at a rate of 26.375% unless a lower withholding rate applied by reference to a double tax treaty (WHT rate usually 15%) or the European Parent-Subsidiary Directive (WHT rate 0%) and further provided that the foreign corporate shareholder was able to meet the substance requirements of the domestic anti-treaty shopping legislation. Because the European Parent-Subsidiary Directive operates a minimum shareholding requirement of 10%, EU based corporate shareholders were discriminated if they held a participation of less than 10%.

In 2011, the European Court of Justice ("ECJ") concluded that the unequal treatment by German tax law of dividend income in the hands of German and foreign corporate shareholders infringed the European freedom of movement of capital. In an attempt to remedy the infringement the German legislator introduced a generally applicable 10% threshold to the German dividend exemption effective as of the expiry of February 28, 2013. As a result dividend income became fully taxable for all shareholders below 10% whether or not resident in Germany. The 10% threshold did, however, not apply to capital gains derived by corporate shareholders which remained 95% tax exempt.



The recently published Discussion Draft dated July 22, 2015 essentially aims at aligning the treatment of dividend income and capital gains of corporate shareholders below 10% as follows:

- Effective as from January 1, 2018, the German participation exemption shall only apply in relation to dividends and capital gains derived by corporate shareholders if the corporate shareholder holds a direct participation of at least 10%.
- Corporate shareholders will, as a general rule, be viewed holding a direct participation of at least 10% if they hold a participation of at least 10% in the subsidiary at the beginning of the calendar year in which the dividend income is received or the capital gain is realized.

With respect to the consequences of the acquisition of additional shareholding quotas during a calendar year, the Discussion Draft draws a distinction between dividend income and capital gains as follows:

### **Capital gains realized by corporate shareholders <10%**

If the shareholding of the corporate shareholder falls short of the 10% threshold at the beginning of the relevant calendar year, capital gains realized by the corporate shareholder during the relevant calendar year will be fully taxable, even if the corporate shareholder increases its shareholding to 10% or more prior to the disposal. Vice versa, capital gains will be 95% tax-exempt, if the shareholding of the corporate shareholder exceeds the 10% threshold at the beginning of the relevant calendar year, even if the corporate shareholder reduces its shareholding quota to 5% prior to the disposal of its remaining shares.

#### Example 1:

A-GmbH holds a participation of 5% in B-GmbH at the beginning of the calendar year. On June 1, A-GmbH acquires an additional shareholding of 20%. On October 10, A-GmbH sells a quota of 10%, realizing a capital gain.

The gain is fully taxable.

#### Example 2:

A-GmbH holds a participation of 15% in B-GmbH at the beginning of the calendar year. On June 1, A-GmbH sells a quota of 10%. On October 10, A GmbH sells its remaining shareholding of 5%.

Both capital gains are 95% tax exempt.

The proposed legislation does not provide for any grandfathering rules. As a result, the undisclosed reserves in existing free-float shareholdings of less than 10% will become fully taxable effective as from January 1, 2018.

### **Dividend income received by corporate shareholders <10%**

As regards dividend income, the acquisition of additional shareholding quota during a calendar year will affect the application of the participation exemption as follows:

If the corporate shareholder acquires additional shareholding of at least 10% in a single transaction during the calendar year and retains the additional quota until the end of the calendar year, dividend income received by the corporate shareholder subsequent to the acquisition of the additional shareholding will be split into a taxable and a 95% tax exempt portion. The taxable portion will be determined by dividing the quota at the beginning of the relevant year by the quota at the end of the relevant year.

If, however, the corporate shareholder sells a certain quota of the additional shareholding acquired during the relevant calendar year prior to the end of the relevant calendar year, the entire dividend will be fully taxable.

#### Example 1:

A-GmbH holds a participation of 5% in B-GmbH at the beginning of the calendar year. On June 1, A-GmbH acquires an additional shareholding of 20%. On October 10, B-GmbH makes a dividend distribution to A-GmbH. A-GmbH retains its shareholding of 25% until the end of the year.

20/25 of the distribution is 95% tax exempt. 5/25 is fully taxable.

#### Example 2:

A-GmbH holds a participation of 5% in B-GmbH at the beginning of the calendar year. On June 1, A-GmbH acquires an additional quota of 20%. On October 10, A-GmbH sells a shareholding of 10%. On December 10, B-GmbH makes a dividend distribution to A-GmbH.

The dividend is fully taxable.

### **Losses realized by corporate shareholders <10%**

It is also important to note that capital gains and losses from the disposal of shareholdings below 10% will be treated differently under the proposed rules. While capital gains will be fully taxable, the off-setting of losses from the disposal of minor shareholdings will be limited. These losses can only be off-set with taxable capital gains from the disposal of other minor shareholdings. To the extent that losses from the disposal of such shareholdings cannot be off-set with capital gains from shareholdings below 10% in a given calendar year, the losses will be carried forward unlimitedly. Similarly to "regular" loss carry-forwards, loss carry-forwards from minor shareholdings may be forfeited upon the occurrence of a detrimental change of ownership.

### **Tax reduction to promote venture capital funding**

The new rules may particularly affect venture capital investors. In order to not drive away these investors from Germany, the Discussion Draft includes the proposal to introduce a new tax reduction. Provided that certain requirements are met, the corporate income tax due on capital gains realized upon the disposal of shareholdings below 10% can be reduced up to an amount of 30% of the acquisition costs. The scope of application of the tax reduction is very narrow, though. *Inter alia*, the tax reduction will only apply to capital gains from the disposal of shares in corporate entities which are eligible to allowances pursuant to the guidelines on state aid in relation to risk financing dated January 22, 2014. Moreover, the investor has to acquire the shares by way of capital increase and it has to hold the shares for a

minimum period of three years. The tax reduction shall take effect as from January 1, 2018 and shall expire on December 31, 2027.

## Conclusion

The Discussion Draft presented by the MoF will be discussed within the Federal Government. According to the MoF website, a so-called government draft shall be published in September 2015. The expectation is that the new legislation will be introduced into the legislative procedure before the end of 2015. Whether the legislation procedure will be completed by the end of 2015 is doubtful. The proposed amendments to the German participation exemption are part of the draft legislation aimed at reforming the taxation of collective investment schemes. Since the new rules for collective investment schemes will substantially change their tax position, it can reasonably be expected that the legislative proposal will be thoroughly discussed in parliament.

For further information, please contact:



Dr. Stephan Georg Behnes  
E-Mail: [stephan.behnes@bakermckenzie.com](mailto:stephan.behnes@bakermckenzie.com)



Dr. Dr. Norbert Mückl  
E-Mail: [norbert.mueckl@bakermckenzie.com](mailto:norbert.mueckl@bakermckenzie.com)



Dr. Christian Port  
E-Mail: [christian.port@bakermckenzie.com](mailto:christian.port@bakermckenzie.com)

**Baker & McKenzie - Partnerschaft von Rechtsanwälten, Wirtschaftsprüfern und Steuerberatern mbB**

### Berlin

Friedrichstrasse 88 / Unter den Linden  
10117 Berlin  
Tel.: +49 (0) 30 2 20 02 81 0  
Fax: +49 (0) 30 2 20 02 81 199

### Dusseldorf

Neuer Zollhof 2  
40221 Dusseldorf  
Tel.: +49 (0) 211 3 11 16 0  
Fax: +49 (0) 211 3 11 16 199

### Frankfurt / Main

Bethmannstrasse 50-54  
60311 Frankfurt/Main  
Tel.: +49 (0) 69 2 99 08 0  
Fax: +49 (0) 69 2 99 08 108

### Munich

Theatinerstrasse 23  
80333 Munich  
Tel.: +49 (0) 89 5 52 38 0  
Fax: +49 (0) 89 5 52 38 199

Get Connected:



[www.bakermckenzie.com](http://www.bakermckenzie.com)

This client newsletter is prepared for information purposes only. The information contained therein should not be relied on as legal advice and should, therefore, not be regarded as a substitute for detailed legal advice in the individual case. The advice of a qualified lawyer should always be sought in such cases. In the publishing of this Newsletter, we do not accept any liability in individual cases.

Baker & McKenzie - Partnerschaft von Rechtsanwälten, Wirtschaftsprüfern und Steuerberatern mbB is a professional partnership under German law with its registered office in Frankfurt/Main, registered with the Local Court of Frankfurt/Main at PR No. 1602. It is associated with Baker & McKenzie International, a Verein organized under the laws of Switzerland. Members of Baker & McKenzie International are Baker & McKenzie law firms around the world. In common with terminology used in professional service organizations, reference to a "partner" means a professional who is a partner, or equivalent, in such a law firm. Similarly, reference to an "office" means an office of any such law firm.

© Baker & McKenzie