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Draft Bill Provides for Additional Exemption from the German Loss Cancellation Rules due to Share Transfers

On September 14, 2016 the German Government published a draft bill that introduces an additional exemption from the German change of ownership rules which principally trigger a (partial) forfeiture of loss carry forwards due to certain share transfers. The proposed relief requires in particular that the loss suffering company has maintained the same business operations prior to and after the share transfer.

Background

Under the current change of ownership rules a direct or indirect transfer of more than 50% of the shares in a company with a loss carry forward to an acquirer or a group of related acquirers within five years results in the cancellation of the loss carry forwards, interest carry forwards and current year losses of the company the shares of which are transferred. If more than 25%, but no more than 50% of the shares are transferred, the losses are cancelled on a pro rata basis. Two exemptions exist from the general cancellation rule: the built-in gains exemption and the intra-group exemption. However, beyond the scope of these two exemptions there are situations where an economically desired recapitalization of a company may require a change of ownership which is currently hampered by the threatened loss cancellation.

Draft Bill

The draft bill introduces a new rule which provides for the possibility to retain tax loss carry forwards, interest carry forwards and current year losses in the event of an otherwise detrimental change of ownership if certain requirements are met. Under the proposed rule the loss cancellation shall - upon application - not apply where (i) the loss suffering company has maintained the same business operations since its incorporation or at least for the last three fiscal years prior to the year in which the change of ownership occurred, and (ii) no "harmful event" occurs subsequent to the change in ownership. If relief is granted, the existing loss carry forwards, interest carry forwards and current year losses will be retained and separately assessed as so called "business continuation loss carry forwards" (*fortführungsgebundener Verlustvortrag*).

Assessed business continuation loss carry forwards may be utilized as long as none of the following harmful events occurs:

- discontinuation of the business operations,

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- the business operations are suspended,
- change of the purpose of the business operations,
- entering into additional business operations,
- investment in a partnership,
- entering into a fiscal unity (Organschaft) as controlling entity, or
- transfer of assets to the loss company below fair market value.

Under certain conditions, however, to the extent the company has built-in gains, tax losses or interest carry forwards may be retained even if one of the above mentioned events occurs.

Main criterion for the proposed exemption from the loss cancellation rules is that the company has maintained the same business operations prior to and following the otherwise detrimental change of ownership. For purposes of such rule "business operations" shall encompass the "sustainable, complementing and supporting activities of a company which are based on a uniform intent to generate profits" and shall be measured on the basis of qualitative criteria. The relevant qualitative criteria defining the "business operations" shall include, in particular, (i) the services and products offered, (ii) the customers and vendors, (iii) the markets serviced, and (iv) the qualification of the employees.

Assessment

Although the proposed new law is a welcome additional relief from the currently overly tight loss cancellation rules, the wording of the provision and the legislative motives and explanatory notes are to some extent ambiguous and leave room for future disputes with tax authorities whether the relief actually applies or not. The harmful events are not defined clearly enough and the distinction between a harm-less business continuation and a harmful extension of the business by virtue of changing the business purpose or opening additional business operations is characteried by uncertainty . In particular, if the investment by a new investor is economically required, such funds are normally required to enter into new markets, extend the customer or vendor base or to develop new products. According to the explanatory notes of the draft bill these very activities would likely qualify as harmful events. It follows that there is a contradiction at the heart of the new rules. Un-der these circumstances the new provision would be meaningless, if not counter-productive, if it implies that the loss making structure and activities of the loss company have to be retained.

Outlook

Companies that wish to benefit from the proposed exemption will have to properly document that the same business operations have been maintained in the past prior to the share transfer and are continued thereafter. Since the new rule does not include a time limitation with respect to potentially harmful events, it will also be necessary to monitor and carefully structure any changes in business activities for as long as it benefits from the business continuation loss carry forwards in order not to jeopardize their existence.

If implemented as currently drafted the new rule shall apply for share transfers that occur after December 31, 2015 and shall cover both corporate income tax and trade tax losses.

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