Tax Loss Carry-Forwards:
Final administrative guidance on new corporate loss limitation rules issued

July 2008

On July 4, 2008 the German tax authorities published the final guidance on the new corporate loss limitation rules (Sec. 8c CITA) introduced by the Business Tax Reform 2008.

Under Sec. 8c CITA, a direct or indirect transfer of more than 25% of the shares within a period of five years to one shareholder or related parties to such shareholder or to a group of acquirers with convergent interests will result in a pro rata forfeiture of tax loss carry-forwards. A similar transfer of more than 50% of the shares will result in a complete forfeiture of all tax loss carry-forwards.

The administrative guidance does not include an exception for intra-group reorganizations. As a result, besides regular share acquisitions also inter-company reorganizations anywhere within the corporate group chain even outside Germany could eliminate German tax loss carry-forwards. The German tax authorities only included an exception for a mere change of the legal form (e.g. a partnership into a corporation) of the shareholder of a German loss entity; i.e. such a conversion should not trigger the loss limitation rules for a lower tier German subsidiary. Pursuant to the final guidance reorganization measures with retroactive effect will not be recognized for the determination of the time of a harmful share transfer.

Planned share transfers or reorganizations at any group level above the German subsidiary with tax loss carry-forwards should be carefully reviewed to ensure that no harmful indirect change in ownership according to Sec. 8c CITA results at the level of such German subsidiary.

In case of a harmful share transfer, tax loss carry-forwards existing at the time of the transfer will be partially (share transfer of more than 25%) or completely (share transfer of more than 50%) disallowed. Current year losses incurred until the date of the harmful share transfer also will be forfeited and may not be carried back to previous financial years.

The guidance specifically provides that profits generated up to the time of the harmful share transfer may not be offset against existing tax loss carry-forwards, e.g. internal asset deals will not be effective to avoid an upcoming forfeiture of tax loss carry-forwards. In the case of a share transfer during a fiscal year, the forfeited loss is determined on a pro rata basis. However, the corporation can present a different apportionment of the losses if it can demonstrate an economic justification for the alternative approach.

The final guidance on the loss limitation rules is also relevant for the treatment of interest carry-forwards under the new German interest barrier rule (Sec. 4h ITA and Sec. 8a CITA).