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A COMPARISON OF CORPORATE TAXATION IN THE UNITED STATES AND GERMANY: DIFFERENT WAYS UP THE MOUNTAIN

Walter D. Schwidetzky[*]

I. INTRODUCTION

This article compares how Germany and the United States tax domestic corporations.[1] While I have written the article from the perspective of an American observing the German corporate tax system, I have also included enough American corporate tax law to make the article of value to a German reader.

From an American perspective, some of the differences between the United States and German systems are startling. It is useful to see how another country's tax system can thrive using a model that at times is very different from our own. As we consider ways of reforming and improving our tax system, we may often benefit from learning how other countries approach raising revenue. These countries may have ideas that we, perhaps accustomed to seeing things from a particular perspective, may not have considered. Indeed, the German system has lessons to teach us and vice versa. In some areas the German system is laudably simpler than the United States system.

[*] Walter D. Schwidetzky is a professor of law at the University of Baltimore School of Law. He wishes to thank Dr. Edith Palmer of the Library of Congress for her invaluable assistance in steering him to the right sources, Professor Fred Brown of the University of Baltimore School of Law for his helpful suggestions, and Ms. Debbie Haverson for her editorial improvements. Finally, he wishes to thank Ms. Peggie Albiker for her labors at the word processor and copying machine.

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[1] There is some tangential discussion of foreign corporations operating in Germany because some of their tax treatment is interwoven with the tax treatment of domestic corporations.

On the other hand, like the American system, at times it also suffers from excessive complexity.

II. BACKGROUND

In the United States there are two main types of corporations for federal income tax purposes: the C-corporation and the S-corporation. The federal government taxes the corporation on its income and taxes the shareholders on any dividends they receive.[2] Generally, an S-corporation is not subject to a corporate-level tax.[3] Rather, the income flows through the corporation and is taxed to the shareholders.[4] Thus, double taxation ordinarily does not occur. Further, in the United States, both federal and state governments can tax corporations. State law generally governs the formation and operation of corporations, though federal securities laws may play a role, particularly for publicly-held corporations.

There are also two main types of corporations in Germany, the *Aktiengesellschaft* ("AG") and the *Gesellschaft mit beschränkter Haftung* ("GmbH"). Larger companies often prefer the AG, the form required in order to have a company's shares traded on public exchanges.[5] The German government heavily regulates AGs[6] and sets the minimum capital requirements relatively high, at DM 100,000 (approximately $50,000).[7] As a consequence, many businesses often prefer the GmbH.

The GmbH traces its history back to 1892. Remarkably, from an American perspective, the relevant legislation has changed little since then.[8] It is one of Germany's more successful exports in that other European countries have authorized comparable organizations.[9] In Germany, the GmbH is a far more

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[2] *See* 26 U.S.C. § 11(a) (1994) (referring to taxable income of a corporation); 26 U.S.C. § 61(a) (including dividends in the gross income of individuals). The combination of these two provisions results in a "double taxation" situation.

[3] *See* 26 U.S.C. § 1363(a) (1994).

[4] *See* 26 U.S.C. § 1366(a) (1994).

[5] *See* Ingrid L. Lenhardt, *The Corporate and Tax Advantages of a Limited Liability Company: A German Perspective*, 64 U. CIN. L. REV. 551 (1996). As of 1994, when the rules for AGs were liberalized, only about 20 percent of AGs were listed on a stock exchange. *See id.* at 555 n.26.

[6] *See* 2 MARK LAMPE, THE TAXATION OF COMPANIES IN EUROPE: GERMANY § 0.1.1.1.1[4] (Int'l Bureau Fiscal Documentation 1997).

[7] *See* § 7 AKTIENGESETZ [AKTGES]. Section 7 AKTGES now refers to the minimum capital requirement as being 50,000 Euros. *See id.*

[8] *See* Lenhardt, *supra* note 5, at 553.

[9] *See id.* at 552.

common type of entity than the AG. In 1994, there were approximately 600,000 GmbHs and only 3,400 AGs.[10] GmbHs have also become more popular than noncorporate entities such as limited partnerships.[11] A GmbH is subject to far fewer regulatory burdens than the AG and is therefore both easier to form and more flexible.[12] The minimum required capital for a GmbH is DM 50,000[13] (approximately $25,000). While this sum is much higher than would be typical in the United States, it is half of that required for an AG.[14] Because there are few differences in the taxation of an AG and GmbH, to simplify matters I will focus on the latter entity. Further, as Germany does not have an analogue to the S-corporation, I will mainly compare United States taxation of C-corporations with the German taxation of GmbHs.

A fair and quite common English translation of *Gesellschaft mit beschränkter Hafftung* is limited liability company ("LLC"), but from a tax perspective the GmbH bears little resemblance to the United States entity of the same name. For federal income tax purposes, the United States normally classifies an LLC as a partnership if it has two or more members.[15] If it has a single member, it is ignored for federal income tax purposes; it assumes the status of a sole proprietorship if the owner is an individual or a branch if the owner is a corporation.[16] The German GmbH more closely resembles a United States closely held C-corporation. Germany taxes the income of a GmbH at the corporate-level and taxes dividends paid to shareholders, though corporate and shareholder-level taxation are integrated in Germany.[17] The GmbH tends to be the form used by small and medium-sized businesses, but these entities can become quite large, as shown, for example, by IBM Deutschland GmbH.[18] Formal share certificates as such are not issued, though share ownership is

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[10] *See id.* at 553.

[11] *See id.*

[12] *See id.* at 556-57.

[13] *See* § 5 GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG [hereinafter GMBHG]. Minimum par value per share is DM 500. *See id.* § 5(4.2); Lenhardt, *supra* 5, at 556. The latest code edition sets the minimum capital required at 25,000 Euros.

[14] *See* § 7 AKTGES.

[15] *See* 26 C.F.R. § 301.7701-3(a) (1999).

[16] *See id.* Alternatively, an LLC may "check the box," i.e., file Form 8553 and choose to be classified as a corporation. Because United States corporations are, in general, less favorably taxed than partnerships or sole proprietorships, this election is rarely made. *See* Lenhardt, *supra* note 5, at 563.

[17] *See* Lenhardt, *supra* note 5, at 559; *see also infra* notes 108-121 and accompanying text.

[18] *See* Lenhardt, *supra* note 5, at 553.

noted on the books of a GmbH;[19] the shares of a GmbH may not be publicly traded.[20] Any transfer of shares must meet certain notarial or judicial formalities.[21]

Like the United States, Germany has a federal governmental system. Germany is divided into states or *Länder*. Corporate tax revenues are shared by the federal government, the *Länder*, and the municipalities.[22] As in the United States, the federal tax system dominates the playing field, yet interestingly, there is little in the way of federal tax administration in Germany. The state tax offices administer, assess, and collect most taxes.[23] Unlike in the United States, German Länder do not generally levy taxes,[24] but municipalities can through the Trade Tax (*Gewerbesteuergesetz*). The Trade Tax is governed by German federal law but is assessed and collected by municipalities.[25] It is designed to offset the direct and indirect burdens that commercial enterprises place on communities.[26] The Trade Tax is assessed at a rate of from one to five percent on trade profits,[27] which are based on taxable income with certain adjustments.[28] The German Trade Tax also imposes a tax on trade capital at the rate of two-tenths of one percent.[29]

III. THE IMPORTANT ROLE OF FINANCIAL ACCOUNTING IN GERMANY

In the United States, tax accounting and financial accounting are on largely separate tracks.[30] This is not true in Germany. Financial accounting rules form the foundation of the German business tax system.[31] Many important, tax-relevant provisions are contained not in the German income tax code

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[19] *See* HENRY J. GUMPEL, CCH WORLD TAX SERIES: TAXATION IN THE FEDERAL REPUBLIC OF GERMANY § 1/4.6c (2d ed. 1987).

[20] *See* LENHARDT, *supra* note 5, at 557; *see also* LAMPE, *supra* note 6, § 0.1.2.2.

[21] *See* § 15(3) GMBHG; Lenhardt, *supra* note 5, at 557.

[22] *See* WERNER EBKE & MATTHEW FINKIN, INTRODUCTION TO GERMAN LAW 51 (1996).

[23] *See* JUERGEN KILLIUS, BUSINESS OPERATIONS IN GERMANY, TAX MANAGEMENT PORTFOLIO (BNA) NO. 962 A-2 (1994).

[24] *See id.*

[25] *See* § 1 GEWERBESTEUERGESETZ [hereinafter GEWSTG].

[26] *See* CCH EUROPE, GERMAN TAX & BUSINESS LAW GUIDE § 170-000 (1992) [hereinafter CCH].

[27] *See* § 11 GEWSTG.

[28] *See* §§ 7-10 GEWSTG.

[29] *See* § 13 GEWSTG.

[30] *See* Walter D. Schwidetzky, *A Comparison of Partnership Income Taxation in the United States and Germany: A Study in Differences*, 10 AM. U.J. INT'L L. & POL'Y 1331 (1995).

[31] *See* § 5(1) EINKOMMENSTEURGESETZ [hereinafter ESTG]; CCH, *supra* note 26, §§ 122-250, 127-700, 187-400; GUMPEL, *supra* note 19, § 6/2.6.

(*Einkommensteuergesetz*) but in the financial accounting rules of the commercial code (*Handelsgesetzbuch*).[32] The German tax system, of course, requires some variation from traditional financial accounting rules. However, financial accounting rules tend to be the starting point. Given the adjustments that German tax law makes to the financial accounting rules, corporations typically must maintain a financial balance sheet and a tax balance sheet, with the latter derived from the former.[33] Commonly, corporations file both balance sheets with their tax returns.[34] The fact that the tax and accounting rules overlap often makes the German tax system less complex than its American counterpart and, at times, contributes to it being more generous to the taxpayer in ways that might surprise a tax specialist in the United States.

IV. TAXABLE INCOME AND LOSS

Germany calculates taxable income and loss for a normal corporation rather differently than the United States. Using the accrual method of accounting, a calculation is made by comparing the net worth of the enterprise at the end of the tax year with its net worth at the end of the immediately preceding tax year.[35] A corporation generally has taxable income to the extent of an increase in net worth and a tax loss to the extent of a decrease in net worth.[36] A number of adjustments are made to ensure that income and losses are not under or overstated. Withdrawals from a corporation, for example, could artificially reduce an income calculation or increase a loss calculation. Accordingly, the net worth difference is increased for withdrawals from a corporation and is decreased by contributions to the corporation.[37] Similarly, it is also corrected for nondeductible expenses, liability changes, and similar items.[38] The United

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[32] Book three of this code contains most of the bookkeeping provisions in §§ 238-342 HANDELSGESETZBUCH [hereinafter HGB].

[33] *See* LAMPE, *supra* note 6, § 2.3.1.1; GUMPEL, *supra* note 19, § 6/2.6.

[34] If not, a statement must be filed showing the differences between the financial balance sheet and the calculations required for tax purposes. *See* § 60(2) ESTDV; GUMPEL, *supra* note 19, § 6/2.6.

[35] *See* GUMPEL, *supra* note 19, § 6/1.3c.

[36] *See* § 4(1) ESTG; GUMPEL, *supra* note 19, § 6/1.3b. The German income tax code is somewhat unusual from an American perspective in that it contemplates income but rarely losses. Losses are deductible, however, both from business operations and from business related property transactions. *See* CCH, *supra* note 26, § 125-850; GUMPEL, *supra* note 19, § 7/4.

[37] *See* § 2(1), § 4(1) ESTG. Technically, the net worth comparison method applies to any business that is required to keep books and records or does so voluntarily. *See* § 5(1) ESTG; GUMPEL, *supra* note 19, §§ 6/1.3, 6/5.6.

[38] *See* ENNO BIERGANS, EINKOMMENSTEUER UND STEUERBILANZ 160 (1990).

States uses a system under which expenses are deducted from gross income to determine taxable income.[39] This system also exists in Germany, but it is principally applicable to the computation of taxable income from employment, investments, rents and royalties, and smaller, unincorporated businesses.[40]

Under a net worth system, certain assets and liabilities of the corporation must be valued at the end of each tax year.[41] Generally, the corporation must value each asset and liability separately; however, it may value groups of sufficiently similar assets together.[42] There are some associated rules that relieve much of the burden of having to make an annual valuation. Depreciable assets are generally valued at cost less depreciation deductions.[43] Thus, no appraisal is normally required. Depreciable assets may alternatively be valued at going concern value, if this produces a lower valuation. Going concern value is defined as the value a purchaser of the entire business would assign to an asset, assuming the purchaser would continue to operate the business.[44] The law requires that most other assets be valued at the lower of cost or going concern value.[45] Liabilities are valued at the gross amount the corporation is required to repay.[46] Loans with below-market interest are thus not discountable. As a consequence of these rules, the company's books and therefore its net worth generally do not reflect unrealized profits but do reflect losses.[47] These rules likely find their origin in a financial accounting bias against overstating the value of a business on the corporate books. To do so would be to overstate the value of the business to shareholders and others, often an anathema to public accountants.

If, based on the net worth comparison, a loss occurs, the loss may be carried to other tax years. It is first carried back to the second previous tax year, then to the immediately preceding tax year. Any remaining loss may be carried forward indefinitely.[48] The maximum amount that may be carried back

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[39] *See* 26 U.S.C. §§ 61-63 (1994).
[40] *See* § 2(2)(2) ESTG; GUMPEL, *supra* note 19, § 7/2.1.
[41] *See* § 240(1)-(2) HGB.
[42] *See id.* § 240(4); KILLIUS, *supra* note 23, at A-30.
[43] *See* § 6(1) ESTG; § 253(1) HGB.
[44] *See* § 6 (1) ESTG.
[45] *See id.*
[46] *See* § 253(1) HGB.
[47] *See* § 6(1) ESTG; GUMPEL, *supra* note 19, § 6/5.2d.
[48] *See* § 8 KOERPERSCHAFTSTEUERGESETZ [hereinafter KSTG]; § 10d(2) ESTG.

is a quite small DM 2 million.[49] There is no limit on the amount that may be carried forward.[50]

Medium-sized and large GmbHs must prepare a balance sheet and a profit and loss statement within three months after the close of the fiscal year. Smaller GmbHs have six months.[51] Medium-sized and large GmbHs are required to have their financial statements audited by an independent auditor. All GmbHs must file their financial statements with the Commercial Register, making them open to inspection by the public, though small and medium-sized GmbHs may file a short form financial statement.[52]

If the net worth system consistently looked to actual values of the corporation's assets, then overall it would more correctly reflect income than the United States system, which largely ignores changes in the value of property. But the revaluation is not consistent and what does occur, of course, comes at a price: the expense and hassle of valuing the property. Further, the fact that losses can be taken currently but gains only have to be recognized on the disposition of property also distorts income and loss calculations. It therefore seems unlikely that the German system more accurately measures income and loss than the United States system. Still, some who argue for the use of mark-to-market rules in the United States can look to the German system for some measure of support.[53]

V. GERMAN CORPORATE TAX RATES

In Germany, a corporation's rate of taxation is in part dependent on whether the corporation is a resident of Germany, subjecting it (in German parlance) to a somewhat frightening "unlimited tax liability." A nonresident

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[49] *See* § 10d(1) ESTG. This amount is to be reduced to DM 1 million starting in fiscal year 2001. *See* KILLIUS, *supra* note 23, at A-37.

[50] As in the United States, a substantial change in shareholdings can affect the ability to carry losses to other years. *See* KILLIUS, *supra* note 23, at A-37.

[51] Under § 267 HGB a small stock company is one that does not meet more than two of the following criteria: (1) DM 5,300,000 balance sheet total less loss carry forward; (2) sales of more than DM 10,620,000; (3) a yearly average of 50 employees. A medium-sized stock company would meet two or more of those criteria but not more than one of the following criteria: (1) DM 21,240,000 balance sheet total less loss carry forward; (2) sales of more than DM 42,480,000; (3) yearly average of 250 employees. Large stock companies would meet two or more of these latter tests. *See id.*

[52] Small and medium-sized GmbHs can file a short form. *See* KILLIUS, *supra* note 23, at A-19.

[53] *See, e.g.*, Fred B. Brown, *"Complete" Accrual Taxation*, 33 SAN DIEGO L. REV. 1559 (1996).

corporation has a much more reassuring "limited tax liability."[54] Corporate taxpayers with unlimited tax liability are taxable on their worldwide income, while those with limited tax liability are taxable only on German-source income.[55] Of course, a corporation formed under German law (such as an AG or GmbH) would be a resident corporation.[56] In determining residency, the country of incorporation or the seat of management is paramount.[57] While in theory a corporation formed outside of Germany could be considered to be a resident of Germany if its management was located in Germany, in practice this is uncommon.[58] Simply having a permanent establishment in Germany only gives rise to limited tax liability.[59]

Germany generally taxes corporate taxable income of resident corporations at a flat rate of 40 percent.[60] In recent years Germany has reduced its corporate rates. As recently as 1990, corporate taxable income was taxed at a rate of 56 percent and in 1998 the rate was 45 percent.[61] To help defray the costs of German unification, the income taxes and the withholding taxes are subject to a surcharge of 5.5 percent of the applicable tax.[62]

VI. FORMATION

The United States tax rules that apply to contributions of property to a corporation are quite complex. If at the time of corporate formation or thereafter property is contributed to a corporation in exchange for stock, any gain or loss inherent in the property transferred goes unrecognized only if strict criteria are met. To avoid recognition of all gain or loss, only stock may be received in the exchange, and the transferor, or transferors as a group, must have control of the corporation immediately after the transfer.[63] Control for these purposes is defined as the ownership of at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the

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[54] *See* LAMPE, *supra* note 6, § 2.2.1.
[55] *See id.*
[56] *See id.*
[57] *See id.* § 2.2.2.
[58] *See id.* § 2.2.6.
[59] *See id.* § 2.2.4.
[60] *See* § 23(1) KSTG.
[61] *See* KILLIUS, *supra* note 23, at A-25 (1996 and 1998 versions).
[62] *See* LAMPE, *supra* note 6, § 4.2.
[63] *See* 26 U.S.C. § 351(a) (1994).

corporation.[64] The transferors must have control after the transfer. Thus, if two shareholders own all of the stock of a corporation and later jointly transfer another asset to the corporation, the gain or loss can go unrecognized. If the gain or loss goes untaxed, the basis of the stock to the shareholders is the same as the basis of the property contributed.[65] The holding period in the stock "tacks" onto the holding period of the contributed property if the transferred property is a capital or section 1231 asset.[66] This tacking can be helpful when trying to meet the more-than-one-year holding requirement necessary to obtain the favorable taxation available under 26 U.S.C. § 1(h) for the recognition of long-term capital gains.[67]

If the requirements of 26 U.S.C. § 351 are otherwise met, except that the contributing shareholder receives something back from the corporation besides stock—"boot" in tax parlance—the realized gain must be recognized to the extent of the boot received.[68] Losses are not allowed to be recognized under these circumstances.[69] If gain is recognized, the basis in the stock received is increased by the gain recognized and reduced by the boot received.[70] The gain recognized also increases the corporation's basis in the property it receives.[71] Thus, if a shareholder with $100 of gain inherent in contributed property receives $20 of cash in addition to stock in a transaction otherwise qualifying under 26 U.S.C. § 351, the shareholder must recognize $20 of gain.[72] The

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[64] *See* 26 U.S.C. § 368(c) (1994).

[65] *See* 26 U.S.C. § 358(a)(1) (1994).

[66] *See* 26 U.S.C. § 1223(1) (1994). A 26 U.S.C. § 1231 asset is depreciable property held for more than one year. *See* 26 U.S.C. § 1231(b) (1994). Gains and losses from the sale of § 1231 property are netted together into an all-inclusive "hotchpot." Subject to 26 U.S.C. § 1245's ordinary income recapture rules for gains attributable to depreciation deductions, a net § 1231 gain is taxed at favorable long-term capital gain rates, whereas net losses are fully deductible in the year of the loss. *See* 26 U.S.C. § 1231(b); 26 U.S.C. § 1245 (1994). From a United States perspective, this is the best of both worlds.

[67] *See* 26 U.S.C.A. § 1(h) (West Supp. 1999).

[68] *See* 26 U.S.C. § 351(b)(1) (1994).

[69] *See id.* § 351(b)(2).

[70] *See* 26 U.S.C. § 358(a)(1)(B)(ii) (1994).

[71] *See* 26 U.S.C. § 362(a) (1994).

[72] If the contributed property qualifies for "installment sale" treatment and a note is received in addition to stock, the gain must only be recognized to the extent that payments on the note are made. *See* Temp. Treas. Reg. § 15A.453-1(a) (1999). In the installment sale context, the shareholder can immediately increase the basis of the stock by the gain to be recognized as a consequence of receiving the note but must also reduce it by the amount of the note, typically netting to the basis of the contributed property. The corporation may only increase the basis of the property received when the installment gain is actually recognized. *See* Prop. Treas. Reg. § 1.453-1(f)(3)(ii). An installment sale is a sale in which a payment is received after the close of the year in which the property is transferred. *See* 26 U.S.C. § 453(b)(1) (1994). There are

corporation's basis in the property is increased by $20. The shareholder's basis in the stock is increased by the $20 gain recognized and reduced by the $20 of cash received and thus results in the same basis as the shareholder originally had in the contributed property.

There is yet another wrinkle. If the shareholder contributes property subject to a liability, or if the corporation assumes liabilities of the shareholder as part of the transaction, 26 U.S.C. § 357(a) provides that the corporation's assumption of this liability generally does not cause the shareholder to recognize gain,[73] except to the extent the liabilities exceed the total basis of the property contributed by a shareholder.[74] The shareholder's basis in the stock received must be reduced by the liability the corporation assumes.[75] Twenty-six U.S.C. § 357 contains an anti-tax avoidance provision, which takes away the benefits of this code provision when these liabilities are incurred primarily to avoid federal income taxes or for a non-bona fide business purpose.[76] Liabilities incurred shortly before the contribution that were not used to acquire or improve property would be particularly suspect, as the intention would appear to be to pull out cash without a tax impact rather than to meet a bona fide business need.

Germany generally does not tax the contribution of business assets to a corporation in exchange for stock, regardless of whether the contribution takes place at corporate formation or at some later point.[77] There is no control requirement, which avoids some of the complexity of the United States system. However, the German system is somewhat more complex in another regard. To qualify for tax-free contribution treatment, the assets contributed must be sufficient to constitute a stand-alone business.[78] Thus, the contribution of a single business asset might not be tax-free.[79] This must prove awkward at times. Assuming the contribution qualifies for tax-free treatment, the corporation takes a carryover basis in the assets. However—rather astonishingly from an American perspective—the corporation is permitted to

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limitations on the availability of installment sale treatment. For example, it is not available on the sale of inventory. *See id.* § 453(b)(2).

[73] *See* 26 U.S.C. § 357(a) (1994).

[74] *See* 26 U.S.C. § 357(c) (1994).

[75] *See* 26 U.S.C. § 358(a)(1)(A), (d) (1994).

[76] *See* 26 U.S.C. § 357(b) (1994).

[77] *See* § 5(4), § 56(1) GMBHG; § 50, 55 UMWANDLUNGSSTEUERGESETZ [hereinafter UMWSTG]; LAMPE, *supra* note 6, §§ 1.1.1, 1.2.1; GUMPEL, *supra* note 19, § 9/10.3a.

[78] *See* GUMPEL, *supra* note 19, § 9/10.3a.

[79] For taxation of capital gains and losses in Germany, see *infra* notes 165-171 and accompanying text.

write up the asset value to going concern value or to a price in between carryover basis and going concern value.[80] There is no provision for a write-down. The downside of a write-up is that the transferor must recognize gain to the extent of the write-up.[81] While this latter feature can be quite favorable to the corporation, it does add a layer of complexity. Presumably, a shareholder who does not want to recognize gain would negotiate with the corporation in advance to assure that no write-up is made.

In the case of the contribution of appreciated property, the German tax code sometimes requires a write-up and therefore also requires recognition of the associated gain. A write-up is required if the transferor receives property other than stock in the exchange.[82] It is also required if the liabilities associated with the contributed assets exceed the book basis of those assets. In this case the assets must be written up at least to the point where basis equals the amount of the liabilities. Finally, in Germany a write-up is also required if the transferor is a nonresident, in which case the write-up must be to full going concern value.[83] The United States system could give comparable results to the German write-up to the extent of any non-stock consideration paid to the shareholder who contributed property.

As in the United States, the basis that the transferor takes in any stock received is equal to the basis the corporation takes in the assets, reduced by any nonstock consideration received by the transferor, and increased by any gain recognized as a consequence of a write-up of the contributed property.[84] Germany does not appear to have any rules that permit the tacking of the holding period of the property contributed onto that of the stock. This is likely because holding periods are less relevant to the way in which Germany taxes capital gains than to the way the United States does, as will be discussed in more detail below.[85]

Many states in the United States assess a transfer tax when real estate is transferred to a corporation. This can occur in Germany as well, though the tax is a federal one. The tax is 3.5 percent of the value of the real estate over DM 5000.[86]

The United States may well have something to learn from Germany in this area. Germany permits tax-free contributions without resorting to any control

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[80] *See* § 20(2) UMWSTG; GUMPEL, *supra* note 19, § 9/10.3b.
[81] *See* § 20(2) UMWSTG.
[82] *See id.*
[83] *See id.* § 20(2)-(3); GUMPEL, *supra* note 19, § 9/10.3b.
[84] *See* GUMPEL, *supra* note 19, § 9/10.3b.
[85] *See infra* notes 164-173 and accompanying text.
[86] *See* §§ 11, 3 GRUNDERWERBSTEUERGESETZ [hereinafter GRESTG].

requirement. It would be worth investigating how much revenue corporations that fail to meet the United States 80 percent control requirement actually generate. It may be minimal because corporations work hard to meet the control requirement or avoid a contribution altogether rather than pay tax on a substantial gain. In the case of contributions to United States partnerships, there is no 80 percent control requirement,[87] and it seems it could be dispensed with as well on contributions to corporations. However, the United States keeps things simpler than Germany in some respects. For example, the United States does not provide for optional, partial, or total write-ups. Gain is generally only recognized if the corporation distributed property other than stock to the contributor or if the liabilities associated with the contributed properties exceed their bases. The German system seems to permit taxpayers to manipulate gain recognition based on a taxpayer's overall tax picture. This approach must be damaging to the fisc. Germany's mandatory write-ups are more defensible, and the United States has comparable provisions.[88] Also, it is not apparent why in Germany an individual business asset or, for that matter, a nonbusiness asset cannot qualify for tax-free contribution. The conversion from a nonbusiness to business purpose does not seem any more in need of gain recognition than moving assets from one business form to another. Here the United States rules, which do not make that distinction, seem more sensible.[89]

VII. TAXATION OF DIVIDENDS

A. General

As mentioned above, corporate income in the United States can be subjected to two levels of taxation. Corporate taxable income is subject to taxation at rates of up to 35 percent.[90] When that income is distributed to shareholders as dividends, it is again subject to ordinary income taxation.[91] Generally, a distribution from the corporation to its shareholders is treated as a dividend to the extent of either a corporation's current or accumulated

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[87] *See* 26 U.S.C. § 721(a) (1994).

[88] *See supra* notes 68-72 and accompanying text.

[89] In the United States, if what was previously a nonbusiness asset is contributed to the corporation and its fair market value is less than its basis, the corporation takes the fair market value as its basis. *See* Au v. Comm'r, 330 F.2d 1008 (9th Cir. 1964).

[90] *See* 26 U.S.C. §§ 11(a)-(b) (1994).

[91] *See* 26 U.S.C. § 61(7) (1994).

"earnings and profits."[92] Earnings and profits are roughly analogous to retained earnings. Distributions that exceed a company's current or accumulated earnings and profits first recover the shareholder's stock basis. Thereafter, the shareholder has gain.[93] If the stock is a capital asset, as is normally the case, the gain is capital gain. If the stock has been held for more than one year, the gain will be taxed at favorable rates. The long term capital gain rate typically is 20 percent.[94] If a distribution is made in property rather than in cash, the corporation must recognize any gain inherent in the property but is not permitted to recognize any inherent loss.[95] In the case of a property distribution, the amount of the distribution to the shareholder for purposes of calculating the dividend income, basis recovery, and gain is the fair market value of the property; the shareholder takes a fair market value basis in the property.[96] Given the inability to recognize a loss,[97] it may be wiser to sell a loss asset and distribute the cash, unless the shareholder has a particular need for the asset. If that is the case, it may be preferable to sell it to the shareholder.

To ensure that deviously minded taxpayers do not avoid double taxation, the United States has adopted a host of highly complex provisions. For example, a redemption of stock, if aboveboard, is treated as a sale and exchange of the stock by the shareholder to the corporation, generating capital gain or loss.[98] However, shareholders in control of a closely held corporation might use this rule to end-run dividend treatment. They could redeem stock proportionately from each shareholder, keeping the percentage ownership the same while trying to obtain capital gain treatment on the supposed exchange, instead of having ordinary income from the receipt of the dividend. To avoid this, 26 U.S.C. § 302(b) contains a host of preventative provisions generally requiring that a redemption change proportional stock holdings significantly before sale and exchange treatment is allowed. Otherwise, the redemption is treated as a dividend distribution to the extent of earnings and profits.

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[92] 26 U.S.C. § 316(a) (1994).

[93] *See* 26 U.S.C. § 301(3)(A) (1994).

[94] *See* 26 U.S.C. §§ 1(h), 1221, 1222(3) (1994).

[95] *See* 26 U.S.C. §§ 301, 311(b) (1994).

[96] *See* 26 U.S.C. §§ 301(b), (d) (1994). The amount of the distribution is reduced, but not below zero, by any liabilities to which the property might be subject. *See* 26 U.S.C. § 301(b)(2) (1994).

[97] *See* 26 U.S.C. § 267(a) (1994) (disallowing losses between a corporation and a shareholder who owns actually or constructively more than 50 percent in value of the outstanding stock of the corporation).

[98] *See* 26 U.S.C. § 302(a) (1994).

Another attempt to "bail out" earnings and profits without receiving a taxable dividend might involve the use of a preferred stock dividend. The first step is to make a preferred stock dividend distribution, which is typically tax free.[99] The shareholder then sells the stock to a third party. Any gain on the sale could qualify for favorable long term capital gain treatment. Normally, this maneuver would not be attempted with common stock because it carries with it the right to participate fully in the growth of the business. Typically, the shareholders would not want a third party to have that substantial a participation. Preferred stock, on the other hand, can be fixed as to dividends and liquidation rights. The fixed rights might also make the purchase of the stock more inviting to an investor. To prevent this type of dividend avoidance, Congress enacted 26 U.S.C. § 306. It provides that under these and similar circumstances, the amount realized on the sale of the preferred stock is ordinary income.[100]

In Germany, federal law determines the sources from which dividends may be paid. Similar to stock dividends in the United States, German stock dividends are generally tax free.[101] A corporation may pay cash or property dividends out of the amount by which net assets exceed the stated equity capital as shown on the balance sheet. This is sometimes called "net available equity capital."[102] That excess can arise from a variety of sources including current income, retained earnings, or paid in surplus.[103] A dividend distribution must be approved by the shareholders.[104] If a corporation distributes property as a dividend, it will typically either recognize a gain or a loss on the distribution. This is a function of the way the net worth system for computing taxable income operates. As discussed above, computing the taxable income or loss of a corporation involves comparing its net worth in the current tax year

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[99] *See* 26 U.S.C. § 305(a) (1994). The basis of the existing stock is allocated proportionately between it and the stock received in a tax free dividend distribution. *See* 26 U.S.C. § 307(a) (1994).

[100] *See* 26 U.S.C. § 306(c)(1)(A) (1994). If the preferred stock is redeemed, dividend treatment results as well. *See* 26 U.S.C. § 306(a)(2) (1994). The amount treated as a dividend cannot exceed the amount that would have been a dividend if the corporation had distributed money instead of the preferred stock. *See* 26 U.S.C. § 306(a)(1)(A) (1994). In the language of the statute, the preferred stock is called "section 306 stock." *See* 26 U.S.C. § 306(c) (1994). Twenty-six U.S.C. § 304 prevents similar shenanigan in the brother/sister, parent/subsidiary context.

[101] *See* GUMPEL, *supra* note 19, § 9/2.5.

[102] KILLIUS, *supra* note 23, at A-20.

[103] *See* §§ 29, 30 GMBHG.

[104] *See* KILLIUS, *supra* note 23, at A-20.

to that of the previous tax year.[105] Contributions to capital and withdrawals from capital are netted, with a net contribution reducing and a net withdrawal increasing the net worth for the current year, so as not to over or understate it.[106] Typically, a property is listed on the books of the corporation at its book value. For purposes of the net worth calculation, the property distributed to a shareholder initially reduces net worth by its book value then is added back in an amount equal to its going concern value (a measure of its fair market value).[107] If the going concern value exceeds the book value, the corporation will effectively recognize a gain; if the going concern value is less than the book value, it recognizes a loss. Thus, both the United States and German systems require gain recognition on the distribution of property to shareholders. Only Germany permits the recognition of a loss.

Does the German system make more sense in the latter regard? After all, if a United States corporation could sell the asset and recognize the loss, why should it be prohibited from recognizing a loss on a distribution? Further, if gains are required to be recognized, it seems unfair to prohibit loss recognition. A counter-argument is that between related parties the amount of the loss could be inflated artificially. It is for this reason that 26 U.S.C. § 267(a) disallows losses on a sale between a corporation and a shareholder who owns over 50 percent of the corporation. Of course, related parties can manipulate the amount of the gain as well. Under its net worth comparison system, Germany has strict valuation rules that are absent in the United States. These rules make manipulation of the loss (or gain for that matter) less likely in Germany than in the United States. However, if the parties are not related, there seems little likelihood of the loss being artificially inflated. The unfairness of requiring gain recognition but disallowing losses seems more manifest. A sensible reform to the United States system would be to permit losses except to the extent the related party rules of 26 U.S.C. § 267(a) apply.

B. Corporate Integration

Germany does not need the United States rules designed to preserve double taxation because it has integrated its corporate and individual income tax systems and by and large does not assess two levels of tax. The integration system used by Germany adds complexity, but probably less complexity than the United States rules designed to preserve double taxation. In Germany, the

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[105] *See supra* notes 35-40 and accompanying text.
[106] *See* GUMPEL, *supra* note 19, § 6/5.6.
[107] *See* § 6(1) ESTG.

general tax rate on corporate taxable income is 40 percent;[108] the government refunds one-quarter of the tax (10 percentage points) to the extent the corporation pays the income as a dividend.[109] The shareholders then receive a credit of the tax paid by the corporation.[110] An example will best illustrate how the system works.

Assume a corporation has DM 100 of income. Without a dividend payment, the corporate tax would be DM 40. However, if a distribution is made of the income, the corporate tax is reduced to 30 percent. After the 30 percent tax, DM 70 of the original DM 100 is available for distribution and that amount is paid as a dividend. The shareholder must gross up the income to DM 100 to reflect the income received by the corporation.[111] The DM 100 is taxable income to the shareholder, but the shareholder also receives a tax credit of DM 30 to reflect the taxes the corporation pays on the income.[112] Because the shareholder receives a credit for the taxes paid by the corporation, the income is only subject to one level of tax. The first 30 percent of the tax occurs at the corporate level. Tax beyond the 30 percent rate can occur at the shareholder level if the shareholder is taxable at a higher marginal rate. German individual rates go as high as 53 percent beginning with taxable incomes of about DM 120,000 (about $70,000).[113] Thus, if the shareholder's effective tax rate is 50 percent, she pays a tax on the dividend of DM 50 less the DM 30 credit, or a net amount of DM 20.

The distributing corporation, rather than the distributee shareholder, must demonstrate that the 30 percent corporate-level tax was paid. The shareholder is then given a certificate showing the creditable nature of the dividend that was distributed. The certificate must be attached by the shareholder to the tax return.[114]

There is no time limit on the availability of the refund and credits. Thus, the corporation can receive the tax reduction, and the shareholder can receive the tax credit even if the income is distributed years after it is earned or at liquidation of the corporation.[115] Corporate income tax rates have declined over time in Germany. Generally, the corporation is entitled to a refund of the

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[108] *See* § 23 (1) KSTG.

[109] *See* § 27(1) KSTG.

[110] *See* § 36 (2)(2) ESTG. The Trade Tax can affect the calculation. *See* KILLIUS, *supra* note 23, at A-25.

[111] *See* §§ 20(1), (3) ESTG.

[112] *See* § 36(2)(2) ESTG.

[113] *See* § 32a(1) ESTG.

[114] *See* §§ 44-46 KSTG; § 36(2), (3), (6) ESTG.

[115] *See* KILLIUS, *supra* note 23, at A-25.

difference between the tax rate paid on income and the 30 percent rate. Thus, if the corporate rate was 50 percent on certain income, the refund to which the corporation is entitled upon distribution of that income as a dividend is 20 percent.[116]

The tax on the income the corporation uses to pay dividends cannot exceed 30 percent and generally cannot be less than 30 percent. Thus, if the distribution is made from income that is otherwise tax exempt to the corporation, the corporation must pay a 30 percent compensatory tax to offset the 30 percent credit the distributee shareholder continues to receive.[117] While the income may have been tax exempt to the corporation, there is apparently no intention that the income be tax exempt in the hands of the shareholder. Without the compensatory tax, the German fisc would see its revenue reduced by the 30 percent credit to the shareholder. An alternative would have been to deny the shareholders the 30 percent credit in this circumstance. Likely, the tax is applied to the corporation because of a greater certainty of collection from a fairly small number of corporations rather than a vastly larger number of shareholders. With regard to tax exempt income, the German code does not maintain a fully integrated income tax system. Full integration would suggest that if the income is tax exempt to the corporation, it should be tax exempt to the shareholder or, failing that, only taxable to the shareholders to the extent their marginal tax bracket exceeds 30 percent. Further, creating special rules for tax exempt income adds complexity to the German system.

Another area of complexity involves the method Germany developed to determine the type of income being distributed. When a corporation distributes a dividend, depending on its source, the corporation can either receive a tax refund of varying amounts or be assessed an additional tax. German tax law had to provide sourcing rules for determining the source of a distribution. This area is quite complex, and I will not overly burden the reader with it. Generally, a dividend is considered to come from the oldest (and, given the rate reductions, typically the highest taxed) taxable income first.[118] This rule is taxpayer-friendly. For example, a dividend would come from the 45 percent category (along with the bigger corporate refund) before the 40 percent category. Further, a dividend comes from the taxable income before the tax exempt income (the latter meaning an additional corporate tax).

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[116] *See* CCH, *supra* note 26, § 130-800.

[117] *See* § 27(1) KSTG.

[118] *See* § 30 KSTG; KILLIUS, *supra* note 23, at A-25; CCH, *supra* note 26, §§ 130-800 through 130-900.

Distributions can also be made from contributions to capital, called EK04.[119] Here the distribution does not come out of income and, consequently, is not subject to a 30 percent compensatory tax.[120] The distribution also is not income to the shareholder.[121]

Is corporate integration an area where the United States could learn from Germany? The idea of integrating corporate and shareholder-level taxation in the United States has been the subject of much debate,[122] and fully engaging that debate here would take this article far beyond its bounds. I will satisfy myself, therefore, with a few tangential comments.

Since Germany and other countries have been able to integrate corporate-level and shareholder-level taxation, they at least demonstrate that integration is possible in large, complex economies.[123] However, the implementation of corporate integration in the United States could generate substantial losses for the fisc. The United States Treasury Department estimated that for 1991, using a model similar to the current German system, the complete elimination of double taxation would reduce federal tax revenues by as much as $36.8 billion annually.[124]

An apparently much cheaper way to achieve integration would be to exclude dividends from the income of the shareholders. The Treasury estimated that for 1991 this approach would "only" cost $13.1 billion. Even with the projected budgetary surpluses, either approach involves "real money," though the latter approach would pose far less of a challenge. It would be no simple matter to find substitute sources of revenue. Germany has sources of

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[119] *See* § 30(2)(4) KSTG.

[120] *See* § 40(1) KSTG; § 20(1)(1)(3) ESTG. The German system of integration assumes that the recipient shareholder is subject to German income taxation. In the case of nonresident shareholders that need not be the case, and they are not entitled to a credit of the 30 percent corporate tax. *See* § 51 KSTG. Nonresident shareholders may apply for a refund if the source of the payment is tax exempt foreign source income. *See* § 52 KSTG; § 40(1) KSTG. The refund is subject to a 25 percent withholding tax, though that amount may be reduced by treaty. *See* §§ 43(1), (6) ESTG; §§ 43a,(1), (3) ESTG.

[121] *See* § 20(1)(1)(3) ESTG.

[122] *See generally Colloquium on Corporate Integration*, 47 TAX L. REV. 427 (1992) (debating integration of corporate-level and shareholder-level taxation in the United States).

[123]. *See* John Livingston, Comment, *Corporate Tax Integration in the United States: A Review of the Treasury's Integration Study*, 58 MO. L. REV. 717, 735. (1993).

[124] Various integration proposals were considered. The one referenced in the text involves an allocation to shareholders of a 31 percent credit for corporate taxes paid. Tax exempt and foreign shareholders would receive no credit. The credit would accompany an allocation of income to the shareholder. *See* Treasury Department Report, *Integration of the Individual and Corporate Tax Systems, Taxing Business Income Once*, 4 DTR L25p Supp. 1/7/92 [hereinafter Treasury Report].

revenue that the United States federal government does not have. It assesses a 15 percent value added tax, and its income tax rates go up to 53 percent, which is substantially in excess of the United States maximum rate of 39.6 percent (though Germany is considering reducing its income tax rates).

Some suggest reducing the projected United States revenue losses from corporate integration by retaining double taxation only for publicly traded corporations.[125] In fact, it is doubtful that the system of double taxation raises much revenue from non-publicly traded corporations. Closely held corporations with owners actively involved in the business often can avoid double taxation in a variety of ways including by paying out corporate income (1) as deductible salaries; (2) as deductible rent on property rented from shareholders; or (3) as deductible interest on loans from shareholders.[126] Further, with the advent in the United States of the LLC form, new businesses can avoid double taxation without any fancy footwork.[127] LLCs should offer the same level of liability protection as corporations[128] and, under the regulations, normally are taxed as partnerships (with no entity-level tax) if they have two or more members. If they have a single member, they are treated for tax purposes as sole proprietorships if the member is an individual or as branches

[125] *See* Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 823-26 (1992).

[126] Excessive debt equity ratios are attacked and the debt can be recharacterized as equity, turning purported interest payments into dividend payments. This is particularly a risk when the stock and debt are held in the same proportions. *See* Fin Hay Realty Co. v. United States, 398 F.2d 694, 699 (3d Cir. 1968) (holding funds given to corporation by two stockholders to purchase apartment buildings were not loans but contributions to capital from which the corporation could not deduct interest). In 1969, Congress enacted § 385 authorizing the Internal Revenue Service ("the Service") to issue guidance in this regard. The Service must see the problem as a thorny one, because we are still waiting for the guidance. Proposed regulations were issued in 1981 but were withdrawn in 1983. *See* William Rands, *The Closely Held Corporation: Its Capital Structure and the Federal Tax Law*, 90 W. VA. L. REV. 1009, 1017-18 n.29 (1988).

[127] Previously, to obtain the preferred partnership system of taxation and a full liability shield, it was necessary to form two entities—a limited partnership and a corporation to serve as a general partner. Many business owners lacked the level of sophistication necessary to reliably operate a two-entity system.

[128] Statutes typically give LLCs a liability shield comparable to those of corporations, and case law has applied corporate-like rules in determining whether the LLC veil should be pierced. *See, e.g.*, Ditty v. Checkrite, Ltd., 973 F. Supp 1320 (D. Utah 1997) (applying state law factors used to consider whether to pierce corporate veil under the alter ego doctrine); Ing (U.S.) Sec., Futures & Options, Inc. v. Bingham Investment Fund, L.L.C., 934 F. Supp. 987 (N.D. Ill. 1996) (mem.) (interpreting Wisconsin's fiduciary shield doctrine); New Horizons Supply Coop. v. Haack, No. 98-1865, 1999 WL 33499 (Wis. App. Jan. 28, 1999).

if the member is a corporation.[129] In either case there is no entity-level tax. Another way to avoid double taxation is to form a corporation and elect S-corporation status, which in the United States generally avoids the corporate level of taxation.[130]

There are, however, arguments for not moving to an integrated system on a partial basis and to cover only public corporations. While most of the dividend-avoidance schemes assume the existence of a closely held corporation, Congress would likely feel compelled to keep the code sections that address those issues on the books. In addition, there would need to be additional legislation in order to implement an integrated system. Thus, implementing integration for the benefit of closely held businesses would mean greater, not less, complexity in a tax code that is already reminiscent of a Kafka novel (and a lengthy one at that). Closely held business owners would realize only minimal benefit because for the most part they can use the corporate form and avoid double taxation anyway. Further, LLCs will increasingly make the closely held corporation a lesser player on the business-entity stage.

While the principle of integration seems sound to many, the consequent revenue losses and the trend toward LLCs make it difficult to build the large-scale momentum needed to implement it. The political reality is that currently there is no significant effort taking place to implement an integrated corporate tax system in the United States, nor is there likely to be one in the future.

C. Constructive Dividends

As in the United States, in Germany a dividend can be actual or constructive. How the two countries treat constructive dividends is more noteworthy for its similarities than its differences. In Germany, constructive dividends typically arise in four circumstances that likely describe the bulk of the United States constructive dividend universe[131] as well: (1) the corporation acquires an asset from a shareholder at an excessive price; (2) the corporation overpays the shareholder for services or the use of funds or assets; (3) the corporation sells assets to the shareholder for less than fair market value; or (4) the

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[129] Alternatively (and improbably), they can check a box on Form 8553 and elect to be taxed as corporations. *See* 26 C.F.R. § 301.7701-2 (1999); MARK SARGENT & WALTER SCHWIDETZKY, THE LIMITED LIABILITY COMPANY HANDBOOK §§ 2.01-2.05, app. 2A (1998-1999).

[130] *See* 26 U.S.C. § 1363(a) (1994).

[131] While not typically characterized as a constructive dividend, excessive debt owed to a shareholder can be recharacterized as equity. Any purported interest payments on recharacterized debt would become dividend payments.

corporation provides the shareholder with services, funds, or assets without adequate compensation.[132]

In the United States, an arrangement with a controlling shareholder tends to attract heightened scrutiny. In Germany, the standard is even higher. Unless there is a preexisting written agreement between the shareholder and the corporation, the government may deem the transaction a constructive dividend, even if the arrangement is otherwise fair.[133]

Typically, in both countries a constructive dividend causes corporate income to increase. In the United States, the constructive dividend could mean that the corporation loses a purported deduction (e.g., the excessive portion of a salary payment) and thereby increases its taxable income.[134] Because Germany has a net worth system for computing income, a constructive dividend also means an increase in taxable income to the corporation. Effectively, the constructive dividend artificially reduces the net worth. When that is corrected by adding the constructive dividend back in, net worth goes up along with taxable income.[135]

VIII. REORGANIZATIONS

A detailed description of United States or German corporate reorganization provisions would warrant the writing of a treatise rather than a law review article. The topic certainly exceeds the bounds of one among many topics in a law review article; however, this article would be incomplete without a brief description.

In the United States, it is possible to engage in a variety of corporate restructurings. If the relevant rules are met, they can be tax free both to the corporation and to the shareholders.

The following types of reorganizations can be tax free:

- a state law merger or consolidation;
- a swap of voting stock for voting stock, if the acquiring corporation has 80 percent or more control of the acquired corporation after the acquisition;

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[132] *See* KILLIUS, *supra* note 23, at A-27.

[133] *See* § 31(3) KSTR.

[134] *See* 26 U.S.C. § 311(b) (1994).

[135] *See* KILLIUS, *supra* note 23, at A-27. The tracing rules can be relevant here. *See supra* notes 35-40 and accompanying text.

- the acquisition of substantially all of the assets of one corporation in exchange for the voting stock of another corporation;
- a recapitalization; a mere change in identity, form, or place of organization of one corporation; and
- a reorganization under the bankruptcy laws.[136]

If these rules are not met, the transaction is fully taxable. For example, a shareholder would recognize gain to the extent the fair market value of the property received exceeds the basis of the stock exchanged.

Of course, for shareholders to receive tax-free treatment, the terms of the reorganization must be met, and those terms may dictate the type of consideration the shareholders must receive. For example, if the reorganization requires voting stock to be exchanged for voting stock, the criteria of the reorganization dictate the shareholder consideration. Where this is not the case, the United States tax code generally provides that to receive tax-free treatment a shareholder must be continuing a corporate stock or debt investment, not swapping stock for debt and not receiving cash. A reorganization becomes taxable, at least in part, to the extent the shareholder has "cashed out" part or all of his investment or converted from a stock investment to a debt investment.[137]

The United States tax code does not mandate any specific consideration in the case of a state law merger or consolidation. However, courts reviewing mergers have required the shareholders of the merged corporation to maintain a continuing proprietary interest in the surviving corporation.[138] Thus, unless a substantial portion of the consideration received by the shareholders of the merged corporation is stock in the surviving corporation, the merger may fail to qualify under the tax code, notwithstanding that it complies with state law.[139]

Another reorganization that can be tax free involves the transfer by a corporation of all or part of its assets to another corporation if—after the transfer—the transferor, one or more of its shareholders, or both are in control of the transferee corporation. Furthermore, the stock and securities of the corporation to which the assets are transferred must be distributed in a

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[136] *See* 26 U.S.C. § 368 (1994).
[137] 26 U.S.C. § 354 (1994).
[138] *See* Roebling v. Comm'r, 143 F.2d 810 (3d Cir. 1944).
[139] See BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 12.22[i] (6th ed. 1999).

transaction qualifying under 26 U.S.C. §§ 354-356. This generally means, as already alluded to, that stock must be exchanged for stock and debt must be exchanged for debt of the same or lesser principal amount or for stock.[140] To be more specific, this "type D" reorganization commonly involves the transfer by one corporation of part or all of its assets to a controlled corporation,[141] followed by a distribution of the controlled corporation's stock in a spin-off, split-off, or split-up. In a spin-off, a corporation makes a distribution to its shareholders of the stock of a subsidiary. A split-off is the same as a spin-off except that the shareholders of the distributing parent corporation surrender part or all of their stock in the parent corporation in exchange for stock in the subsidiary. A split-up occurs when the parent corporation distributes its stock in two or more subsidiaries in complete liquidation.[142] These "divisive reorganizations" are often used to separate groups of shareholders which are at loggerheads. For a divisive reorganization to be tax free it must meet the requirements of 26 U.S.C. § 355. This code section imposes a number of requirements, including the requirement that, immediately before the distribution, the distributing corporation control the corporation whose shares or securities it is distributing.[143] Immediately after the distribution, both the distributing corporation and the controlled corporation must be engaged in the active conduct of a trade or business that is at least five years old.[144]

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[140] *See* 26 U.S.C. §§ 354(a)(1), (2)(B) (1994). "Nonqualified preferred stock" received in exchange for a different type of stock does not qualify for tax free exchange treatment. *See* 26 U.S.C. § 354(a)(2)(C) (1994); 26 U.S.C. § 351(g)(2) (1994).

[141] Under 26 U.S.C. § 368(c) "control" usually means 80 percent of the voting stock and 80 percent of all other classes of stock. For purposes of a type D reorganization, that threshold can be reduced to 50 percent or more. *See* 26 U.S.C. § 368(a)(2)(H)(i) (1994).

[142] *See* BITTKER & EUSTICE, *supra* note 138, § 11.01[1][e].

[143] Here "control" means 80 percent of the voting stock and 80 percent of all other classes of stock. *See* 26 U.S.C. § 368(c) (1994).

[144] *See* 26 U.S.C. § 355(b)(1)(A) (1994). If immediately before the distribution the distributing corporation had no assets other than stock or securities in the controlled corporation, then each controlled corporation must be engaged, immediately before the distribution, in the active conduct of a trade or business. *See* 26 U.S.C. § 355(b)(1)(B) (1994). With regard to the five-year trade or business requirement, the trade or business cannot have been acquired during the five year period in a taxable transaction or be conducted by another corporation the control of which was acquired during the five-year period in a taxable transaction. *See* 26 U.S.C. § 355(b)(2) (1994); BITTKER & EUSTICE, *supra* note 138, § 11.02[2]. Further, to qualify under 26 U.S.C. § 355, the distributing corporation must either distribute all of its stock and securities in the controlled corporation or enough to meet the 80 percent control test. In the latter case, it must be established to the satisfaction of the Internal Revenue Service that the retention of stock and securities was not part of a tax-avoidance plan. *See* 26 U.S.C. § 355(a)(1)(D) (1994). Finally, the transaction must not be principally a device for the distribution of earnings and profits. *See* 26 U.S.C. § 355(a)(1)(B) (1994). *See generally* BITTKER & EUSTICE, *supra* note

The laws in Germany are similar but thankfully less complex. The federal government, not the states, promulgates substantive corporate law. While at times German law requires that the acquiring corporation have majority control of the target corporation, there does not appear to be any requirement that the shareholders exchange voting stock for voting stock as is often the case in United States reorganizations. Apparently, stock can be exchanged for stock, regardless of whether it is voting, nonvoting, preferred, or common. The rules on consideration are more uniform. To obtain tax-free treatment, stock must be exchanged for stock. Other types of consideration may be received without preventing the transaction from generally qualifying as a reorganization, though nonstock consideration can cause gain or loss to be recognized.

Mergers in Germany can be tax free, provided the only consideration received by the shareholders of the merged corporation is stock, and the surviving corporation takes a carryover basis (*Buchwertfortführung*) in the transferred assets.[145] Mergers can take place between a variety of entities including AGs and GmbHs. Remarkably from an American perspective, Germany also permits a tax-free merger between a corporation and a partnership.[146] The fact that this is allowed becomes less surprising after recalling that Germany has an integrated corporate tax system and, unlike the United States, does not have a need to preserve double taxation.[147]

A stock-for-stock swap is tax free in Germany provided the acquiring corporation acquires a majority (not the typical United States 80 percent) of the voting stock of the target.[148] Transforming a corporation from one type to another, e.g., from GmbH to AG, can also go untaxed. The transformation is effectively viewed as a nonevent, so there is no transfer or exchange that could generate taxation.[149]

Germany also has an equivalent to the spin-off, split-off, and split-up (*Ausgliederung, Abspaltung, and Aufspaltung*).[150] In each case, sufficient assets must be transferred to a corporation to constitute a stand-alone business

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138, chapter 11 (discussing the tax consequences of corporate divisions).

[145] *See* §§ 11(1), 13(1) UMWSTG.

[146] *See* § 3(1) UMWANDLUNGSGESETZ [hereinafter UMWG]. There is some question of whether such mergers may trigger a real property transfer tax. *See* MANFRED BENKERT & ANNEGRRET BUERKLE, LAW OF REORGANIZATIONS/REORGANIZATION TAX LAW 168-70 (1996).

[147] *See supra* notes 101-113 and accompanying text.

[148] *See* §§ 20(1), 23(4) UMWSTG.

[149] *See* §§ 1, 190, 202(1) UMWG; BENKERT & BUERKLE, *supra* note 145, at 167-68.

[150] *See* § 123(1) UMWG.

(*Teilbetrieb*). Each of these can be tax free provided the transferee corporation takes a carryover basis in the assets and receives no consideration other than stock.[151] If only part of the assets of a corporation are transferred to another corporation, the assets retained and transferred must each be sufficient to constitute a stand-alone business.[152]

German reorganization law has different fundamentals than that of the United States, including corporate income tax integration and determining taxable income through net worth comparisons. That said, most transactions that qualify for tax-free reorganization treatment in one country will likewise qualify in the other country. What is perhaps most noteworthy is that in an advanced economy like that of Germany, it is possible to have a somewhat simpler and more flexible system than that of the United States. Would there really be much loss to the fisc if the United States used a majority control test rather than the typical 80 percent control test or if the United States allowed stock to be swapped for stock without concern about the type of stock involved? It seems unlikely. Also, the United States often has rigid categories of reorganization and varying types of consideration that may be received. In one type, only voting stock may be received while in others it is possible to receive cash (though gain may have to be recognized to the extent of the cash received). Germany's provisions are more uniform and do not vary the permitted consideration based on the type of reorganization used. The United States would be well advised to take Germany's lead and look for ways to simplify its reorganization provisions and make them more uniform.

IX. CAPITAL GAINS AND LOSSES

In the United States, corporate capital gains are taxed ordinary income rates.[153] Corporate capital losses may only be deducted from corporate capital gains.[154] Excess corporate capital losses may be carried forward five years.[155] Under limited circumstances, the excess capital losses may also be carried back three years and forward for up to ten years.[156] However, in the business

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[151] *See* §§ 11(1), 15(1) UMWSTG; LAMPE, *supra* note 6, §§ 10.3.2, 10.4.
[152] *See* § 15(1) UMWSTG.
[153] *See* 26 U.S.C. §§ 11, 1201(a) (1994).
[154] *See* 26 U.S.C. § 1211(a) (1994).
[155] *See* 26 U.S.C. § 1212(a)(1)(B) (1994).
[156] The excess capital loss may be carried back three years if it is a foreign expropriation capital loss and does not increase or produce a net operating loss. Such foreign expropriation capital losses may be carried forward ten years. Excess capital losses incurred by a regulated investment company (e.g., mutual fund) may be carried forward eight years. *See* 26 U.S.C. §

context, 26 U.S.C. § 1231 is often more relevant than the capital gain and loss rules. This code section primarily applies to both depreciable property and land used in a trade or business and held for over one year.[157] Gains and losses from the sale of 26 U.S.C. § 1231 property are netted. Subject to 26 U.S.C. § 1245's ordinary income recapture rules for gains attributable to depreciation deductions on personal property, if 26 U.S.C. § 1231 gains exceed losses, the gains and losses are characterized as capital gains and losses.[158] If losses exceed gains, the losses are characterized as ordinary gains and losses.[159] For a noncorporate taxpayer, this is the best of both worlds because net losses are fully deductible and net gains are taxed at favorable long term capital gain rates. For corporations, the picture is less rosy. Because corporate long term capital gains are taxed at ordinary income rates, 26 U.S.C. § 1231 is tax neutral for net gains. However, § 1231 does permit a corporation to fully deduct losses on property covered by this code provision, and typically corporate assets will be 26 U.S.C. § 1231 property.

For individuals in the United States the situation is substantially more favorable, though the complexity of the tax code in this regard is astonishing. Due to the complexity, I will spare the reader a detailed explanation, but suffice it to say that long term capital gains (i.e., those arising from the sale of capital assets held over one year) are, incredibly, subject to seven different favorable rates of taxation, the most common of which is 20 percent.[160] Individuals may deduct capital losses from capital gains and up to $3,000 of any excess from ordinary income.[161] Excess capital losses may be carried forward indefinitely but not back.[162] Further, 26 U.S.C. § 121 excludes from

1212(a) (1994).

[157] *See* 26 U.S.C. § 1231(b) (1994). In the case of a condemnation, casualty, theft, or other compulsory or involuntary conversion, it can also apply to a capital asset held over one year that it used "in connection" with a trade or business. This requires less of a business nexus than the usual requirement that the asset be used "in" the trade or business. *See* 26 U.S.C. § 1231(a)(3)(A)(ii)(II) (1994).

[158] *See* 26 U.S.C. § 1231(a)(1) (1994).

[159] *See* 26 U.S.C. § 1231(a)(2) (1994). If casualty and theft losses exceed gain, then all such gains and losses are ordinary regardless of whatever other 26 U.S.C. § 1231 gains and losses might exist. *See* 26 U.S.C. § 1231(a)(4)(C) (1994).

[160] *See* 26 U.S.C. § 1(h) (1994); *see also infra* notes 157-159 for a discussion of 26 U.S.C. § 1231 and favorable treatment on the disposition of depreciable trade or business property.

[161] *See* 26 U.S.C. § 1211(b) (1994).

[162] *See* 26 U.S.C. § 1212(b) (1994).

income up to $250,000 of the gains from the disposition of a principal residence.[163]

In Germany, generally there are no special rules for corporate capital assets and no analogue to 26 U.S.C. § 1231. Typically, gains and losses from all asset sales are treated the same—gains are fully taxable at ordinary income rates, and losses are fully deductible.[164]

For nonbusiness assets held by individuals in Germany, the situation is almost the reverse of that for corporations. Generally, capital gains are not taxable, and capital losses are not deductible. Exceptions exist for capital gains and losses arising from "speculative transactions" or from the sale by a "substantial investor" of stock in a corporation.

The German tax code considers a transaction to be speculative if the holding period of the nonbusiness asset is less than a specified term. The holding period for real estate is ten years and for other assets one year.[165] Gains on speculative transactions that annually total less than DM 1000 are not taxed.[166] Otherwise, Germany taxes gains from speculative transactions as ordinary income.[167] Losses from speculative transactions may be deducted only from gains from speculative transactions. Any excess of losses over gains from speculative transactions in a tax year may be carried back for one year and forward indefinitely to the extent that adequate gains from speculative transactions exist in those years.[168]

A substantial investor is defined as a person who holds directly or indirectly more than 10 percent of the stock of a corporation at any time during the five years preceding the sale of such stock.[169] Capital gains realized on the sale of such stock or on its disposition in liquidation are taxed as ordinary income.[170] Capital losses realized on the disposition of such stock apparently remain nondeductible. If a transaction falls both under the rules for specula-

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[163] *See* 26 U.S.C. § 121 (1994). The residence must have been owned and occupied as a principal residence for two of the prior five years. For married couples filing joint returns the exclusion is $500,000. *See id.*

[164] *See* KILLIUS, *supra* note 23, at A-31. Capital gains realized involuntarily through theft, condemnation, etc. are not taxable if replacement assets are acquired in the same fiscal year in which the gain is realized. Special treatment is sometimes also given for replacement assets acquired later. *See* § 31 KSTR; KILLIUS, *supra* note 23, at A-31.

[165] *See* § 23 ESTG; KILLIUS, *supra* note 23, at A-50.

[166] *See* § 23(3) ESTG.

[167] *See* § 22(2) ESTG; KILLIUS, *supra* note 23, at A-50.

[168] *See* § 23(3) ESTG; KILLIUS, *supra* note 23, at A-50.

[169] *See* § 17(1) ESTG.

[170] This does not apply to the extent the liquidating distribution constitutes a dividend. *See* KILLIUS, *supra* note 23, at A-51.

tive transactions and those for substantial investors, it is governed by the rules for speculative transactions.[171]

The German system for taxing corporate gains and losses from asset sales is much simpler than that of the United States. Generally, all gains are fully taxable, and all losses are fully deductible. In the United States, corporate assets held for over one year typically have to run the gauntlet of 26 U.S.C. § 1231, and for the rare corporate asset not used in a trade or business, the capital gain and loss rules.[172] For most corporate assets, regardless of whether they are held for over one year, the rules will work the same as those in Germany, i.e., gains will be fully includable and losses fully deductible. Because, most commonly, corporate taxpayers end up in the same place, it would seem sensible for the United States to make life simpler for its corporate taxpayers, follow the German example, and not have a special rule for corporate capital or 26 U.S.C. § 1231 gains and losses.[173]

The German system for taxing gains on the dispositions of nonbusiness real estate seems a bit harsh. Ten years is decidedly long, and unlike in the United States, there is no exclusion for a home purchase. Beyond that, the German system for taxing nonbusiness assets is certainly simpler than its American counterpart. Of course, for the United States to follow this example, other sources of revenue would have to be found to make up for the revenue losses from the reduced taxation of capital gains. While the United States system is less taxpayer-friendly for corporate gain, it taxes ordinary income at lower rates. The maximum United States rate is 39.6 percent versus the German rule of 53 percent. Also, Germany assesses a 15 percent value added tax. It seems unlikely that most Americans would exchange a higher rate of ordinary income taxation and/or a value added tax for more favorable capital gains taxation, although they might happily give up the complexity of the current United States system.

X. LIQUIDATION

In the United States, the liquidation of a corporation[174] generally results in two levels of taxation. The corporation typically recognizes gain or loss

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[171] *See* § 23(2) ESTG; KILLIUS, *supra* note 23, at A-50.

[172] *See supra* notes 153-163 and accompanying text.

[173] There could be the risk of individuals trying to take unfair advantage of these rules by putting assets in corporations because their capital gains would be taxed as ordinary income and losses would remain in the corporate solution, except to the extent of gains.

[174] For application in situations other than a liquidation of a corporate subsidiary, see 26 U.S.C. § 332 (1994).

inherent in the property distributed in liquidation.[175] The shareholders recognize a gain or loss on the difference between the fair market value of the property and money received and their bases in the stock.[176] The shareholders take a fair market value basis in the property received.[177] The earnings and profits of the corporation effectively disappear, with none of the distribution treated as a dividend.

In Germany, as in the United States, a liquidating distribution of assets triggers gain or loss recognition by the distributing corporation. The amount of gain or loss recognized is the difference between the fair market value of the distributed property and its basis.[178] Unlike in the United States, dividend treatment can occur on a liquidating distribution. The corporate balance sheet must be examined to determine amounts available for a dividend distribution. Any recognized gain on liquidation increases, and any recognized loss on liquidation decreases, the net available equity capital. To the extent of a shareholder's share of net available equity capital, any liquidating distribution is treated as a dividend, and the normal dividend rules apply.[179] If the source from which the distribution was made was corporate income taxed at the 40 percent rate, for example, the corporation would be entitled to a 10 percent tax refund, and the shareholder would be entitled to a 30 percent tax credit.[180] The remaining amount of the distribution is compared to the shareholder's stock basis, and the shareholder recognizes capital gain or loss to that extent.[181] Unless the transaction fits within the speculative transaction rules or the shareholder holds more than a 10 percent interest in the corporation, however, any capital gain on liquidation is excluded from income, and no capital loss is deductible.

Unlike in the United States, the liquidation of a German corporation avoids double taxation. On liquidation, the German corporation might have gain, but the gain comes out as a dividend. Given corporate integration, there would be one level of tax: at the corporate level for the first 30 percent of tax and at the shareholder level if the shareholder's marginal rate were higher than that.

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[175] *See* 26 U.S.C. § 336(a) (1994). Section 336(d) limits corporate loss recognition on distributions to related parties and on distribution of property that was contributed by a shareholder to the corporation with losses inherent in it within a short period before the liquidating distribution.

[176] *See* 26 U.S.C. § 331(a) (1994).

[177] *See* 26 U.S.C. § 334(a) (1994).

[178] *See* § 11(2) KSTG; KILLIUS, *supra* note 23, at A-28.

[179] *See* KILLIUS, *supra* note 23, at A-28.

[180] *See supra* notes 108-117 and accompanying text.

[181] *See* KILLIUS, *supra* note 23, at A-28.

An example best clarifies how this works. A GmbH makes a liquidating distribution to a shareholder of an asset with a fair market value of DM 300,000 and a book basis of DM 250,000 and thus with DM 50,000 of inherent gain. After factoring in gain on the transaction and the corporation's other income, assume DM 40,000 of the distribution constitutes a dividend. The shareholder's basis in the stock is DM 200,000. The corporation recognizes DM 50,000 of gain on the distribution (increasing net available equity capital). DM 40,000 of the DM 300,000 received by the shareholder constitutes a dividend. If the source from which it came was subject to 40 percent tax on the corporation, the corporation receives a 10 percentage point tax refund. The shareholder receives a 30 percent tax credit.[182] The remaining DM 260,000 of the distribution when compared to the shareholder's DM 200,000 basis generates DM 60,000 of capital gain to the shareholder, which most likely goes unrecognized.[183]

XI. CONCLUSION

In some areas, the German system operates with significantly less complexity than its American counterpart, though no one would call the German system simple in absolute terms. It handles certain critical aspects very differently, such as the computation of taxable income by comparing annual net worths and the integration of corporate and shareholder income taxes. Given that it is improbable that the United States would, or for that matter should, adopt either approach, I cannot suggest wholesale changes to the United States corporate tax system based on the way things are done in Germany. However, the German system does suggest ways in which the American system can be improved, including abandoning the 80 percent control test required for contributions to a corporation to be tax free and making the United States reorganization rules more uniform and flexible.

Perhaps the greatest value in comparing different legal taxation systems is that it grants us perspective. We can become so habituated to our own system that we forget that there are very different, perfectly viable ways of doing things. By examining tax codes in other countries with successful free-market economies, the United States can more easily identify the advantages and disadvantages of alternative approaches. Policy makers should make it a standard step to consider how other countries handle a particular area before adopting substantial changes to their own legal system. Perhaps most

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[182] *See supra* notes 108-117 and accompanying text.

[183] *See* KILLIUS, *supra* note 23, at A-28.

importantly, the United States should welcome any assistance that would help it simplify the current morass of tax provisions, both corporate and noncorporate.