Federal Republic of Germany*

I. Tax Law—Tax Reform Act Enacted

In accordance with the government's promise thoroughly to revise the German tax system during its current term, the Federal Parliament has now enacted the Tax Reform Act 1990 (the Act).[1] The Act entered into effect on the day after its publication, yet most of its substantive new features will be applicable for the first time to future fiscal years of the taxpayer. The Act contains a number of amendments to the law currently in effect that might also affect foreign investment in Germany.

A. Increased Tax Rate on Sale of Business

The Tax Reform Act has partly abolished the benefit of a 50 percent tax reduction on capital gains derived from the sale of a business.

New section 34(1) of the Income Tax Code (*Einkommensteuergesetz*) now provides for a scaled tax rate depending on the amount of the capital gain. For that part of the capital gain not exceeding DM 2 million, the tax rate is 50 percent of the rate applicable, and for the capital gain exceeding DM 2 million, but not DM 5 million, 66.6 percent. Any capital gain in excess of DM 5 million is taxed at the regular rate.

The new rule has earned mostly criticism, particularly from interest groups representing small and medium-sized businesses. In spite of the scaled rate, the new law is viewed as a burden on the shareholders of medium-sized businesses and a disincentive for necessary restructuring. The result has been to encourage many business owners to sell their investments before the new law becomes operative in 1990.

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This article covers developments between April 1987 and August 1988.

1. Steuerreformgesetz [STG], 1990, BUNDESGESETZBLATT, TEIL I [BGB1 I] 1093.

B. Withholding Tax on Interest Income

Another feature of the Act concerns Income Tax Code section 34(1), paragraph 8. The new legislation introduces a 10 percent withholding tax on interest payments from savings and bonds. While these types of income had already been taxable under the old tax law, it is generally recognized that adequate controls have not existed, and that most taxpayers have failed to include interest income in their tax returns. The new rule has been severely criticized by consumers and the banking industry. While the government argues that the withholding tax is designed only to enforce what is already law today, commentators say the new rule is inconsistent with the 25 percent withholding tax on dividend income, unnecessarily bureaucratic, and encourages taxpayers to invest their savings abroad. The Federal Reserve Bank has stated that the new rule has already resulted in increased interest rates on German bonds, putting them at a disadvantage to foreign bonds, which will remain exempt from the withholding tax. This development will encourage German issuers to market new instruments through their foreign subsidiaries.

C. Tax Rate on Undistributed Profits Lowered to 50 percent

The Tax Reform Act has lowered the tax rate on undistributed profits of corporations from 56 percent to 50 percent. The amendment to section 23(1) of the Corporate Income Tax Code, which is perhaps the most significant change affecting corporations, was considered indispensable not only to adjust the corporate rate to the new maximum personal rate (now lowered from 56 percent to 53 percent), but also to keep up with competition abroad, where corporate income tax rates are usually lower. Even though the tax rate on dividend distributions will remain at 36 percent, it is expected that shareholders will also profit from the tax break, as corporations may use the tax savings on undistributed earnings to increase dividend distributions. The new 50 percent rate will for the first time be applicable to 1990 earnings.

D. Sale of Corporate Shell

The sale of corporate shells (*Mantelverkauf*) with a substantial loss carryforward for tax purposes became in the past one and one-half years a flourishing market. In two judgments rendered in October 1986 the Federal Tax Court (*Bundesfinanzhof*) held that a corporation remained entitled to the statutory five-year loss carryforward even if after the accumulation of the loss its shareholders had completely changed and the corporation had started an entirely new business. The court itself found nothing to the contrary in the tax law and deemed itself unfit to create entirely new rules on the denial of loss carryforwards to corporate shells.

To counteract this trend the Tax Reform Act adds a new section, 8(4), to the Corporate Income Tax Code (*Koerperschaftsteuergesetz*) that disallows the sale of a corporate loss carryforward. Under the new rule, in order for a corporation to enjoy the loss carryforward, it must not only be the same legal entity, but also be "economically identical" with the corporation that suffered the losses. Economic identity will, in particular, be absent where more than 75 percent of the shares have changed hands and the corporation thereafter resumes its business activity with substantially new assets.

E. No Change in Capital Gains Taxation on Sale of Substantial Shareholding

Investors, in particular shareholders of family-owned business corporations, were relieved to find out that the Legislature has not tightened the taxation on capital gains from the sale of a substantial shareholding. Under German income tax law, capital gains upon the sale of shares are subject to income tax only if they are achieved by a business, if they are to be considered speculative profits, or if they involve the sale of a private shareholding by a taxpayer who has held a substantial shareholding at any time during the last five years prior to the sale.

The current law defines a substantial shareholding as an equity interest conferring at least 25 percent of the voting rights. The 25 percent rule is rooted in a long-standing policy of German tax law that subjects to capital gains taxation only the sale of business assets but not private assets. A 25 percent shareholder usually enjoys important voting and control rights, whether by law or by virtue of the by-laws, which give the shareholding an entrepreneurial rather than a private investment character. The Tax Reform Bill had proposed to lower the decisive quota to 10 percent. Faced with severe opposition from the public, the proposal was eventually withdrawn.

F. Silent Partnership Debt Financing Remains Possible

German corporate income tax law allows the 100 percent shareholder of a corporation to finance its subsidiary partly by equity and to a substantial degree by debt even if the consideration paid is not a fixed interest rate but a portion of profits. The scheme most widely used is a so-called silent partnership under commercial law (*"Stille Gesellschaft,"* Sections 230 *et. seq.* of the German Commercial Code—*Handelsgesetzbuch*), whereby the shareholder contributes funds to the corporation, participates in its losses and profits, and upon termination of the arrangement receives back his principal plus unpaid profits minus uncompensated losses, if any. Under German tax law, this arrangement is not viewed as a partnership but as an investment, and the subsidiary is entitled to deduct any payments to its parent as an expense, thereby lowering its taxable profits.

The Tax Reform Bill had proposed to treat such an investment as constructive equity, which would have subjected all payments to the shareholder to corporate income taxation at the subsidiary level (proposed new section 8(a) of the Corporate Income Tax Code). In a last-minute çall the proposal was dropped and referred to a more comprehensive reform yet to be worked out in detail.

II. Corporate Law

A. Law Concerning Preparation and Publication of Corporate Financials (*Bilanzrichtliniengesetz*)

When the German Bundestag, at the end of 1985, passed the Law on the Preparation and Publication of Corporate Financials implementing the 4th, 7th, and 8th EEC Directives, those mostly medium-sized German business organized in the form of a GmbH & Co. KG were relieved to find that the law did not apply to them. As this type of company, which is a limited partnership whose unlimited partner is a limited liability company (GmbH), is unknown or unlawful in most member states, the EEC Directives had not addressed it, and the German Legislature felt justified in leaving it out of the scope of application of the new law.

The European Commission reacted promptly by proposing an amendment to the EEC Directives to include partnerships that did not have any natural persons as unlimited partners. As a result of successful lobbying by the German Government, it now appears likely that the Council of Ministers will pass the amendment only if at the same time the publication Directives are amended to allow the Member States to introduce less strict publication and auditing requirements for small and medium-sized companies.

The features of the EEC Directives that concern businesses and governments not only in Germany but also in other Member States include the publication of the financials of small and medium-size corporations, the use of the number of employees as a criterion for the amount of publicity required, and the degree to which information in the published financials must be detailed. The European amendment might replace the general publication requirement for small and medium-sized corporations with a right of interested parties to inspect the financials at the companies' offices only if they can show a justified interest (so-called "house publicity") and might otherwise grant more flexibility in establishing the year-end financials.

While debates and discussions continue on a national and European level, the GmbH & Co. KG remains, at least for the time being, exempt from the publication and auditing requirements for corporations. In the meantime, however, the new publication and auditing laws for small and medium-sized corporations remain in place and must be complied with, as the Federal Minister of Justice emphasized in a general communication of July 11, 1988.

B. Limited Liability of Foreign Corporations Doing Business in Germany

Doing business in Germany through a foreign corporate entity that does not have an effective business organization in its country of incorporation may subject its directors and officers to personal liability for the company's debts.

In a recently published case decided by the Cologne District Court,[2] an English private limited company, acting through the defendant as its director, had rented office space in Germany from the plaintiff. The English corporate tenant later terminated the lease prematurely, and the plaintiff-landlord sued the corporate director for the rent payments. The court, finding that the private limited company had no true office organization in England, and applying the rule of German private international law according to which issues of corporate status and liability are governed by the law at the company's seat, held that the English company had its seat in Germany and not in England. As German procedures for incorporation had not been observed, the individuals purportedly acting on behalf of the foreign company were held personally liable for the company's debts.

This case is in line with many decisions by other courts, including the Federal Supreme Court, which applied the law at the seat of the company and not the law where the company was incorporated to determine issues of status and liability.[3] Incorporating in a foreign jurisdiction where incorporation is less costly and more expeditious is, therefore, not a way

2. Judgment of Nov. 25, 1985, Landgericht, Cologne (ordinary court of first instance), RIW 1987, 54.

3. For the most recent examples in a long line of cases, see Judgment of Mar. 21, 1986, Bundesgerichtshof (Supreme Court), 97 Bundesgerichtshof in Zivilsachen [BGHZ] 369; Judgment of May 6, 1986, Oberlandesgericht, Munich (Munich Court of Appeals) DB 1986, 1767; *see also* Ebke, *The Limited Partnership and Transnational Combinations of Business Forms*, 22 INT'L LAW. 191 (1988).

to obtain limited liability in Germany unless the foreign company carries on a real activity at its place of incorporation.[4]

III. Product Liability—Federal Government Introduces New Law

On June 6, 1988, the Federal Government introduced into the parliamentary law-making process the draft of a German Product Liability Law (Produkthaftungsgesetz), implementing the EEC Product Liability Directive.[5] After lengthy debates between industry, consumer protection organizations, and government officials, the Federal Republic of Germany will be among the last to have a new product liability law.

The authors of the draft decided not to incorporate the substantive provisions of the EEC Directive into the Civil Code but to draft a new law, which will have nineteen sections. Some of the law's features demonstrate the rather favorable attitude of the Legislature towards the interest of industry and business:

- The law excludes from the definition of "product" any unprocessed agricultural product.
- The law contains the so-called development risk defense, thus protecting the manufacturer from liability when, according to the state of science and technology at the time the product was marketed, the defect could not be detected.
- The law provides for a maximum amount of DM 160,000,000 for liability in case of death and bodily injury caused by one product or one series of defective products.

In accordance with the EEC Directive, damages for pain and suffering are not mentioned and are left to the general rules of civil law requiring fault. For special products such as pharmaceuticals, already existing legislation will remain in place. Thus, development risks do not constitute a defense against liability for defective pharmaceuticals.[6]

Although the law for the first time introduces the concept of strict liability for all types of industrial products, insurance premiums are not expected to be drastically raised.

Even though the three-year implementation period granted by the EEC Directive expired on August 1, 1988, the German Legislature has not been able to meet this deadline. The new law is now expected to enter into effect on January 1, 1989.

4. German law does, however, grant limited liability to a U.S. corporation having its principal place of business in a U.S. jurisdiction different from its state of incorporation.

5. Bundestagsdruecksache [BT-Druecksache] 11/2447.

6. Sec. 84 of the Federal Drug Law.

IV. Labor Law—New Case on Assumption of Employment Contracts upon Transfer of Business

Section 613(a) of the German Civil Code keeps the courts busy. This section, which is in accordance with an EEC labor law Directive, provides that where a business or part of a business is transferred to another party by contract, the acquiring party, by operation of law, assumes all rights and liabilities from the employment contracts existing in the business at the time of the transfer. While the Federal Supreme Labor Court (*Bundesarbeitsgericht,* or BAG) in the past years had consistently expanded the scope of application of this provision, it has now handed down several decisions showing an inclination to define limits to the rule.

In the most recent case decided by the BAG,[7] a manufacturer of pallet storage systems had decided to close down its operations and sold all machinery and equipment for the production of these systems to another manufacturer of similar systems, whose plant was about 300 km away from the seller's facilities. Prior to the sale, the seller's management and shop council had worked out a plan designed to facilitate the move of as many employees as possible to the new location. The assets sold were shipped to the buyer's premises, and some of the employees of the old business moved along with them. The BAG had to decide whether this activity constituted a "transfer of business" within the meaning of BGB section 613(a), or if it was the closing of a business and a subsequent sale of individual assets. The BAG held that in drawing the line, the relevant test was whether the former physical and personal production and business unit had been dissolved or whether it had been integrated into a new business. In applying the test, a court would have to look at such criteria as how many of the former employees had actually transferred to the new location, whether the same processes were applied, and whether the new owner operated the production program taken over as a separate business line with separate distribution channels. In the case at hand, the BAG remanded the case to the appellate court for further factual investigation.

This case illustrates that the sale of individual assets to a location far away enough to keep a substantial portion of the former staff from moving to the new location may avoid the assumption of employment contracts as a whole.

7. Judgment of Feb. 12, 1987, Bundesarbeitsgericht (high court for labor matters), Zeitschrift fuer Wirtschaftsrecht und Insolvenzpaxis [ZIP] 1987, 1478.

E. Attorneys—Federal Constitutional Court Holds Code of Professional Conduct Unconstitutional

In Germany, the educational requirements, admission, and professional organization of attorneys are governed by the Federal Attorneys' Law (*Bundesrechtsanwaltsordnung*). As far as professional conduct and ethical rules are concerned, section 43 of the law contains only a rather general clause, requiring the attorney to do his job "conscientiously" and "prove himself worthy of the respect and confidence required from him by his status as an attorney." Otherwise the law grants power to the Federal Chamber of Attorneys (*Bundesrechtsanwaltskammer*) to establish guidelines laying down the general opinion on issues of professional conduct. In accordance with the law, ethical guidelines (*Grundsaetz des anwaltlichen Standesrechts*) had been worked out, covering such topics as advertising, behavior towards courts, colleagues, and clients, and office organization. Whenever the behavior of an attorney had to be tested by the courts of professional honor, the guidelines were looked upon as a tool to interpret and specify the general requirement of professional conduct as set forth in section 43 of the law.

The Federal Constitutional Court[8] has now invalidated these guidelines as violating the freedom of profession guaranteed by the Federal Constitution. According to the court, the guidelines had taken on a quasi-statutory character, lacking constitutional legitimacy and preventing professional evolution in a changed political, economic, and social environment in Germany and abroad. The Legislature therefore has to revise the Federal Attorneys' Law to empower the professional organizations to establish rules on professional conduct by means of an ordinance (Satzung). Such rules would have to respect the individual attorney's constitutional rights, in particular the freedom of profession and freedom of speech. Until the new rules have been established, professional conduct will be governed by the general rule laid down in the Federal Attorneys' Law, which must be interpreted in accordance with the Federal Constitution and precedents decided by the courts of professional honor.

With this landmark decision, the Federal Constitutional Court has created an entirely new situation and perspective for the legal profession. Professional organizations are beginning to form committees, discussion groups, and experts' groups to start work on a new body of rules governing professional conduct. In an atmosphere of newly gained freedom, attorneys and professional organizations are rethinking their self-image and

8. Decision of July 14, 1987, Bundesverfassurgsgericht (highest constitutional court), Anwaltsblatt [AnwBl] 1987, 598.

position within a modern society and within the internal market to be established in the EEC by the end of 1992. It is expected that the new rules for the first time will allow advertising (albeit within reasonable limits), will be more liberal on attorneys' behavior in public, and will grant more freedom with respect to office and law firm organization.

VI. Banking Law—ECU Now Recognized as Quasi-Currency

Since June 1987, German residents have been allowed to open European Currency Unit (ECU) accounts and obtain ECU loans from their German banks. They may also enter into ECU contracts for the sale of goods or services upon authorization of the German Federal Bank. After mounting pressure from both the German Government and the European Community, the Central Bank Council of the German Federal Bank finally decided to allow the private use of the ECU in Germany to the same extent as foreign currency.

Since the ECU's creation in 1979, the private use of the ECU had developed tremendously outside of Germany. As a composite of the various EC Member currencies, it is a relatively stable currency and is, therefore, particularly attractive to businessmen from countries with weaker currencies. The private use of the ECU was prohibited in Germany, because the German Federal Bank refused to characterize the ECU as a currency and took the position that ECU loans were unauthorized indexed loans, which are prohibited pursuant to section 3 of the German Currency Law of 1948.

In its general communication of June 16, 1987, the Central Bank Council characterized the ECU as a currency equivalent and issued a general authorization under section 3 of the Currency Law permitting the private use of the ECU. The authorization became effective upon publication in the Federal Gazette on June 24, 1987. ECU accounts are subject to the same minimum reserve requirements as foreign currency accounts maintained by German banks. Due to the current strength of the Deutsche Mark it is not anticipated that the private use of the ECU will increase dramatically in Germany for the time being.

VII. German Antitrust Law

A. Merger Control

In the area of merger control, the Federal Cartel Office (FCO) has continued to scrutinize a great number of important mergers such as the merger between the Swiss BBC and the Swedish ASEA group and the acquisition of German Texaco GmbH by the largest German utility (RWE). Relatively few mergers, however, have actually been prohibited. Whether this is due to the fact that the FCO is beginning to apply less stringent standards of merger control is a matter of some dispute. A considerable number of merger projects are abandoned by the parties after the Federal Cartel Office has raised objections without a formal prohibition order ever being issued. Thus, German merger control law continues to exert a substantial influence upon merger and acquisition activities in Germany.

B. Joint Ventures

In the field of joint ventures the FCO has repealed the guidelines that it had issued in 1978,[9] citing the Federal Supreme Court's *Mischwerke* decision of 1986.[10] Despite being repealed, the guidelines continue to shape the actual practice of the FCO toward joint ventures. Nevertheless, the FCO's decision does not help to create legal certainty in an area of antitrust law where it is most urgently needed.

C. Legislation

Certain political groups and sectors of German industry continue to press for a new Antitrust Improvement Act, primarily with the goal of curbing the recent wave of mergers between supermarket chains. If such an amendment to the Law Against Restraints of Competition is passed which at present appears almost assured, it will in all likelihood include changes with respect to such regulated industries as banking, insurance, transportation, and energy. These industries presently enjoy far-reaching exemptions from the application of the antitrust laws.

D. Relationship to Community Law

As more and more block exemptions are being passed by the Commission, a long neglected question gains increased relevance: Can national antitrust laws and national antitrust authorities prohibit an agreement that fulfills the conditions of an EEC block exemption? Community law should prevail in these cases just as it does in cases of individual exemptions.[11] The FCO, however, continues to espouse a contrary view in an attempt to stem the tide that is slowly eroding the authority of national antitrust enforcement agencies in favor of the EEC Commission. At any rate, in

9. *See* Biannual Report of Activities of the FCO, BT-Druecksache 11/554, at 24 (1985–86).

10. Judgment of Oct. 1, 1986, BGH, 96 BGHZ, 69.

11. For a complete reasoning in support of this thesis, see Lieberknecht, *Das Verhaeltnis der EWG-Gruppenfreistellungsverordnungen zum deutschen Kartellrecht*, in: Festschrift fuer Gerd Pfeiffer 589 (1988).

all but the most local business relationships not only national antitrust law but also EEC antitrust law is applicable. Any lawyer advising with respect to German antitrust law, therefore, will have to look to Community antitrust law as well.

VIII. EEC Antitrust Law

A. EEC Commission Practice

In a number of recent decisions[12] the Commission has reiterated its long-standing opposition to restrictions on parallel imports that result in a territorial division of markets between Member States. On appeal, the Court of Justice will have the opportunity, inter alia, to pass upon the question to what extent article 85(1) of the Treaty of Rome applies to an export prohibition unilaterally imposed by the seller on his customer.

The Commission has also dealt with a number of important joint venture issues. It granted individual exemptions pursuant to article 85(1).[13] Also, it held that article 85(1) did not apply to a joint venture where the parent companies had completely withdrawn from the joint venture market and 20 percent of the joint venture corporation's stock had been sold to individual investors.[14]

B. Court of Justice

It had been considered well settled that under the EEC Treaty merger control could only be based upon article 86 and upon a (so far nonexistent) Merger Control Regulation to be passed by the Council. In what clearly constitutes the most important development during the reporting period, the Court of Justice, in its cigarette companies judgment of November 17, 1987,[15] held that article 85 of the Treaty may also apply to certain kinds of acquisitions and, possibly, mergers. Whether such application is limited to the acquisition of minority interests or not, is one of the many questions left open by this enigmatic judgment. The decision has created considerable uncertainty in the area of EEC merger and acquisition control law. It has also given a new impetus to efforts towards the enactment of a Merger Control Regulation.

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12. *In re* TippEx, 30 O.J. Eur. Comm. (No. L 222) 1 (1987); 30 *In re* Sandoz, O.J. Eur. Comm. (No. L 222) 28 (1987); *In re* Fisher-Price/Quaker Oats Ltd.-Toyco, 31 O.J. Eur. Comm. (No. L 49) 19 (1988).

13. I.C.I. v. Enichem, 31 O.J. Eur. Comm. (No. L 50) 18 (1988); Olivetti v. Canon, 31 O.J. Eur. Comm. (No. L 52) 51 (1988).

14. Case Montedison/Hercules (Himont), Bulletin EC, Mar. 1987, at 37.

15. British American Tobacco Co. and R. J. Reynolds Indus. v. EEC Commission (Philip Morris Inc. and Rembrandt Group Ltd. intervening), cases 142/84 and 154/84, [1988] 4 Common Mkt. L.R. 24, Common Mkt. Rep. (CCH) ¶ 14,405 (1987).

C. Legislation

A draft regulation concerning Know-How Licensing Agreements[16] has been published and is expected to be passed into law by the Commission during the second half of 1988 or early 1989. Furthermore, a regulation concerning Franchising Agreements[17] is likely to be enacted soon.

The greatest attention is presently focused on the draft Merger Control Regulation.[18] In its present form, the regulation would apply to all mergers where the merging enterprises are active in more than one Member State. Excepted are mergers where the worldwide turnover of all merging enterprises is below one billion ECU, where the worldwide turnover of the acquired enterprise amounts to less than 50 million ECU, or where the merging enterprises derive more than 75 percent of their total turnover from one member state. The extraterritorial application of the regulation is not clearly spelled out, but it is expected that the "effects"[19] test will be used for merger control as well.

A merger is considered incompatible with the Common Market if it would result in an enterprise acquiring or strengthening a dominant position in the Community or in a substantial part of the Community. This criterion seems to be modeled following the lines of section 24 of the German antitrust law. Exemptions similar to those of article 85(1) of the Treaty are available. The draft regulation also provides for mandatory premerger notification and a waiting period of two months, which can be extended to a maximum of six months.

In Germany the relationship between the EEC Merger Control Regulation and the merger control provisions of German antitrust law is a matter of considerable debate, since the FCO stands to lose a lot of its authority in this field when a community-wide merger control is enacted. On the other hand only a community-wide standard of merger scrutiny will ensure that cross-border mergers and acquisitions—de facto one of the most important means of European integration—will be able to include Germany to the same degree as, for example, Italy, which still has no antitrust law at all. The German industry, in fact, would welcome a European merger control as this would ensure a level playing field for German corporations.

16. 30 O.J. Eur. Comm. (No. C 214) 2 (1987). (The Draft Regulation has since been modified in certain aspects.)

17. 30 O.J. Eur. Comm. (No. C 229) 3 (1987), [1988] 4 Common Mkt. L.R. 569, 570.

18. *Amended proposal for a Council Regulation (EEC) on the control of concentrations between undertakings*, 31 O.J. Eur. Comm. (No. C 130) 4 (1988).

19. The place of the effects doctrine in EEC antitrust law doctrine is one of the issues that the Court will pass upon in its judgment in the Wood Pulp cases. 28 O.J. Eur. Comm. (No. C 127) 4 (1985) (Case 89/85); 28 O.J. Eur. Comm. (No. C 148) 4 (1985) (Case 104/85); 28 O.J. Eur. Comm. (No. C 152) 5 (1985) (Case 114/85); *Id.* at 6 (Case 116/85); *Id.* at 7 (Case 117/85).