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Inbound Inversions for German Technology Companies

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I. INTRODUCTION

Inversions have received an enormous amount of attention in the United States in recent years, as scores of companies have relocated to more tax-friendly jurisdictions. However, many non-U.S. companies (particularly in the technology area) may find it preferable to move into the United States to gain access to the U.S. capital markets, thereby creating local law exit tax issues. Set forth is a case study with a fairly typical fact pattern involving a German technology company that is evaluating the consequences of relocating to the United States. We discuss both the German and U.S. tax aspects.[1]

II. FACTS OF THE CASE

To put the discussion in some context, we consider the following case. Max, a German citizen, and Karol, a Polish citizen, start their own company after graduating from university. They are both former IT students. They live and work in Berlin where Max was born and raised and where Karol has spent the last three years. Karol has come directly from Poznan, Poland, where he lived before.

The two incorporate a German limited liability company for the venture, a GmbH (''GerCo''). Max holds 55% of the shares in the GmbH via a private limited liability holding company, a German UG (*haftungsbeschränkt*). Karol holds 45% of the shares directly. The two are directors of the GmbH. Max is the CEO, crucial for marketing and developing the business, whereas, Karol is the CFO and CIO, responsible for finances and technology. Because a German UG provides limited liability for its owners, under the U.S. tax system its default classification is that of a corporation for U.S. federal income tax purposes. Since Max has made no election regarding its classification, it will be treated as a corporation for U.S.

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* The authors gratefully acknowledge the helpful comments of Stephen Lessard, a Senior Associate in the New York office of Orrick, Herrington & Sutcliffe LLP.

[1] U.S. portfolio investors might be willing to invest in a German company, but the associated due diligence is likely to be more difficult and costly. In addition, if dividends are anticipated, there will be additional taxation since any dividends, like U.S. dividends, are likely to qualify for a preferential tax rate applicable to ''qualifying dividends.'' Under the foreign tax credit limitation, when a dividend is a qualifying dividend (and subject to a maximum tax rate of 20%), the amount eligible for the credit is reduced. As a result, the German withholding tax will not be fully creditable. (The zero German withholding tax rate under Article 10(3)(a) of the U.S.-Germany Income Tax Treaty (''U.S.-Germany Treaty'') will be available only to certain controlling shareholders, not to portfolio investors.) Pension plans, however, should generally benefit from a zero withholding rate under Article 10(b)(3). Thus, the overall effective rate may be higher than comparable dividends from U.S. corporations.

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federal income tax purposes.[2] Neither Karol nor Max are members of a church entitled to apply church tax in Germany.[3]

Two years later, the two have grown the German business and incorporated a Delaware corporation for their U.S. business (''U.S. Subsidiary''). U.S. Subsidiary is a 100% subsidiary of GerCo and a marketing platform for internet solutions created in Berlin. It is essentially managed out of Berlin. So far, the two have used their own money to fund the business. Now they want to raise $5 million in Silicon Valley. They offer a 30% stake of preferred stock in their business (convertible into ordinary voting stock) and find investors on these conditions. The investors expect to invest in a U.S. company rather than GerCo. In order to address this situation, Max and Karol consider ''flipping'' their interest in GerCo into a U.S.-based structure. To accomplish this, they would exchange the GerCo shares for shares of another U.S. company (''U.S. HoldCo'').

A year later, Max wants to move to San Jose, California, to grow the U.S. business further from there. At that time, they foresee a joint exit within the next three years if a minimum valuation of $50 million can be reached for the total equity, of which at least 50% would be payable in cash. Upon the sale, Karol may want to leave Germany and move to either London, Barcelona, or back to Poland. The plan is for Max to become the sole managing director of the U.S. entities whereas Karol will become the sole managing director of GerCo.

We review the tax implications of each of these steps in III.A. to III.D., below.

As an alternative, to effect the flip, Max and Karol consider exchanging their GerCo shares for U.S. Subsidiary shares, such that they and GerCo would be the owners of U.S. Subsidiary, and then redeeming the interest of GerCo. This is discussed in III.E, below. As a second alternative, they consider selling U.S. Subsidiary or GerCo to U.S. HoldCo. This is discussed below in III.F.

III. TAX ISSUES

A. General Comments

In order to raise U.S. capital, the two German-based founders consider ''inverting'' the shareholding

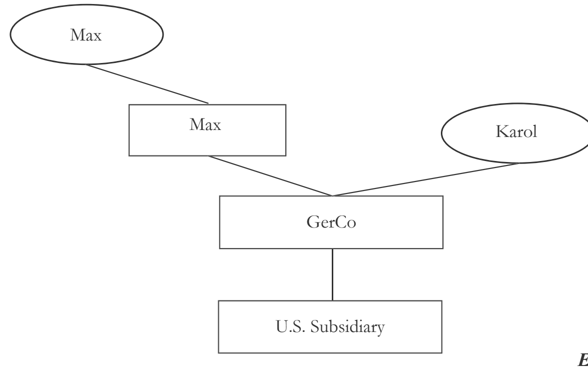

Exhibit 1

structure. Their German holding company will become the subsidiary of a U.S. company which, in turn, takes out the new capital. The German tax effects of such ''inversion'' are at the center of the following analysis.

Additional German tax issues raised include the tax residence of the different companies and German exit tax on corporate and personal levels.

Creating a U.S. holding company will cause the German subsidiary to fall under the U.S.-controlled foreign corporation regime. That is, GerCo, a subsidiary of a U.S. corporation, will be a controlled foreign corporation for U.S. federal income tax purposes. GerCo's income will be taxable either as earned, if it falls within certain categories of Subpart F income, or, if not, upon repatriation to the United States. (Some taxpayers create an international holding company to facilitate the movement of cash in this situation.) In addition, U.S. Subsidiary will no longer be able to reduce its tax base with intercompany debt.

If the transaction was reversed — that is, a U.S. company was moved under a German company — the transaction could be subject to §7874 and the shareholders subject to taxation under §367. Under §7874, if the assets or stock of a U.S. entity are transferred to a foreign entity and 80% of the vote or value of the U.S. entity shares are owned by the same shareholders, the entity will be deemed to be a U.S. corporation.[4]

Additionally, under §367, if a U.S. person transfers property to a foreign corporation in what otherwise would be a tax-free exchange, the U.S. person will recognize gain on such transfer. The regulations provide an exception to the general rule of §367(a)(1) for certain transfers of stock or securities of a domestic corporation (the U.S. target company) by a U.S. person to a foreign corporation. This exception only applies, however, if the U.S. target company complies with certain reporting requirements and if four condi-

[2] Reg. §301.7701-3(b)(2)(i)(B). Unless otherwise indicated, all ''section'' or ''§'' references are to the U.S. Internal Revenue Code of 1986 and ''Reg. §'' references are to the regulations issued under such section.

[3] Taxpayers may have to pay an add-on of 8% or 9% of their income tax under the so-called church tax. This tax is earmarked for certain religious institutions in which they participate.

[4] §7874(a) and §7874(b). If the 60% continuing shareholdings criterion is met, the corporation is considered a surrogate foreign corporation. When this test is met, the taxable income of the entity is in no event less than the inversion gain. §7874(a)(1).

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tions are satisfied.[5] One condition requires the active trade or business test to be satisfied, which, in turn, requires the substantiality test to be satisfied (among other requirements).[6] The substantiality test is satisfied if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company.[7] Under this test, the transferee foreign corporation must have been engaged in an active trade or business for the entire 36-month period before the transfer. Further, the fair market value of the transferee foreign corporation generally does not include assets acquired outside the ordinary course of business within the 36-month period preceding the exchange if they produce, or are held for the production of, passive income or are acquired for the principal purpose of satisfying the substantiality test.

B. The Start-Up Raises Capital in the Silicon Valley — Inversion by Way of Exchange of Shares in GerCo for Shares in U.S. HoldCo

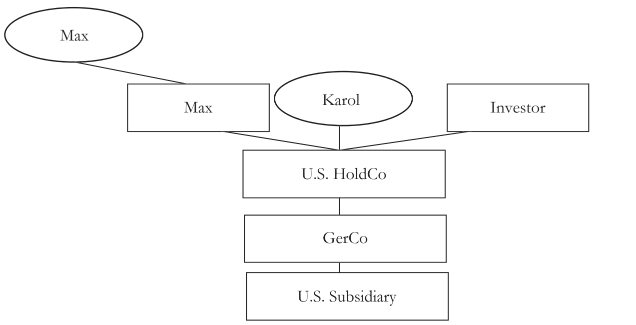

Exhibit 2

Final Structure

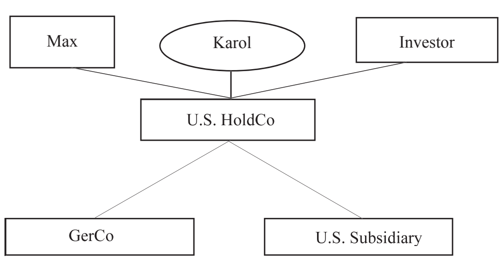

Exhibit 3

1. Germany

The "inversion," by way of an exchange by the founders of GerCo shares for newly issued ordinary U.S. HoldCo shares, will be burdened with German tax considerations. After the exchange, U.S. HoldCo would own GerCo, which in turn owns U.S. Subsidiary (see Exhibit 2). In a second step, U.S. Subsidiary will be transferred from GerCo to U.S. HoldCo to achieve the final structure (see Exhibit 3), which constitutes a further German taxable event.

The inversion cannot be achieved in a tax-neutral manner for German income tax purposes (no rollover of gain). For German tax law purposes, shares in the German company are deemed to be transferred at a fair market value. A taxable gain will arise if such value is higher than the book value — the latter of which is often equivalent to the initial small capital contribution. Taxability of the gain is particularly unfortunate because the founders do not benefit monetarily from the subsequent entry by the U.S. investor as his money goes into the company. A common mechanism of mitigating the taxable gain in the European Union ("EU") and other countries of the European Economic Area ("EEA") is a "rollover" by way of a transfer of shares at book value (e.g., transfer of shares in a German GmbH to a Dutch BV).[8] However, the rollover regime is not applicable in the case of a flip into a U.S. corporation.[9] Exchanging the GerCo shares for shares of a company of an EU jurisdiction first, which has a more favorable regime toward the United States, and then exchanging these EU company shares for U.S. HoldCo shares, will not mitigate the issue, as Germany will uphold its right to tax the second exchange.[10] Thus, mitigation of the taxable gain is not possible.

However, there are certain tax relief mechanisms. In the case of Max's holding company, which holds the GerCo shares prior to the exchange, 95% of the gain will be tax-exempt, with approximately 30% aggregate tax applying to the remaining 5% (approximately 1.5% effective tax rate).[11] If there are transaction expenses, the effective tax rate is further reduced. In the case of Karol, being an individual, 40% of the capital gain will be tax-exempt,[12] with 60% of the

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[5] The four conditions are in Reg. §1.367(a)-3(c)(1)(i) to §1.367(a)-3(c)(1)(iv).

[6] The "active trade or business test" is set forth in Reg. §1.367(a)-3(c)(3).

[7] The "substantiality test" is set forth in Reg. §1.367(a)-3(c)(3)(iii).

[8] *Cf.* §21(1), (2) of the German Reorganisation Tax Act (*Umwandlungssteuergesetz*, "GRTA").

[9] A U.S. corporation is not listed under §1(4) no. 1 GRTA. Such provision determines which entities qualify for the rollover regime under German tax law if they receive shares in the transferred entity in a share exchange.

[10] *Cf.* Art. 13(5) of the U.S.-Germany Treaty.

[11] *Cf.* §8b(2), §8(3) of the German Corporation Tax Act (*Körperschaftsteuergesetz*, "GCTA"). Aggregate nominal rates of corporate taxes (corporation tax including the solidarity surcharge and trade tax) are approximately 30% on aggregate.

[12] *Cf.* §3 no. 40(c), §17(1) of the German Income Tax Act (*Einkommensteuergesetz*, "GITA").

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gain being taxed at up to 47.475%[13] (effective tax rate of up to 28.485%). However, this may still have a prohibitive effect on engaging in such a transaction.

As the tax applying to the share exchange may be particularly prohibitive for Karol and, to a lesser degree, Max's holding company if they do not receive a cash purchase price from the investor, valuation of the founders' stock at the time of the exchange will be crucial.

Such valuation will be important toward refuting the German tax authorities' likely argument that the pre-money valuation can be based on the Venture Capital (''VC'') valuation offered by the investor (here, $5 million for 30% shares). An argument supporting a lower value of the founders' shares is that early-stage investments usually do not reflect actual company value but rather uncertain growth potential. A further argument is that the new investment is structured as preferred equity, which, as long as the holder does not convert it into common stock, grants him preference repayments in case of liquidation or sale or other preferences compared to the founders' shares. The German tax authorities explicitly acknowledge in a decree on gift tax[14] (which is not directly applicable but has indicative value) that such preferences may reduce valuation for the other stock.

Any subsequent transfer of U.S. Subsidiary shares by GerCo to U.S. HoldCo would constitute a further taxable event in Germany, deemed to be effected at the fair market value of U.S. Subsidiary's shares. A 95% tax exemption on any gain realized should be available.[15] Additionally, German withholding tax may be attracted if GerCo sells its shares of U.S. Subsidiary to U.S. HoldCo for less than fair market value (the difference of which would be treated as a constructive dividend), but it should be possible to get relief under the U.S.-Germany Treaty.

2. United States

The exchange of the GerCo shares for U.S. HoldCo shares will not be taxable in the United States, as neither Max's holding company nor Karol are U.S. tax residents.

The structure results in a ''sandwich'': U.S. HoldCo has shares in a German company which in turn owns shares in a U.S. corporation (U.S. Subsidiary). Dividends from U.S. Subsidiary would be subject to U.S. withholding tax (although the rate of tax may be 0% if the provisions of Article 10(3) of the U.S.-Germany Treaty are met). Once the dividends are paid to the German company, they would be taxable under the Subpart F rules as well.[16] Thus, there would be some tax inefficiencies.

To eliminate the structural inefficiency, it would be necessary for GerCo to sell U.S. Subsidiary or declare a dividend of the U.S. Subsidiary shares to U.S. HoldCo. The sale of U.S. Subsidiary or the dividend would be taxable to GerCo under the Subpart F rules.[17] However, it would allow U.S. HoldCo and U.S. Subsidiary to file consolidated tax returns.

It might also be possible to spin off U.S. Subsidiary to U.S. HoldCo in a tax-free transaction if the requirements for tax-free spin-offs can be met. Under §355, the distribution of the stock of a subsidiary that is ''controlled'' by another corporation may not be subject to tax, either at the corporate level or to the recipient shareholders, if a number of requirements are met.

The benefits of the tax-free spin-off rules are available only to transactions that meet very rigid requirements contained in §355. Among the requirements is an active trade or business requirement. This rule applies to both the corporation being distributed and the distributing corporation. Under this provision, the trade or business must have been actively conducted throughout the five-year period ending on the date of the distribution. This would not be met under the facts here, so the transaction would not qualify.

C. Max Moves to San Jose

1. Germany

Max's move to San Jose may attract German exit tax on multiple levels.

First, the corporate level may be affected. Note that, before Max's move, all companies are fully liable to German tax (*unbeschränkt steuerpflichtig*) as a result of having Berlin-located central management.[18] German tax authorities will likely seek to uphold such right to tax when they consult with U.S. tax authorities regarding the tie-breaker rule of the U.S.-Germany Treaty.[19] Companies fully liable to German tax would thus potentially include U.S. Subsidiary and, eventually, U.S. HoldCo, which are U.S.-incorporated entities that are tax resident in Germany. The U.S. tax authorities likely will insist that the U.S.-incorporated entities be U.S. tax resident only.

The crucial point is that, for purposes of German tax law, Max's relocation will cause any company in

[13] This is the maximum income tax rate including the solidarity surcharge.

[14] *Cf.* Ministries of Finance of the German Federal States, decree of 15 March 2012, §3.3.5 (Federal Tax Gazette I 2012, p. 328).

[15] GCTA §8b(2), §8b(3).

[16] §954(c)(1)(A).

[17] §954(c)(1)(B).

[18] GCTA §(1) nos. 1, 5.

[19] U.S.-Germany Treaty, Art. 4(3).

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which Max is the central executive (U.S. HoldCo, U.S. Subsidiary, Max's holding company) to be subjected to German exit tax on the value reserves in their assets that have so far been untaxed in Germany.[20] Value reserves in the assets of these companies will be determined by comparing the assets' fair market values to their carrying book values under German law. By the mere wording of the law, this consequence may also apply in respect of assets that are deemed not to relocate to the United States, but are continuously attributable to a Berlin permanent establishment of the relocating entity.

Note that some scholars suggest that German exit taxation may even have an effect at the level of the respective companies' shareholders (Max's holding company, Karol, GerCo, and Max) in this case and attract taxable gains from a deemed liquidation of the entity on their level.[21] This consequence may not be covered by the wording of the law and is not recognized by other scholars, however.[22]

To prevent any aforementioned German taxation, the central place of management of any of the companies would have to be perpetuated in Germany (by installing German-resident managing directors in these companies). Such strategy may prove operationally difficult for U.S. HoldCo and U.S. Subsidiary given the role Max will assume in the United States under the group strategy.

Perpetuating the German residence would also mean that any later sales gains will continue to be subject to German tax. In this context, it may be beneficial, if valuation permits, to exit Germany and fund taxes arising rather than postponing German taxation.

Second, on a personal level, a taxable relocation and subsequent exit tax may further apply to Max with regard to his shareholding in his personal holding company under the German Foreign Tax Act.[23] German exit tax regarding corporate participations applies on the personal level if an individual person has been tax-resident in Germany for at least 10 years in aggregate during his life. Unconditional deferral of such tax will be granted only if the relocation occurs within the EU or countries of the EEA, but not if relocation occurs to the United States.[24]

Note that criteria for change of residence of an individual are different from those of a corporation under German law. For the latter, the location where day-to-day management decisions are taken on a continuous level is relevant; for the former, the habitual abode and center-of-life interests are relevant.[25] An individual person with a double abode can spend the majority of his time (in days) in one country and still maintain his vital interests in another country over years. Such a split is much less conceivable for a corporation.

As a result, Max may argue that despite his (allegedly) temporary move he has kept his vital interests in Germany and, thus, kept his tax residence there. He needs to maintain an apartment at his personal disposal in Germany for such argument, though, when moving to San Jose. Such strategy is not without risks if Max cannot demonstrate merits for this argument continuously because the German tax authorities may challenge the argument and apply exit tax to share values upon the relocation or at a later point in time. As with the corporate level, it may even be beneficial for Max, if valuation permits, to exit Germany and fund any taxes arising on his personal level rather than postponing German taxation.

If any tax was attracted under the German Foreign Tax Act on Max's personal level, Max would be eligible to postpone payment of the tax by paying it in five annual installments if he presented security for the tax.[26] If Max gave up his vital interests in Germany, but proved his intentions to leave Germany only temporarily, further relief may be available.[27]

2. United States

Max's move to the United States is likely to make him a tax resident in the United States. The standard is whether he meets a 183-day presence test over a three-year period.[28] This test counts all the days he is present in the current year, one-half of the days he is present in the first year before the current year, and one-sixth of the days he is present in the second year before the current year. (This test is referred to as the ''substantial presence test.'') As a U.S. tax resident, he would be subject to worldwide taxation. In addition, Max's holding company would be subject to the controlled foreign corporation regime. Passive income earned by the holding company would be subject to immediate taxation, and no credit would be available for German taxes paid.

If Max is both a U.S. and a German tax resident, the U.S.-Germany Treaty will apply to determine resi-

[20] GCTA §12(3).

[21] *Cf.* Benecke/Staats, in Dötsch et al., *Körperschaftsteuergesetz*, Dec. 2012, §12 margin no. 513.

[22] *Cf.* Lambrecht, in Gosch, *Körperschaftsteuergesetz*, Dec. 2009, §12 margin no. 100 *et seq.*; Hofmeister, in Blümich, *Körperschaftsteuergesetz*, 2012, §12 margin no. 105 *et seq.*

[23] *Cf.* §6(1) of the German Foreign Tax Act (*Außzensteuergesetz*, ''GFTA'').

[24] GFTA §6(5).

[25] *Cf.* U.S.-Germany Treaty, Art. 4(2), 4(3).

[26] GFTA §6(4) sent. 1 (personal hardship, as additionally required under the provision, can be demonstrated by lack of funds to pay the whole tax initially).

[27] GFTA §6(4) sent. 3.

[28] §7701(b)(3).

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dence. An ordering rule applies under Article 4 of the U.S.-Germany Treaty, looking first at where he has a permanent home, then where his vital interests are. If he has a habitual abode in both or neither, he is deemed to be a resident of the state in which he is a national. If none of the foregoing tests are met, then the Competent Authorities must settle the question by mutual agreement.

D. Sale of U.S. HoldCo on a $50 Million Valuation for 50% Cash and 50% Shares

1. Germany

Here we consider the consequences of a sale of U.S. HoldCo for $50 million. Each of Max's holding company, Karol, and the investor would sell their respective interests.

The sale of 38.5% (55% of 70%) of U.S. HoldCo shares by Max's holding company for $19,250,000, will not attract German tax if exit tax has been incurred in Max's holding company upon his prior relocation to San Jose, and his holding company would be deemed tax-resident in the United States thereafter.[29] If Max's holding company's central place of management had successfully been retained in Germany at that time, German tax would apply at approximately 1.5% of the gain (approximately 30% aggregate tax rate of 5% taxable gain).[30] With a realized gain of up to $19,250,000, application of the rules may result in the EUR equivalent of approximately $290,000 ($19,250,000 × 1.5%) of German tax.

Karol will be taxed in Germany on 60% of the capital gain from the sale of his 31.5% (45% of 70%) interest in U.S. HoldCo shares for $15,750,000, at a maximum rate of 47.475%, leading to an eventual German tax charge of the EUR equivalent of up to $4,490,000 (31.5% of 47.475% of 60% of $50 million).[31]

Karol may, however, avoid such German taxation at the exit if he restructures his residence before selling the shares.

Based on the fact that Karol will have spent less than 10 years in Germany on aggregate during his lifetime, he can leave Germany and terminate his tax residency without incurring a German exit tax with regard to value increases of the shares in U.S. HoldCo under the Foreign Tax Act.[32] Relocation provides for an imminent end of Germany's right to tax such value increases. U.S. HoldCo shares, being shares of a non-German corporation managed outside Germany at this time (Max has moved to San Jose), will cease to be German-source assets after Karol's potential relocation. If Karol sells the shares from abroad, Germany will not tax the gain. Of the three potential destinations (London, Barcelona, or Poland), Karol may consider choosing the one with the most favorable tax regime in relation to the capital gain from the sale.

Without further restructuring, Karol's relocation will lead to the relocation of the central place of management of GerCo. This could lead to potential exit tax and German taxable gains on the GerCo level.[33] To avoid these effects, Max and Karol may consider replacing Karol as managing director of GerCo with a German resident prior to his relocation.

2. United States

Assuming Max is a German tax resident, the sale of U.S. HoldCo shares by his holding company will not generate U.S. tax. However, if he is a U.S. tax resident and Max's holding company disposes of the shares, then this gain will be passive income and will trigger application of the Subpart F rules because capital gains are considered a category of passive income. The gain will create a deemed dividend. This will be taxed to Max at the rate of 39.6% or $7,623,000. This may also be subject to tax in California at the rate of 12.3% or $2,367,750 ($19,250,000 × 12.3%) if he is tax-resident there. The Medicare tax of 3.8% ($731,500) would also be due, but this would not be payable until a distribution had occurred, unless he elected to be taxed at the time of the Subpart F inclusion.[34] This compares to the $290,000 payable in Germany if Max is tax-resident there.

Assuming Karol is a German tax resident, the sale of U.S. HoldCo shares will not generate U.S. tax. However, if he is a U.S. tax resident, capital gain will be taxable at the rate of 20%, resulting in tax of $3,150,000, on $15,750,000 of gain. In addition, California state taxes might apply at the rate of 12.3%, resulting in tax of $1,937,250, although the tax would be payable in the year of distribution. The Medicare tax of $598,500 ($15,750,000 × 3.8%) would also be due and no deferral election would be available.[35] If German tax applies as well — here, approximately

[29] U.S.-Germany Treaty, Art. 13(5).

[30] GCTA §8b(2), §8b(3); under the U.S.-Germany Treaty, Max's holding company should be deemed a German taxpayer in this case.

[31] GITA §17(1), §3 no. 40(c).

[32] GFTA §6(1) sent. 1.

[33] GCTA §12(3).

[34] Reg. §1.1411-10(g).

[35] The Medicare tax is 3.8% on passive income over certain thresholds. It was enacted to fund the Obama Administration's health care program.

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$4,490,000 — a credit may be allowed for U.S. federal income tax purposes because the source of gain will be deemed to be Germany under Article 23(2) of the U.S.-Germany Treaty. No foreign credit would be available for purposes of the California tax. The operation of the foreign tax rules are subject to a number of complexities, though.[36] Most notably, the credit may not exceed the U.S. tax that the income (after deductions) would be subject to. Once again, the German tax is lower in this situation, although not by the same magnitude as in Max's holding company's case.

E. Alternative: Exchange of GerCo Shares by Max's Holding Company and Karol for Shares in U.S. Subsidiary

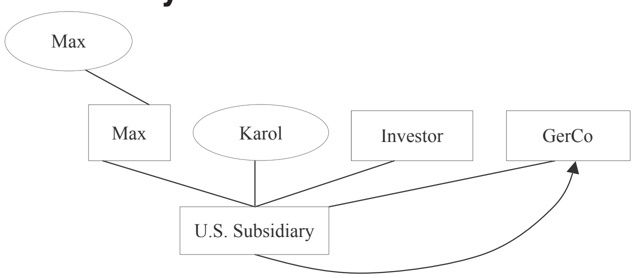

Exhibit 4

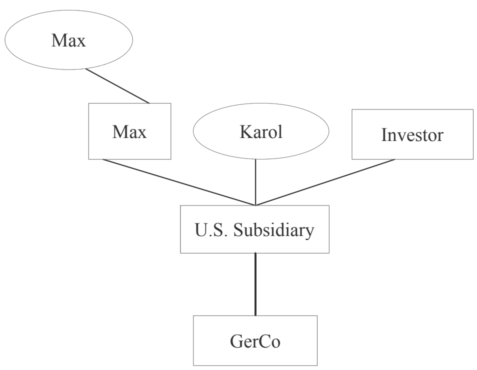

Exhibit 5

In this section we discuss an exchange of GerCo shares for newly issued shares in U.S. Subsidiary. Because this will create some cross-ownership, it will be necessary to redeem GerCo with respect to its shareholdings in U.S. Subsidiary.

1. Germany

An exchange of GerCo shares by Max's holding company and Karol for newly issued ordinary shares in U.S. Subsidiary will create similar tax effects in Germany as depicted above for the exchange of GerCo shares into U.S. HoldCo shares in III.B., above. A tax-neutral rollover will not be possible. Tax will apply at the above-mentioned rates on any gain, so valuation will be as important as before.[37]

As a result of the exchange, GerCo shares will be held by U.S. Subsidiary, whereas, U.S. Subsidiary shares would be held by GerCo (cross-holding) and by Max's holding company and Karol. U.S. Subsidiary could now issue preferred stock to the investor. To eliminate the cross-holding, U.S. Subsidiary shares held by GerCo could be redeemed for cash. Redemption would be a taxable sales event in Germany,[38] but a 95% tax exemption should apply to any capital gain.[39] If redemption was made below fair market value or any cash paid was redistributed, German (constructive) dividend taxation would also apply and attract German withholding tax.[40] Full relief from withholding tax would depend on meeting the criteria of the U.S.-Germany Treaty, which seems unlikely here.

Relocation of management from Berlin to the United States correspondingly may attract German exit tax, and the final sale of the shares in U.S. Subsidiary would attract German tax on capital gains at the level of any German tax-resident seller.[41]

2. United States

The cross-ownership would need to be eliminated. Otherwise, dividends from U.S. Subsidiary would be subject to U.S. withholding tax when paid to GerCo. While redemptions are usually treated as dividends for U.S. tax purposes (and, as such, subject to U.S. withholding taxes), they can be considered capital gain transactions if they are substantially disproportionate.[42] Because these are capital gain transactions, GerCo would not be subject to taxation unless it has a permanent establishment in the United States and the profits are attributable to it.[43] Here, because the ownership level would be reduced from 55% and 45% to 38.5% (70% of 55%) and 31.5% (70% of 45%), the requirements for a substantially disproportionate redemption of stock would be met.

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[36] §904(a).

[37] See III.B.1, above. Karol will be subject to income tax on any gain at an effective tax rate of up to 28.485% (40% tax exemption, 47.475% maximum rate); Max's holding company will be subject to tax at an effective rate of approximately 1.5% (95% tax exemption, approximately 30% aggregate corporate tax rates).

[38] *Cf.* German Federal Ministry of Finance, decree of 27 November 2013, §C (DStR 2013, p. 2700).

[39] GCTA §8b(2), §8b(3).

[40] GITA §43(1) sent. 1 no. 1, sent. 3.

[41] See strategies relating to potential German taxation on relocation and final sale in III.C.1. and III.D.1., above.

[42] §302(b)(2).

[43] U.S.-Germany Treaty, Art. 7(1).

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F. Second Alternative: Sale of U.S. Subsidiary to U.S. HoldCo

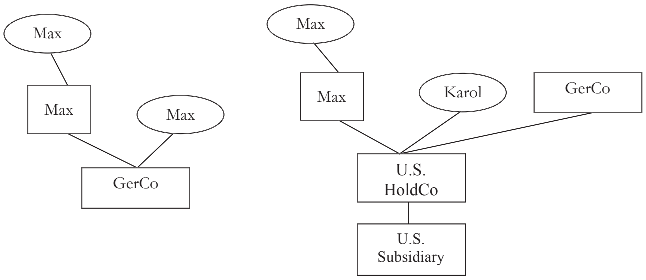

Exhibit 6

Final Structure

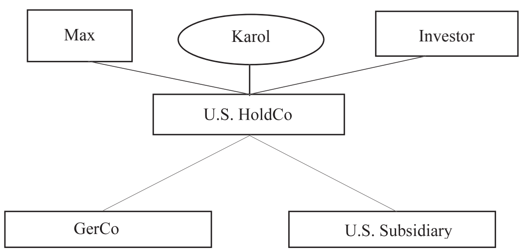

Exhibit 7

In this section, we consider an outright sale of the U.S. Subsidiary shares by GerCo to U.S. HoldCo followed by a sale of GerCo shares by Karol and Max's holding company to U.S. HoldCo.

1. Germany

Selling the U.S. Subsidiary and GerCo shares to U.S. HoldCo creates several practical issues:

(1) A sale is typically characterized by a sale price being realized by the seller. Sellers in this scenario are GerCo with respect to the sale of U.S. Subsidiary shares, and Max's holding company and Karol with respect to the sale of GerCo shares. But the investor will typically not allow its investment capital to leave the structure in which he invests. If the sellers insisted on any such cash-outflow from the jointly held structure, they would in fact ask for a different economic deal than under an inversion scenario. The founders would likely need to contribute the sales price to U.S. HoldCo, to give the investor the same economic deal.

(2) No U.S. or German tax benefits can be achieved by a share sale in comparison to a share exchange.

(3) Again, relocation of management from Berlin the United States and the final sale of shares in U.S. HoldCo will attract the aforementioned German tax issues.[44]

2. United States

Similar to the first structure in III.B. involving an exchange into U.S. HoldCo, this alternative is attractive from a U.S. perspective because the end result — namely, having a U.S. company own the Germany subsidiary — puts the companies in the most efficient structural position. It also avoids the problematic sandwich structure that existed in the case in III.B. and the cross-ownership in III.E. The sale of the U.S. Subsidiary shares will not be taxable in the United States. Similarly, the sale of the GerCo shares will not be taxable.

IV. CONCLUSION

Raising capital by way of inversion or share sale to U.S. HoldCo and transferring management functions from Germany to the United States raises a number of German and U.S. tax issues with regard to the taxation of capital gains, exit taxation, and withholding taxes on both sides.

Creating a sensible corporate structure after an inversion or share sale to eliminate the sandwich structure where one German entity is caught in between two U.S. entities will add further tax issues. From a German perspective, an inversion into a U.S. structure will inevitably be a taxable event, so it should be done when valuation is still low if no cash purchase price is paid to finance German tax.

Founders should hold their interest in their company through holding companies to profit from greater German tax benefits in case of a taxable sale or inversion. However, relocation of central management from Germany to the United States will create German exit tax issues on the corporate level where German-resident companies are affected, and potentially on the personal level of the relocating manager. One may consider strategies to avoid exit taxation upon relocation of management within the boundaries of what is legally possible and feasible from a management structure. Note that, under German tax laws, a company will be treated as German-resident irrespective of its legal form (U.S. company or German company) if its central place of management is in Germany. However, the use of a non-U.S. holding company has potential adverse consequences if the owner is a U.S. tax resident at the time of the exit, since such a holding company will be a controlled foreign corporation. Relocation and effects on tax residence will therefore have to be scrutinized very closely upfront with regard to both tax regimes.

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[44] *See* III.C.1., III.D.1. and III.E.1., above.

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Looking at the primary scenario in III.B. and the two alternatives in III.E. and III.F., German tax effects will be similar given that in each case the whole business will be brought from underneath a German holding company to underneath a U.S. holding company (U.S. HoldCo in the primary scenario and the second alternative, and U.S. Subsidiary in the first alternative) and in each case triggering a taxable event. However, U.S. tax considerations — likely relating to the need to eliminate GerCo ownership of U.S. Subsidiary (that is, the so-called sandwich) or the cross-ownership — may make one of the alternatives more compelling than the others.

Founders and investors should look carefully at these issues in order to avoid unpleasant surprises along the way. If the United States is the likely source for raising capital, a U.S. structure involving a Delaware corporation or limited liability company may be more appropriate. Note also that, for German tax purposes, the central place of management of the entity outweighs the use of German or U.S. legal forms.

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