Germany: interest barrier, loss of losses and other delicacies

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The 2008 tax year marked one of the deepest cuts in modern German tax history: the introduction of the new interest barrier rules (Zinsschranke), i.e., a deduction ceiling also for interest paid on genuine third party loans. These rules, infringing the constitutional principle of net taxation, will cut deeply into the financing structure of German and foreign enterprises, and investors engaged in Germany. Another severe aggravation of the taxpayers’ position is caused by the cancellation of carried-forward losses as a result of certain transactions. By contrast, the partial withdrawal of a ‘centennial reform’ of German tax law, i.e., the exemption of dividends from corporate income tax, for portfolio dividends received from shareholdings of less than 10% that had been initiated following pressure from the European Commission, was stalled – at least for the time being.

Interest barrier

Basic rule

According to the basic rule, interest paid by a business is deductible as business expenses in the amount of interest earned during the same fiscal year. To the extent that the amount of interest expenses is higher than the interest earned, the net interest expenses (excess of interest paid over interest earned) are only deductible up to 30% of the EBITDA of the business concerned. The new interest deduction rules apply as of the 2008 tax assessment year.

Foreign corporations are subject to these rules even if they only earn passive income from German sources – in particular, income from the non-commercial

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letting of properties situated in Germany. However, partnerships with only passive income are not affected by the new rules.

In contrast to previously applicable law, the interest deduction ceiling not only covers certain financing structures under the aspect of abuse, e.g., certain shareholder loans or back-to-back financing structures intended to circumvent shareholder loans, but every kind of debt financing, in particular genuine third party (even non-recourse) loans granted by banks.

Interest expenses which cannot be deducted due to the application of these rules will be assessed and carried forward to the following fiscal years, in which they may possibly be deducted, again subject to the interest barrier. In case of termination or transfer of the business, interest carried forward is lost. If a partner withdraws from a commercial partnership, interest carried forward is lost proportionate to his interest in the partnership.

The interest deduction ceiling also applies to trade tax. However, to the extent that interest expenses are non-deductible due to the ceiling, they are not added to the trade tax base. In contrast, 25% of the interest which remains deductible for corporate income tax purposes, even when the interest barrier is applied, must be added back for the determination of the trade tax base.

Exceptions to the interest deduction ceiling

The new law contains three main exceptions to the basic interest deduction ceiling rule. Unfortunately, these exceptions are sometimes so complex and, at the same time, so unclear in detail that they hardly seem to be applicable in practice. Malicious tongues maintain that they were purposely made that way in order to prevent their invocation.

**Exception 1: exemption threshold**

This is still a simple one: the interest deduction ceiling does not apply if the amount of net interest expenses is lower than €1m. In this event, all interest is deductible as business expenses. However, if the threshold is exceeded, the deduction ceiling is applied to the total amount of (net) interest.

In a tax group (Organschaft), the group parent (Organträger) has to include the interest earnings and the interest expenses paid/owed by a subsidiary member of the tax group (Organgesellschaft) in its own calculation; thus, the threshold is applicable to the tax group only once.

**Exception 2: no group/no harmful debt financing**

This one is already much more complicated: the interest deduction ceiling does not come into action if the taxpaying business is not a member of a group of companies (Konzern). However, a corporation may only invoke this exception if no harmful debt financing is applied.

A business forms part of a group of companies if it is, or (in case there are no consolidated financial statements) ‘could be’ consolidated with one or more other businesses. The possibility and/or duty to consolidate is based upon IFRS or, secondarily, upon the accounting standards according to the commercial law of an EU Member State. Furthermore, a business is deemed to belong to a group if its financial and business policy can be determined in a uniform way with one or more other businesses (IAS 27).

The definition of a ‘group of companies’ in this context is highly unclear and entails difficulties, especially in private equity structures where several tiers of holding entities are sometimes interposed.

For purposes of the interest deduction ceiling, a ‘group’ can even be assumed if an individual holds shares in two corporations which are controlled by the individual or if an individual conducts a business and is, in addition, a controlling shareholder in a German limited liability company.

A business which only partly belongs to a group is deemed not to belong to this group. This rule covers partial consolidations of joint ventures within the meaning of IAS 31. It means that exception 2 could, in principle, be applied.
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However, corporations which do not belong to a group can only avoid the application of the interest deduction ceiling if no ‘harmful debt financing’ is applied:

‘Debt financing’ is deemed to be ‘harmful’ if the taxpaying corporation pays/owes interest to:

- a shareholder directly or indirectly holding more than a quarter of the share capital;
- a party related to such a shareholder; or
- a third party lender with harmful recourse to the aforementioned persons,

and such interest exceeds 10% of the net overall interest paid/owed by the corporation.

In case of financing via third party lenders, it is feared that the effect of the new rules will be much stricter because of the broad and vague concept of ‘recourse’ as compared to previous law. The explanation of the legislative intent assumes ‘harmful recourse’ even if the shareholder/related party is only factually liable for the third party loan. Besides back-to-back structures, a multitude of structures is to be covered. The proposal of the Bundesrat to limit the definition of recourse to the understanding that had been reached under previous law, was not successful.

In a tax group – in which the whole tax group is a ‘business’ – interest earnings and interest expenses have to be balanced. Interest expenses for ‘harmful debt financing’, as characterised previously, must not exceed 10% of the net overall interest.

**Exception 3: group/no harmful equity ratio/no harmful debt financing**

Unfortunately, this one will probably elude applicability in practice: a business which is a member of a group of companies may escape the interest deduction ceiling if the equity ratio comparison test is met (‘escape clause’). However, a corporation may rely on the escape clause only if no harmful shareholder/related party debt financing is applied.

**Equity ratio comparison test.** The requirements are met if the respective business’s equity ratio equals or exceeds the average equity ratio of the group (with one percentage point tolerance).

Generally, the equity ratios are determined on the basis of the IFRS financial statements. However, secondarily, financial statements according to the commercial law of an EU Member State or USGAAP can also be used.

In order to make the equity ratios of the business and the group comparable, the same accounting standard must be used. Alternatively, (where there are no commercial financial statements for the business at all), the equity ratio of the business must be determined in a ‘reconciliation statement’ (Überleitungsbilanz), which must be audited. Both the financial statements of the business as well as those of the group must to be presented in German language or in a certified translation into German.

Accounting options have to be exercised the same way in the consolidated group financial statements and in the business’ stand-alone financial statements. Assets and liabilities must be uniformly valued. In the case of withdrawal rights according to company law, the equity must at least be assessed at the amount it would have been under (German) commercial law. This is to avoid having (German) partnerships only show liabilities (IAS 32).

For the sake of comparability of the equity ratios, further special rules apply. For example, the equity of the business has to be increased by the goodwill included in the consolidated group financial statements, as far as it is allocable to the business. The business’ equity must be reduced by shares in other group companies. In order to avoid tax structuring, the equity must be reduced by contributions made during the last six months before the relevant balance sheet date to the extent withdrawals from reserves or profit distributions are made during the first six months after the relevant balance sheet date. Under the new rules, a penalty may be assessed if the certified equity ratio of the group and/or business is incorrect.

**No harmful debt financing.** However, the escape clause (equity ratio comparison test) will only be relevant for a corporation which is a member of a group if no harmful shareholder/related party debt financing is applied (see above).
Interest paid/owed to a direct or indirect shareholder holding more than 25% of the share capital, a person related to such a shareholder or a third party having recourse to the aforementioned persons must not exceed 10% of the overall net interest expenses of the interest-paying/owing entity. In contrast to the non-group scenario, not only the taxpaying corporation is addressed by this requirement, but also any worldwide entity which is a member of the group. If harmful debt financing is applied in any one of the entities, the escape clause cannot be invoked, so that for the purpose of German taxation the interest deduction is limited.

However, not every kind of shareholder/related party debt financing is considered to be harmful. In the case of a corporation which is a member of a group, such financing only is considered harmful if it is granted from outside the group and/or recourse may be taken by persons outside the group. This rule allows specific tax structuring.

Change of ownership: loss of losses carried forward

The rule, amended and significantly tightened, deals with the loss of losses carried forward in case of a change in a corporation's shareholder(s). Despite the introduction of the new rule, the previous version will continue to be in effect until the end of 2012 because of the five-year period fixed for harmful contribution of predominantly new business assets in connection with a change of ownership (at the latest in 2007).

New sec. 8c CITA provides for the total or partial loss of losses carried forward by a corporation in case of a harmful acquisition of a stake in that corporation. A harmful acquisition is the direct or indirect purchase of more than 25% (but no more than 50%) of the shares (legal consequence: partial loss of the losses carried forward) or of more than 50% of the shares (legal consequence: complete loss of the losses carried forward) by a single shareholder within a period of five years. Under the amendment, a group of acquirers with parallel interests will be regarded as a single acquirer. Relief hoped for, such as exceptions for reorganisations, financial restructurings or groups of companies, is not granted. The new rule is also applicable for trade tax purposes.

Repeal of portfolio dividend/capital gain exemption stalled

According to current law, 95% of the dividends from and capital gains on the disposition of shares in corporations held by corporations are generally exempt from corporate income tax (notable exceptions are dividends and capital gains received by certain financial institutions from shares held for their own trading purposes or by life insurance or health insurance companies or certain pension funds). This inter-company dividend and capital gain privilege has been applicable thus far, irrespective of the size of the stake held. Therefore, it can also be enjoyed by certain institutional investors (e.g., in the private equity sector) which – contrary to many strategic investors – frequently hold only minority interests. The abolishment of this inter-company privilege for minority shareholdings of less than 10% was recently under discussion.

These legislative intentions have to be viewed against the following background: the European Commission had initiated a treaty infringement procedure against Germany objecting to the legal situation that dividends received by foreign parent companies from portfolio participations in German companies are burdened with a 20% withholding tax (21.1% including solidarity surtax), for which no credit is granted – neither in Germany nor, possibly, in the parent company's country of residence – and for which no expenses are taken into account, whereas German parent companies are entitled to a credit for, or even reimbursement of, such withholding tax when corporate income tax and trade tax are assessed on their net income (where expenses are generally deductible). Only those foreign parent companies which enjoy the benefits of the EU Parent/Subsidiary Directive or those of an inter-company dividend exemption contained in an applicable tax treaty do not have to suffer this discrimination; both sorts of relief are generally not available in cases of shareholdings of less than 10%.

It is true that the problem will be mitigated as of January 1, 2009, when Germany will begin to apply withholding tax of 25% on dividends, two-fifths of which (i.e., 10 percentage points) may be reclaimed by foreign corporations resident outside Germany even in the absence of a tax treaty. However, this will not resolve the issue.
The idea of overcoming the discrimination of foreign parent companies by also repealing the inter-company privilege for German corporate portfolio shareholders did not meet with sufficient political approval in order to make its way. Since, however, the European Commission seems to be unenthusiastic about withdrawing from its infringement procedure, there may soon be an attempt to re-launch this solution. Alternatively, the German government is said to consider, e.g., levying a final, non-creditable withholding tax also on distributions to German corporate portfolio shareholders or just to argue the problem away by pointing out that the trade tax burden which is only borne by German portfolio dividend recipients should be considered comparable to the dividend withholding tax that is not creditable only for foreign shareholders.