

A constructive structuring

Wolfgang Richter, Claus Lemaître and Frank Schoenherr, RP RICHTER & PARTNER, discuss the main features, impact and structuring options of law concerning the taxation of groups: debt financing after the company tax reform 2008.

Pursuant to the Company Tax Reform Act 2008 (CTRA) the tax rate for corporations is reduced from 25 percent to 15 percent. Due to the strong influence of municipalities, the trade tax has not been abolished. Depending on the municipal rate, the tax rate for corporations is going to drop from approximately 40 percent to approximately 30 percent (corporate income tax and municipal trade tax). However, the thin capitalisation rules are being tightened by the tax reform. These rules are generally very important to foreign groups and investors. The article describes the completely changed rules and outlines structuring approaches.

The new interest barrier rule

The reform does, however, not only provide for tax cuts but – for purposes of a counter-financing of the reform – also for numerous tax increases. The so-called interest barrier rule – a general non-shareholder based new thin capitalisation rule – is one of such measures which may have a strong influence on the financing structure of companies. The new regulations (Section 4h of the German Income Tax Act ('ITA'), Section 8a of the German Corporate Income Tax Act 'CITA') will basically change the tax framework for debt financing. In addition to shareholder debt financing, any and all debt financing (even classic bank financing) of German companies, even foreign group companies, if applicable, will be subject to considerable tax sanctions in the future. Interest for shareholder loans for partnerships will continue to be non-deductible from taxes. For purposes of trade tax, 75 percent of deductible interest expenses are generally deductible under the new law. Interest for long-term liabilities have so far been deductible from trade tax only at 50 percent (interest for long-term debts), interest for short-term loans, however, at the full amount.

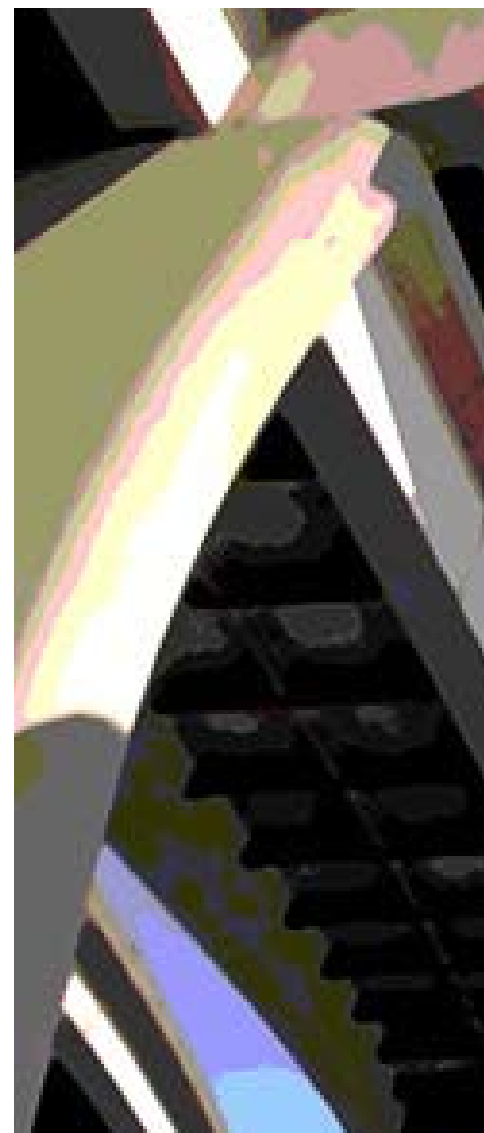


Wolfgang Richter (top), Claus Lemaître (middle) and Frank Schoenherr (below) from RP RICHTER & PARTNER

Interest expenses for shareholder loans and other loans (eg bank financing) are subject to the so-called interest barrier rule pursuant to CTRA (Section 4h ITA). The initial amount of the general interest barrier rule under Section 4h ITA is the negative interest balance, the negative balance between interests earned and interest expenses per fiscal year and business. Interest expenses are thus deductible up to the amount of the interest earned per business without limit. The negative interest balance is basically being deductible only in the amount of 30 percent of the business' fiscal EBITDA. As this gears to the taxable EBITDA, tax-free earnings – such as dividends received from foreign and German corporations – do not increase the EBITDA. The interest expenses which cannot be deducted from income and corporate income tax can be carried forward to the next years (interest carry forward). The interest is subject to full taxation with the recipient irrespective of its deductibility.

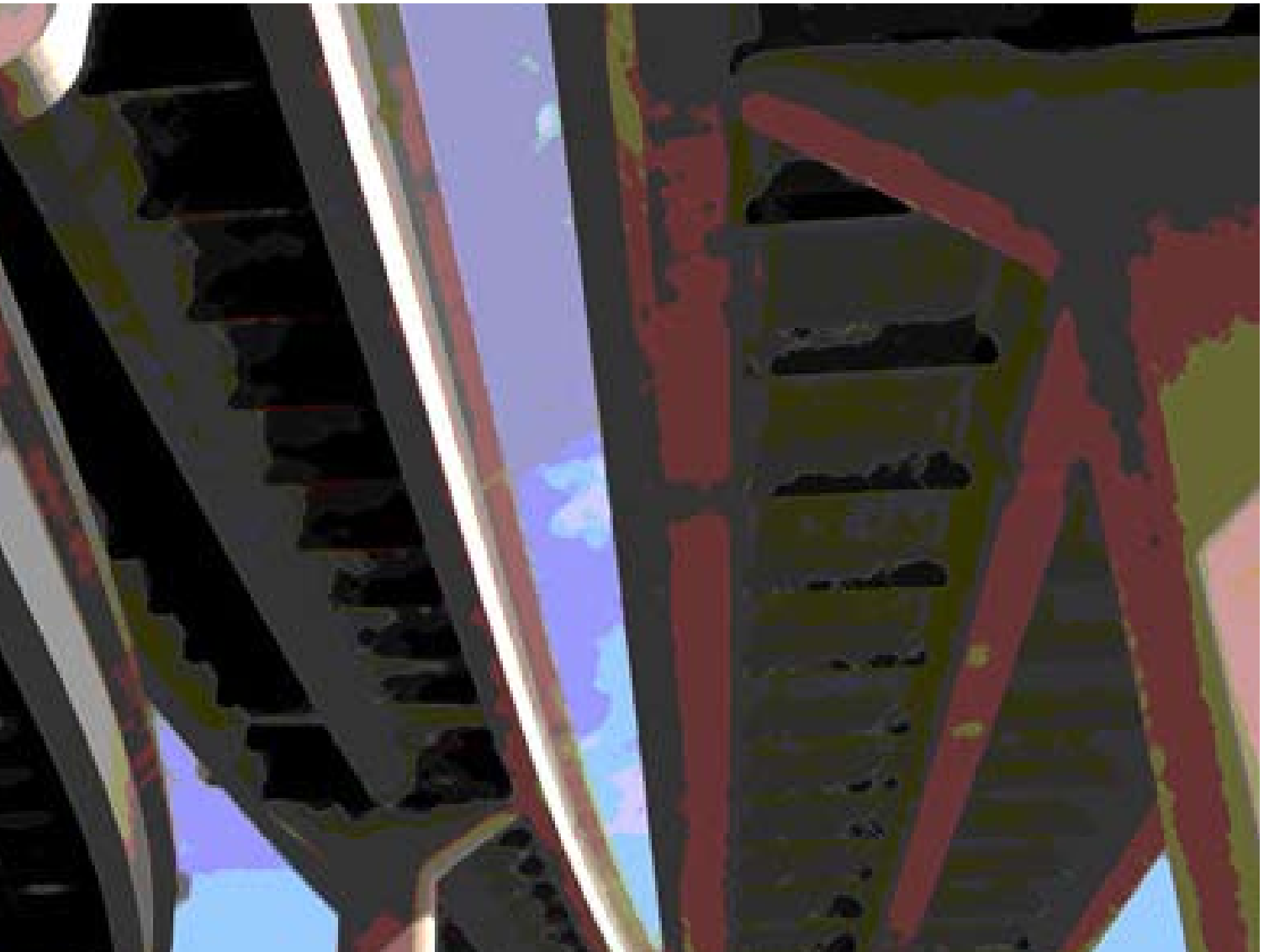
Definition of business

The interest barrier rule pursuant to Section 4h ITA is applicable for each business. In this case, a business is every partnership or corporation. In case of fiscal unity (Organschaft), the group of integrated companies is considered as one business for purposes of the interest barrier rule, ie corporations, which have been entered into a profit and loss transfer agreement with their parent company, are treated as one business together with the holding company. The interest barrier rule does not apply if; i) the negative interest balance does not reach an amount of €1m per year (tax threshold), ii) the business is not or only partially part of a group of companies (no group company) or iii) the business is part of a group of companies but its equity ratio in the last annual financial statements equals at least the consolidated equity ratio of the



whole group, whereby a difference of one percentage point below the consolidated equity ratio is harmless (so-called escape clause by equity ratio comparison in cases of groups). Thereby, the term of the 'group' should be broadly interpreted by the tax authorities. A business shall not only be part of a group under the new regime if it is only consolidated with one or several businesses but already if it 'could' be consolidated. This applies to the consolidated financial statements which are also the basis for the equity ratio comparison of the escape clause. This basically refers to consolidated financial statements according to IFRS if these must be prepared or disclosed. If this is not the case, financial statements according to the generally accepted accounting principles of EU member states can be applied. If such consolidated financial statements have neither to be prepared nor disclosed, US-GAAP can be applied.

As is the case under the old regime for shareholder loans with corporations, the book values of participations are to



be reduced in case of the equity ratio comparison. This may result in a lower equity ratio of the holding company compared to the equity ratio of the whole group. Unlike under the old regime there is unfortunately no holding clause. That is why the escape clause could not be a great help for groups. In many cases it could be favourable to change and amend the finance routes within the group to avoid the application of the new rules.

Also an individual who holds shares in two or more corporations and who is thus not obliged to prepare consolidated financial statements shall be considered as a 'group' under the new regime if it may uniformly determine the financial and business policy of the two or more corporations.

In addition to the general interest barrier rule, corporations will face a new thin capitalisation rule for shareholder loans (Section 8a CITA new version). It will apply to corporations with German taxable income, even for foreign PropCos holding German real property. Unlike the

/// Depending on the municipal tax rate, the tax rate for corporations is going to drop from approximately 40 to 30 percent. ///

general interest barrier rule this special corporate interest barrier rule is not only linked to the negative interest balance but also to interest expenses themselves. Thus the interest barrier rule applies also to corporations not being part of a group if the interest expenses for loans granted by shareholders, who directly or indirectly hold a share of more than 25 percent in the lending corporation, of a person related to such a shareholder or a third party having recourse to these shareholders or related persons (damaging recourse) makes up for more than 10 percent of the negative interest balance. The escape clause does not apply in cases of groups if the interest expenses for loans to German corporations or to another company within

a group of a shareholder, who directly or indirectly holds more than 25 percent in a group company, a related person or a third party having recourse to the shareholder or related person, exceeds 10 percent of the negative interest balance. The latter, however, applies only to interest expenses for loans which are completely shown in the consolidated financial statements according to this provision as well as in case of loans granted by third parties having recourse ie recourse to a shareholder who does not belong to the group or a related person. However, this rule is one of the most important pitfalls of the new rules. The application of the rules should be checked in detail to avoid major tax damages.

Lost interest

The interest carry forward not used to offset profits is (partially) lost if the interests in a partnership are transferred by a partner. If less than 25 percent of the shares or voting rights in a corporation are directly or indirectly transferred within >>



>> a period of five years, the interest carry forward is saved. If more than 25 percent but less than 50 percent of the shares or voting rights are transferred, the interest carry forward is lost pro-rata to the amount of the transfer ratio. In case of a transfer of more than 50 percent of the shares or voting rights within a period of five years, the interest carry forward is totally lost. Capital increases which result in a change of the participation quotas are deemed to be transfers. There is no group clause. The consequence of this totally excessive rule is that the unused interest carry forward can not be used to offset profits in the end in case of reorganisations within the group, the sale of subsidiaries and the exit of an investor from the group.

The range of the new regulation of the interest barrier rule is unclear in many points and not fully manageable in the practice or only with difficulties. Is eg a foreign private equity fund, which holds several participations in portfolio companies worldwide and also in Germany, the head of a 'group,' only because it could consolidate a German portfolio company according to IFRS? Must worldwide consolidated financial statements be prepared only to meet German tax requirements? When does, eg, a damaging recourse exist for example? The preamble provides for a very broad interpretation of the term recourse. This may result in the same practical problems as in the case of Section 8a CITA (old version), in particular, but not against the background, of the requirement to check

whether there is a damaging recourse in case of any foreign group company within a global group. Otherwise the escape clause is not applicable to the German group companies. In practice this might be manageable for large group units only with difficulties. If the examination of any and all domestic and foreign financing agreements results in the fact that there is no harmful financing, the equity ratio comparison might not be realised in most cases as foreign financing decisions are – obviously – not made according to the German tax requirements. Not only because of the extended coverage of the German tax law to uninvolved companies but also for other reasons do we have considerable doubts whether the interest barrier rule is consistent with the German Constitution and European law as well as with existing double taxation treaties. Tax advisors will certainly leave open the assessment by appeals and fight against the law in court.

Impacts and structuring

Multi-national groups with one or more German subsidiaries with (any) debt financing will have to analyse the impacts of the interest barrier rule in detail. Only if the tax threshold of €1m is not reached, no action will be required. In case of large investments of foreign companies, the threshold is, however, generally reached. In addition, the range of interest expenses pursuant to the interest barrier rule is broader than under German or any other GAAP. Therefore each German company

should be analysed in detail.

There are a number of structuring options. The interest barrier rule can be avoided if fiscal unities are established or dissolved. In some cases it may be favourable if a profit transfer agreement is entered into with a subsidiary which is highly debt-financed to establish a fiscal unity. The dissolution of a fiscal unity may be a possibility to repeatedly apply the tax threshold within the group and thus avoid the interest barrier rule. A similar instrument is the conversion of corporations into partnerships. If parts of the business have a negative book value and high hidden reserves, the equity ratio may be improved by way of a tax neutral spin-off with a step-up for German GAAP purposes and the application of the escape clause thus optimised. Despite trade tax sanctions, intercompany leasing constructions (sale and lease back), nevertheless, experience a comeback. In order to reduce the need for debt financing and thus to avoid or limit the impacts of the interest barrier rules, ABS structures will increasingly come into the spotlight. In the international context it may be a good alternative to provide foreign group companies with more debt financing than the German businesses or to optimise transfer prices to the extent permissible.

Looking ahead

The Company Tax Reform 2008 does not only entail tax reductions but also a tightening of the tax environment in many areas. In particular the interest barrier rule whose practical application leaves a lot of questions still unanswered, restrains the freedom of financing of German business units of foreign groups or investors to a broader extent than in the past. The interest barrier rule may be manageable in numerous structures with some difficulties. There are, however, plenty of structuring options, which have to be customised in the individual case, in order to avoid the interest barrier rule. Financing structures should in any way be scrutinised in detail now. ■

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