Thin capitalisation rules

Wolfgang Richter, Claus Lemaitre and Frank Schoenherr take us through the main features, impacts and structuring options of thin capitalisation rules according to the Company Tax Reform 2008 and the new treatment of write-offs of certain shareholder loans according to the Tax Act 2008.

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Germany ended up with two important tax acts changing significant parts of the tax rules in 2007; the so-called Company Tax Reform Act 2008 (CTRA) and the so-called Tax Act 2008 (TA) were adopted. The rules of both acts have basically entered into force with effect from January 1, 2008, in case of deviating fiscal years even earlier. Pursuant to the CTRA the tax rate for corporations is reduced from 25 percent to 15 percent. As local municipalities have been successful in defending trade tax, this tax survived the CTRA. Depending on the municipal tax rate, the aggregate tax rate for corporations under the CTRA is reduced from around 40 percent to around 30 percent (corporate income 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 TA amends – among other things – the tax deductibility of write-offs with respect to certain shareholder loans. This is important due to the fact that write-offs of shareholdings are tax-wise not deductible so that the deductibility of write-offs with respect to shareholder loans has been a very effective measure to influence the tax basis despite of the non-deductibility of write-offs of shares. This is an important change for German based shareholders including interposed German resident holding/acquisition companies of foreign investors.

Deductibility of interest under the new regime (‘Interest Barrier Rule’)

The CTRA does not only provide for tax cuts but also for various tax increases. The so-called interest barrier rule is one of such measures which may have a strong influence on how investments in Germany will be financed.

The new regulations (Section 4h of the German Income Tax Act (ITA), Section 8a of the German Corporate Income Tax Act (CITA)) has basically changed the tax framework for debt financing. In addition to shareholder debt financing, any and all debt financing (even classic bank financing) of German companies will be subject to considerable tax sanctions in the future. Interest on shareholder loans for partnerships will continue to be non-deductible for tax purposes. For trade tax purposes, 75 percent of the interest expenses deductible for CITA purposes are deductible for trade tax purposes under the CTRA. This 75 percent regime applies to all interest expenses irrespective of whether the underlying debt is long- or short-term (thereby replacing the old regime according to which interest on long-term debts is 50 perecent deductible and interest on short-term debts is 100 percent deductible).

Interest expenses for shareholder loans and other loans (e.g. bank financing) are subject to the so-called interest barrier rule pursuant to the CTRA (Section 4h ITA). First, interest expenses are deductible up to the amount of the interest earned per business without any limits. Any interest expenses which exceed the amount of interest earned is basically deductible only in the amount of 30 percent of the business’ 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 can be carried forward to the next years (interest carry forward). At the level of the recipient of the interest payments, interest income is subject to full taxation irrespective of whether or not the corresponding interest expenses have been deductible.

Definition of business

The interest barrier rule pursuant to Section 4h of the 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 the purposes of the interest barrier rule, i.e. 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 one million euros 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 '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 the 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 generally can be applied.

Additional rules for corporations

In addition to the general interest barrier rule of Section 4h of the ITA, corporations face with a new thin capitalisation rule for corporate shareholder loans (Section 8a CITA new version). It applies to corporations with German taxable income, even for foreign PropCos holding German real property. Unlike the 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 shown in the consolidated financial statements according to this provision as well as in case of loans granted by third parties having recourse i.e. 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.

Lost interest

To the extent that the amount of the effective annual interest expenses exceeds the amount of the deductible interest expenses for tax purposes, the difference can be forwarded to future periods and deducted in those periods to the extent that the effective annual interest expenses are less than the interest expenses deductible for tax purposes (=30 percent EBITDA; so-called interest carry forward). For this interest carry forward, the same rules apply as for loss carry forwards according to which the future deductibility of interest expenses carried forward depends on the direct or indirect transfer of voting rights or shares in the company carrying forward interest expenses within a five year period: if less than 25 percent are transferred, the interest carry forward remains fully available for future offset. If more than 25 percent but not more than 50 percent is transferred, the interest carry forward is lost pro rata to the amount of the transfer ratio. If more than 50 percent is transferred, the interest carry forward is completely lost. The consequence of these interest carry forward rules is that in practice it will be difficult or even impossible to effectively deduct unused interest expenses carried forward in subsequent periods in the particular in case of reorganisations, the sale of subsidiaries and the exit of a significant investor. ▶

Impacts and structuring

Although there are lots of open questions regarding the new regime, it is safe to say that multinational groups with one or more German subsidiaries with (any) debt financing will have to analyse the impacts of the interest barrier rule in detail. Hence, only if the tax threshold of €1m is not reached, no action will be required. Therefore, in case of material investments an analysis will be required.

There are a number of structuring options. The interest barrier rule can for example be avoided if fiscal unities are established or dissolved. In some cases it may be favorable 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 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.

Write-offs of certain shareholder loans

The TA introduces the non-deductibility of expenses (write-offs) incurred at the level of a shareholder of a corporation with respect to loans granted to a corporation or securities provided in connection with a loan granted from third parties. If such expenses occur, they will no longer be deductible for tax purposes, if the shareholder owns or owned in the past a qualifying (= directly or indirectly more than 25 percent) shareholding in the corporation. The same applies to those who represent a related person within the meaning of German tax rules or a third party having recourse to the shareholder or a related person. However, these expenses remain tax deductible, if evidence can be provided according to which an unrelated third party would also have granted the loan under the same conditions or would not have requested the repayment of the loan.

These rules will in many cases lead to the non-deductibility of said write-offs as the evidence required to rescue the deductibility of the write-offs could hardly be obtained in many cases. Moreover, the law does not define how the evidence should look and who has to provide such evidence. According to experience with similar evidence tests in context with the thin cap rules in the past, it will take some years until the German tax authorities will have defined the detailed requirements for such test so that the uncertainties regarding the evidence test will continue for quite a while.

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The logical consequence is to write off any shareholder loans qualifying for the new regime before this new regime will enter into force (balance sheet a per December 31, 2007). Such a write-off requires appropriate documentation in order to get the write-off accepted in the commercial statements by the commercial auditor (and later by the tax authorities!). As the German GAAP balance sheet is the basis also for the balance sheet for tax purposes, it will not be possible to get a write-off just for tax purposes.

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. The Tax Act 2008 provides a significant change for write-offs of shareholder loans. One should have this in mind when preparing the balance sheet as per December 31, 2008. ■

FURTHER INFORMATION

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