



Constituting a step in the right direction

One nettle Germany's Grand Coalition government has had to grasp since it came to power last year is the fact that German company tax rates are currently some of the highest by international standards, and this is making Germany internationally uncompetitive when the EU's open market today stretches from the Atlantic to the Black Sea.

Companies would often rather go elsewhere in Europe, to Ireland, for example, to take advantage of better corporate tax rates when carrying out new projects than open up in high-tax Germany.

Realising that a cut in effective tax rates including both federal corporate tax and municipal trade tax, from their current 40 percent or so would make Germany more attractive to foreign investors, the coalition government has guided a tax reform package through the Bundestag and Bundesrat, the lower and upper houses of German parliament respectively, with the aim of having the Bill passed before the summer break and due to come into effect in 2008. The bill passed the Bundestag at the end of May and is supposed to pass the Bundesrat in July.

However, the tensions in the ruling coalition between the right-wing Christian Democrats and the left-wing Social Democrats, and the political pressures from

As the European Union grows, even the biggest members are finding they can no longer settle matters such as tax policy as if they were operating in a vacuum.

Germany's municipalities, anxious not to lose their share of the tax cake, has meant that the reforms have been designed to try to cut rates to levels found elsewhere in Europe without reducing the tax take by more than around €5bn. The result, critics say, is a dog's breakfast that is likely to cause more problems than it solves.

At RP RICHTER & PARTNER, a tax and law firm founded in Munich less than six years ago, but which is already ranked at number 11 in tax law in Germany, managing partner Wolfgang Richter, a former senior partner in the tax department at Ernst & Young Munich, and his colleagues are already advising clients on the best way to cope with the likely changes in tax law in Germany next year.

The good news, Mr Richter says, is that "rates will be lowered significantly. The corporate income tax rate will be lowered from a current level of 25 percent to 15 percent." However, a peculiarity of the German tax system, the municipal trade tax, will be preserved. After the tax reform, the trade tax will be approximately the same level as the corporate income tax, so that the tax burden on business profits

will be around 30 percent, that is, some 10 percent lower than at the moment. "The German tax burden will, as a consequence, average that of other European industrial nations," Mr Richter says.

Agreed elements

The reforms are having a bumpy passage; "Almost every day, there was a media report about disputes regarding some part of the reform," Mr Richter says, adding; "I personally, however, like most observers, did not expect the bill to undergo major changes." The fact that Germany is currently governed by a big coalition of Christian and Social Democrats, means, he says, that "the main elements of the reform were already agreed between the two big parties in the cabinet."

Despite this agreement, there are still problems, in large part caused by the complexity of the new laws. Claus Lemaitre, tax partner at RP RICHTER & PARTNER, says; "In the run-up to the reform, models had been elaborated by commissions made up of reputable members that would have fundamentally changed as well as simplified the now extremely desultory >>

>> German tax legislation. A lot of people had hoped that the tax law system would be simplified. These hopes have been shattered.”

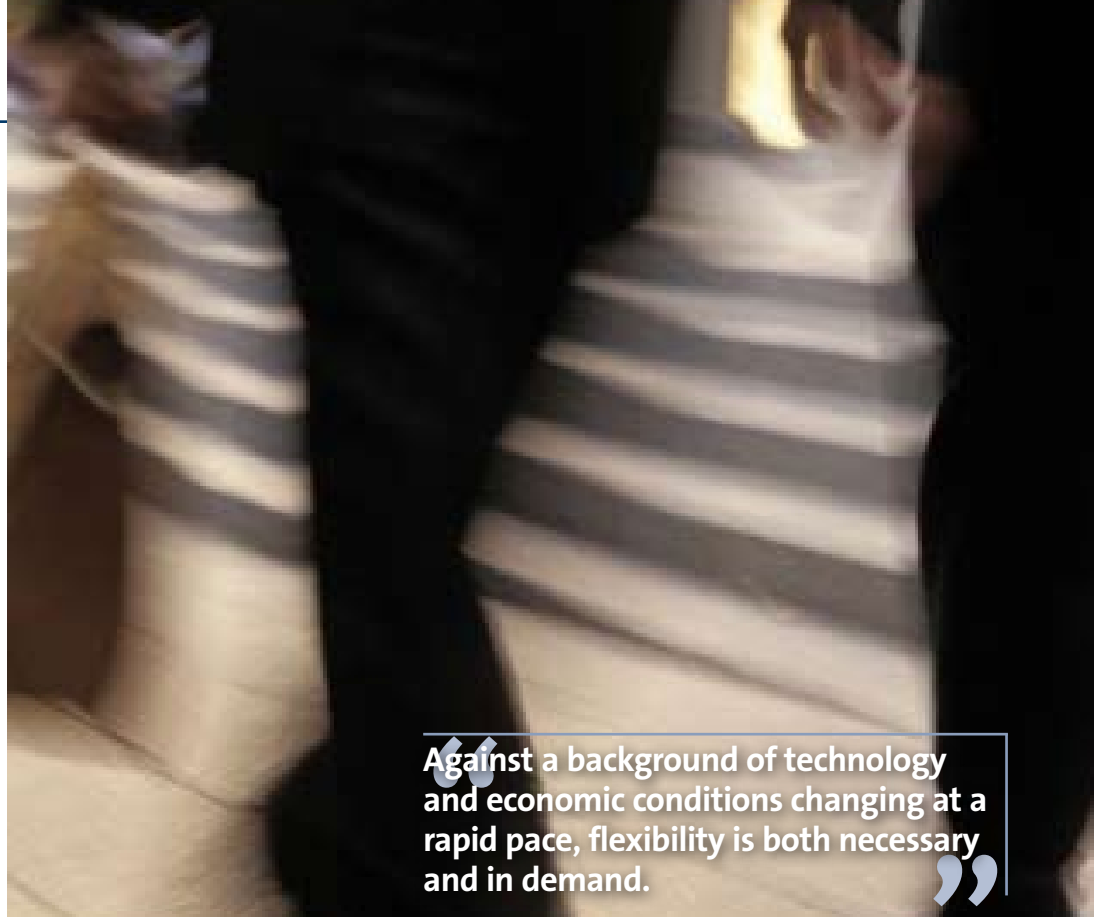
The problem, according to Frank Schönherr, tax law expert and another founding partner of RP RICHTER & PARTNER, is that “the underlying principles of German tax law had already been developed at the beginning of the last century. A fundamental and far-reaching reform of the system, however, would have implied abolition of the municipal trade tax. The trade tax, a tax on profits which exists in parallel to the corporate income tax, ensures a lot of independence and influence on the part of German communities in the federalist system. Towns did not want to lose this privilege and wielded their political clout to keep this tax, not least because of the current buoyancy of trade tax revenues.”

The reforms are envisaged to cost a maximum of €5bn, a relatively small amount, in the first years. Later on, the reforms are expected to result in an actual increase in tax revenues, Mr Lemaitre says, because as part of the changes, and in an attempt to mitigate the effect of the cut in tax rates, the scope of many unfavourable tax rules will be widened and new rules will be adopted to make it more difficult for companies to deduct financing costs, particularly interest on loans, from pre-tax profits. “There will also be limits on the setting of losses carried forward and tighter rules in the field of transfer pricing, there will be taxes on companies relocating divisions from Germany to abroad, and conditions for depreciation of movable assets will become more stringent,” Mr Lemaitre says.

What businesses have protested most about, Mr Schönherr says, is the so-called ‘interest limit.’ “The ‘interest limit’ constitutes a tightening of Germany’s already rather strict ‘thin capitalisation’ rules,” he says. “Whereas only financing and collateral of shareholders or affiliated companies had been affected to date, interest deduction will, in future, be limited to 30 percent of the result before interest, taxes depreciation and amortisation (EBITDA). Smaller-scale financing with interest expenses of up to €1m per year is not to be affected, however.”

Preventing shifting

International groups which have complex and, sometimes nested, financing structures, have expressed particular dissatisfaction with the new rules. “The main aim of legislators was to prevent a shifting of interest to foreign countries in order to evade tax,” Mr Richter says. “When the whole company, that is, domestic as well as foreign parts, is loan-financed, however, it will hardly make sense to assume that profits have been shifted for tax reasons.



Against a background of technology and economic conditions changing at a rapid pace, flexibility is both necessary and in demand.

This is why an exemption had to be included for groups. And this has been no mean feat.”

The efforts by the tax authorities to ensure they stop tax evasion by companies switching interest abroad means “they even applied analysts’ ratios,” Mr Lemaitre says. “After all, you can compare an individual business unit’s capital ratio to that of the overall group. If the group’s capital ratio is higher than that of the individual business unit, tax authorities proceed on the assumption of excessive loan financing. Thus it will not be possible to deduct interest expenses from taxation. Furthermore restrictions are existing for shareholder and inter-company loans. In terms of these rules, it is absolutely irrelevant whether a company uses financing to transfer profits to a foreign country in order to evade taxes or, as would mostly be the case, for operational reasons.”

The result of this, Mr Richter says, is that “almost all internationally operating groups will therefore have to adopt their financing structures with a view to the new rules.” It won’t be possible to plead that the loans existed prior to the new legislation, either; “The new rules apply to any financing whatsoever, no matter when it was agreed. Foreign investors, in particular, should therefore have their existing investments reviewed.” However, Mr Richter says, the new rules will be mitigated by structural changes and “it may even be possible to avoid the application of the new rules in some cases altogether.”

One particular scenario is the property market. Investors’ exposure to German real estate is frequently organised in corporations (Gesellschaft mit beschränkter

Haftung, GmbH, or limited liability company), Mr Lemaitre says. “These companies also comprise project financing and, as a consequence, these companies generate hardly any profits. As a result of the new rules limiting deduction of interest, high tax burdens may be imposed on such companies even if they are not yet generating any profits. This means that there will have to be a structural response if the financial attractiveness of investments is to be ensured.”

However, all German business units with a high loan financing rate may be affected, Mr Schönherr says, and “in any case, it may prove to be beneficial to check the situation in due time, to be able to implement changes. The new rules will already apply from next year on.” Interest expenses that could not be deducted for tax reasons “may be offset in subsequent years, similar to losses carried forward,” he says. This, however, only applies within the deduction limits, that is, 30 percent of EBITDA.

Carried forwards

There are also changes to the rules governing losses carried forward. Under the new rules, losses carried forward will, in future, be cancelled on a pro rata basis if more than one fourth of shareholder interests are sold to a new shareholder. If more than half of the interest is transferred to a new owner, losses carried forward would be disallowed for tax deductions completely. “There was opposition from businesses against this, however,” Mr Richter says. “This would, of course, constitute a major obstacle, particularly for research companies who need to raise a high amount of capital, especially in the start-





up phase. And politicians have insistently emphasised that support of research activities in Germany is given top priority.”

Not only research companies but start-up companies growing at a fast pace in general would be affected, Mr Lemaitre adds. “It is normal for a company which was only just founded to generate losses in the start-up phase,” he says. “These companies sometimes even have a relatively high exposure to loss. Start-up is generally associated with several rounds of financing and the involvement of new investors. In future, however, the fact that new investors are involved may imply that start-up losses may no longer be offset against initial profits for tax purposes. This means that the company will have to pay taxes on earnings even if it is still far from breaking even.” It is, he says dryly, “self-explanatory that these circumstances will not exactly help to attract potent international investors.”

The problem from the tax authorities’ point of view, Mr Schönherr says, is that figures suggest ‘several billions’ of tax loss are carried forward in Germany every year. “Tax authorities are genuinely afraid of losing a big portion of their tax revenues; therefore, the rules have been tightened considerably, step by step. Even within government parties, however, there was considerable opposition against the new rules. However, only minor changes had been made in the Bill now having passed the Bundestag. It is not likely that the Bundesrat will not pass the bill in this version.”

The German tax authorities also want to keep companies on a shorter leash as far as transfer pricing is concerned by reducing tax rates. Mr Schönherr says;

“Many German companies have relocated their businesses abroad, especially after the border to Eastern Europe had been opened in the early 1990s. Vice versa, there are more and more foreign investors investing in Germany. There is now an international value-adding chain in many a company. As every country has its own tax legislation, high-tax countries – and high-tax Germany still is indeed – have a particular fear of profits being shifted abroad and therefore narrow down companies’ options.”

It will not be possible for the tax authorities to prevent financially justified restructuring, Mr Lemaitre adds. “In future, however, the tax authorities will impose a heavy tax for any loss in tax base. After all, every company or business unit relocated abroad implies a loss of potential future tax revenues. Consequently, a tax on hidden reserves, or unrealised income will be imposed on companies relocating their business abroad. This is also to apply to goodwill and intangible assets and even future chances of profits – even if these companies are still in the start-up phase.”

Easier said than done

This means that every investor will have to consider long-term investment plans before exposure which, as Mr Richter says, “is easier said than done.” Against a background of technology and economic conditions changing at a rapid pace, flexibility “is both necessary and in demand,” he says. The new tax rules “will not be any sort of an incentive for investors to opt for an investment in Germany as an industrial location.” Research companies are a prime example, Mr Richter says; “A group or investor planning to develop a product or process in Germany should carefully consider in advance where this product or process will actually be mainly used or even completely developed in the end. After all, should it be necessary to transfer the process or product to another country, the investor will encounter a tax problem – even if the process or product is not yet marketable. German tax authorities

will determine the value of the work-in process as if it were already marketed. The company will then have to pay income tax on fictitious profits.”

There will be those who benefit from the proposed tax reforms, Mr Lemaitre says; “Corporations that are already doing well and are equipped with a lot of equity capital will be among the winners. They will benefit from the reduction in tax rates and will hardly feel the implications of the adverse changes like limited deductibility of interest or loss carry forward set-off.” However, he says, “companies with a cyclical operating result and high outside capital needs will be among the losers. If profits fall or if they plunge into the red, the chances of these companies deducting interest on loan capital will diminish.”

Right now RP RICHTER & PARTNER are advising clients to use the second half of 2007 to get prepared for the new law. “It will be possible to avert many a disadvantage by adjusting the corporate structure,” Mr Richter says. “On the other hand, companies will almost automatically benefit from the advantages of the new law, that is lower tax rates.”

Overall the firm gives the reforms a wary and qualified welcome. “From an international perspective, lowering interest rates surely bodes well; it is important and points in the right direction. It will help Germany move up further, at least in terms of a ranking among key industrial locations in Europe,” Mr Schönherr says. Mr Lemaitre fears that “this improvement of the ranking will only be of a temporary nature, not least because other countries are not standing still. Structurally speaking, I had hoped the reform would be more fundamental.”

But Wolfgang Richter declares that while the reforms “are no masterpiece,” they “surely constitute a step in the right direction.” Next, he says, Germany’s politicians should look south for their example; “Our Austrian neighbours have shown us how to do it: A number of years ago, they abolished trade tax, and now also inheritance tax.” ■

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