

GERMAN TAX LAW CHANGES LEAVE INVESTORS LITTLE REASON TO CHEER

Over the last years, Germany has built up a reputation of having an unstable, revenue-protective and highly complex business tax regime. Recent developments suggest that the government has no intention of changing this situation. Several changes in the 2007 tax act, as well as the 2008 business tax reform package, have created a more challenging tax environment, especially for inbound investment into Germany, and for highly leveraged M&A transactions.



1. German 2008 Business Tax Reform – General

The German business tax reform for 2008 contains a number of regulations that will affect inbound investors:

- The G-REIT has to be set up as a German public limited company, what is known as a 'REIT AG'.
- The combined effective tax rate for corporations is reduced to an average of 29.8 (depending on the business location in Germany; trade tax would no longer be treated as a deductible business expense, which is reflected in the effective rate).
- A comprehensive earnings stripping rule is being introduced (see below), replacing the current thin capitalisation regime. Even if an interest deduction is not affected by this rule, it still could be restricted for trade tax purposes. For trade tax purposes, the current 50% add-back of long-term interest expense is replaced with a general add-back of 25% of all interest expense (which now includes deemed interest elements in rental and lease payments).
- The transfer pricing rules are significantly changed, targeting in particular the transfer of business functions and intangibles out of Germany.
- The current change-in-ownership rules regarding the potential to carry forward tax losses have been revised. The only decisive criteria for a denial of loss utilisation is a change in ownership. The revised rule results in a pro rata forfeiture of loss carry-forwards where shares comprising 25–50% of the capital or votes of the loss company are directly or indirectly transferred to a new owner over a five-year period. If more than 50% is transferred over a five-year-period to a new owner, the entire loss carry-forward would be forfeited. This rule applies even if the transfer occurs within a group of companies.

2. 2008 Business Tax Reform – Earnings Stripping Rule

The new earnings stripping rule stipulates the net interest expense (i.e. the difference between interest income and interest paid) deduction per annum would be limited to 30% of pre-interest, pre-depreciation and -amortisation taxable income. "Interest" in this sense includes all interest payments, receipts and/or accruals, whether to or from a related party or a third party (secured or unsecured). Since dividend income is generally 95% tax-exempt, this could result in no interest deduction in many situations (e.g. in case of a holding company). Interest expense that would be disallowed as a result of the 30% limitation would be able to be carried forward indefinitely, although following a change in shareholders, the carry-forward could be denied under the same conditions as a normal tax loss carry-forward (change-in-ownership rule; for changes, see above). All entities included in a German tax group (Organschaft)

would be treated as a single entity for purposes of the interest deduction limitation.

The general earnings stripping rule would not apply if:

- Net interest expense does not exceed €1 million per annum, or
- The business is not part of a group ("Konzern"), or
- The business is part of a group and the taxpayer can prove that the borrower's gearing is not higher than the group's leverage ratio ("escape clause").

For the escape clause to apply, the taxpayer would need to prove the equal or lower German leverage ratio with CPA-reviewed IFRS (potentially also US GAAP, where neither IFRS nor German GAAP accounts are available) financial statements for both the borrowing entity and the group. Critically, the clause measures "equity" at the borrower single balance sheet level as stated equity less investments in other group companies (except for Organschaft subsidiaries), which would appear to rule out the application of the escape clause in many cases. The escape clause would not apply where any group company pays more than 10% of its net interest expense on debt to shareholders, related parties or secured third parties. If such interest is paid on debt that is eliminated in the consolidated accounts (i.e. to shareholders or related parties if they are all part of the same

consolidated group), the escape clause would probably continue to be available. The definition of a secured third party with recourse appears to revert to the very broad pre-2004 definition, which, for example, treated any related party guarantees to the third party as harmful recourse.

Finally, it is worth noting that the definition of a "group" is broad. The official interpretation refers to common control as defined in IAS 27. It is not decisive for the group's scope whether consolidated group accounts are actually set up at a certain level – the legally decisive "group" is the largest possible group of companies to be consolidated under IFRS. Substantial uncertainty surrounds the extent of such a group – it is conceivable that, for example, all investments held by the same private equity fund form a "group" in the sense of the proposed rule.

For many leveraged German companies, the law change would negate the beneficial effects of the proposed general rate reduction. Acquisition vehicles in leveraged transactions, in particular, may not be able to rely on the escape clause if they cannot meet the strict requirements for the escape clause test.

In summary, all of this is evidence that Germany remains a challenging place to invest in from a tax perspective. Although many restrictions can in

practice be dealt with, what is frustrating for both taxpayers and their advisers is the seemingly increasing speed of change and thus instability in the tax system. The constant debate about tax reform forces groups to reconsider their structures almost continuously, and definitely adds a risk element to any German investment.

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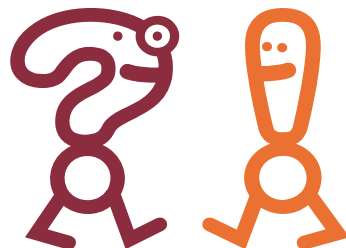
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