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by Wolfgang Kessler and Rolf Eicke

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FEATURED PERSPECTIVES

Germany's Growth Acceleration Act — Taming the Sunshine Tax Legislation

by Wolfgang Kessler and Rolf Eicke

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Many of our previous columns dealt with the framework and the aftermath of the major corporate tax reform (Unternehmenssteuerreformgesetz) in 2008. The reform included a fundamental modification of the German thin cap rule, or *Zinsschranke* (see *Tax Notes Int'l*, July 16, 2007, p. 263, *Doc 2007-15373*, or *2007 WTD 141-9*), and the change-of-ownership rule, or *Mantelkauf* (see *Tax Notes Int'l*, Dec. 10, 2007, p. 1045, *Doc 2007-26131*, or *2007 WTD 242-14*).

What these measures have in common is that they fulfill their underlying purpose only in a normal or booming economic environment. In times of crisis, however, they have the same effect as gasoline poured on a burning fire. In short, this legislation was drafted for times of sunshine and not for times of thunder and rain.

The government and the legislature eventually recognized that these measures made coping with the crisis even worse for many companies. The legislative response is a set of legal provisions with the euphemistic name Growth Acceleration Act (Wachstumsbeschleunigungsgesetz), effective January 1, 2010.

Zinsschranke

The German legislature replaced the old debt-equity-related thin cap rule with the earnings before interest, taxes, depreciation, and amortization (EBITDA)-driven *Zinsschranke* (interest barrier) in 2007-2008.

The cornerstone of the new rule is that it places a cap on the deductibility of interest payments regardless of whether the interest is paid to a related or an unrelated party. The interest deduction is capped at 30 percent of EBITDA. Anything beyond that is either deductible under the three exceptions or can be carried forward indefinitely. However, using €1 of carried forward interest expenses requires an additional taxable EBITDA of €3.33. For purposes of the *Zinsschranke*, the tax EBITDA and not the commercial EBITDA is applied. One difference between the two is that tax-exempt dividends and diverse book depreciations on participations are not taken into account.

The rule does not apply solely to corporations; it also applies to partnerships.

However, the rule does not just cover shareholder loans or back-to-back financed loans with third persons. Germany is one of the few jurisdictions in the world that also applies its thin cap rule to normal bank loans. Thus, it covers any interest expense.

There are three exceptions. The rule does not apply if:

- net interest expenses below €1 million (€3 million because of later amendments) per year are incurred;
- the company in question does not belong to a group of companies, unless the company in question is a corporation and excessive interest is paid to a related party (a holding of a minimum 25 percent and a payment of at least 10 percent of the interest balance to the shareholder); or

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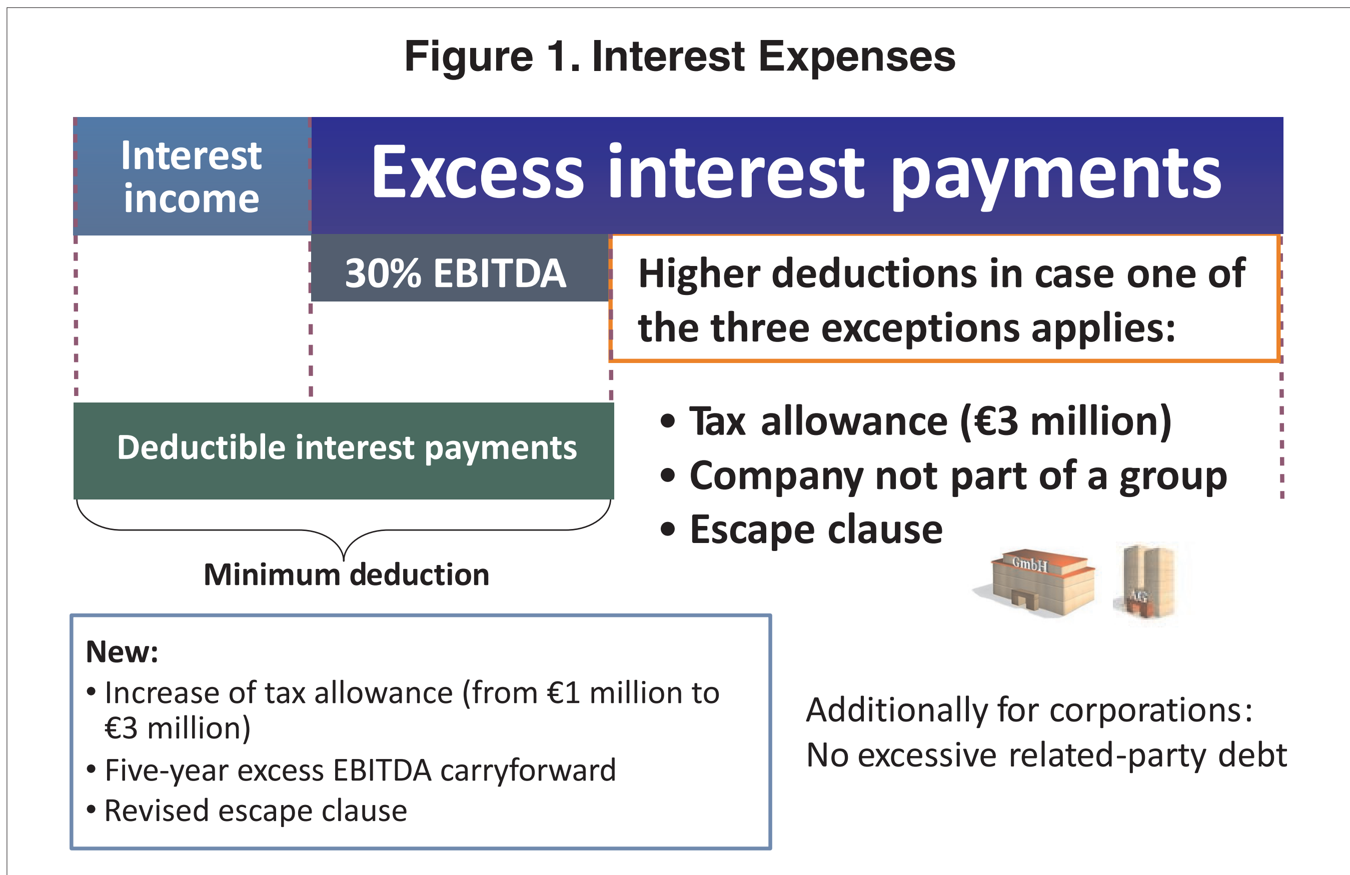

- the escape clause applies, unless the company is a corporation that pays excessive interest to a related party or whose company members pay excessive interest.

While the first two exceptions are relatively easy to handle, the escape clause is one of the most complex provisions in German tax law and too impractical to be applied by most taxpayers. It is the very last resort. The clause allows the deduction of all interest expenses if the equity ratio of the German business is up to 1 percent lower, equal to, or higher than the worldwide equity ratio of the group to which the German company belongs. (See Figure 1.)

In an international context, double taxation problems arise because the taxpayer cannot rely on Germany's treaty partners to accept the classifications and legal consequences from the *Zinsschranke*. Also, holding companies are deprived of their so-called safe haven in the pre-2008 rule, which provided that qualifying holding companies did not have to deduct the book value of their participations for purposes of calculating the debt-equity ratio. Thus, the thin cap rule leads to a holding discrimination.

It is problematic that the *Zinsschranke* violates the fundamental principle of exclusively taxing net income. The new rule disallows the deduction of real economic losses and thereby taxes income that has not been generated. Coping with this detrimental effect in normal times is barely feasible; in times of crisis, the consequences are highly dangerous and could tip the scales between survival and doom.

The Growth Acceleration Act lessens these harsh consequences a little.

The tax allowance (or threshold exception) of €1 million is permanently increased to €3 million. Because of the severe consequences of the crisis, the tax allowance was already increased to €3 million in the Citizen Relief Act of July 16, 2009 (Bürgerentlastungsgesetz). However, this was only a sunset provision that expired on December 31, 2009. In times of crisis, many companies demand more debt and incidentally triggered this abuse rule with its detrimental effects.

Moreover, an EBITDA carryforward of the unused interest deduction potential has been introduced. Under the old rule, the deduction of net interest expenses was always capped at 30 percent of the EBITDA in the respective year. The new rule provides for the opportunity to carry forward the unused EBITDA in subsequent years. After five years the carryforward will lapse. The carryforwards are deemed to be used in order of their creation, meaning that older carryforwards are used first.

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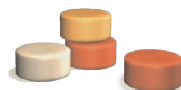
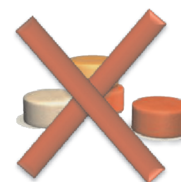
Figure 2. New Change-of-Ownership Rule

New:
- Insolvency restructuring exception
- Intragroup exception
- Built-in gain exception

Change of Ownership	**0%-25%**	**25%-50%**	**>50%**
Loss and Interest Carryforwards	Full	 Ratably lost	 No carryforwards

However, the EBITDA is not increased in years in which the taxpayer takes advantage of the tax allowance, the group clause, or the escape clause. It is possible to take into account the EBITDA potential that was not used in previous accounting periods starting after December 31, 2006, and ending before January 1, 2010.

Also, the escape clause was revised by granting a 2 percent annual volatility margin for equity comparison (instead of 1 percent) between the commercial establishment in question and the group average equity rate.

The measures taken by the legislators are all necessary and welcome, but more modifications are urgently needed. The holding discrimination described above has not been cured and remains an immense burden for German groups with cross-border business activities.

What is still burdensome is that even the escape clause is denied by the related-party exception; any excessive related-party interest payment would affect the entire group. Because the escape clause applies on a global group perspective, one single excessive interest payment to a small majority holding would deprive the entire group of the benefits of the escape clause.

Change-of-Ownership Rule

Another heavily criticized provision of the 2008 corporate tax reform is the codification of a new set of rules governing the use of net operating losses in case of a change of ownership. (*Mantelkauf* literally means ''purchase of a coat.'')

The new rule in paragraph 8(c) KStG (Corporate Income Tax Act) replaced the former regime in paragraph 8(4) KStG. It applies:

- to a direct or indirect transfer of 25 percent;
- to stocks, membership rights, participation rights, voting rights of a corporation, or a similar transaction;
- within five years, computed retroactively after the last acquisition; and
- to an acquirer or a related person, regardless of whether the acquirer is already a shareholder.

An increase of capital stock is deemed to be a transfer if it alters the participation quota. The legal consequences are twofold: First, corporate income tax and trade tax loss carryforwards on a pro rata basis in case of a change of ownership between 25 and 50 percent is eliminated. Beyond 50 percent, all carryforwards are lost. Once the 50 percent threshold is triggered, a new

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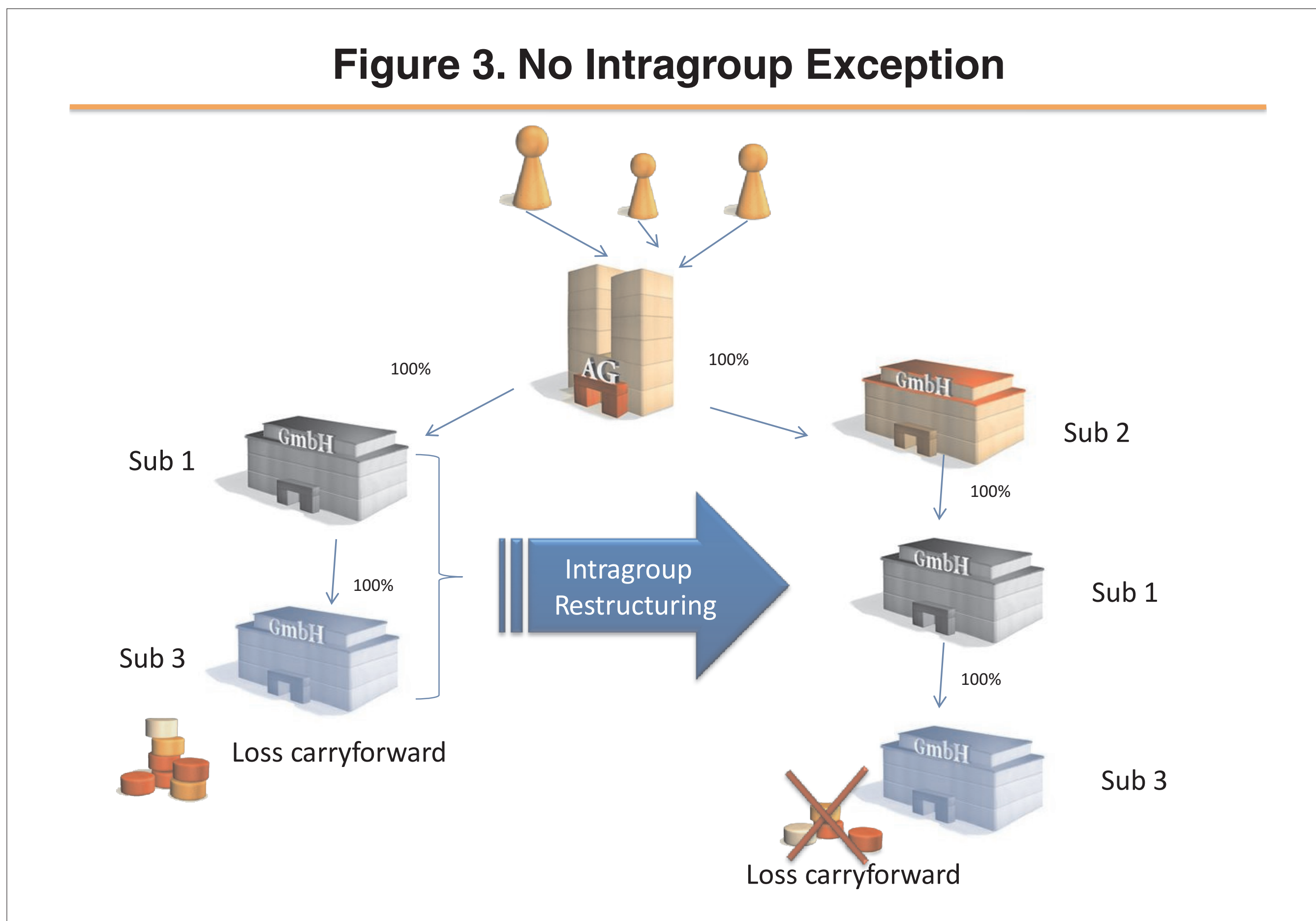

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five-year period begins. Second, the interest carryforward of the new thin cap rule (*Zinsschranke*) is eliminated. (See Figure 2.)

In times of crises, losing the ability to take tax losses makes a takeover target less attractive and reduces the chances of a successful restructuring after a takeover. That the new regime did not contain any intragroup exception for the transfer of participations within a group of companies was also detrimental. As a result, any intragroup reorganization leads to a loss of carryforward credits. The legislature argued that such a group exception would be too hard to administer and would create too many loopholes for tax planning.

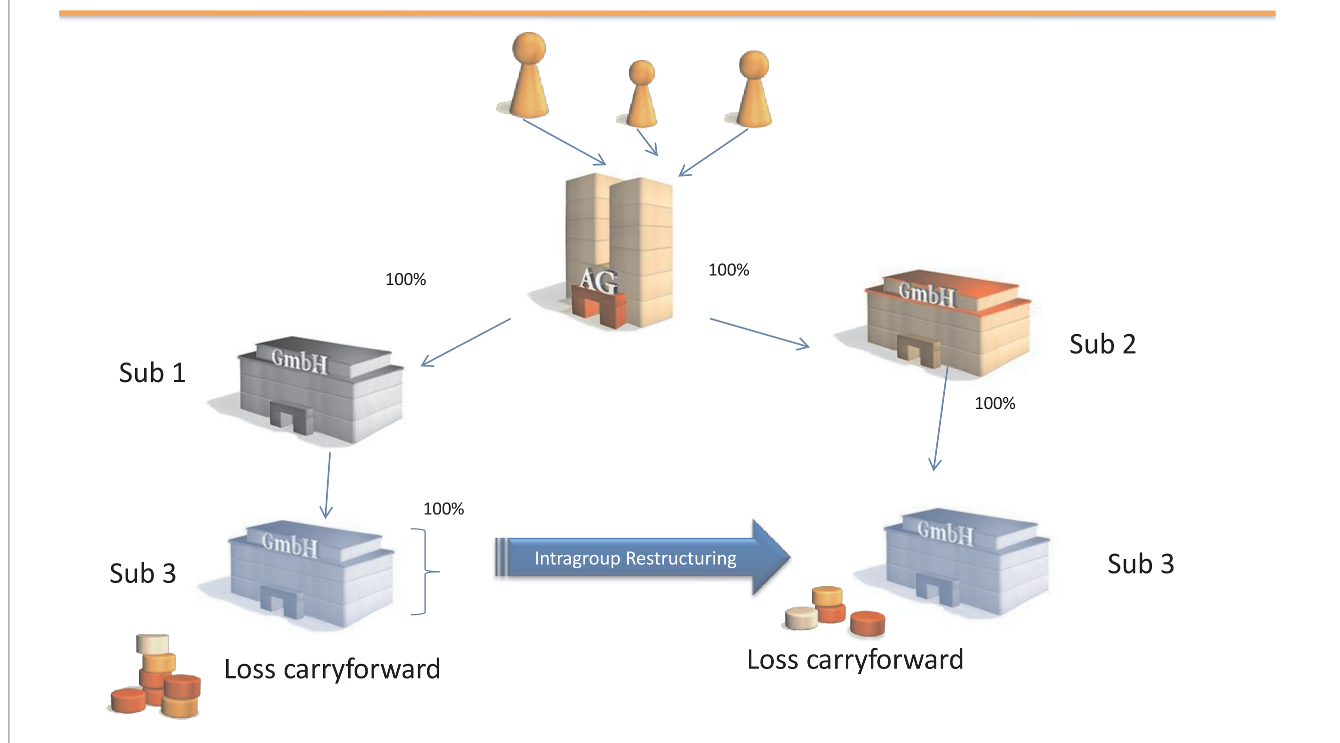
Both dilemmas are (partly) eased by the Growth Acceleration Act. It introduced a permanent (a temporary one was already enacted in the 2009 Citizen Relief Act) insolvency restructuring exception (the so-called *Sanierungsklausel*); consequently the change-of-ownership rule does not apply if the following prerequisites are met:

- measures have been taken to prevent the insolvency or the overindebtedness of a company; and
- essential business structures remain untouched.

The last requirement is fulfilled if a business contract that provides for a job arrangement is concluded. Alternatively, the acquirer must guarantee that either the sum of wages will not fall below 400 percent of the initial sum of wages within the following five years, or that the corporation is capitalized with essential business assets (of which further limitations apply).

Also, an intragroup exception has been introduced providing that a transfer of shares does not trigger the rule if after a direct or indirect legal transfer, the same person owns directly or indirectly 100 percent of the loss entity. Currently, there is some uncertainty as to how to interpret the phrase ''the same person.'' If interpreted in a strict manner, the exception would not apply to companies with more than one shareholder. For example, if a company with more than one shareholder sells a 100 percent subsidiary (Sub 1) and its subsidiary (Sub 3) to another 100 percent subsidiary (Sub 2), the transaction might trigger the change-of-ownership rule on the level of Sub 3 because the parent company is not owned by the same person as shown in Figure 3.

However, the intragroup exception does apply if Sub 1 sells Sub 3 to Sub 2. (See Figure 4.)



Furthermore, a built-in gain exception applies for all transfers performed after December 31, 2009. Under this exception, NOLs remain usable in an amount equal to the built-in gains of the loss corporation. The usable NOLs are reduced ratably for ownership changes between 25 to 50 percent. However, the built-in gains are only taken into account to the extent that they already existed at the time of the transfer of shares.

Other Measures

Besides family-support provisions, other measures included a controversial reduction of the VAT rate on hotel accommodations, amendments to the inheritance tax reform of 2009, and the addbacks for trade tax purposes of rental payments for immovable assets were reduced from 16.25 percent to 12.5 percent.

German Finance Minister Wolfgang Schäuble announced in February 2010 that he will set up a reform commission to search for alternatives to the trade tax. The German trade tax, a municipal tax, is unprecedented in the world and a burden for investors because it includes non-earnings-dependent elements that tax the substance of a company. However, these factors are why the trade tax is so popular with municipalities; it generates revenue even in times of crisis. One proposal is to give a share of the individual income tax and corporate income tax to the municipalities as compensation for the abandonment of the trade tax. However, there is a long way to go.

Another measure of the intragroup exception was introduced to the real estate transfer tax allowing a tax-free restructuring within groups when they are conducted as reorganization within the scope of the German Reorganization Act (for example, a merger). This constitutes an exception to the basic rule that more than a 95 percent change of ownership triggers real estate transfer tax. The exception also applies to a more than 95 percent change in the partners of a partnership owning real estate.

Next Steps

All measures taken are good for the economy and received positive feedback from the taxpayers (except for the tax cut for hotel accommodations).

Although it is a step in the right direction, more measures must be taken. The legislature has many items left on its to-do list.

The thin cap rule and the change-of-ownership rule must be designed in a way to exclusively target cases of abuse and thereby comply with the requirements set by the European Court of Justice in *Cadbury Schweppes* (C-196/04) regarding the drafting of antiavoidance legislation. Also, the German rules on the transfer of

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functions must be brought in line with international standards, and the rules must be loosened regarding research and development. A draft version, dated January 25, 2010, has already been published. Also, international agreements are needed to prevent double taxation when functions shift abroad.

It would be an advantage if Germany would introduce an international group taxation regime as considered in the current coalition agreement between the governing parties (CDU and FDP). Such a regime could solve many tax problems and facilitate cross-border transactions.

A new cross-border loss aggregation system must be implemented to revitalize the principle of net earnings taxation and eliminate obstacles for cross-border investments.

Moreover, the legislature must modify the addbacks for royalties and finance expenses for purposes of the trade tax that have shown detrimental effects in this time of crisis.

After all, the new liberal-conservative coalition has shown that it is not resistant to constructive criticism. Hopefully, this mindset can survive the next budget announcement. ◆

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