tax notes international
Volume 50, Number 8 ■ May 26, 2008

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Is Germany a 'Holding Haven'?

by Wolfgang Kessler and Rolf Eicke

Reprinted from *Tax Notes Int'l*, May 26, 2008, p. 687

taxanalysts®
Respectfully disagreeable since 1970.

FEATURED PERSPECTIVES

Is Germany a 'Holding Haven'?

by Wolfgang Kessler and Rolf Eicke

Wolfgang Kessler is the director of the tax department of the business and economics faculty at the University of Freiburg and a partner with Ernst & Young in Freiburg, Germany. The views expressed here are entirely his own. Rolf Eicke is his assistant at the tax department of the University of Freiburg. E-mail: Wolfgang.Kessler@tax.uni-freiburg.de and Rolf.Eicke@tax.uni-freiburg.de

In this article, we use the expression ''holding haven'' to describe a tax jurisdiction with a very attractive legal framework for holding companies. Holding haven regimes are more sophisticated than conventional tax haven regimes, demanding more infrastructure and business activities. Holding haven regimes are extremely fast changing because of competition, which forces holding havens to continuously incentivize multinational corporations (MNCs).

Traditionally, Germany has held great appeal for U.S. investors, not only as a production location and consumer market, but also as a holding location. Germany is the leading investment location of U.S. investors in Europe. Investments in the amount of €130 billion and 800,000 direct jobs are closely connected to U.S. activities in Germany.

Germany attracts many companies even though it competes with Eastern European countries over U.S. investments. In March 2008 the ''AmCham Business Barometer,'' created by the Boston Consulting Group (BCG) and AmCham Germany, revealed that Germany is the prime location for holding competence centers and headquarters, and the second most popular finance holding location of U.S. MNCs in Europe. Competence centers tie together several essential corporate functions such as strategy, organization, and technical support. The survey represents the opinion of 86 major U.S. MNCs, which generated €135 billion in sales in 2006 in Germany. (See Table 1.)

Holding companies are a great instrument for pooling group and shareholder interests and managing cash flows by optimizing the distribution of profits while simultaneously financing other companies. However, the most important function of a holding company is the systematic avoidance of double taxation that is caused by the separate taxation of each group company. (See Figure 1.) Therefore, holding companies are a key tool to fulfill the tax principle of *ne bis in idem* (''not twice for the same'').

For many, a holding company is closely related to tax evasion. In business circles, the concept of holding companies implies the establishment of effective management structures to minimize costs. Since taxes are, from a management point of view, just another cost, the cost minimization process includes the minimization of tax liabilities.

Regarding holding companies in Europe, recent data from the U.S. Commerce Department's Bureau of Economic Analysis (BEA) offer some interesting insights. Figure 2 shows U.S. direct investments between U.S. parent companies and European holding companies. The balance of payment transactions (and associated positions) between parents and affiliates are recorded against the country of the foreign affiliate with which the U.S. parent had a direct transaction, even if the transaction may reflect indirect claims on, liabilities to, or income from indirectly held affiliates in third countries. Even though these indirect payments could lead to a misinterpretation of the figures, some general remarks can be made:

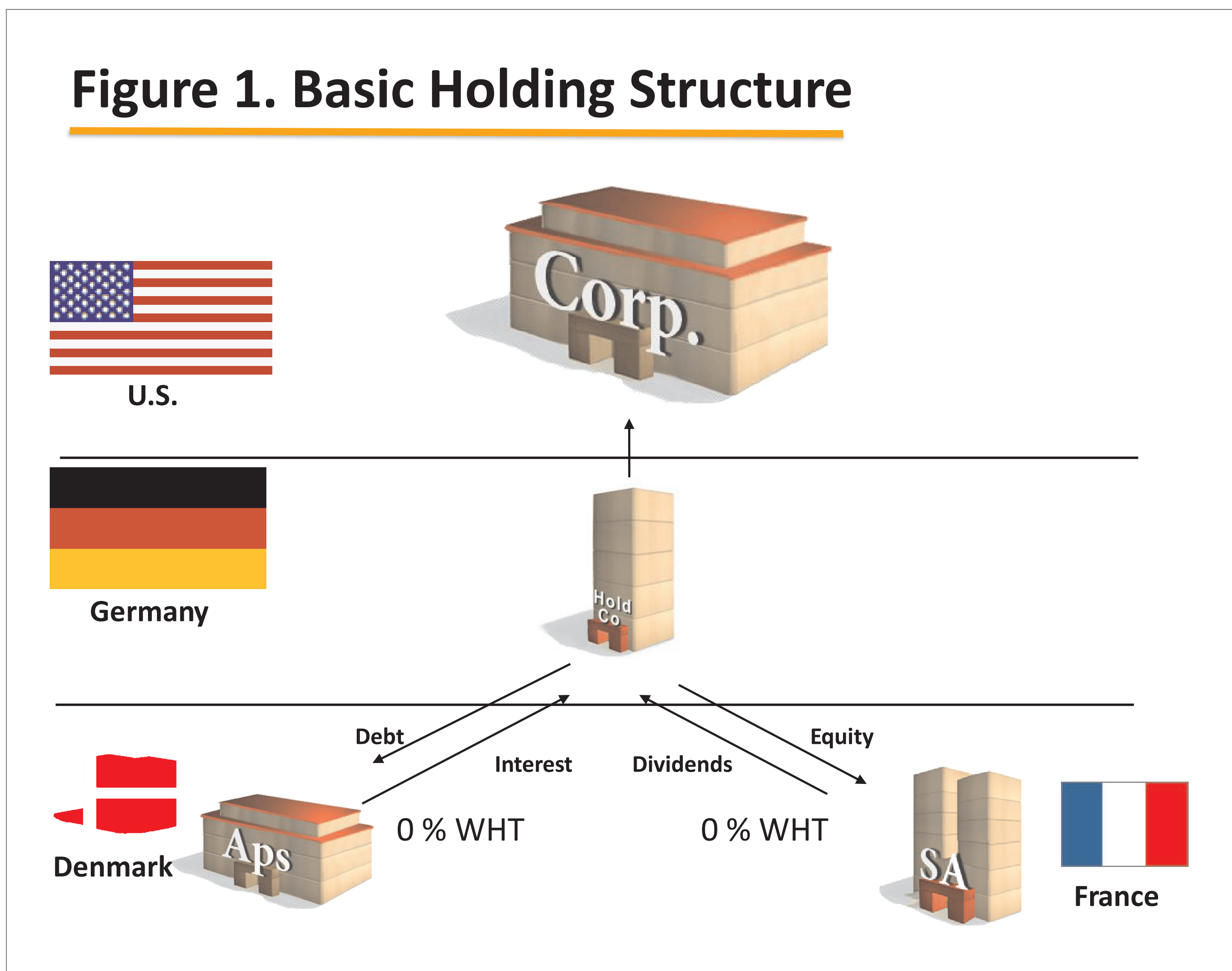
- the four leading holding locations (the Netherlands, the United Kingdom, Luxembourg, and Switzerland) have not changed positions between 2003 and 2006;
- the payments are not stable, as the decrease in the Netherlands in 2005 shows;

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Table 1. Ranking of the Most Popular Holding Locations of U.S. MNCs in Europe

Competence Centers		Headquarters		Finance Holding	
1. Germany	37%	**1. Germany**	32%	1. Netherlands	21%
2. U.K.	27%	2. U.K.	29%	**2. Germany**	19%
3. France	11%	3. Switzerland	16%	3. Switzerland	17%
4. Switzerland	7%	4. Belgium	11%	4. U.K.	17%
5. Belgium	6%	5. France	8%	5. Luxembourg	15%

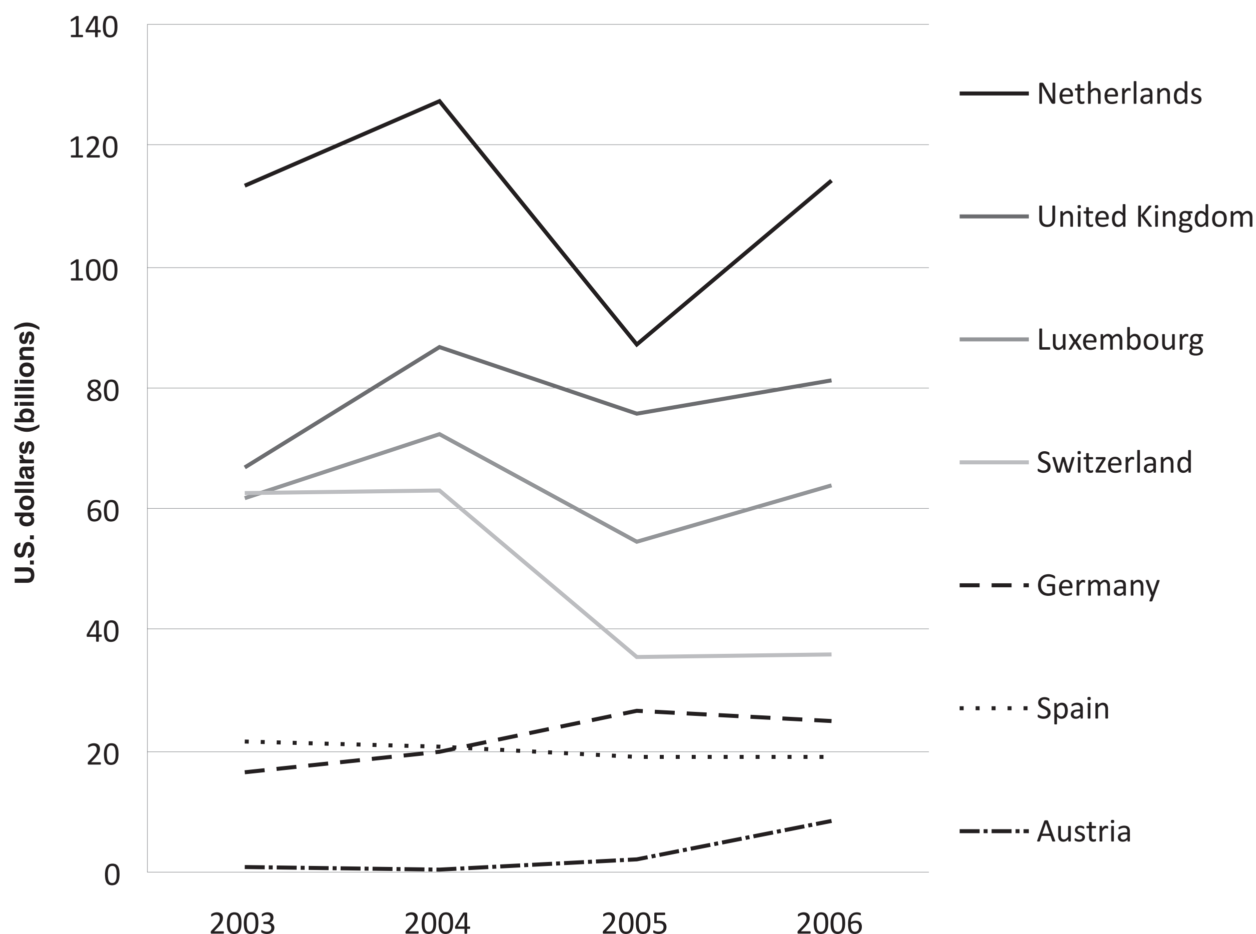
Source: AmCham Germany/Boston Consulting Group, *Perspektiven zum Wirtschaftsstandort Deutschland*, 2008, p. 14.



- despite the special holding regime in Spain (EVTE), Germany was able to pass Spain and moved into fifth place; and

- the payment figures of Austrian holding companies increased by a factor of 4 between 2003 and 2005 and by a factor of 16 between 2003 and

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.



(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

2006, suggesting that U.S. investors endorse the newly established Austrian regime for holding companies.

Holding Location Factors

Countries rarely become a holding haven by chance. Often, an attractive holding taxation framework is part of an integral policy to attract foreign investors. A holding haven regime primarily must systematically avoid double taxation, the main function of a holding company. Yet countries that want to become a holding haven must be aware that being a quality holding haven involves a long-lasting tax policy of mutual trust in both legal certainty and reliability of being a permanent attractive investment location.

For MNCs, using holding companies is especially appealing because of the intense competition between countries and because of the high location elasticity. This means that since the transaction costs are fairly low, it is always possible (and practical) to move a holding company from one country to another if the legal framework changes. Thus, if the holding location does not live up to its expectations, investors can quickly shift their holding company to a different country.

A suitable holding location must combine as many of the features listed in Table 2 as possible.

Germany's Holding Framework

In 1994 Germany passed an act to promote the country as a holding location (*Standortsicherungsgesetz*).

Table 2. Holding Location Factors

- participation exemption of dividends
- exemption of capital gains on the disposal of shares
- no withholding taxes on incoming and outgoing dividends and on liquidation distributions
- deductibility of finance costs, goodwill, and current-value depreciation
- liberal antiavoidance legislation
- liberal thin cap rules
- no CFC rules
- broad treaty network
- no capital duty on capital contributions
- low corporate income tax rate
- low taxation of employees
- attractive investment climate
- no exit taxation
- favorable VAT taxation

This measure was eventually contradicted by tightened thin capitalization rules (section 8a KStG), controlled foreign corporation rules (section 7 AStG), and a 5 percent lump sum taxation on received dividends and capital gains (section 8b KStG). Nonetheless, Germany is a competitive holding location, and there is political will to establish the country as a favorite holding regime. Germany offers planning opportunities with partnerships, which are taxed as transparent entities. The beauty of implementing a German partnership as Euro holding is that withholding taxes on dividend repatriations and thin cap rule restrictions can be completely eliminated. Also, a German partnership allows diverse arrangements that reduce the tax burden. The simplest type of German partnership is a sleeping partnership (*stille Gesellschaft* or *stille Beteiligung*), which offers great international tax planning opportunities.

Germany has also caught the eye of U.S. private equity funds that demand structures that tax efficiently and repatriate profits back to the United States. In the last few years, the German legislature and tax authorities have worked hard to design an investor-friendly private equity regime, including a private equity law.

The Upside

Germany offers a broad 100 percent participation exemption on dividends and capital gains without a minimum holding period or minimum shareholding requirement for purposes of the corporate income tax participation exemption. Moreover, business expenses are fully deductible even if related to tax-exempt income.

For international tax planning purposes, the group relief system (*Organschaft*) is very appealing; it provides for an aggregation of profits and losses on the group parent level. Unfortunately, the regime does not apply in a cross-border context. Another attractive feature is Germany's broad treaty network, including treaties with all major industrial countries, especially the revised treaty with the United States that provides for a 0 percent dividend withholding tax under special circumstances. Unlike many other favorable holding locations, Germany does not impose any capital or stamp duty.

The Downside

Even though there is 100 percent participation exemption on dividends and capital gains for corporate income tax purposes, 5 percent of the dividend income and all the capital gains are deemed to be nondeductible business expenses. It is important to note that the draft of the Annual Tax Law 2009 includes a taxation of portfolio dividends (less than 10 percent holdings). Unlike the corporate participation exemption, the trade tax participation exemption requires not only a 12-month holding period but also a minimum shareholder participation of 10 percent in cases when the EU parent-subsidiary directive applies, and 15 percent in all other cases.

The last major corporate tax reform, which took place in 2008, brought about many beneficial rules for corporations, but also some detrimental effects, including the new thin cap rule (*Zinsschranke*) and the broadened taxation of function shifting.

The cornerstones of the new thin cap rule are that it places a cap on the deductibility of interest payments no matter if the interest is paid to a related or unrelated party. (See ''New German Thin Cap Rules — Too Thin the Cap,'' *Tax Notes Int'l*, July 16, 2007, p. 263, *Doc 2007-15373*, or *2007 WTD 141-9*.) The interest deduction is capped at 30 percent of EBITDA (earnings before interest, taxes, depreciation, and amortization). Anything beyond that is either deductible under the three exceptions shown below or can be carried forward indefinitely. The rule does not apply if:

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

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

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

However, although the introduction of the *Zinsschranke* carries some detrimental effects, it also opens up new planning opportunities because of the abolishment of any group finance restrictions.

Also very detrimental for Germany as a holding haven is the tightened new change-of-ownership rule (*Mantelkauf*). Loss carryforwards are pro rata or completely lost in case of a direct or indirect transfer of 25 percent of stocks, membership rights, participation rights, voting rights of a corporation, or a similar transaction within five years, computed retroactively after the last acquisition to an acquirer or a related person, regardless of the acquirer already being a shareholder. (See ''Losing the Losses — The New German Change-of-Ownership Rule,'' *Tax Notes Int'l*, Dec. 10, 2007, p. 1045, *Doc 2007-26131*, or *2007 WTD 242-14*.) At last, Germany does not offer any preferential taxation for holding managers or other executives.

Holding Haven?

The attractiveness of a holding haven, like beauty, is in the eye of the beholder. For MNCs that do not trigger the thin cap or change-of-ownership rules, Germany can be as attractive as classic holding havens such as Luxembourg, the Netherlands, and Switzerland. However, these holding havens have a key advantage over Germany — a great reputation as a reliable tax jurisdiction with a permanently friendly tax climate. This often underestimated factor might tip the scales and must no longer be ignored by the German legislature. ◆

(C) Tax Analysts 2008. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.