

German Tax & Legal News

Monthly Newsletter for Inbound Investors into Germany

Draft law proposes reliefs for business taxation

The coalition agreement signed by the new German government on 26 October 2009 contains several business tax reliefs that are intended to apply as from 1 January 2010 (see the GTLN Special Edition October 2009). The short-term measures mentioned in this agreement have now been clarified in a draft law ("Proposal for a law to accelerate economic growth").

While the proposed reliefs still may be subject to changes because they must be approved by both the Upper and the Lower Houses of Parliament, final approval of the law is scheduled for 18 December 2009.

The reliefs proposed in the draft law are as follows:

Interest deduction limitation rule (30% EBITDA limitation)

- The recently introduced temporary increase in the de minimis threshold to EUR 3 million of net interest expense for 2008 and 2009 would become permanent. Thus, net interest expense of up to EUR 3 million would be deductible irrespective of the 30% EBITDA limitation in future. Assuming an interest rate of 5%, entities having net debt of up to EUR 60 million would thus not be subject to the limited interest deduction.
- The 30% EBITDA limitation currently does not apply if a group company can show that its equity ratio is equal to or at least does not fall below more than 1% of the equity ratio of the entire group of which it is a member. The 1% threshold would be increased to 2%. This increase does not constitute the hoped-for relief in group situations, particularly because the equity ratio test still would be subject to the requirement that the German entity demonstrates that there is no harmful shareholder financing in any other group company worldwide.
- An EBITDA carryforward would be introduced retroactively as from 2007. An EBITDA carryforward would be generated if a taxpayer has net interest expense lower than 30% of the EBITDA for tax purposes. The difference between 30% of the EBITDA and the net interest expense (the excess EBITDA) would then be carried forward and could be used in the following five years when the net interest expenses exceeded 30% of current EBITDA.

Example: In 2009, X GmbH has an EBITDA of EUR 20 million and can fully deduct its net interest expense of EUR 5 million (i.e. EUR 5 million is less than EUR 6 million which is 30% of EUR 20 million). X GmbH generates an EBITDA carryforward of EUR 1 million in 2009. In 2010, X GmbH only has an EBITDA of EUR 10 million, but the same amount of net interest expense (i.e. EUR 5 million). The deduction of the



net interest expense would generally be limited to EUR 3 million (30% of the EBITDA). However, X GmbH may additionally offset net interest expense of EUR 1 million because of the EBITDA carryforward generated in 2009.

- As an important exception, an EBITDA carryforward would not be generated in periods in which one of the three general exceptions to the limited interest deductions applies: (i) the de minimis threshold exemption; (ii) the company does not belong to a group; or (iii) the company is part of a group but proves that the equity ratio is equal to or at least not more than 2% less than that of the group as a whole. Since the EBITDA carryforward would generally be forfeited after five years, EBITDA carryforwards that have been generated first are deemed to be used first (i.e. FIFO method). Net interest expense that would be deductible because of using an EBITDA carryforward (deduction of net interest expense in excess of the 30% EBITDA of that particular year) would not create an additional interest carryforward. Irrespective of the five-year period, the EBITDA carryforward would be forfeited in cases where a business is transferred and in certain reorganizations (but would not be subject to the change-in-ownership rules).
- Although the EBITDA carryforward may be computed retroactively as from 2007 (i.e. there would be a deemed applicability of the interest deduction limitation rule for 2007), the first increased interest deduction would technically not be earlier than 2010. Further, this first increased interest deduction in 2010 would only be granted upon request.

Example: In 2008, X GmbH has an EBITDA of EUR 20 million and may fully deduct its net interest expense of EUR 5 million (i.e. EUR 5 million is less than EUR 6 million which is 30% of EUR 20 million). X GmbH thus generates an EBITDA carryforward of EUR 1 million in 2008. In 2009, X GmbH only has an EBITDA of EUR 10 million, but the same amount of net interest expense (EUR 5 million). The deduction of the net interest expense would be limited to EUR 3 million (30% of the EBITDA). X GmbH cannot use the 2008 EBITDA carryforward of EUR 1 million in 2009, even though it has nondeductible interest expense of EUR 2 million. In 2010, X GmbH has an EBITDA of EUR 10 million and the same amount of net interest expense (EUR 5 million). The deduction of the net interest expense in 2010 would generally be limited to EUR 3 million (30% of the EBITDA). However, starting in 2010, X GmbH can use the EBITDA carryforward of EUR 1 million generated in 2008. Consequently, upon request, X GmbH may additionally offset net interest expense of EUR 1 million. The excess of the nondeductible interest expense in 2010 (EUR 1 million) would increase the interest carryforward of EUR 2 million generated in 2009. Since the new rules are technically applicable as from 2010, the EBITDA carryforward generated in 2008 might still be available up to 2015 (despite the general five-year period).

Change-in-ownership rule

- The recently introduced temporary exemption from the change-in-ownership rule for share transfers in the context of a qualifying financial restructuring, which had been limited to restructurings taking place in 2008 and 2009, would be extended indefinitely beyond 2009.
- Exceptions to the change-in-ownership rule would apply to intragroup restructurings: loss and interest carryforwards would not be forfeited if a single person or entity directly or indirectly owns 100% of the shares in the transferring company (i.e. the company selling shares in the German corporation with loss and interest carryforwards) and the receiving company (i.e. the company acquiring these shares), nor would it be necessary to own 100% of the shares in the company with the loss carryforwards, but minority shareholders at an upper tier company would be harmful. As a consequence and based on the draft, reorganizations within a 100% controlled group of companies should generally no longer be harmful from 1 January 2010.

Example: Company A owns 100% of Company B and Company C, the latter of which owns 60% of the shares in LossCo. If Company A transfers its shares in Company C to Company B or Company C transfers its 60% shareholding in LossCo to Company B, this should not be considered a harmful event under the new rules. A transfer of the shares in LossCo to Company A, however, would seem to be harmful if Company A is not itself wholly owned by a single person or entity.

Amended example: If Company A only holds 95% in Company C (and the remaining 5% is held by a third party), the exception for intragroup restructurings would not be available. This might even be true, if Company B had the same shareholders' structure as Company C.

- Even if there was a harmful share acquisition (either by a related party or a third party), from 1 January 2010 losses would continue to be available to the extent built-in gains in the loss company are subject to tax in Germany (if necessary on a pro rata basis). To the extent these built-in-gains would exceed the unused losses, existing interest carryforwards also would continue to be available.

Example: X-Co acquires 100% of the shares in LossCo for EUR 30 million from an unrelated third party. LossCo has unused loss carryforwards of EUR 10 million and interest carryforwards of EUR 15 million. According to the tax balance sheet of LossCo, the equity (inside tax basis) of LossCo is EUR 10 million. Assuming LossCo would only be active in Germany, usable built-in-gains would amount to EUR 20 million. Thus, the full amount of unused loss carryforwards (EUR 10 million) would still be available and built-in-gains would exceed the unused loss carryforwards by EUR 10 million. Of the remaining interest carryforwards (EUR 15 million), only EUR 10 million would still be available and EUR 5 million would be forfeited under the change-in-ownership rule.

Real estate transfer tax

- An exception to the real estate transfer tax (RETT) would be introduced for certain intragroup restructurings. According to the draft law, there are a number of restrictions and uncertainties relating to this exception so that its practical relevance outside of the real estate sector is doubtful and the legislative process should be monitored closely.
- The RETT exemption for intragroup restructurings would differ from the exception for intragroup restructurings for purposes of the change-in-ownership rule. For RETT purposes, it is not decisive whether a 100% direct or indirect shareholding is maintained; instead, certain restructurings under the Reorganization Act (not the Reorganization Tax Act) would be covered by the proposed exception (such as a hive-down, a merger or a demerger).
- The proposed provision only mentions the German Reorganization Act and not restructurings under comparable foreign rules. This would contradict the general tax rules for reorganizations, which in principle have been extended to cover reorganizations under comparable foreign rules. Also, at least in intra-EU cases, the proposed provision could be in violation of the fundamental freedoms of the EC Treaty.
- Intragroup restructurings involving a mere share transfer, an exchange of shares (unless structured as an “Ausgliederung” according to the Reorganization Act) or a contribution-in-kind would not be covered by the proposed RETT exemption, since these transactions are not covered by the Reorganization Act. Thus, an intragroup transaction that is of practical relevance, but that would not normally fall under the proposed exception is the interposition of an additional tier in the holding structure above a German subsidiary by way of an exchange of shares. RETT would still be triggered due to the consolidation of shares at the new tier.
- Certain restructurings that trigger RETT due to the change in the partners of a partnership would not be covered by the RETT exemption for intragroup restructurings.
- The draft would tie the RETT exemption to additional holding requirements. The real property would have to be owned for five years before and after the intragroup restructuring to qualify for the exemption.
- In particular with regard to this RETT exception for intragroup restructurings it appears to be questionable whether the proposed change in law will finally be approved. In the past, several attempts to introduce such an exemption have already been blocked by the Upper House of Parliament.
- All changes – if finally approved – will become effective from 1 January 2010.

Trade tax add-back of rental payments for immovable property

- The current trade tax add-back of 16.25% of rental payments for immovable property would be reduced to 12.5% from FY 2010.

Amortization for low-value assets

- The previous rule according to which the acquisition or production cost of assets with a value of up to EUR 410 could be deducted immediately would effectively be reintroduced.
- As an alternative to an immediate deduction for assets with a value of up to EUR 410, the recently introduced and currently applicable treatment with respect to low-value assets would remain available. Under this rule, only acquisition or production costs of assets with a value of up to EUR 150 can be deducted immediately. However, in case of applying this alternative treatment, the acquisition or production cost of assets with a value between EUR 150 and EUR 1,000 may be amortized under the straight-line method over a period of five years on a pooled basis.

Concluding remarks

The draft law contains other relief measures for individuals and businesses. VAT for hotels would be lowered from 19% to 7% and amendments to the inheritance and gift tax rules would facilitate the use of tax exemptions for businesses that are continued after a transfer and would lower tax rates for certain relatives. Although the coalition agreement mentions a relaxation of the rules governing a transfer of functions out of Germany, this is not included in the draft law. It is unclear whether – due to the complexity of this framework – this will be incorporated in another law proposal or whether the government intends to scrap the relaxation as initially announced.

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