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German Tax and Legal News

Considerations regarding proposals further limiting tax deductibility of interest expenses

Draft law would tighten existing rules and introduce a “maximum interest barrier rule”

The German government on 30 August 2023 approved a draft of a business tax reform bill (“Growth Opportunity Act”), which includes a multitude of different tax measures. One of the most important proposals for foreign investors into Germany is the tightening of the interest deduction limitation rules, which would generally become effective as from 1 January 2024. Even though the draft law is still pending in the legislative process and must be approved by the upper and lower houses of parliament, this article discusses what businesses should consider in regard to the proposed changes to the interest deduction limitation rules, as well as the proposal to introduce a “maximum interest barrier rule,” to better understand any potential implications.

Current interest deduction limitation rules
The current interest deduction limitation rules, which were introduced in 2008, are based on a general limitation of annual net interest expense to 30% of the EBITDA (earnings before interest, taxes, depreciation, and amortization) of a company. Excess interest expense can be carried forward indefinitely, and unused EBITDA capacity can be carried forward for five years. For purposes of the interest deduction limitation rules, a tax consolidated group qualifies as one company. Under the current rules, there are three exceptions to the general 30% EBITDA limitation:

- The company does not belong to a group (“stand-alone clause”);
- The company’s annual net interest expense is less than EUR 3 million; or
- The German borrower’s equity ratio does not fall short by more than 2% compared to the group’s worldwide equity ratio provided no harmful shareholder financing exists (“escape clause”).

In order to determine the arm’s length character of the interest expense, general transfer pricing rules based on the OECD transfer pricing guidelines apply.

Proposed changes to the interest deduction limitation rules
The pending draft law proposes the following changes to the current interest deduction limitation rules:

- The definitions for interest expense and interest income would be broadened so that they are aligned with the requirements as provided in Council Directive (EU) 2016/1164 (Anti-Tax Avoidance Directive). The proposed rule would refer to the definition of interest expense as provided in article 2 (1) of the Anti-Tax Avoidance Directive and, therefore, include “interest expenses on all forms of debt, other costs economically equivalent to interest, and expenses incurred in connection with the raising of finance.” Contrary to recent jurisprudence of the federal tax court (see GTLN dated 08/02/23), this definition would include “arrangement fees.”
- Any unused EBITDA capacity carryforward would be disallowed for years in which net interest income is generated.
- An exception would be introduced for interest expense related to funding of long-term public infrastructure projects within the EU as allowed by the Anti-Tax Avoidance Directive.
- The stand-alone clause would be tightened and no longer apply where there is at least a 25% shareholding or a foreign permanent establishment of the German company.
- The EUR 3 million threshold would no longer apply on a separate per-entity basis but on a group basis where person(s) acting in concert control(s) various companies that are engaged in the same business (“de-fragmentation clause”). If the de-fragmentation clause applies, the EUR 3 million threshold would need to be allocated to the respective companies based on their net interest expense. This proposal might be of

particular importance for real estate investments, construction projects, and other businesses that use special purpose vehicles.

- For purposes of the escape clause, the definition of "group" for purposes of the equity test would be aligned with the definition in the Anti-Tax Avoidance Directive. The opinion of the tax authorities regarding the "harmful shareholder financing criterion" for purposes of the escape clause would be introduced into the law in response to a 2015 taxpayer friendly decision of the federal tax court. Based on such criterion, interest expense paid by all group companies to a qualifying shareholder that is not a member of the consolidated worldwide group must not exceed 10% of the net interest expense of the German company. Based on the proposed rule, the 10% threshold would need to be determined for all qualifying shareholders together rather than on per-qualifying shareholder basis.
- An exception from the general 30% EBITDA limitation based on the stand-alone clause, the EUR 3 million threshold, or the escape clause would no longer be available to the extent annual net interest expense is increased by the utilization of interest carryforwards.

The proposed changes to the interest deduction limitation rules would become effective for expenses in fiscal years that begin after the approval of the proposed law by the lower house and that do not end before 1 January 2024.

Introduction of a maximum interest barrier rule
The proposed law also would introduce a maximum interest barrier rule in a newly introduced section 4l of the Income Tax Code.

Under the proposed rule, interest expense paid to certain related parties would become nondeductible if it exceeds a certain maximum interest rate (a base rate as provided in section 247 of the Civil Code plus a 2% margin). As the current base rate in section 247 of the Civil Code is 3.12%, this would result in a maximum rate of 5.12% (the base rate is updated by the German Federal Reserve every six months on 1 July and 1 January). Any changes to the floating maximum interest rate would apply for purposes of the maximum interest barrier rule one month after the change in the Civil Code. An exception would apply in two scenarios:

- Group escape: The borrower and the ultimate group parent entity (in case of a group) provide evidence that a borrowing would have been possible only for an interest rate that exceeds the maximum interest rate as provided by the maximum interest barrier rule. The explanatory notes to the proposed rule specify how to prove that the conditions of the group escape are given, i.e., how to prove that the creditor and the ultimate group parent entity (in case of a group) would have been able to borrow only for an interest rate that exceeds the maximum interest rate as provided by the maximum interest barrier rule. Based on the explanatory notes, such proof can be provided based on the refinancing rate of the ultimate parent entity or a benchmarking study at the ultimate parent entity level at the time when the respective financing arrangement with a German borrower is concluded. Bank offers or offers from other third-party lenders are not seen as being acceptable. If the group escape clause is applicable, the maximum rate acceptable under the maximum interest barrier rule should be the most favorable rate that the German creditor or the ultimate parent entity could have achieved.
- Substance and activity escape: The creditor has sufficient substance and activities in its jurisdiction of residence provided the jurisdiction exchanges information for tax purposes with Germany based on a qualifying provision in a double tax treaty or in a tax information exchange agreement with Germany. The explanatory notes to the proposed law include a statement that the substance and activity escape would be available only if the activities at the level of the lender are related to the specific financing activity, i.e., the specific loan provided to a German borrower. It is stated that the lender must have the ability and the authority to control or to bear the risk of the financing activity in question. In order to meet this condition, it is required that the decision makers at the level of the lender have the necessary experience and competencies and access to all the required information.

It has to be highlighted that the proposed maximum interest barrier rule also would apply to purely domestic transactions, even if both the lender and borrower are part of the same tax consolidated group.

The maximum interest barrier rule would apply for interest expense triggered after 31 December 2023.

Comments

The proposals in the draft law include important changes to the general interest deduction limitation rules and the introduction of a new “maximum interest barrier rule,” which might affect existing financing arangements without any grandfathering rules. Taxpayers should review their financing structures in this regard and prepare for a change of the rules. Even if the interest rates for intercompany loans are below the current maximum interest rate, the floating character of the maximum interest rate should be taken into account. If an escape is not available, it might be a prudent approach to consider this when determining intercompany interest rates with a German borrower.

It should be highlighted that the proposed rules are not final yet and still subject to approval in the legislative process. The outcome of the legislative process is uncertain, and the rules as described might be subject to change. Nevertheless, it is recommended to get familiar with the proposed changes and to follow any updates that might arise until the finalization of these rules.

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