German tax reform paves way for restructuring

Changes to tax laws in Germany are likely to have a dramatic impact on German corporations. Jan Kooi of Omnicom explores the implications.

German tax law was substantially reformed in 2000, as we looked at briefly in the December edition of *The Treasurer*. In this article, we will discuss the key changes that may have an important impact on the way German businesses owned by foreign groups will be structured, financed and owned.

The sweeping tax reform in Germany is implemented in two stages. Certain provisions became effective from 1 January, while others will take effect in next year. The new rules that will come into play on 1 January 2002 are likely to have dramatic consequences for corporate ownership in Germany.

> The new rules that will come into play on 1 January 2002 are likely to have dramatic consequences for corporate ownership in Germany

Changes in corporate income tax

The most important changes in German tax rules, to the extent that they relate to corporations, are as follows:

- abolition of dual rate structure;
- reduction of corporate income tax (CIT);
- introduction of participation exemption for domestic dividends;
- relaxation of conditions for tax consolidation; and
- substantial limitation in the thin-capitalisation safe harbour rules.

Until fiscal years starting on or after 1 January 2001 German companies were subject to different rates of CIT depending on whether the company distributed its profits or not. For 2000, the CIT rate on non-distributed profits was 40%, while the rate for distributed profits stood at 30%. Technically, this meant that distributions in a given year out of profits of previous years when they were taxed at the higher rate led to a cash payment by the German state to the distributing company, equal to the difference between the rate applicable at the time the income was earned, but not distributed and the CIT rate on distributed profits applicable at the time of distribution. Shareholders of the company were entitled to a credit of the underlying tax. In corporate situations, this meant that effectively (within the corporate sphere) corporate profits were taxed only once.

For non-corporate shareholders, the credit was also available, but there would usually be additional income tax due. Unlike other countries, German tax rules did not provide for a mechanism to provide a credit or refund to non-resident shareholders, as with the ACT refund system, which used to apply in the UK. For profits realised in 2001 and beyond there will be only one CIT rate of 25%. The trade tax remains unchanged and is due on top of that, still deductible for CIT purposes. Similarly, the solidarity tax (introduced to finance the cost of the reunification) remains in place.

Jan Kooi

Distributed dividends will, if they are paid out of 2001 or later years' profits, no longer be taxed at the level of the corporate parent. This brings such dividends in line with foreign dividends from qualifying participations. The credit system is therefore replaced by a full exemption system.

The downside to the reform

However, due to a not widely publicised (but long existing) provision in the law, there also is a downside to this new treatment. For a long time, Germany has had a provision (article 3c of the CIT-Act) which determines that costs related to exempt income are not deductible. Since, under the new rules, dividends from domestic subsidiaries – regardless of the ownership percentage – will be fully exempt from tax, any related costs, such as interest on a loan to finance the acquisition thereof, will no longer be deductible.

Note here that article 3c does not have any negative consequences for foreign dividends. In 1998 Germany introduced a system similar to the French one. This resulted in 5% of foreign exempt dividends being non-deductible,since this is deemed to represent the costs related to the ownership – and receipt of dividends – from the foreign subsidiary.

The non-deductibility caused by article 3c is relevant only in the year in which a domestic, exempt dividend is actually received, which may, in the light of what follows, be relevant.

Tax consolidation

The old tax consolidation regime in Germany, for CIT and trade tax, required not only a certain ownership percentage, but also de facto management control. For CIT purposes, this has been changed, although for trade tax and VAT the rules remain the same.

For CIT purposes, it is now sufficient that the parent owns 50% or more of the subsidiary to be able to file a consolidated tax return. As a consequence of this relaxation, it will often be easier to have the parent enter into a tax consolidation with its subsidiaries and so deduct expenses related with the ownership in the subsidiary directly from the profits of the subsidiary itself. This would avoid, at least for CIT, but not for trade tax purposes, the 3c issue.

One should, however, be careful with this general statement. Under certain circumstances, for example, the existence of tax losses in one of the companies, it may not be wise to enter into a tax consolidation, since such tax losses will be frozen for the duration of the consolidation. Furthermore, the rules for forming a tax consolidation also for trade tax purposes still remain strict and require de facto management control.

If you are faced with a situation where a tax consolidation would result in 'freezing' losses, you may want to avoid the result of article 3c by postponing dividend distributions.

Thin capitalisation

Until now, Germany had the following thin-cap rules. If the borrowing company qualified as a holding company (that is, owning at least two subsidiaries which represented 75% of the total assets or yielding at least 75% of its gross income) the debt/equity ratio was 9:1. An average company could borrow safely three times its equity. In the case of qualifying German hybrid financing, *partialisches Dahrlehen*, the ratio was 0.5:1. This meant that interest on the amount of hybrid borrowings that exceeded 0.5% of the company's equity was not deductible, but treated as a non-deductible dividend distribution.

The new rules are fairly simple. For holding companies the ratio is now 3:1, while for other companies it is 1.5:1, and there is no longer a safe harbour rule for German hybrid instruments.

This change in itself will lead to some corporate restructuring for the financing. The thin-cap rules only apply to foreign-related party borrowings. Loans from a related German company are

not affected, nor are loans from a domestic or foreign-related party. By restructuring, one might under certain circumstances be able to reconstitute the relevant equity and create a higher reference equity, reducing the exposure. Alternatively, the new thin-cap rules can be avoided by entering into loan transactions with non-related parties such as banks, domestic cash-rich companies or companies that could borrow abroad from related parties without falling foul of the thin cap rules.

The above changes will result in important changes in the way German companies are organised and finance themselves. The introduction in 1999 of the 5% forfeit, *Pauschal,* on qualifying dividends from foreign subsidiaries while allowing a full deduction of the actual costs made Germany an attractive country to use for the acquisition of

Points for leasing companies

Those treasuries involved in cross-border leasing transactions into Germany will have been offended by the position taken by the German tax administration in the past concerning the deductibility of lease payments for trade tax purposes. The position was that only 50% of lease payments was deductible for trade tax purposes if paid to a foreign lessor, while 100% was deductible in case paid to a domestic lessor.

It will not be a surprise that this treatment was considered by the European Court in Luxembourg to be an infringement of the Treaty of Rome (former article 48 now 39).

When Germany published the first draft of its tax reform in April 2000 there was also a proposal to harmonise the tax treatment of leases. The suggestion was that all lease payments would be treated in the same way, whether they were paid to a domestic lessor or a foreign lessor. In both cases, only 50% of the lease payments would be deductible for trade tax purposes.

Not surprisingly, this proposal was not popular with the German financial sector. But on the basis of the decision by the European Court of Justice referred to above, there is a problem. The proposal did not become law, but the old rule partially disallowing the deduction for trade tax purposes has not been repealed. A practical, interim solution was called for. Pending an expected change (perhaps complete overhaul) of the trade tax laws the *Länder* have stated that, even though they could deny the deduction for 50%, they will not enforce it. Regarding this point, bear in mind that the trade tax is a tax that is not levied by, or controlled by, the federal government, but by the *Länder* which constitute the German Federal Republic. ■

foreign subsidiaries and was intended to do so. This is because under certain circumstances the gain on the sale of a foreign subsidiary would not be taxed, which increased this attractiveness (compared with, for example, France or the UK). This clearly was the intention, since German companies needed to become multinationals.

The further changes to be implemented in 2002, however, are even more crucial when you consider how the German domestic market has been severely hampered by high taxation on the sale of a domestic subsidiary.

Next year's tax changes

As of 1 January 2002, the gain a German company will realise on the sale of a domestic subsidiary will be tax exempt. Though it may seem strange, this may also have international consequences. Before, we discussed that under circumstances gains on qualifying *foreign* subsidiaries would be exempt from German CIT and trade tax since that tax only applies to active trading income. Since the new rules apply to domestic subsidiaries and the way the law is structured, it will also apply to all gains on foreign subsidiaries.

As from 2002, German companies will be able to sell subsidiaries without being penalised by high taxation. This will lead to a substantial change in the German corporate environment and may create important investment opportunities for companies that are interested in investing in the German market.

It also seems that you may not have to wait to conclude of certain deals until the beginning of next year. You could possibly have deferred sales or conditional sales which means you could get the deal done now, with deferred payment and deferred delivery.

Dramatic changes

The tax reform acts of the past few years have had a dramatic impact on how German groups finance their own internal expansion and their investments in domestic and foreign subsidiaries.

In some cases, it may be necessary to look for alternate funding structures with third parties or to use intermediary German resident companies to reduce or eliminate the consequences of the limitations imposed on foreign-related party debt. In other cases, however, Germany may prove a perfect location for a holding company.

In view of the up-coming exemption of capital gains realised by corporate taxpayers on the sale of a subsidiary, wherever located and whatever the ownership percentage, the environment for German groups and subgroups of foreign organisations has become very interesting and attractive. In addition, German groups will be able to sell or exchange companies that do no longer really belong in the group without tax penalties. ■

Jan Kooi is European Tax Counsel at Omnicom Europe Ltd and Omnicom Group Inc.
Jan will be providing regular updates on international tax issues for The Treasurer.

www.omnicomfinance.com