The German Finance Minister, Peer Steinbrück, Hessen’s Minister-President, Roland Koch, and the State Secretary in the Federal Ministry of Finance, Axel Nawrat, and perhaps a few other financial politicians may have asked themselves the following questions, when they met within their small circle to draw up their ostensibly great “coup” designed to prevent allegedly abusive or merely tax-reducing structures in order to save the German tax revenues (as described in the government statement):

Why, they may have asked themselves, should companies operating globally and earning profits in many countries – including Germany – only pay (low) taxes abroad but not in Germany? Particularly if profits generated in Germany do not lead to taxable income just because the company can offset a disproportionately high share of its worldwide interest expenses against German income. Specifically, this applies to so-called inbound investments, i.e. foreign companies investing within Germany.

So-called outbound investments constitute the reverse case: German-based corporations investing abroad by acquiring participations in foreign companies which finance such acquisitions at home through third parties are, however, also affected. In such cases, interest on the acquisition loan was basically deductible, also and in particular against other German source taxable income. At the same time, the foreign corporation’s profits were (and still are) not taxable at all in Germany and dividends distributions, if any, as a rule only at 5%, although the assets of the foreign corporation and the income thus generated were financed – indirectly through the share purchase – by a loan-bearing interest which was deductible in Germany. From a dogmatic perspective, this may be correct. Nevertheless, such questions are justified from a financial policy viewpoint, provided it is true that there are cases in which up to 90% of the worldwide financing expenses of a globally operating group of companies is offset against its German source income.

This scenario was certainly one reason for the understandable desire to find a remedy to save Germany from financial ruin with an unflinching will and, as far as possible, in conformity with EU law. This situation must have been a thorn in the side of many politicians, in particular the Finance Minister. However, it goes much too far to take this as a justification for covering Germany with a board of nails on which all taxpayers may get their feet bloody.

It is certainly helpful to be consistent when it comes to ambitious targets. However, the reality now looks different. The detrimental effects go far beyond what politicians had planned to achieve, even if the regulation is downplayed and now neatly called “interest deduction ceiling” (“Zinsschranke”). Even worse: they actually missed the target, in particular due to the limitation of the deductibility of interest on third-party bank loans, even if those loans are only guaranteed by pledging the financed assets (so-called non-recourse loan). In such a case there is no reason for any limitation. Here, a summary of the current situation:

**New German Interest Deduction Rules – Wish, Will and Reality**
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- The interest deduction ceiling will have no bearing at all on many companies/groups which are the target of the new rules. Since they are profitable and very healthy, they have enough EBITDA; for these companies, the 30% EBITDA limit does not allow anything. While such companies’ maximum shareholder debt financing used to be limited to 1.5 times the allocable equity until the end of 2007 under the former thin cap rules, there are now no interest deduction obstacles to the further reduction of these companies’ taxable German income by taking out even more shareholder loans.

- However, many companies fall under the interest deduction ceiling even though they are not covered by the purpose of this rule at all. This is particularly true for structures which cannot be qualified as abusive or tax-reducing and which do not allow the shifting of profits abroad at all, for instance where taxable income is only generated in Germany. Such companies will in effect be punished for investing solely in Germany (not abroad) and generating taxable profits only in Germany. Furthermore, the implementation of an interest deduction ceiling leads to enormous costs for tax advice which are – contrary to the government’s view – not justifiable. Moreover, it can result in a tax burden of more than 100% of the actual profit and thus in a company’s insolvency.

- Finally, what was actually intended to be regulated by the new rules is often not regulated at all; sometimes even the opposite is true. Sentence 1 of sec. 8a para. 3 Corporate Income Tax Act (CITA), which is difficult to understand, probably means the following: for a group company which is subject to tax in Germany, a so-called escape based on proving “reasonable” equity ratios should not be possible if interest on a “harmful” loan in this company or any other group company exceeds 10% of the overall interest expenses of the debtor company concerned. As a matter of fact, this does not make any sense. Why should, for instance, interest of only €100 paid on a shareholder loan by a very small passive group company in China or elsewhere in the world have negative repercussions on the deduction of bank interest for a company operating in Germany which is many times larger? An explanation is simply not to be found. However, these considerations may be left aside for the moment, because the wording of sentence 1 in sec. 8a para. 3 CITA provides for quite the opposite: an escape is feasible if only one group company is not financed by debt in a “harmful” way; if so, no other group companies face restrictions. Such failures and adverse developments are a result of the much too complicated regulation, the details of which very few are able to and will understand and which already lead to abstruse structures today.

What to do? The best and in fact only reasonable solution would be to do away with the new interest deduction rules, which taxpayers, the tax administration and tax courts alike are unable to handle anyway. It is alarming that the advisory, court, ad-
Ministrative, training and other costs which occur in the wake of the interest deduction ceiling exceed the tax income expected from this provision. Adam Smith would roll over in his grave! Putting up with collateral damages is unjustifiable because they will not be outweighed by the budgeted increase of tax income of “only” €600m. A tax rate decrease to “only” 15.5% instead of 15% may have been an alternative because this would have been much easier to achieve and would also have yielded €600m. Unfortunately, the powers that be are (not yet) open to such reasoning. In order to at least mitigate the worst implications, it would be possible and also necessary to find a rule, e.g. by way of a decree, according to which bank interest on loans guaranteed only with assets directly (e.g. land charges, etc.) and/or indirectly (e.g. share pledge), which were acquired and/or financed through that loan (so-called non-recourse loan) would not be subject to the deduction limitations of sec. 4h Income Tax Act and sec. 8a CITA.

As can be heard and read, there are rumors in international banking circles (Frankfurter Allgemeine Zeitung of September 28, 2007) that the interest deduction ceiling – in conjunction with the collapse of securitizations in Germany – could trigger a significant international financial crisis. Hence, only a small time window remains for those in charge to act.

For further information see the law firm profile at the end of the Handbook.

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