The Lowest Corporate Tax Rate in the G7

Substantial Tax Cuts in Germany's 2008 Corporate Tax Reform

Who would have thought that Germany would one day stand side by side with Luxembourg in their corporate income tax (CIT) rates? Well, exactly that is going to happen on 1 January 2008, when Germany will impose the lowest effective CIT rate amongst the G7 countries and compete with countries generally perceived as low tax jurisdictions. This provides ample reason to take a closer look at two main aspects of the corporate tax reform that has recently been passed, the implications for businesses on an international level and the responses that may be triggered.

The bright side: significant cuts in CIT

The key element of the reform is a reduction of the effective profit tax burden for corporations. German corporations are subject to CIT (plus a solidarity surcharge) and local Trade Tax. Currently, the total tax burden amounts to roughly 40 percent on a corporate level, depending on the Trade Tax multiplier, which varies from city to city. The law passed by the German legislature will reduce the CIT rate from 25 percent (26.375 percent including solidarity surcharge) to 15 percent (15.825 percent including solidarity surcharge).

This will place the combined CIT and Trade Tax rate for corporate taxpayers below the "magic" threshold of 30 percent: to be precise, 29.83 percent on the basis of an average Trade Tax multiplier of 400 percent.

The price to pay: new German thin-capitalisation rules

Amongst several others, the most drastic adjustment to the tax base is a complete change of tack regarding the deductibility of any and all interest expense – and not just interest for shareholder loans and not just in relation to cross-border funding. Where formerly thin-cap limits were based on shareholder debt/equity ratios, the new law looks to an interest/income ratio. Thus, whether or not interest expenses are tax deductible will depend on the income of the taxpayer for a particular fiscal year adjusted by interest, tax, depreciation, amortisation or capital allowances, i.e., EBITDA. The consequence is that interest deductibility will be just as volatile as income, making medium- and long-term tax projections more difficult, to say the least.

In terms of a broad picture the new regime works as follows: tax deductible interest is limited to 30 percent of EBITDA, with a very broad definition of interest. Excess interest, for example in loss situations, may be carried forward indefinitely and used to offset income in the future, but this treatment

may be endangered by tax regulations tied to corporate change of control or corporate restructuring due to mergers or share for share transactions. No grandfather relief is granted, so the new regime kicks in for all as from 1 January 2008.

It is important to note in this context that the interest base is defined as taxable EBITDA, not statutory EBITDA for accounting purposes. Therefore, exempt income, e.g. from foreign sources or from shareholdings (dividends and capital gains), does not qualify, further increasing the negative effects of the new regulations specifically for holding companies.

There are four exceptions to the general regime described above but unfortunately none of them is likely to draw any enthusiastic cheers: firstly, all interest expenses up to the amount of interest income are fully deductible.

Secondly, an annual interest threshold of €1 million per entity is prescribed. Thus for example, a leverage of €20 million at an interest rate of 5 percent will be completely disregarded and all interest will be deemed deductible no matter what the EBITDA may be. However, if the interest amount exceeds the prescribed threshold only by €1, the aforementioned general regime is applicable and the 30 percent of EBITDA rule applies to the whole interest amount.

Thirdly, the general regime does not apply if the entity is not part of a group of companies subject to consolidation rules under IFRS, an EU- or US-GAAP. The entity is deemed to be part of a group if it is "controlled" within the meaning of IAS 27. And finally, the reform prescribes an escape clause if the entity is part of a group but does not exceed the equity ratios of its group.

So what kind of response to the new thin-cap regime may be expected and what type of financial services may benefit from the new scheme? Well, most obviously, we will likely see a trend to splitting or setting up more entities and SPVs because the €1 million threshold applies per company whether or not part of a group. Beyond that, there seem to be two principal avenues by which to mitigate the effects of the new rules: increase EBITDA or lower interest expenses. I dare say that the first alternative is intended by the German legislature, but it may also make sense, for example, to generate more income in Germany than via foreign subsidiaries – specifically if the foreign tax rates are higher than in Germany, which is becoming more likely due to the new tax cuts.

I would also see a trend to alternative financing instead of plain-vanilla debt funding. Such a trend could tie in nicely with the recently enacted German Real Estate Investment Trusts. Selling real property to G-REITs and leasing it back will be very tax-efficient and at the same time provide for funding without getting caught up in the new thin-cap trap. Sale and leaseback will also be available for movable property but may not be as tax beneficial. Asset-backed security transactions (ABS) and receivable finance follow the same strategy – at least if structured as true sales: the idea is to securitise your property instead of using it as collateral for debt funding. What may also work under specific cir-

cumstances is to borrow assets instead of money – the interest for an asset loan is not covered by the new regime and thus is fully deductible. Finally, we may see more and more “hybrid financing” emerging provided the hybrid instrument is treated as equity for tax purposes.

All in all, I see the new thin-cap rules predominantly as a test of creativity, not as an insurmountable problem. Therefore, the bottom line is clearly positive – a 29 percent tax rate will leapfrog Germany to the forefront of the mature industrialised countries – a long way from the 59 percent imposed only 14 years ago. This is very good news for inbound investment. If tax is the cost of companies doing business in a specific country, Germany is coming up with quite an attractive cost/benefit ratio these days.

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