New interest deduction ban on inbound acquisition structures under preparation

*by. Dr. Arne von Freeden, LL.M. (NYU)/Dr. Dietmar Lange**

When an inbound acquisition is financed, interest expenses can sometimes be deducted twice. The cause of such a 'double dip' is the German technique of taxing partnerships or their partners (so called 'co-entrepreneurs' [*Mitunternehmer]*) that take the entrepreneurial risk. The German *Bundesrat* even wanted to eliminate this double tax relief on interest expenses while the German Customs Code Amendment Act (*Zollkodexanpassungsgesetz* – ZKAnpG) was undergoing the legislative process in 2014. In the end, Parliament did not implement the *Bundesrat's* proposal. Now it seems to be having a second go at introducing a new interest deduction ban. What's it all about?

Interest deduction for tax purposes under foreign and domestic law

A foreign investor – *e.g.* foreign acquiring corporation – acquires a shareholding in a domestic (target) corporation – *e.g.* a GmbH, a German closed corporation – 'via' a domestic (interposed) partnership – *e.g.* a GmbH & Co. KG, a German limited partnership with a GmbH as its general partner. The foreign acquiring corporation regularly funds the acquisition of the shareholding in a target (as the case may be, *pro rata*) using an interest-bearing loan that the acquiring corporation takes out from a bank, for example. The proceeds from borrowing the capital are given to the intermediate GmbH Co. KG, which acquires the shareholding in the target. Under foreign law, the interest expense can be a (tax-deductible) business expense incurred by the acquiring corporation; (the) German tax law (of partnerships) classifies the interest expense as a tax-deductible special business expense. The payment of interest can therefore reduce both the acquiring corporation's foreign and domestic tax bases – exempted income from a permanent establishment if a DTT is involved.

It's worth pointing out that the relief brought about by this 'tax effect' isn't the result of a tax-structuring scheme. The cause is much rather the German technique of taxing partnerships and their co-entrepreneurs. The interest expense incurred by the acquiring corporation is undoubtedly a special business expense that reduces the acquirer's share of the profit from the GmbH & Co. KG.

Financial Committee proposes adding a new Sec. 4i to the German ITA

The Financial Committee bases one of its recommendations to the *Bundesrat* on the Implementation of Changes in the Mutual Assistance Directive and further Measures against Profit Cutting and Shifting Act, *i.e.* putting a stop to the double dip outlined above by incorporating a new Sec. 4i into the German Income Tax Act (ITA, [*Einkommensteuergesetz* – EStG]) (BR-Drs. 406/1/16 of September 9, 2016). The subsequent *Bundesrat* sitting at which Financial Committee's proposal was accepted took place on September 23, 2016 (BR-Drs.

Groupement d'intérêt économique - RCS : C 68
1B, Heienhaff - L – 1736 Senningerberg (Luxembourg)
Banque et Caisse d'Epargne de l'Etat, Luxembourg
IBAN LU49 0019 2855 1871 6000, BIC : BCEELULL
VAT identification : LU 220 135 38

406/16(B)). The new provision shall prohibit the deduction of expenses by a co-entrepreneur (here: the foreign acquiring corporation's interest expense) as special business expenses if these expenses also reduce its tax base in another state (here: the acquirer's tax base in the foreign state) (Sec. 4i sentence 1 ITA Bill). According to the rationale for the Bill, a simultaneous double dip will not be a prerequisite for applying the regulation. The deduction ban will also apply if the deduction is claimed in another state in a preceding or subsequent assessment period, fiscal year, business year or calendar year.

The deduction ban will not apply if the expenses reduce the same taxable person's income that is taxable in the Germany and also proven to be subject to actual taxation in the other state (Sec. 4i sentence 2 ITA Bill). The Financial Committee wants to prevent the rule from overshooting the mark via the exemption clause. The rationale for the Bill mentions tax credit and lack of a DTT as exceptions.

Comments

From a tax-policy perspective, you might well ask whether the above structure is actually an unwanted 'hybrid' from the BEPS perspective. The Financial Committee itself shows doubts in its reasoning as to whether the envisaged measure 'conforms to BEPS'. But its similarity to hybrid structures does, according to the Committee, justify taking immediate action.

If the proposal is implemented, tax advisors and practitioners in companies should review whether it would have any impact on existing (financing) structures (or whether, as the case may be, an exception under sentence 2 of Sec. 4i ITA Bill exists). I consider it possible that interest may not be deductible at all if the acquiring corporation abroad sustains tax losses, which would (in fact) prevent interest from being deducted, and tax from being reduced. In this case, the deduction of interest should, nevertheless, be ruled out in the domestic country because the foreign tax base is also reduced if a business sustains losses.

Groupement d'intérêt économique - RCS : C 68
1B, Heienhaff - L – 1736 Senningerberg (Luxembourg)
Banque et Caisse d'Epargne de l'Etat, Luxembourg
IBAN LU49 0019 2855 1871 6000, BIC : BCEELULL
VAT identification : LU 220 135 38