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Full of enthusiasm, the preacher in Ecclesiastes advised his listeners to trade overseas because they would have a good return: "Cast your bread upon the waters, for after many days you will find it again."

There is no doubt that international trade is a worthwhile venture. However, one might rethink that assessment after triggering the new German thin cap rule, *Zinsschranke* (literal translation: "interest barrier").

In a globalized world, thin cap rules are the last resort of legislatures to avoid the fact that the deduction of interest payments eats away at their tax bases. The threat is real, for there is no faster movement on earth than the transfer of capital (except, of course, the speed of light). Therefore, thin cap rules are not only the last resort for governments, but also, as the new German version shows us, a new source of revenue to counterfinance a tax reform.

Drafting antiavoidance legislation is one of the biggest challenges of modern tax law. The English, German, and French languages have long had the saying "Don't throw the baby out with the bath water." Only those with a sharp tongue would ever contend that this saying serves as a warning for the drafters of the new German thin cap rule. Nonetheless, the German legislature is about to enact a rule that targets the international tax planning practice of two global players and may have detrimental effects on both national and international companies.

Overall, we like Germany's 2008 corporate tax reform package.[1] However, the *Zinsschranke* is one of its least attractive features. Since the rule will be the most complex one in German tax law — a status not easy to achieve, considering the competition — we will skip the details[2] and stick with a general description of it.

The Cornerstones

The new rule caps the deductibility of interest payments regardless of whether the interest is paid to a related or unrelated party. The interest deduction is capped at 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA). Anything beyond is either deductible under the three exceptions or can be carried forward indefinitely. However, using €1 of carried-forward interest expenses requires an additional taxable EBITDA of €3.33. EBITDA is a mere figure for tax purposes. As a result, neither tax-exempt dividends nor diverse book depreciations on participations are taken into account.

Not only do corporations fall under the scope of the new rule, but so do partnerships and commercial establishments. The rule applies only if the company is part of a group. Companies that form part of a German *Organschaft* (group tax consolidation) are treated as one commercial establishment for purposes of the interest limitation and are therefore better off under it.

However, the rule does not solely cover shareholder loans or back-to-back financed loans with third persons. Germany is the only jurisdiction in the world that applies its thin cap rule to normal bank loans. Again, the rule covers any interest expense.

The tricky part of the new rule is in its exceptions. The rule does not apply if:

- net interest expenses below €1 million per year are incurred;

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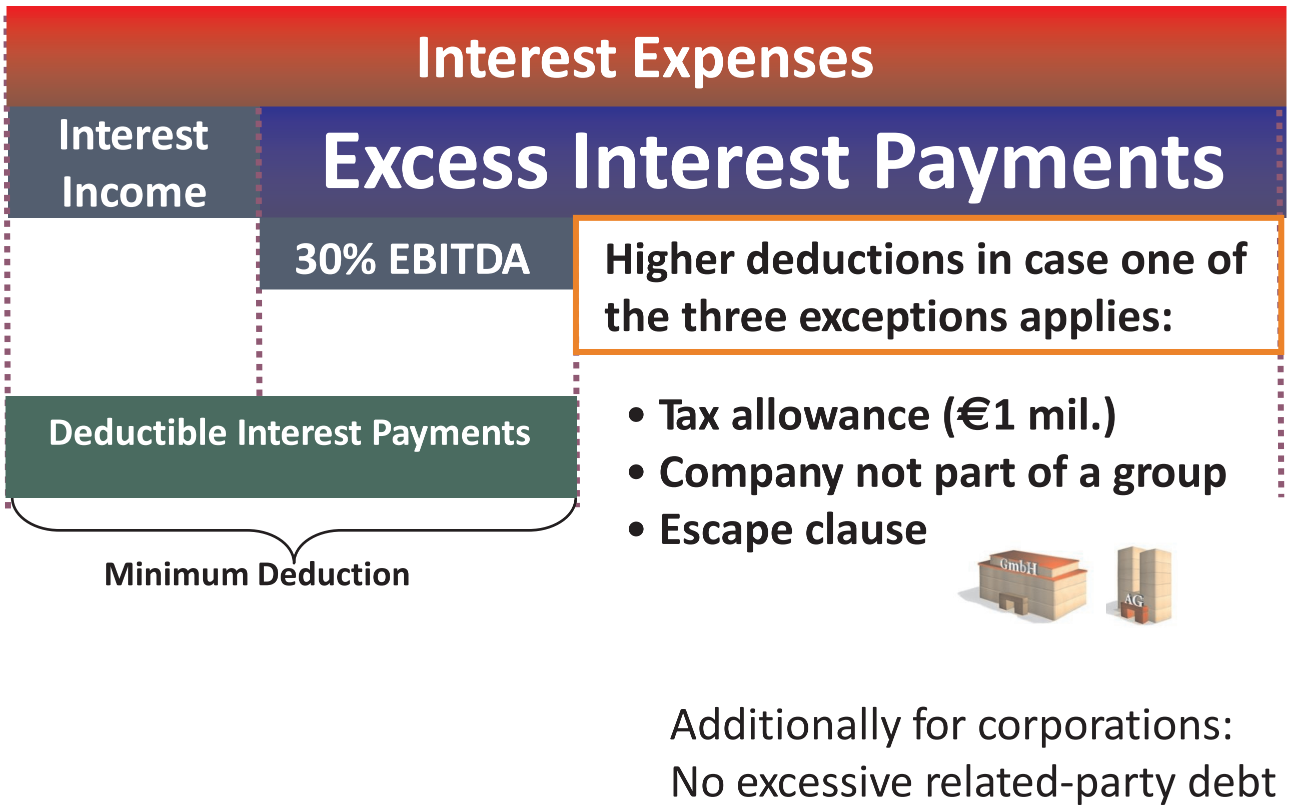
[1]*See* Wolfgang Kessler and Rolf Eicke, "Germany's Corporate Tax Reform — The Road Not Taken," *Tax Notes Int'l*, June 11, 2007, p. 1135.

[2]*See* Thomas Eckhardt, "German Lower House Passes Business Tax Package," *Tax Notes Int'l*, June 4, 2007, p. 985.

Figure 1.



- the company does not belong to a group of companies, unless the company is a corporation and an excessive interest is paid to a related party (a minimum holding of 25 percent and a payment of at least 10 percent of the interest balance to the shareholder); or
- the escape clause applies, unless the company is a corporation that pays excessive interest to a related party.

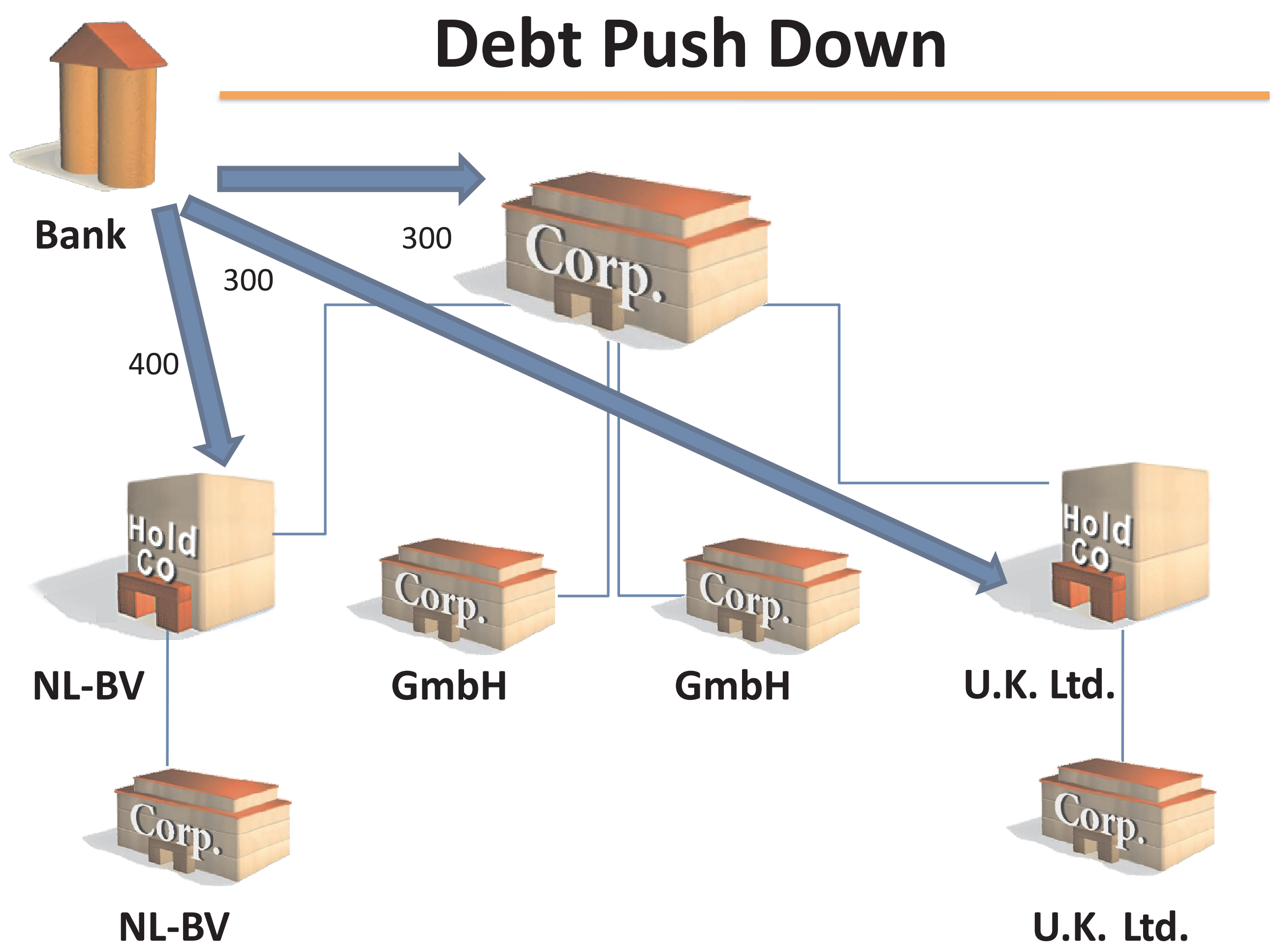
While the first two exceptions are easy to understand, it takes a rocket scientist to grasp and implement the escape clause. That clause allows the deduction of all interest expenses if the equity ratio of the German business is up to 1 percent lower than, or equal to or higher than, the worldwide equity ratio of the group the German company belongs to. The necessary figures must be derived from both the company's individual financial statements and the consolidated group's financial statements, according to German generally accepted accounting principles, international financial reporting standards, or U.S. generally accepted accounting principles. Not only is the escape clause complex, it is also dangerous. Because of the related-party exception, any excessive related-party interest payment would affect the entire group. One excessive interest payment to a small majority holding in, say, Brazil would deprive the entire group of the benefits of the escape clause.

Reasoning and Merits

Although the law is intended to be an antiabuse provision, the government is mainly focused on how the legislation will help counterfinance the tax cut in the 2008 tax reform. The official estimates of the German Federal Tax Office are at about €1 billion. However, we believe that because of all the enterprises that will eventually be targeted, the additional revenue from the *Zinsschranke* will be significantly higher.

The legislature has been concerned that for both domestic and foreign investment, interest deductions are taken in Germany, whereas interest gains are taxed abroad. In some cases, they are not taxed at all, if the foreign country does not effectively tax

Figure 2.



the income and the German controlled foreign corporation rules are not triggered. Generally, interest deductions are performed in two ways: First, the German parent corporation endows a lot of equity with its foreign subsidiary, and the foreign subsidiary grants a loan to its parent, which can then deduct the interest payments. Second, the German parent corporation finances its foreign subsidiary with a bank loan and deducts the interest payments.

To prevent that kind of tax planning, the German legislature enacted a regime that drives debt out of Germany. Instead of granting the German parent corporation a loan for 1,000, the bank will grant a loan of only 300, within the boundaries of the 30 percent EBITDA limitation. Two other loans can be granted to intermediate holding companies, which in our example (see Figure 1) are located in the United Kingdom and in the Netherlands. At the end of the day, the German tax authorities do not have to deal with interest deductions of 1,000, but with only 300.

U.S. Earnings Stripping Rule

Unlike the *Zinsschranke,* which covers a wide range of finance activities, the U.S. earnings stripping rule's focus is more specific. However, the U.S. earnings stripping rule could have easily become the big brother of the *Zinsschranke*. In fact, it was the reform draft of the American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong., sec. 7210 (2002), that first proposed an intragroup comparison of equity levels. That version of the U.S. reform draft did not materialize, mainly as a result of criticism. However, the nondeductibility of interest subject to the company's cash flow remains a common feature of both the U.S. law and the German thin cap rule.

Problems . . .

Contrary to the current rule, the triggering of the new rule will result in a temporary double taxation, because unlike the current requalification of interest payments into dividend distributions, which at the level of the corporate shareholder leads to an effective 95 percent exemption or a 50 percent exemption if the shareholder is an individual, under the *Zinsschranke* the income is 100 percent taxable. The interest deduction on the level of the company is at the same time not deductible. In that, Germany follows a trend in international tax law that departs from a requalification of interest payments into dividends in favor of a nondeductibility of excessive interest payments. In Europe, not only traditional EU member states such as France, the United Kingdom, Denmark, and the Netherlands, but also most Eastern European countries have decided against a dividend treatment of relevant payments.

The new regime raises many questions in an international context. For instance, what happens if a double tax treaty applies and Germany readjusts profits because of the *Zinsschranke*? In our view, profits must be readjusted in case the *Zinsschranke* is triggered, even though the transaction may not have been solely artificial.

Also problematic is that the *Zinsschranke* violates the fundamental principle of exclusively taxing net income. The new rule disallows the deduction of real economic losses and thereby taxes income that is simply not there. Wolfgang Schön, director of the Max Planck Institute of Tax and Competition Law in Munich, recently wrote a column in the national newspaper *Frankfurter Allgemeine Zeitung* that had the headline "A corporate tax reform for winners." He said companies on the verge of insolvency feel the strongest effects of the *Zinsschranke*. Those companies have only high losses and are still forced to pay taxes with money they cannot come up with. Thus, in times of crisis, the *Zinsschranke* approaches these companies in the guise of an undertaker. But it is not just troubled companies that suffer ill effects — fast-growing start-up companies that have much debt, many losses, and little income will also be endangered.

. . . With Holding Companies

Unlike under the current regime, there is no special regime for holding companies. According to the existing thin cap rule, qualifying holding companies need not deduct the book value of their participations when calculating the debt-equity ratio. As a result, the rule grants a safe haven to the holding company, but denies a safe haven for its subsidiaries.

The *Zinsschranke* denies a safe haven for holding companies; it deducts the book value of the participations and thereby prevents the application of the escape clause. Thus, the legislator replaces the holding safe haven with a holding discrimination because, in practice, the treatment of holding companies leads to a denial of any deductibility of interest expenses. That the U.S. earnings stripping rule in the draft version mentioned above also contained a holding discrimination is little comfort, as this part of the original draft was much criticized. And the Bush administration made one significant change to the proposal: An underlying asset safe harbor was added that would have eliminated the holding discrimination if the reform draft had been enacted.

. . . With EC Law

Since the *Zinsschranke* is an antiabuse provision, it must comply with the latest reasoning of the European Court of Justice regarding the justification of an infringement of the fundmental freedoms. The ECJ pointed out in *Cadbury Schweppes* and several other recent cases that antiabuse provisions must target only artificial structures that exist solely for tax planning purposes. The *Zinsschranke* goes far beyond this standard and does not comply at all with the case law of the ECJ.

Even more problematic is that the *Zinsschranke* does not apply if the whole group is part of a German *Organschaft,* because an *Organschaft* is treated as one commercial establishment under the *Zinsschranke*. However, as the *Organschaft* regime does not yet provide for a cross-border consolidation of profits and losses, foreign investors have more trouble using the *Organschaft* as a way around the *Zinsschranke*, even though a foreign company can be a parent company of an *Organschaft* while a foreign company is barred from being a mere subsidiary under the *Organschaft*. In practice, being embedded in an *Organschaft* gives foreign corporations an opportunity to avoid triggering the *Zinsschranke*. In our view, it is impossible to justify this unequal treatment under European Community law.

But there are more concerns regarding EC law. First, the new thin cap rule intentionally creates double taxation without focusing on abusive behavior of taxpayers. Second, it is unclear whether the new rule is in line with the definition of profit under the parent-subsidiary directive. Finally, it must be asked to what extent the *Zinsschranke* complies with the freedom of establishment principle.

. . . With Private Equity

Even though the legislation provided for the introduction of a private equity act within the next 12 months, the *Zinsschranke* causes problems for private equity funds. The only way out of the *Zinsschranke* is the escape clause, which requires a consolidated group balance. However, there is no such thing as a consolidated group balance in this business. If the private equity fund is deemed to be the group parent, all worldwide private equity investments must be identified and consolidated, which is a hassle. We doubt that private equity funds will support the upcoming private equity act if the regime does not provide for a favorable approach for handling interest deductions.

Winners and Losers

As mentioned above, if an enterprise is financially sound, the *Zinsschranke* is not much of a threat unless the enterprise is a fast-growing start-up company. However, if a business is having difficulties, the threat is greater, as it will be taxed on costs that accrued and on cash that is not owned.

Holding companies are worse off under the *Zinsschranke* than under the current regime because they are discriminated against. This jeopardizes Germany's status as a location for holding companies, a status that has been improving since 1994.

The complexity of the escape clause makes the rule not only difficult to follow for corporate taxpayers, but also unadministrable for the tax authorities.

At the end of the day, the ultimate question remains unanswered — whether or not the preacher in Ecclesiastes would have recommended trading in Germany after he studied the *Zinsschranke*. ◆