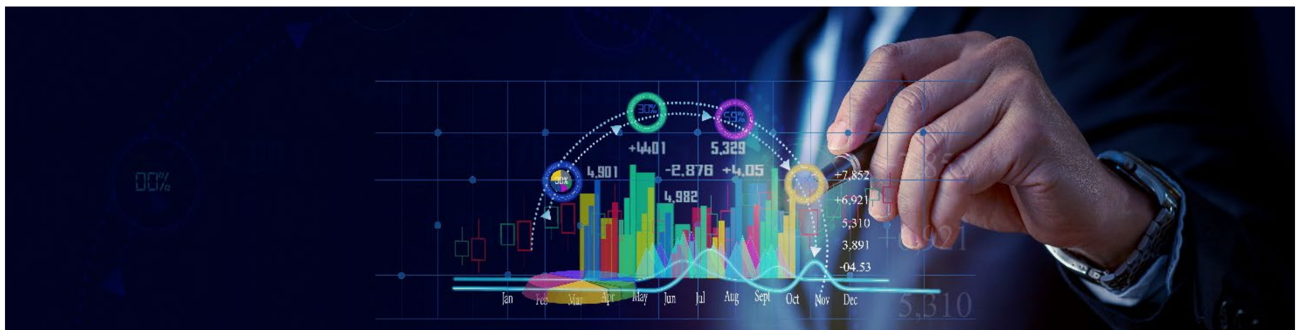
Changes to the German interest deduction rules

THE SECONDARY CREDIT MARKET PROMOTION ACT BROUGHT IN CHANGES TO THE GERMAN INTEREST DEDUCTION RULES ("INTEREST BARRIER") AS OF 2024[1], WHICH MAY BE RELEVANT FOR PRIVATE EQUITY/VENTURE CAPITAL PORTFOLIO STRUCTURES IN GERMANY. WE HAVE SUMMARIZED THE ESSENTIAL INFORMATION ON THESE CHANGES BELOW.



Executive Summary

- **EUR 3 million exemption limit (*Freigrenze*) remains in place**[2]: The exemption limit of EUR 3 million has been retained. The proposed change of the exemption limit to a tax-exempt allowance (*Freibetrag*) of EUR 3 million contained in the draft bill was not implemented. If net interest expenses reach an amount of at least EUR 3 million, only a maximum of 30% of EBITDA continues to be deductible.
- **Broadening of the definition of interest**: The definition of interest has been broadened so that the interest barrier can be reached more rapidly.
- **Restriction of exemptions**: The rules on exemptions for stand-alone operations and corporate groups (equity escape) have been tightened. In addition, the rules on interest carryforwards and offsetting EBITDA carryforwards have been restricted.
- **Conclusion**: Against the background of the changed interest rate environment, financial investors would be well advised to keep an eye on the financing structure of their portfolios.

1. Introduction

The Growth Opportunities Act (*Wachstumschancengesetz*) was aimed at helping companies to improve their liquidity situation so that they can invest more on a long-term basis and have the entrepreneurial courage to dare to innovate.[3]

[1] (Implemented by the Secondary Credit Market Promotion Act.) Cf. legislative resolution of the German Bundestag of 14 December 2023, BR-Drs. 656/23, "Act on the Promotion of Orderly Secondary Credit Markets and on the Implementation of Directive (EU) 2021/2167 on Credit Service Providers and Credit Purchasers and on the Amendment of Other Provisions of Financial Market Law (Secondary Credit Market Promotion Act)".
[2] If the net interest expense reaches this limit, the interest barrier rule applies in full to the entire net interest expense. Converting the exemption limit into an allowance would have been advantageous because only the net interest expense exceeding the amount of EUR 3 million would have been subject to the interest barrier, i. e. with an allowance, the first EUR 3 million of net interest expense would always have been deductible.
[3] Cf. draft law to strengthen growth opportunities, investments and innovation as well as tax simplification and tax fairness (Growth Opportunities Act) of 29 August 2023.

The Secondary Credit Market Promotion Act (*Kreditzweitmarktförderungsgesetz*), which came into force on 1 January 2024, has already implemented one aspect of the Growth Opportunities Act. However, the tightening of the interest barrier rules contained therein will have the opposite of the intended effect. For the private equity/venture capital sector, which typically has a relatively high debt financing ratio, tightening the interest barrier will ultimately mean a deterioration in the underlying tax conditions in which these companies operate.

2. Changes to the interest barrier in detail

2.1. Simplified explanation of the interest barrier

According to the interest barrier rules, the company paying interest is prohibited from deducting interest as a business expense for tax purposes under certain conditions. The economic consequences: No tax effect despite expenses and outflow of liquidity on the company's commercial balance sheet, but rather a kind of "tax on assets" ("*Substanzbesteuerung*"). The interest barrier rules are summarised here as follows:

In principle, interest expenses can only be deducted up to the amount of interest income and beyond that ("net interest expense") up to an exemption limit of EUR 3 million or, if the exemption limit is reached/exceeded, up to an amount of 30% of taxable EBITDA (offsettable EBITDA). Net interest expenses amounting to a maximum of EUR 2.999.999,99 an immediate deduction is possible. However, this exemption does not apply in case the exemption limit of EUR 3 million is met.

Excess net interest expenses can be carried forward to future financial years. If the offsettable EBITDA is not utilised in full, an EBITDA carryforward can generally be created. This EBITDA carryforward can then be offset against net interest expenses in the future (five financial years).

Any remaining non-deductible interest expenses must be carried forward to subsequent financial years (interest carryforward). In practice, this (subsequent) offsetting is unfortunately rather rare; it is more common for this carryforward to increase steadily and then be lost in the event of certain events, such as an exit via a share deal.

The possible interest deduction is calculated in stages as follows:

Stage 1: Interest expenses are offset against interest income (the interest expense exceeding the interest income = "net interest expense")
Stage 2: Deduction of net interest expense below the exemption limit of EUR 3 million or offsettable EBITDA (30% of taxable EBITDA)
Stage 3: Deduction of remaining net interest expense up to the amount of EBITDA carried forward from previous financial years
Stage 4: Carry forward of non-deductible net interest expense to future financial years, if applicable

Restrictions on the deduction of interest are often applicable to group-affiliated companies, with group affiliation being determined on the basis of consolidation rules ("**group clause**"). What is known as the "**equity escape**" rule may apply as a further exception for group-affiliated companies. In addition, the "**stand-alone clause**" can be considered as an additional exception if the taxpayer does not or only partially belongs to a group. These two exceptions, the group clause and the stand-alone clause, have been restricted as described below so that the restriction on the deduction of interest expenses for tax purposes can become the rule. If the conditions for one of these exceptions are fulfilled, the prohibition on deducting interest expenses in principle no longer applies. The legal consequence is therefore the same regardless of which of the three exceptions (one of the two aforementioned exceptions or the above exemption limit) applies.

2.2. Changes from 1 January 2024

The following rules in connection with the interest barrier have been changed in particular:

- **Broadening of the definitions of interest expense and interest income**: Under the previous legislation, interest expenses were merely payments for borrowed capital that reduced the relevant profit.

According to the new – broader – definition, interest expenses also include economically equivalent expenses and other expenses in connection with the procurement of borrowed capital. Commission and fees (arrangement fees), for example, could therefore now be covered by this definition. Interest income is no longer merely income from capital claims of any kind, but from now on also economically equivalent income in connection with capital claims that have increased the relevant profit.

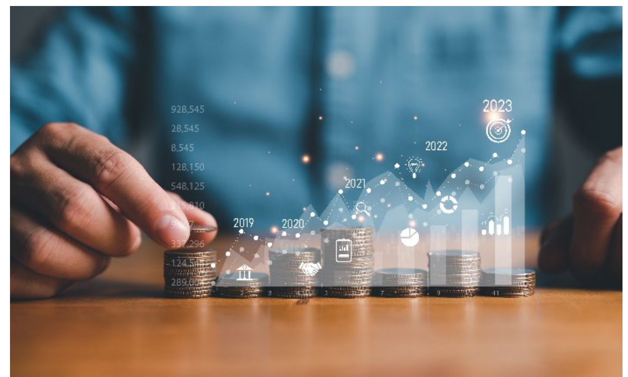
- **Tightening of the stand-alone clause**: In future, this exception only applies if the taxpayer is not a related party within the meaning of Section 1 (2) of the German Foreign Tax Act (*Außensteuergesetz*) and does not have a foreign permanent establishment (new "**stand-alone clause**"). Related parties in this sense are significant shareholders (at least 25%), controlling shareholders or companies controlled by the taxpayer (influence can be legal or de facto in nature), significant third parties in triangular relationships (such as affiliates) and other constellations with non-arm's length influence.

- **Tightening of the equity escape rule**: The adjustment of the group definition has resulted in a worse equity ratio comparison for group-affiliated companies. This exception to the interest barrier still does not apply in the case of "harmful" shareholder debt financing.

- **Stricter rules for the offsetting option:** Unlike previously, the creation of an EBITDA carryforward is excluded in financial years in which, for example, interest expenses do not exceed interest income. This restricts the offsetting of interest expenses in future financial years.

- **Stricter rules for interest carried forward**: If interest expenses increased in a financial year due to interest carried forward from previous years, the three exceptions to the ban on deducting interest expenses do not apply. This means that interest carried forward can only be compensated by offsettable EBITDA.

The amendments are to be applied for the first time for financial years beginning after 14 December 2023 (date of the legislative resolution) and not ending before 1 January 2024.



2.3. Simplified example

A S. á r. l. based in Luxembourg holds 100% of the shares in AkquiCo GmbH based in Germany. AkquiCo GmbH acquires all of the shares in a target company based in Germany and finances a considerable share of the purchase price via a shareholder loan and a traditional bank loan. The annual net interest expense at the level of AkquiCo GmbH amounts to EUR 5 million.[4] AkquiCo GmbH does not have its own operating business, meaning that in principle no offsettable EBITDA is generated at this level. As the exemption limit of EUR 3 million is exceeded and there is a "harmful" related party in relation to AkquiCo GmbH (= Luxembourg S. á r. l.), no exemption from the interest barrier applies. The interest expenses at the level of AkquiCo GmbH cannot in principle be deducted as operating expenses and continue to accumulate over time. The extent to which the interest carried forward in this way can be used to reduce the tax burden in the context of an exit – assuming the structure remains unchanged–- must be examined. However, in this case, 95% of the

[4] For the purposes of this example, it is assumed that AkquiCo GmbH does not fall within the scope of the equity escape rule (because the equity ratio of AkquiCo GmbH differs by more than 2 percentage points from the equity ratio of the group) and that this exemption from the interest barrier therefore does not apply.

capital gains are generally tax-free, meaning that the "off-setting potential" is likely to be rather low. Numerous structuring options can be considered to improve this situation.

3. Conclusion

The stricter rules in connection with the interest barrier also mean a deterioration in the legal conditions under which private equity/venture capital portfolio structures operate. They would therefore be well advised to analyse whether they need to take action with regard to their tax structures or at least what effects this will have on their economic calculations. For the ideal tax shield, investment and financing structures should be urgently reviewed in detail with regard to the new regulations.

It must also be carefully checked as part of the tax due diligence when purchasing a target whether the target has incorrectly recognised interest in the past in light of the changes to the interest barrier, which may require a recalculation and quantification for the purposes of the purchase process.

Depending on the specific circumstances of the individual case, certain solutions could be considered. For example, companies may attempt a "debt push-down" by concluding a control or profit transfer agreement between the acquiring company and the target or by merging these companies (up-stream or down-stream). In both cases, the acquiring company's interest expense can be offset against the income of the target. Other common methods for ensuring debt interest is tax deductible include *inter alia* debt equity swaps (conversion of a loan receivable into equity), loan waivers and other arrangements.

Please do not hesitate to contact us!

Dr Dirk Koch
Attorney at law (Germany), Certified Tax Advisor
Specialised lawyer in tax law
dirk.koch@gsk.de

Dr Petra Eckl
Attorney at law (Germany), Certified Tax Advisor
Specialised lawyer in tax law
petra.eckl@gsk.de

Dominik Berka
Attorney at law (Germany), Certified Tax Advisor,
Dipl.-Finw.
dominik.berka@gsk.de

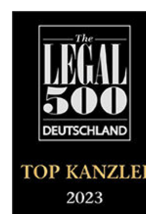
Stefan Schmidt
Attorney at law (Germany), Certified Tax Advisor
stefan.schmidt@gsk.de

Sebastian Gerhards
Attorney at law (Germany)
sebastian.gerhards@gsk.de

Esther Seibt-Pfitzner
Attorney at law (Germany)
esther.seibt-pfitzner@gsk.de

Stephan Wachsmuth LL.M.
Attorney at law (Germany), Certified Tax Advisor
stephan.wachsmuth@gsk.de

Marc Nostitz
Certified Tax Advisor
marc.nostitz@gsk.de



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GSK Stockmann
Rechtsanwälte Steuerberater Partnerschaftsgesellschaft mbB

BERLIN
Mohrenstrasse 42
10117 Berlin
T +49 30 203907 - 0
F +49 30 203907 - 44
berlin@gsk.de

HEIDELBERG
Mittermaierstrasse 31
69115 Heidelberg
T +49 6221 4566 - 0
F +49 6221 4566 - 44
heidelberg@gsk.de

FRANKFURT/M.
Bockenheimer Landstr. 24
60323 Frankfurt am Main
T +49 69 710003 - 0
F +49 69 710003 - 144
frankfurt@gsk.de

MUNICH
Karl-Scharnagl-Ring 8
80539 Munich
T +49 89 288174 - 0
F +49 89 288174 - 44
muenchen@gsk.de

HAMBURG
Neuer Wall 69
20354 Hamburg
T +49 40 369703-0
F +49 40 369703-44
hamburg@gsk.de

LUXEMBOURG
GSK Stockmann SA
44, Avenue John F. Kennedy
L - 1855 Luxembourg
T +352 271802 - 00
F +352 271802 - 11
luxembourg@gsk-lux.com

LONDON
GSK Stockmann International
Rechtsanwaltsgesellschaft mbH,
London branch
Queens House, 8-9 Queen Street
London EC4N 1SP
United Kingdom
T +44 20 4512687-0
london@gsk-uk.com

Registered office: Munich
Munich Local Court
HRB 281930
Managing directors:
Dr Mark Butt, Andreas Dimmling

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