Growth Opportunities Act and Interest Barrier – Restricting instead of Growing

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The extensive draft (just under 280 pages) for a law to strengthen growth opportunities, investment and innovation as well as tax simplification and tax fairness (Growth Opportunities Act) contains a number of changes that are important for the real estate industry. We had presented the adjustments envisaged for real estate funds in the Investment Tax Act as a result of the Growth Opportunities Act to you in our **beinformed** dated July 27, 2023. Today, we would like to highlight the - in implementation of the ATAD - planned, far-reaching changes to the previous interest barrier regulation as well as the additional introduction of a so-called interest rate cap (Zinshöhenschranke) by the Growth Opportunities Act.

In 2008, the Corporate Tax Reform Act introduced regulations restricting the deduction of interest within the framework of an interest limitation regulation (Zinsschranke) for the first time. According to the basic principle of the interest limitation regulation in Section 4h of the Income Tax Act and Section 8a of the Corporate Income Tax Act, the interest expenses of a business are generally only immediately deductible up to the amount of the interest income of the same business. Interest expenses in excess of the interest income (net interest expenses) are deductible only up to the amount of 30 percent of the relevant profit increased by the interest expenses and reduced by the interest income („attributable EBITDA"). However, interest expenses may be deducted in full for tax purposes if either the exemption limit of EUR 3 million (no tax allowance) is not exceeded or the conditions of the so-called group clause or the escape clause are met.

In 2016, the ATAD (Council Directive (EU) 2016/1164 of July 12 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market) was adopted at European level, creating a European-wide framework for an interest limitation regime. The regulations applicable in Germany to date do not fully comply with the ATAD, so that an adjustment of the national interest limitation regulations is necessary. In doing so, however, the German legislator is in part going beyond the requirements of the ATAD Directive. With regard to the amended regulations of the interest limitation and the newly introduced interest rate cap, the Growth Opportunities Act certainly does not live up to its name.

Expansion of definitions of interest expense and interest revenue

Under Section 4h(3) of the Income Tax Act, interest expenses are defined as remuneration for borrowed capital that has reduced the relevant profit. Interest revenue is, in mirror image, income from capital claims of any kind that have increased the relevant profit. The compounding and discounting of non-interest-bearing or low-interest-bearing liabilities or capital receivables also result in interest revenue or interest expense.

In the future, interest expenses should include, in addition to interest, economically equivalent expenses and other expenses in connection with the raising of borrowed capital within the meaning of Article 2 (1) of the ATAD. Article 2 (1) of the ATAD contains a (non-exhaustive) comprehensive list of borrowing costs to be taken into account. In the definition of interest revenue, correspondingly, economically equivalent expenses are also eligible for consideration, whereas other revenue in connection with the provision of borrowed capital does not fall under the term interest revenue. As a result of the divergence in the definitions of interest expense and interest revenue, increased net interest expense is therefore to be expected in principle in the future.

Amendment of the regulation on the exemption limit

To the extent that net interest expense does not exceed the exemption limit of EUR 3 million, interest expense may be deducted in full. According to the ATAD, the implementation of an exemption amount would also have been permissible, but Germany has regrettably decided - unlike other states in the European Union and unlike provided for in the draft bill of the Growth Opportunities Act of July 14, 2023 - to retain the current exemption limit.

However, there are significant changes in the calculation of the exemption limit as a result of the Growth Opportunities Act. Under current law, the exemption limit was calculated at the level of the individual business. In the future, for the purposes of calculating the exemption limit, similar businesses under common management or controlling influence of a person or group of persons will be considered as one business for the purposes of applying the exemption limit. The exemption limit will then be divided according to the ratio of net interest expenses. With regard to the question of whether there is common management, the legislator refers to the regulations on consolidated financial statements in Section 290 (2) of the German Commercial Code.

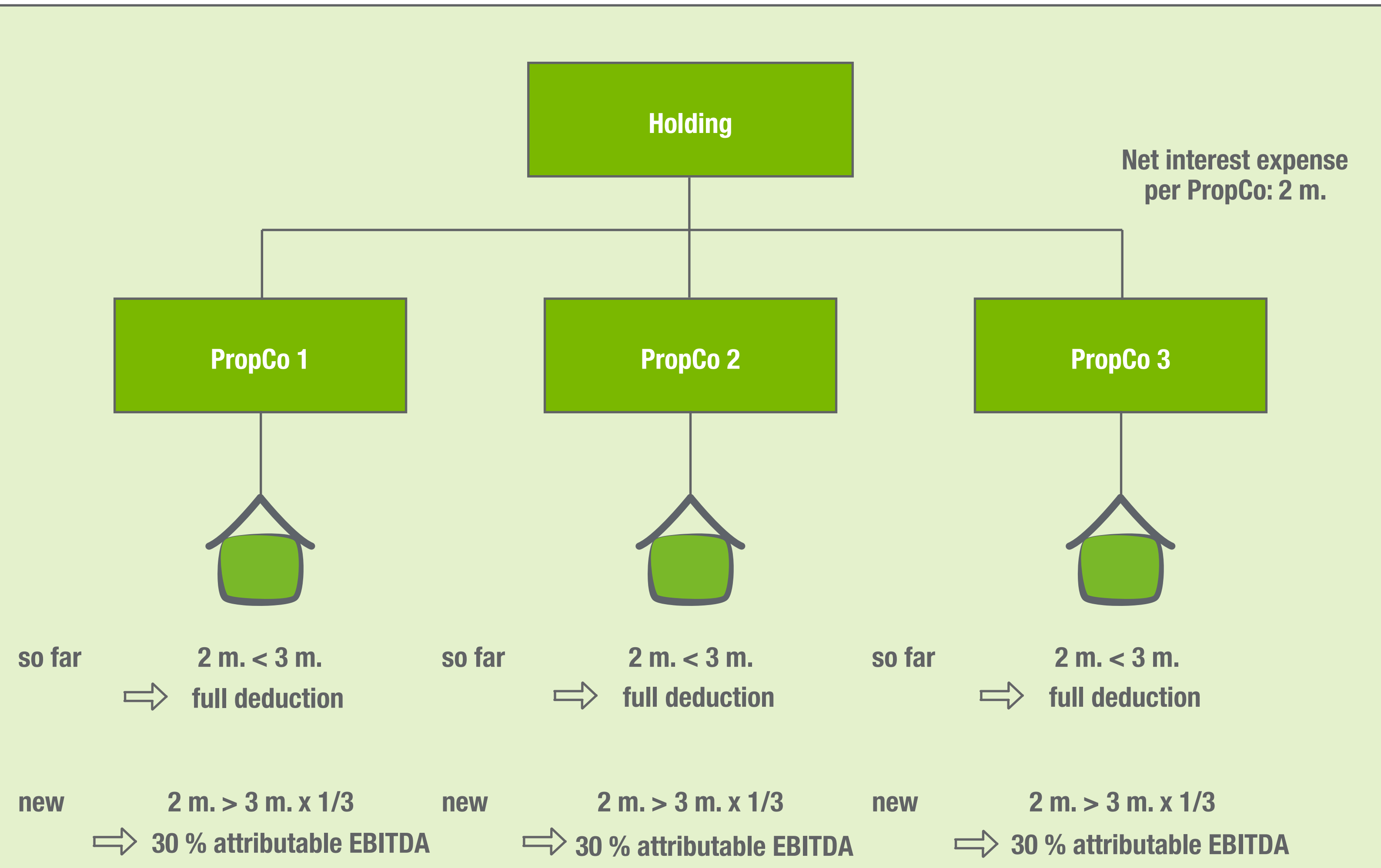
However, it has not been clearly clarified what is to be understood by the term „similarity of operations“. Reference is made here to the regulations in Section 4 (1) Number 6 of the Corporate Tax Act. In particular, it is questionable whether the regulations on the grouping of commercial operations (so-called tax unity (steuerlicher Querverbund)) can be the appropriate connecting link for the similarity of operations under the interest limitation regulation. Section 4 (1) number 6 of the Corporate Tax Act is ultimately intended to prevent competitive tax advantages of commercial operations of legal entities under public law.

The background to the new provision on the uniform exemption limit (so-called anti-fragmentation clause) is to avoid situations in which, for example, real property is acquired via several businesses in order to benefit from the exemption limit more than once. However, the anti-fragmentation clause also applies to cases in which no abuse can be identified, such as when a real estate fund holds several properties (e.g., for liability shielding or administrative reasons) in each case via a separate property company. Here, the special purpose companies could qualify as similar businesses under a common management. The Growth Opportunities Act is more likely to become the Growth Restriction Act in this case.

Amendment to the stand-alone clause

Under previous law, the interest limitation is not applicable if there is no full consolidation (stand-alone). This means that the application of the interest limitation requires at least two companies. A tax group counts as one business.

Under the Growth Opportunities Act, the stand-alone clause only applies if the taxpayer is not an affiliated company within the meaning of Section 1 (2) of the Foreign Tax Act and does not have a



foreign permanent establishment. Pursuant to Section 1 (2) of the Foreign Tax Act, an affiliated company already exists (among other things) if a participation of 25 percent or more exists. Compared to the current law, the amendment leads in this respect to a worse position of enterprises with the participation of an interestholder of 25 percent, but not more than 50 percent, or of enterprises with a foreign permanent establishment.

Section 8a (2) of the Corporate Tax Act, according to which the stand-alone clause does not apply in the case of harmful shareholder financing, is deleted. Admittedly, this is not based on any benevolence on the part of the legislator. Rather, this provision will become superfluous, as in the future, any shareholding of 25 percent will lead to the application of the interest limitation even without harmful shareholder financing.

Amendment of the equity ratio clause

Pursuant to Section 4h (2)(c) of the German Income Tax Act, the interest limitation does not apply if the business belongs to a group and its equity ratio at the end of the preceding reporting date is equal to or higher than that of the group (equity ratio comparison). In this context, a shortfall of up to two percentage points in the equity ratio of the group is harmless.

Previously, a business was considered to be part of a group if the business was consolidated or if consolidation was possible (Section 4h (3) Sentence 5 of the German Income Tax Act). In the future, actual consolidation will be required and the option will be eliminated. Also, the affiliation of a business to a group within the framework of the regulations on the horizontally organized group of equal companies (Gleichordnungskonzern) (Section 4h (3) Sentence 6 of the Income Tax Act) is to be deleted.

Pursuant to Section 4h (2) Sentence 5 of the Income Tax Act, when determining the equity ratio of the business, equity must be increased by half of special reserves with an equity portion (Sonderposten mit Rücklagenanteil) (Section 273 of the Commercial Code). This increase in equity by half of special reserves with an equity portion is also to be deleted.

In addition, the exception in Section 8a (3) of the German Corporate Income Tax Act is to be tightened. In its ruling of November 11, 2015 (BStBl. II 2017, 319), the Federal Court of Justice had decided, contrary to the view of the tax authorities (BMF letter of July 4, 2008, BStBl. I 2008, 713, paragraph 82), that remuneration for borrowed capital of the individual qualified interestholders is not to be added together when determining the 10 percent limit. The Growth Opportunities Act is now intended to implement the legal view of the tax authorities.

Introduction of a new interest rate cap

In addition to the changes to the previous regulations on the interest limitation, the Growth Opportunities Act also introduces a new so-called interest rate cap for loans between related persons (Section 4l of the draft Income Tax Act).

According to this, an interest expense from a loan with a related person may not be deducted if the interest expense is based on an interest rate that is higher than the maximum rate. The maximum rate is the basic interest rate (Basiszinssatz) pursuant to Section 247 of the German Civil Code increased by 2 percentage points.

With regard to the definition of a related party, reference is made to Section 1 (2) of the Foreign Tax Act, i.e. a person with a shareholding of 25 percent or more is generally deemed to be a related party in this case as well. In this context, the explanatory memorandum to the Act explicitly states that the regulation on the interest rate cap applies not only to cross-border cases, but also to purely domestic business relationships.

However, the interest rate cap does not apply if it can be proven that both the creditor and the ultimate parent company within the meaning of Section 4 (3) of the Minimum Tax Act could only have received the capital at an interest rate higher than the maximum rate, all other things being equal. This proven interest rate will then be deemed to be the maximum rate. Furthermore, the interest rate cap also does not apply if the creditor carries out a substantial economic activity in its state of residence (Section 8 (2) of the Foreign Tax Act) and a tax information exchange agreement exists with the state of residence (substance test).

The legal consequence of the application of the interest rate cap is the denial of the interest deduction for the borrower, with simultaneous full taxation of the interest revenue for the lender. The explanatory memorandum to the Act explicitly states that the principles of hidden profit distribution do not apply if an interest rate not exceeding the maximum rate (e.g., 7 percent in the case of a maximum rate of 8 percent) was agreed between the parties and this agreed interest rate is higher than the interest rate according to an arm‘s length comparison (e.g., 6 percent).

If the maximum rate changes due to the semi-annual adjustment of the basic interest rate, a one-month deferral of application applies in case of a reduction of the basic interest rate. It is then possible to adjust the loan conditions to the new maximum rate within this month.

In this respect, the interest rate cap will probably not lead to growth in the economy, but at best to an increase in tax revenue, simply because of the additional administrative requirements for contract drafting. Nor is it clear from the legislative process to what extent tax simplification or an increase in tax fairness can be achieved here.

Timetable, effective date and dates of application

The Growth Opportunities Act is similar in scope to an annual tax bill. We therefore assume that the legislative process is not expected to be completed until the end of 2023.

The amendments to the interest limitation and the introduction of an interest rate cap are scheduled to come into force on January 1, 2024, according to Article 46 (5) of the government draft for the Growth Opportunities Act.

Pursuant to Section 52 (8e) of the draft Income Tax Act, the interest rate cap is to be applied for the first time to interest expenses incurred after December 31, 2023. Under Section 52 (8b) of the draft Income Tax Act, the revised provisions of the interest limitation are to be applied for the first time to fiscal years beginning on the day after the Bundestag (German federal parliament) passes the Growth Opportunities Act and not ending before January 1, 2024.

be in touch: Any questions? Please do not hesitate to contact us!

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