German tax aspects of mergers and acquisitions

Dr Rolf Füger and Dr Norbert Rieger of Milbank, Tweed, Hadley & McCloy LLP summarise the main tax aspects which arise when foreign investors ('Investors') structure acquisitions for a German target company ('Target')

1. General objectives and basic tax issues

From a mere tax planning point of view, acquisition structures are usually designed to achieve a number of different objectives, in particular, to step-up the book value of the Target's assets, to maximise the availability of deductable interest expense in Germany for acquisition financing to be offset with the Target's income, to effectively use loss carry-forwards available at the level of the Target, to minimise or eliminate withholding taxes on debt service and other investment return cash flows, to avoid or reduce (real estate) transfer taxes, and to minimise exposure to potential German capital gains taxes upon a future sale of the Target.

Some of the above objectives of the Investors and very often the objectives of the Investors and the seller are mutually exclusive. In connection with the decision for or against a structure or specific elements of a structure the various advantages and disadvantages have to be evaluated. The below summary of tax aspects is restricted to the main German tax issues to be taken into account by the Investors.

The nature of such tax issues depends on whether the acquisition is structured as a share deal (acquisition of shares in a German corporation – see below 2.) or an asset deal (acquisition of assets and - possible - liabilities of a company or of a partnership interest – see below 3.).

2. Acquisition of a German corporation – share deal

Simply put, German acquisition structures have two different components, namely the acquisition through a German acquisition vehicle and the establishment of a European holding structure. The use of the German acquisition vehicle is to maximise the deductibility of interest on the acquisition financing. The use of an EU holding company may help to reduce or eliminate withholding taxes on dividends and German capital gains taxes depending on whether or not the Investors reside in a country with which Germany has concluded a treaty against double taxation ('Tax Treaty') or whether the Investors reside inside or outside of the European Union ('EU').

2.1 Acquisition and financing structure – overview

In order to facilitate the deductibility of interest on the acquisition financing and a respective set-off against the Target's operating income, the Investors usually incorporate a German corporation ('NewCo'). NewCo would be financed with equity, downstream shareholder loans and bank loans in appropriate proportions. As the filing of consolidated returns is not possible under German tax law, following the closing of the transaction, the NewCo and the Target need to establish a so-called fiscal unity, or the Target is merged upstream into the NewCo. In bigger transactions where debt comes from a variety of sources the debt is layered according to its ranking, eg into senior debt (first ranking), high yield debt (second ranking) and PIK notes (third ranking). Each layer of debt will be put into different tiers of NewCos in order to ensure this ranking and to structurally subordinate the second ranking debt to the first ranking debt and the third ranking debt to the second ranking debt. The establishment of multiple tiers of NewCos is exclusively driven by the financing and security structure and not by tax reasons. In such a structure fiscal unities need to be established at each level of the German NewCos.

2.2 Fiscal unity

The fiscal unity causes the profit of the Target to be attributed to the NewCo for tax purposes. Therefore, NewCo may deduct its interest expense from the profit of the Target attributed to it under the fiscal unity. A fiscal unity inter alia requires that (i) the NewCo holds the majority of the voting rights in the shares of the Target (so-called 'financial integration') and (ii) the NewCo and the Target have concluded a profit and loss absorption agreement for a minimum period of five years during which the profit and loss absorption agreement must be carried out. A fiscal unity only becomes effective as of the beginning of the fiscal year of the Target as of which such requirements are met. In order to establish a fiscal unity as soon as possible, the fiscal year of the Target is normally shortened effective as of the closing so that a new fiscal year and the fiscal unity may commence as from closing of the transaction.

2.3 Deductibility of interest – German thin capitalisation rules

Subject to restrictions under German thin capitalisation rules, interest on bank and shareholder loans is fully deductible for corporate income tax purposes and 50 percent of the interest is deductible for trade tax purposes. This means that while German corporations are subject to an average tax rate of approximately 38 percent (depending on the trade tax rate determined

by the municipality in which the tax payer is subject to trade tax) the tax relief obtained by paying interest out of pretax profits is approximately 32 percent.

2.3.1 Deductibility of interest on shareholder loans

Under German thin capitalisation rules, interest expenses on fixed interest bearing shareholder loans exceeding a debt/equity safe haven of 1.5:1 are not deductible. Interest which is not exclusively determined as a fraction of the principal of the loan, eg interest on profit participating loans, is, in principle, not deductible at all. The following basics of the German thin capitalisation rules influence the acquisition structure:

• Each corporation in the structure (ie NewCo, Target, and generally any subsidiary of the Target in and outside of Germany) will have its own equity safe haven calculated on the basis of the corporation's equity shown in its commercial balance sheet.

• The book value of the shares in subsidiaries, ie in particular the book value of the shares in the Target reflected in the commercial balance sheet of the NewCo, reduces the equity of NewCo for thin capitalisation purposes unless the NewCo qualifies as a holding corporation. Provided that NewCo does not hold other business assets and does not have its own business activities, it would normally qualify as a holding corporation if it holds shareholdings exceeding 20 percent in at least two separate corporations.

• For each shareholder the safe haven 150 percent of the equity of the financed subsidiary is allocable to them on a pro rata basis in proportion to their nominal share in such subsidiary. This means that an Investor holding 100 percent of NewCo (and assuming an equity of NewCo of 100) may grant a loan of 150 without exceeding the safe haven.

• The relevant equity of the financed subsidiary is the equity as of the end of the fiscal year preceding the taxable year in which the interest shall be deductible. If the equity of NewCo as of the end of fiscal year 00 is 100, the safe haven of an Investor holding all of the shares in NewCo for the whole year 01 is 150 independent of whether the equity during 01 increases or falls below 100. In order to establish NewCo as a holding corporation for thin capitalisation purposes it is necessary that it acquires, at closing of the transaction or as soon as reasonably practicable thereafter, a second subsidiary and then 'commences' a new fiscal year.

• For fixed interest bearing shareholder loans the financed corporation is eligible for the so-called third party test, ie if the company can prove that it would have been able to obtain the loan from an unrelated third party at otherwise identical terms, the loan does not fall within the scope of the thin capitalisation rules, even if the applicable safe haven is exceeded.

2.3.2 Deductibility of interest on bank debt

German thin capitalisation rules do not only cover interest expense on shareholder loans but also on third party loans provided that the third party could take recourse against a substantial shareholder or a person related to such shareholder. The German tax authorities define the term 'recourse' as comprising any upstream and downstream security. Only own asset security of the debtor should not cause the application of the German thin capitalisation rules. Therefore, the security structure usually suggested by the financing banks, in principle, triggers the application of German thin capitalisation rules. However, contrary to the wording of the German thin capitalisation rules, the German Federal Ministry of Finance issued a decree to the effect that interest expenses on third party loans may nevertheless be deductible if and to the extent that the financed corporation may establish that the third party loan is not part of a so-called back-to-back financing arrangement. The German Federal Ministry of Finance issued detailed guidelines as to the content and form of the documents to be produced in order to furnish the required proof and a sample wording for a confirmation letter to be signed by the financing banks. The financing arrangements with the financing banks should, therefore, provide for the obligation of the financing banks to cooperate in producing the relevant documentation.

2.4 Use of loss carry-forwards of Target

German corporations may use tax loss carry-forwards (LCF) without limitation in time. There is no expiration date. There are, however, two important restrictions:

First, to the extent that the current profit exceeds a threshhold of €1m, only 60 percent of the current profit (CP) may be credited against an existing LCF (Example: LCF: 10m; CP: 2m; taxable profit: 400k).

Second, the corporation using the LCF has to be legally and economically identical with the corporation which incurred the losses. According to the wording of the underlying rules, economic identity is lost if more than 50 percent of the shares in the

corporation are sold and if the corporation reassumes or continues its business with predominantly ‘new’ business assets. The relevant provisions of the German code range among the most disputed and unclear provisions in Germany and case law is diverse and subject to constant change. Despite deviating case law, in applying the business asset test, the tax authorities look at a period of five years and this means that it is often uncertain whether the Target may continue to use a LCF after closing. Therefore, an Investor is normally only willing to pay a consideration for the LCF unless the LCF is huge and if costly analysis based on balance sheet data and business projections warrant it. If the LCF may still be used after closing, a fiscal unity may not be established because otherwise such LCF would be locked in and could not be used.

2.5 Step-up

A share deal does not lead to a step-up in the book value of the assets held by the Target. The former so-called conversion model, which led to a step-up if the Target was converted into a partnership following closing, is no longer feasible due to changes of the German Reorganisation Tax Act. Alternative structures have been developed but under normal circumstances do not have a reasonable risk pattern.

2.6 Use of an EU holding structure

In particular for those Investors who do not reside in a country with which Germany has concluded a Tax Treaty, NewCo could be held through an EU holding. The benefits offered by an EU holding structure are the following:

- No German capital gains tax on the disposal by the EU holding company of shares in NewCo;
- dividends from NewCo to the EU holding company are not subject to German withholding taxes (facilitating a tax efficient flow of excess cash from NewCo to the EU holding company) provided that certain holding requirements are met and that the EU holding has obtained a so-called tax exemption certificate from the Bundeszentralamt für Steuern in Bonn prior to the distribution of the dividend; and
- with respect to certain European countries hybrid financing structures and qualification conflicts facilitate that interest on downstream shareholder loans accruing to NewCo are deductible in Germany without at the same time triggering taxes in the country in which the EU holding or the Investor resides.

However, in order to be recognised for German tax purposes and to be granted the tax exemption certificate, the EU holding corporation has to have sufficient ‘substance’ in order to escape the German substance over form or anti-treaty and anti-directive shopping rules. Pursuant to recent case law of the Federal Supreme Tax Court the holding has sufficient substance if it holds the shares in the German subsidiary on a permanent basis, ie not only temporarily and not for the purpose to avoid otherwise payable German taxes.

The German tax authorities do not apply such new case law and request that the holding corporation establishes that it has actual substance (a fully equipped office with telefax and telephone lines; employees etc) and an economic function of its own, eg the function of an active management holding with at least two subsidiaries.

3. Acquisition of a German partnership – asset deal

3.1 Step-up

As opposed to the acquisition of shares, the acquisition of assets (or a partnership interest) may lead to a step-up in the basis of the acquired assets. If and to the extent the purchase price exceeds the book value of the assets of the seller (‘Exceeding Amount’), the acquirer has to increase the book value of the acquired assets. In the case of the acquisition of a partnership interest, such increase in the book value has to be made in a so-called positive supplementary balance sheet.
To the extent the Exceeding Amount is allocated to depreciable business assets, the acquirer may fully deduct the additional depreciations from his otherwise fully taxable income.

In order to optimise the deductions, it is generally preferable to allocate the Exceeding Amount to those assets which will be depreciated or sold over a comparably short period of time. Needless to say that against this background the allocation of the Exceeding Amount is often a matter of dispute in tax field audits. Therefore, it is recommended to determine the parts of the purchase price allocable to the individual assets in the purchase agreement with the seller. The German tax authorities will then be inclined to accept the allocation unless the seller and the acquirer have a joint interest in the allocation or if the allocation appears on first view to be incorrect.

While there are significant tax benefits for an acquirer of assets, a seller will often wish to avoid the sale of assets. This is because 95 percent or 50 percent of the capital gain derived from the sale of shares is tax-free depending on whether the seller is a corporation or an individual. Capital gains from the sale of assets (excluding shares) are, in principle, fully taxable.

In exceptional cases the situation could be reversed. This is, eg the case where the assets to be sold are held by a corporation or an individual with LCF. In an asset deal subject to the general restrictions (see above 2.4) such corporation could set off the capital gain against the existing LCF. The acquirer may prefer a share deal because he believes he could structure the acquisition so that the Target could continue to use the LCF to offset future profits.

3.2 Deductibility of interest

Interest on shareholder loans and bank loans taken on in order to acquire assets or a partnership interest are deductible in accordance with general rules (see above 2.3) – without additional measures like the establishment of a fiscal unity or an upstream merger – see above 2.2.

3.3 Loss carry forwards

In an asset deal, a LCF does, in principle, not transfer to the acquirer. The same is true if a partnership interest is acquired.

4. Transfer taxes

The transfer of shares in a German corporation, of a partnership interest or of a whole business is not subject to German value added tax. Furthermore, there is neither a capital duty nor any other similar tax triggered by the acquisition or the financing with equity or downstream shareholder loans of NewCo or Target. The only transfer tax of relevance is the real estate transfer tax (RETT) which does not only apply to the sale or transfer of German-located real estate but also to the (direct or indirect) aggregation of at least 95 percent of the shares in a German or foreign corporation holding directly or indirectly German-located real estate. The tax base is determined on the basis of special real estate evaluation rules set forth in the Valuation Act. As a rule of thumb, the tax base for RETT is on average approximately 80 percent of the fair market value of undeveloped land and approximately 40 percent of the fair market value of other real estate. ■

For further information please contact:

Rolf Füger
Tel: +49 (0)89 255 59-3616
Fax: +49 (0)89 255 59-3700
email: rfueger@milbank.com

Norbert Rieger
Tel: +49 (0)89 255 59-3626
Fax: +49 (0)89 255 59-3726
email: nrieger@milbank.com

Milbank, Tweed, Hadley & McCloy
Maximilianstraße 15
80539 Munich
Germany

www.MillbankEurope.com