

# German Tax Developments & Insights



## ABOUT THIS NEWSLETTER

*This newsletter provides high-level information on German tax developments relevant to foreign businesses investing in Germany.*

## DISCLAIMER

*In the preparation of this newsletter, every effort has been made to offer the most current, correct, and clearly expressed information possible. Nonetheless, inadvertent errors can occur, and tax rules and requirements may change with little advance notice. Furthermore, the information in the text is intended to afford general guidelines on matters of interest to taxpayers. The application and impact of tax laws can vary widely from case to case, based upon the specific or unique facts involved. Accordingly, the information in this newsletter is not intended to serve as tax, legal or accounting advice, nor is it intended to constitute a legally binding offer. Ernst & Young AG, to the extent permitted under German law, disclaims any responsibility for positions taken by taxpayers in their individual cases or for any misunderstanding on the part of readers of this newsletter.*

*Readers are encouraged to consult with their established Ernst & Young Germany contact for advice concerning specific matters before making any decision. If no such contact yet exists, please get in touch with one of the individuals listed on the last page of this newsletter at an office nearest to where you do business in Germany.*

## ADD TO OR REMOVE FROM DISTRIBUTION LIST

*If you would like to add someone to the distribution list, or be removed from the distribution list, please send an e-mail to [TaxNewsletter@de.ey.com](mailto:TaxNewsletter@de.ey.com)*

## Tax Authorities Clarify Scope of Thin Capitalization Rules on Loans Provided by Lenders with Recourse to a Related Party

With a letter memorandum dated July 22, 2005, the German Tax Authorities clarified the conditions under which an (unrelated) lender should be treated as having a detrimental recourse to the borrower's shareholder or a party related to that shareholder in a so-called "back-to-back" financing arrangement. Such "back-to-back" recourse would make a loan a related-party loan, and consequently, result in application of German thin capitalization restrictions on the borrower concerning the deductibility of the interest. Contrary to previously-debated positions, the German tax authorities have now clarified that a detrimental back-to-back financing requires legally-secured access by the lender to a deposit or similar debt instrument owned by the shareholder or related party.

### General Rule on Recourse Financing

Pursuant to Sec. 8a (1) of the German Corporate Income Tax Act (CITA), a third-party loan to a corporation or a partnership owned by a corporate entity is treated like a related-party loan if the lender has "recourse" to the corporation's shareholder or any party that is related to such shareholder. Interest paid on a related-party loan is generally only deductible when computing German taxable income if all the requirements of Sec. 8a CITA are met, which prescribe most notably the maintenance of a 1.5/1 debt-equity ratio. However, in spite of the language of the statute, German tax authorities took the position in the July 15,

2004 letter memorandum to Sec. 8a CITA that a “recourse” loan should be treated as a related-party loan only if the lender had recourse to the shareholder in the context of a so-called “back-to-back” financing arrangement. Consequently, any other recourse, e.g., a plain guarantee of a related party, would not make the loan a related-party loan.

The July 15, 2004 letter memorandum included no detailed definition of the term “back-to-back financing,” and referred only to the general comment that a back-to-back financing situation would be found if: (i) a lender makes a loan, and (ii) the shareholder or any other related party maintains a (not only short-term) deposit or other receivable, which can be accessed by the lender. Further to the July 15, 2004 memorandum, the burden of proof for the nonexistence of a “back-to-back” arrangement falls on the taxpayer.

#### Definition of Back-to-back Arrangements in the July 22, 2005 Memorandum

Following the publication of the July 15, 2004 letter memorandum, a discussion arose concerning the circumstances under which the lender should be treated as “having access” to a deposit made or a receivable owned by a related party. In particular, the question was raised whether “factual access” or even the mere maintenance of a deposit by the shareholder would suffice to assume a back-to-back arrangement. In the July 22, 2005 memorandum, German tax authorities now take the position that a back-to-back arrangement (and thus a related party loan) should be assumed only if the lender has legally secured access to a deposit or receivable. The letter ruling declares explicitly that the related-party loan rules should, in this respect, only apply in the following cases:

- The lender has an “in rem” security right on a deposit (or other debt instrument) owned by the shareholder of the borrower or a party related to the shareholder.

As an example, the letter memorandum describes the following situation:

- ◆ Bank 1 grants a loan to a German GmbH. The GmbH shareholder maintains a deposit in an interest-bearing account with Bank 2. To secure the loan from Bank 1, the share-

holder pledges the deposit maintained at Bank 2 to Bank 1. The pledge constitutes an “in rem” security right, and results in a detrimental recourse of the lender, which qualifies the loan as a related-party loan.

- ◆ Similarly, an “in rem” security is also given if the lender obtains a guarantee from the shareholder/related party, and according to the lender’s general terms and conditions on business transactions (*Allgemeine Geschäftsbedingungen*), the guarantee triggers a pledge on any deposits or receivables owned by the guarantor to the benefit of the lender.

- The shareholder/related party guarantees the loan and agrees with the lender on restricted access to a deposit or receivable.

Concerning this second category, the letter memorandum describes the following situation:

- ◆ Bank 1 grants a loan to a German GmbH. The GmbH shareholder maintains a deposit on an interest bearing account with Bank 2. To secure the loan from Bank 1, the shareholder guarantees the loan, and agrees with Bank 1 that he will not access the deposit at Bank 2 until all payments have been made on the loan (principal, interest, penalties, etc.). Because the deposit is accessible to the lender in the event of default, it results in a detrimental recourse of the lender, which qualifies the loan as a related-party loan.

- The shareholder/related party guarantees the loan and executes an agreement which subjects the shareholder/related party to the possibility of immediate execution (*Unterwerfung unter die sofortige Zwangsvollstreckung*) with respect to all the assets of the shareholder / related party to the benefit of the lender.

- ◆ In this third category, the example provided by the letter ruling describes the following situation: Bank 1 grants a loan to a German GmbH. The GmbH shareholder maintains a deposit on an interest-bearing account with Bank 2. To secure the loan from Bank 1, the shareholder guarantees the loan and consents to immediate execution with respect to all its assets in favor of Bank 1. Since the lender has now, in the event of default, the ability to access immediately the

assets of the related party (including the deposit), the consent to immediate execution results in a detrimental recourse of the lender, which qualifies the loan as a related-party loan.

Generally, one could say that the outlined positions reflect the intention of the German tax authorities to treat only those third-party loans (with recourse) as related-party loans, where the lender is, because of his direct access to other liquid investments in the group only a “placeholder” for a related-party loan from an economic perspective. One could debate whether this is indeed the case with the second and third category examples (restricted account, and consent to immediate execution). These measures may strengthen the position of the lender, but would not provide secure access to the funds in the event of a financial crisis of the borrower. This is, however, a moot discussion, since the entire decision of the German tax authorities to restrict the definition of detrimental, related-party, recourse debt to back-

to-back financing arrangements does not seem to be explicitly supported by the statute, and is thus of a discretionary nature.

According to the memorandum, the taxpayer has the burden of proof for the lack of a detrimental back-to-back financing arrangement. Such proof can be rendered through an appropriate confirmation letter, which includes a list of all granted securities, provided by the lender. In any situation in which a third-party lender obtains recourse to a related party, it would be advisable for German taxpayers to include in the loan documentation a corresponding obligation of the lender to provide such confirmation letter.

For additional information with respect to this special issue of the German Tax Developments & Insights please contact your established EY adviser, or if you do not have an EY contact, one of the individuals listed on the last page of this newsletter in an office near to where you do business in Germany.

## German Tax Developments & Insights

### Publisher

Ernst & Young AG Wirtschaftsprüfungsgesellschaft

### Editorial Team

Felix Klinger, Uwe Woywode, Volker Bock  
EditorsTax@de.ey.com

### Ernst & Young Germany Contacts

#### Cities in alphabetical order

#### Berlin, Franz-Josef Epping

Phone: +49 (30) 25471 21782  
E-Mail: franz-josef.epping@de.ey.com

#### Bremen, Martin Ellerbusch

Phone: +49 (421) 33574 11246  
E-Mail: martin.ellerbusch@de.ey.com

#### Cologne, York Zöllkau

Phone: +49 (221) 2779 25647  
E-Mail: york.zoellkau@de.ey.com

#### Dortmund, Christoph Spiekermann

Phone: +49 (231) 5501 226  
E-Mail: christoph.spiekermann@de.ey.com

#### Dresden, Christa Peterson

Phone: +49 (351) 4840 23310  
E-Mail: christa.peterson@de.ey.com

#### Düsseldorf, Dirk Brueninghaus

Phone: +49 (211) 9352 10606  
E-Mail: dirk.brueninghaus@de.ey.com

#### Essen, Stephan Kunze

Phone: +49 (201) 2421 21808  
E-Mail: stephan.kunze@de.ey.com

#### Erfurt, Jörg Hellmann

Phone: +49 (341) 2526 22210  
E-Mail: joerg.hellmann@de.ey.com

#### Frankfurt, Felix Klinger

Phone: +49 (69) 15 208 27458  
E-Mail: felix.klinger@de.ey.com

#### Freiburg, Ulrich Eberhardt

Phone: +49 (761) 1508 23214  
E-Mail: ulrich.eberhardt@de.ey.com

#### Hamburg, Wilfried Lahmann

Phone: +49 (40) 36132 11201  
E-Mail: wilfried.lahmann@de.ey.com

#### Hanover, Wilhelm Niggemann

Phone: +49 (511) 8508 17651  
E-Mail: wilhelm.niggemann@de.ey.com

#### Heilbronn, Armin Sohler

Phone: +49 (7131) 939 104  
E-Mail: armin.sohler@de.ey.com

#### Leipzig, Siegfried Herr

Phone: +49 (341) 2526 23015  
E-Mail: siegfried.herr@de.ey.com

#### Mannheim, Jürgen Staiger

Phone: +49 (621) 4208 12231  
E-Mail: juergen.staiger@de.ey.com

#### Munich, Oswald Rohrer

Phone: +49 (89) 14331 17310  
E-Mail: oswald.rohrer@de.ey.com

#### Nuremberg, Rolf Müller

Phone: +49 (911) 3958 28120  
E-Mail: rolf.mueller@de.ey.com

#### Ravensburg, Achim Müller

Phone: +49 (751) 3551 10751  
E-Mail: achim.mueller@de.ey.com

#### Saarbrücken, Peter Wöhe

Phone: +49 (681) 2104 13400  
E-Mail: peter.woehle@de.ey.com

#### Stuttgart, Ekkehard Groß

Phone: +49 (711) 9881 15224  
E-Mail: ekkehard.gross@de.ey.com

#### Villingen-Schwenningen, Clemens Möhrle

Phone: +49 (721) 801 27140  
E-Mail: clemens.moehrle@de.ey.com



### Ernst & Young German Tax Desk

#### New York, Jörg Menger

Phone: +1 (212) 773 5250  
E-Mail: jorg.menger@ey.com

#### New York, Thomas Eckhardt

Phone: +1 (212) 773 8265  
E-Mail: thomas.eckhardt@ey.com