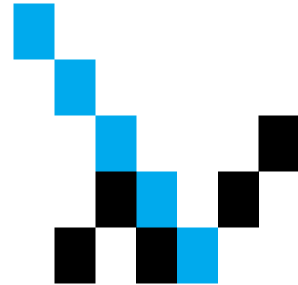


TAX DRIVEN M&A STRUCTURES IN GERMANY

A special report by Florian Schultz and Axel Mielke, Linklaters Oppenhoff & Rädler, Frankfurt

Tax climate

Once again, the German government is planning to tighten German tax law. Nevertheless, times could be worse for buyers and sellers. Purchase prices for German companies have fallen while no one can predict for how long the recently introduced capital gains exemption privilege will be available in its current form.

Before the 2001 tax reform, capital gains from share disposals of German corporations were generally subject to tax. The question whether to sell assets or shares could often be decided by simply comparing the tax base of the company's assets to the tax base of the shares and evaluating the availability of losses carried forward. The buyer on the other hand could usually benefit from a post-acquisition conversion of a corporation into a partnership. Thereby, acquisition costs could be converted into deductible depreciation volume for corporate income tax purposes.

The 2001 tax reform introduced a somewhat surprising complete exemption on capital gains from share disposals by incorporated shareholders and a 50% exemption for individual shareholders. Consequently, the legislator abolished (nearly) any possibility of achieving a step-up in bases in cases where the seller benefits from the exemption privilege.

Consequently, most current transactions take the form of a share deal. There are however still various scenarios in which asset deals may be attractive. For instance, a seller may not benefit from the exemption privilege because the seven-year lock-up period is running. He may carry forward significant tax losses that can be set off with taxable gains. In the hands of foreign sellers, capital gains may also be subject to non-German tax against which German tax can be credited. Even if German holding vehicles are selling shares exempt from German tax, foreign tax might become due to rules on controlled foreign companies, check-the-box regimes or simply on the repatriation of capital gains by distribution.

The question share versus asset deal has to be decided by taking into account all interests of sellers and buyers. Therefore, the identification of an appropriate transaction structure is certainly a challenge. However usually even more challenging is the design and implementation of an optimized acquisition structure that takes into account the ongoing post-acquisition tax burden of the buyer.

These challenges are certainly not reduced by the latest tax law changes proposed by the German government. If fully enacted, the effects on M&A transactions will be dramatic. In particular, the proposed abolition of fiscal unity for trade tax purposes and serious restrictions on the use of tax losses will completely change German corporate group and finance structures. The following should provide some insight in typical tax driven M&A structures in Germany under the new tax regime and how they would be affected by the proposed tax law changes. An ambitious aim considering that the tax reform proposals change nearly everyday. The statements are based on the adopted draft bill for an act on the reduction of tax privileges (*the Steuervergüngstigungsabbaugesetz - StVergAbG*) dated November 20 2002. Unfortunately, the legislative process will by no means be finalized before the end of March 2003 and the existing draft bill will be changed significantly without any doubt.

For the time being German tax planners and taxpayers have to live with a heavily criticized uncertainty in these days and in the following months. Proposals to cope with the abolition of trade tax fiscal unity include profit pooling, silent partnerships, business leases and the amalgamation of corporate structures to one single entity. There are, however, indications that trade tax fiscal unity will not be abolished, so that it is generally regarded as too early to change existing structures. At year-end 2002 and in early spring 2003, flexible acquisition structures are more important than ever before.

The following focuses on share transactions rather than asset deals. Starting with holding corporations as acquisition vehicles partnership structures will be looked at. Furthermore, mergers and demergers will be discussed. All these structures have to fit in the given scenario and satisfy seller and buyer demands. The tax effects of the transaction as well as the ongoing post-acquisition tax consequences have to be weighted up in each case.

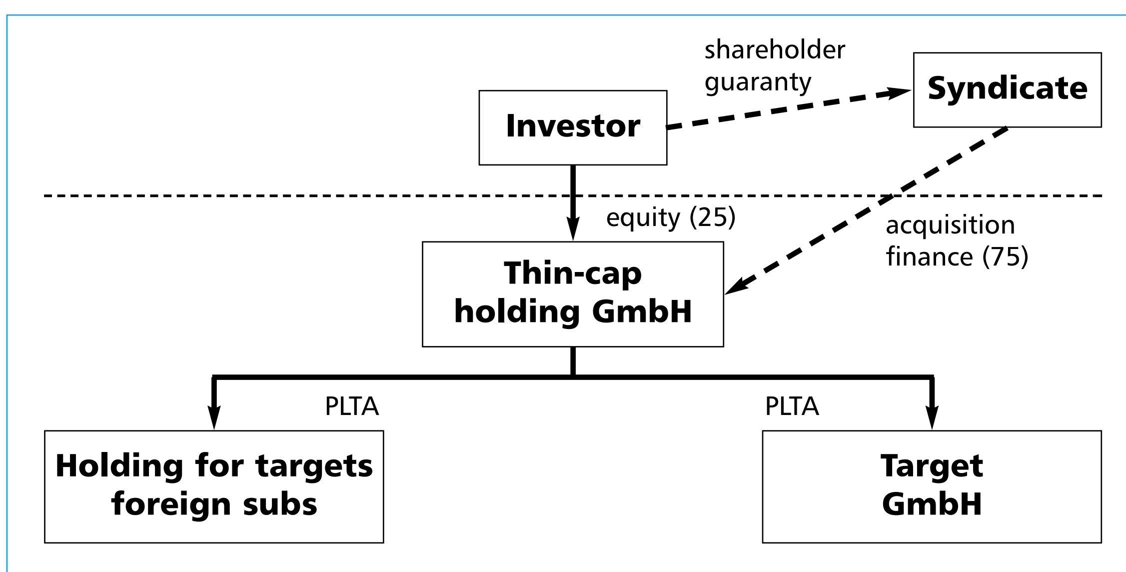
Using German thin-cap holding companies

Before the 2001 tax reform, corporate investments into Germany were almost exclusively made via German top-tier limited liability companies (GmbH). As German resident companies, they benefited from the reduced corporate income tax rate on distributed earnings (30%) while foreign corporations which directly invested into a German partnership or a branch were subject to the ordinary corporate income tax rate on retained earnings (40%). Today and in the future, even though the split rate has been replaced by a flat corporate tax rate of 25% for resident and non-resident corporations, the use of a top-tier holding GmbH is, and will remain, attractive.

The allocation of acquisition debt to the target jurisdiction is one key driver of every

acquisition structure. For Germany this holds especially true since cross-border intercompany loans regularly incur a positive tax differential even if no low-tax finance company is used. Furthermore, the German holding regime allows the deduction of interest expenses related to tax exempt foreign dividend income (however, non-deductible expenses are deemed in an amount 5% of the actual dividends). Interest payments are also an effective means for cash extraction since fixed interest is not subject to German withholding tax as opposed to dividend payments to non-EU companies, which are subject to 20% withholding tax. However, only 50% of interest payments on long-term debt are deductible for trade tax purposes. Therefore, a high leverage can result in excess foreign tax credits in the home jurisdiction of an investor.

Typically, a high leverage is achieved by using an upper-tier GmbH, a so-called thin-cap holding (3:1 debt-to-equity ratio according to section 8a *Corporate Income Tax Act)*.

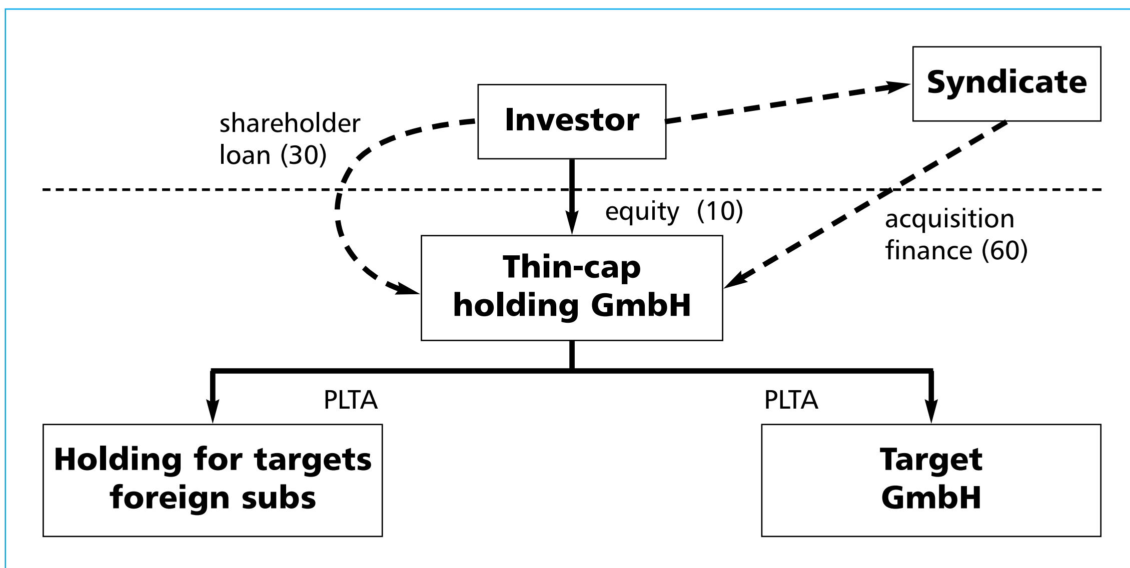


A thin cap holding company must hold two or more substantial participations in incorporated subsidiaries. The book value of these participations must make up at least 75% of the companies' assets (alternatively, the company activities can primarily comprise the holding and financing of subsidiaries). The holding company can be financed by intercompany debt and group supported third-party debt up to 75%. Within this range, interest payments are fully deductible for corporate tax purposes. For trade tax purposes there is regularly an add-back of 50% of the interest payments to the assessment base. Direct lending to subsidiaries of a thin-cap holding company, however, enjoys no safe harbour; loans required for the financing of the target and its subsidiaries need to be granted by the holding company.

A thin-cap holding company has to build a fiscal unity (*Organschaft*) for corporate income and trade tax purposes with its subsidiaries to achieve the desired set-off of interest expenses with the target's profits. A profit and loss transfer agreement (PLTA) with the subs

must be concluded. From 2002 onward, the controlling company's engagement in active business should no longer be necessary. Also, the establishment of tracking stocks for different business lines allocated under a thin-cap holding company has become easier.

The leverage of a thin-cap holding company can be increased beyond 75% if a third party lender is satisfied with a preferred security interest in the assets of the thin-cap holding company. Without shareholder support, such as guarantees or recourse to other group entities, such third party debt does not count against the safe harbour. Therefore, the total safe harbour can be used for shareholder loans. If a third-party lender is willing to finance, for instance, 60% of the value of the target group, the total leverage of the thin-cap holding company could be approximately 90%.



The future of the German thin-cap regime is uncertain. German thin-cap rules are under review by the European Court of Justice (ECJ) and at the time of writing a decision was expected on December 12 2002. The court will likely hold that the German thin-cap regime is in breach of EU law. Future structures and reorganization will depend on German legislators reaction, if the EU court rules as expected (and hoped).

An immediate end to the German thin-cap holding company structure would also be caused if fiscal unity is abolished for trade tax purposes as currently contained in the draft bill. A push down of the acquisition debt to the target to achieve an immediate set-off at the level of the target could be reasonable. This could be achieved by acquiring the target via a further subsidiary of the thin-cap holding company into which the target would be merged later. The merger would be tax neutral and would allow a step-up of target assets for commercial balance sheet purposes. However, the loans could not be granted directly to the target since the subsidiary does not enjoy any safe harbour. Therefore, the loans would need to be channeled via the thin-cap holding company with severe negative trade tax consequences.

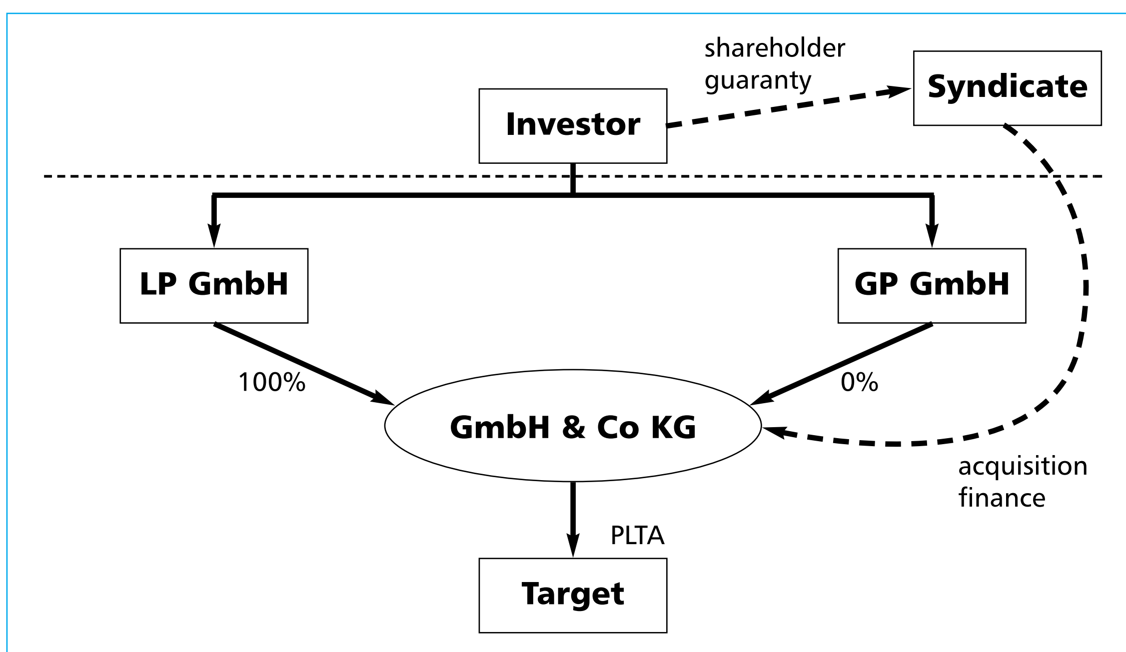
As an alternative, the acquisition vehicle could be financed via a typical silent partnership agreement with the holding company. This would avoid the add-back of 50% of the interest expenses and the respective portion of profits and losses could be pooled at the level of the holding company. Tax authorities would presumably attack this structure with the aim that the partnership itself would be subject to trade tax.

Using German partnerships

German partnerships provide interesting opportunities for inbound acquisitions. The disadvantage that at least one partner must assume an unlimited liability is usually avoided by using a GmbH & Co KG (KG) with a special purpose limited liability company as general partner. GmbH & Co KGs are commonly used in Germany and the thin-cap regime is in principal not applicable.

Lower tier partnerships

A common structure is the use of an acquisition vehicle in the legal form of a partnership as a subsidiary of two German corporations. GmbH & Co KG is a transparent entity and pays only German trade tax (depending on the municipality).

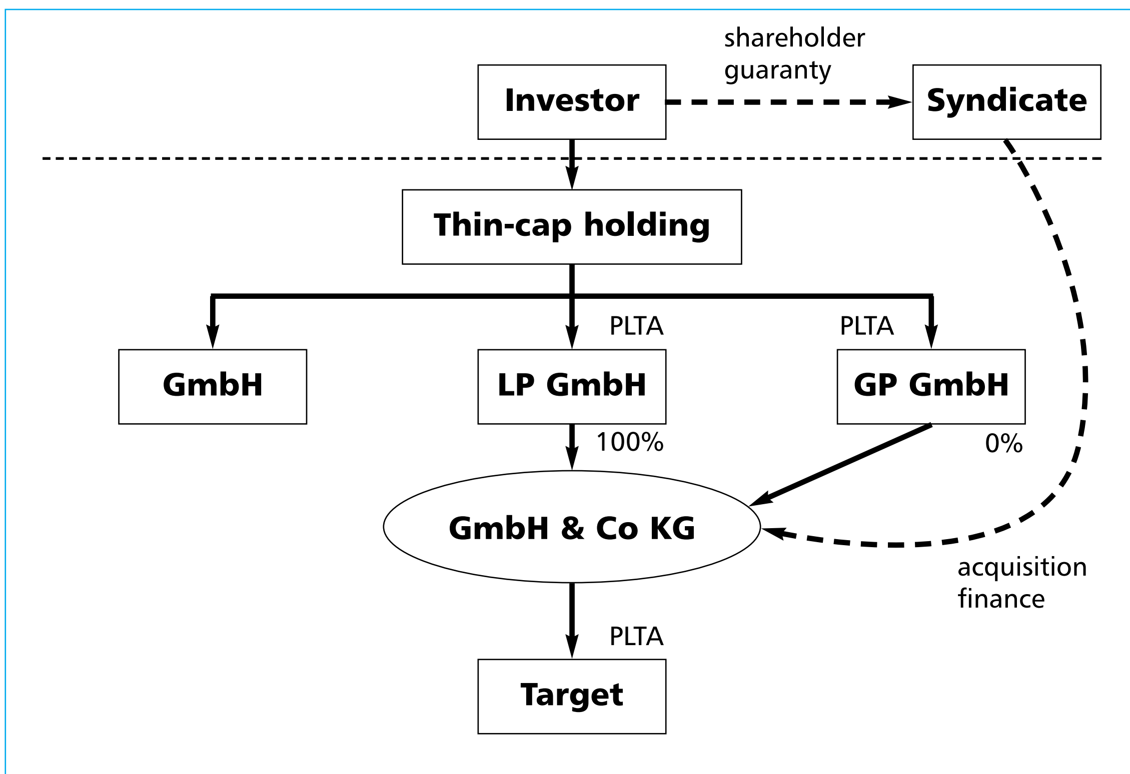


Under current law, the KG should be able to integrate the acquired target into a

fiscal unity for corporate income and trade tax purposes. The deduction of interest expenses for the acquisition debt is not restricted by any thin-cap rules. Profits of the target are set-off against interest expenses on the acquisition debt at the level of the partnership.

Should trade tax fiscal unity be abolished next year, the target can easily be merged into the acquisition vehicle even with retroactive effect as of the transfer date (within eight months). The acquisition vehicle can continue to use the firm name of the target. The target's assets can be stepped up to their fair market value for commercial balance sheet purposes.

A combination of this model with existing thin-cap holding company structures has been suggested as a wait-and-see solution.



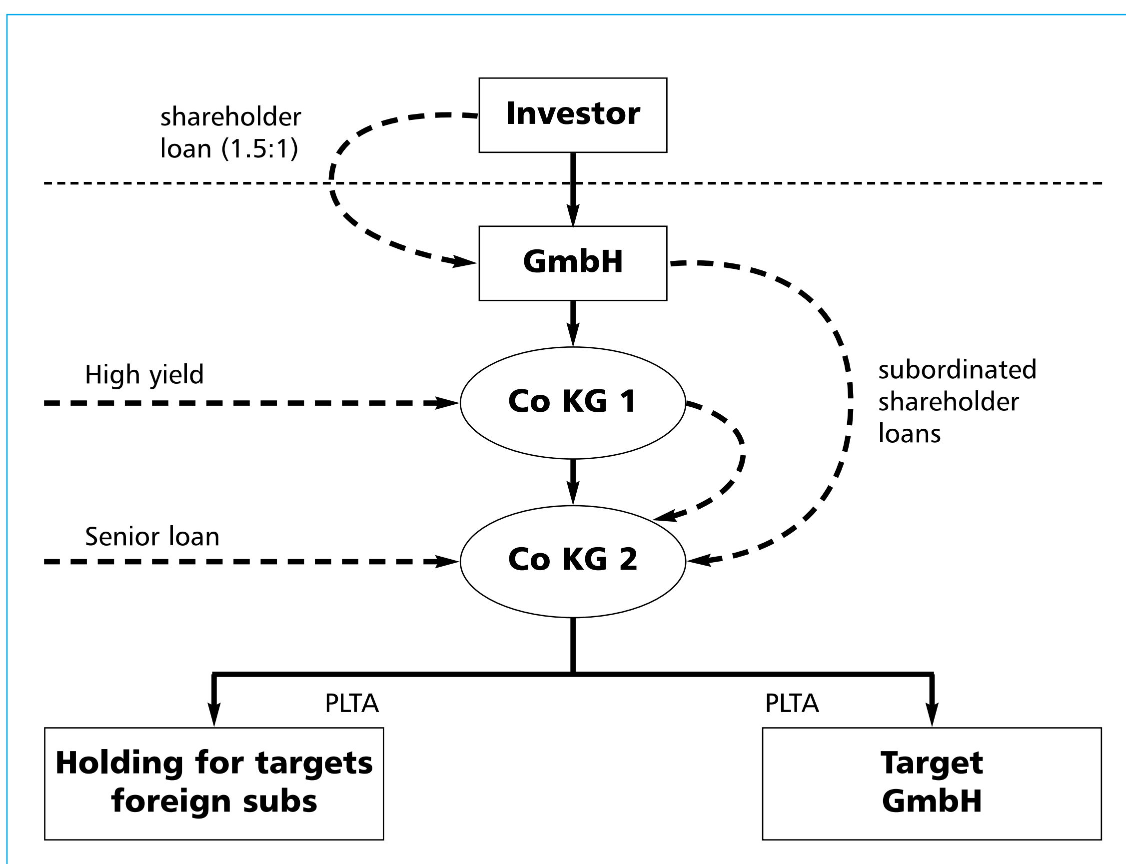
If the transfer date occurs prior to year-end 2002, KG would be able to switch its business year to the calendar year and establish a fiscal unity at least effective as of the beginning of 2003 (if not, two short business years could be introduced in 2003 to achieve the same result). In case of final abolition of trade tax unity, the target can be merged into the KG retroactively with effect as of the transfer date. Without abolition, LP GmbH and GP GmbH can be merged with the thin-cap holding company retroactively as of December 31 2002. In this case the KG would collapse resulting in the target becoming a further subsidiary of the thin-cap holding company.

Buy-out techniques

Lower tier partnerships are also used for leveraged buy-out transactions. Multiple tiers can be utilized in order to provide different lenders with differing risk profiles.

A structural subordination can be achieved, for instance, by a three-tier structure with two partnerships underneath a top-tier holding corporation. In this scenario, shareholder loans could be granted to the upper-tier corporation, a high yield loan to the middle-tier partnership and a senior loan to the lower-tier partnership which would act as acquisition vehicle. Shareholder loan and high yield loan would be lent on by way of subordinated shareholder loans to the acquisition vehicle. The target could build a fiscal unity with the acquisition vehicle or alternatively be merged onto the acquisition vehicle in order to provide the senior lender with the desired first rank security interest over the targets assets.

The shareholder loan to the upper-tier corporation would be in line with the current 1.5:1 debt-to-equity ratio for non-holding companies. The senior loan and the high yield loan would not be subject to thin-cap rules. Profit and loss pooling would occur at the level of the lower-tier partnership since the funds are channeled to the lower tier by way of shareholder loans and not as partnership capital.

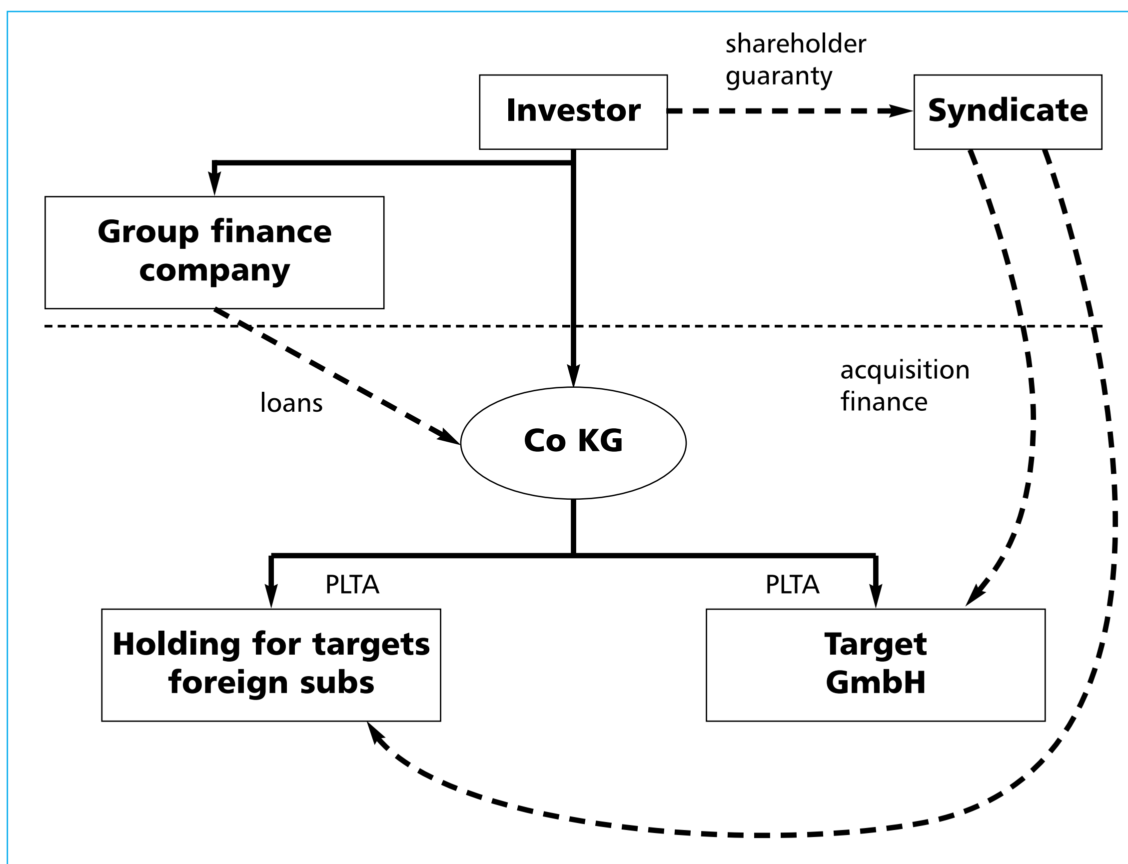


Upper-tier partnerships

Another not uncommon structure is a leveraged upper-tier partnership which acts as the acquisition vehicle and integrates the target into a fiscal unity. The partnership has to be an active management holding company to qualify as a permanent establishment for the application of double taxation agreements.

Thin-cap rules are generally not applicable to the partnership but only to the incorporated subsidiaries. Since the partnership is not a thin-cap holding company, each incorporated subsidiary has its own regular safe harbour of 1.5:1 (debt-to-equity ratio).

The debt funding of the partnership is limited by various tax rules such as income determination principles for permanent establishments and also anti-abuse rules. However, if certain preconditions are met, the partnership can be debt-capitalized to a large extent, for example, 80-90%. These funds can be used to finance the subsidiaries with equity, in order to provide them with a safe harbour to allow them to take up further shareholder loans and shareholder supported loans. In the aggregate, leverage well above 90% can be achieved.



Besides the high leverage, partnerships' distributions are not subject to German withholding tax. Upper-tier partnerships also provide excellent opportunities for double dip financings.

A disadvantage of this structure may be that German tax authorities intend to treat capital gains from the disposal of shares in corporations by the partnership as being subject to trade tax. However, the disadvantage may not materialize.

Mergers and demergers

The *German Reorganization Act* provides for a variety of possibilities to transfer domestic companies or parts of domestic companies by paper deals. Rollover relief is applicable for most of these transfers as long as a whole business, a separately conducted business line, a partnership interest or, in some cases, stock is transferred.

Two key points of the draft bill are:

- that losses carried forward can no longer be passed onto successors on corporate restructurings especially in mergers and demergers; and
- that existing losses carried forward will be lost in the event of transferring more than 50% of the shares in a loss company (change of control approach).

Mergers

These two new rules have to be carefully taken into account if mergers are planned. In any case, one has to avoid a transfer of a corporation with significant losses carried forward (LossCo) to profit companies. The other way around is the right idea. But one has to be careful that an amalgamation of the profit company into the LossCo will not result in a change of more than 50% of the shareholdings in assuming LossCo. In other words, one has to take into account the economic values of the two different companies before deciding on the merger; otherwise existing losses carried forward could be lost. If, under the given figures and economics, these aims can't be achieved, using the existing losses carried forward before merging might be reasonable. Suggested ideas to use and refresh existing losses carried forward comprise sale and leaseback transactions (including trade marks), group internal asset deals, interest free loans, waiver of liabilities or the use of loopholes in the *Foreign Investment Tax Act* and German controlled foreign company rules.

Demergers

Company splits have been popular in Germany. The shareholders of Hoechst AG, for

example, found themselves holding shares of Celanese AG in their portfolio as well. After a series of spectacular mergers in the nineties, company splits seem to be an attractive restructuring instrument for the international economy in the future.

Company splits in Germany can be carried out as demergers (*Aufspaltung*), separations (*Abspaltung*) or as spin-offs (*Ausgliederung*). In a demerger, the original corporation ceases to exist and is usually replaced by two or more corporations that are legally independent of each other. In a separation, the original corporation continues to exist, and a new, independent legal entity is created alongside the original entity. A spin-off also involves the creation of a new entity in addition to the old company, but unlike demergers and separations in which the shareholders in the original corporation become shareholders in the two successor corporations, spin-offs involve the creation of a new company as a subsidiary of the original corporation.

Company splits can generally be carried out with rollover relief for the companies involved pursuant to the *Reorganization Tax Act* (*Umwandlungssteuergesetz*) if the transferred assets as well as the remaining assets, each individually constitute so-called separate undertakings (*Teilbetriebe*) under tax law. Separate undertakings must be commercially viable. Interests in partnerships and wholly-owned subsidiaries are deemed to be separate undertakings if they have existed at least three years prior to the company split. Whether or not the successor entities constitute separate undertakings is often a topic of discussion in tax field audits, but tax authorities will generally accept the existence of separate undertakings unless unusual circumstances exist. In the case of public companies, tax neutrality can fail because of a hidden obstacle in the *Reorganization Tax Act* (section 15 sub section 3) which was intended to avoid abuse of the tax neutrality benefits. Tax neutrality is only possible if less than 20% of the value of the shares existing before the split are sold within five years after the split. In publicly quoted companies, it is virtually impossible to prove compliance with this sales limit. Therefore, a publicly traded company like Hoechst AG is said to have paid taxes of approximately €65 million attributable to its Celanese demerger. Although the company split is tax neutral for German shareholders the taxes at the level of the demerging company have been a deal stopper in some cases.

Looking into the draft bill and the likely minimum taxation, demergers could be an attractive way to use losses carried forward. Furthermore, if the target of a planned demerger is a corporation, a taxable event at the level of the company could be avoided, since the participation exemption privilege is likely to be applicable.

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In 1997 Axel joined the Munich office of Linklaters Oppenhoff & Rädler. During 2000, he worked in the New York office. Axel is now working in the Frankfurt office as a junior partner. His areas of specialization are mergers and acquisitions, corporate restructuring, asset finance and cross-border tax planning. He is a frequent contributor to tax literature and regular speaker at German and international conferences.