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Draft Law on the Growth Opportunities Act and Minimum Taxation Directive Implementation Act – Tax Changes Effective 2024

On 30 August 2023, the German government passed the draft law on the strengthening of growth opportunities, investments and innovation as well as tax simplification and tax fairness, also known as the **Growth Opportunities Act** (Wachstumschancengesetz) and on 16 August 2023, the draft law on the implementation of the directive to ensure global minimum taxation for multinational enterprise groups and large domestic groups in the Union and the implementation of additional supporting measures, known as the **Minimum Taxation Directive Implementation Act** (Mindestbesteuerungsrichtlinie-Umsetzungsgesetz – MinBestRL-UmsG), thereby initiating the legislative process. Provided the draft laws are passed by the Bundestag, they will result in major tax changes for Luxembourg fund structures at the turn of the year.

We have summarized the most important changes for Luxembourg investment fund structures below. These include the introduction of an interest rate cap, which had already been part of the German government's coalition agreement[1], the amendment of the interest rate cap with regard to the tax exemption limit, the adjustment of the low tax rate under the CFC rules and the extension of the taxable income of an investment fund to include sales of shares in a real estate company. Our statements are based on the status of the legislative process at the time this newsletter was prepared.

1. Introduction of an Interest Rate Cap, Section 4l of the German Draft Income Tax Act

The deduction of interest expenses for financing between related parties as defined in Section 1(2) of the German Foreign Tax Act (Außensteuergesetz – AStG) is to be limited to a maximum interest rate per transaction. The maximum interest rate is to be equal to the basic rate of interest plus 2%. The basic rate of interest amounts to 3.12% as of 1 July 2023 and is set every six months on 1 January and on 1 July by the Deutsche Bundesbank and published in the Federal Gazette. The maximum interest rate is therefore subject to regular changes. The interest rate cap is to apply for the first time to interest expenses incurred after 31 December 2023.

[1] Coalition agreement between the SPD, Alliance 90/The Greens and FDP dated 7 December 2021, page 167.

The regulation is set to apply to both solely domestic and cross border transactions, although according to the explanatory memorandum to the law, the legislator intends to take action against foreign financing companies with low substance that grant loans to group companies in Germany.

Lenders who pursue a significant economic activity in the country in which they have their registered office or place of management are to be exempt from the limitation, the so-called substance exemption.

The notion of significant economic activity can already be found in Section 8(2) of the German Foreign Tax Act and stems from the ruling of the ECJ in the Cadbury Schweppes case.[2] Pursuant to Section 4l of the German draft Income Tax Act, the principles of Section 8 (2) of the German Foreign Tax Act are to be applied mutatis mutandis. According to the German government, a significant economic activity is deemed to exist if the lender has the ability and authority to actually control or assume the risk of the specific financing transaction. This requires the decision-makers to have the necessary experience and skills and to be sufficiently informed. The focus on risk control or the assumption of risk was already listed in point 3.92 of the administrative principles governing transfer pricing published in 2021. However, this regulation was removed in the administrative principles governing transfer pricing from 2023 after the Federal Fiscal Court objected to this concept in its ruling of 18 May 2021. As part of the proposed interest rate cap, the tax authorities are likely to continue to maintain the concept of risk control.

In addition, the borrower has the option to prove that both the creditor and the ultimate parent company could only have received the capital at an interest rate above the maximum rate if all other circumstances were the same. In these cases, the maximum rate is the interest rate that they could have achieved in the most favorable case. It remains to be seen how the evidence is to be provided and what effort is involved.

The regulation also affects Luxembourg investment funds and holding companies that grant loans to German companies, regardless of their legal form. For pure holding companies and investment funds, a significant economic activity should generally not exist or be difficult to prove due to the fact that their activities involve primarily asset management. For borrowers domiciled in Germany, this may lead to a tax deduction limitation of loan interest on the loans granted by the investment fund or holding company. This is also the case for loans for which transfer pricing documentation is available.

However, the Federal Council (Bundesrat) recently expressed its concerns regarding the draft law on the interest rate cap and published a proposed amendment. The German Government may review this proposal.[3]

[2] ECJ of 12 September 2006, C-196/04.

[3] According to the German government’s response of 25 October 2023 to the Federal Council’s statement of 20 October 2023.

AIQUNITED's Recommendation:
Even though the Federal Council has expressed concerns about the introduction of an interest rate cap, we believe it would be advisable to review current and planned future financing relationships with regard to interest rates and the existence of any significant economic activity by the end of the year in order to apply the substance exemption. If necessary, the loan agreements should also be adjusted to a variable interest rate.

We will be happy to assist you with the review and to advise you on the proposed introduction of the interest rate cap.

2. Addition of an Anti-Fragmentation Rule to the Interest Barrier Rule Pursuant to Section 4h of the German Income Tax Act

The interest barrier rule is not to be applied if the interest expenses exceeding the interest income (defined in the future as net interest expenses) amount to less than EUR 3 million (exemption limit). Among other things, this rule is now being amended to the effect that similar businesses or companies that are under a single management are to be consolidated for the exemption limit of EUR 3 million ("Anti-Fragmentation"). This is to prevent the exemption limit from being used more than once if separate (special purpose) companies are established for similar activities and the exemption limit of EUR 3 million can be claimed for each company. With the proposed amendment, the exemption limit is only to be used once and is to be allocated to the companies in proportion to the net interest expenses.

For example, companies are deemed to be similar if their corporate purposes are the same. Companies have a single management if the same person or the same group of persons is authorized to manage the business in both companies or can exercise his/her will in both companies.

AIQUNITED's Comment
The proposed amendment is a German regulation that is not required under European law by the ATAD Directive and, in our opinion, will lead to considerable additional tax burdens, particularly in the real estate sector. Subsidiaries of Luxembourg investment fund structures may also fall within the scope of the new regulations, provided that the German subsidiaries or special purpose vehicles constitute similar businesses as defined by the Anti-Fragmentation rule. For real estate funds in particular, this can lead to a significant reduction in the exemption limit for each subsidiary due to the allocation to all subsidiaries.

3. CFC Rules – Reduction of the Low Tax Rate

The Minimum Taxation Directive Implementation Act provides for a reduction of the low tax rate under the CFC rules. The term "CFC (controlled foreign company) rules" refers to the taxation of so-called passive income in accordance with Section 8 of the German Foreign Tax Act of a low-taxed foreign

subsidiary that is controlled by a shareholder resident in Germany.[4] Up to now, a company was considered to be subject to low taxation if the passive income calculated in accordance with German regulations had a tax burden of less than 25%. As a result, passive income such as interest income from Luxembourg subsidiaries was regularly subject to the CFC rules applicable to the controlling German shareholders. The controlling interest in investment funds as defined in the German Investment Tax Act (Investmentsteuergesetz – InvStG) is generally exempt from the CFC rules, provided that the investment fund's income is not derived from transactions conducted with the controlling shareholder or related parties by less than one third. However, this rule has no shielding effect, meaning that any foreign subsidiaries of the investment fund may be subject to the CFC rules applicable to the shareholders of the investment fund resident in Germany.

The low tax rate is now to be reduced from 25% to 15%, so that in the future, significantly fewer German shareholders will be subject to German CFC rules applicable to their shareholdings in foreign companies.

AIQUNITED's Comment

The adjustment of the low tax rate is to be welcomed, as it has been demanded by associations and companies for years and is long overdue. Especially in light of the agreement on a global minimum tax rate of 15%, we believe it was essential to adjust the low tax rate.

4. Extension of the Tax Liability of Investment Funds to Include Capital Gains From Companies With German Real Estate

Luxembourg and German investment funds that fall within the scope of the German Investment Tax Act are subject to German corporate income tax on their German investment income, German real estate income and certain other German income. Under the German Investment Tax Act, profits generated from the sale of a significant shareholding, i.e. ≥ 1%, in a corporation that has its registered office or place of management in Germany or whose share value is more than 50% based on real estate located in Germany are explicitly exempt from taxation under the current legal situation.[5]

As a result of the proposed amendment to Section 6(5) of the German Investment Tax Act, profits from the sale of significant investments in German and foreign corporations that predominantly hold real estate in Germany will in the future be subject to German corporate income tax of 15% at the level of the investment fund.[6] Since the real estate in question is located in Germany and the right of taxation is assigned to Germany under the real estate provision laid down in several double taxation agreements, including the double taxation agreement between Germany and Luxembourg[7], the sale of Luxembourg subsidiaries with real estate predominantly located in Germany will in the future also be taxable in Germany at the level of the Luxembourg investment fund.

[4] Additional information can be found in our newsletter of 27 September 2023 on the German Foreign Tax Act: German Foreign Tax Act and Luxembourg Funds – AIQUNITED

[5] Section 6(5) no. 1 of the German Investment Tax Act.

[6] Bundestag publication 20/8628, on Article 31, on no. 3.

[7] Art. 13 (2) of the double taxation agreement between Germany and Luxembourg.

Investments whose share value is not based to more than 50% on German real estate remain unaffected by this change, meaning that their sale continues to be exempt from corporate income tax in Germany in accordance with the German Investment Tax Act.

AIQUNITED's Comment

For German investors, the new regulation creates unequal treatment of investments through investment funds compared to direct investments, as the German Investment Tax Act excludes the application of the participation exemption (*Schachtelprivileg*) (Section 8b of the German Corporate Income Tax Act (KStG)) as well as the partial-income procedure (Section 3 no. 40 of the German Investment Tax Act), and thus the capital gain in its entirety is subject to taxation at the level of the investment fund, whereas such gains are partially tax-exempt in the case of direct investments. The capital gain is therefore taxed in the same way as an asset deal but without any provision governing a step-up in the recognition of the property in the balance sheet. In the event of a future sale of the property by the corporation, this would lead to the capital gain being taxed again, taking into account the initial acquisition costs.

This is a considerable disadvantage for investment funds compared to direct investors and contradicts the explanatory memorandum to the law when the provision was introduced: With the German Investment Tax Act 2018, the legislator lured investments in properties to Germany under the promise of tax exemption, only to renege on this promise four years later, thus jeopardizing the promise of returns to investors and residential construction.

5. Prevention of Tax Arrangements for Real Estate Funds

The so-called partial real estate exemption, which results in a partial tax exemption of income from real estate funds (60% for domestic and 80% for foreign real estate funds) for investors, is, due to the introduction of Section 2(9a) of the German Investment Tax Act, only to be applied in the future if the relevant income of the real estate fund has been subject to a prior tax burden. As the partial exemptions are intended to mitigate economic double taxation at fund and investor level, the partial exemption should, according to the German government, only be applicable if double taxation actually occurs.

A property or an interest in a real estate company is only to be taken into account for the purposes of the real estate fund quota if more than 50% of the income of the investment fund or the real estate company from renting and selling the property is subject to taxation. The same applies if the income generated by the real estate company is attributed to the investment fund as a shareholder.

AIQUNITED's Comment

German investors in Luxembourg investment funds should only be affected or no longer benefit from the partial real estate exemption if income from renting and selling properties is not subject to taxation or is partially tax-exempt at the level of the real estate companies. The regulation should not result in any changes for German properties, for example, as the Luxembourg investment fund generating income from renting and selling properties is subject to limited corporate income tax in Germany, and real estate companies generating such income are generally also subject to unlimited or limited

corporate income tax in Germany. Whether individual properties or real estate companies are not subject to any prior tax burden and are therefore not to be included in the real estate fund quota must be examined on a case-by-case basis.

6. Other Changes

- The obligation to report cross-border tax arrangements is to be extended to domestic German tax arrangements. A domestic tax arrangement is any arrangement,
  - which is not a cross-border tax arrangement,
  - which is subject to income tax or wealth tax and trade tax,
  - which meets at least one of the hallmarks set out in Section 138l(3) of the German draft Fiscal Code, and
  - whose main purpose is to obtain a tax advantage.

  In contrast to cross-border tax arrangements, the main benefit test for domestic tax arrangements must therefore be met for each hallmark.

- It should be possible to carry back losses to the three (previously two) immediately preceding financial years.

- In the future, the extended trade tax reduction can also be claimed if income from the supply of electricity associated with the operation of renewable energy plants does not exceed 20% (previously 10%) of the income from the rental of the property.

- A similar change can also be found in the context of the harmfulness threshold in Section 26 no. 7a of the German Investment Tax Act for income from the generation and supply of electricity, which, if exceeded, may result in the loss of the status as a specialized investment fund. In the future, such income will not be harmful if it does not exceed 20% (previously 10%) of the investment fund's total income.

- Introduction of a statutory regulation on the mandatory use of electronic invoices from 1 January 2025 for taxable and certain tax-exempt transactions in Germany if both the supplier and the recipient of the service are based in Germany. For the sake of simplification, other forms of invoicing may still be used until 31 December 2025, and until 31 December 2027, invoicing via the EDI procedure may continue to be used in addition to the electronic invoice.

- A declining balance depreciation will be introduced for a limited period for movable assets that are acquired or manufactured after 30 September 2023 and before 1 January 2025. Depreciation should be up to 25%, but no more than 2.5 times the straight-line depreciation. In addition, the declining balance depreciation will also be temporarily permitted for residential buildings. This, however, requires that the construction of the buildings begins

after 30 September 2023 and before 1 January 2029. The percentage rate of declining balance building depreciation is to be 6%.

7. Conclusion

With the exception of the reduction of the low tax rate to 15% under the CFC rules and the adjustment for real estate funds, all other proposed changes pursuant to the draft law on the Growth Opportunities Act and Minimum Taxation Directive Implementation Act will have a significant impact on investment funds and their German subsidiaries.

In particular, the introduction of the interest rate cap and the Anti-Fragmentation rule as part of the interest barrier rule will result in significant restrictions on financing through debt capital. With regard to the interest rate cap, any adjustments to the financing structure should therefore be considered and implemented by the end of the year – even if the Federal Council has expressed concerns in this regard. The Anti-Fragmentation rule could mainly affect investment funds in the real estate sector, where separate subsidiaries are regularly established for each construction or real estate project. As interest on bank loans is also subject to the interest barrier rule, there will be negative economic consequences, particularly given the current interest rate level.

The extension of the taxable income of an investment fund to include income from the sale of investments in real estate companies also leads to a significant disadvantage for German investors in fund structures compared to direct investments in real estate companies due to the lack of applicability of Section 8b of the German Corporate Income Tax Act and Section 3 no. 40 of the German Investment Tax Act.