GERMANY: TAX ALLEVIATIONS UNDER THE CITIZENS RELIEF ACT

June 23, 2009

To Our Clients and Friends:

On June 19, 2009, the German parliament passed the Citizens Relief Act. The Act must be approved by the second chamber, which is all but certain. The Act includes the following amendments of relevance to companies:

The So-Called Interest Barrier Rule. It limits the deduction of interest on any type of financing to 30 % of the tax EBITDA. Currently, the limitation does not apply if the annual net interest expense is less than € 1 Mio. Under a sunset clause, this threshold, which is in the form of a "cliff" is now increased to € 3 Mio. The higher threshold is applicable for all fiscal years that start after January 25, 2007, (and do not end prior to January 1, 2008) and end prior to January 1, 2010. Thereafter, the law reverts back to the € 1 Mio. threshold.

Change of Ownership Rules. Loss carry forwards are ratably forfeited if and to the extent that more than 25% of the shares of a corporation are directly **or indirectly** transferred to the same purchaser within five years. A transfer of more than 50% destroys all of the loss carry forwards. Currently there is only limited relief available that applies to government aid in the form of equity contributions to banks under the special legislation relating to government aid to financial institutions.

Under the law change, shares acquired with an intent to salvage the company and to avoid over-indebtedness or illiquidity will be disregarded provided that the objective is to preserve the essential elements of the existing business. The "essential elements of the business" are defined to include any of the following:

- adherence to any labor agreement concluded with the works council on jobs;
- the aggregate sum of all salaries and wages in the five years following the acquisition must be equal or greater than 400% of the original amount of salaries and wages; or
- contribution of fresh assets equal to an amount of 25% or more of the total amount of all assets as per the tax balance sheet at the close of the fiscal year preceding the share acquisition (if less than 100% of the shares are acquired, a proportionate amount of such 25% will be sufficient).

The statute prescribes that a share acquisition does not qualify if the company had ceased to operate at the time of the acquisition or if it materially changes its line of business within the subsequent five years.

The above relaxation of the change of ownership rules is subject to a sunset provision and only applies to share transfers from January 1, 2008 to December 31, 2009, when it reverts back to the present rule.

ANALYSIS

In light of the sunset rules, both tax alleviations have only a very limited benefit. Also, in large cases the increase of the "de minimis" threshold from € 1 Mio. to € 3 Mio. will not help. The temporary relaxation of the change of ownership rules will be of interest in situations where a debt for equity swap is considered since the law says that a cancellation of debt counts for purposes of meeting the 25% asset contribution test, although only to the extent of the fair value of the loan which is cancelled. However, the time window that the statute affords is very limited: only six months from the date of enactment until the sunset of the new clause. Debt equity swaps tend to be complex and it is therefore doubtful how many of these transactions can be negotiated and consummated until year end.

If you have any further questions, please feel free to contact any of the authors of this client alert.

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Friedrich Hey
+49 69 2097 5110
fhey@debevoise.com

Andreas Striegel
+49 69 2097 5253
astriegel@debevoise.com