

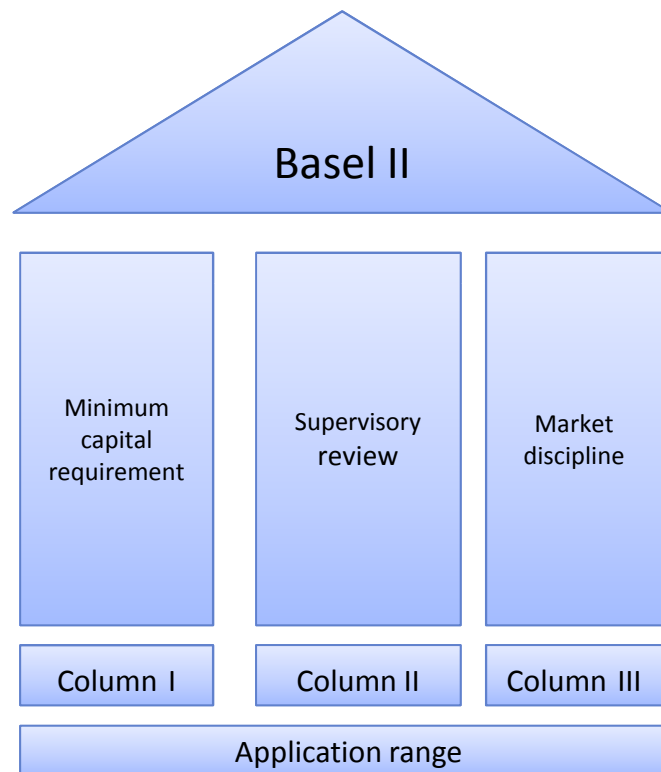
Hybrid Financial Instruments

Introduction – General Information

- Hybrid Financial Instruments = Mezzanine Capital
- The term “Mezzanine Capital” originates from the Italian word „il mezzanino“ and means the level between ground floor and second floor.
- In Palladian architecture the mezzanine is a low upper floor, usually for servants and/or storage.

Introduction – General Information

Implementation of „Basel-II“ regulations in 2007 made the access to credits for small and medium entities more difficult.



Introduction – General Information

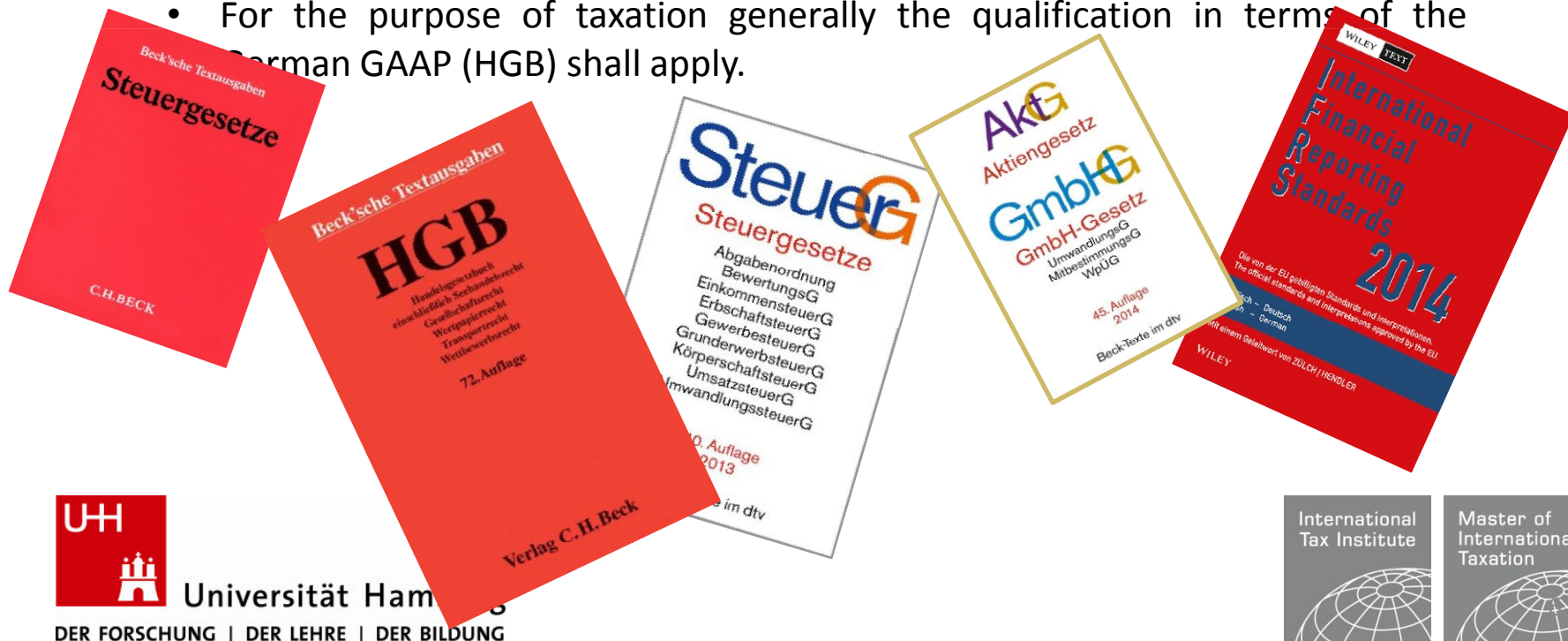
- For the purpose of a better access to credits companies use Hybrid Financial Instruments.
- Depending on how the Financial Instruments have been designed they can be classified as equity or as debt capital.
- Hybrid Financial Instruments give a great flexibility in fund raising to the issuer.
- For the purpose of capital requirements of Basel II the issuer of Hybrid Financial Instruments may even be a credit institution itself.

Introduction – General Information

- Hybrid Financial Instruments often have a high rate of return and are very attractive for investors therefore. The rate of return has a scope between 5 and 25%.
- Hybrid Financial Instruments often bear a high equity risk and lead in a higher equity ratio. The issuer enjoys an increased value and liquidity.
- Hybrid Financial Instruments lead to a higher financial leverage, higher investment capacity and higher financing scope.
- The execution of Hybrid Financial Instruments is very complex regarding economic, fiscal, financial and legal aspects.

Introduction – General Information

- Qualification between equity- and debt capital has to be made in accordance with the civil law, the corporate law (right of co-determination) as well as tax law and economical strategies (participation in profit and liquidation proceeds).
- The treatment of Hybrid Financial Instruments is used to be very complex regarding the economic, fiscal, financial and legal questions.
- For the purpose of taxation generally the qualification in terms of the German GAAP (HGB) shall apply.

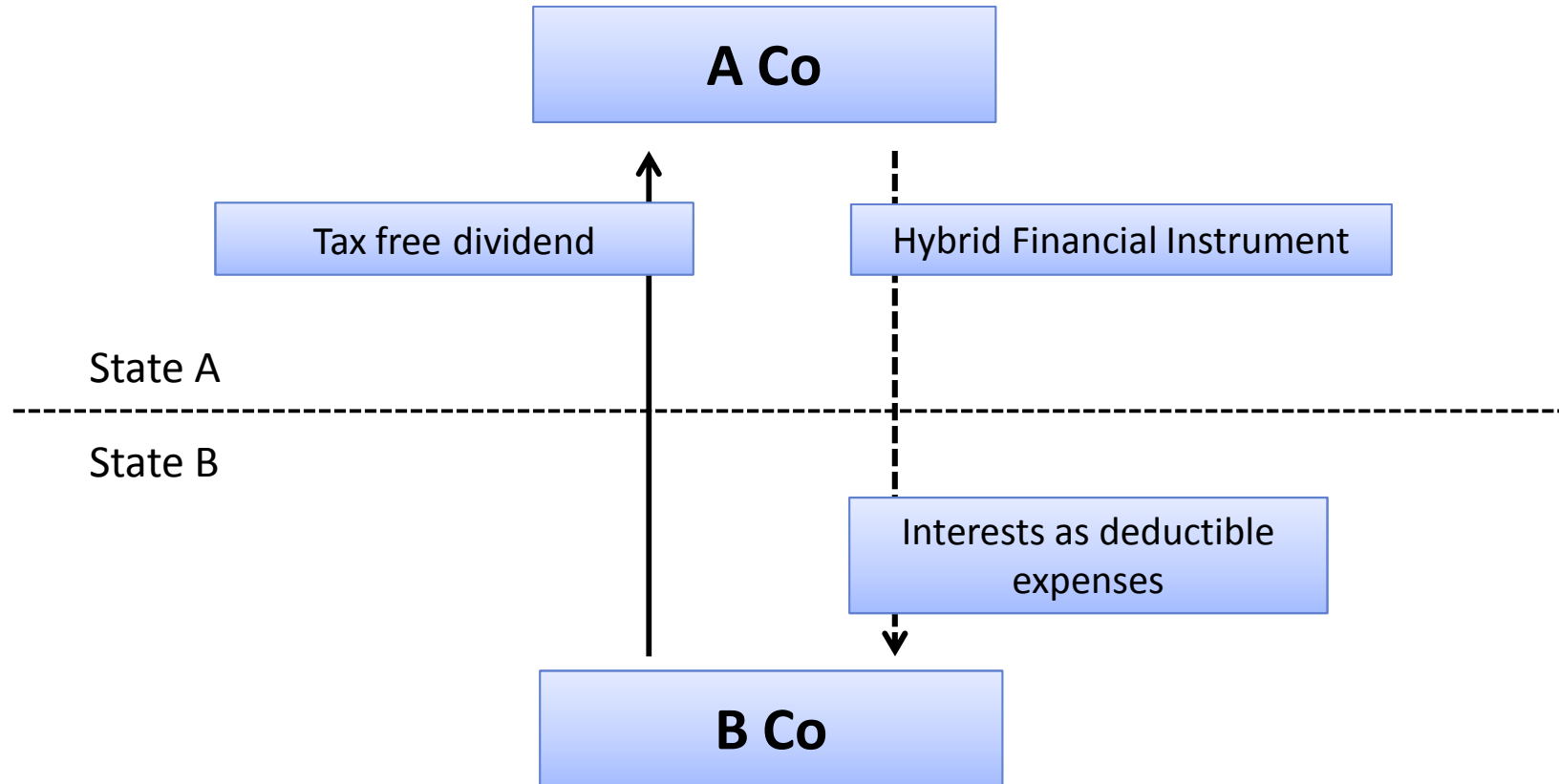


Equity or debt capital- Qualification Criteria

Criteria	Equity	Debt Capital
Liability	At least the amount of invested capital (joined ownership)	No liability
		Protection of creditor
Entitlement to payout	depending on profit / loss	Fixed interest rate
Claim to property	proportionately	Nominally (loan amount)
Time limitation	No limitation	Based on the contractual conditions
Governing rights	yes	no

- For the purpose of taxation many tax benefits will only be granted in case that the income of the issuer has not been reduced.

Typical Structure



Hybrid Financial Instruments in the international context

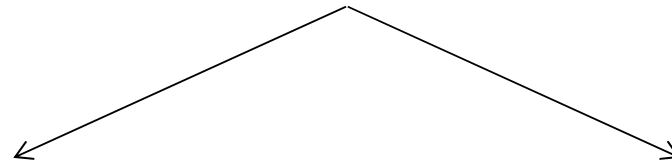
- Conflicts can be created in cases where foreign countries have other definitions of equity and debt capital.
- Consequence: In cases where foreign country qualify a Hybrid Financial Instrument as debt capital income of the issuer will be reduced. In case that the country of the receiver qualify the instrument as equity tax benefits can be granted (e.g. tax exemption or low tax rate).
- Therefore in Germany many tax benefits will only be granted in case that the income of the issuer has not been reduced.

Typical Hybrid Financial Instruments

- Convertible Bonds („Wandelanleihen“)
 - Warrent-linked Bonds („Optionsanleihen“)
 - Profit Participation Loan („Partiarisches Darlehen“)
 - Silent Partnership („Stille Gesellschaft“)
 - Subordinated Loan („Nachrangdarlehen“)
 - Profit Participation Rights („Genussrechte“)
- In practice, the most important Hybrid Financial Instruments are: Profit Participation Loan, Silent Partnership, Profit Participation Rights

Profit Participation Rights

Two types of Profit Participation Rights:



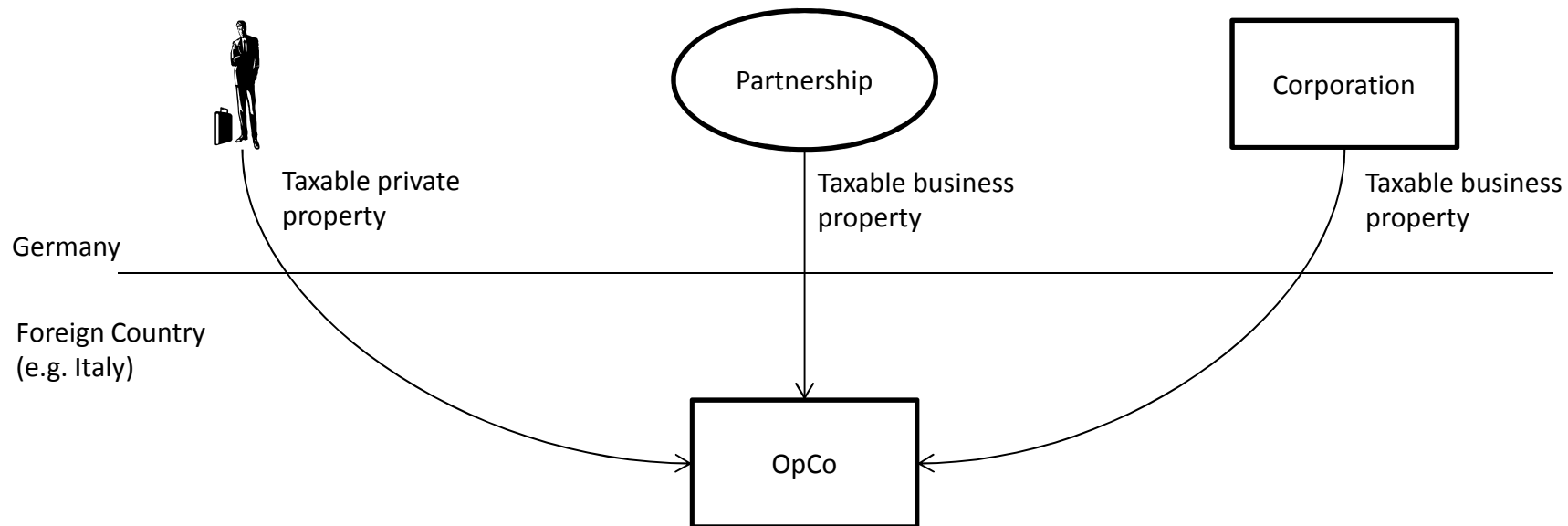
Investment-like (quasi-equity)
Participation in the profits
and liquidation proceeds

Loan-like
Participation in
profits only

Characteristics:

- Continuing obligation
- No shareholder and no voting rights
- Property rights (depending on the contractual conditions)

Investment-like Profit Participation Rights - Outbound case

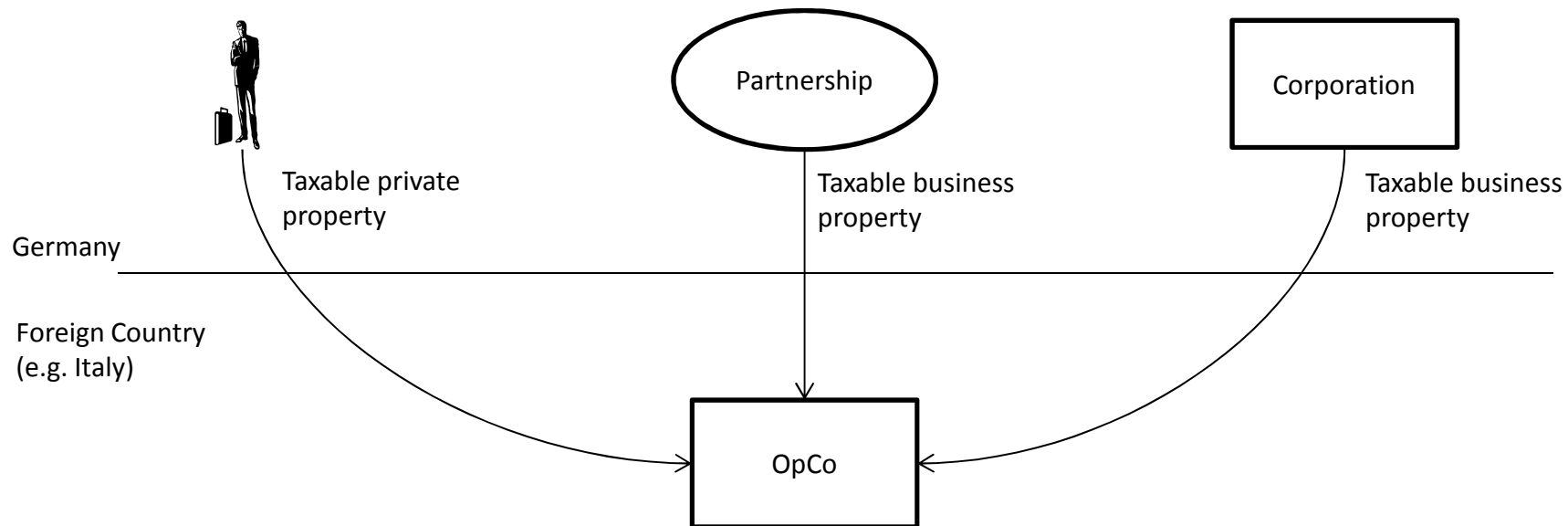


- Treaty:
 - Right to taxation is generally allocated to Germany
 - Limited Withholding Tax Rate in the Source State
 - Some treaties (e.g. UK) contain clauses where the Withholding Tax Rate shall not be limited if the profits have reduced the income of the issuer

Investment-like Profit Participation Rights - Outbound case

- National Law:
 - Taxable private property: Income Tax Rate of 25% plus Solidarity Surcharge of 5.5% on the Income Tax (1.375%). Income-related expenses are not deductible.
 - Business property of a partnership: Individual Tax Rate up to max. 45% on 60% of the profit (equal to 27%) plus Solidarity Surcharge of 5.5%. Income-related expenses are deductible.
 - Business property of a corporation: profits received are generally exempt from taxation where the profit participation rights give at least 10% of the property to the holder and have not reduced the income of the issuer. 5% are regarded as non-deductible expenses. Otherwise the profits are subject to Corporate Income Tax and Trade Tax (appr. 30%). Income-related expenses are deductible.

Loan-like Profit Participation Rights - Outbound case

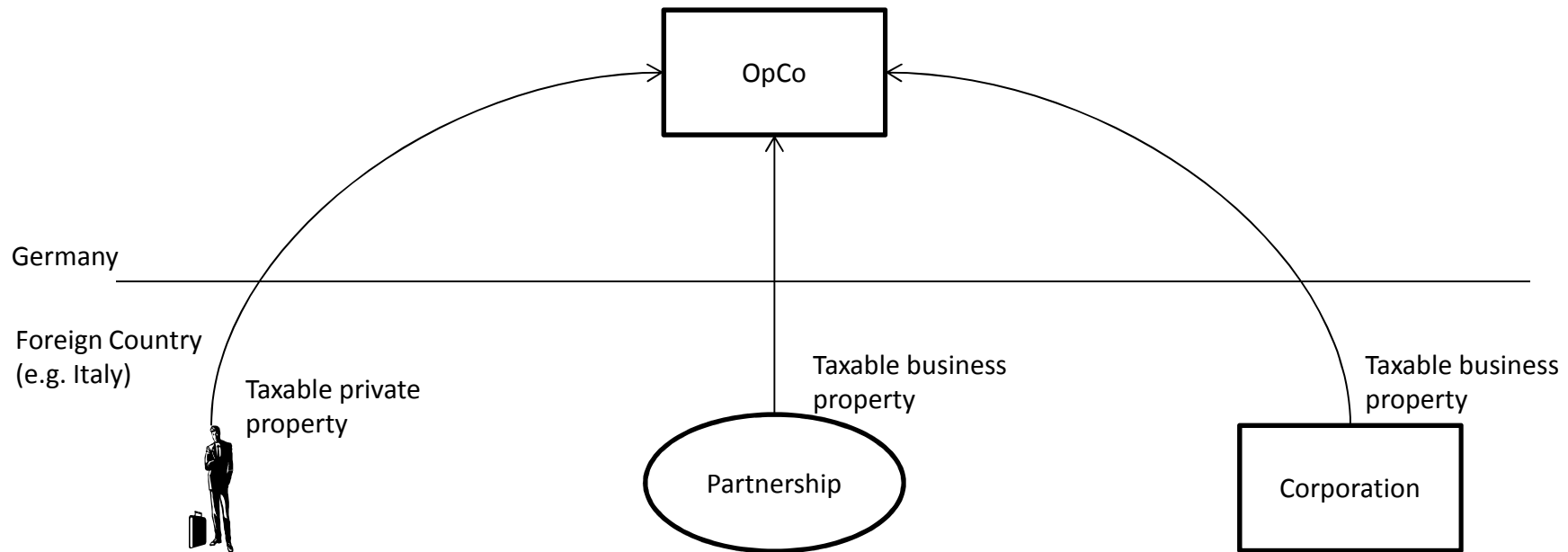


- Treaty:
 - Right to taxation is generally allocated to Germany
 - Limited Withholding Tax Rate in the Source State
 - Some treaties (e.g. UK) contain clauses where the Withholding Tax Rate shall not be limited if the profits have reduced the income of the issuer

Loan-like Profit Participation Rights - Outbound case

- National Law:
 - Taxable private property: Income Tax Rate of 25% plus Solidarity Surcharge of 5.5% on the Income Tax (1.375%). Income-related expenses are not deductible.
 - Business property of a partnership: Individual Tax Rate up to max. 45% on 100% of the profit plus Solidarity Surcharge of 5.5%. Income-related expenses are deductible.
 - Business property of a corporation: The profits are subject to Corporate Income Tax and Trade Tax (appr. 30%). Income-related expenses are deductible.

Investment-like Profit Participation Rights - Inbound case



- Treaty:
 - Right to taxation is generally allocated to the foreign country
 - Limited Withholding Tax Rate in Germany of 15%
 - Some treaties contain clauses where the Withholding Tax Rate shall not be limited if the profits have reduced the income of the issuer

Investment-like and Loan-like Profit Participation Rights - Inbound case

- National Law:
 - Income from profit participation right is subject to limited tax liability
 - Taxable private property and business property of a partnership: As far as the profit participation rights can not be allocated to a permanent establishment in Germany, the income is subject to Withholding Tax of 25% plus Solidarity Surcharge of 5.5% (flat rate). Income-related expenses are not deductible.
 - Business property of a corporation: As far as the profit participation rights can not be allocated to a permanent establishment in Germany the income is subject to Withholding Tax of 25%. 10% of the Withholding Tax are recoverable so that the effective tax burden amounts to 15% plus Solidarity Surcharge of 5.5%.
 - Anti-abuse provisions of Section 50d German Income Tax Act („ITA“)

Profit Participating Loan („PPL“)

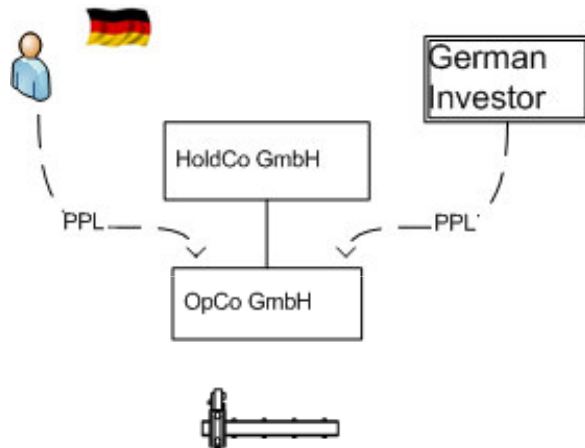
– „Partiarisches Darlehen“

Characteristics:

- Purpose is the granting of a loan
- Difference to silent partnership: Different purposes of lender and borrower
- Interest is based on a fixed interest rate and/or certain amount of the profit/sales
- Loss participation has to be excluded
- Claim to repay capital required
- Shareholder may also grant PPL
- If shareholder owns the majority in the shares => silent partnership is assumed

Profit Participating Loan („PPL“)

– „Partiarisches Darlehen“



Tax impacts:

OpCo GmbH:

- Interest expenses tax deductible, as long as interest capping rules do not apply
- Add back for trade tax purposes (25%)
- WHT of 25% + solidarity surcharge

German Investor:

- Interest income is fully taxable
- WHT can be credited

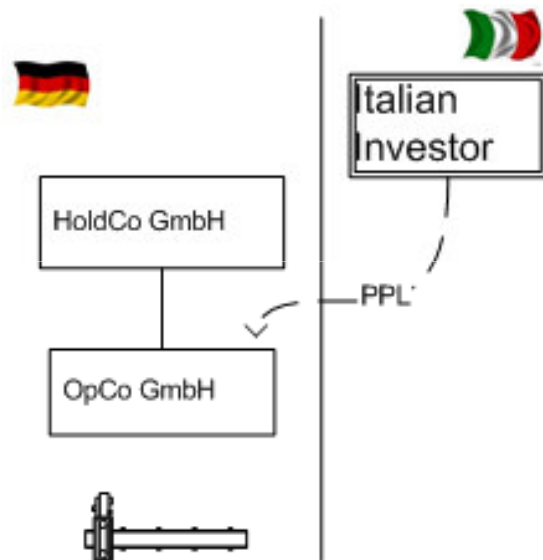
Private Investor:

- Flat rate taxation (25%)
- Sale of PPL would also be subject to flat rate taxation

Profit Participating Loan („PPL“)

– „Partiarisches Darlehen“

Tax impacts:



OpCo GmbH:

- Interest expenses tax deductible, as long as interest capping rules do not apply
- Add back for trade tax purposes (25%)
- WHT of 25% + solidarity surcharge

Italian Investor:

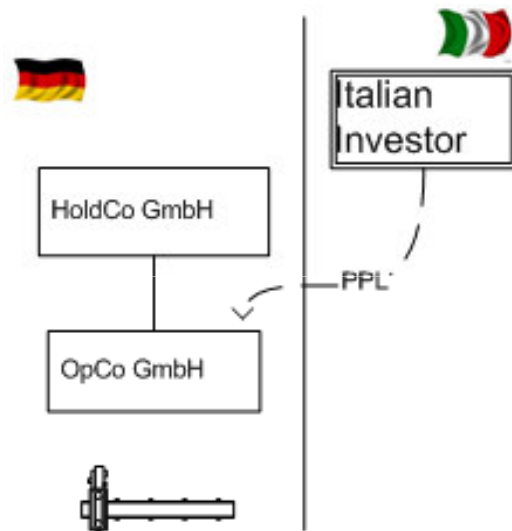
- Subject to limited tax liability in Germany
- DTT generally allocates taxation right to state of residence. However, WHT may be levied.
- Art. 11 DTT Germany - Italy: State of source can tax, if interest on PPL and interest expenses are tax deductible for the borrower => Protocol

Profit Participating Loan („PPL“) – „Partiarisches Darlehen“

Tax impacts:

Italian Investor:

- => Interest income is subject to German CIT at a rate of generally 25%
- Reduction to 15% is possible, para 44a IX ITA
- To receive reduction para 50d ITA has to be fulfilled
- EU interest directive



Profit Participating Loan („PPL“) – „Partiarisches Darlehen“

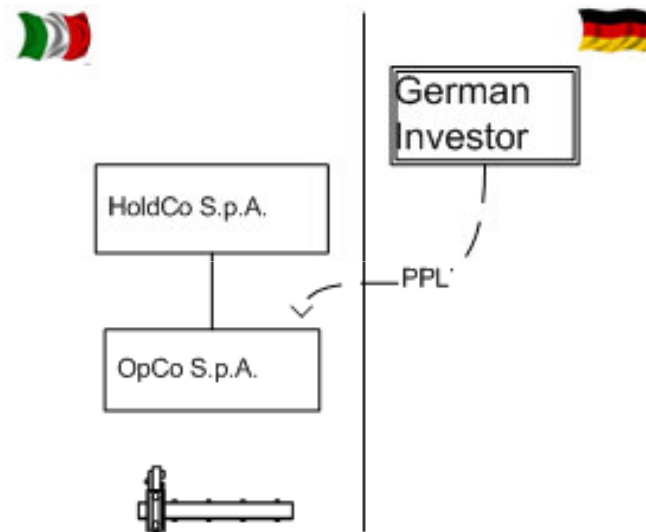
Excursus: Sect. 50d para 3 ITA

- Amended as per 1 January 2012 to meet EU requirements
- Effects all non-resident parent entities seeking relief from German WHT
- German WHT relief can (only) be claimed to the extent that:
 1. foreign company's shareholders would have been entitled to a refund/exemption had they received the income directly, **or**
 2. foreign company's gross receipts stem from own active business activities
 3. for those receipts that do not stem from foreign company's own active business activities
 - economic or other significant non-tax reason exist for interposing foreign company, **and**
 - foreign company has suitable business premises and equipment to participate in commerce
- Certain exemptions: E.g. entities that are listed at a stock exchange

Profit Participating Loan („PPL“)

– „Partiarisches Darlehen“

Tax impacts:



OpCo S.p.A.:

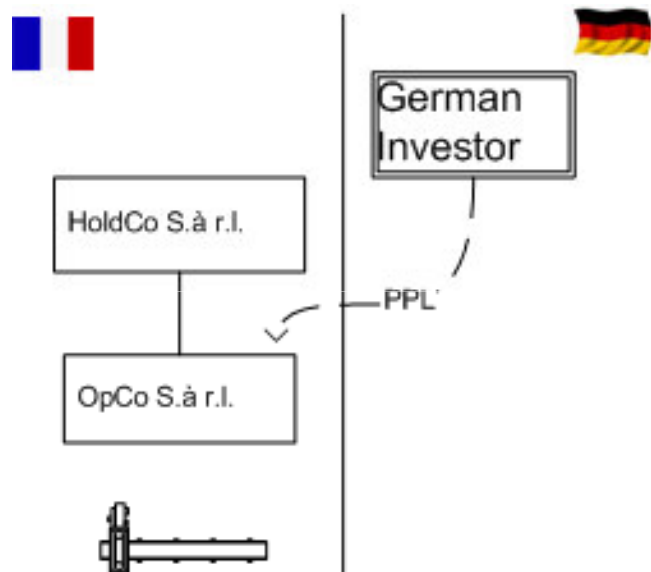
- Interest expenses tax deductible, as long as interest capping rules do not apply?
- WHT?
- Other tax impacts?

German Investor:

- DTT generally allocates taxation right to state of residence. However, WHT may be levied.
 - Art. 11 DTT Germany - Italy: State of source can tax, if interest on PPL and interest expenses are tax deductible for the borrower => Protocol
- => Interest income fully taxable in Italy

Profit Participating Loan („PPL“) – „Partiarisches Darlehen“

Other international tax issues:



- Sometimes PPL fall under the scope of the dividend article (e.g. Art. 9 para 6 DTA France – Germany)
- Under certain DTAs WHT may be levied if interest can be deducted from tax base (e.g. DTA UK – Germany, DTA Netherlands – Germany)

Typical Silent Partnership („SP“) – Stille Gesellschaft

Characteristics from a civil law perspective:

- association of individuals or companies
- with a common intention
- not foreseen itself for trading business as it is an undisclosed partnership
- special kind of a contractual obligation
- tier 3 or mezzanine capital
- Difference to profit participating loan: Different purposes of lender and borrower Interest is based on a fixed interest rate and/or certain amount of the profit/sales
- joining losses is capped by the amount of participation
- Claim to repay capital required
- Shareholder may also grant PPL
- Income from that partnership is considered as capital income with flat tax

Atypical Silent Partnership („SP“) – Stille Gesellschaft

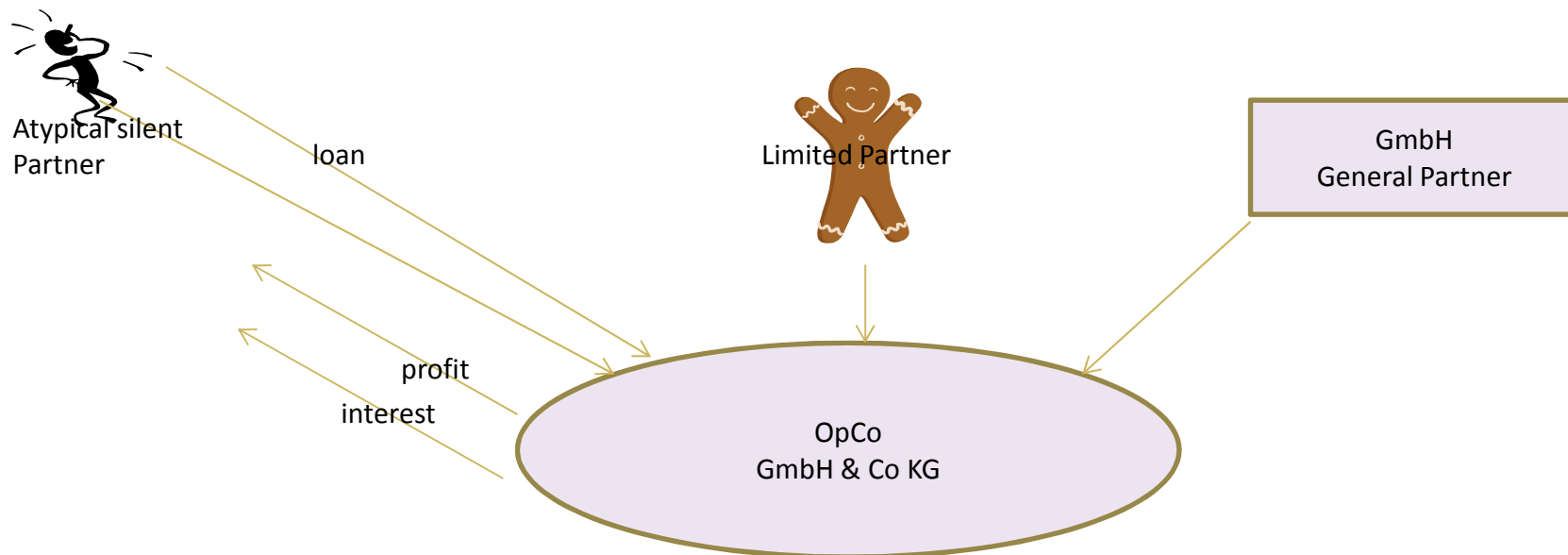
Compared to the typical silent partnership – What makes the difference?:

- The rights of control and/or management are expanded
- Income from that partnership is considered as business income for tax purposes
- personal tax rate is applicable to that income

German tax supreme court decision 11.12.2003

Payments from a German atypical silent partnership to an Italian partner

General tax treatment of that structure with only German Investors



German tax supreme court decision 11.12.2003
Payments from a German atypical silent partnership to an Italian partner

General tax treatment of that structure with only German Investors

Tax Treatment of the OpCo GmbH & Co KG – German perspective:

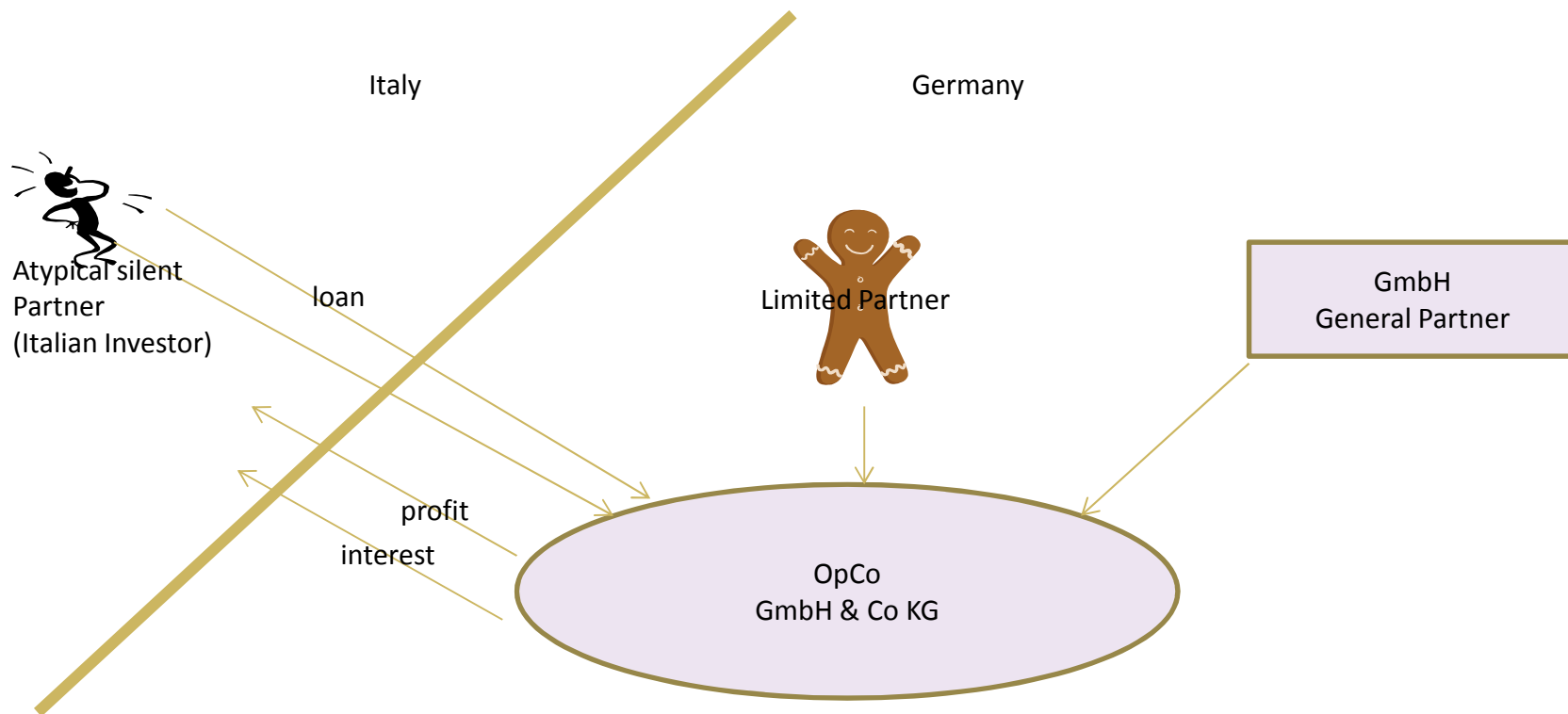
- Interest expenses are tax deductible

German Investors tax treatment

- Treatment as business income
- uniform determination of profits
- triggers trade tax as well as personal income tax

German tax supreme court decision 11.12.2003

Payments from a German atypical silent partnership to an Italian partner



German tax supreme court decision 11.12.2003
Payments from a German atypical silent partnership to an Italian partner

Tax Treatment of the OpCo GmbH & Co KG:

- Interest expenses are tax deductible

Where will the interest income of the Italian Investor be taxed?:

- Subject to potential limited tax liability in Germany
- DTT generally allocates taxation right to state of residence.
- Art. 11 DTT Germany - Italy: State of source can tax, if interest on SP and interest expenses are tax deductible for the borrower => Protocol
- Art. 11 Sec. 5 DTT G-I: If the asset / debt belongs to a PE in Germany the interest will be treated as business profits taxable in Germany

German tax supreme court decision 11.12.2003

Payments from a German atypical silent partnership to an Italian partner

German treaty override par. 50d Sec. 10 German ITA

- Fiction for foreign Investors under a DTT which not objects special personal income (such as interest from an atypical silent partnership)
- this income is treated as business profit with a fictitious PE in Germany
- OECD approach is that German law overrules the DTT and therefore Germany can tax
- An investor of an atypical silent partnership does not found an PE by his investment nor by granting a loan and the administration of it

German tax supreme court decision 11.12.2003
Payments from a German atypical silent partnership to an Italian partner

German treaty override par. 50d Sec. 10 German ITA

Finally the German tax supreme court presented this case to the Federal Constitutional court with the core question:

Whether it can be accepted from a rule of law perspective that Germany generates a taxation right in opposition to a DTT.

A judgment remains to be seen!

Questions?