

GERMANY'S STRICTER RULES ON INTERCOMPANY FINANCING: ONE YEAR IN

WHAT LUXEMBOURG-BASED INVESTMENT FIRMS AND MULTINATIONALS NEED TO KNOW

WHAT CHANGED IN 2024

The *Growth Opportunities Act* of 27 March 2024 introduced new Sections 1(3d) and 1(3e) to Germany's Foreign Tax Act (AStG), significantly tightening the regulatory framework for cross-border intercompany financing. These rules are aimed at inbound financing but should also be applicable to outbound financing transactions.

On 12 December 2024, the German tax authorities published the Administrative Principles on Transfer Pricing 2024 (VWG), which include their perspective on how the new regulations should be applied.

The new German rules apply to all fiscal years starting after 1 January 2024. However, a transitional rule exempts interest expenses incurred by 31 December 2024 from Section 1(3d) AStG, if they relate to financing arrangements legally agreed and implemented before that date. If such arrangements are significantly modified between 31 December 2023 and 1 January 2025, the exemption applies only to expenses incurred before the modification. Thus, the new rules affect both existing and new financing transactions.

The limitations introduced by these rules are designed to prevent profit shifting through excessive interest deductions. However, possible penalties for non-compliance are not explicitly mentioned in the law.

This article delves into the details of these changes and their implications for Luxembourg groups and investment structures with business and investments in Germany, providing useful recommendations for compliance.

The specific cumulative binding requirements introduced in Section 1, Paragraph 3d AStG for intercompany financing transactions are:

- ▶ **The group credit ratings** should be used to determine interest rates, unless a deviation can be shown to comply with the arm's length principle.
- ▶ **The commercial rationale** (i.e., transaction is economically necessary and serves a genuine business purpose) must be substantiated for each loan.
- ▶ **A debt capacity test**, based on a forward-looking cash flow analysis, must be performed and documented before the loan is granted or the financing is executed.

In addition to the arm's length test, the rules target foreign intermediary financing entities (e.g., in cash pooling, back-to-back lending), which are presumed to bear limited risk. Unless taxpayers prove these entities manage and assume financial risk and add value, tax authorities may apply a simplified cost-plus method excluding financing costs.

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ONE YEAR LATER: WHERE DO WE STAND?

Germany's updated transfer pricing rules for intercompany financing are now fully in effect, raising the bar for compliance across multinational and investment structures.

Tax authorities are intensifying audits, reviewing not only documentation and compliance with the stricter rules but also whether financing terms align with legal and economic substance.

Despite the administrative guidance issued late in 2024, practical uncertainties persist, and taxpayers must now proactively defend their positions to withstand increased audit scrutiny and navigate interpretive uncertainties. The absence of thresholds, safe harbors, or clearly defined minimum standards adds to the burden, especially for smaller transactions or taxpayers.

More frequent audits and regulatory reviews are expected, so businesses should act promptly to ensure documentation and processes meet the new requirements.

What Should Luxembourg Structures do now?

Luxembourg entities lending to or borrowing from German related parties should proactively assess their compliance with the new German rules and revise their financing strategies and TP loan benchmarking documentation accordingly.

Key focus areas include:

1. Credit Rating Analysis

Assess if the loan benchmarking studies in place are performed by using the Group rating.

When deviating from the group rating, robust economic justifications are required (e.g., SPVs, siloed fund structures etc).

2. Debt Capacity and Business Purpose

Verify if the TP documentation includes a tailored debt capacity analysis justification for the loan's economic necessity and genuine business purpose.

3. Financing intermediation

Luxembourg entities within the scope of **Circular LIR 56/1** should ensure consistency with German expectations, especially regarding functional characterization. Luxembourg intermediary financing vehicles must assess and document their substance, functions, value creation, and financial risk control and assumption to justify any deviation in remuneration from that set out under the new German rules.

Thorough documentation is critical to avoid debt reclassification as equity and prevent denial of interest deductions or income adjustments.

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HOW BDO CAN HELP

BDO Luxembourg, in close collaboration with BDO Germany, offers comprehensive support to help you comply with Germany's new transfer pricing rules. Our services include:

- ▶ **Risk & readiness diagnostics** for existing financing arrangements
- ▶ **Integrated documentation strategies** aligned with German and Luxembourg requirements
- ▶ **Credit rating** analyses including assessment when deviations from the group rating are possible
- ▶ **Debt capacity** - forward-looking financial modelling and **interest benchmarking** studies
- ▶ **Reviews and advice on substance and functional profile** and help to accurately document the commercial rationale and business purpose
- ▶ **Support with audits** from the tax authorities

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INTERESTED?

Get in touch with:



Adina Conner

Partner

+352 45 123 865

adina.conner@bdo.lu



Daniel Ortega

Director

+352 45 123 730

daniel.ortega@bdo.lu

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