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# German Federal Fiscal Court doubts the constitutionality of the Interest Barrier Rule

**In a recently published decision, the German Federal Fiscal Court (BFH) ruled in a preliminary proceeding that the German thin cap regulations ("Interest Barrier Rule") may violate the principles of fair taxation as laid down in the German Constitution. The Court affirmed a stay of execution of the tax assessment notice for the claimant and specified the demands for such a suspension until the final decision (BFH, I B 85/13, dated 18 December 2013). Affected taxpayers should take all measurers to keep their assessments open and to stay the execution of their tax assessment notice.**

## 1. Effect of the Interest Barrier Rule

The German Interest Barrier Rule (as laid down in sec. 4h of the German Income Tax Act and sec. 8a of the German Corporate Tax Act) is a complex and difficult to understand concept. Basically, it sets forth the rule that interest expenditures can only be deducted up to the amount of interest earnings. If interest expenditures exceed the interest earnings, interest expenditures can be recognised only up to 30% of the so-called "tax EBITDA", which is defined as the annual profits increased by the interest balance and the amounts of depreciation and amortization.

The Interest Barrier Rule may have an enormous economic effect on companies that are highly debt-financed, be it through bank loans or shareholder loans. The limitation of interest expenses may become problematic in times when companies have an increasing demand for loans. This is especially true in times of an economic crisis of the entity, where running costs somehow have to be compensated if profits decline, resulting in the consequence that exceeding interest payments are confronted with a decreasing calculation base. This effect leads to increased financing costs and can end up in a threatening liquidity situation for a financially-stricken company.

In addition to this economic effect, the Federal Fiscal Court had to deal with the demands raised by the German Constitution for fair taxation and the tax treatment of interest expenses.

## 2. Decision of the Federal Fiscal Court

The Court found that the rule may constitute a discrimination under the principle of fair taxation under the Constitution: if business earnings are liable to tax, business expenses need to be deductible. Generally, only the net income is subject to tax. The Interest Barrier Rule, as it currently stands, violates this principle, as the deductibility of interest expenses is limited.

### 2.1. No justification of the discrimination

The Federal Fiscal Court concluded that there may possibly be no justification for this unfair treatment. According to the view of the legislator, the rule is supposed to act as an anti abuse rule. The deduction of expenses may be denied especially in cases of abuse. The rule is intended to prevent foreign financing practises, the sole reason of which is to lower the tax burden in Germany and to shift profits to other countries. The Court came to the decision that, in its view, it is doubtful whether the Interest Barrier Rule meets the conditions set up for anti abuse rules under the Constitution.

In the past, the Federal Constitutional Court (BVerfG) stated in precedent cases that anti abuse rules must apply realistic criteria to cases alleging an abuse of law. The Federal Fiscal Court doubts that the Interest Barrier Rule complies with these criteria. In its decision, it states that, in its view, the rule is not formulated precisely as it equates, in the view of the legislator, the abuse of law with a too high debt ratio. In short, the Federal Fiscal Court asked the German Parliament to do a better job in drafting statutes to precisely reflect their intention.

### 2.2. Stay of execution

The Federal Fiscal Court affirmed the stay of execution of the assessment notice until the main proceeding will be finalized.

The Court ruled that the interest of the taxpayer in suspending the enforcement of the assessment notice has to be given greater weight than the public interest in the execution of the assessment notice because the effect for the German national budget was estimated to be rather low. The Court found the arguments that indicate the unconstitutionality of the rule carried significant weight. It further held that – in opposition to earlier decisions – the fact that the Federal Constitutional Court may perhaps only dismiss the Interest Barrier Rule for future cases without retroactive effect will not hinder the Federal Fiscal Court from suspending the enforcement of the assessment notice.

### 3. What to do as a taxpayer

The recent decision by the Federal Fiscal Court indicates that the Federal Constitutional Court will have to decide on the constitutionality of the Interest Barrier Rule in the near future. The Federal Fiscal Court will have to deal with two cases concerning the Interest Barrier Rule this year, which will allow a referral to the Federal Constitutional Court. Taxpayers should therefore take all necessary measures to keep affected tax assessments open. Based on the argumentation of the Federal Fiscal Court, there are good chances for achieving a stay of execution of those tax assessments until the Federal Constitutional Court hands down a final decision.

## be in touch: If you have any questions, please do not hesitate to contact us!


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