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Federal Fiscal Court challenges constitutionality of German interest barrier rule and refers it to the Federal Constitutional Court for decision

Ever since its implementation, the German interest barrier rule (*Zinsschranke*) has been criticized and several experts held that it violates the German constitution. In 2013, the Federal Fiscal Court expressed doubts about the constitutionality of the interest barrier rule (file I B 85/13). By way of decision dated 10 October, 2015 (file I R 20/15) and published 10 February, 2016, the German Federal Fiscal Court (*BFH*) has now decided to refer the question whether or not the German interest barrier rule violates the German constitution to the Federal Constitutional Court (*BVerfG*). The *BFH* is convinced that the interest barrier rule constitutes a violation of the principle of equal treatment pursuant to Art. 3 para. 1 of the German Constitution.

I. Legal Situation and Interest Barrier Rule in a Nutshell

In general, interest expenses related to operational activity are deductible as business expenses. However, the German legislator limited the ability to deduct these expenses in 2008 with the passing of section 4h of the Income Tax Act (*EStG*) in conjunction with sections 8 and 8a of the Corporate Income Tax Act (*KStG*).

According to the interest barrier rule, net interest expenses (interest expense exceeding interest income) are generally only deductible up to 30% of the taxpayer's tax EBITDA (earnings before interest, taxes, depreciation and amortization). The non-deductible part in a given year is to be carried forward to reduce the tax base in the following years. The interest barrier rule does, however, not apply if one of the built-in exemptions applies. In particular, the interest barrier rule does not apply if the net interest expense of the taxpayer is less than EUR 3 million ("safe harbor rule")

II. Facts of the Proceedings

The plaintiff in the lawsuit was a German real estate company (*GmbH*) which was part of a German group. The plaintiff's business purpose was the construction, acquisition, sale, management and administration and maintenance of real estate. Following a tax field audit, the local tax office of the plaintiff held that the interest barrier rule applies. As a result, the plaintiff was not permitted to deduct its entire interest expense incurred in the relevant tax year 2008. Instead, a certain portion of the interest expenses incurred by the plaintiff in 2008 had to be carried-forward into the following calendar years.

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Due to a business restructuring occurring in 2009, the interest carry-forward of the plaintiff was cancelled. The plaintiff appealed against the amended tax assessment notices and subsequently filed court action, *inter alia* pleading that the interest barrier rule violates the German constitution.

III. Ruling by the BFH (I R 20/15)

The BFH concluded that the interest barrier rule constitutes a violation of the principle of equal treatment pursuant to Art. 3 para. 1 of the German Constitution (GG).

In general, the German legislator enjoys broad discretion in the selection of tax objects and in the determination of tax rates. However, this discretion is confined by constitutional principles such as the ability-to-pay principle (*Gebot der finanziellen Leistungsfähigkeit*) and the principle of consistency (*Gebot der Folgerichtigkeit*).

According to the BFH, the German legislator infringed both the principle of consistency and the ability-to-pay principle by qualifying interest expenses as non-deductible business expenses for the purpose of determining the taxable income of a taxpayer. The fact that the portion of the non-deductible interest expense can be carried forward by the taxpayer to reduce its tax base in following tax years was not held to be sufficient to mitigate the infringement. The BFH in particular argued that the possibility to carry-forward interest expenses in itself does not ensure that the taxpayer will actually be able to utilize these interest expenses in future tax periods.

The BFH held that there was no justification for the infringements. Infringements of the constitution can be justified if they pursue legitimate objectives and if they are proportionate to the legitimate objective they pursue. However, with respect to the German interest barrier rule the BFH was of the view that the objective of preventing tax avoidance, the objective of increasing the domestic tax revenue and the objective of strengthening the equity basis could not be brought forward by the German legislator to justify the infringement of the principle of consistency and the ability-to-pay principle.

IV. Consequences

The reaction of the German legislator and the German tax authorities remains to be seen. The final decision as to the constitutionality of the interest barrier rule is now with the BVerfG. It could, however, take several years before the BVerfG will make a decision and as of today it is impossible to predict how the BVerfG will rule. Taxpayers should in any event consider keeping their tax assessment notices open.

Until a final decision is made by the BVerfG, tax authorities can continue to apply the interest barrier rule. It is likely that future tax assessments will be preliminary. They will then need to be amended to the benefit of the taxpayer if the interest barrier rule is retroactively declared unconstitutional. If the BVerfG rules otherwise, the preliminary assessment will become legally binding.

If the assessments do not contain such notice of provisional status, taxpayers should contest them to avoid them becoming legally valid.

It seems to be worthwhile to note that the concept of the German interest barrier rule was copied by several other countries and that it served as a model for one of the interest limitation rules proposed by the BEPS report on Action Item 4 as well as for the interest limitation rule included in the recently published anti-tax avoidance package of the EU Commission.

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