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The Interest Limitation Rule of the Proposed EU Anti-Tax Avoidance Directive: A Violation of the German Constitution?

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Introduction

On 28 January 2016, the proposal for a council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the so-called ATA-directive) has been published. Article 4 of the ATA directive contains an interest limitation rule that very closely resembles the German interest limitation rule which is called "Zinsschranke".

Only two weeks later, on 10 February 2016, the German Federal Tax Court (Bundesfinanzhof; BFH) rendered a decision with respect to the Zinsschranke. In the case under review, the taxpayer, a German corporation had claimed that, at least in a purely national situation, the provision regarding the Zinsschranke would violate the equal treatment principle as laid down in Article 3 of the German constitution. The BFH took the view that the taxpayer was right and decided to refer the case to the German constitutional court (Bundesverfassungsgericht; BVerfG) in order to receive a judgment on the compatibility of the Zinsschranke provision with Article 3 of the German constitution.

According to previous case law of the BVerfG, in income tax matters, equal treatment entails taking into account the ability to pay doctrine. Taxpayers should be taxed equally, considering their financial ability to pay taxes. With respect to corporate taxpayers, the BVerfG laid down the so-called "objektives Nettoprinzip" (objective net principle). This principle means that corporate enterprises are to be taxed on the basis of their net profits, i.e. that business costs, as a rule, must be deductible from the taxable basis. Furthermore, the BVerfG requires that the legislator adheres to the so-called "Gebot der Folgerichtigkeit", which can be translated as principle of consistent legislation. Thus, while the legislator has a wide margin of appreciation when it comes to the decisions what to tax and how to tax it, the implementation of these decisions into law has to be consistent and has to take into account as much as possible the equal treatment of taxpayers according to their ability to pay.

Let us briefly compare the Zinsschranke and the interest limitation rule of the proposed ATA-directive.

German Zinsschranke

Under the Zinsschranke, to the extent that interest costs exceed interest received, these so-called "exceeding interest costs" are only deductible up to 30% of the EBITDA of an enterprise. It does not matter who the creditor of the interest is. There are three escapes: firstly, if the exceeding interest costs are lower than EUR 3 million, they are fully deductible. If the exceeding interest costs increase this threshold, the full amount is limited by the 30% EBITDA-rule. Secondly, if the enterprise is not part of a group, the Zinsschranke does not apply. Thirdly, if the debt-equity ratio of the enterprise is no more than 2% worse than the debt-equity ratio of the group, the Zinsschranke does also not apply. However, if the enterprise is financed by associated enterprises and the interest due to those associated enterprises exceeds 10% of the exceeding interest costs, the second and third escape do not apply. Exceeding interest costs that are not deductible as a consequence of the application of the Zinsschranke can be carried forward unlimitedly and are regarded as additional interest costs in future years, thus subject to the 30%-EBITDA-limitation. In later years, the Zinsschranke provision also provided for a carry-forward of non-absorbed EBITDA to future years. In certain cases of a change of control in the enterprise and of a reorganisation changing the corporate identity of the enterprise, the interest/EBITDA carry-forward is forfeited.

Proposed Interest limitation rule ATA-directive

If we take a look at the interest deduction rule of the proposed ATA directive, we can see that there is a comparable 30%-EBITDA-limitation. The proposed rule also comprises an escape for exceeding borrowing costs of (just) EUR 1 million, which however, contrary to the Zinsschranke, always applies irrespective of the total amount of exceeding borrowing costs. The stand-alone-escape is not part of the proposal, but the group ratio escape is. There is also a rule countering group financing, which states that payments to associated enterprises may not exceed 10% of the group's total net interest expense for the group ratio escape to apply. Exceeding borrowing costs that are not deductible as a consequence of the application of the interest limitation rule can be carried forward unlimitedly and are regarded as additional interest costs in future years, thus subject to the 30%-EBITDA-limitation. The interest limitation rule also provides for a carry-forward of non-absorbed EBITDA to future years. The rule does not say anything about the consequences of a change of control or changes in the corporate identity of the enterprise for the interest/EBITDA carry-forward.

Both rules are quite the same, so to see. Thus, the findings of the BFH are to a great extent also true for the interest limitation rule of the proposed ATA-directive. Some of those findings are quite interesting.

Violation of the 'objective net principle'

According to the BFH, the German legislator violated the objective net principle by limiting the deduction of interest, which is to be qualified as business costs. The fact that there is a possibility to carry-forward the interest (and in later years the EBITDA) does not change that, because in a system of yearly periodic taxation, costs must be deductible in the year that they are borne. Furthermore, because the deduction of the interest carry-forward in future years is also subject to the 30%-EBITDA-rule, utilisation of the interest carry-forward for companies that suffer from a period of stagnation is made virtually impossible. Moreover, the breach of the objective net principle cannot be justified by the argument that the existence of the interest carry-forward eventually provides for a full deduction of the interest during the total span of existence of an enterprise according to the BFH. The simple reason is that the German legislator has decided to apply a yearly periodic taxation system. A multi-tax-period approach is only recognized with respect to losses, but not with respect to business expenses that can be allocated to a specific tax year. Therefore, the BFH finds that the situation of interest carry-forward and loss carry-forward are not comparable. While a loss *cannot affect the ability to pay* in the year that it arises (because the ability to pay cannot be lower than zero), and therefore can only be utilized in other years, the interest costs *do have an effect on the ability to pay* in a given tax year (safe for loss situations) and therefore, as a rule, must be deductible in the tax year that the interest arises. Therefore, from a systematic viewpoint, the German tax system as a whole does not provide the legislator with the possibility to allocate business costs to other years than the year to which they are economically connected.

Justifications

In addition, according to the BFH, there is no other objective reason that justifies this violation of the objective net principle. The BFH looked at several possible justifications, out of which the following are the most interesting: The aim to strengthen the equity of German enterprises, the aim to safeguard the national tax base and the aim to counter anti-avoidance.

a) Strengthening the equity of German enterprises?

The BFH sets out that the Zinsschranke is not suitable to strengthen the equity of German enterprises: The vast majority of enterprises (those with exceeding interest of less than EUR 3 million) are not at all affected by this rule, which was applicable in the year 2008 to less than 1.200 German enterprises. Furthermore, if enterprises change their debt-equity ratio in order to avoid the Zinsschranke, this has to be qualified as a side-effect of this rule that is not sufficient to justify the breach of the equality principle.

b) Safeguarding of the German national tax base?

With respect to the safeguarding of the German national tax base, the BFH stated that this justification resembles the EU justification of the balanced allocation of taxing rights. The BFH firmly dismisses the fair-share theory which is the underlying theory of the BEPS-project. Why? Simply because the Zinsschranke also applies in purely national situations (like the case at hand), and in purely national situations Germany already has the full taxing right and does not have to share with another state. But the BFH dismisses this justification also for another reason: The German tax system is not based on a fair share theory, but on the ability to pay principle which takes into account the individual ability to pay taxes of each and every taxpayer. This principle requires taxation on the basis of the actual net profit (and therefore requires the deduction of business costs) rather than setting the tax base on the basis of some target profit that is meant to equal a fair share. In my opinion, this reasoning should be food for thought for the Council of the EU.

c) Anti-tax avoidance?

Finally, the German legislator had identified the possibility of base erosion by cross-border debt financing as tax avoidance, which was meant to be countered by the Zinsschranke. The BFH dismissed the justification based on countering tax avoidance. On first sight, its reasoning seems a little weird for those of us who specialize in EU direct tax law: The BFH states that by not limiting the scope of the Zinsschranke to cross-border situations, the legislator went further than necessary to counter tax avoidance. According to the BFH, in purely national situations the German tax base usually cannot be eroded, and therefore the scope of the Zinsschranke should have excluded purely national situations. Wait… what? How can this be in line with EU law? It can, according to the

BFH, based on the CJ EU cases Test Claimants in the CFC and Dividend Group Litigation (C-201/05), Cadbury Schweppes (C-196/04) and Itelcar (C-282/12). Those judgments of the CJ EU left a Member State the possibility to specifically counter tax avoidance in cross-border situations, to the extent that the anti-avoidance rules concern wholly artificial situations and leave the taxpayer with a possibility to prove that his actions have sound business reasons. Thus, the BFH found that the German legislator could, and should, have chosen for a Zinsschranke that is only applicable to cross-border situations and that provides for a possibility to prove that the financing was made for sound business reasons and not for tax reasons. The BFH finds the wide scope of the Zinsschranke without the possibility to prove sound business reasons to be unproportional. Again, food for thought for the Council of the EU.

What will happen next?

So, what are the Germans going to do with the interest limitation rule in the proposed ATA directive? First of all, there is no final decision yet. The BVerfG could take up to three to four years to come up with a decision, and even if it finds the Zinsschranke unconstitutional, it will most probably not abolish it retroactively, but only declare it inapplicable for the future (prospective overruling). This means that the German legislator might just wait and implement the ATA directive if it enters into force. However, German taxpayers will demand that their tax assessments remain open until the BVerfG has taken its decision.

Given the resemblance of the Zinsschranke and the interest limitation rule of the proposed ATA directive, especially their applicability to both purely national and cross-border situations, the rather high threshold limiting its scope to only a small group of taxpayers, and the breach of the objective net principle, I believe that the BFH would also consider the interest limitation rule of the ATA directive in breach of the equality principle of the German constitution.

Imagine that the BVerfG agrees with the BFH, can it rule that a provision of EU law is in breach of the German constitution and therefore not applicable? That is not easy to say. In the famous "Solange II"-ruling (Decision of 22 October 1986, case 2 BvR 197/83), the BVerfG ruled that so long as the EU, and in particular the case law of the European Court, generally ensure an effective protection of fundamental rights as against the sovereign powers of the EU which is to be regarded as substantially similar to the protection of fundamental rights required unconditionally by the German constitution, and in so far as they generally safeguard the essential content of fundamental rights, the BVerfG will no longer exercise its jurisdiction to decide on the applicability of secondary EU legislation, and it will no longer review such legislation by the standard of the fundamental rights contained in the German constitution. However, from later decisions of the BVerfG it became clear that the BVerfG still claims the right to decide whether EU law is ultra vires and whether in is in breach of the fundamental rights of the German constitution. Furthermore, the BVerfG only refrains from judging on EU law matters, as long as the legal protection of constitutional rights in the EU has about the same high standards as in Germany. It remains to be seen what that means in the case of the interest deduction rule. Ultimately, this question could be end up at the European Court of Human Rights.

Let's hope that tax specialists make some noise and bring this issue under the attention of the Commission and the Council.

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