

BFH questions constitutionality of interest deduction limitation rule

In a decision dated 18 December 2013, the Federal Tax Court (BFH) expressed doubts that the interest deduction limitation rule is in line with the principles of the German constitution. The BFH provided its opinion in an order suspending the taxpayer's obligation to pay the appealed tax assessment notice.

Under the general German interest deduction limitation rule, which covers interest payments to related and unrelated parties, the tax deductibility of net interest expense is limited to 30% of the tax EBITDA of a business. Exceptions from this general rule apply where (i) the annual net interest expense does not exceed EUR 3 million (EUR 1 million for the period covered by the assessment in this case); (ii) the relevant business is not part of a "group"; or (iii) the conditions of the "escape clause" are satisfied, i.e. where the German borrower's equity ratio does not fall short by more than 2% (1% for the period covered by the assessment) of its worldwide equity ratio.

The taxpayer in the case appealed a tax assessment notice in which the tax authorities partially denied an interest deduction based on the rules described above. In addition, the taxpayer asked for a suspension of the obligation to make the tax payment due under the assessment until a final decision about the assessment is reached on appeal; the request was denied by the tax authorities and by the lower tax court.

The BFH has now suspended the taxpayer's obligation to make the payment until a decision is reached on its appeal against the tax assessment notice, which currently is pending in a separate proceeding at the BFH (reference number I R 2/13). The fact that the Constitutional Court (which has the exclusive right to ultimately declare a law/provision unconstitutional) could declare the interest deduction limitation invalid prospectively (and not retroactively) should not affect the taxpayer's ability to obtain such a suspension based on the opinion of the BFH.

In its decision, the BFH refers to the governing principle of German tax law, according to which each taxpayer must be taxed based on its financial performance and ability. The BFH stated that the interest deduction limitation rule violates this principle and that it is questionable whether such a violation can be justified. The court looked at various reasons that could justify such a violation (abuse of law, fiscal stability) but it concluded that it is doubtful whether such a justification exists.

The BFH's decision is the first decision in which a tax court has opined on the constitutionality of the interest deduction limitation rule, although the question whether the rule is in line with constitutional principles has been controversial.

Affected taxpayers with nondeductible interest expenses due to the 30% limitation should consider filing an appeal against their tax assessment notice (where possible) that refers to the pending court case, and requesting a suspension of the payment obligation based on the BFH's decision. It should be noted that interest may arise on a suspended tax payment if the appeal is unsuccessful.

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