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German Tax and Legal News

BFH refers constitutionality of interest deduction limitation rule to constitutional court

Decision of the constitutional court may take years

In a decision dated 14 October 2015 (and published on 10 February 2016), the federal tax court (BFH) referred the question of whether the interest deduction limitation rule is in line with German constitutional principles to the constitutional court. The BFH has taken the position that the rule violates constitutional principles, but it is up to the constitutional court to make a final determination on the issue.

The BFH issued a decision at the end of 2013 (see [Deloitte Tax-News](#)) expressing its doubts about the constitutionality of the rule in a suspension-of-payment procedure. Shortly thereafter, the ministry of finance issued a [non-application decree](#) regarding the decision of the BFH.

Under the general interest deduction limitation rule, which covers interest payments made to both related and unrelated parties, the tax deductibility of net interest expense is limited to 30% of the tax EBITDA of a business. Exceptions to 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 the case before the BFH); (ii) the relevant business is not part of a "group"; or (iii) the "escape clause" conditions are satisfied, i.e. 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 disallowed an interest deduction based on the above rules.

In its decision, the BFH referred to the governing principle of German tax law, i.e. that each taxpayer must be taxed based on its financial performance and financial capabilities. The BFH stated that the interest deduction limitation rule violates this principle and that it is doubtful that the violation can be justified. The court looked at various potential justifications (e.g. abuse of law, fiscal stability), but it concluded that no justification could be found.

The BFH is not the first tax court to question the constitutionality of the interest deduction limitation rule, but this is the first time the issue has been referred to the constitutional court. The question has been controversially discussed in German tax literature since the limit was introduced in 2008.

The final decision on the constitutionality of the rule now is in the hands of the constitutional court, which could take years.

Affected taxpayers with nondeductible interest expenses due to the 30% limitation should consider filing an appeal against their tax assessment notices (where possible) that references the pending court case. Although the tax authorities likely will continue to apply the current rule, tax assessment notices may be issued on a preliminary basis that would keep the notices open until the constitutional court issues its decision.

Based on the 2014 non-application decree, it is unclear whether an application for a suspension of payment until a final decision of the constitutional court would be successful. Such a request may need to be brought before a court before it is granted. However, if a suspension is granted and the constitutional court ultimately rules in favor of the tax authorities, any payment of additional tax by the taxpayer will trigger a 6% annual interest payment. The same would apply on a tax refund that would occur if a suspension was not granted and the constitutional court rules in favor of the taxpayer (in this case, the 6% annual interest calculation would commence 15 months after the end of the relevant year).

It is difficult to predict how the constitutional court will rule. In some cases where the court has declared a tax provision to be unconstitutional, it has determined that the unconstitutionality had retroactive effect, but in other cases, the court has held that the

provisions continued to apply until a specified date by which the legislator must enact new rules that are in line with the constitution.

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