# THE 2008 CORPORATE TAX REFORM – GERMANY'S NEW INTEREST DEDUCTION RULES AND THEIR COMPATIBILITY WITH EC LAW

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## 1. Introduction

The 2008 Corporate Tax Reform is a tightly bound package of legislation that has the primary objective of easing the tax burden of corporations and business enterprises thus promoting business and investment in Germany. One major feature is the change of the established system of thin capitalisation rules by moving away from a static debt-equity ratio approach towards a system that compares interest income with interest expenses and limits the deduction of the amount of interest payments that exceeds a floating value (the so-called "Zinsschranke" – literal translation: "*interest barrier*"). Thus, Germany's thin capitalisation rules have been changed yet again. They were last changed in 2004 following the *Lankhorst-Hohorst*[2] decision.

In 2007, the Lower House of the German Parliament (Bundestag) and the Upper House of the German Parliament (Bundesrat) approved the Corporate Tax Act 2008 and implemented the reform package. In February 2008, the German Finance Ministry published draft guidance regarding the tax reform.[3] One of the long expected letters of guidance deals particularly with the thin capitalisation rules and

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2 Case C-446/03.

3 The German Finance Ministry published three letters of draft guidance in connection with the Corporate Tax Reform 2008 on 20 February 2008: one on the interest barrier (section 4h ITA, section 8a CITA), one on loss deductions in connection with change of ownership (section 8c CITA) and one on trade tax add backs (section 8 no. 1 Trade Tax Act). Written statements of industry organisations and associations are expected and will be implemented in the final version of the guidance, which is likely to be published this spring.

their application ("*the guidance*"). Instead of bringing clarity to the matter, the guidance generates further questions in some areas and underlines the strictness of the new rules.[4]

## 2. The present system

In *Lankhorst-Hohorst*, the European Court of Justice (ECJ) concluded that Germany's thin capitalisation rules were not in compliance with the European Community Treaty (ECT) because they were limited to cross-border financing. As a result the thin capitalisation rules were fundamentally changed. Their application was widened to include domestic financing. Since 2004, all corporations have been scrutinized regarding their debt-equity ratio. If the safe haven of 1:1.5 (equity/debt) was exceeded during the fiscal year and a connected party made a loan, the interest payments could not be deducted but were deemed to be hidden dividends. However, if the transaction was at arm's length the interest could be deducted. These rules made tax avoidance harder but in the eyes of the legislators not hard enough.[5] That is one of a number of reasons for changing the system in 2007/2008.

## 3. The 2008 Corporate Tax Reform

The 2008 Corporate Tax Reform in Germany will have a serious impact on corporate taxation. In particular, thin capitalisation rules will change completely.
The following are the key elements of the reform package. The corporate tax rate will be lowered and the trade tax adjusted, thus ensuring an overall corporation tax rate of 29.8 per cent.[6] A retention reserve for partnerships and small businesses will be introduced in order to ensure a similar tax rate compared to corporations.[7] A flat tax of 25 per cent on non-business investment (interest, dividends and capital gains on the disposition of shares) will be introduced. In order to finance these tax reductions an interest barrier is introduced, as well as a loss carry forward limitation rule with a strict change-of-ownership provision. Furthermore, the possibility of deducting securities' lending fees will be limited. New transfer pricing rules will apply, especially for the taxation of business activity shifts.

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4 Hopefully, this will change during the consultation process and result in a different final version of the guidance.

5 See for instance Lower House of the German Parliament BT-Drucks. 16/4841, p. 29.

6 Lowering the corporate tax rate from 25% to 15% (section 23 subsec I CITA) and lowering the trade tax base rate (i.e. the factor by which the municipal rate is multiplied) to 3.5%. This is supposed to reduce the overall tax rate for corporations from approx. 38.8 per cent to approx. 29.8 per cent.

7 The applicable tax rate is 28.25% plus solidarity surcharge for profits that remain in the sphere of the business.

Most of these changes – including the interest barrier – will become effective for fiscal years starting after May 25, 2007, which end after January 1, 2008[8]. No transitional provisions apply.

## The concept of the interest barrier

In the past, thin capitalisation schemes were targeted by using a debt-equity ratio system. The new interest barrier provided for in section 4h ITA and section 8a CITA moves away from such a static approach towards a more dynamic model. This means that Germany disposed of the thin capitalisation concept altogether and introduced a general interest limitation system. Both systems differ fundamentally in their conditions and legal consequences. Basically, if certain conditions are met, the interest barrier disallows the deduction of interest payments of a business. This not only covers intra-group payments, but all interest payments, including interest payments to third parties, such as interest paid for bank loans. However, dividends – including hidden distributions – discounts ("*skonti*") and bonuses ("*boni*") are not covered.[9]

Although the term "business" is not expressly defined by law, its meaning has to be understood in a very wide sense. This means the new rule is not limited to corporations – as the old system was – but applies to trading partnerships, sole traders and commercial establishments, whether related or unrelated. Unlike the debt-equity system, interest income will not be re-defined as dividend income at the level of the shareholder. The interest income at the shareholder level is taxed at the full rate as income and is not exempt dividend income. But if the interest barrier applies, the interest payments cannot be deducted as a business expense. Both lender and borrower are taxed on the transaction. The lender is taxed on the interest income and the borrower is not allowed to deduct the expense from his income. This system leads to economic double taxation. In order to avoid economic double taxation interest can be carried forward (see below). The idea is that a business is burdened only until interest expenses can be deducted in the future. Interest payments which are not deductible in the current tax year may become deductible in future years because of this flexible approach. However, this system generates huge problems in certain situations, which are discussed below, and fundamentally changes the taxation environment for businesses.

## The scope of the interest barrier

A financed business that has more interest income than interest expense is deemed to be sufficiently capitalised. The amounts of interest expense and interest income in one fiscal year are therefore totalled. The amount of interest expense that remains is

8 For the interest barrier see section 52 subsec 12d ITA, also confirmed in draft guidance annot. 1.

9 See draft guidance annot. 16 and 17.

referred to as “net interest expense”. The interest barrier applies only if there is net interest expense.

If the interest barrier comes into play, a business can deduct net interest as business expenses only up to 30 per cent of the EBITDA (“Earnings Before Interest, Taxes, Depreciation and Amortisation”). Although the wording seems to cover worldwide profits it is the intention of the legislators to include domestic profits only.[10] For interest barrier purposes a special definition of “EBITDA” is used. This “taxable EBITDA” for corporate and income tax purposes may differ significantly from the “EBITDA” for financial purposes under the International Financial Reporting Standards (IFRS).[11] Therefore, in order to determine the amount of deductible interest payments a special “taxable EBITDA” has to be determined first. The taxable profit of the financed business, which – for corporations – includes hidden dividends and excludes tax-free distributions and capital gains, is the starting point. From that, interest income has to be deducted, whereas interest expense, depreciation and amortization have to be added. 30 per cent of that figure is the limit for the deduction of net interest expense in that particular fiscal year.

In section 4h subsec 3 sentence 2 ITA “interest expense” is defined as payment for debt capital that has decreased the taxable profit of the financed business. It does not matter if the amount is dependent on an uncertain event. However, the draft guidance clarifies that the interest barrier applies only to interest expense in a narrow sense and that only cash loans are covered.[12] Asset loans – except securities’ lending transactions – are not harmful and, therefore, payments in consideration of same are fully tax deductible.[13]

## The interest carry forward

Interest expenses that are not deductible in one fiscal year due to the application of the interest barrier must be used in future fiscal years (section 4h subsec 1 sentence 2 ITA). The carry forward increases interest expenses in these years, but not the

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10 Lower House of the German Parliament BT-Drucks. 16/4841, p. 48. However, this view is not stated again in the draft guidance. It is important to note that the interest barrier is not limited to German entities. Foreign companies that operate in Germany through permanent establishments or branches are also affected by the interest barrier.

11 One example is the “taxable EBITDA” of holding companies, which will be rather low since 95 per cent of all dividend and capital gains are tax exempt (section 8b subsec 1 and 2 CITA).

12 This includes – among other things - interest based on fixed or floating interest rate, consideration for shareholder loans, profit-participating bonds, yields on silent partnerships and quasi-factoring agreements. Equity funding is not covered by this. For a full list see draft guidance annot. 11, 13, 14, 26ff. This was also stated in the legislative motives for the Corporate Tax Reform 2008 and also the case in the old thin capitalisation rules. See Letter Ruling, December 15, 1994, Federal Tax Gazette I 1995 p. 25 (annot. 51).

13 See draft guidance annot. 11 and 22. See also section 8b subsec 10 CITA.

taxable EBITDA (Section 4h subsec 1 sentence 3 ITA). This means that interest expenses that are not deductible due to the application of the interest barrier are not lost but will (hopefully) be deductible in future fiscal years. The outcome is that economic double taxation is prevented, merely burdening the financed business for a period of time until they are deducted in the future. The draft guidance expressly states that this might void the application of the exemption limit in section 4h section 2 sentence 1 lit. a ITA (see below).[14] However, this also means that in subsequent years, the financed business needs to raise its interest income substantially, or enjoy one of the statutory exemptions, in order to make use of the carry forward. If the situation stays the same or becomes worse, i.e. if there is no substantial increase in interest income or the requirements for the exemptions are not met, the non-deductibility of interest expense becomes final.

Importantly, section 4h subsec 5 sentence 1 ITA states that if an unincorporated business is transferred or ceases to exist, all carry forward is lost. Corporations, however, are subject to a more complicated change-of-ownership rule. If a corporation becomes restructured, the interest carry forward – as well as the loss carry forward – might be partially or entirely lost.[15] If more than 50 per cent of the shares in the corporation are transferred directly or indirectly within five years, all the carry forward is lost. If, within five years, between 25 and 50 per cent of the corporation are transferred directly or indirectly, the carry forward will be lost proportionately.[16] This especially affects businesses in times of crisis where debt financing and restructuring might become necessary to remain in business.

The draft guidance includes further harsh consequences regarding the interest carry forward. According to the tax authorities interest carry forward will be denied if a branch or a business activity is transferred.[17] This also applies if one subsidiary leaves the fiscal unity. This interpretation is not supported by the wording of the statute at all. Even without this new development the interest barrier and its interest carry forward violate the fundamental principle of taxing only net income.[18]

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14 See draft guidance annot. 43.

15 See section 8a subsec 1 sentence 3 CITA and section 8c CITA accordingly.

16 In regard to partnerships, section 4h subsec 5 sentence 2 ITA states that the interest carry forward will be lost proportionately in case a partner leaves the partnership.

17 See draft guidance annot. 44.

18 Especially on the question of constitutionality see Prof. Dr. Musil, B. Volmering in Der Betrieb 2008, p.12ff..

## The statutory exemptions

In order to exempt certain businesses and structures, three exemptions have been implemented in the statute. These are the exemption limit of one million Euro, the non-affiliation exemption and the so-called "escape clause".

## The exemption limit

In order to exempt small and medium sized businesses from the complicated and burdensome system of the interest barrier,[19] an exemption limit has been added in section 4h subsec 2 sentence 1 lit. a ITA. However, there are several issues with this clause. If the net interest expense limit of one million Euro is exceeded, not just the exceeding amounts but all interest payments are affected by the interest barrier. This leads to problems with unexpected external factors (e.g. a rise in the key interest rate).

Another problem is that the amount is very small and does not reflect the day-to-day business of medium sized companies in Germany. Furthermore, it is questionable where the interest expenses have to originate from geographically. The legislative materials of the 2008 tax reform point out that only domestic interest expenses must be used to determine the net interest expense for the interest barrier in general and the one million Euro limitation in particular.[20] However, this was not expressly implemented into the statute. The provisions on the interest barrier – and by that also the exemption limit – do not mention the sole use of domestic interest expense. Finally, the interest carry forward adds difficulty to this exemption. If in the past interest was not deductible it will be carried forward and might render the exemption not applicable in the following year.

## The non-affiliation exemption

Section 4h subsec. 2 lit. b ITA states that the interest barrier will not apply if the financed business is not a full or only in part a member of a consolidated group. In that case there will be no limitation on interest expenses. According to the legislative materials this favours non-affiliated single businesses as well as non-affiliated free float corporations.[21] However, corporations also have to fulfil the requirements set out in section 8a subsec. 2 CITA (see below).

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19 Lower House of the German Parliament BT-Drucks. 16/4841, p. 48.

20 Lower House of the German Parliament BT-Drucks. 16/4841, p. 48. The draft guidance does not shed light on this topic.

21 Lower House of the German Parliament BT-Drucks. 16/4841, p. 48.

The meaning of "consolidated group", in an interest barrier context, is defined in a very extensive way. Actual consolidation, and also the mere possibility to consolidate, is sufficient to void the application of the non-affiliation exemption. It is therefore important to determine whether the financed business can be consolidated under the accounting standard it is using IFRS, financial accounting standards of Germany or any Member State (EU-GAAP) or Generally Accepted Accounting Standards of the United States (US-GAAP)). If consolidation is possible the non-affiliation exemption does not apply. Section 4h subsec. 3 sentence 6 ITA deems a business to be part of a consolidated group if its financial and operating policies can be uniformly decided.[22] A business operating by using branches and permanent establishments instead of subsidiaries does not constitute a consolidated group in this context and, therefore, does not trigger the interest barrier.[23] However, the fact that the mere chance to consolidate is enough to void the application of this exemption underlines how broadly the interest barrier is intended to strike.

**The escape clause**

The third statutory exemption is the so-called "escape clause". The equity ratios of the financed business and of the consolidated group[24] of which it is a member are compared. If the former is higher or equal to the latter, the interest barrier does not apply and all of the financed business's interest expenses are deductible. A *de minimis* tolerance limit is in place, i.e. missing the equity ratio of the consolidated group by up to 1 per cent is not detrimental. This results in a cumulative three-step test to determine whether the escape clause applies. If there is membership in a consolidated group AND there is no harmful financing under section 8a subsec 3 CITA (see below) AND the equity ratio of the financed business is higher or equal to the consolidated group (within the one per cent limit) the escape clause applies and the interest expenses are fully deductible.

The method of determining equity for the escape clause is laid out in section 4h subsec. 2 lit. c sentences 3ff. ITA and consists of two steps. First, the same accounting standard has to be used for both the financing business and the consolidated group. Second, the resulting amount then has to be modified in a second step (see below).

The preferred accounting standards are IFRS (section 4h subsec 2 sentence 8 ITA). If IFRS are not mandatory and have not been used for the last five consecutive years

22 This concept is in line with IAS 27.

23 The legislative materials expressly state that a foreign permanent establishment will not void the application of the non-affiliation exemption. See Lower House of the German Parliament BT-Drucks. 16/4841, p. 50. See also draft guidance annot. 61.

24 The term "consolidated group" is used in the extensive meaning as well, including all businesses that are or can be consolidated under that applied financial accounting standard.

EU-GAAP may be used (section 4h subsec 2 sentence 9 ITA). US-GAAP may be used if neither IFRS nor EU-GAAP are required by law. If, however, the accounting standard used for the financed business differs from the one used for the consolidated group, a transitional statement converting the accounting standard of the former to the accounting standard of the latter needs to be provided (section 4h subsec 2 sentence 11 ITA). Furthermore, the legislative materials state that financial statements need to be produced in German or with a certified translation. Accounting options need to be exercised in the same way in both financial statements (section 4h subsec 2 sentence 4 ITA).

The modifications for tax reasons that follow are numerous. The equity that results from the applicable accounting standard is increased by the goodwill of the business included in the consolidated group's statements (section 4h subsec 2 sentence 5 ITA). Half of the special account with reserve characteristics under section 273 Commercial Code also increases the equity. The resulting equity is decreased by equity that carries no voting rights, shares in other companies of the group and contributions within the past six months before the balance sheet date that correspond with payments or dividends within the past six months after the balance sheet date (section 4h subsec 2 sentence 5 ITA). The last rule was implemented to avoid the possibility of artificially distorting equity ratios by making payments shortly before the balance sheet date.[25] It should be noted that the draft guidance allows the use of consolidated group financial statements that have in fact been audited for the calculation of the equity ratio.[26] This offers some relief to groups since they do not have to produce statements for tax reasons that include all the companies that could possibly be consolidated.

By using this comparison the legislators deem the financing of a business not to be harmful if it is the same as the consolidated group. This is a very stereotypical approach towards thin capitalisation. There might be sound reasons for a deviation from the consolidated group's equity ratio, e.g. high pension reserves of the financed business in Germany that are not necessary for foreign group members. This is not at all reflected in the statute. Many constitutional and ECT compatibility issues emerge. These will be discussed in the analysis, which will focus on the ECT issues.

## Special rules for corporations

The non-affiliation exemption and the escape clause do not apply if there is harmful debt financing of a corporation through a shareholder (section 8a subsec 2 and 3 CITA). Harmful shareholder debt financing means that the financed business must not pay more than 10 per cent of its net interest expenses to a shareholder. For the purposes of the non-affiliation exemption this includes a shareholder that directly or indirectly participates in the business with more than 25 per cent, a person that is

25 See Lower House of the German Parliament BT-Drucks. 16/4841, p. 49.

26 See draft guidance annot. 68.

related to such a shareholder or a third a party that holds a right of recourse against such a shareholder or related person.[27]

For the escape clause exemption, harmful shareholder debt financing is defined slightly differently, i.e. only those liabilities that are stated in the financial statements of the consolidated group are taken into account. Therefore, intra-group financing is ignored and only financing of a non-consolidated group member or a right of recourse of a third party is deemed harmful. However, it is important to note that there must not be harmful shareholder debt financing in any consolidated group member. Otherwise the escape clause will not apply. This includes German and foreign members of the worldwide group. This view is expressly stated in the draft guidance[28] and means that, for instance, debt financing of a foreign consolidated group member by a foreign non-consolidated group member will void the escape clause for a German consolidated group member.

Furthermore, the burden of proof regarding harmful shareholder debt financing and therefore the fulfilment of the requirements of the non-affiliation exemption and the escape clause is transferred to the taxpayer. Consequently the financed corporation has to produce evidence that meets the requirements set out in section 8b subsec 3 CITA – which might be difficult especially for the escape clause.

**Special rules for fiscal unities**

Fiscal unities, i.e. companies that form a German tax consolidation, are considered to be solely one business for purposes of the interest barrier according to section 15 sentence 1 no. 3 CITA. Section 4h ITA does not apply for corporations forming a fiscal unity. Intra-fiscal unity financing does not trigger the interest barrier. Thus the exemption limit of one million Euro can be used only once for all group companies that form a fiscal unity. The non-affiliation exemption applies to the fiscal unity as a whole. If the fiscal unity is not affiliated to another business the interest barrier does not apply at all. The escape clause also applies to the fiscal unity as a whole. The equity ratios between members of the fiscal unity are not required to meet the conditions of the escape clause. Therefore, establishing a fiscal unity can help to avoid the application of the harsh consequences of the interest barrier and a cash-

27 This provision is consistent with the participation requirements in the previous thin capitalisation provision. However, section 8a subsec 3 CITA (old version) stated that participation amounts of shareholders participating in the same corporation and forming a partnership or being under common control could be added together for the 25 per cent threshold evaluation. Furthermore, a shareholder was deemed to have a significant participation if he was able to exercise control. The new provision does not contain this clause. Until now, a right of recourse of a third person was only considered by the tax authorities in case of back-to-back financing. The draft guidance states that back-to-back financing leads to a right of recourse, but so might other arrangements as well (see draft guidance annot. 79).

28 See draft guidance annot. 76.

flow disadvantage due to temporary economic double taxation. However, fiscal unities are only possible between German corporations. It is not possible to form a cross-border fiscal unity. Partnerships cannot be part of a fiscal unity.

## 4. Analysis

Thin capitalisation rules have been deeply scrutinized by the ECJ in recent years.[29] The German legislators turned away from a debt-equity thin capitalization concept and introduced the interest deduction limitation. The intention was also to comply with EC law. At first glance, the interest barrier seems to do that. It applies to all businesses in Germany – resident and non-resident. However, there are several issues with the new rules.

### Restriction

Under EC law the freedom of establishment granted in Art. 43 ECT is infringed if there is a restriction that constitutes an obstacle to enjoying the freedom. This is seen in *Lankhorst-Hohorst*, where foreign parent companies were treated differently compared with resident parent companies regarding dividend payments made by their subsidiaries.

In *SEVIC*[30], a German corporation wanted to merge with a Luxembourg corporation. The German commercial register refused the registration of the merger since the German merger rules applied only to mergers between companies established in Germany. The ECJ relied on the Advocate General's (AG) opinion, stating that

> "*…the right of establishment covers all measures which permit or even merely facilitate access to another Member State and the pursuit of an economic activity in that State by allowing the persons concerned to participate in the economic life of the country effectively and under the same conditions as national operators*".[31]

Through the merger, conducting business would have been easier for SEVIC. Denying the registration therefore constituted a restriction of Art. 43 ECT.

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29 See cases *Lankhorst-Hohorst*, Test Claimants in the Thin Cap Group Litigation (Case C-524/04) ("*Thin Cap GLO*"), *Lasertec* (Case C-492/04) and NV Lammers & Van Cleeff (Case C-105/07) ("*Van Cleeff*").

30 Case C-411/03.

31 See *SEVIC* at para 18.

Thus, in a host state situation like in this case, an individual or a company resident in another Member State should not face an obstacle because of the interest barrier when conducting business in Germany.

According to the legislative materials, only domestic interest payments are computed to determine the net interest expense. This view is not stated again in the wording of section 4h ITA or the draft guidance. Omitting this statement seems to be a correction of a mistake during the legislative process. However, if only domestic interest payments were considered this would constitute a restriction on the right of establishment of a foreign company or business enterprise. The following example illustrates the problem.

A foreign company has a subsidiary in Germany. In this situation, cross-border financing is more likely, for instance, between the parent company and its subsidiary, than for a German parent company that has a German subsidiary. This renders interest payments that were *de facto* made by the subsidiary useless for interest barrier purposes. Interest income that would normally lower the net interest expense is not taken into account only because it is not domestic interest income. Taking into account only domestic interest payments constitutes an obstacle to the right of freedom of establishment of the foreign EU/EEA parent company. However, it seems the tax authorities do not follow this approach. Interestingly, they have not expressly stated the opposite either.

The application of the interest barrier can be avoided by fulfilling the requirements of one or more of the three exemptions. For instance, if a group of companies forms a fiscal unity, the conditions of the non-affiliation exemption and the escape clause cannot be met by the members of the fiscal unity since they are deemed to be only one business for interest barrier purposes. However, only German resident companies can form a fiscal unity. Cross-border consolidated groups can form a fiscal unity only for their German resident group members. If two comparable situations are treated differently, discrimination occurs.[32] Here the comparators are German groups and corporate groups with members in Germany and in other Member States. These foreign groups are treated less favourably solely because Germany does not allow companies of other Member States to form a fiscal unity. They are hindered in their pursuit of an economic activity in Germany because exemptions from the interest barrier are not as easily available to them. This creates an obstacle to the freedom of establishment for foreign companies doing business in Germany.

These two aspects of the interest barrier constitute a restriction only on Art. 43 ECT. However, interest carry forward might also constitute a restriction on Art. 56 ECT – the free movement of capital. Interest is carried forward if the interest barrier applies and the net interest expense exceeds 30 per cent of the taxable EBITDA. This

32 See case C-279/93 (*Schumacker*) at para. 34.

violation of the principle of taxing only net income burdens the affected business with a loss of interest deduction for a temporary period of time that usually results in a cash-flow disadvantage. In some cases it might result in the terminal loss of interest expense.

The AG's opinion in *Lidl Belgium GmbH & Co. KG*[33] ("*Lidl*") deals with cash-flow disadvantages. In this origin state case the AG concludes that German rules that treat a domestic company with a permanent establishment in Luxembourg less favourably than a resident company with a permanent establishment in Germany discriminate against the former and are therefore not in compliance with Art. 43 ECT.[34] The interest barrier applies the interest carry forward to all businesses and does not differentiate between resident and non-resident companies. However, the amount of interest expense that must be carried forward might differ in cases where the non-affiliation exemption and the escape clause are applicable from cases where these exemptions are not applicable. Forming a fiscal unity helps to reduce net interest expense of group companies. As stated above, fiscal unities are available only to German group members. Therefore, although the interest carry forward generally applies to all businesses the same way, there is a cash-flow disadvantage for cross-border groups compared with German groups because the fiscal unity is not available to them. According to the AG's opinion in *Lidl* the foreign parent company suffers an infringement of Art. 43 ECT if a cash-flow disadvantage arises. However, even if the AG's opinion is not followed by the ECJ, there is a breach of Art. 43 ECT with regard to the final loss of interest carry forward. In *Marks & Spencer*[35] the ECJ decided that a terminal loss of cross-border losses of a subsidiary in another Member State restricted the right of a parent company in the UK since the losses would not have been terminal in a UK-UK situation. Even though terminal loss of interest carry forward is suffered by German groups and cross-border groups, the amounts of actual loss might differ since the German group might be able to enjoy the exemptions for all their businesses whereas the cross-border group is not allowed to form a fiscal unity for all group members.

Although the interest barrier constitutes a restriction on the freedom of establishment (Art. 43 ECT) this might not provide relief for groups with a parent company in a third country. Art. 43 ECT provides protection only to EU nationals. However, Art. 56 ECT gives the right of free movement of capital to third countries.

The question therefore is whether Art. 56 ECT is applicable in this context. In *Thin Cap GLO*, the question was whether a UK thin capitalization rule that applied only to cross-border financing was compatible with the ECT. The ECJ concluded that, although there was a restriction, it was applicable to wholly artificial arrangements

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33 Case C-414/06.

34 See opinion of AG Sharpston delivered on 14 February 2008, Case C-414/06.

35 Case C-446/03.

that were designed to circumvent national tax rules. Art. 43 ECT was applicable whereas Art. 56 ECT was not. This was due to the fact that the UK thin capitalisation rules applied only in situations where one company controlled the other. The UK thin cap rules were directed at majority shareholders. Therefore the domestic rules targeted establishment situations, not the loan arrangement itself. The same reasoning could be seen in *Lasertec* where the ECJ found that the old German debt-equity based thin capitalisation rules did not infringe Art. 56 ECT. They targeted establishment situations just like the UK rules. In *Van Cleeff* the ECJ examined Belgian thin capitalisation rules. Those rules were also based on control of the parent company over a subsidiary. Consequently, the applicable freedom was Art. 43 ECT, and not Art. 56 ECT.

The interest barrier, however, strikes on a much broader level. Control over a company is not a requirement of the interest barrier.[36] The granting of a loan is listed in Annex I of the Directive 88/361/EEC and is thereby covered under Art. 56 ECT. The German rules directly affect a parent company resident in a third country because if a loan is made cross-border to a German subsidiary, that business might suffer a greater cash-disadvantage or an even higher terminal loss of its interest expense. In a Germany-Germany situation, the disadvantages might be smaller or even non-existing due to the ability to make use of the exemptions. In *Holböck*[37] the court applied both Art. 43 ECT and Art. 56 ECT to a third-country situation. There, Austrian rules did not apply to establishment. However, the benefit of Art. 56 ECT was countered by the standstill provision in Art. 57 (1) ECT, which states that domestic rules that already were in place before 1994 may continue to be used by the Member States.[38] Germany's interest deduction limitation is totally new and therefore not protected by Art. 57 (1) ECT. Art. 56 ECT is applicable and infringed by the interest barrier. Third-country parent companies could therefore also receive ECT protection.

**Justification**

The restriction could be justified by one of the justifications set out by the ECJ. Coherence of the tax system could justify the restriction. For that justification to apply, there must be a direct link between the tax advantage and the offsetting of that advantage.[39] The court requires the same tax of the same taxpayer to be

36 Section 8b subsec. 2 and 3 CITA does have an element of control. However, these are only additional requirements that the financed business has to fulfil in order to enjoy the exemptions from the interest barrier.

37 Case C-157/07.

38 See *Holböck* at para. 31.

39 See *Bachmann* (case C-204/90) at para. 28, *Thin Cap GLO* at para. 68, *Lankhorst-Hohorst* at para. 42.

affected.[40] In the situation at hand interest payments are deductible at the level of the subsidiary whereas they constitute income at the level of the parent company. Parent company and subsidiary are two separate entities. A direct link cannot be established. Therefore, the coherence of the tax system cannot be used by the German government to justify the interest barrier.

The principle of territoriality allows Member States to restrict freedoms under the ECT in order to take into account the limits on their powers of taxation.[41] A Member State may tax resident companies on the basis of their worldwide income whereas it can tax only source income of non-resident companies. The interest barrier applies to all businesses and affects German groups as well as groups with members in other Member States. The problem is the link between granting an exemption from the interest barrier and forming a fiscal unity between the group members. The interest barrier does not in itself constitute a justification for Germany to infringe Art. 43 ECT or Art. 56 ECT. It is through linking preferential treatment under the interest barrier rules with the requirement of having a fiscal unity that the German rules might be justified. It is not possible to form a fiscal unity cross-border. A cross-border fiscal unity would result in the consolidation of profits at the level of the foreign head company. In some situations this could lead to non-taxation of profits deriving from the German group members and transferring profits to a low-tax jurisdiction. Allowing fiscal unities cross-border would limit Germany's power to tax profits that belong to Germany. This might be seen as a just reason by the ECJ to infringe Art. 43 ECT and Art. 56 ECT.

However, even if the ECJ were to allow this justification the German rules would have to meet the proportionality requirement.

In *Marks & Spencer*, the principle of territoriality was regarded as a justification in connection with the danger of double-dipping.[42] Regarding the interest barrier, there is no such danger. Interest income will be taxed at the level of the lender. The question is whether the borrower can deduct the interest expenses at all.

The justification of balanced allocation of taxing rights states that profits and losses of one legal entity must be taken into account in the same tax system in order to achieve symmetrical treatment.[43] The interest barrier disallows the deduction of interest expense at the level of the borrower who has in fact made a payment. The payment will constitute profit at the level of the lender. In that regard, the balanced allocation of taxing rights is not an applicable justification.

40 See case C-35/98 (*Verkooijen*) at para. 57f..

41 See case C-347/04 (*Rewe Zentralfinanz*) at para. 69.

42 See *Marks and Spencer* at para. 47.

43 See *Marks and Spencer* at para. 43.

However, it might be applicable in connection with fiscal unities. If cross-border fiscal unities were allowed the symmetric taxation of losses and profits might not occur. This seems not likely because all members of the fiscal unity have to push profits, i.e. income over expenses, up the chain to the head corporation. Even if the ECJ accepted the justification of the balanced allocation of taxing rights in this context, Germany would have to meet the proportionality requirement.

Germany might also argue the need to preserve the effectiveness of fiscal supervision. For that justification to apply the interest barrier rules must allow the supervision of the amount of taxable income by the tax authorities.[44] The measures must ascertain the amount clearly and precisely.[45] Neither the sole use of domestic interest payments, nor the preferential treatment of German fiscal unities supports the fiscal supervision. The effectiveness of fiscal supervision is not an applicable justification for the infringement of the freedoms.

The reduction of tax revenue does not justify the infringement of one of the fundamental freedoms.[46]

However, the justification of preventing tax avoidance might be applicable in this context. In *Cadbury Schweppes*[47] the court stated that the restriction resulting from UK anti-avoidance rules that included the profit of a controlled foreign company in another Member State in the tax base of the parent company in the UK was justified if it affected only wholly artificial arrangements. According to the court's decision in *Thin Cap GLO* the restriction on the freedom of establishment that resulted from the UK thin capitalisation rules was justified if the rules applied only to abusive transactions that lacked commercial substance.[48] In *Van Cleeff*, the Belgian thin capitalisation rules also targeted abusive arrangements by applying an arm's length comparison.[49] The interest barrier is intended to be an anti-abuse instrument. Interest expense is considered a major factor in trafficking profits cross-border by the German legislators. Therefore, the interest barrier might be justified by Germany's aim to combat tax avoidance.

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44 See *Lankhorst-Hohorst* at para. 43f.

45 See *Futura* (case C-250/95) at para. 31.

46 See *Lankhorst-Hohorst* at para. 36.

47 Case C-196/04.

48 See *Thin Cap GLO* at para. 74.

49 See *Van Cleeff* at para. 30.

## Proportionality

The rules do not only need to be justified but also have to be proportional. They must be able to achieve the objective of the legislation and not go beyond what is necessary to achieve that aim.[50] Germany might raise the prevention of tax avoidance, the principle of territoriality and the balanced allocation of taxing powers as justifications.

By forcing businesses to have either a balanced amount of interest expense or suffer a cash-flow disadvantage, the interest barrier prevents excessive debt financing and by that transferring losses abroad, even more than the previous thin capitalisation rules. The new rules achieve the aim of the legislation. It is however very likely that they go beyond what is necessary to achieve their purpose. Typically, excessive debt financing occurs in group structures. The interest barrier applies to every business. Control or influence is not a requirement. Third-party financing is affected just as intra-group financing. There is no arm's length comparison any more.

Therefore, the interest barrier goes far beyond what is necessary to prevent tax avoidance and this justification is not proportional.

The principle of territoriality and the balanced allocation of taxing rights might be applicable justifications due to the link between some of the statutory exemptions with forming a fiscal unity. The aim of the legislators is to combat the transfer of profits abroad.

By exempting German groups from the harsh consequences of the interest barrier these structures enjoy a preferential treatment compared with groups with members in other Member States. This also affects perfectly legitimate groups well equipped with equity.

In the *Oy AA*[51] case the ECJ upheld a Finnish rule that allowed intra-group payments between a Finnish parent company and a Finnish subsidiary to be deducted at the subsidiary level whereas the deduction was not allowed if the parent company was resident of another Member State. The restriction of Art. 43 ECT could be justified by the balanced allocation of taxing rights and the need to prevent tax avoidance.[52] Regarding proportionality, the ECJ stated the rules did not go beyond what was necessary because they effectively kept group companies from choosing the Member State where the profits were to be taxed.[53] The threat of transferring profits

50 See Case C-9/02 (*Lasteyrie du Saillant*) at para. 52.

51 See case C-524/04.

52 See *Oy AA* at para. 60.

53 See *Oy AA* at para. 64f..

cross-border and allowing companies to freely choose the most advantageous Member State is therefore a legitimate reason for Member States to impose restrictions on Art. 43 ECT. Germany might therefore be justified regarding cross-border fiscal unties in general because not granting them might be proportional.
Although a cross-border fiscal unity might pose a serious threat to the German tax base in general, this is not the case in an interest barrier context. There is no reason to make it easier to fulfil the requirements of the exemptions for German groups that are allowed to form a fiscal unity rather than for cross-border groups that cannot form a fiscal unity. The interest barrier applies only to interest payments. A fiscal unity is much broader and covers all income and expenses. By linking both, Germany must not be protected by the broad implications of a cross-border fiscal unity when the only purpose is to prefer German groups by easing their burden of the interest barrier. The German rules go beyond what is necessary to achieve the aim of combating tax avoidance.

The right of freedom of establishment (Art. 43 ECT) is infringed. Third-country companies also receive ECT benefits through Art. 56 ECT due to the interest barrier’s broad application.

## 5. Final Thoughts

The Corporate Tax Reform 2008 affects many areas of taxation. The interest barrier however is the legislator’s broadsword that is supposed to raise revenue and finance the various tax cuts that have been made. The draft guidance sheds light on some areas but raises new doubts as well. Many questions remain unsolved. In its current version, the interest barrier does not comply with domestic constitutional law and the ECT. The final guidance will hopefully contain some changes to the current draft. However, the legislators are asked to act if they do not want their rules changed yet again by the ECJ.