Challenges Inherent in Addressing Debt and Equity Financing – And How Germany Went Over the Top

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1. Introduction

Financing a company with either equity or debt provides for an entirely different tax burden at both the investor level and the company level. Consequently, it is not surprising that the choice between debt and equity is an important issue in everyday's tax practice, and also occasionally in abusive schemes. To identify the tax policy needs resulting therefrom is an essential concern of this article.

Particular attention is given to cross-border debt financing. Here, specifically, tax rate differentials provide for tax planning opportunities that can, in the absence of defensive legislation, also be used in an abusive manner. In particular this holds true for the so called thin capitalization and fat capitalization schemes, i.e. the under-capitalization of domestic subsidiaries of foreign corporate groups on the one hand *(thin cap)* and the over-capitalization of foreign finance subsidiaries of domestic corporate groups on the other hand *(fat cap)*.

Latter-mentioned schemes, however, are to be clearly distinguished from the straight-forward capitalization of a domestic group with both domestic and foreign subsidiaries facing financing needs regarding both its domestic and foreign business activities. The so called interest barrier *(Zinsschranke)*, an internationally unprecedented[2] instrument recently introduced by the German legislative bodies in order to limit the tax deductibility of interest expenses, needs urgent repair in this respect[3]. Unfortunately,

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[2] See, however, for a similar set of rules in Italy § 96 of the Italian Income Tax Consolidation Act (30% EBITDA plus 5 year carry forward).

[3] See also the Coalition Agreement dated October 26, 2009 between *CDU, CSU* and *FDP*, page 11 ("modifying the equity escape and making it applicable to German corporate groups").

the so-called equity escape (being in theory designed to provide unlimited interest deduction to corporate groups that finance their German operations with at least as much as equity as the overall group average) has not yet been adjusted to eliminate the devastating effects of the so-called book value reduction (*Beteiligungsbuchwertkuerzung*).

This holds true notwithstanding the fact that it is well known even within the German tax administration that virtually no German-based corporate group can avail itself of the aforementioned equity escape. Accordingly, virtually all German-based corporate groups are denied the full interest deduction even though presumably the vast majority of them provide for a well above-average equity financing within their home country. A modification of § 4h of the German Income Tax Act[4] *(ITA, Einkommensteuergesetz)* thus remains one of the most urgent tasks of corporate tax policy in Germany.

2. Distinguishing Debt and Equity in Germany

To distinguish between either equity or debt financing for purposes of the German tax law is rather simple. This is because the tax law in this respect generally follows the German Commercial Code *(Handelsgesetzbuch[5])* providing for straight-forward and consistent debt equity rules (compared, for instance, to the United States, where the tax courts apply a numerous factor test for this purpose[6]).

The relevant characteristics for equity are subordination (behind debt in case of insolvency), sustainability (no right of cancellation and thus open-ended commitment) and participation in losses and profits of the company[7].

A specific tax regime is provided only by § 8(3)(2) of the Corporate Tax Act[8] (CTA, *Körperschaftsteuergesetz*). According to this provision, payments are deemed to be

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[4] § 4h ITA.
[5] HGB.
[6] See *William T. Plumb*, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 *Tax Law Review* 369, 1971
[7] See with respect to the application of these criteria to different types of legal entities *Wolfgang Schoen e.a.*, Debt and Equity – What's the Difference – A Comparative View, B.III.1, Social Science Research Network (SSRN).
[8] § 8(3)(2) CIT.

made on debt (and therefore will not constitute equity compensation and vice versa) unless the underlying instrument provides for both a participation in the profits of the company and the proceeds resulting from its liquidation. Accordingly, unless an instrument participates in the hidden reserves of a company, payments on this instrument will likely qualify as interest (debt).

3. Taxing Debt and Equity in Germany

3.1 Deduction at Payor Level, Taxation at Payee Level – Symmetry Only in Principle

Why is the use of either equity or debt helpful in the first place to impact the tax burden? The reason is the different tax treatment of payments on equity and debt at both the payor level and the payee level.

In general, i.e. subject to specific anti-abuse provisions, interest expenses are deductible. Since they are incurred within the context of earning income, interest payments reduce the ability to pay of the payor. The net principle requires their deductibility.

Distributing earnings as dividends, however, is not part of the income earning process. Instead, it is its outcome. The yield of a source of income, e.g. the profit of a company is a residual amount and thus the basis of taxable income.

The deductibility or non-deductibility of either debt or equity compensation generally has its counterpart on the receiving end, with this symmetry being a precondition of a "finance neutral income tax system". Interest income deductible at the payor's level should in general be fully taxable at the payee's level. Dividends, however, should not be taxed (at least not at the ordinary rate) since they have already been subject to tax at the level of the distributing company.

At first glance, this interplay between tax deductibility on the one hand and taxation on the other hand appears to be symmetrical, preventing abusive schemes systematically from the outset. However, the symmetry is often not even close to perfect. While most of the issues arise in cross border situations (due to different national tax rates), at least in Germany this holds true even in a purely domestic setting, namely with respect to the *Abgeltungssteuer*.

3.2 Only 25% Tax on Capital Income (Abgeltungssteuer)

The so-called *Abgeltungssteuer* was introduced in Germany as of January 1, 2009 and levies a 25% tax burden on private income from capital, § 32d ITA[9]. This tax (plus surcharges of up to 3%-points thereon) is levied regardless of any tax attributes of the payee (like business expenses or loss carry forwards) and collected by the banking industry. Accordingly, a taxpayer is in general no longer required to report income from capital in her personal income tax declaration.

On its own, the rather low (compared to a personal income tax rate in Germany of up to 45%) 25% taxation of both dividends on the one hand and interest income on the other hand can be justified. Regarding the equity compensation (dividend income), the reduced tax rate takes into account that dividends have already been subject to tax at the level of the distributing company. Combining a 30% corporate and trade tax taxation with a 25% tax rate on the 70 remaining for dividend payments results in 47.5% which is rather close to the afore-mentioned 45%. With respect to the debt compensation (interest income), the reduced rate acknowledges that a significant portion of nominal interest income is commonly no "real" income but only compensates for inflation. With an interest rate of 6% and an inflation rate of 3%, a 25% taxation of the 60 actually results in a 50% tax burden on the "real" gain in net worth, i.e. the inflation-adjusted income amounting to 30.

Notwithstanding the fact that the only 25% taxation of both dividend and interest income each can rather easily be justified by itself, the combination of the two allows for abusive structures even in a domestic setting. This is first because interest payments have not been subject to tax at the corporate level while dividend payments have, and second because particularly in closely-held corporations, debt and equity financing can be rather easily substituted for each other. Therefore the German tax legislator was well advised to limit the scope of the 25% tax rate to interest payments

[9] § 32d ITA.

in a third-party context. Interest on loans given out by a 10% shareholder is subject to the ordinary income tax rate of up to 45%[10].

3.3 No Withholding Tax on Outbound Interest Payments

In Germany as well as in presumably all OECD countries[11], there is also a lack of symmetry between the deductibility of interest at the payor level and the withholding tax collected on behalf of the payee. In general, i.e. outside the scope of thin capitalization rules or any other anti-avoidance rules, interest payments made to foreign banks or bond holders are deductible at the payor level (third-party interest). Outbound interest payments, however, are not subject to withholding tax. Thus interest payments to bond holders located in tax havens (such as hedge funds domiciled in the Cayman Islands) or U.S. pension funds (commonly being tax exempt) do not bear any tax burden – they are deductible at the payor level and are not subject to tax at the payee level.

Under certain circumstances, the lack of taxation at the payee level (accompanied by the lack of any withholding taxes) makes perfectly sense. There may be a hedge fund in a tax haven incurring as many business expenses (for instance, from financing the bond investment) as receiving interest payments. According to the net principle, the interest "income" of such hedge funds should not be subject to (withholding) tax. Also, interest payments made to a tax-exempt pension funds will eventually be taxed, and if it is only numerous years later when those funds are distributed to the retirees as pension payments being fully taxable.

The aforementioned lack of symmetry, however, also exists in many other cases giving rise to tax-planning opportunities. Even if Germany or any other OECD country wanted to put an end to this situation by levying a withholding tax not only on interest payments made to domestic debt holders, but also on outbound interest payments, such country would not be free to do so. First, within the Common Market, any withholding taxes between two subsidiaries directly linked to each other and located in

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[10] § 32d(2) ITA.

[11] In the U.S., for instance, Sec. 871(h) and Sec. 881(c) Internal Revenue Code provides for a portfolio interest exemption from levying withholding tax.

different member are prohibited by secondary community law, i.e. Article 1(1) Council Directive 2003/49/EC[12]. If, for instance, a Dutch finance company emits bonds to the public and loans on the proceeds to a German affiliate company, Council Directive 2003/49/EC prevents Germany from levying a withholding tax on those intra-group interest payments. Unless the Netherlands (and all other EU member states) decide to also levy a withholding taxes on outbound interest payments, Germany will in practice not be able to collect withholding tax on interest paid to foreign persons.

Second, a dense network of tax treaties designed in accordance with the OECD Model Convention in Germany (and almost all other OECD countries) would be in the way of levying a withholding tax on outbound interest (obviously regarding "only" investors who are entitled to treaty benefits). Article 11 of the OECD Model Convention[13] (and of the US Model Convention as well[14]) provides for the exclusive right of the residence state to tax interest payments, leaving no room for any kind of withholding levied by the source state.

Third, and maybe most importantly, a withholding tax on outbound interest does not seem to be economically feasible. As long as there are other (far predominantly withholding tax free) investment alternatives out there, a company domiciled in a country charging withholding taxes on outbound interest payments would most likely experience severe problems receiving sufficient and cost-efficient funds on the international debt markets (which would presumably also hold true for this country itself with many other governmental bonds without incurring withholding tax). Why would an investor decide in favour of a rate of return that is reduced by a withholding tax as long as there are other debt instruments paying interest without any taxes?

In summary, the long-standing practice of abstaining from a source state taxation of interest payments is likely to be at least in the short and medium term without any viable alternative, both for legal and economic reasons. The asymmetry of deductibility and lack of withholding tax in cross-border settings will continue to pose great challenges to tax legislators worldwide.

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[12] Council Directive (EC) 2003/49/EC of 3 June 2003 on Interest and Royalty Payments between Affiliates.

[13] Art. 11 OECD Model Convention.

[14] Art. 11 US Model Convention.

3.4 An Alternative Concept: Allowance for Equity Deduction

An alternative approach of taxing income would solve this symmetry problem. In an income tax system that does not burden the normal rate of return of capital, i.e. the risk-free rate of return (being the mere compensation for transforming present consumption in future compensation), abstaining from taxing interest income would be inherent to the system. Accordingly, there would be not mismatch between tax deductibility at the payor level and the lack of taxation at the payee level. Therefore the lack of withholding taxes on outbound interest payments would not cause any asymmetry within the system but, exactly to the opposite, were actually a necessity in order to provide symmetry.

The tax policy idea underlying the allowance for equity approach is that savings are derived from income that has already been taxed. Taxing the return of an investment made with after-tax-dollars would put an additional tax burden on taxpayers saving money as opposed to spending it immediately.

The discussion between tax scholars on whether or not the taxation of capital income results in "double-taxation" has been going on for hundreds of years[15]. This article only wants to point out that an allowance for equity concept of taxing income would get rid of an asymmetry caused by the lack of withholding taxes on outbound interest. In the business context, an allowance for equity taxation would not only allow for a deduction of interest payments, but also for a deduction of the equity shown in the tax balance sheet multiplied with the risk-free return of for instance 3%. If that were the case, neither interest payments nor dividend payments (to the extent they do not exceed the normal rate of return) were subject to tax at the payor level. Since none of such items of income were taxed at the payee level, there would be no asymmetry that could be exploited for tax planning purposes.

Other than this, in light of the lack of collecting withholding taxes on outbound interest payments, the only conceivable alternative in order to establish symmetry in this respect appears to be a denial of tax deductibility with respect to all interest expenses. Then, interest and dividend payments would receive the same tax

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[15] See, for instance, *Joachim Lang*, Taxing Consumption from a legislative point of view, in *Manfred Rose* (Ed.), Heidelberg Congress on Taxing Consumption, Heidelberg 1990, page 273.

treatment at the payor level, none of them would be deductible. Denying a deduction for all interest expenses, however, would clearly violate the ability to pay principle which provides at least in Germany for a constitutional dimension[16] (by being read into the constitutional entitlement to equal treatment, Article 3(1) of the German Constitution[17] *(Grundgesetz)*). Since many countries are presumably neither willing to deny all interest deductions (or, even if they were willing, in a position to do so from their respective constitutional point of view) nor in favour of an allowance for equity deduction, tax legislators will most likely continue to face the challenges resulting from the lack of symmetry in taxing debt and equity, especially in a cross-border setting. The underlying issue is always that interest is taxed at a lower rate in one jurisdiction than in another. This allows for tax arbitrage, in particular by thin capitalization and fat capitalization structures that are addressed in section IV and V below.

4. Thin Cap in Germany

4.1 Related Party Debt (§ 8a CIT Former Version)

The tax scenario addressed by thin capitalization provisions is rather simple. In order to create a domestic interest deduction (for purposes of reducing taxable profits) in a jurisdiction with a rather high tax rate, a foreign parent company (or related party) hands out a cross-border loan to a domestic subsidiary. Since shareholder loans on the one hand and equity on the other are legally and economically largely interchangeable, domestic interest expenses can be increased almost arbitrarily if no tax law defence mechanism were in place.

In the very beginning, the German tax authorities had tried to address abusive thin cap scenarios with the general anti-abuse rule, § 42 of the German Fiscal Code[18]. The Federal Tax Court found, however, that a taxpayer is not only with respect to third-

[16] See, for instance, the decision of the German Supreme Court *(Bundesverfassungsgericht)* as of December 12, 2008, 2 BvL 1/07 (regarding commuting expenses of employees).
[17] Art. 3(1) GC.
[18] § 42 FC.

party debt, but also in a shareholder loan context to a very large extent free to finance her business activities with either equity or debt (including related-party debt)[19]. In order to prevent the profits of a German subsidiary of a foreign parent being inappropriately eaten up by cross-border interest payments on shareholder loans, § 8a CIT was introduced in 1994, being modelled after the tax law of numerous other countries that had similar thin cap rules already in place [20]. The underlying idea was that related party interest above a certain level (for instance, if shareholder loans exceeded the company's equity by more than 150%) is caused by an artificial allocation of equity and debt within a corporate group and should therefore be non-deductible.

4.2 Interest Barrier also on Third-Party Debt (§ 4h ITA, § 8a CIT Current Version)

As of 2008, Germany does no longer follow international "market" practice with respect to thin cap regulations. As opposed to limiting the scope of such rules to related-party debt, the German rules now apply to all interest expenses, regardless of whether or not they are owed on shareholder loans or third-party debt instruments.

a) Full Interest Deduction Unless Less-than-Average Equity

Technically, the new German interest barrier rules (so-called *Zinsschranke*) work as follows: In general, interest expenses (on both related and third party loans) are deductible only to the extent they do not exceed 30% of the taxpayer's domestic income before interest, taxes, depreciation and amortization (EBITDA). The 30%-EBITDA limitation does not apply, however, unless the equity ratio of the domestic business operations of a taxpayer falls below the equity ratio of the corporate group to which the taxpayer belongs (so-called equity escape). (In addition, there are no

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[19] *See* BFH as of May 5, 1992 (I R 127/90), BStBl. II 1992, 532).

[20] Due to the reaction of the German legislative bodies on ECJ 12 December 2012, C-324/00 in *Lankhorst-Hohorst* [2002] ECR 2002 I-1179 the German thin cap rules applied as of 2004 also to mere domestic settings. Since there are no tax rate disparities within one country, however, addressing purely domestic inter-company financing does make no sense.

restrictions on interest deductions (i) as long as they do not exceed € 3 million annually or (ii) the taxpayer is not part of any corporate group (stand alone escape)).

In order to conceptually characterize the interest barrier rules, it seems to be helpful to reverse the design of the statutory language. Then, the general rule turns is that interest expenses are fully deductible. There is an exception to this general rule of full deductibility, however, in case the equity ratio of the domestic business is below group-average. In this case, the taxpayer is only allowed to deduct interest expenses up to 30% of her EBITDA.

The new German interest barrier rules have been widely and heavily criticized, mostly validly (no limitation to related-party interest, overly harsh and complicated, reference to IFRS etc.). The idea of denying full interest deduction in case the domestic equity of a taxpayer is below group average, however, can be justified from a tax policy and fairness point of view. At least it is not absurd to assume that an equity ratio below group average is somehow tax driven. In light of the fact that equity and debt within a corporate group are both legally and economically largely interchangeable, why, if not for tax reasons, should a corporate group equip one country with significantly less equity than the average of equity provided to the other countries?

An example might illustrate this thought: Assume a multinational corporate group with an equity ratio of 100%, i.e. without any external debt. If the domestic subsidiary of the debt free corporate group were now to claim a significant interest deduction in Germany, one can hardly blame a local tax inspector challenging the appropriateness of such interest deduction.

b) 30% EBITDA Allowance as De Miminis Rule

It is a conceptual mistake, however, to deny the deductibility of interest expenses entirely in case the domestic equity ratio falls short of the equity ratio of the corporate group. This is because the respective interest expenses can only be reasonably assumed to be tax driven to the extent they relate to debt exceeding the group average debt ratio. Accordingly, interest on loans up to the average group debt ratio should be deductible.

The 30% EBITDA rule, however, provides for a balancing effect in respect of this conceptual shortcoming. That is because it allows for the deduction of some interest expenses even though the domestic operations of the taxpayer are financed with less equity than the group average. In light of this, it seems to be fair to say that the 30% EBITDA allowance is to be characterized as *de minimis* rule as it allows for an interest deduction even though the taxpayer did not pass the equity test.

In summary, in the thin cap context (i.e. regarding foreign multinationals with German subsidiaries), both the old and the new version of the German earning stripping rules can in principle be justified from a tax policy point (with respect to the new rules, however, this holds only true to the extent the foreign group is not burdened with undue administrative burden of proof regarding the harmful related-party debt within the meaning of § 8a(3) CIT[21]). That is because neither of those set of rules misses a link to tax-motivated schemes entirely. While the former thin cap regime only applied to shareholder loans that in themselves bear some abusive potential, the scope of the current regime is at least in theory limited to taxpayers that provide their German operations with less equity than is appropriated in light of the group average.

5. Fat Cap in Germany

5.1 CFC Rules

As shown above, foreign corporate groups can generally reduce their tax burden on domestic profits by allocating interest expenses (on shareholder loans) accordingly. This is addressed by thin cap regulations. Corporate groups domiciled in Germany, however, can do as follows in order to minimize their tax burden, a tax-planning scheme commonly referred to as *fat cap*:

A German parent company contributes equity to a subsidiary located in a low tax jurisdiction. The low tax (or no tax) subsidiary returns the funds to Germany by giving out a loan to parent. In the absence of any legislative measures, the German parent

[21] § 8a CIT.

could reduce its tax base almost indefinitely by artificially producing interest expenses. The interest payments would be subject to low (nor no) tax in the residence state of the subsidiary. The corresponding profits can be returned to Germany largely tax free under the 95% participation exemption, § 8b(2) CIT[22].

In order to address those fat cap structures, Germany implemented in the 70ies rules regarding controlled foreign corporations (CFC) and being rather similar to the respective regulations in other OECD countries, for instance in the United States since the *Kennedy* administration. The idea is "piercing the corporate veil" for tax purposes in case of (i) a low tax jurisdiction, (ii) passive-type income and (iii) predominantly domestic shareholders. If applicable, the German CFC rules (§ 7 Foreign Tax Act[23]) tax the interest income of the foreign subsidiary as if incurred in Germany directly, i.e. without any deferral.

However, as in all EC member states, the German CFC rules are subject to scrutiny regarding the basic economic freedoms under the EC Treaty. Since the *Cadburry Schweppes* ruling of the European Court of Justice[24] (ECJ), § 7 FTA is applied within the Common Market only in cases that lack substance[25]. The interest barrier, however, also helps to prevent fat cap schemes.

5.2 Interest Barrier also on Third-Party Debt (§ 4h ITA, § 8a CIT Current Version)

An example may illustrate how the interest barrier contributes to addressing fat cap scenarios.

Assume a German parent company financing its German operations with as much equity as the entire group. In theory, due to the same equity ratio in Germany and group wide, the German parent company should be able to deduct all of its interest expenses claimed in Germany. If this corporate group were now planning on a fat cap transaction, i.e. on providing a finance subsidiary in a low tax jurisdiction with equity

[22] § 8b(2) CIT.
[23] § 7 FTA.
[24] ECJ 12 September 2006, C-196/04 *Cadburry Schweppes* [2006] ECR I-07995.
[25] *See*, for instance, *Jens Schoenfeld*, in *Flick/Wassermeyer/Baumhoff* (Ed.), Foreign Tax Act, Before §§ 7-14 note 261.

in order to return the funds via inter-company loan, the parent would no longer be entitled to deduct all of its interest expenses. This is because the equity ratio of the domestic business would decrease while the equity ratio of the entire corporate group remained unchanged. Due to consolidation, a group-internal loan has no effect on the overall debt of the group. Because of the fat cap structure in place, the interest deduction of the parent is now limited to 30% of its domestic EBITDA.

6. Financing of German-Based Multinationals in Absence of Thin Cap and Fat Cap

6.1 Virtually No Equity Escape Due to Lack of Sound Technique (Cut-Back of Acquisition Costs Also Regarding Foreign Subsidiaries)

While the new German interest barrier rules may have some merits regarding thin cap and fat cap structures (or at least are justifiable in this respect), their effect can be simply devastating regarding multinational corporate groups being headquartered in Germany and fulfilling *plain vanilla* financing functions regarding the business operations of their domestic and foreign subsidiaries.

The reason is that those domestic taxpayers are only in theory – but not in practice – entitled to the equity escape being supposed to allow for unlimited interest deductions in the absence of an inappropriately low equity ratio within Germany. As a matter of fact, virtually all multinational corporate groups with a top parent company based in Germany are limited in their interest deductions to 30% of domestic EBITDA[26]. Foreign multinationals, on the other hand, are actually able to show to the German tax authorities that they are entitled to an unlimited interest deduction in case of an appropriate equity funding of their German business. As a result, German multinationals are clearly discriminated against their foreign counterparts.

This result is particularly surprising in light of the fact that before 2008 German multinationals were not affected by the German earning stripping rules at all (as are

[26] In light of the fact that the new Italian interest barrier rules do not even provide for an equity escape in theory (see § 96 of the Italian Income Tax Consolidation Act), the same should hold true for all Italian companies.

foreign multinationals are still not by the earning stripping rules of their respective home countries). Only German subsidiaries of foreign multinationals (but not German top parent companies) commonly have major foreign shareholders being capable (by handing out shareholder loans, for instance) of reducing the domestic tax base.

The reason why the German multinationals are prevented from availing themselves of the equity escape (and therefore the unlimited interest deduction) is the mechanics of § 4h(2)(c)(5) ITA[27]. According to this provision, the domestic equity within the meaning of the equity escape is reduced by the book value of foreign subsidiaries. This reduction leaves many German-based companies arithmetically with no equity at all, and – what is by the way very well known to the German tax authorities – in virtually all cases with a domestic equity ratio that by far falls short of the group's equity ratio.

The weird effects of this may be illustrated by the following example. Assume a German parent company (D-GmbH) with equity of 40 and debt of 60. The assets of D-GmbH consist of a 100% shareholding in foreign company T-Corp and machines, each providing for a book value of 50. T-Corp is loaded with much more debt (80% as opposed to 40%). Machines of 250 are financed with 200 debt and 50 equity. The equity ratio of the consolidated group is thus 13%.

One would think that D-GmbH had no issue with the equity escape. The equity ratio of D-GmbH is not only far greater than the equity ratio of the foreign subsidiary (40% as opposed to 20%), but also exceeds the equity ratio of the consolidated group (40% as opposed to 13%). Because of the book value reduction, however, the equity ratio of D-GmbH arithmetically goes below zero. 40 equity less 50 book value regarding T-Corp sums up to minus 10 (!) equity. This is lower than 13% group equity ratio and results in D-GmbH being cut-off the unlimited interest deduction. D-GmbH can only deduct 30% EBITDA although its domestic business is actually financed with far more equity than both the group and its foreign operations.

Foreign multinationals are at least not automatically affected by the book value reduction. That is because a foreign multinational group – other than one with a German top parent company – does not necessarily need to hold its shareholdings

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[27] § 4h(2)(c)(5) ITA.

within Germany. Moreover, a group structure foreign top parent – German parent – foreign subsidiary appears to be rather uncommon (and maybe tax-driven).

It is worth noting that the holding of a German company does not hurt for interest barrier purposes. According to § 15(1)(3) CTA[28], all members of a consolidated group (Organschaft) are considered to be one business for interest barrier purposes. Since this entire group is deemed to be consolidated for equity escape purposes, there is no book value that could be deducted from the parent company`s equity. As only domestic subsidiaries may form a consolidated tax group in Germany (by concluding profit and loss pooling agreements), a severe community law issue arises. The equity escape appears to clearly violate the freedom of establishment, Article 43 EC Treaty[29]. While acquiring a domestic company (and subsequently entering into a profit and loss pooling agreement) does not hurt for interest barrier purposes, the acquisition of a company resident in a EU member state does do so due to the parent's equity being reduced 1:1 by the respective purchase price and therefore book value[30].

Interestingly, the German legislative bodies did not give any reasoning for the book value reduction. Within the entire legislative history[31], there is not a single paragraph dealing with this provision that prevents as of 2008 virtually all German-based multinational groups from being able to deduct as many (third party) interest expenses as they incur (unless they are within the scope of the 30% EBITDA *de minimis* rule). This astonishing lack of legislative reasoning could lead to the conclusion that German-based multinationals were not willingly deprived from a fair chance of passing the equity escape. Actually, such a mistake would even be understandably. That is because the former version of § 8a CIT did also contain a provision according to which the equity of a parent company was reduced by the book value of its (also foreign) subsidiaries. The former German thin cap rules, however, provided for special rules with respect to holding companies, § 8a(4) CIT former version. Those provisions thoroughly mitigated the effect of the book value reduction which is exactly what is needed for the current version of § 8a CIT as well. Well-

[28] § 15(1)(3) CTA.
[29] Art. 43 EC-Treaty.
[30] *See*, for instance, *Stefan Köhler*, First Thoughts Regarding the New Interest Barrier Rules, Deutsches Steuerrecht (DStR) 2007, 597 (602); *Homburg*, The Interest Barrier – Tax Innovation without Precedent, Finanz-Rundschau (FR) 2007, 717 (725).
[31] BT-Drucks. 16/4841.

designed rules regarding holding and top parent companies as described in the following section prevent the double-counting of domestic equity – an understandable claim of the tax authorities – without depriving virtually all German-based multinationals from the urgently-needed equity escape.

6.2 Holding Mechanism Modelled after § 8a(4) CIT Former Version

Abstaining from any book value reduction is not a viable option for earning stripping rules that somehow connect to equity. The reason is that then interest deductions could be almost indefinitely increased by having the parent company within one country providing equity to its subsidiary in the same country which in turn would pass this equity on to a subsidiary of itself and so on. In the end, all of those companies, albeit being in one corporate chain, would receive tax benefits based on their respective equity (for instance, with respect to a 1.5:1.0 debt equity safe haven) even though it is all about the very same equity that was just passed down[32].

In order to address this "cascade" issue, the former German earnings stripping rules also reduced the taxpayer's equity by the book value of her shareholding. They provided, however, for an exception to this rule with respect to the parent company in case its subsidiaries agreed not to use their equity for tax purposes. If the parent company did not want its equity to be reduced by the book value of its shareholdings, the respective subsidiaries were not allowed to employ the 1.5:1.0 debt equity safe haven for their interest deduction purposes, § 8a(4) CIT former version.

The same logic can easily be applied to the new German earning stripping rules. The equity of a parent company should not be reduced by the book value of its subsidiaries unless such subsidiaries are entitled to an equity escape themselves. If this condition is met (by preventing the subsidiaries from employing the equity escape), there can be no double-counting of domestic equity. Accordingly, a rather minor change to the current law modelled after a former provision of the CTA and therefore well-known to tax practitioners would make the new interest barrier rules also for multinationals based in Germany.

[32] See, for instance, *Norbert Herzig*, Thin Cap Regulations § 8a CIT, Der Betrieb (DB) 1994, 168 (173).

As an alternative to a wording modelled after the former version of § 8a(4) CIT, the Bavarian Ministry of Finance proposed a similar approach[33] that had apparently been subject to extensive discussion during the negotiations leading to the Coalition Agreement as of October 26, 2009[34]. This foundation of the new German government demands explicitly: "Revising the equity escape and making it applicable to German-based corporate groups".

Furthermore, even without any legislative change, the tax authorities should be able to interpret the current wording of the statute in a way that would no longer prevent German-based multinationals from availing themselves of the equity escape. As correctly done in a circular of the German Ministry of Finance dated December 15, 1994[35] with respect to almost exactly the same statutory wording, the tax authorities could reasonably conclude that the equity reduction by the book value of shareholdings according to § 4h(2)(c)(5) only applies to domestic subsidiaries. As there can only be a double counting of equity with respect to domestic subsidiaries, the *telos* of the rule would undoubtedly support such interpretation.

6.3 No Justification of mere 30% EBITDA Limitation by (Allegedly) Only Temporary Effect

A mere 30% EBITDA limitation without a technically-sound equity escape also for German-based multinationals, however, i.e. an interest barrier without any clear link to tax-driven structures like shareholder loans (former German earning stripping rules) or a domestic equity ratio falling short of the group average (theory of current German earning stripping rules), can hardly be justified from an either tax policy nor fairness point of view. Instead, given their lack of any anti-avoidance character, such earning stripping rules should constitute a clear violation of the net principle, being one of the basic foundations of the ability to pay principle. The debt financing needs of the taxpayers are just too different (for instance, depending on the taxpayer's

[33] See BT-Drucks. 16/12525.
[34] See Coalition Agreement dated October 26, 2009 between *CDU, CSU* and *FDP*, page 11 ("Escape-Klausel überarbeiten und für deutsche Konzerne anwendbar machen").
[35] See Circular of the Federal Ministry of Finance dated December 15, 1995, note 90.

industry (with its respective capital intensity), the risk profile of the taxpayer's investors or the profit and loss situation in the past) for being clustered in "appropriate" and "inappropriate" by a fix EBITDA proportion. Neither the mere tax exemption of foreign income nor of dividend income can justify the denial of interest deduction in the absence of any specific abusive behaviour of the taxpayer, and if it were only because such income items are not tax free, but have been subject to tax abroad or at the level of the distributing company.

In particular, the (allegedly) only temporary nature of the denial of the interest deduction does not make an anti-avoidance link dispensable. Even leaving aside the time value of money, this is because in numerous cases the denial of the interest deduction will be permanent, regardless of any carry-forwards. First, carry-forwards often do not survive mere changes to the legal form of conducting the business like for instance corporate reorganizations or a change of control. Second, and more importantly, by far not all viable business models require an equity ratio of 30% as a *grosso modo* requirement for a chance to make use of interest carry forwards. With an equity ratio of 10% or 20%, one might have a profitable business, but will often be unable to utilize any interest carry-forwards.

7. German Trade Tax and Community Law

According to § 8 No. 1 German Trade Tax Act[36] (TTA), 25% of all interest expenses are non-deductible for trade tax purposes, technically by being "added back" to the trade tax base. Assuming an average local trade tax multiplier resulting in a trade tax rate of about 14%, interest expenses are taxed at a 3.5% rate. On May 27, 2009 the German Federal Tax Court[37] *(Bundesfinanzhof)* decided to refer to the ECJ for a preliminary ruling whether or not the 25% add-back provision violates secondary community law, i.e. Council Directive 2003/49/EC[38].

The broad wording of Article 1(1) of the Council Directive 2003/49/EC indicates its violation by the add-back provision (and not only by withholding taxes), reading as

[36] § 8 No. 1 TTA.
[37] BFH I R 30/08.
[38] Council Directive (EC) 2003/49/EC of 3 June 2003 on Interst and Royalty Payments between Affiliates.

follows: "Interest shall be exempt from taxes any taxes, whether by deduction of source or assessment". Accordingly, the decision of the ECJ may also have some impact on (overly broad) thin cap rules that no longer focus on mere abusive structures.

An issue that has not been taken to the ECJ by the German Federal Tax Court, however, concerns primary community law. With respect to cross-border finance companies, there might be a case against the 25% adding back of interest expenses for trade tax purposed on grounds of the freedom of establishment, Article 43 of the EC-Treaty[39]. That is because the adding-back mechanism does not apply in a mere domestic setting in which a German finance company provides a German affiliate with a loan (in case the German affiliates form, as usually, a fiscal unity for trade tax purposes due to a profit and loss pooling agreement)[40].

Even though in the purely domestic scenario described above there would also be an adding-back – this time at the level of the finance company with respect to its refinancing expenses (for instance, interest on bonds issued to the debt capital markets) –, the ECJ might nevertheless find a discrimination of the EU-foreign finance company against the German finance company. This is because a justification on the grounds of coherence usually requires the tax disadvantage and the corresponding tax advantages to be at the level of one single legal person (as opposed to two legal entities, even if they are members of the same corporate group)[41]. In addition, if the German finance subsidiary were, for instance because of some loans to employees, a finance company within the meaning of § 19(3) of the Trade Tax Regulations *(Gewerbesteuerdurchfuehrungsverordnung, GewStDV)*, there would be no adding-back of interest expenses altogether.

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[39] Art. 43 EC-Treaty.

[40] According to ECJ 18 September 2003, C-168/01 *Bosal* [2003] ECR I-9409, a mere constraint regarding the decision between a domestic and a foreign subsidiary is sufficient to constitute a violation of the basic economical freedoms under the EC Treaty.

[41] See, for instance, ECJ 13 December 2005, C-446/03 *Marks&Spencer* [2005] ECR I-10837, after ECJ 7 September 2004, C-319/02 *Manninen* [2004] I-7477 had advocated a broader coherence concept. See also *Wolfgang Schoen*, Back to the Future – Thin Cap in the Light of ECJ Decisions, *Internationales Steuererecht* (IStR) 2009, 882 (885), arguing for a broader coherence concept with respect to thin cap regulations as well.

8. Conclusion

In principle, interest expenses are as good as other business expenses from an ability to pay and therefore tax deductibility point of view. There is, however, some lack of symmetry regarding the taxation at the payor and payee level in particular in a cross-border setting. Since this will continue to be the case in world without withholding taxes on outbound interest payments – and such a world seems to be without alternative for various legal and economic reasons –, and because (shareholder) debt and equity are rather exchangeable, anti-abuse rules can in general be justified in this respect.

In particular, this holds true in an inter-company setting with both high tax and low tax countries. Tax law needs to address thin cap structures as well as fat cap schemes, for instance by limiting the interest deductions on shareholder loans or by ending deferral with respect to finance subsidiaries in low tax jurisdictions incurring only passive-type income.

Unfortunately, Germany went over the top on this by (i) also addressing interest on third-party debt and (ii) at the same time lacking to introduce a technically-sound equity escape. As a consequence, German-based multinationals are virtually never able to pass the equity test and therefore limited in deducting also third-party interest even if their domestic equity is far above group-average. This is because the book value also of foreign shareholding is deducted from the domestic equity notwithstanding the fact that there is no risk of double counting of equity in this respect.

Germany urgently needs to address this issue by introducing a holding mechanism modelled after the former German thin cap rules, or, alternatively, by returning to the former thin cap rules being limited to interest payments on related party debt. Otherwise, German-based corporate groups will always be limited to 30% EBITDA interest deduction while foreign multinationals are not – a rather surprising result and, moreover, one that violates the ability to pay principle as the 25% add-back provision regarding the trade tax treatment of interest expenses presumably violates both primary and secondary community law.