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Court doubts on interest limitation to third party lenders with recourse to shareholders

The Supreme Tax Court has resolved a stay of execution of a payment demand due to its constitutional doubts on the interest limitation as applied to a non-group company borrowing from banks with recourse to significant shareholders.

A company was held jointly by two – otherwise unrelated – shareholders. Each held 50% of the share capital, so neither included the company as a subsidiary in its group accounts. The company was thus not part of a group. However, it could not claim exemption from the 30% EBITDA limitation on its net interest expense, as its not inconsiderable bank loans were secured by guarantees from the shareholders supplementary to the mortgages on its properties. It has attacked this exclusion as an unnecessary restriction on its freedom to do business, and the Supreme Tax Court has now granted a stay of execution on an interim payment demand because it holds doubts as to whether the inclusion within the interest limitation merely because of the recourse of lenders to significant shareholders might not go far beyond the extent necessary to achieve a legitimate object and thus infringe the equal treatment requirement of the constitution.

The primary aim of the interest limitation is to put a brake on the repatriation of earnings by way of interest as opposed to dividend. The German authorities see interest payments abroad as a loophole leading to taxation in the home country as opposed to Germany, whilst investors tend to see them as necessary in order to obtain a deduction for their interest expense at home. Those drafting the interest limitation felt they were combating an avoidance tactic and thus felt justified in surrounding their rule with precautions. Accordingly, interest expense (if more than €3 m) falls under the limitation if the taxpayer is a group company, or if more than 10% of its interest expense is incurred on loans from significant shareholders (over 25%). Shareholders as loan creditors include the shareholders themselves, their related parties and third parties with recourse to a significant shareholder or his related party. The net is cast wide in order to prevent circumvention of the rules through nominee constructions. However, it also catches professional lenders acting in the ordinary course of their business who merely wish the personal guarantee of the major shareholders of closely held companies that they will not use their influence to effectively deprive the lender of his security. It is this latter effect stemming from common banking practice that gives rise to the constitutional doubt.

A company borrowing funds from a bank in the ordinary course of its business bore the interest cost as a business expense. A shareholder guarantee as an additional security precaution for the bank did not change the nature of the transaction and, in particular, did not open a tax avoidance loophole. The situation of closely held companies was thus different from that of German subsidiaries of foreign parents. Indiscriminately including loans guaranteed by shareholders within the interest limitation thus led to dissimilar situations being treated alike, an apparent infringement of the corollary to the constitutional demand that similar situations be treated alike.

The present resolution is not the Supreme Tax Court's final decision on the matter. The court has granted the stay of execution on the basis that there are important points in favour of the plea as well as against it. Which side carries greater weight is a matter for the main hearing, at which stage it will also be open to the Supreme Tax Court to turn to the Constitutional Court for guidance.

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Keywords

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