The State’s Tax Predicament

It is a subject guaranteed to cause a stir: the practice by which international groups use the domestic infrastructure to generate profits that are then channeled abroad as interest payments that bypass the German tax authorities. Preventing the practice, however, is difficult, and not just from a legal perspective: economically, too, an ill-considered tax impost can do the government more harm than good.

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German tax law is littered with opportunities for companies to legally avoid paying taxes. A prime example in the public discourse is the case of the German subsidiary of a major Swedish furniture retailer. In 2003, this subsidiary generated profits of more than 300 million euros before license fees and interest payments – but its tax burden in Germany was a mere 50 million euros. The company succeeded in transferring a large share of its profits abroad, where its earnings were subject to a substantially lower tax rate. The group was able to drastically reduce its tax burden, to the detriment of the German treasury. It is not surprising that politicians would like to prevent such legal “tax dodges.”

Companies are able to save taxes not least because they can meet their financial needs for raw materials, machinery, buildings, wages and other production costs in two ways: through equity or through debt. Equity can be acquired, for example, by issuing (new) shares in the company. A capital investor who buys the shares provides the company with funds for an indefinite period and, in return, acquires a stake in the opportunities and risks of the undertaking. In good times, he makes a profit, and in bad times, he suffers losses.

In the case of debt, in contrast, the simplest alternative is a straightforward loan – money on which the company must pay interest, even in years in which it realizes a loss, and which must be repaid within a contractually fixed period. It is not until equity has been consumed that losses must be covered through debt. In that case, creditors may have to defer repayment of the loan, or in the event of insolvency, forfeit some – in the worst case even all – of the expected repayment.

In general, national law places few stipulations on how the owners of a business may fund their undertakings. As long as they are not bound to consider any legal requirements, companies follow economic criteria.

One factor that is of critical importance, particularly to multinational entities, is the difference in the tax treatment of equity and debt in different
countries. When a corporation that is resident in Germany raises equity, it has to pay full tax on the entire return on capital. While it is true that investors, too, must generally pay tax on the return on their investment when profits are distributed, the bulk of the tax burden is borne by the company.

The picture is quite different when the company chooses to meet its financial needs with debt, such as loans. In this case, the company pays tax only on that portion of the return that is not paid to the lender as interest. The reason is simple: the interest payments are deductible from the tax base – that is, the income on which the tax liability is assessed. The lender, however, must pay full tax on the interest received.

Even if the state treats equity and debt differently for tax purposes, the fiscal revenue is still the same provided that, at the end of the day, both alternatives bear the same total tax burden. However, the levies on these two forms of financing vary from country to country. This is where the opportunity for multinational enterprises to reduce their overall tax liability arises. There may, for example, be a tax advantage for a parent company resident in a low-tax country to pass on its equity in the form of a loan to a subsidiary that is resident in a high-tax jurisdiction.

The problem for the tax authorities is obvious: excessive borrowing by a subsidiary from abroad erodes the domestic tax base. Germany traditionally ranks among the high-tax countries. Multinational enterprises based in Germany thus have an incentive to transfer domestic profits to foreign subsidiaries in the form of interest payments. Ideally, the foreign group member recipient will pay substantially lower taxes on the interest received. This issue is of critical importance, because a country loses its tax jurisdiction once profits have been transferred abroad.

Of course a high-tax country such as Germany has a legitimate interest in preventing companies from offsetting the interest they pay against their domestic taxable base and transferring net profits abroad. After all, the government provides the infrastructure that these companies need and thus contributes significantly to their success. If the tax base shrinks, the government has no incentive – and moreover no funds – to maintain or even expand this infrastructure.

But how can governments prevent companies from transferring profits abroad as interest payments? First of all, one might consider changing the rules and, in the future, providing for equal tax treatment of equity and debt. Companies would then be unable to deduct interest payments on debt – just as they cannot deduct dividends on equity – from their taxable profits. However, this would overturn fundamental principles of the current tax system. More importantly, unless such a change is harmonized internationally, it would result in a dramatic location disadvantage, as companies that are resident in Germany would face substantially higher costs. Thus, at least for now, a reform of this nature is not a viable solution.

Another approach might be a withholding tax regime that applies to interest payments made to foreign recipients. In this case, the resident company still pays the tax, but only as an agent, and it is actually the foreign recipient that is liable for tax to the German tax authorities. This would work in exactly the same way as the withholding tax that banks remit to the treasury on behalf of their customers (Abgeltungsteuer). However, German legislators have deprived themselves of this option by entering into double taxation agreements, not to mention a European Directive adopted in 2003.

This is why, in the end, there appears to be only one solution: in cases that the state perceives as abusive, it must restrict the deductibility of interest payments. Then excessive borrowing to the point considered to be abusive would be significantly less attractive. But there is more to developing a mechanism to expediently restrict the tax deductibility of interest than commonly meets the eye. This is mainly due to the constitutional constraints, policy con-
siderations and economic criteria that legislators must take into account when drafting new rules on the deductibility of interest payments.

For example, research in the field of business administration and economics has not yielded any generally applicable formula for the ideal ratio of debt to equity. In fact, there are various factors that companies must take into account when deciding on their preferred method of financing in each individual case. Tax criteria are hardly ever the sole crucial factor. A company may, for example, be debarred from financing itself through an increase in capital (for instance by issuing new shares) because the corresponding resolution fails to find favor with the majority of existing shareholders. In this case, borrowing is the only option.

With only these considerations in mind, it is scarcely possible to determine unequivocally and feasibly whether a company is financed solely on the basis of tax criteria. Plus, already understaffed fiscal authorities can hardly audit a company’s financing relationships in every single case. If legislators want to get their hands on interest flowing abroad, they must ultimately find a blanket method by which to suppress excessive deduction of interest in association with cross-border lending arrangements.

On the other hand, the fundamental freedoms of the European Union, such as the freedom of establishment and the free movement of capital, demand equal treatment of internal and cross-border interest payments. Companies must therefore be able to offset these payments in equal measure against tax – irrespective of whether the interest is paid in Germany or sent abroad. So far, the Court of Justice of the European Union has allowed an exception to this strict policy of non-discrimination only where, taking into account all relevant circumstances, an administrative authority can prove that a specific financing arrangement is dictated solely by tax motives. For the reasons stated above, it appears to be virtually impossible to prove such a case, both in theory and in practice.

Thus, in effect, legislators are compelled to limit the deduction of interest also on purely domestic financing arrangements if the relevant conditions are met. By imposing sanctions on companies that operate and raise loans only within the borders of a country, legislators are inevitably exceeding their desired aim, as in those cases there is no risk that a portion of the tax base will be transferred abroad. Nevertheless, borrowing is impaired, with the result that even economically expedient loans – for example in connection with restructuring – may be beyond a company’s reach. In the worst case, the company thus affected is left with insolvency as its only option.

Such a situation is critical not only from an economic perspective, but in Germany, it also raises the specter of conflict under constitutional law. Permitting a company to deduct its interest expenses only under certain circumstances is limited by constitutional constraints. Under the tax system as it currently applies, interest expenses must be tax deductible as a matter of principle. Legislators are bound by this constitutional framework and cannot deviate from it at will. Specific justification is required.

The German Federal Constitutional Court is less strict on this point than the Court of Justice of the European Union, permitting blanket regulations.

There is no generally applicable formula for the ideal ratio of debt to equity

Nonetheless, legislators bear the burden of proof to show that the formula limiting the deduction of interest targets, in the majority of cases, arrangements that are tax-driven. However, particularly in domestic cases, lawmakers will scarcely be able to prove their point: in such cases, tax aspects play at most a subordinate role, since the various forms of financing are generally subject to a more or less equal tax burden. Consequently, such regulations are at risk of being declared unconstitutional – especially when the unrestricted deduction of interest effectively becomes the exception rather than the rule. >
annual gross profits collapse. A mechanism was thus introduced recently that provides for the “smoothing” of gross profits over several years.

Despite its considerable complexity, the interest cap is not suited to identifying even roughly those financing arrangements that are motivated by tax reasons. The ratio between gross annual profits and interest costs gives no indication of whether or to what extent a company’s debt financing is driven by tax considerations. Highly profitable companies can still lend substantial amounts of capital, while companies with already weak earnings may, under certain circumstances, suffer a tax penalty despite being adequately financed with equity. The fundamentally convincing approach of comparing equity ratios fails in practice simply because a German company may not be able to provide evidence of the financing structure of its entire, often globally distributed group to a degree that satisfies the high standards demanded by the tax authorities.

In view of this unsatisfactory outcome, the question arises whether other jurisdictions have found more convincing solutions to the problem. Some countries use a company’s ratio of debt to equity to regulate the deduction of interest (as Germany did prior to the introduction of the interest cap). They presume that there is a common ratio of equity to debt. Another approach is based on a company’s assets: the higher the cumulative value of its assets, the more interest it may deduct.

In practice, however, these approaches, too, yield arbitrary results. The “right” ratio of debt to equity does not exist – average equity ratios vary, in some cases widely, from one industry to another – and there can even be variations within industries. Nor is it possible, on the basis of the value of assets, to determine unambiguously whether a company’s borrowings are primarily tax-driven or are accounted for by other reasons.

All approaches thus far put into practice have proven unsuitable to even roughly identify those financing arrangements that are motivated by tax. And this deficiency can’t even be genuinely overcome by combining the various methods. Decisions on how companies finance themselves are simply

The new interest cap hits domestic companies hard in times of crisis
far too complex to be convincingly modeled in a regulatory instrument that is workable in practice.

Place a blanket restriction on the ability of companies to offset interest, and the resulting legislation will always impact a considerable number of businesses that are not, or not primarily, financed through debt simply for tax reasons. Legislators who follow this approach to assert their justified interest in taxing domestic profits inevitably face comparison with the proverbial bull in a china shop.

All the more reason for them to have a clearer understanding that restricting the tax deductibility of interest is a politico-economic decision. It is a question not just of safeguarding tax income, but of the attraction of Germany as a place to do business. By structuring their finances in a specific way, companies may indeed succeed in spiriting their profits away right under the nose of the German taxman, and yet the effective reduction in their tax burden can be beneficial for Germany itself. The opportunity to save tax is, after all, a powerful incentive to invest here.

A country’s attraction as a place to do business is dependent not only on its nominal tax rates, but on how investments are taxed generally. When interest can no longer be deducted from earnings as an operating expense, the effective tax burden increases. The more indiscriminately legislators limit the deduction of interest in their desire to protect the tax base, the greater the collateral damage to the economy and the greater the risk that the German Federal Constitutional Court will intervene.

It is a question of both safeguarding tax income and Germany’s future as a business location.

er countries are in limiting the deduction of interest. They can then fashion their own rules to ensure that their country remains as competitive as possible in international comparison. On the other hand, an approach should be selected that entails positive incentives to do business in Germany.

Taking into account all of the above factors, the most viable option appears to be to make the deduction of interest dependent on whether the debt is invested in productive assets – for instance, plant and equipment, inventories or real estate. Besides the taxable income to be expected on such investments, in this case, there are additional positive effects on the labor market. It is also not unlikely that the stringent implementation of such a regulation would pass muster even in the eyes of the Federal Constitutional Court. With this in mind, it might be desirable for German legislators to reconsider their current concept for the restricted deduction of interest.

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