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Profit-sharing loan not necessarily dependent on annual surplus

The Supreme Tax Court has held that a profit-sharing loan can be dependent on an overall, as opposed to an annual, surplus.

A KG with limited partners drawn from the general public operated a ship through a Cypriot shipping line. It partially financed its ship with a loan from the operator. The loan was 7.5% fixed interest and immediately repayable on sale of the ship. The operator as lender was required to defer his interest claim until the KG was sufficiently liquid to meet all current costs and to make a 5% distribution to its limited partners. If the sale proceeds were insufficient to meet the lender's claim for repayment of capital and for his accumulated interest, the shortfall was to be forgiven. On the other hand, any surplus was to be split between the lender and the partners. The taxpayer maintained the interest on the loan to be fixed and therefore payable to a Cypriot lender without withholding tax. The tax office saw the arrangement as profit-sharing leading to tax on the interest as a distribution of business income. This meant a withholding tax of 10% at the relevant treaty rate for interest.

The Supreme Tax Court has held in favour of the tax office. A loan ranks as profit-sharing if its interest is dependent - in part - on variable factors, such as profits or turnover. However, the profits to be shared do not have to be annual; they can be based on a final surplus on conclusion of a particular operation, particularly where the loan was taken up for the operation in question. In the present circumstances, it was clear that the profit-sharing intention was of realistic business substance and should be taken into account in any overall assessment of the arrangement. The profit-sharing entitlement was to be seen as consideration for the enhanced risk borne by the lender in linking his finance to a single object. (AM)

Supreme Tax Court judgment I R 78/09 of June 22, 2010 published on November 17

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