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By PwC Deutschland | 31. August 2011

Foreign tax credit on hedged loan interest takes hedge costs into account

The Supreme Tax Court has held that the hedge costs on a foreign currency loan are to be deducted from the interest received in calculating the net foreign income as the basis for the foreign tax credit available.

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A bank bought two short-term Brazilian notes in cruzeiro with a cruzeiro loan from a US bank. It hedged this liability with a forward exchange contract with the same bank and with the same maturity. Its net result from the transaction was thus the difference between the interest income and the loss on the hedge. The Supreme Tax Court has now held that where the two transactions are mutually intermingled to the extent that the one is preconditioned by the other, they must be seen as two parts of a single whole. This meant that the Brazilian withholding tax at 20% (including a "tax sparing" notional uplift on the actual deduction of 15%) on the gross interest could only be credited against the corporation tax due on the net income recorded in Germany. This was the corporation tax at the then rate of 50% on the margin between the gross interest received and the hedge loss. The fact that the withholding tax had been levied on the gross interest was irrelevant, as was the fact that the hedge loss did not arise in Brazil, but rather in Germany on a transaction with a US bank. The excess of credit for the Brazilian withholding tax (20% of the gross interest) over the German corporation tax of 50% on the net margin (interest less hedging costs) was irrecoverable.

In the meantime, the case has gained in importance as a guide to the foreign tax credit calculation with the fall in the German corporation tax rate to 15%. On the other hand, it lost in relevance to Brazil, when the double tax treaty with that country was cancelled for 2006 (withholding taxes) or 2007 (year of assessment).

Supreme Tax Court judgment I R 103/10 of June 22, 2011 published on August 31

Schlagwörter

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