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German trade tax restriction on interest deductibility upheld

The Supreme Tax Court has upheld the German disallowance of one-half of the long-term interest expense for trade tax as not conflicting with the Interest and Royalties Directive and not infringing the German/Dutch tax treaty prohibition on discrimination.

A German subsidiary received a long term loan from its Dutch parent. At the time, the Trade Tax Act disallowed one-half of all long-term loan interest paid as a business expense (the disallowance is now one-quarter of all interest paid over €100,000). The subsidiary maintained that this disallowance thwarted the object of the Interest and Royalties Directive – the avoidance of double taxation on interest and royalty payments within groups – and appealed against its trade tax assessment. The Supreme Tax Court saw at least some merit in this argument and had referred the question to the ECJ. However, the ECJ held that the German Trade Tax Act disallowance is not in conflict with the Directive and therefore acceptable under community law. It reasoned that the object of the Directive is to avoid legal double taxation in the hands of the income recipient. Nowhere does the Directive refer to the payer of the charge or to a concept of economic double taxation for a group. The trade tax disallowance of one-half the interest expense had no effect on the net proceeds received by the parent as interest creditor. It was therefore irrelevant to the Directive, rather than being in conflict therewith.

Accordingly, the final decision of the Supreme Tax Court turned out against the German subsidiary. The subsidiary had indicated that this controversial issue would not have come up if it had been allowed to establish a trade tax group (Organschaft) with its Dutch parent, bearing the elimination of intra-group interest in mind, its object being to avoid the partial disallowance of the expense to the borrower without a corresponding reduction of the income of the lender. The court emphasized, however, that in the case at hand the fear of double taxation was unfounded as the parent was resident in the Netherlands and the interest paid was allocated to that parent, being not subject to German taxation.

It also pointed out that the add-back did not constitute discrimination by nationality prohibited under article 24 of the German/Dutch double tax treaty. This treaty dates back to 1959 and does not resemble the concepts of the OECD-model treaty (meanwhile, a new agreement which is in line with the OECD-standards was signed on April 12, 2012 and will be in force from 2014). In the view of the Supreme Tax Court there was no justification for breaching the non-discrimination provision since article 24 – contrary to the respective clause in the OECD-model treaty – does not refer to discrimination based on residency of the shareholder (i.e. the German subsidiary) but rather aims at permanent establishments as the ones suffering possible disadvantages. (mh)

Supreme Tax Court judgment I R 30/08 of December 7, 2011 - published on March 7, 2012

Schlagwörter

Inerest deduction, add-back, discrimination, long-term interest expense, trade tax group