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Loan interest subject to profits is profit sharing under Austrian treaty

The Supreme Tax Court has held that payment of interest only if the payer remains profitable means that the payment is profit sharing and subject to withholding tax under the Austrian treaty.

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An Austrian investor took up three fixed-interest, fixed-term debentures from a German bank. However, the interest was only payable to the extent it did not lead to, or increase, a loss. Claims for unpaid interest were suspended until the bank returned to profitability. They were then to be met prior to those of the bank's shareholders. Unsatisfied interest claims remaining on expiry of the debenture term lapsed, if lack of profits still prevented the bank from meeting them.

The Supreme Tax Court has now held that this profitability condition renders the interest profit-dependent. Under the Austrian treaty, interest is, as such, paid free of withholding tax to residents in the other state. However wholly or partially profit-sharing interest is taxable in the state of source without further treaty limitation. The court held that the profit-dependency of this interest rendered it partially profit-sharing and thus taxable in Germany, in this case by withholding at 25%. The recipient argued that the arrangement was not profit, but merely loss, sharing. To this the court replied that that was only a matter of wording. The substance of the agreement was that interest could not be paid unless and until sufficient profits had been earned. The argument that the profitability condition together with the recovery provision meant that not the interest, but only its payment date, was profit-dependent, also failed. In this connection the court saw the lapse on expiry of the debenture as a transmuting the initial deferral to an absolute loss for the holder. (AM)

Supreme Tax Court judgment I R 53/09 of August 26, 2010 published on December 1

Keywords

Profit-sharing interest, fixed-term debentures, loan interest, loss sharing, profit-dependency