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Declining rate loan interest to be spread over term of the loan

The Supreme Tax Court has held that declining rate interest on a loan should be taken to prepaid expense and then written off in equal portions over the term of the loan, unless the borrower had an early repayment facility without a claim for partial refund of the higher interest paid.

A bank took out a ten-year loan at an annual interest rate of 7.5% for the first two years. Thereafter the rate was to progressively decline to 3% by year ten. The tax office this “step down” interest rate arrangement as essentially bringing the interest payment burden forward to the earlier years of the loan. Since the loan was a fixed sum repayable in full at the end of term, the value of the service and the cost to the provider remained constant throughout the period. Thus, the expense should also be constant, and to achieve this, the debtor should take up an appropriate prepayment in the earlier years of the loan, to be progressively expensed when the interest rate fell below the ten-year average.

The Supreme Tax Court has now agreed with this view. In the absence of any indication to the contrary, the value of the service to the borrower was the same throughout the term of the loan and his expense should therefore be constant. This was generally the case for a fixed-term loan with no provision for early repayment. If the contract contained an early repayment option with a partial refund of the high interest paid in the initial period, the refund could be seen as indicating the extent to which the parties had agreed to spread the interest burden equally. If no interest was refundable on early repayment, the indication would be that the parties had, in fact, seen the service as more valuable to the borrower, or more hazardous to the lender, during the early part of the term. In this case, the conclusion could be that the interest should be expensed as paid.

The court was careful to point out that these calculations were to be distinguished from penalty interest payable on early loan repayment. Penalty interest was to compensate the lender for lost income; thus basing it on future amounts due gave no indication of which services had already been remunerated in the past.

Supreme Tax Court judgment I R 77/10 of July 27, 2011 published on October 26

Keywords

declining rate, early repayment, prepaid expense, step down