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By PwC Deutschland | 26 November 2014

Income adjustment for interest-free loan to foreign subsidiary

The Supreme Tax Court has held that an income adjustment for the interest lost on an interest-free loan to a foreign subsidiary can be made under the Foreign Tax Act unless the loan was granted as a substitute for share capital.

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A GmbH granted an interest-free loan to its Belgian subsidiary. The tax office felt that the GmbH should have charged a market rate of interest and adjusted the income accordingly. It based its position on the provision in the Foreign Tax Act calling for arm's length dealing between related parties and providing for a compensating adjustment to taxable income were this not the case. The GmbH countered with the contention that the loan was a substitute for share capital and that, alternatively, an adjustment for uncharged interest was not possible within a domestic environment (interest cannot be "contributed" as a payment in kind on account of capital), so that to require it in respect of a Belgian subsidiary offended against community law.

The Supreme Tax Court has now held that the income adjustment provision of the Foreign Tax Act is valid and should be followed. However, no interest should be charged or imputed on a loan granted in substitution of share capital. A loan was a share capital substitute if seen as such by the national law of the subsidiary, or if it were clearly necessary in the long term for the subsidiary to function properly. In regard to the latter, the lower court had seen 35% of the loan as a share capital substitute on the basis that the future profit projections of the company indicated that only 65% of the loan granted could be serviced under arm's length conditions. The Supreme Tax Court saw no reason to disagree with this estimate and therefore accepted that a shareholder loan could be in part a capital substitute. The income adjustment was confined to the interest on the remaining part. Here, the court saw no clash with community law – and no need to turn to the ECJ – since community law generally accepted that related party dealings should be at arm's length. An adjustment to that standard could not be an offence.

Supreme Tax Court judgment I R 88/12 (NV) of June 25, 2014 published on November 26

Keywords

Foreign Taxes Act, foreign subsidiaries, income adjustment, interest-free loan