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Pre-2008 disallowance of related-party loan interest

The Supreme Tax Court has held that the pre-2008 disallowance of loan interest on related-party finance for the purchase of shares refers to direct investments only.

Up to 2008 the then thin capital rules (basically disallowance of interest on related-party loans in excess of one-and-a-half times the company's opening equity) included an exception to disallow all related-party interest cost incurred in financing the purchase of shares. This exception has been variously interpreted as including, or not including, interest on loans taken out to finance investments through subsidiaries (indirect investments). The Supreme Tax Court has now resolved the dispute in favour of a restrictive interpretation of the exception as opposed to the broader interpretation set forth in a finance ministry decree.

A German member company of an international group took out a loan from its Luxembourg fellow subsidiary at a supposedly market-rate of interest. It forwarded the funds to its Italian subsidiary, so that that company could purchase the entire share capital in a Spanish company from its own Dutch shareholder (European group holding company). The tax office followed a finance ministry decree and disallowed the interest paid by the German company on the loan, as that loan had been taken out to finance the cost of acquiring the shares in the Spanish company through the Italian subsidiary.

The Supreme Tax Court has now resolved the issue in favour of the taxpaying company. It had not taken up the loan from Luxembourg in order to finance the purchase of shares, but to make a capital contribution to its Italian subsidiary. That company's purchase of the shares in the Spanish company was not the equivalent of a direct acquisition by the German company. Thus while the loan interest in question might be wholly or partially disallowable for other reasons – such as failure to meet the arm's length standard – it could not be disallowed solely because of its use to strengthen the working capital of the Italian subsidiary, enabling that company to buy the Spanish shares.

Supreme Tax Court judgment I R 68/13 of January 29, 2015 published on June 17

Keywords

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