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Arm's length related-party loan interest to include risk uplift

The Supreme Tax Court has held that a write-off of an irrecoverable related-party loan is not subject to income adjustment under the arm's length rules, although the interest rate should reflect the bad debt risk.

The German subsidiary of a Canadian group lent significant sums to its under-capitalised UK subsidiary. The debt proved irrecoverable and was written off in 2002 when the UK company ceased trading. At the time, such write-offs were permitted subject to adherence to the principle of dealing at arm's length. The tax office objected that unsecured loans were not at arm's length.

The Supreme Tax Court has now held that the lack of security does not invalidate the write-off. The lender was entitled to rely on the solidarity of the group, rather than demanding specific security from its subsidiary as debtor. In any case the arm's length income adjustment provision of the Foreign Tax Act applied to trading transactions and relationships, but not to those entered into as a shareholder. The loans in question substituted share capital and their write-off was not subject to income adjustment on the grounds that a third party would not have suffered the loss. However, the interest rate charged should reflect the credit risk actually borne.

In the meantime, there have been several changes to the relevant statutes. In particular, related-party loan losses can only be deducted if a third party creditor would have granted the finance (or allowed it to remain outstanding) under otherwise similar conditions. Also the Foreign Tax Act definition of "trading" has changed somewhat to bring certain aspects of intercompany finance into the scope of arm's length adjustments. However, the general conclusion of the court that an arm's length interest rate must reflect the degree of risk borne by the creditor remains valid.

Supreme Tax Court judgment I R 29/14 of June 24, 2015 published on September 9

Keywords

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