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By PwC Deutschland | 24 October 2021

Supreme Tax Court rules on arm’s length interest on intercompany loans

In a most recent judgment, the Supreme Tax Court decided on the transfer pricing method to determine an arm's length interest on intercompany loans. In its decision the highest tax court also provides some guidelines on the parameters to be observed from a purely tax point of view. Also, the court takes time to compare the adequacy of the various standard methods under review.

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Background

How high may the interest rate for an intercompany loan be? This has been a controversial issue, ever since. Now, the Supreme Tax Court issued a landmark decision to establish transfer prices for financial transactions, whereby reversing the highly controversial ruling of the lower instance (the regional tax court of Muenster) and referring the case back to that court for a different hearing and final decision. The issue is whether independent third parties in the same or a similar position of the taxpayer would have agreed to the relevant transactions on the same or similar terms.

The taxpayer may use the standard methods to set his transfer prices for tax. In the case of dispute these are: The comparable uncontrolled price method ("*Preisvergleichsmethode*") or the cost-plus method ("*Kostenaufschlagsmethode*"). – In the case of dispute a Dutch financing company granted several unsecured loans to its German-based operative sister company on an ongoing basis. The interest rates of these loans where in the range of 4.375% to 6.45%. The tax office considered the interest rates charged to be excessive and determined the arm's length interest rates based on the cost-plus method.

Decision

The Supreme Tax Court instead supports the use of the comparable uncontrolled price method as this method is the basic method for determining appropriate transfer prices because it leads directly to the determination of the comparative price. The arm's length nature of the agreed interest rate for an intercompany loan must first be determined by comparing the agreed interest rate with the interest rate agreed in comparable transactions between independent third parties or between one of the group companies and an independent third party (comparable price method). Only if such a price comparison is not possible may the cost-plus method be applied, under which the lender's cost of goods sold is determined and increased by an appropriate profit mark-up.

In its decision, the Supreme Tax Court also addressed other aspects of the arm's length principle. For example, the creditworthiness of the borrower, which is relevant for the interest rate, must always be based on the creditworthiness of the individual company and not on the creditworthiness of the entire group. The financial capacities of the lender, on the other hand, do not play a decisive role in the appropriateness of the agreed interest rate.

The Supreme Tax Court did not further engage itself with the estimate by the regional tax court in determining the loan interest rates based on the cost-plus method, because it holds this to be inadmissible from the outset and - secondly - also found serious and fundamental errors in the calculation itself.

Source:

Supreme Tax Court decision of 18 May 2021 (case ref.: I R 4/17), published on 21 October 2021.

Note: Another high tax court decision involving intra-group financing is expected shortly: The case *I R 62/17* pending before the Supreme Tax Court deals with an excessively high interest rate on a shareholder loan as

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a hidden profit distribution. One of the questions there is if the mutual support between group members (*group support*) has any effect on the arm's length interest rate in the case of an intercompany loan granted by the parent company to its subsidiary. Another issue to be clarified is whether the subordination of a shareholder loan pursuant to Sec. 39 (1) No. 5 of the German Insolvency Statute plays a role when determining the interest rate. According to this provision "claims for restitution of a loan replacing equity capital or claims resulting from legal transactions corresponding in economic terms to such a loan may – under circumstances – also rank below the other claims of insolvency creditors."

For a more indepth specialist view into the decision I R 4/17 of the Supreme Tax Court we refer to the pwc **TP Perspectives - Newsflash October 2021**

Keywords

arm's length, comparable price method, cost-plus method, intercompany loan