

TP Perspectives - Newsflash

Dear Readers,

In its ruling of 18 May 2021 (Case I R 62/17, lower court: Cologne Fiscal Court), which was published on 28 October 2021, the Federal Fiscal Court (“Bundesfinanzhof” or “BFH”) made a further landmark ruling in the area of intra-group financing, having already established far-reaching principles for determining arm's length interest in its ruling on Case I R 4/17 (lower court: Münster Fiscal Court), which was published on 21 October 2021 ([LINK](#) to our Newsflash).

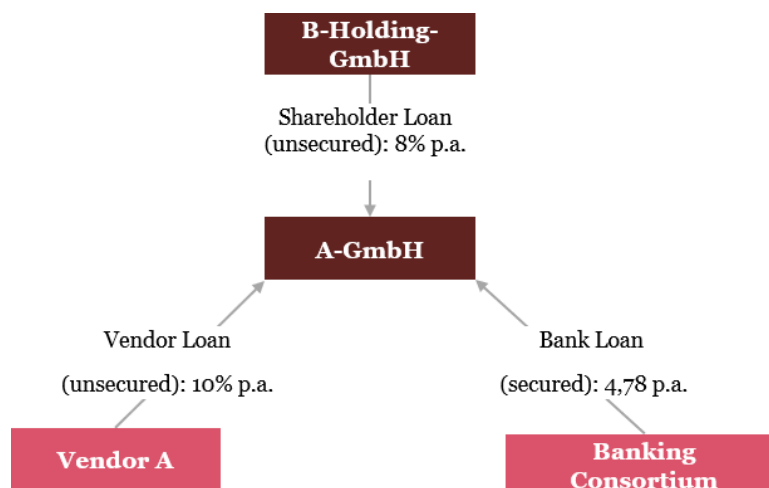
In the case I R 62/17, in addition to the question of the selection of the most appropriate TP method for setting intra-group interest rates, the main issue was whether a subordinated rank of a loan resulting from the German Insolvency Code (“InsO”) can have an influence on the amount of the interest rate.

As a result of the ruling, the BFH - similarly to the case on FG Münster - overturned the judgment of the Cologne Fiscal Court (“FG Köln”) of 29 June 2017 (10 K 771/16) and referred it back to the FG Köln for a different hearing and decision.

In the following, we summarize the ruling and address the far-reaching implications from a practical standpoint.

Facts

A German-based company (“A-GmbH”) entered into various loans to finance an acquisition, as illustrated in the chart below:



- A bank loan (consisting of two tranches) at an average interest rate of 4.78% p.a. The bank loan is secured, senior to other financing and has a term of five years;

- A vendor loan at an interest rate of 10% p.a. The vendor loan is unsecured, subordinated to the bank loan and has a term of 6 years; and
- A shareholder loan from "B-Holding GmbH", the sole shareholder of A-GmbH. This loan has an interest rate of 8% p.a., is also unsecured and subordinated and has a term of nine to ten years.

The taxpayer had prepared transfer pricing documentation based on the external comparable uncontrolled price ("CUP") method to demonstrate the arm's length nature of the interest rate of the shareholder loan, relying, among other things, on bonds as comparable transactions.

Position of the local tax office

In the course of the tax audit of the shareholder loan, the tax office came to the conclusion that the agreed interest rate of the shareholder loan of 8% p.a. was not at arm's length. The tax office considered an interest rate of 5% p.a. to be appropriate and therefore treated the interest expense exceeding this rate as a hidden profit distribution by A-GmbH to B-Holding GmbH.

In particular, the tax office considered the risk premium in comparison with bank financing for an unsecured and subordinated loan to be inappropriate. The tax office's reasoning for this was that in the case of intra-group loans, no collateral had to be provided because of the group relationship (in English often referred to as "implicit support").

Ruling of the FG Köln

The FG Köln did not uphold the taxpayer's admissible claim in court. The benchmark for the interest rate of the shareholder loan was the average interest rate paid for the bank loan (4.78% p.a.).

The FG Köln argued that the subordination of claims from shareholder loans and economically equivalent legal acts had been standardised by section 39 (1) no. 5 InsO¹ and that subordination could therefore not be circumvented. This subordination could also not be undermined by the granting of collateral. Consequently, according to the FG Köln, neither the non-granting of collateral nor the subordination of shareholder loans could justify a risk premium when determining the interest rate.

In addition, the FG Köln held that A-GmbH had sufficient substance to serve as a guarantee to B-Holding GmbH that the loan would be repaid.

FG Köln also pointed out that at least in the case of loans granted by the parent company to the subsidiary, the legal concept of "implicit support" ("Konzernrückhalt") was irrelevant to determine the level of the arm's length interest rate, so that group backing had to be left out of the calculation of the arm's length interest rate.

In its ruling, the FG Köln came to the conclusion that a hidden distribution of profits was to be assumed in the amount of the difference between a (in the opinion of the FG Köln) reasonable interest rate of 5% p.a. and the interest rate of 8% p.a. actually paid.

¹ In the version of the Law for the Modernization of the Private Limited Companies Act and to Combat its Abuse (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen, "MoMiG")

BFH strengthens the consideration of risk premiums for subordinated and unsecured loans

The BFH criticised the position of the FG Köln - which, according to the BFH, was erroneous in law - with regard to the following points:

- In the context of the CUP method, the conditions for granting the loan (here: non-collateralisation and subordination) would have to be taken into account from an arm's length perspective in the context of adjustment calculations (i.e. as risk premiums on the interest rate). The FG Köln, on the other hand, had only taken into account the external syndicated loan and had used its interest rate (4.78%) as a basis for comparison. In doing so, FG Köln failed to consider the fact that the syndicated loan - in contrast to the intra-group loan - is a secured and senior loan. According to 'general principles of experience', a third party would not have granted an unsecured and subordinated loan at the same interest rate as the syndicated loan.
- In this context, the BFH stated that the reference by FG Köln to the statutory subordination of shareholder loans per the German Insolvency Code was irrelevant, as the arm's length principle requires to think of the parties as if they are independent. Thus, claims by unrelated third party would not be subject to a statutory subordination in the event of insolvency and would thus demand a higher interest rate to compensate for the higher risk.
- In the opinion of the BFH, the statements of FG Köln that no additional risk premium is justified as the borrower has sufficient substance and hence security for loan repayments, would not reflect arm's length behaviour. On the contrary, a third party would, when granting a loan, not only consider the current economic situation of the borrower, but also its future development (and thus in particular, the potential future risk of default). However, since the future development could at best be forecasted, a third party would have charged a higher interest rate than in the case of a secured loan.
- The BFH is thus clearly in favour of the applicability of the CUP method, taking into account appropriate adjustment calculations with regard to subordination and non-collateralisation.
- The question of whether the loan agreement should be recognised at all for tax purposes and thus whether an interest deduction reducing income tax should be possible in the first place is referred back to the FG Köln.
- Furthermore, the BFH once again emphasises that the burden of proof of establishing that interest rates are not at arm's length lies with the tax auditor.

Impact and relevance

The judgment is to be welcomed:

- Together with the ruling in the case I R 4/17, the BFH is now taking a path that points the way forward, which provides for the application of the CUP method in the interest calculation of intra-group loans and specifies its application.
- For taxpayers, this provides important guidance on how to determine an interest rate that complies with the arm's length principle.
- It is imperative to note that the taxpayer must ensure in advance in its contractual arrangements that the loan is also recognised as borrowed capital for tax purposes. This requires clear contractual



provisions on the loan conditions, which must also be implemented accordingly during the term of the loan.

- When determining an arm's length interest rate, these same conditions must also be included in the amount of the interest.
- In the context of a transfer pricing analysis, this means that the need for proper adjustment calculations gains further importance. This applies to both the internal and external CUP method.

We cordially invite you to participate in our upcoming webinar, in which we will present in detail the BFH's rulings in the cases I R 4/17 and I R 62/17 and their significance from a transfer pricing perspective.