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By PwC Deutschland | 19 November 2021

Supreme Tax Court: Income from convertible bonds subject to limited tax liability

Interest received by a US limited liability company from convertible bonds issued by a German debtor is subject to German withholding tax pursuant to Sec. 49 (1) No. 5 letter a Income Tax Act. This also applies if partial debentures were issued for these bonds. With its decision, the Supreme Tax Court put an end to the existing discussions and differing opinions in the professional literature regarding the correlation of two provisions in the Income Tax Act on that subject.

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The relevant provisions of the Income Tax Act

According to Sec. 49 (1) No. 5 letter **a** Income Tax Act (ITA) domestic income subject to limited income tax liability includes, i. a., investment income within the meaning of Sec. 20 (1) No. 1, except for distributions on investment fund units, if the debtor has a German residence, management, or seat. Pursuant to 2nd half sentence of Sec. 49 (1) No. 5 **a** ITA "*this*" also applies to income on convertible or profit-sharing bonds.

Sec. 49 (1) No. 5 letter **c** ITA, on the other hand, deals with the limited tax liability for investment income within the meaning of Sec. 20 (1) Nos. 5 and 7 ITA (i. a. "income from other capital receivables of any kind"): A limited income tax liability arises where the investment is directly or indirectly secured by mortgage of domestic real estate, of domestic rights subject to the real estate provisions of civil law, or of ships entered in a domestic register of shipping. Here, however, sentence 2 states that "excluded (from a limited tax liability) *is interest on bonds and loans for which debentures have been issued"* (partial debentures/bonds or "*Teilschuldverschreibungen*").

Case of dispute

The parties are in dispute as to whether interest income received by a foreign shareholder (plaintiff) from convertible bonds, through which partial debentures were issued, was subject to limited tax liability in Germany in the years 2012 and 2013 and thus be subject to a 25 per cent withholding tax. The plaintiff has neither a permanent establishment nor a permanent representative in Germany. On the due payment date of the interest the German issuer of the bond did not deduct and pay the 25 per cent withholding tax. The tax office therefore issued a notification holding the issuer liable for payment of the withholding tax. The regional tax court dismissed the appeal as unfounded. So did the Supreme Tax Court.

Decision

Since the plaintiff, as the holder of the convertible bonds, is not resident in Germany, the obligation to withhold and pay the withholding tax additionally requires that the interest is among the types of income which is subject to limited taxation as provided for in Sec. 49 ITA. In the past, the relevant criteria which must be fulfilled for a tax withholding were highly controversial and debatable in the case of interest from convertible bonds. This has now been finally clarified and confirmed by the Supreme Tax Court as follows:

The definition "income from other investments" as specified in Section 20 (1) No. 7 ITA also includes interest from convertible bonds, which is generally subject to withholding tax pursuant to Section 43 (1) Sentence 1 No. 2 ITA. The limited tax liability for income from convertible bonds is to be determined and derived exclusively from Section 49 (1) No. 5 letter **a** ITA, the specific exceptions mentioned in Sec. 49 (1) No. 5 letter **c** (see above), i. e. "*except for partial debentures/bonds, insofar as they are not convertible bonds or participating bonds*" do not apply to interest from convertible bonds as such.

Section 49 (1) no. 5 letter **a** ITA not only defines the criteria for a limited German tax liability ("German source income") , but also addresses the limited tax liability of certain types of capital investment income.

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According to the second half of the sentence, "*this* (i.e., the definition as German source income) should also apply to convertible bonds". The SupremeTax Court went on to say that the wording of this provision not only defines the criteria which give rise to a limited tax liability, but also finally determines the limited tax liability for the special type of income from convertible bonds. This provision is more specific and thus has precedence over Sec. 49 (1) No. 5 letter **c** ITA.

Moreover, the special rule for convertible bonds in Sec. 49 (1) No. 5 letter **a** ITA would have virtually no scope of application if the exception for partial bonds (debentures) under Sec. 49 (1) No. 5 letter **c** ITA were also to be considered. After all, convertible bonds are generally issued as partial bonds.

Source:

Supreme Tax Court decision of 13 July 2021 (case ref.: I R 6/18), published on 11 November 2021.

Keywords

convertible bonds, limited tax liability, partial debentures