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By PwC Deutschland | 01 July 2022

Income adjustment pursuant to Section 1 (1) FTA vis-à-vis a write-down of an unsecured loan receivable issued within a group

Following a referral from the Federal Constitutional Court, the Supreme Tax Court has again had to rule on the income adjustment pursuant to Section 1 (1) Foreign Taxes Act vis-à-vis the write-down of an unsecured loan receivable issued within a group

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The relevant provisions

Section 1 (1) Foreign Taxes Act (FTA) states: “Where a taxpayer's income from business relations with a related party is reduced by the fact that, in the context of such business relations with a foreign country, the taxpayer agrees terms and conditions that differ from those that would have been agreed between unrelated third parties under the same or similar circumstances, the taxpayer's income is to be recognized as it would have been under the terms and conditions agreed between unrelated third parties, without prejudice to other provisions”

Section 1 (4) FTA defines a “business relations” as any relationship giving rise to income under contract law, which is not an agreement under company law and which, either in the case of the taxpayer or in the case of the related party, is part of an activity to which Sections. 13, 15, 18 or 21 of the Income Tax Act apply or, in the case of a foreign related party, would apply if the activity were carried out in Germany.

Facts of the case

The parties are disputing the legality of an income adjustment pursuant to Section 1 FTA (2003 version) with regard to the partial write-down of an unsecured loan (debt from a clearing account).

The plaintiff, a limited liability company domiciled in Germany, is the sole shareholder (and at the same time the controlling company in a tax group) of A GmbH, also domiciled in Germany. The latter held 99.98% of the shares in B N.V., a corporation domiciled in Belgium. The remaining shares in B N.V. were held by the plaintiff itself.

A GmbH maintained a clearing account for B N.V. (interest scale method), which bore interest at 6% p.a. from January 1, 2004. No security was agreed. In the year in dispute (2005), the interest rate on a working capital loan granted to the plaintiff by a bank was 3.14%.

On 30 September 2005, A GmbH and B N.V. concluded an agreement on a debt waiver subject to a debtor warrant. The amount corresponded to what the parties to the agreement considered to be the worthless portion of the receivables due from B N.V. from the clearing account. Although it was written-down in the balance sheet of A GmbH, reducing its profits, the tax office neutralized the deduction under Section 1 (1) FTA through an off-balance sheet add-back.

The action brought by the plaintiff against this before the Düsseldorf Tax Court was successful.

In the initial appeal to the Supreme Tax Court on 27 February 2019, the appeal of the tax office was allowed and the action dismissed the (judgment of 27 February 2019 - I R 73/16). On appeal (4 March 2021, 2 BvR 1161/19, to the Federal Constitutional Court, the constitutional complaint was upheld and the Supreme Tax Court decision overturned. The case was referred back to the Supreme Tax Court under the new case number I R 15/21.

Decision of the Supreme Tax Court

The Supreme Tax Court allowed the appeal, reversed the decision of the lower court and referred the case

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back to the tax court.

The previous findings of the tax court on the applicability of Section 1 FTA to the dispute with regard to the partial write-down of the unsecured loan (debt from a clearing account) were not sufficient to allow the Supreme Tax Court to make a final decision.

The distinction between loans made for business purposes and contributions made for purposes of the shareholder must be made on the basis of the objective circumstances as a whole. Thereby individual criteria of an arm's length comparison cannot be ascribed in considering the quality of indispensable factual prerequisites (confirmation of the case law: Supreme Tax Court, judgment of 29 October 1997, I R 24/97, under II.2.).

The lack of security for the loan is one of the elements within the meaning of Section 1 (1) FTA which, when considered as a whole, can lead to the business relationship being considered unusual; see also Art. 9 (1) OECD Model Treaty (here: Art. 9 DBA Belgium 1967) (confirmation of case law).

Whether an unsecured intercompany loan is arm's length in the context of an overall consideration of all circumstances of the individual case depends on whether a third party would also have granted the loan under the same conditions - if necessary, taking into account possible risk compensation (confirmation of case law).

If an unsecured intercompany loan would only have been granted at a higher interest rate than the interest rate actually agreed, an income adjustment must be made primarily in the amount of this difference (confirmation of case law).

In the context of assessing the arm's length nature of a transaction, the grant of unsecured loans by third parties to the parent company of the group cannot be considered a suitable comparison to evaluate whether a loan granted to a (subsidiary) company itself meets the criteria for an arm's length granting of credit (confirmation of case law).

Reference

Supreme Tax Court, ruling of 13 January 2022 (I R 15/21), published on 23 June 2022.

Keywords

International Tax, income adjustment, unsecured group loan