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Interest limitation only if remuneration is for temporary provision of capital

The tax courts had to clarify whether an "arrangement fee" and an "agency and security agency fee" are to be included as interest expenses when determining the interest limitation under Section 4h (1) of the German Income Tax Act. The tax authorities were of the opinion that both fees are to be included insofar as they are payable to the lender. The Supreme Tax Court held that the agency fee must be regarded as interest expense, but that the situation is different for the arrangement fee.

Legal background

The interest limitation (interest capping) rule was introduced as part of the corporate tax reform in 2008. It limits the maximum allowable interest expense to 30% of the EBITDA (earnings before interest, taxes, depreciation, and amortization). More specifically, annual net interest expense (the excess of interest paid over that received) of group companies is only deductible at up to 30% of EBITDA for corporation and trade tax purposes. The 30% limitation applies to all interest, whether the debt is granted by a shareholder, related party, or a third party. The limitation does not apply where the total net interest expense for the year is less than EUR 3 million or where the net amount paid to any one shareholder of more than 25% (or a related party) is no more than 10% of the total.

Interest expenses that are subject to the limitation are defined in Sec. 4h (3) Sentence 2 Income Tax Act (ITA) as the consideration for borrowed capital charged against the relevant profit.

Facts of the case

In 2011, the plaintiff and its shareholder, B-GmbH, took out a syndicated loan in the amount of €... million. Originally, a loan in different amount was agreed, from which the aforementioned amount was subsequently called up. The lenders were C-Bank, and four other banks.

C-Bank had to organize and manage all aspects of the syndicated loan, including the term, the selection of potential lenders, the acceptance and distribution of the loan agreements and the distribution of the fees to the lenders. The "arrangement fee letter" stated that an amount equal to 4.25% of the agreed loan amount was to be paid to C-Bank as an "arrangement fee." The arrangement fee was a non-refundable one-time payment. However, it was not payable if the loan agreement was not executed.

B-GmbH recorded the arrangement fee incurred in 2011 as an expense. The tax office took the view that, when applying the interest limitation pursuant to Section 8a Corporation Tax Act (CTA) and Section 4h Income Tax Act (ITA), not only the „agency fee“ but also the arrangement fee be treated as an interest expense for matters of the interest limitation. The lower tax court of Muenster (court of first instance) took the view that the "arrangement fee" was not an interest expense within the meaning of Section 4h (3) sentence 2 ITA. However, the agency and security agency fee are part of the interest expenses for purposes of the interest limitation as these fees were payable for the ongoing administration of the syndicated loan or the loan collateral granted by the relevant bank as lead manager.

Decision

The Supreme Tax Court confirmed the conclusions of the lower tax court and dismissed the tax office's appeal regarding the arrangement fee.

In the opinion of the court, it is important that the remuneration be paid in consideration for the temporary provision of borrowed capital. Traditionally, interest expense is remuneration depending on a specific amount of borrowed capital and the compensation is based on the amount of borrowed capital and on the overall term (life) of the loan.

The Supreme Tax Court specifically does not agree with the tax administration‘s purported view (Federal Ministry of Finance, circular dated 4 July 2008, item 15) insofar as they assume that payments which "are not charged as interest, but are of a compensatory nature (e.g. “... commissions and fees paid to the lender of borrowed capital)" are also included as interest expenses within the meaning of the interest limitation. In its broad interpretation the tax administration obviously - but according to the Supreme Tax Court wrongly -implies that this also includes payments of other natures, e. g. which are made for other services or on different legal grounds.

In light of the above, the Supreme Tax Court reached **the following conclusions**:

- The arrangement fee is a one-time fee to compensate the lead manager for his negotiation and placement activities until and up to the conclusion of the loan agreement.

- The fee was payable to C-Bank as lead manager for negotiating and establishing the syndicated loan with several other banks.

Furthermore, the arrangement fee was not calculated based on the actual amount of debt drawn, but rather on the contractually agreed loan amount.

Source

Supreme Tax Court, decision of 22 March 2023 (XI R 45/19), published on 20 July 2023.

Keywords

Arrangement Fee, interest limitation