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By PwC Deutschland | 01 September 2023

Charitable contribution may be tax deductible even if returned to donor as loan

According to a decision of the Supreme Tax Court, the mere fact that a foundation returns the amount it previously received from the donor to the latter within a short period of time as an interest-bearing loan and uses the interest income earned to promote its tax-privileged statutory purposes is not in itself a reason to deny the tax-deductibility of the contribution as donation.

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Background

The plaintiff established a charitable foundation in 2011. A basic endowment capital (i. e., the assets, which must be permanently maintained by the foundation) of €50,000 was provided which can be increased at any time in accordance with the articles of association. The foundation's board of directors consists of two members (the plaintiff and his partner).

On 19 December and 29 December 2011, the plaintiff transferred a total amount of €400,000 to the foundation as "contribution to the basic assets“. The foundation issued a tax receipt as donations, which the plaintiff signed. On 27 December 2011, the plaintiff and the foundation concluded two loan agreements upon which the foundation granted the plaintiff two loans of €200,000 each, with interest at 3.5% per annum and which were to be used for the acquisition of real estate and be repaid with final maturity on 1 January 2022; premature repayment by the plaintiff was permitted.

Following a tax audit, the local tax office took the view that the payments to the foundation could not be deducted as charitable donations due to the close connection with the loans granted in return. The tax court of Saxon rejected the claim of the plaintiff: The payments made by the plaintiff to the foundation were not gratuitous, as is required for the tax-deduction of donations.

Decision

The Supreme Tax Court granted the appeal brought by the plaintiff.

The tax deduction of a charitable contribution made to a foundation as its basic capital endowment is not excluded merely because the foundation - within close time - provides the payer with an equal amount as an interest-bearing loan and uses the interest income to promote its tax-privileged statutory purposes.

Contrary to the opinion of the tax office, it is not relevant that the founder's liquidity has remained unchanged as a result of the loan. Rather, the distinction between equity and debt capital is decisive for the fundamental admissibility of loans granted to the founder from amounts which he donated. After the transfer of the funds to the foundation, a loan amount - even if it is equal to the amount given earlier - is no longer part of the donor's own funds; rather, it is considered as debt on which interest must be paid and which must be repaid eventually.

However, the matter was **referred to the lower tax court,** as it still must finally determine the arm's length nature of the loan and the agreed interest rate.

Since the **deduction of donations** as special personal expenses for income tax purposes requires that the payment to the charitable corporation be made voluntarily and free of charge, the loan given in return must not be associated with any advantage for the donor. In the opinion of the Supreme Tax Court there would be no such advantage if both the granting of the loan in principle and the agreed loan conditions stand up to an arm's length comparison and the actual implementation of the loan agreement does not raise any doubts as to the qualification of these funds as borrowed capital from the perspective of the donor.

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The Supreme Tax Court did not consider the transaction to be an **abuse of legal forms** under Section 42 of the German Fiscal Code. Moreover, the judges pointed out that - had the plaintiff financed the donated amount with a bank loan - his liquidity would have been not any more strained, but the same tax advantage would have occurred.

Source:

Supreme Tax Court, decision of 26 April 2023 (X R 4/22), published on 31 August 2023.

Keywords

charitable organization, donations