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Calculation of gift tax for low-interest loans

In a recent judgment the Supreme Tax Court held that the granting of a loan at an interest rate which is not customary in the market is subject to gift tax as gratuitous contribution. When calculating the interest advantage the standard (typically used) interest rate of 5.5% as mentioned in Section 15 (1) of the Valuation Act cannot be applied if a lower market value for comparable loans has been established.

Background

The dispute concerned the question whether the transfer of a loan from the plaintiff's sister at a reduced interest rate resulted in a so called „hybrid gift“ (containing elements of a true gift and transfer of value). The tax office had assumed a free gift in the amount of the difference between the actually agreed interest rate of 1% and the interest rate of 5.5% based on the one-year use of a certain amount of money pursuant to Section 15 (1) Valtuation Act.

The appeal of the plaintiff was rejected by the Tax Court of Mecklenburg-Vorpommern. The tax court confirmed the decision of the tax office, as the agreed interest rate was not in line with the market and the plaintiff could not have obtained comparable financing on the capital market at a lower interest rate.

Decision

The Supreme Tax Court confirmed the opinion of the court of first instance.

The plaintiff received a loan at favorable conditions which - as a benefit of use - is subject to gift tax. The interest-rate advantage is 1.81 % and determined as the difference between the standard market loan interest rate of 2.81 % as identified by the lower tax court and the agreed interest rate of 1 %. It is irrelevant whether a different interest rate may result from the exclusion of discounting pursuant to **Section 6 (1) no. 3 Income Tax Act (ITA)** or whether the statutory interest rate of 5.5 % pursuant to **Section 15 (1) Valuation Act (VA)** is unconstitutional.

According to the regulation in **Section 6 (1) no. 3 ITA**, in force until the end of 2022 and therefore still applicable to the case in dispute, non-interest-bearing liabilities with a remaining term of at least 12 months are to be discounted using a discount rate of 5.5%. Whereas **Section 15 (1) VA** provides that the one-year amount of the use of a sum of money is to be assumed at 5.5%if no other value has been established.

The granting of a low-interest loan is to be regarded as a free gift within the meaning of Section 7 (1) no. 1 Inheritance and Gift Tax Act. The intention of the gift is the partial and gratuitous conferral of the right to use the capital provided as a loan. The recipient of such a loan receives a pecuniary advantage through an increase of assets (net worth) because he can use the capital made available to him at a lower interest rate than the market rate (or without paying interest).

In the case of low-interest loans, the relevant interest difference to be used as the tax basis is the difference between the agreed interest rate and the interest rate resulting from Section 15 (1) VA. Through the wording of the second half of the sentence in § 15 (1) VA “*if no other value has been established*” the legislator conveyed that in general the fair market value of 5.5 % is to be assumed but that another value might be as well be used if appropriately established. Such was the situation in the case of dispute.

Source:

Supreme Tax Court, decision of 31 July 2024 (II R 20/22) – published on 28 November 2024.

Keywords

loan interest, low interest