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Compensation payment for premature termination of interest swap not deductible from rental income

The Supreme Tax Court held that the compensation payment for the early abandonment of an interest rate swap is to be taxed as a separate item, rather than as part of the results of the main transaction.

Background

The question before the Supreme Tax Court was whether a compensation payment that the plaintiff had to make due to the premature termination of an interest rate swap is to be considered as income-related expense for the year 2017 (year in dispute). The acquisition of the rental property was financed by a bank loan. The plaintiff later restructured the loan arrangement with the lender. The contractual payment date was 30 November 2014. The variable interest rate was based on the 1-month Euribor. **In addition, the plaintiff and the creditor concluded an interest rate swap agreement on 28 January 2010 running from 28 November 2014 to 29 November 2024.**

The Düsseldorf Tax Court had granted the appeal but the Supreme Tax Court had a different opinion and sided with the arguments brought by the tax office.

The interest on the restructuring loan is deductible as income-related expenses for rental and leasing income. However, if the taxpayer terminates an interest rate swap that he concluded in connection with the financing of a rented property to limit the risk of interest rate changes, the compensation payments made as a result of the termination is no longer linked to the rental of the property and the income therefrom.

The compensation payment was largely caused by the taxpayer's decision to terminate the interest rate swap. The original inclusion of the interest rate swap in the financing of the acquisition costs of the rented property was not sufficiently connected from an economic point of view with the rental income.

With this most recent decision the Supreme Tax Court confirmed its previous case law, especially the judgment IX R 13/14 of 13 January 2015 where it decided that the gain from the early abandonment of a hedge is to be taxed as a separate item, rather than as part of the results of the main transaction. **The business had hedged its interest rate risks with a series of interest swaps. With view of the market situation the management concluded that the hedges were no longer necessary. It thus took advantage of early break clauses in the contracts to wind up the hedged transactions. The Supreme Tax Court held that the gains from the release of the hedges are to be taxed as short-term gains from speculation. They were achieved from the sale of the asset – the claim to an interest swap – and were thus not, or no longer, linked to the property or the rental income. This applied even if one took the view that the hedge had been made for the sole purpose of protecting the income from the property. Winding up the hedge destroyed the link to its original purpose and thus to the rental income.**

Source:

Supreme Tax Court, judgment of 19 November 2024 (VIII R 26/21) – published on 16 January 2025.

Keywords

compensation payment, interest swap