Downloaded from Blogs on 23.11.2026 05:00

By PwC Deutschland | 20 February 2026

Arm's length interest on direct pension commitment through deferred compensation

When testing the arm's length nature of the interest rate on a direct pension commitment financed through deferred compensation in favor of a shareholder-employee, the interest rate agreed for the similar pension promise in favor of an employee who is not a shareholder and who is employed in the same company is not a suitable yardstick, the Supreme Tax Court said in a most recently published decision.

Downloaded from Blogs on 23.11.2026 05:00

Background

The case in dispute concerned the question whether an agreed interest rate of 6% on direct pension commitments which were financed by deferred compensation could be qualified as a hidden distribution of profits.

The plaintiff is a limited liability company (GmbH) engaged in the construction and development of machines and machine components. In 2013 and 2014 (the years in dispute), the shareholders were M, with a 60% interest, and his son S, born in 1978, with 40%. S was also the managing director of the plaintiff; he had a contractually agreed right of veto against all decisions made by M.

The promised company pensions were to be financed in such a way that the shareholders would waive part of their wages (vacation and Christmas bonuses) in favor of the pensions (deferred compensation). The limited liability company had undertaken to pay interest of 6% per annum on the capital stock thus accumulated. In contrast, an employee who was not a shareholder received only 3% interest per annum on his employer-financed pension commitment.

The tax office therefore considered the interest rate granted to the shareholder-employees to be excessive and treated the provisions for future pensions accrued by the limited liability company as hidden profit distributions insofar as the interest rate exceeded 3% per annum.

Decision

The Supreme Tax Court did not necessarily agree with this. Admittedly, a pension commitment based on deferred compensation in which the capital stock is to be remunerated by the employer at a rate exceeding the low-risk market interest rate is no longer financed exclusively by the employee. However, even “mixed financed” pension commitments of this kind are generally recognized for tax purposes if the appropriations granted to the employees are reasonable. In addition to pension entitlements, such total appropriations (emoluments) also include monthly wages and other employer benefits, such as the provision of a company car for private use.

If, in the case of a direct pension commitment based on deferred compensation, the employer assumes a significant risk of having to co-finance future pension entitlements by agreeing to pay interest on the capital stock that exceeds the low-risk market interest rate, the commitment is financed by the employer in this respect. A hidden distribution of profits cannot be inferred from this circumstance alone.

The Supreme Tax Court therefore referred the matter back to the lower tax court. Based on the findings of fact established there so far, it is not possible to conclusively assess the extent to which the allocations to the pension provisions in question are to be regarded as hidden distributions. Although the lower tax court correctly assumed that the agreement on a 6% interest rate for the interest on the deferred remuneration amounts does not in

Downloaded from Blogs on 23.11.2026 05:00

itself constitute a hidden distribution of profits, the factual findings regarding the adequacy of the total appropriations provided to the employees are not sufficient to finally decide whether this is in line with arm's length principles.

Source:

Supreme Tax Court, decision of 17 December 2025 (I R 4/23), published on 19 February 2026.

Keywords

pension promises, pension provision