

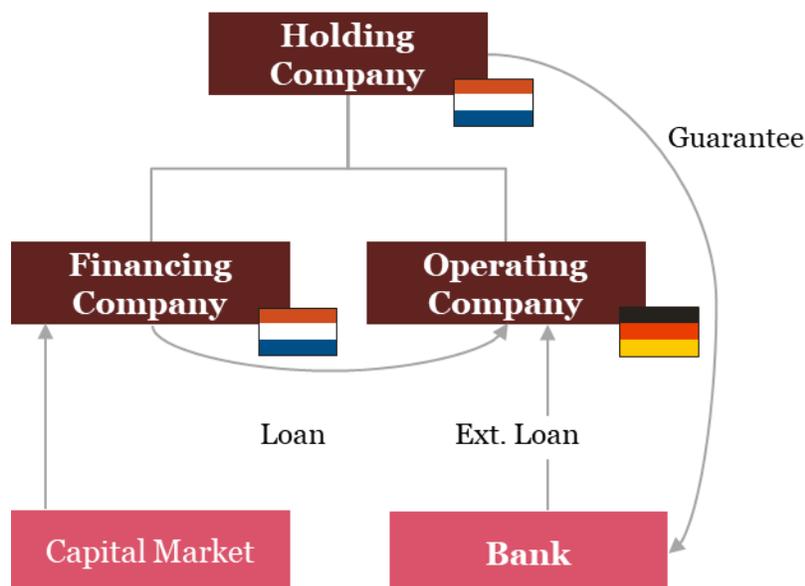
TP Perspectives – Newsflash

Dear Reader,

In its ruling of 18 May 2021 (Case I R 4/17), which was published on 21 October 2021, the German Fiscal Court (“Bundesfinanzhof” or “BFH”) issued a landmark ruling on pricing of financial transactions and thus overturned the highly controversial ruling of the Münster Fiscal Court of 7 December 2016 (13 K 4037/13 K,F; hereinafter: “FG Münster”) and referred it back to the Münster Fiscal Court for a different hearing and decision.¹ At the same time, the BFH provides very fundamental guidance on the analysis of the appropriateness of transfer prices for intra-group loan transactions which would need to be considered by FG Münster. In the following, we summarize the ruling and address the far-reaching implications from a practical perspective.

Factual background

A Dutch financing company (hereinafter: “FinCo”) provided continuously since 1997 unsecured loans to its Germany-based operating sister company (hereinafter: “OpCo”). The interest rates on these loans ranged from 4.375% to 6.45%. To finance the loans, FinCo borrowed on the capital market and used equity (about 1/3 of the balance sheet total; see illustration). The interest rates of FinCo's bank loans were between 2.6% and 4.1%.



For the determination of the interest rate on the related party loans, the taxpayer applied the external Comparable Uncontrolled Price (“CUP”) Method. In applying the CUP method, a rating tool from

¹ Accessible under: <https://www.bundesfinanzhof.de/de/entscheidung/entscheidungen-online/detail/STRE202110196/>



Standard&Poors was used to determine the creditworthiness of the OpCo as "BB". The transfer pricing documentation supported the intra-group pricing.

Position of the local tax office

The local tax office came to the conclusion that the interest expense booked by OpCo was excessive and should therefore be partially treated as hidden profit distributions (*verdeckte Gewinnausschüttung*) to the parent of OpCo and FinCo.

In particular, the tax office took the view that the CUP method was not applicable; instead, the cost plus method should be applied. The tax office took into account the actual refinancing costs and estimated the cost of equity of FinCo by assuming a return on equity of 70% of the interest rate of the refinancing costs.

Ruling of FG Münster

The Münster Fiscal Court partially upheld the position of the local tax office. It first pointed out that the three recognized transfer pricing methods for determining arm's length prices (CUP method, resale price method and cost plus method) were of equal importance. However, in the case at hand, the Court - following the tax office - rejected the CUP method for the following reasons:

- There was no internal CUP because the joint parent company had guaranteed the loan that OpCo had taken out with an external bank.
- An external CUP is not applicable for the following reasons:
 - o FinCo was not comparable to an external lender because it did not operate in the market.
 - o The credit rating of OpCo was not comprehensible because the algorithms used to determine the rating were secret and therefore could not be reviewed by the Court.
 - o The average creditworthiness of the entire group and not the creditworthiness of OpCo ("stand alone" rating) could be considered in determining interest rates.

As a result, the cost plus method was chosen as the most appropriate method to determine arm's length interest rates.

In addition, the Court recognized that the transfer pricing documentation and other material provided by the taxpayer were not sufficient, as OpCo was not in a position to disclose FinCo's refinancing costs. Technically, this entitled the Court to make an estimate within the meaning of section 162 (2) sentence 1 of the General Fiscal Code.

However, the Court considered the tax office's estimates to be clearly excessive and replaced them with its own estimate as follows:

1. First, it calculated the costs of FinCo according to the ratio of its own interest expenses to its interest income. For this purpose, the values from the profit and loss accounts of FinCo were used.
2. In a second step, the Court estimated the costs of equity capital by calculating the equity capital ratio as the difference between 100% and the debt capital ratio and applying a factor of 150%.
3. Finally, personnel and other costs of FinCo were considered plus a profit mark-up.



BFH strengthens the use of the CUP method

The BFH overturns the ruling of FG Münster and refers it back to it, in some cases with significant criticism. The reasons for the judgement contain numerous, very important findings on the determination of interest rates for intra-group loans. Among other things, the BFH states:

- The application of the CUP method has priority over the application of the cost plus method. This is firstly because the OECD considers the CUP method to be the most direct method for conducting a transfer pricing analysis. In addition, the CUP method is also reliably applicable in relation to financing transactions, as a lot of market data is available.
- The Court must examine whether the internal CUP method could even be used in the facts of the case. Accordingly, it must be examined whether the external bank loan, which is secured by the parent company, could not be made comparable with the unsecured intra-group transaction by making appropriate adjustments.
- If the internal CUP method is not applicable, the applicability of the external CUP method must be examined. Contrary to the view of FG Münster, banks and especially corporate bonds are not fundamentally unsuitable as an external CUP simply because an internal financing company does not have the same structures as a commercial bank. Corporate bonds in particular are targeted at a broad spectrum of lenders.
- In principle, the stand-alone rating of the borrower is relevant; this rating may be improved in case following a case by case analysis of whether the borrower is expected to enjoy material benefits due to its association with the group (consistently with German administrative principles issued in July 2021). Contrary to the view of the local tax office and the Court, the group rating is not decisive.
- The fact that the algorithms of the rating tool are secret does not prevent the use of such ratings if they are a basis for the assessment of creditworthiness recognized by market practice.
- Limited or even lack of substance at the level of the lender in itself cannot lead to the interest rate being challenged. This could otherwise lead to the contradictory result that a loan would be priced differently than an otherwise comparable loan only because the lenders have different substance.

The BFH does not even deal with the estimate of the interest rates for the loan made by the Tax Court, because it considers the cost plus method to be inappropriate per se and also identifies serious technical weaknesses in its application. If the Tax Court maintains its opinion that the cost plus method is the most suitable transfer pricing method, the BFH recommends that the Tax Court consults an expert to calculate the exact amount of interest.

Impact and relevance

The BFH ruling is a very positive development for various reasons:

- The determination of arm's length interest rates according to the CUP method is common practice internationally and has also been common practice in Germany for many years. In Germany, this approach is however frequently challenged by tax auditors, precisely by looking at the financing costs of the lender. The ruling therefore provides certainty that it is not the financing costs and the capital resources of the lender that are important, but only the creditworthiness of the borrower.
- In addition, the BFH states clearly that only the individual rating of the borrower matters and not the average creditworthiness of the group. This is extremely relevant in practice, since the tax authorities frequently refer to the group rating in tax audits and want to base the interest rate



determination on external refinancing costs that apply to the entire group. The BFH's position on the importance of the stand-alone rating is further in line with the OECD guidelines. At the same time, the BFH is open to the view, also advocated by the OECD, that in addition to the individual rating, implicit advantages resulting from pure group membership and which would also be priced in by third parties should also be taken into account when determining arm's length interest rates.

- The BFH also appears to be generally open-minded with regard to the OECD's new concept of risk control, which places certain requirements on the substance of the lender. However, it clearly states that the question of the substance of a FinCo is to be clarified at the level of the financing company or, at best, in the relationship of a superior group company of the FinCo supporting or guaranteeing the FinCo and, in any case, not at the level of the borrower. The administrative opinion in no. 3.92 of the Administrative Principles Transfer Pricing 2021, which limits the interest rate on a loan from an insubstantial lender to a risk-free return, is in clear contradiction to the ruling because it starts at the wrong level and should therefore not be tenable.

The BFH decision on another intra-group financing case is expected shortly. This case also deals with the selection of a transfer pricing method as well as with the question of whether a subordination of an intercompany loan which also results from the German Insolvency Code should be considered for transfer pricing purposes.