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German Tax and Legal News

BFH changes view on domestic transfer pricing adjustments in tax treaty cases

Tax deduction disallowed for write-off of unsecured intercompany loan.

Three recently published decisions dated 27 February 2019 (I R 73/16, I R 51/17 and I R 81/17) indicate that the German federal tax court (BFH) has changed its view on the application of the transfer pricing rules in relation to the write-off of intercompany receivables in certain cases involving an applicable tax treaty. The court disallowed an income tax deduction for the write-off of the receivable for an unsecured loan in the one case where it issued a final decision, changing its prior view. The BFH's new position broadens the circumstances in which transfer pricing adjustments may be made where there is a deviation from the arm's length principle.

In past decisions involving situations where there is an applicable German tax treaty that contains a provision equivalent to the associated enterprises article (article 9) in the OECD model tax treaty, the BFH had ruled that, under article 9(1), the application of the transfer pricing rules was limited to the determination of the interest rate on intercompany loans. However, the February 2019 decisions indicate a new interpretation by the BFH that the scope of transfer pricing now also comprises losses from the impairment or waiver of receivables. At the same time, the BFH no longer assumes that, in a multinational enterprise group, group support (or the "halo effect") replaces the provision of collateral. Rather, the lack of collateral in an intragroup financing arrangement is a strong indicator of conditions that are not at arm's length.

In the three cases, German multinationals incurred losses from foreign receivables on current accounts for deliveries, loans or a guarantee arrangement, in cases where there was an applicable German tax treaty with a provision equivalent to article 9 of the OECD model. The BFH ruled that in all three cases it would be possible to apply the transfer pricing rules to disallow a tax deduction for the loss, but issued a final decision in only one case and reverted the other two cases back to the lower level court for further review of the facts. The relevant facts for these purposes comprised when a third party would ask for collateral on an increasing balance of a current account, if the collateral actually provided in one case was sufficient and whether a 50% ownership interest is a sufficient indication of third party behavior.

On the issue of the delineation between debt and equity, the court ruled that a lack of collateral (or any other deviation from the arm's length principle) does not, in and of itself, allow for the automatic conclusion that debt should be recharacterized as equity. Rather, it should be reviewed from an overall perspective whether the parties were expecting a permanent transfer of funds or a provision of capital over time. While collateral is a strong indicator of the latter, under other circumstances, positive income-related expectations of the borrower also can serve as evidence for the assumption that a debt arrangement exists. Overall, however, the court's decision seems to increase the risk of recharacterization of debt to equity.

In a May 2018 decision (C-382/16), the Court of Justice of the European Union (CJEU) decided that a deviation from the arm's length principle could be justified where the lender had a superior interest in supporting its own interests as a shareholder, and came to the conclusion that a guarantee does not require remuneration if it is required to allow for the operation of subsidiaries. The BFH considered the CJEU decision, but took a rather narrow interpretation of the decision and did not apply its principles to the cases at hand, as these were not as extreme in their fact patterns.

The BFH did not explicitly rule on the determination of interest rates for intercompany loans, but it would seem reasonable to conclude that future decisions will develop as follows: First, in

outbound cases, it cannot be assumed that group support replaces collateral, so determining interest rates under the assumption that all entities have the same rating as the group could become critical. Second, in inbound cases, a lack of collateral could be seen as a deviation from the arm’s length principle and, hence, sufficiently high interest rates based on this consideration also could become critical.

The February 2019 BFH decisions seem to follow a legalistic, schematic view. Under this view, in principle, loans should be sufficiently collateralized (so that it is unlikely that a loss of the principal receivable may occur), and it is likely that principles for the determination of an appropriate interest rate will follow along these lines in the future.

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