


URL: <http://mobile.deloitte-tax-news.de/german-tax-legal-news/germany-s-taxing-rights-based-on-section-11-ftp-can-be-restricted-under-associated-enterprises-article-in-tax-treaty.html>

 23.03.2015

German Tax and Legal News

Germany's taxing rights based on section 1(1) FTC can be restricted under associated enterprises article in tax treaty

The BFH has confirmed that Germany's tax treaties can limit Germany's taxation rights if a treaty contains a provision equivalent to the associated enterprises article in the OECD model treaty and if the prices paid between the entities involved are on arm's length terms.

In a decision dated December 17, 2014, the Federal Tax Court (BFH) confirmed that Germany's tax treaties can limit Germany's taxing rights based on section 1(1) of the Foreign Tax Code (FTC) if the treaty contains a provision equivalent to the associated enterprises article (article 9) in the OECD model treaty and if the prices paid between the entities involved are at arm's length.

Facts of the case

The case involved a German enterprise I-GmbH that made several unsecured loans to its wholly owned affiliate H-Inc., a US company operating at a loss, during the period 2004-2007. The loan bore an interest rate of 5% per annum. Due to the loss situation of H-Inc., I-GmbH depreciated the loan receivable to current value based on the applicable German tax rules, resulting in a reduction of its taxable income (H-Inc.'s financial statements contained a note to the effect that I-GmbH as parent-company intended to continue to support H-Inc. in the future).

During a tax audit of I-GmbH, the German tax authorities accepted the depreciation to current value, but took the position that the depreciation was triggered by the fact that I-GmbH had granted an unsecured loan to H-Inc. According to the tax authorities, third parties would not have agreed on a loan without any collateral, so the terms and conditions agreed upon by I-GmbH and H-Inc. were not at arm's length. The tax authorities adjusted I-GmbH's taxable income based on section 1(1) of FTC upward (in an amount equal to the depreciation claimed). The version of section 1(1) that applied at the time read as follows: "If a taxpayer's income from business dealings with a foreign related party is reduced because the taxpayer's foundation for the determination of its income is based on conditions other than those that would have been agreed upon between unrelated parties under the same or similar circumstances, then, notwithstanding other provisions, the taxpayer's income shall be determined as if it would have accrued under conditions made between unrelated parties."

Court decisions

The taxpayer appealed the decision of the tax authorities to the first instance court, but that court agreed with the German tax authorities. The taxpayer appealed the first instance court decision and the case was referred to the BFH.

The BFH held, however, that the arm's length standard contained in the Germany-US tax treaty (which is equivalent to the language in article 9(1) of the OECD model treaty) prevailed over the rules in section 1(1) FTC. According to the BFH, the "dealing at arm's length principle" as set out in the OECD model treaty allows for an adjustment of taxable income only if a transfer price is not an arm's length amount (the interest rate in the case at hand). The court further held that an income adjustment cannot be based on the fact that the terms and conditions agreed upon between the related parties on the unsecured loans were not at arm's length, unless these conditions affected the amount of the transfer price (the interest rate charged).

The court also clarified that the "dealing at arm's length principle" is not a self-executing principle, but provides the "framework" and the conditions for adjustments of taxable income and, as such, limits national taxing rights that go beyond the rights allocated in article 9(1) of the Germany-US treaty.

While the term, "conditions agreed on" in the OECD model includes all factors that could be subject to an economic and financial relationship (i.e. the price charged, as well as other business terms and conditions), these conditions should be taken into account only if they

affect the amount of the transfer price charged.

In light of the above, the BFH concluded that the disallowance of the depreciation of the loan receivable to its current value because the underlying loan had been granted without collateral was not in accordance with the arm's length standard under the Germany-US treaty, which limits Germany's taxing rights in this regard.

Notwithstanding the above, the BFH pointed out that the lack of collateral could be a factor that affects the amount the transfer price. However, for the analysis of whether the interest rate charged by I-GmbH complied with the arm's lengths principle measured against the lack of collateral, potential parental support should be taken into account, because this qualifies as collateral in kind.

Since the first instance court had not fully analyzed the appropriateness of the interest rate applied to the loan, the BFH remanded the case to the court to further examine the facts and circumstances.

www.deloitte-tax-news.de

Diese Mandanteninformation enthält ausschließlich allgemeine Informationen, die nicht geeignet sind, den besonderen Umständen eines Einzelfalles gerecht zu werden. Sie hat nicht den Sinn, Grundlage für wirtschaftliche oder sonstige Entscheidungen jedweder Art zu sein. Sie stellt keine Beratung, Auskunft oder ein rechtsverbindliches Angebot dar und ist auch nicht geeignet, eine persönliche Beratung zu ersetzen. Sollte jemand Entscheidungen jedweder Art auf Inhalte dieser Mandanteninformation oder Teile davon stützen, handelt dieser ausschließlich auf eigenes Risiko. Deloitte GmbH übernimmt keinerlei Garantie oder Gewährleistung noch haftet sie in irgendeiner anderen Weise für den Inhalt dieser Mandanteninformation. Aus diesem Grunde empfehlen wir stets, eine persönliche Beratung einzuholen.

This client information exclusively contains general information not suitable for addressing the particular circumstances of any individual case. Its purpose is not to be used as a basis for commercial decisions or decisions of any other kind. This client information does neither constitute any advice nor any legally binding information or offer and shall not be deemed suitable for substituting personal advice under any circumstances. Should you base decisions of any kind on the contents of this client information or extracts therefrom, you act solely at your own risk. Deloitte GmbH will not assume any guarantee nor warranty and will not be liable in any other form for the content of this client information. Therefore, we always recommend to obtain personal advice.