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German Tax and Legal News

Federal fiscal court rules on arrangement fees within the meaning of the interest deduction limitation rules

Federal fiscal court rules that arrangement fees are not interest expense within the meaning of the German interest deduction limitation rules

In a decision dated 22 March 2023 (and published on 20 July 2023), Germany's federal fiscal court (BFH) ruled against the tax authorities and in favor of taxpayers that "arrangement fees" that are paid to lenders do not qualify as interest expense under the interest deduction limitation rules.

Background
The interest deduction limitation rules generally limit the deductibility of annual net interest expense to 30% of the EBITDA of a company. The definition of what qualifies as interest expense under the interest deduction limitation rules has been part of controversial discussions between taxpayers and the tax authorities. One such example are arrangement fees, which are often seen in loan arrangements where there is not only one lender but rather a syndicate of lenders. Typically, one lender (usually a bank) in the syndicate will take the lead and interact with the borrower. Commonly, such services, e.g., helping with the selection of potential lenders, monitoring timelines, organizing the syndication process, are provided and remunerated by a fee.

In a case decided by the BFH, a German GmbH paid an external bank an arrangement fee for the loan syndication to multiple banks in an effort to raise capital. In line with current administrative guidance, the tax authorities were of the opinion that fees that are of compensatory nature (e.g., arrangement fees) are classified as interest expense within the meaning of the interest deduction limitation rules. The taxpayer was of the opinion that a less strict interpretation of what qualifies as interest expense must be applied and that services provided in return for the arrangement fee are services that are not closely related to interest and go beyond what qualifies as payment for the provision of capital. Therefore, the taxpayer argued that the arrangement fee does not qualify as interest expense in terms of the interest deduction limitation rules.

Federal fiscal court decision
The BFH ruled in favor of the taxpayer and against the tax authorities and concluded that interest expense for purposes of the interest deduction limitation rules does not cover a service fee that goes beyond the mere granting of capital. The decision was in line with the decision of the lower tax court and against the appeal of the tax authorities.

According to the interest deduction limitation rules, interest expense is defined as remuneration for the provision of capital. The BFH used this literal interpretation of the law to argue that interest expense in terms of the interest deduction limitation rules can only be fees, interest, or other remuneration directly linked to the provision of capital. The description of the remuneration as interest or fees should be irrelevant. According to the BFH, a fee, interest, or other remuneration for the granting of capital usually is based on the amount of borrowed capital and length of the borrowing term.

In the case, the arrangement fee was not based on the actual capital that was withdrawn by the borrower but rather a percentage of the maximum borrowing amount and was designed as a one-time payment, which was not refundable but had to be paid only if the loan arrangement was successfully concluded. The arrangement fee was to be paid for the coordination activities of the syndicate leader for the conclusion of the loan agreement including, e.g., developing the financing concept, preparing an information memorandum, and organizing and documenting the signing.

Based on the above fact pattern, the BFH had no objection to the interpretation of the lower tax court that the arrangement fee was not remuneration paid for the granting of the capital itself and therefore concluded that the interest deduction limitation rules were not limiting the deductibility of the arrangement fee.

Comments

The decision of the BFH is a welcome clarification of what qualifies as interest expense in terms of the interest deduction limitation rules. It is particularly relevant, as the decision confirms the arguments provided in tax literature and refuses an extensive definition of interest expense as provided in the administrative guidance from the tax authorities. Arrangement fees often are seen in practice, e.g., in acquisition financing or refinancing activites and have, therefore, high practical relevance, as they can be significant. The decision also should be applicable for other remuneration that goes beyond the provision of capital, as long as sufficient documentation can be provided to demonstrate the underlying services. Ideally, the remuneration in such a scenario should not be based on the amount of the borrowed capital and the length of the borrowing term, as this might indicate that the remuneration is more linked to the provision of capital. If arrangement fees have been paid in the past that were not deductible due to the tax authorities' opinion and the assessment period is still open for an appeal, an appeal should be considered.

Even if the decision of the BFH is a win from a taxpayer's perspective it should be noted that, based on a recent draft law proposal (see GTLN dated 07/14/23) from the Ministry of Finance ("Growth Opportunity Act"), the definition of interest expense for purposes of the interest deduction limitation rule will be significantly broadened. According to the draft law, interest expense in terms of the amended interest deduction limitation rules also would include "economic equivalent expenses" and "other expenses incurred in connection with the raising of finance." Based on the explanation provided by the Ministry of Finance, the expanded definition is required in order to bring the German interest deduction limitation rules in line with article 2 of the EU Anti-Tax Avoidance Directive (ATAD 1). The EU directive explicitly mentions arrangement fees and similar costs related to the borrowing of funds and includes them into the definition of borrowing costs for purposes of the interest deduction limitation rules. Based on Germany's obligation to have its interest deduction limitation rules in line with the requirements of the EU directive, the favorable decision of the BFH likely no longer provides relief on a going forward basis after the implementation of the proposed law changes.