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German Tax and Legal News

Lower tax court denies deemed dividend treatment on related party loan

The lower tax court of Baden Wuerttemberg has denied deemed dividend treatment as a result of a write-off of a loan receivable in a related party situation.

In a decision dated 9 September 2014 (6 K 3313/12), the lower tax court of Baden-Wuerttemberg ruled that a write-off of an arm's length loan note against a related party where the debtor declared bankruptcy will not result in a deemed dividend.

The case involved a German limited liability company (GmbH) that granted a loan to a relative of the GmbH's sole shareholder and managing director. The loan was to be repaid in monthly installments. Only 25% of the amount of the loan was secured by collateral provided by the debtor. Because of the low collateral percentage, the interest rate on the loan note was relatively high and was in line with third-party interest rates in comparable situations. After the first 18 installment payments, the debtor went into bankruptcy. The GmbH liquidated the collateral and wrote off the remaining balance of the loan note and claimed the amount of the write-off as a tax deductible expense.

The tax authorities disallowed a deduction for the amount of the write-off on the grounds that a prudent and diligent business manager would not have granted a loan to an unrelated party based on such low collateral – a creditor would have required significantly more collateral in a third-party situation. As a result, the issuance of the loan note was based on the close relationship between the debtor and creditor and the write-off qualified as a deemed dividend.

The lower tax court held in favor of the taxpayer who had argued that, as a result of the small percentage of collateral, a higher interest rate was agreed on to cover risk. The interest rate was an arm's length rate. The tax court also stated that collateral of 25% of the loan note is not unusual and generally would not violate the duties of a prudent and diligent business manager.

The lower tax court decision is a welcome clarification of the circumstances in which the write-off of loan notes between related parties can be recognized for tax purposes.

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