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German Tax and Legal News

Tax auditors instructed not to apply recent BFH decisions on impaired intercompany loans in similar circumstances

The Ministry of Finance has published a notice instructing tax auditors not to apply recent decisions, in which the BFH held that article 9 of the OECD model tax treaty overrides the interpretation of the arm's length principle under German domestic tax law.

On 30 March 2016, the German Ministry of Finance (MOF) published a notice on the Federal Tax Court (BFH) decisions dated 17 December 2014 (I R 23/13) and 24 June 2015 (I R 29/14) regarding the treatment of impaired intercompany loans, stating that tax auditors should not apply the principles in these decisions in similar circumstances.

Both of the cases concerned the issue of whether the impairment on an intercompany loan granted by a shareholder to its subsidiary may be adjusted according to the domestic interpretation of the arm's length principle in section 1 of the Foreign Tax Code in a case where the loan is not collateralized, on the basis that the potential support from group members cannot be considered. In both cases, the BFH rejected the income adjustment by the tax auditors that would have disallowed the write-down due to the impairment of the loans.

To understand the decisions in the cases, it is important to note that the BFH considers there to be a difference between the German domestic implementation of the arm's length principle in section 1 of the Foreign Tax Code and the interpretation of the arm's length principle and the relevant adjustment mechanisms in article 9 of the OECD model tax treaty, which is relevant in cases where an applicable German tax treaty includes a clause corresponding to article 9 of the OECD model.

In both cases, the BFH held that the wording of article 9 of the OECD model treaty — in contrast to the wording included in Germany's domestic tax law — allows the tax authorities to adjust prices, but not the other terms and conditions of a controlled transaction. The BFH opined that under article 9, the terms and conditions of a transaction may be considered only with respect to their impact on the transfer price. The BFH held that because article 9 overrides domestic tax law, an adjustment with respect to a controlled transaction's terms and conditions based on section 1 of the Foreign Tax Code is not permitted.

Position of the MOF
The MOF provided the following reasons for instructing auditors not to apply the principles of the BFH decisions:

- Article 9 of the OECD model treaty does not allow only an adjustment of the actual transfer prices of controlled transactions; because the terms and conditions of a controlled transaction may influence the assessment of whether a taxpayer's profit is in line with the arm's length principle, in addition to the actual transfer price, adjustments of the terms and conditions (e.g. whether a loan is collateralized) may be permitted. According to the MOF, there should be no difference in the application of the arm's length principle according to German domestic tax law and the application of the principle under article 9 of OECD model treaty. Such a difference would not have been intended by the German legislature — the difference has been created by the interpretations of the BFH.
- A limitation permitting adjustments to affect only the actual transfer prices of controlled transactions would, in some cases, not allow a result in line with the arm's length principle to be reached. Such a restriction would contravene the purpose of article 9 OECD model treaty.
- Tax treaties require an implementing law to enter into force and, therefore, become "plain national law." Because the provisions of section 1 of the Foreign Tax Code override potentially contradictory provisions of domestic law, the BFH should have ruled that section 1 would override article 9 of the OECD model treaty in the case of a conflict, i.e. section 1 should serve as a treaty override.

No effect on case relating to hidden profit distribution
It is important to note that the MOF notice does not refer to the BFH decision dated 11 October 2012 (I R 75/11), which was referenced by both BFH decisions that are subject to the notice.

In the case that was the subject of the 2012 BFH decision, the tax auditors assessed a hidden profit distribution under the provisions of section 8(3) of Corporate Income Tax Code (rather than making an adjustment based on section 1 of the Foreign Tax Code) on the basis that certain formal requirements were not met, since the contracting (related) parties concluded a legally binding agreement before entering into the transaction. The BFH held that article 9 of OECD mode treaty blocked the relevant income adjustments because it overrode the formal requirements under domestic tax law regarding controlled transactions.

Implications
The MOF notice can be expected to have a significant impact on taxpayers, and its issuance may be linked to recent OECD base erosion and profit shifting (BEPS) publications on the issue of “substance over form” and the Australian Chevron case that involved the same issue. Accordingly, German tax auditors may be encouraged to question business decisions and agreements with respect to controlled transactions (e.g. the currency denomination of an intercompany loan, which was at issue in Chevron), as well as the “bigger picture” of the various controlled transactions entered into by a taxpayer (e.g. granting and receiving related party loans).

Based on the notice, the administrative principles on the application of section 1 of the Foreign Tax Code on the impairment of loans, issued by the MOF on 29 March 2011, are likely to be applied in tax audits going forward. This means that the type of income adjustments that led to the BFH decisions in question are likely to resume. Unfortunately, it remains to be seen how the conflict between the MOF and the BFH will be resolved; there could be another BFH decision explicitly overruling the MOF position or an amendment/clarification of applicable domestic tax laws.

For controlled transactions to be respected, taxpayers should ensure that controlled transactions do not “merely” include an arm’s length price and that the overall terms and conditions of the transactions and certain related business decisions can be considered as being at arm’s length. Intercompany agreements should be drafted carefully with respect to such terms and conditions, to reduce the risk of income adjustments and potential double taxation. Examples of potentially significant terms and conditions include the currency denomination for a delivery of goods or an intercompany loan (and the allocation of the respective risks), and the implementation and execution of “year-end adjustments” (and whether a third party would have accepted an unfavorable price adjustment without an enforceable contractual basis).