

Real Estate Tax Services News

Keeping you informed

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New Federal Fiscal Court rulings relevant to transfer pricing on intercompany loans

In brief

In October and November 2021, the German Federal Fiscal Court published three rulings on court cases which impact transfer pricing and the real estate industry. These rulings concerned previously highly controversial lower court cases. The Federal Fiscal Court provides fundamental guidance for assessing the appropriate transfer prices for intercompany loan transactions and has strengthened the arm's length principle based on internationally accepted OECD Guidelines.

However, the German "2021 Administrative Principles" recently issued by the German Federal Ministry of Finance and presented in our July NewsAlert are clearly not in line with these verdicts outlined below, which will therefore be of high importance for pending tax audits.

In detail

Whilst the rulings by the lower courts were controversial, the new Federal Fiscal Court rulings are essentially in line with the current OECD Guidelines for financial transactions (Chapter X) and in general follow an economically rational position. The highlights of the different court cases are as follows:

Federal Fiscal Court ruling on the Münster Fiscal Court case

In this court case, a Dutch finance company (FinCo) had provided unsecured loans to its Germany-based operating sister company on an ongoing basis since 1997. The interest rates on these loans ranged from 4.375% to 6.45%. To finance the loans, FinCo borrowed on the capital market and used equity. The interest rates of FinCo's bank loans were between 2.6% and 4.1%.



To determine the interest rate on the related party loans, the taxpayer applied the external comparable uncontrolled price (CUP) method. In applying the CUP method, a rating tool from Standard & Poors determined the creditworthiness of the operating company as "BB". The transfer pricing documentation supported the intra-group pricing by using market data of corporate bonds from database studies.

The Münster Fiscal Court had ruled that neither the internal nor the external CUP methods were applicable. In the ruling, only the cost-plus method was chosen to be the appropriate method to determine arm's length interest rates. Furthermore, it was outlined by the Münster Fiscal Court that credit models are not suitable for determining the rate, because the rating model algorithms are not publicly available ("black box"), and that corporate bonds are unsuitable for determining the interest rate of intercompany loans.

The Federal Fiscal Court has now ruled as follows:

- 1) The application of the CUP method has priority over the application of the cost-plus method. This is firstly because the OECD considers the CUP method to be the most direct method for conducting a transfer pricing analysis. In addition, the CUP method can also be applied reliably to financing transactions, as a lot of market data is available.
- 2) The Court must examine whether using the internal CUP method is appropriate to the facts of the case. Accordingly, it must be examined whether the external bank loan, which is secured by the parent company, could be made comparable with the unsecured intercompany transaction by making appropriate adjustments.
- 3) If the internal CUP method is not applicable, the applicability of the external CUP method must be examined. Contrary to the view of the Münster Fiscal Court, banks and especially corporate bonds are not fundamentally unsuitable as an external CUP simply because an internal financing company does not have the same structures as a commercial bank. Corporate bonds in particular are targeted at a broad spectrum of lenders.
- 4) In principle, the starting point is the stand-alone rating of the borrower; this rating may be improved if the borrower is expected to enjoy material benefits due to its association with the group.
- 5) The fact that the algorithms of the rating tool are secret does not prevent the use of such ratings if they are recognised by market practice as a basis for the assessment of creditworthiness.
- 6) Limited or even lack of substance at the level of the lender cannot in itself lead to the interest rate being challenged. This could otherwise lead to the contradictory result that a loan would be priced differently than an otherwise comparable loan only because the lenders have different substance. This finding stands in clear contradiction to the "2021 Administrative Principles", which state that lenders, which have no or just a limited substance can only charge a risk-free interest rate.

Federal Fiscal Court ruling on the Cologne Fiscal Court case (1)

In this court decision, an unsecured intercompany loan was granted by a holding company (offshore) to a German GmbH with an interest rate of 8%. Alongside this loan, there were secured bank loans (with an average interest rate of 4.78%) that were granted to the German GmbH and another unsecured loan (with an interest rate of 10%) by a company (third party), which the German GmbH planned to acquire. All the funds were used for the acquisition.

The Cologne Fiscal Court had ruled that the interest rate for the intercompany loan should be based on the average interest rate of loans provided by the external banks, i.e. 4.78%, because intercompany loans always have to be subordinated according to German insolvency rights (Section 39(1) No 5 InsO) and cannot become more senior due to securities. Therefore, it was found that no adjustment calculations could be made for the fact that the intercompany loan was unsecured and subordinated in contrast to the loans by the external banks, which were secured.

The Federal Fiscal Court has now ruled the following:

- 1) Within the framework of the internal CUP method, from an arm's length perspective, the conditions of the loan (here: non-secured and subordinated) needed to be taken into account within the adjustment framework (i.e. as risk premium on the interest rate). The Cologne Fiscal Court did not take into account that the bank loan – in contrast to the intercompany loan – was a secured and senior loan. According to the "general principles of experience", a third party would not have granted an unsecured and subordinated loan at the same interest rate as (secured) loans by the external banks.
- 2) In relation to the adjustment calculations, the Federal Fiscal Court stated that the legal subordination of intercompany loans was irrelevant, as it is at the core of the arm's length principle to disregard the intercompany nature of the transaction.

Federal Fiscal Court ruling on the Cologne Fiscal Court case (2)

In this court decision, there was a German holding company, which had provided unsecured and subordinated intercompany loans to foreign entities in France and the USA. At some point in time, these intercompany loans and respective interest were written off by the German holding (taxpayer) with a profit reducing effect. The German authorities have not accepted these depreciations during the tax audit and have reversed the profit reducing effect of the write-off. Consequently, the taxpayer brought the case to the Cologne Fiscal Court.

The Cologne Fiscal Court had dismissed the lawsuit. Therefore, the taxpayer appealed to the Federal Fiscal Court.

The Federal Fiscal Court has now ruled as follows:

- 1) Whether an unsecured intercompany loan is in line with the arm's length principle in the context of an overall consideration of all the circumstances of the individual case depends on whether a third party (potentially taking into account risk margins in the interest rate) would have granted the loan under the same conditions. In this respect, not only banks but also other lenders can be considered as "third parties" if there is a market for the specific financing in which such lenders are active.
- 2) If third parties would grant unsecured loans, but the interest rate for an unsecured intercompany loan would be higher, then the tax adjustment is limited to the interest rate difference (secured vs. unsecured) and should not include the reversal of the write-off of the total loan amount.

Our view

These rulings are good news for taxpayers in the real estate sector. The Federal Fiscal Court has largely based its decisions on the current OECD Guidelines and has strengthened the international consistency of taxation. It has made clear that the comparable uncontrolled price method has priority over other methods, that the individual risk of the borrower is relevant for determining risk premiums and that the substance of the lender is not relevant in the choice of the transfer pricing method to determine an arm's length interest rate.

It remains to be seen how the German tax authorities will react to these rulings, since they are clearly inconsistent with the new German "2021 Administrative Principles" regarding transfer pricing, which specifically aim to restrict interest deductions in respect of loans from FinCos with low substance.

For further details of the German "2021 Administrative Principles", please see our *Real Estate Tax Services News* from July 2021.

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