New Guidelines from Ministry of Finance on Tax Treatment of Decrease in Value of Loans to Affiliated Companies

The Annual Tax Act 2008 brought new rules on the tax treatment of losses resulting from loans to affiliated companies. In response to two notable court rulings, the Ministry of Finance has now issued guidelines on the same subject, which primarily apply to fiscal years before the law itself was revised. This article discusses certain aspects of the new rules in greater detail, by means of several examples.

1. Introduction

With the Annual Tax Act 2008 the German legislature has introduced in Sec. 8b, Para. 3 of the Corporate Income Tax Act (Körperschaftsteuergesetz, KStG) new rules which stipulate that losses resulting from a decrease in value of loans granted to affiliated companies are tax deductible only if the taxpayer provides evidence that the granting of the loan, as well as the subsequent failure to reclaim the loan was in compliance with the arm’s length principle.\(^1\)

The new rules apply in all cases where the company suffering the loss holds, directly or indirectly, a participation of more than 25% in the company to which the loan is granted. Moreover, the new rules also apply if the loan is granted by an affiliated company of the shareholder or by a third party that can revert to the shareholder or to one of its affiliated persons. The rules therefore apply – at least if just the wording of the law is considered – to all loans that are granted between affiliated companies.

Sec. 8b, Para. 3 of the KStG as amended by the Annual Tax Act 2008 is applicable only to losses that accrued in tax periods ending after 1 January 2008. From the beginning, however, the German tax authorities held the view that the new rules were not of a constitutive character, as they allegedly only “clarified” the state of the law. Therefore, the new rules should also be applied retroactively. On 14 January 2009, the Federal Tax Court held that this view was not in compliance with the law, and consequently disallowed any retroactive application of the new rules to fiscal years ending before 1 January 2008.\(^2\) The tax authorities accepted this ruling, but stated at the same time that the conclusions drawn by the Court were applicable only in cases where the company receiving the loan is resident in Germany. In all other cases, the tax authorities assert that the same consequences as stated in Sec. 8b, Para. 3, sentences 4 through 7 of the KStG should also result from an application of the arm’s length principle, which is defined in Sec. 1 of the Foreign Tax Code (Außensteuergesetz, AStG). On 29 March 2011, the Federal Ministry of Finance (Ministry of Finance) published guidelines in which detailed guidance is given to taxpayers on how this approach is supposed to be applied by tax auditors.

This article will discuss certain aspects of the new rules in greater detail, by means of the following example:3

Example 1

On 1 January 2005, P AG provided a loan of EUR 1 million to S BV, its Dutch subsidiary that serves as the group’s distribution entity for the Dutch, Belgian and UK markets and performs its distribution functions generally autonomously. The loan yielded arm’s length interest and had an initial duration of 36 months. In 2006, S BV faced serious financial problems due to a default of one of its customers and a sharp economic decline in its local market. Therefore, in November 2006, the duration of the loan was extended for another 24 months. On 31 December 2007, P AG recorded an impairment of 70% of the loan. In 2011, a tax auditor questioned the tax deductibility of the impairment.

2. New Guidelines Issued by Ministry of Finance on 29 March 2011

The Ministry of Finance commences its Guidelines with the statement that while Sec. 8b, Para. 3, sentence 4 through 7 of the KStG as such may be applicable only for fiscal years ending after 1 January 2008, in cases of cross-border loans to affiliated companies Sec. 1 of the AStG and the arm’s length principle as stipulated in Art. 9 of the OECD Model Convention must be applied. Based on this, the Ministry of Finance concludes that all circumstances of lending to related parties (i.e. all conditions of the loan, and not only the interest paid) must be in compliance with the arm’s length principle. Within this conclusion, the Ministry of Finance specifically refers to the collateralization of intra-group loans.

In this context, the Guidelines distinguish between three different scenarios. In the first scenario, the intra-group loan is collateralized by actual securities and arm’s length interest, (determined based on a stand-alone rating of the debtor) is paid. In the second scenario, no actual collateral is agreed upon, but the additional risk of an unsecured loan is adequately reflected in higher interest (depend-

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1. Sec. 8b, Para. 3, sentences 4 through 7 KStG.
3. For a similar example see further Wolter (Jahrbuch der Fachanwälte für Steuerrecht (JbFStR) 2010/2011), at 813.
ing on the stand-alone rating of the related party). These two scenarios are considered to be unproblematic by the Guidelines.

The Guidelines then focus on a third scenario in which a loan is granted to a related party without actual securities or higher interest because of the fact that both parties belong to the same group of companies (Rückhalt im Konzern). For these cases, the Guidelines first refer to two rulings of the Federal Tax Court in which the Court stated that it must be regarded as compliant with the arm’s length principle if related parties do not demand any collateral in connection with the granting of a loan to an affiliated company, as the corporate relationship between them and the possibility to influence the debtor’s behaviour resulting from this relationship is sufficient to constitute, as such, an arm’s length collateral.4

For the third scenario, the Ministry of Finance infers from these two court decisions that under the following two conditions, it is possible to consider the corporate relationship between creditor and debtor as an arm’s length collateral when determining the interest rate:

- the loan is granted by a direct or indirect shareholder to a subsidiary, i.e. the creditor must have the possibility to exercise control over the debtor based on corporate law provisions; and
- the shareholder actually safeguards the subsidiary’s financial solvency or the subsidiary actually fulfils its obligations vis-à-vis third parties alone.

This conclusion of the tax authorities is of importance with regard to potential adjustments of interest payments to a German-based parent company. In the Guidelines the German Tax authorities for the first time explicitly accept that under certain circumstances interest rates below market interest rates are acceptable for non-secured intercompany loans. The corporate relationship in these cases obviously is considered as permissibly replacing arm’s length collaterals.

However, it remains unclear in which way exactly the corporate relationship can be accounted for when determining arm’s length interests in such a case. Under third-party circumstances, different forms of collateralization exist, which provide a different degree of security to the creditor, and therefore have a varying impact on the level of interest to be paid by the debtor. The Guidelines lack any indication on how the collateralization provided by the corporate relationship has to be evaluated when determining the intercompany interest rate applicable. The most obvious approach to assess such circumstances therefore might be to treat the collateralization provided by the corporate relationship as some form of guarantee or comfort letter and determine the value of the collateralization by considering the protection actually provided to a third party by a collateral agreement with the grantor. Practically this would mean assessing the value of the collateralization provided by considering the rating of the grantor of the collateralization, i.e. the company group in total, when determining the interest applicable.5

With regard to the tax deductibility of decreases in value or other losses resulting from such a loan, the Guidelines include the following assumption to be followed by tax auditors: An impairment of such a loan generally is not tax deductible, as long as the corporate relationship still exists and the subsidiary fulfils its obligations vis-à-vis third parties. The same explicitly applies to cancellations of such loans.

Only if the taxpayer provides evidence that the corporate relationship that secured the loan at the time the loan was granted, no longer serves as collateral at the time of the impairment, the impairment is tax deductible. The Guidelines specify three examples of such situations:
- the shareholder actually does not safeguard that the subsidiary fulfils its obligations vis-à-vis third parties;
- the shareholder does not safeguard the redemption of a loan that has been granted to the subsidiary by a third party without actual collateral, because the third party at the time the loan was granted was relying upon the collateralization provided by the corporate relationship between the subsidiary and its shareholder; and
- the financial situation of the shareholder or the whole group does evince to a third party that no financial support would be provided by the shareholder because of the corporate relationship.

If the taxpayer is able to show credibly that such circumstances existed, the impairment of the loan in principle is tax deductible. However, in these cases, according to the Guidelines, it must also be scrutinized by a tax auditor whether a prudent business manager at the time it became obvious that the loan no longer was secured by a corporate relationship, would have been able to claim collateralization of another kind. If such a possibility existed, the impairment of the loan is considered to be the result of a behaviour being not at arm’s length, and consequently the tax deduction of the impairment will be disallowed. The respective amount must be added to the taxable profits of the taxpayer under Sec. 1 of the AStG.

The Guidelines continue to discuss additional aspects and specific facts that must be considered when dealing with the impairment of a loan. The Ministry of Finance states that in cases where in addition to the loan, commercial transactions exist between the creditor and the debtor, the influence of this relationship on the loan must be examined. In such cases it is considered to be possible for the taxpayer to provide evidence that third parties would have accepted a partial or total default in order to maintain the commercial relationship with the debtor.

Moreover, the Guidelines discuss the application of the above-stated principles with regard to the impairment of trade receivables originating from a commercial relationship between the shareholder and its subsidiary. For these cases, it is stated that third parties generally consider a re-

tention of title as providing sufficient collateralization. If such collateralization is agreed upon, the tax deduction of an impairment of intra-group trade receivables is allowed. However, if the shareholder fails to claim and collect trade receivables at the due date, and if the commercial relationship is continued after the subsidiary has failed to settle such trade receivables, these trade receivables are deemed to constitute a loan. If, in addition, the shareholder does not claim additional collateralization for the overdue receivables, this “loan” is deemed to be secured only by corporate relationship. Subsequent impairments on such trade receivables must be corrected by application of Sec. 1 of the AStG if the taxpayer does not provide evidence that the corporate relationship which secured the loan at the time the loan was granted, no longer serves as collateral at the time of the impairment and that third parties would not have been able to claim collateralization of another kind after this became obvious. Alternatively, the taxpayer may provide evidence that third parties would have accepted a loss in order to uphold the commercial relationship.

Moreover, the Guidelines assume that third parties usually would end a commercial relationship if not at least the payment of new receivables has been safeguarded. Therefore, all future losses resulting from a commercial relationship that is continued without modification after such a default to settle receivables, are considered to be the result of a behaviour not being at arm’s length. Consequently, the tax deduction of all future losses resulting from such a relationship is disallowed.

In cases where an intra-group loan is not granted by a shareholder to its subsidiary, but among other related parties, in the Guidelines the Ministry of Finance denies that the corporate relationship between the parties to the contract can be regarded as constituting a kind of collateralization at all. If, therefore, no actual collateralizations are agreed upon and this fact is not adequately reflected in higher interest rates, the granting of the loan as such is considered to constitute behaviour that does not comply with the arm’s length principle.

In these cases a tax auditor is first supposed to determine an arm’s length interest rate for the non-secured loan based on a stand-alone rating of the receiving company. If it is possible to determine such an arm’s length interest rate, the interest income of the company granting the loan, if necessary, must be adjusted by application of Sec. 1 of the AStG. If subsequently such a loan becomes impaired, the impairment is tax deductible if the creditor under arm’s length conditions would not have been able to successfully claim additional collateralization after the loan was granted. If it is not possible to determine an adequate interest rate (as third parties would have refused to grant a loan at all), an impairment of such a loan is disallowed and must be corrected by application of Sec. 1 of the AStG.

3. Analysis of the Guidelines

3.1. Sec. 1 of the AStG and Art. 9 of the OECD Model Convention as legal basis to correct impairments on loans

Before commenting on the provisions of the Guidelines in detail, it is first necessary to consider whether Sec. 1 of the AStG provides any legal basis for profit adjustments to equalize losses resulting from the impairment of loans granted to affiliated companies at all. Sec. 1, Para. 1, sentence 1 of the AStG (in the version applicable before 2008) reads as follows:

If a taxpayer’s income from business dealings with a related person is reduced because the taxpayer agreed upon between unrelated parties under the same or similar circumstances, then, notwithstanding other provisions, his income shall be determined as if it would have accrued under conditions agreed between unrelated parties.7

The expression “conditions” in German literature always was understood as meaning only “prices” in this context.8 In reaction to this, the German legislature amended Sec. 1 of the AStG with the Business Tax Reform Act 2008, which since then reads as “conditions, especially prices”. The new wording again is declared to only “clarify” the state of the law before the amendment, and for this reason is regarded by the tax authorities as being applicable retroactively. This legal opinion must be regarded as highly dubious, as the law before the amendment at least seemed “unclear” with regard to this point. Under German constitutional law, it is not permissible to clarify an unclear legal situation with retroactive effect. Moreover, there are authors who even doubt whether the new wording of the law must actually be construed as capturing “conditions” not directly relating to prices, such as collateral.9 Based on the understanding of the law generally accepted before 2008, the collateralization of a loan therefore should not constitute a “condition” in the sense of Sec. 1 of the AStG, and therefore the failure to provide securities in dealings between related parties should not be able to trigger a profit adjustment.

This interpretation of the law, furthermore, is supported by the purpose of Sec. 1 of the AStG. As the German legislature has confirmed in its explanatory memorandum for the Business Tax Reform Act 2008, the purpose of Sec. 1 of the AStG is to avoid “profit shifting” to other countries. However, the depreciation of a loan does not constitute “profit shifting” to another country, as there is neither a shifting of “German” profits to other jurisdictions, nor are there any “foreign” losses transferred into Germany. In contrast, the tax authorities intend to apply Sec. 1 of the AStG in order to disallow the tax deduction of a loss that was actually accrued in Germany and as such would

7. Author’s translation.
8. See e.g. Baumhoff, in Flick, Wassermeyer and Baumhoff, Außenteuerrecht, § 1 AStG, Sec. 270; Ditz and Tcherveniakchi, IStR (2009), at 713; Wolter, IFSR (2010/2011), at 816.
have also accrued between third parties to the respective contract. By going back to the underlying contract and by arguing that this contract – for lack of an arm’s length collateralization – as such was not at arm’s length, the tax authorities intend to justify the overall non-recognition of the transaction. While the Guidelines refrain from drawing the consequences of this non-recognition by not answering the question of how the actual transfer of capital to the subsidiary must be classified instead, the transfer of capital apparently is reclassified as constituting equity financing.

In sum, the German tax authorities obviously do not intend to correct the German company’s profits in accordance with the arm’s length principle, but apparently intend to apply Sec. 1 of the AStG in order to reclassify a domestic loss of credit capital into a loss of equity. Thus, they seem to ignore the fact that Sec. 1 of the AStG does not provide a legal basis for such a reclassification, but in contrast explicitly states in Sec. 1, Para. 5 of the AStG that equity-like shareholder loans for tax reasons must be treated as loans. Moreover, the tax authorities – after possibly taxing interest rates from the loan for years – refuse to expand this reclassification to the entire transaction. While in practice intercompany loans rarely include the assumption that the loss does not result from a behaviour that fails to comply with the arm’s length principle. 

Finally, one must conclude that the interpretation of Sec. 1 of the AStG as advanced by the tax authorities, is not in compliance with the purpose and the logic of the provision.

Moreover, Art. 9 of the OECD Model Convention must be considered. Sec. 1 of the AStG in German tax law serves as the national codification of this provision of the OECD Model Convention, but above all Sec. 1 of the AStG is limited in its effects by the arm’s length principle if related parties do not demand any collateral in connection with the granting of a loan to an affiliated company. Based on this, a loan agreement between the parties that does not include any collateralization of the loan must be regarded as being at arm’s length and therefore – even in case of default – does not support a profit adjustment.

From Art. 9 of the OECD Model Convention it can be inferred that all conditions of a transaction between related parties must be analysed when determining whether a transaction is at arm’s length. This, therefore, also includes the question of whether third parties in the same situation agreed upon additional collateral. However, there is another aspect of the rule that must be observed. Even though all aspects of a transaction are scrutinized, Art. 9 of OECD Model Convention allows only for a correction of prices and not for the overall non-recognition of the underlying transaction. Arm’s length prices therein are defined as prices agreed between third parties in view of all other provisions of the contract. Therefore, the only aspect of a transaction that may be adjusted under Art. 9 of the OECD Model Convention is the prices or the interest rates agreed upon. This interpretation, furthermore, is supported by Art. 9(2) of the OECD Model Convention, which obligates the tax authorities of the other country involved in the transaction to provide for a corresponding adjustment in order to avoid double taxation. Such an adjustment is possible only if there is a correction of prices. In contrast, no adjustment is possible in cases where losses resulting from an impairment of a loan are disregarded by the tax authorities of one country.

For the reasons stated above, it must be considered highly doubtful if the German rules in Sec. 1 of the AStG should be interpreted in the light of Art. 9 of the OECD Model Convention as providing a legal basis for adjustments as intended by the German tax authorities.

3.2. Possibility for taxpayers to rebut the assumption that impairment does not comply with the arm’s length principle under the Guidelines

If one looks to the Guidelines in more detail, from a practical perspective, it seems advisable to discuss in greater detail the exceptions provided by the Guidelines that allow the taxpayer to deduct the losses in question.

While in practice intercompany loans rarely include the provision of actual securities, it should be possible to scrutinize in greater detail whether the interest rate actually agreed upon between the parties already accounts for the fact that no actual securities have been agreed upon.

The Guidelines, moreover, include two rules that allow the taxpayer, where a loss actually has accrued, to rebut the assumption that the loss does not result from a behaviour that fails to comply with the arm’s length principle. First, the taxpayer is allowed to deduct the losses in question. While the taxpayer, where a loss actually has accrued, to rebut the assumption that the loss does not result from a behaviour that fails to comply with the arm’s length principle.

The relevant portion of Art. 9(1) of the OECD Model Convention provides as follows:

Where … conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

12. Sec. 15 Guidelines.
tcrts an additional business relationship, the taxpayer
also has the possibility to demonstrate that third parties
would have accepted the full or partial cancellation of the
loan in order to maintain the business relationship with
the debtor.\textsuperscript{13}

3.2.1. **Adequate interest for an agreed unsecured loan**
The determination of arm’s length interest has to be based
on the individual rating of the debtor. This rating is sup-
posed to reflect adequately the risk associated with a loan
granted to the debtor, and therefore also should consider
all securities that reduce the actual risk of the debtor.
Consequently, third parties, when calculating an entity’s
rating, do not only consider the debtor’s assets and cash
flows on an isolated basis, but also consider all the sub-
sidiaries of the company receiving the loan, as their as-
sets and their cash flows also constitute a security for the
creditor. Thus, third parties actually would apply at least
a partial group rating if the debtor owns a participation
in other group companies.

Moreover, third parties also would consider in their rating
the fact that the debtor belongs to a group of companies,
as such a group membership can impact significantly the
risk exposure of a debtor. The rating agency Standard &
Poor’s, for example, classifies companies belonging to a
group of companies into three categories, namely “Core”,
“Strategically Important” and “Nonstrategic”.\textsuperscript{14} The clas-
sification depends on the importance of the individual
entity for the group, which is inferred from several criteria
such as the entity’s capitalization, its strategic importance
and its integration into the group. Within the latter cri-
teria, the rating agency also considers the intra-group
transactions in which the entity is involved and the role it
holds in the process of the group’s value creation.

If a company is considered under these criteria to be a
“core company”, Standard & Poor’s believes that the rest
of the group would support the entity in question un-
der any foreseeable circumstances. Therefore, such com-
panies are always awarded the group rating, irrespective
of their corporate law position in the group. Companies
belonging to the second group of “strategically important”
companies benefit from a higher rating because of their
importance for the group and are therefore attributed
additional notches.\textsuperscript{15} Only the third class of companies,
which includes companies that can easily be replaced or
which are performing “experimental, start-up, or periph-
eral activities”, are not benefiting from their belonging to
the group at all.\textsuperscript{16}

Considering these aspects, it becomes obvious that the
question of which interest rate is adequate for an unsec-
cured loan, constitutes a very complex issue that leaves
much room for debate.

Consider the following example:

**Example 2**
The facts are the same as stated in Example 1. The loan yields
interest of 7.5\% per year, which for 2006 has actually been paid.
5 BV also acts as an intermediate holding company and is the par-
ent of the group’s French and Spanish distribution subsidiaries.
This must be considered when determining the rating.

Given the strategic importance and the integration of the distri-
bution company, it can be classified as “strategically important”.
The rating of 5 BV, therefore, in this example, is increased
by three notches, which led to arm’s length interest at the time the
loan was granted between 7.45\% and 7.75\%. The actual yield
of the loan therefore must be considered to be at arm’s length.
The loss resulting from the impairment in 2007 therefore should be
tax deductible.

3.2.2. **Non-existence of any collateralization resulting
from the corporate relationship**

Under Sec. 15 of the Guidelines, the taxpayer may deduct
the loss resulting from an impairment of loans granted to
an affiliated party if the taxpayer credibly shows that the
corporate relationship under arm’s length conditions will
no longer serve as a collateralization for the loan and that
therefore the collateralization originally provided by the
corporate relationship does no longer exist.

Such a situation exists, to begin with, in cases where the
subsidiary not only fails to meet its obligations vis-à-vis
its parent company, but also ceases to fulfil its obligations
from dealings with third parties.

Moreover, Sec. 15 of the Guidelines specifies three other
situations in which the taxpayer, according to the German
tax authorities, is entitled to deduct the losses from its tax
base. First, the taxpayer can show that the parent com-
pany which used to support the subsidiary in fulfilling
its obligations vis-à-vis third parties, no longer provides
any support to the subsidiary to allow it to fulfil its obli-
gations. The taxpayer, furthermore, can show that a third
party (for example a third-party supplier) relied upon
the corporate relationship and therefore did not demand
any additional collateralization, and now suffers from a
default. Third, it can been shown that a third party would
no longer have expected the parent company to intervene
in favour of its subsidiary, because the parent company
suffered economic problems itself.

These examples provided by the tax authorities suggest
that the tax authorities tend to consider the collateraliza-
tion provided by a corporate relationship as originat-
ing for the elevated creditworthiness resulting from the
company’s affiliation to the group. In the Guidelines, the
tax authorities explicitly express the view that third par-
ties also would consider this aspect. The tax authorities
therefore seem to accept the opinion also expressed by
rating agencies that the integration of the subsidiary into
the group can constitute as such a collateralization, as the

\textsuperscript{13} Sec. 19 Guidelines.
\textsuperscript{14} See Standard & Poor’s, Group Methodology, RatingsDirect (22 April
2009), at 4 ff.
\textsuperscript{15} See Standard & Poor’s, Group Methodology, RatingsDirect (22 April
2009), at 5. This approach was also applied by the Tax Court of Canada
in its GE Capital Canada decision (Tax Court of Canada, judgment of 4
December 2009, General Electric Capital Canada Inc. v. The Queen, 2009
TCC 563; appeal dismissed by the Federal Court of Appeal on 15 Decem-
ber 2010).
\textsuperscript{16} See Standard & Poor’s, “What Makes An Insurance Or Reinsurance Sub-
sidiary ‘Core’ Under Group Rating Methodology?”, RatingsDirect (31
March 2003), at 4.
rest of the group is likely to provide support to its member company. In order to show that the collateralization provided by this corporate relationship no longer exists, the taxpayer therefore must provide evidence that a third party – for objective reasons – also could no longer expect such support.

Apart from this, the Guidelines, moreover, demand that the taxpayer additionally provide evidence that a third party, after the severe economic situation occurred, would not have had any possibility to ask for additional collateralization. However, this requirement seems not really adequate, as, after a crisis has occurred, third parties usually do not have the possibility to protect their pre-existing debt by additional collateralization. Therefore, it is not really clear what kind of proof a taxpayer should provide in these cases.

Consider the following example:

Example 3
The facts are the same as stated in Example 1. But now not only P AG is a creditor of S BV. F BV, an independent third party, sells certain complementary products to S BV that are distributed by S BV together with the products sourced from P AG. From these dealings, F BV possesses certain trade receivables vis-à-vis S BV that are overdue and have not been settled yet. F BV has therefore not received any collateralization for its debts. F BV has therefore commenced to deliver new products only against prepayment. P AG refuses to assume any direct responsibility for these debts and does not provide the entity with additional liquidity.

In this case, the assumption that the corporate relationship between the debtor and its parent company provides any protection from a default of the company has been rebutted. P AG should be able to deduct from its taxable profits the loss resulting from the impairment.

3.2.3. Possibility of contributing to the recapitalization of a business partner
The second exception as included in the Guidelines allows the taxpayer to deduct losses resulting from the impairment of a loan to a related party, in cases where the taxpayer credibly shows that third parties would have accepted a partial cancellation, as there is “a predominant interest” on the creditor’s side to uphold another business relationship with the debtor.

This conclusion as such seems adequate from an arm’s length perspective. Third parties in a comparable situation should accept a default of a commercial partner if the business relationship with this party is of strategic importance for them (as, for example, the other party has represented them for years in another market) and if they realistically can expect that the continuation of the business relationship will be advantageous for them in the medium or long term. When determining if there is a “predominant interest” to continue the business relationship with the debtor, third parties would, moreover, in the first place not consider the amount of the original loan, but the amount of redemption that they could expect if the recapitalization fails. In these cases, usually the only alternative realistically available to the creditor is to terminate the business relationship and accept the insolvency of the debtor.

Consider the following example:

Example 4
The facts are the same as stated in Example 1. But now P AG accepted a cancellation of 70% of the loan. If P AG had not cancelled the loan in part, S BV would have been obligated to initiate insolvency proceedings. During these insolvency proceedings, P AG would have been able to recover 30% of its loan. It is, furthermore, expected that the markets S BV operates in will recover during the next years. These markets are of strategic importance for the whole group. Within such a recovering, the customer base of S BV and its status in the market will be of great strategic value. To open a new distribution entity in the Benelux countries and establish comparable structures and a comparable customer base would cost approximately EUR 2 million.

In this situation, P AG should have had a “predominant interest” to participate in a recapitalization of S BV. The loss resulting from the cancellation of the loan must be treated as tax deductible, even when the new Guidelines are applied.

3.3. Treatment of non-shareholder loans
In cases where the loan is not granted from a shareholder to a subsidiary, the Guidelines assume that there is no collateralization provided by the corporate relationship between the contracting parties. In the following the Guidelines differentiate between two different cases. In the first case it is possible to determine an interest rate that reflects the lack of any collateralization. If such an interest rate is applied, a subsequent impairment of the loan is tax deductible. If there is no possibility to determine arm’s length interest, as third parties in a comparable situation would not have granted an unsecured loan at all, there is no correction of the interest rate agreed upon, but in the event of a default of the debtor the respective tax deduction is denied.

With regard to cases in which a third party would not have granted an unsecured loan at all, it is remarkable that the German tax authorities under certain circumstances determine that interest rates that do not reflect the actual risks of an intercompany loan are acceptable and therefore do not trigger income adjustments. The German tax authorities in these cases deny the existence of any collateralization resulting from the corporate relationship, but obviously seem to look at “virtual” collaterals that secure the loan. Therefore, it should be acceptable to apply in such cases from the beginning the interest rate applicable to a comparable collateralized loan even though no actual collaterals are provided. However, the advantage regarding the determination of intercompany interest is, according to the Guidelines, counterbalanced by the fact that losses resulting from such a loan are under no circumstances regarded as tax deductible.

With regard to cases in which third parties would have granted a loan to the subsidiary, the German tax authorities refuse to consider any form of collateralization result.

18. See Sec. 27 Guidelines.
19. See Sec. 29 Guidelines.
adjust a company's profits under Sec. 1 of the AStG. The 8b, Para. 3 of the KStG prevails over the possibility to exercise control over the subsidiary can under no circumstances rely on the corporate relationship as being comparable to a non-corporate relationship.

Consider the following example:

Example 5

The facts are the same as stated in Example 1. But now the loan is granted by B AG, a related production entity based in Germany. As demonstrated above, the interest rate of 7.5% is adequate under arm's length criteria. The fact that B AG is the creditor of the loan does not invalidate this result, as it is the strategic importance of a company within the group, and not (or at least not only) the ability to exercise corporate control over the debtor, that provides collateralization to the creditor.

The refusal of the tax authorities to accept any collateralization resulting from the corporate relationship in cases where the loan is not provided from a shareholder to a subsidiary, moreover, suggests that the tax authorities assume that a collateralization from a corporate relationship exists only in situations where the creditor controls the subsidiary. While the Federal Tax Court also stressed this aspect in its rulings cited by the Guidelines, these explanations are consistent with neither the approach followed in Sec. 15 of the Guidelines, nor with economic reality.20

In Sec. 15 of the Guidelines, the tax authorities assume that third parties can rely on the collateralization provided by a corporate relationship, and obviously regard the corporate relations as being comparable to a non-binding comfort letter. In Sec. 27, the Guidelines now apparently stress the argument that such collateralization should exist only if the shareholder has the possibility to exercise control over the subsidiary and that, therefore, affiliated parties which are not directly exercising control over the subsidiary can under no circumstances rely on the corporate relationship as a form of collateralization. This implies that the collateralization provided by the corporate relationship can only result from the fact that the parent company has the capacity to prevent the subsidiary for entering into dealings that are too risky and therefore endanger the redemption of the loan. If the collateralization resulting from the corporate relationship is understood this way, there is no need for proof that the collateralization no longer exists, because the default itself proves that the security was insufficient to secure the loan. Sec. 15 of the Guidelines therefore would be without cause.


The Guidelines state that in fiscal years after 2008, Sec. 8b. Para. 3 of the KStG prevails over the possibility to adjust a company's profits under Sec. 1 of the AStG. The relevance of the rules for later fiscal years is still unclear. On one hand, it can be assumed that the interpretation of Sec. 1 of the AStG should correspond with the tax authorities' interpretation of Sec. 8b, Para. 3 of the KStG, as both regulations are based on the arm's length principle. On the other hand, it has to noted that the Guidelines conflict with Sec. 8b, Para. 3 Sentence 6 of the KStG as the law, other than the Guidelines, does not allow for any consideration of the fact that the debtor of a loan belongs to a group of companies.

In any case, the rules remain directly relevant in cases where a loan is granted by physical persons or partnerships.

5. Conclusion

The new Guidelines from Ministry of Finance on the tax treatment of the decrease in value of loans to affiliated companies deal with a subject matter that is of increasing importance in German tax audits. The new rules significantly reduce the possibility of taxpayers to deduct losses resulting from loans granted to affiliated companies in fiscal years before 2008. Such losses are only allowed tax deductibility if the taxpayer can credibly show that either

- the interest rate agreed on was at arm's length when only collaterals actually provided by the debtor are being considered;
- the security provided by corporate relationship, which originally secured a loan granted by a parent company to a subsidiary, does no longer exist, and that a third party creditor would have had no other possibility of collateralization when this became obvious; or
- third parties would have accepted a default in order to keep up a business relationship which is of strategic importance for them.

With regard to the testing of intercompany interest rates, the new rules include several provisions that can prove to be advantageous for the taxpayer. First, the German tax authorities accept that under certain circumstances the corporate relationship between affiliated companies can provide sufficient collateralization for a loan and can be reflected in lower interest rates. Moreover, the German tax authorities refrain from adjusting intercompany interest rates in cases in which – given the circumstances under which the loan is granted – no market interest rates can be determined, if at least interests sufficient to remunerate the creditor for a comparable collateralized loan are charged to the debtor.

On the other hand, the new regulations include several provisions that seem disputable or at least need further clarification. The Guidelines lack consistency especially on the question of how the

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20. See 3.2.2.
fact that the debtor belongs to a group of companies should be weighed when determining the arm’s length interest and assessing the tax deductibility losses resulting from an intercompany loan granted to an affiliated company.

Finally, the legal basis for the new rules stated by the fiscal authorities is still unclear. While Sec. 8b, Para. 3 of the KStG is not applicable to fiscal years before 2008, it has to be considered highly doubtful whether Sec. 1 of the AStG or Art 9 of the OECD Model Convention does provide a sufficient legal basis for the correction of losses resulting from an actual default of intercompany loans.