Nexia

Cross-border financing relationships: higher obligation to provide evidence and limitation of interest deduction

The draft bill for the Growth Opportunities Act originally provided for the introduction of an interest rate cap to limit the amount of interest deducted by a company. However, this was removed from the law. Instead, special regulations have been introduced in Section 1 (3d) and (3e) AStG, which specify the arm's length comparison for financing relationships.

Arm's length comparison for financing relationships within a group

Section 1 (3d) AStG sets out the conditions under which cross-border financing relationships within a multinational group of companies that lead to income-reducing expenses for the recipient of the financing do not comply with the arm's length principle.
The term financing relationship includes both loan relationships and the use as well the provision of borrowed capital or similar instruments.
A multinational group of companies exists if at least two related parties or companies are domiciled in at least two different countries and at least one foreign permanent establishment exists.

However, the arm's length nature of the financing relationships is not measured by comparative relationships between unrelated third parties, but essentially depends on the evidence provided by the taxpayer.

For example, a financing relationship is not at arm's length and the deduction of business expenses is denied if the recipient of the financing cannot prove that the company was able to service the debt and that the financing was economically necessary and used for the purpose of the company.

This also applies if the interest rate that the recipient of the financing must pay to an affiliated (foreign) Group company is higher than the interest rate at which the company could obtain financing from external third parties based on the rating for the Group.

In certain cases, the taxpayer can prove that the rating of the corporate group complies with the arm's length principle by submitting a derived rating.

Differentiation between functional and low-risk financing services

In accordance with Section 1 (3e) AStG, it is generally assumed that a financing relationship within a multinational group of companies is a low-functioning and low-risk service if the company merely acts as an intermediary or the financing is passed on internally.

These principles also apply when a company within a corporate group assumes responsibility for

managing the financial resources of other companies within the same group. This includes, for example, liquidity management, financial risk management, currency risk management or acting as a financing company.

However, the taxable person can prove by means of a functional and risk analysis that it is not such a service.

Consequences of the new regulation

The amendments to Section 1 AStG lead to increased obligations for taxpayers to provide evidence. In particular, Section 1 (3d) AStG will require regular analyses and documented intentions of use. In Section 1 (3e) AStG, financing services are classified as low-functioning and low-risk across the board, whereby the taxpayer must provide corresponding evidence in the event of a deviating profile.

Do you have any questions on this topic?

Do you need support? Simply contact our experts Henning Straeter and Christoph Thomas. They will be happy to explain our range of services to you.

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Imprint

Publisher
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Steuerberatungsgesellschaft
Georg-Glock-Str. 4
40474 Düsseldorf
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Status 03/2024

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