COMMENTARY

The decision involves several interesting tax treaty issues:

First, the Federal Fiscal Court (Bundesfinanzhof) regards an indirect discrimination as sufficient for a violation of art 25.3 of the German-Swiss 1971/1992 tax treaty which equals art 24.5 of the OECD Model.

The wording of the German thin capitalisation rules in dispute did not attach directly to an owner who is a foreign resident in order to re-qualify interest into dividends. Instead, the law which was in force until 2000 (s 8a KStG old version) required an owner not entitled to a tax credit under the imputation system which was valid at the time to prevent double taxation in case of profit distributions by corporations. Under this regime the owner of a German corporation would obtain a credit for the corporation tax paid by the corporation. It is true that in most cases in which the credit was not granted this was due to the owner's foreign residence. Nonetheless, it was also possible that German residents such as public bodies or charities could not benefit from the credit, either.

The law which entered into force in 2001 (s 8a KStG new version) assumed that a hidden profit distribution was present if besides other conditions the interest was paid to (i) the owner of the borrowing corporation without being taxed at the level of the owner by way of assessment or (ii) another person affiliated with the owner without being subject to German taxation at the level of the recipient or (iii) a third party with recourse to the owner or its affiliated person. Under this law most cases in which the thin capitalisation rule applied involved a foreign owner to whom the interest was paid, too. But again this was not necessarily the case because an owner at the level of which the interest was not taxed by way of assessment could also have been a tax exempt domestic charity, for example.

Nevertheless, the Federal Fiscal Court refers to the case law of the Court of Justice of the European Union according to which it is sufficient that the national rule primarily and effectively covers cross-border situations even if the wording does not directly reflect that (see para [23] of the Federal Fiscal Court decision).

One may debate whether art 25.3 of the German-Swiss treaty as well as art 24.5 of the OECD Model were really designated to prevent this so-called 'indirect discrimination'. Paragraph 1 of the 2008 Commentary to art 24 of the OECD Model makes a clear statement against this construction of the article. As can be seen from other decisions of the Federal Fiscal Court, its judges seem to prefer a static interpretation of tax treaties, though. They tend not to take into account amendments to the

OECD Commentary that were made after the conclusion of the actual *a*
treaty in question.

However, one should note that the majority opinion in German tax
treaty literature has always opined for a strict interpretation of art 24 as
prohibiting only direct discrimination (see for example the comparison of
EU non-discrimination rules and art 24 of the OECD Model in *Klaus* *b*
Vogel on Double Taxation Conventions (3rd edn), art 24 margin notes 5b
et seq).

Secondly, even if one construes art 25.3 of the German-Swiss treaty as
preventing also indirect discrimination, one must still observe that the rule *c*
requires two aspects. The discrimination must be based on the facts that
(i) the taxpayer concerned has an owner and (ii) the owner is resident of
the treaty partner state. A national tax provision does not violate the rule
if the discrimination is grounded on the fact that the taxpayer does
business with a company resident in the treaty partner state and the fact *d*
that the other company is the owner is just coincidence (see *Klaus Vogel*
on Double Taxation Conventions (3rd edn), art 24 margin note 165). In
this respect, it is interesting that s 8a KStG new version which took effect
in 2001 did not necessarily imply a foreign owner (the description of the
law in para 18 of the decision is misleading in this respect). It was also *e*
applicable if the owner was domestic as long as the recipient of the interest
was a foreign resident which was either affiliated with the domestic owner
(eg a sister company) or had recourse to the domestic owner for the
repayment of the loan. Against this background it is doubtful whether the
discrimination was actually based on foreign ownership in the case at hand *f*
as far as the year 2001 is concerned. Since the Federal Fiscal Court does
not address this issue, the decision is not convincing insofar.

Thirdly, the court had to evaluate the relationship between art 9 and
11.4 of the German-Swiss treaty and art 25.3. The named provisions *g*
correspond to arts 9.1 and 11.6 of the OECD Model. Article 9 of the
German-Swiss treaty gives the contracting states the right to adjust the
profits of affiliated companies if they do not deal at arm's length in their
commercial or financial relations. Article 11.4 reduces the scope of art 11
to the amount of interest which would have been paid between unrelated *h*
parties and states that the excess part of interest shall remain taxable
according to the laws of each contracting state, due regard being had to
the other provisions of the convention.

The Federal Fiscal Court states that it is unnecessary to analyse whether
the German thin cap provisions are compatible with arts 9 and 11.4 of the *i*
treaty and, if so, whether in the case at hand the parties to the loan
agreement stipulated conditions at arm's length. The court leaves these
questions unanswered because in any case arts 9 and 11.4 do not permit a
discriminatory taxation of interest which disallows the deduction at the

level of the payor only in cross-border cases.

Article 24.4 of the OECD Model however does indeed permit such discriminatory taxation if the provisions of art 9.1, 11.6 or 12.4 of the Model apply, ie if the payment was not made under arm's length conditions (see the second sentence of para 74 of the 2008 Commentary on art 24 which states that art 24.4. prohibits thin cap rules which are not compatible with para 1 of art 9 or para 6 of art 11 *and* apply to non-resident creditors only; see also *Klaus Vogel on Double Taxation Conventions* (3rd edn), art 24 margin note 147a).

However, the German-Swiss treaty does not include a clause which corresponds to art 24.4 of the Model because this provision was inserted into the Model Convention in 1977 whereas the German-Swiss treaty had already been concluded in 1971. The Federal Fiscal Court held that in the absence of a provision that equals art 24.4 of the Model even thin capitalisation rules which are in line with art 9.1 or 11.6 must not discriminate against companies whose owner is a resident of the treaty partner state.

According to the Federal Fiscal Court's view the German thin capitalisation rules of s 8a KStG old version (valid until 2000) and s 8a KStG new version (valid until 2003) must not be applied to a domestic company which borrowed money from a foreign shareholder if the tax treaty concluded between Germany and the foreign shareholder's state of residence includes a clause that corresponds to art 24.5 of the OECD Model but has no similar clause to art 24.4. This equates domestic companies having non-EU shareholders with domestic companies having EU shareholders to a certain extent. As to the latter group of companies, the European Court of Justice already held in its *Lankhorst-Hohorst* decision of 12 December 2002 (*Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (Case C-324/00) (2002) 5 ITLR 467) that s 8a KStG old version was inapplicable because it discriminated against companies with foreign (in this case EU) shareholders.

With effect from 2004 the scope of the German thin capitalisation rules was extended to purely domestic cases. Hence, the discriminatory element was abandoned.

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