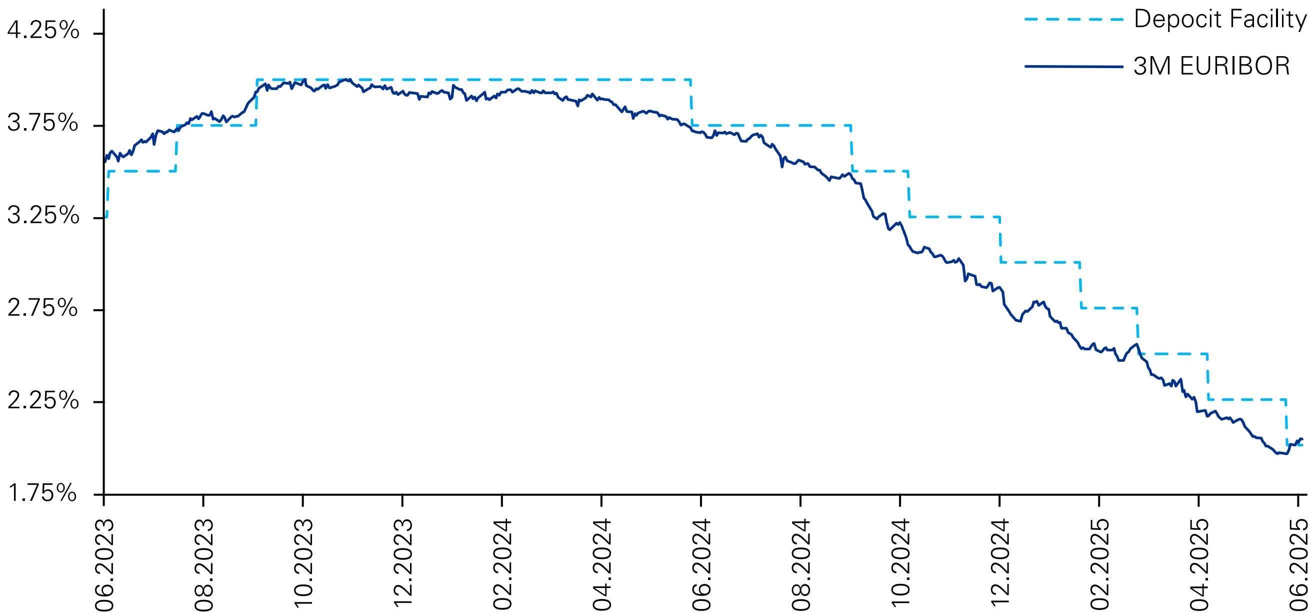
03

Transfer pricing pitfalls in a declining interest rate environment

The impact of declining market interest rates from a transfer pricing perspective on inbound loans

With the latest decision by the ECB, taxpayers are faced with a further decline in market interest rates, which has various implications on their intra-group financing relationships (e.g., shareholder loans). Borrowers increasingly need to consider whether refinancing existing liabilities could be a realistic option (or whether this might be assumed by the tax authorities during an external audit), while simultaneously ensuring that intra-group loan agreements are structured at arm‘s length.

On June 05, 2025, the European Central Bank („ECB“) decided to lower the deposit facility rate by another 25 basis points, bringing it down to the current level of 2.00 percent. The decision to further reduce the interest rate reflects the updated assessment by the ECB‘s Governing Council regarding current inflation dynamics as well as uncertainty regarding the trade policy measures.[1] Following the deposit facility rate, the main refinancing operations is currently at 2.15 percent, while the marginal lending facility stands at 2.40 percent[2]. The ECB‘s decision marks the fourth consecutive reduction in the key interest rate level and the seventh since August 2024. The following figure illustrates the development of the deposit facility and the 3-month Euribor over the past two years. It can be seen that the refinancing rate in the form of the 3-month Euribor and the deposit facility exhibit a high correlation, showing a negative trend since the end of 2023.[3]



1 *Cf. European Central Bank, press release dated June 05, 2025; Monetary policy decision*
2 *As of: June 23, 2025*
3 *The picture is similar for the €STR, which is regarded as an alternative to the Euribor.*

In the context of the arm's length principle, which must be considered for cross-border transactions between affiliated companies, intra-group financial transactions must take into account the current developments in the interest rate environment. This means, for example, that a shareholder loan granted at the beginning of 2024, ceteris paribus, bears a higher interest rate than an identical loan granted in January 2025.

Given the influence of the general interest rate environment on the interest rate for intra-group loan transactions, both borrowers and lenders are faced with interest rate risks in the absence of hedging transactions, with the allocation of risks depending on the type of interest rate. In real estate financing, which typically has a fixed interest rate, the risk of a decrease in the interest rate level lies with the borrower, while the risk of an increase in the interest rate level lies with the lender. In the case of a variable interest rate, the parties involved take the opposite position, with the risk of a decrease in the interest rate level being borne by the lender and the risk of an interest rate increase by the borrower.

Due to the fact that intra-group loans (especially shareholder loans) for real estate financing are regularly equipped with an early termination option – typically without prepayment penalties („PP") – and considering the currently declining interest rate environment, the borrower rationally has the option to repay already existing liabilities, for example, through external refinancing. The borrower would now have the option to receive a loan at a lower interest rate and thus repay the existing intra-group loan that was issued in a high interest rate environment. This would result in a decrease of future interest expenses and an increase of pre-tax earnings. German tax authorities regularly imply this behaviour in external tax audits covering fiscal years also with a declining interest rate environment especially from 2012 until 2019 for intra-group (inbound) loans, which were originally provided in a high rate interest rate environment, to enforce an adjustment (reduction) of the interest rate and thus increase the tax base. This behavior by the German tax authorities is also to be expected for tax audits of fiscal years starting from 2024.

Based on our experience, the tax authorities would, in addition to examining the interest rate in terms of its basis and amount according to sec. 1 para. 3d Foreign Tax Act[4] also assess whether it would be advantageous to exercise the early termination option without prepayment penalties, repay the loan, and take out a new one at a more favorable interest rate.

Example

- A shareholder loan of EUR 50 million was granted in December 2023 to finance a property at an arm's length interest rate of 6.5 percent, with a term of 10 years and an early termination option without PP, resulting in EUR 3.25 million in annual interest expenses.

- The tax audit now covers the period from 2024 onwards.

- The benchmark study to justify the interest rate and the debt sustainability analysis were fundamentally accepted.

- However, due to the fallen interest rate environment (assuming no change in the market value of the property), the arm's length interest rate for the same risk investment would now be 4.5 percent in June 2025, which is 2 percentage points lower.

- The tax authorities assume that a prudent and diligent business manager would have exercised the early termination option, refinanced at 4.5 percent, and thus paid 2 percentage points (i.e., EUR 1 million in annual interest expenses) less in the future.

- Consequently, the tax authorities would adjust the taxable income by EUR 1 million annually for the following years, typically leading to an additional cash tax burden (usually up to approximately EUR 300,000 per year).

Recommendations for action

For existing intra-group loans, the following recommendations can be identified:

- Check whether early repayment is contractually provided for and whether prepayment penalties would apply.

4 *Cf. John, Ronny & Mölleken, Christoph: Real Estate Tax Newsletter, 2nd edition 2024.*

- Examine whether, in the case of additional bank financing for the property, clauses in the bank loan agreement allow for early repayment of the intra-group loan.

- Determine the interest loss due to the decreased market interest rate environment (possibly considering a changed market value of the property) and thus identify the potential tax risk.

For new intra-group loans to be concluded:

- Conduct a transfer pricing analysis in accordance with se. 1 para. 3d Foreign Tax Act and the Administrative Principles on Transfer Pricing 2024.

- Agree on an early repayment option with prepayment penalties in the loan agreement.

- Include a clause for the arm's length determination of prepayment penalties in the loan agreement.

Facts

With its latest interest rate decision, the ECB has once again adjusted the interest rate level downward. The interest rate environment thus remains in a dynamic state, which has various implications for intra-group financial transactions. Borrowers should regularly check whether there is an opportunity for early repayment of intra-group liabilities and whether this would be advantageous from the borrower's perspective. If advantageous, this could potentially result in a tax risk that needs to be determined. At the same time, when concluding new intra-group loan transactions, in addition to an arm's length interest rate and debt sustainability analysis, it should also be ensured that an early termination option is included, and a prepayment penalty is agreed upon to address tax risks in the event of a further decline in the interest rate environment.

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