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German Tax and Legal News

Federal tax court clarifies application of dual consolidated loss rules

Dual consolidated loss rules apply only in the case of a loss at the consolidated group level, not at the entity level

In a recently published opinion, Germany's federal tax court (BFH) clarified the application of the dual consolidated loss (DCL) rules (under section 14 (1) No. 5 of the Corporate Income Tax Code). In its decision dated October 12, 2016, the court stated that the existence of a loss for purposes of the rules must be determined on a consolidated basis at the group level, and not at the level of the controlling/controlled entity on a stand-alone basis.

Germany's DCL rules were expanded at the beginning of 2013 to apply to any situation in which the losses of either a group parent or a subsidiary are taken into account in a foreign jurisdiction. Where the DCL rules apply, the relevant losses are disallowed for German tax purposes. Due to the unclear wording of the rules, tax practitioners had faced significant uncertainty regarding how to interpret the rules since their expansion. The ruling of the federal tax court is a welcome clarification of the provisions.

In the case decided by the BFH, a German limited partnership (KG) deducted interest expense paid by its (indirect) partner as "special business expenses" for German tax purposes (such a deduction may be allowable under the specific German tax accounting rules for partnerships). The interest expense was paid at the level of a Dutch BV in relation to equity that had been contributed into the KG for purposes of acquiring an additional subsidiary and strengthening the equity of another subsidiary of the KG. The KG was the controlling entity in a tax group with several subsidiaries; the consolidated taxable income of the tax group was positive, whereas the income of the KG on a stand-alone basis (without considering the effects of the tax consolidation) was negative. The BFH opinion does not include any description if, or how, the negative income of the KG/the interest expense was considered for foreign tax purposes.

The tax authorities disallowed the interest expense by referring to the DCL rules and applying them to the loss that arose at the KG level on a stand-alone basis, triggered by the treatment of the interest expense as special business expense.

The BFH did not follow the interpretation of the tax authorities. The court referred to the positive overall income of the tax consolidated group and reasoned that, therefore, the DCL rules were not applicable. In its decision, the BFH explicitly mentioned that the controversial question of whether the DCL rules are applicable for a partnership that is the controlling entity in a tax group did not have to be decided. In addition, the BFH explicitly did not rule on the question of whether the application of the DCL rules is limited to cases where the negative income at the level of the controlling entity is a result of losses from subsidiaries transferred under a profit and loss pooling agreement.

The decision of the BFH clarifies the interpretation of the amended DCL rules in a positive way for taxpayers. In its decision, the tax court refers to the explanation of the amended rules provided by the legislature, going beyond the plain wording of the rules. However, even though this decision should help affected taxpayers to assess their position under the DCL rules, significant uncertainty remains with regard to the interpretation of the rules in other scenarios.

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