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BFH rules on set off of loss carryforwards against profits derived in year of harmful change-in-ownership

The BFH has allowed the setoff of existing loss carryforwards against profits generated in the year of a harmful change in ownership but before the change took place.

In a recently published decision (case reference: I R 14/11), the Federal Tax Court (BFH) stated its position on the deductibility of tax losses carried forward under the change-in-ownership rule. The court's position deviates from tax administrative practice.

Under the German change-in-ownership rule (applicable as from 1 January 2008), a direct or indirect transfer to one acquirer within a five-year-period of more than 25 % (and up to 50 %) of the shares in a company that has loss carryforwards results in a pro rata forfeiture of the loss carryforwards. A share transfer of more than 50 % will result in the forfeiture of all available loss carryforwards.

According to the tax authorities, where tax losses are incurred in the year in which the harmful change-in-ownership takes place, but before the change takes place, such losses will be forfeited. The Ministry of Finance, however, has taken a conflicting position to the effect that where profits are generated in the year but before the harmful change in ownership takes place, it will not be possible to offset such profits with existing tax loss carryforwards – such losses being forfeited because of the harmful share transfer.

According to the BFH, the aim of the change-in-ownership rule is to limit the deduction of tax loss carryforwards to profits realized after the harmful share transfer. However, and contrary to the Ministry of Finance's position the change-in-ownership rule is not designed to limit the setoff of tax loss carryforwards against profits generated *before* the share transfer.

The BFH has clarified that neither the wording nor the meaning and purpose of the change-in-ownership rule justify the BMF's interpretation: the change-in-ownership rule is designed to disallow the setoff of prior tax loss carryforwards against profits generated in connection with a subsequent economic activity (i.e. the new economic identity of the company resulting from the share transfer). Taxpayers should, however, be aware of the fact that the loss utilization should still be subject to the German minimum tax rules. Under the minimum tax rules, loss carryforwards may be set off against current year income up to 1 million Euro without restriction, but amounts exceeding 1 million Euro may be offset only to the extent of 60 % of the excess over 1 million Euro (a potential exception from the minimum tax rules may apply for the years 2008 and 2009, for details see Deloitte Tax News). By contrast, profits generated before a harmful change in ownership should not be affected by the rule, so they can be offset by existing loss carryforwards – any remaining loss carryforwards will then be forfeited due to the harmful share transfer.

If you have any questions, please contact the authors of the article at gtln@deloitte.de or your regular Deloitte contact.

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