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German Tax and Legal News

Lower tax court clarifies application of double deduction rule for partnerships

Taxpayer favorable decision based on specifics of Dutch tax consolidation regime

In a decision dated 31 August 2023 and published in the beginning of November 2023, Germany's lower tax court of Muenster ruled that there was no double deduction for purposes of the double deduction rule for partnerships where interest expense incurred by a Dutch resident BV partner was deductible at the level of the German limited liability partnership (KG) but no deduction was available for Dutch tax purposes at the level of the BV due to the Dutch tax consolidation regime.

The double deduction rule for partnerships was introduced into German tax law in 2016 as a result of the OECD BEPS initiative. The rule targets "double dip" structures where expenses (in particular, interest expenses) incurred at the level of a foreign partner in a German partnership are deducted for both German and foreign tax purposes at the same time (an exception to the rule exists to the extent "dual inclusion income" is available). Prior to the double deduction rule, if the foreign jurisdiction where the partner was resident also granted a tax deduction for such an expense, a "double dip" would arise. The double deduction rule for partnerships in section 4i of the Income Tax Code (ITC) is a rule separate from the general anti-hybrid rules in section 4k ITC, which have been in force since 2020 and are based on the EU anti-tax avoidance directive.

Based on the tax accounting rules for partnerships, expenses incurred at the partner level that are closely connected to a partner's interest in the partnership are treated as "special business expenses" and are deductible for tax purposes at the level of the partnership. This concept is, in particular, of relevance for interest expense related to a debt financed acquisition of an interest in a partnership by a partner.

Facts of the case
A Dutch resident BV was the 100% limited partner in a KG. The BV was part of a Dutch tax consolidated group (fiscale eenheid) with its Dutch parent company. The Dutch parent company provided the BV with an intercompany loan that the BV used to finance the operations of the KG. Due to the German tax accounting rules for partnerships, the interest expense on the loan was deductible for German tax purposes at the level of the KG. Due to the Dutch tax consolidated rules, neither the interest income at the level of the Dutch parent company nor the interest expense at the level of the BV was recognized for Dutch tax purposes.

During a German tax audit, the tax authorities argued that, even though the interest expense and interest income offset each other for Dutch tax purposes as a result of the Dutch tax consolidation rules, the interest expense still is recognized for Dutch tax purposes and, therefore, results in the application of the double deduction rule for partnerships, since the interest expense of the BV is recognized for German and Dutch tax purposes at the same time.

Decision of the lower tax court
In its decision, the lower tax court concluded that due to the Dutch tax consolidated group being a "full consolidation" for tax purposes, no tax deduction of the interest expense in the Netherlands is available and, therefore, no double deduction in terms of the German double deduction rule for partnerships arises. Under the Dutch tax consolidated rules, both the BV and its Dutch parent company are treated as if they were a single entity under a deemed merger concept from a Dutch tax perspective. As such, any intercompany transactions between the two entities are deemed nonexistent for Dutch tax purposes. The Dutch tax consolidated group prepares only one balance sheet and one profit and loss statement for tax purposes, rather than combining several single balance sheets and proft and loss statements into a consolidated balance sheet and a consolidated profit and loss statement by offsetting intercompany transactions.

Due to the classification of the Dutch tax consolidated group as being fully consolidated, the lower tax court concluded that the interest income and interest expense are nonexistent at the level of the group (and not just as a result of consolidating book entries) and, therefore, no double deduction under the German double deduction rule for partnerships arose.

The lower tax court also rejected the tax authorities' argument that the nonrecognition of the interest income at the level of the Dutch parent company resulted in a double deduction. As the wording of the double deduction rule only refers to the double deduction of expenses for tax purposes in two different jurisdictions, any corresponding income should not be taken into account when determining whether the requirements of the double deduction rule for partnerships are met. The consideration of any corresponding income should only be of relevance for purposes of the dual income inclusion exemption.

Comments
The decision of the lower tax court is a welcome development for taxpayers, as it is the first decision by a tax court in relation to the double deduction rule for partnerships. As the wording of the rule is very brief and no additional guidance is available, the application of this rule can be challenging for taxpayers.

The scope of application of the lower tax court's decision should be limited to tax consolidation regimes that treat a tax consolidated group as a single entity. Tax consolidation regimes in which several single entities are combined via consolidation entries should be outside of the scope of the decision.

The lower tax court has allowed for an appeal at the federal tax court; whether the tax authorities will pursue such an appeal is not yet known but can be expected.

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