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German Tax and Legal News

Lower tax court confirms conditions for cross-border loss relief

Binding legal agreement between parent and subsidiary required for relief to be allowed for German tax purposes.

In a decision dated 3 March 2019 and published in September 2019, the lower tax court of Schleswig-Holstein set forth its position regarding the conditions for the recognition of final losses of a foreign subsidiary at the level of its German parent entity under the German tax consolidation rules (Organschaft). In line with previous decisions of other German lower tax courts, the court held that the recognition of such final losses requires a binding legal agreement between the German parent entity and its foreign subsidiary that contains a legal obligation for the parent entity to compensate the subsidiary for its final losses.

In the case decided by the lower tax court, a German GmbH was the sole shareholder of a loss-making French subsidiary. The French subsidiary ceased its activities and was liquidated in 2012. The German parent entity claimed a deduction for the losses of the French subsidiary in its 2011 and 2012 German tax returns. The tax authorities disallowed the deductions, and the taxpayer subsequently filed an appeal with the lower tax court.

Under the German tax consolidation rules, the profits and losses of a majority-owned subsidiary may be offset against the income at the level of the parent entity, provided a profit and loss pooling agreement (PLPA) between the controlling parent entity and the controlled subsidiary has been concluded for at least a five-year period and the PLPA has been filed with the commercial register. Unlike tax consolidated group rules in most countries, the German consolidated group rules are based on legal obligations arising from the PLPA: the controlled subsidiary is required to annually transfer its profits to the controlling parent entity and the controlling parent entity is required to compensate the subsidiary for its annual losses. The Organschaft is more than just a tax concept in Germany —it is a legal concept that has tax, legal and accounting consequences.

The lower tax court based its decision upholding the tax authorities' disallowance of cross-border loss relief on the fact that the French subsidiary did not fulfill the conditions for establishing a tax group with its German parent entity. The subsidiary did not have its statutory seat or its place of management in Germany, as required by the law at that time (the relevant provision has since been amended to allow controlled companies to have their statutory seat in another EU/European Economic Area (EEA) country). In addition, there was no PLPA in place between the two companies. The lower tax court also denied the existence of a "de-facto" tax group (which may be considered to exist where the parent entity is compensating the subsidiary for its losses, even though there is no legal agreement requiring it to do so).

In its decision, the lower tax court provides a detailed overview of the Court of Justice of the European Union (CJEU) decisions regarding the requirements for the cross-border recognition of losses (starting with the 2005 Marks & Spencer decision). The lower tax court then states that it is unnecessary to reach a decision on whether the German concept of a consolidated tax group violates EU principles (namely, the freedom of establishment principle under the Treaty on the Functioning of the European Union) because even if there were such a violation, the appeal could not be successful. The court stated that a violation of EU law in the case at hand would not automatically lead to a recognition of cross-border losses for German tax purposes, but potentially only to a different interpretation of the requirements for a tax group under German principles.

In such a case, the requirement of a formal PLPA would have to be interpreted in such a way that, at a minimum, a legally binding agreement between the parent entity and its subsidiary would be required (even if the agreement lacks all the formalities of a PLPA). No such agreement was concluded between the German parent entity and its French subsidiary, so the lower tax court found it unnecessary to analyze whether the German tax consolidation rules potentially violate EU principles.

The decision of the lower tax court follows previous decisions of other lower tax courts and does not come as a surprise. However, the decision highlights a couple of noteworthy points:

- EU law does not include a general principle that cross-border losses must be allowed from a tax perspective; the recognition of such losses may be required only under very limited circumstances, as provided by CJEU jurisprudence.
- A violation of EU law does not necessarily lead to the automatic result that a domestic provision is invalid; a different interpretation of a domestic provision could be sufficient as a less drastic measure to rectify the violation. In particular, this may be the case for the conditions to form a German tax consolidation, including the key requirement that a PLPA be concluded.

Whether the German tax consolidation regime requires a binding legal agreement between the parent and the subsidiary for a subsidiary's losses to be recognized at the parent's level under EU principles is a long-standing dispute among German tax practitioners. The lower tax court of Schleswig-Holstein's decision confirms the position of the German lower tax courts.

Since this case involved tax year 2012, the court did not have to consider a request (a letter of formal notice) from the European Commission in July 2019 with regard to the recognition by Germany of profit and loss transfer agreements concluded with corporations established under the laws of another EU/EEA member state. Based on our knowledge, Germany has not yet responded to the request from the commission.

The taxpayer has filed an appeal against the lower tax court's decision with the federal tax court. It will be interesting to see whether the federal tax court shares the view of the lower tax courts.
