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German Tax and Legal News

Lower tax court decides on trade tax loss forfeiture in case of shareholder change in a partnership that is a controlling parent entity in a tax group

Lower tax court confirms view of the tax authorities that results in a current year loss forfeiture for trade tax purpose in consolidated tax groups with a controlling partnership.

The lower tax court of Muenster in a decision dated 21 March 2023 and published in June 2023 ruled on the forfeiture of current year losses for German trade tax purposes where a partner in a controlling partnership in a tax consolidated group exits the partnership during a financial year (FY). In the court's view, the change of shareholder results in a current year trade tax loss forfeiture at the level of the controlling partnership even if the consolidated income of the tax group for the FY results in a profit. The court held that for trade tax purposes, the income of a controlling entity and a controlled entity in a tax consolidated group must be determined on a standalone basis as a first step and can only be consolidated at year end as a second step. Where there is a change of shareholder during an FY, a current year loss is (partially) forfeited for trade tax purposes without any current year profit of a controlled subsidiary being taken into account.

Background

The case decided by the lower tax court involved a German limited partnership (KG) that was a controlling parent entity in a tax group with several controlled corporate subsidiaries. The KG did not have any net operating loss (NOL) carryforwards, either for corporate income tax or trade tax purposes. Based on the current year activities, the KG was generating a loss on a standalone basis; however, its subsidiaries were profitable, so that based on the profit and loss pooling agreement (which is a requirement for a tax consolidated group for income tax purposes) the consolidated group as a whole was profitable for the year in question. During the FY, the partners in the KG contributed their partnership interests (except for a 3% interest held by the general partner) into a newly formed partnership.

The tax authorities took the position that the contribution of the partnership interests into a newly formed partnership qualified as a harmful ownership change for the purposes of the trade tax specific change-in-ownership rule in section 10a of the Trade Tax Act (TTA). As a result, the tax authorities disallowed 97% (representing the percentage ownership change) of the current year trade tax loss that was generated at the level of the KG on a standalone basis for the period from the beginning of the FY until the date of the harmful ownership change event. The tax authorities argued that based on the mechanics of the profit and loss pooling agreement, a consolidation with the taxable trade tax profit at the level of the controlled subsidiaries only takes place at year end and that in the case of a harmful ownership event during an FY, the standalone loss at the level of the controlling parent entity has to be considered. The taxpayer contended that even in the case of an ownership change in the course of an FY, a trade tax loss forfeiture could only happen where the consolidated income for the whole FY resulted in a current year loss for trade tax purposes. Where a consolidated taxable profit for trade tax purposes arose for the whole FY, the trade tax specific change-in-ownership rule should not apply to an ownership change that took place during the FY.

Decision of the lower tax court

The lower tax court of Muenster based its decision on the mechanics of the profit and loss pooling agreement and section 2(2) sentence 2 of the TTA which provides, that for trade tax purposes, the controlling parent entity and the controlled subsidiaries in a tax group must be treated as separate businesses for calculating their income for trade tax purposes. Only as a second step at the end of the FY may their income be consolidated for trade tax purposes.

The tax court in its decision analyzed the trade tax specific change-in-ownership rule in section 10a of the TTA. Based on this provision (which is different to the general change-in-ownership rule in section 8c of the Corporate Income Tax Code) a direct change of a partner in a partnership results in a pro rata trade tax loss forfeiture irrespective of any interest percentage thresholds. This principle does not only apply where the partnership has NOL carryforwards but also where the partnership generates current year losses for trade tax purposes. In the case of current year losses, the loss generated prior to the date of the harmful ownership change is forfeited based on the percentage of the ownership change. The tax court confirmed a harmful ownership change as a result of the contribution of the partnership interests into a new partnership and disallowed 97% of the current year trade tax losses that were generated at the level of the KG prior to the date of the contribution of the partnership interests.

The court also confirmed that a consolidation of the income of companies that are part of a tax consolidated group does not take place on a continuous basis but only at year end. For ownership changes during an FY and the application of the change-in-ownership rule, the profit or loss situation of the companies that are part of a tax consolidated group has to be taken into account on a standalone basis.

Comments

The decision of the lower tax court of Muenster demonstrates that a harmful change-in-ownership event during an FY in the case of a consolidated tax group with a German partnership as the controlling parent entity may result in the unintended forfeiture of current year trade tax losses even if the tax consolidated group is profitable based on the end result for the FY. The same consequences may apply for corporate income tax purposes; however, the conditions for a loss forfeiture for corporate income tax are slightly different.

The transfer of an ownership interest in the controlling parent entity in a tax group during an FY could result in unexpected consequences and a careful analysis of the potential implications should be undertaken when an ownership change takes place or is proposed.
