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Federal Tax Court (I R 40/19): Waiver of Loan Interest in Cross-Border Triangular Cases

In its judgment of 27 November 2019 (40/19), the BFH ruled that according to the wording of § 1 (1) AStG an income correction in connection with a constructive dividend has no primacy.

According to § 1 (1) AStG, if the income of a taxable entity arising from cross-border transactions with a related party is reduced by arrangements that are not arm's length, the income without prejudice to other provisions is to be corrected. Pursuant to § 8 (3) sent. 2 of the Corporate Income Tax Law [KStG] constructive dividends also do not reduce income and are thus to be corrected off-balance sheet.

In the case at hand, the plaintiff, a German limited liability company [GmbH], was sole shareholder both of a German limited liability company (A-GmbH) and a company domiciled in the Czech Republic. In addition to the plaintiff, A-GmbH also granted a loan to its Czech affiliate. The loan was provided free of interest with retroactive and future effect in 2003. The tax office added back the respective interest income off-balance sheet. An appeal against this before the Lower Tax Court was unsuccessful.

The BFH upheld that all requirements are met in respect of the interest-free loan of A-GmbH to the affiliate in the Czech Republic and therefore the reduction in profit according to § 1 (1) AStG is to be corrected off-balance sheet. In its ruling, the BFH also made general statements on the relationship between § 1 (1) AStG and a correction due to **constructive dividend** according to § 8 (3) sent. 2 KStG: while § 1 (1) AStG is only to be applied without prejudice to other provisions, at the level of A-GmbH a correction pursuant to § 8 (3) sent. 2 KStG could also come into consideration. From this wording, there appears to be no primacy of § 8 (3) sent. 2 KStG. Instead, both provisions would overlap in the sense that a profit correction in accordance with one provision is unnecessary if it was already carried out in accordance with the other provision. Provided the legal consequences of both provisions do not deviate from one another, the practitioner can select which

Content

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legal norm he considers to be primary.

In giving reason, the BFH first cites the wording of the law, according to which the term "without prejudice" is applied in the legal context within the meaning of a co-existence of standards. Furthermore, the purpose of § 1 (1) AStG is to serve the "recording of the applicable domestic profit". According to established case law, the provision of advantage between affiliates is to be assessed such that the providing subsidiary affords the advantage initially to the common parent – by way of a constructive dividend – which then transfers the advantage to the other subsidiary. In case of the advantage – namely making use of the loan interest-free or where the interest receivables already accrued were not recoverable – this does not represent a contributable asset under tax law. In the triangular case at hand, interest income would therefore not be recorded in profit or loss, although § 8 (3) sent. 2 KStG initially applies for the constructive dividend. Consequently, the objective of imposing tax on an applicable domestic profit in this case can only be attained by a correction of income according to § 1 (1) AStG.

In the case at hand, the BFH overturned the decision of the lower court and referred the case back to the Lower Tax Court as not all findings necessary for a ruling had been made.

Federal Tax Court (IV R 11/18): Advance Profit Payment for Management at a Partnership

In its judgment of 28 May 2020, the German Federal Tax Court [BFH] ruled that the advance profit payment made to the general partner in form of a German limited liability company [Komplementär-GmbH] for the assumption of management of a limited partnership [KG] can be attributed to the limited partner as special remuneration if the latter provides management as managing director of the GmbH. This applies to the extent that the business purpose of the GmbH is restricted to management of the affairs of the partnership.

Remuneration received by a partner of a commercial partnership from the partnership for its activity in service of the partnership is considered business income and has equal standing with the profit share of the partner.

In the case in question, the plaintiff and appellee was, among others, P GmbH & Co. KG. Its general partner (with unlimited liability) of the plaintiff is A Verwaltungs GmbH, which has no participation in the capital of the KG. A Verwaltungs GmbH alone is entitled and obligated to manage and represent the KG. The limited partners of the KG, in equal parts, are B and C. Both are in equal parts also sole partners and managing directors of A Verwaltungs GmbH. Pursuant to the partnership agreement, A Verwaltungs GmbH receives advance profit payment for management. However, the tax office attributed this management remuneration to the limited partners B and C, which, as managing directors of the general partner, managed the affairs of the KG. The Lower Tax Court allowed the action brought against this ruling to proceed.

The BFH has now ruled that the decision of the Lower Tax Court is to be reversed. According to established case law, remuneration as share of profit is attributed to a limited partner, which the latter receives at a limited partnership with a limited liability company as general partner [GmbH & Co. KG] where the limited partner manages the business operations of the KG in his capacity as managing director of the Komplementär-GmbH. The limited partner thus has a dual role, as it is executive body of the GmbH and partner of the KG at the same time. In this respect, its management activity cannot be detached from its capacity as partner of the KG. This reasoning applies to the extent that the business purpose of the Komplementär-GmbH is restricted to management of the affairs of the partnership. The effect of this judgment is that only an shareholding manager of the Komplementär-GmbH, which is not at the same time limited partner of the KG, is granted the option to retain profits at the Komplementär-GmbH through prior waiver of management remuneration to the Komplementär-GmbH, but not the shareholding manager, which is at the same time limited partner.

The subject was referred back to the Lower Tax Court for further hearing and ruling. The Lower Tax Court has now to determine the appropriate amount of remuneration for liability and management.

Lower Saxony Lower Tax Court (7 K 67/15): Transfer of an Asset to a Partnership

In its judgment of 17 October 2019, the Lower Saxony Lower Tax Court ruled that a transaction against payment is only assumed for the transfer of an asset in exchange for partners' rights to the extent that the equivalent value of the asset increases the fixed capital.

In the case of the transfer of assets to a partnership, the income tax consequences differ

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depending on whether the transaction qualifies as against payment or without compensation. This categorisation is based on the manner in which the equivalent value of the asset received is recognised at the level of the partnership. In the case of an uncompensated transfer, as legal consequence, among others, for the partnership the basis of assessment for future depreciation is to be reduced by those amounts that were already previously applied by the transferor to the private assets. By contrast, if a transfer qualifies as against payment, tax-effective depreciation of the unreduced value of the asset can occur at the level of the partnership.

In the case under dispute, the plaintiff was a partnership (private partnership under the German Civil Code, GbR), whose partner had transferred land including wind turbine to the assets of the newly established GbR. A small portion of the equivalent value of the transferring asset was recorded as fixed capital on what is known as "Kapitalkonto I" (capital account I) and otherwise credited to a jointly restricted reserve. In the opinion of the plaintiff, given that it was partially credited to Kapitalkonto I, the transaction qualifies in total as against payment in accordance with the opinion of the German Federal Ministry of Finance in a circular of 11 July 2011. In contrast, the tax office assumed uncompensated contribution and consequently reduced the tax base for depreciation of the transferred asset for the uncompensated part.

The Lower Tax Court ruled that the transaction is not to be valued singly but to be divided into parts. The amount of the credit on the fixed capital account is considered a transaction resembling a swap in exchange for partners' rights and therefore a transaction against payment. The amount of the credit on the reserve account, on the other hand, does not qualify as granting of partners' rights and thus is considered an uncompensated transaction. Consequently, the basis of assessment for depreciation of the uncompensated portion is to be reduced. In the opinion of the Lower Tax Court, this treatment reflects the economic substance of the transaction. To the extent that the German Federal Tax Court [BFH] in similar cases in the past ruled that a single evaluation for separation of the equivalent value is nevertheless to be made (referred to as "combination model"), it must be implicitly inferred from the BFH's more recent rulings that this opinion is no longer held.

Permission to appeal to the German Federal Tax Court was granted given the fundamental significance of the case (file ref. IV R 2/20). It remains to be seen whether amendment of the judgment of the BFH, as expected by the Lower Tax Court, will occur.

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