By PwC Deutschland | 10. August 2026

Interest expense not deductible if tax base is also reduced in another state

In a recently published judgment, the Supreme Tax Court decided that the disallowance to deduct special business expenses under Section 4i Sentence 1 of the German Income Tax Act for partnerships with foreign partners may also apply to cases of Dutch group taxation. Furthermore, it is not only important whether a formal deduction for business expenses is made abroad, but also whether the expenses economically reduce the taxable income abroad.

Key message of Section 4i Income Tax Act (ITA)

In essence, Section 4i ITA is related to action point 2 of the OECD/G20 recommendations on “Base Erosion and Profit Shifting (Neutralizing Hybrid Mismatch Arrangements) and restricts the deduction of special business expenses where the same expenses are deducted again from the tax base in another country. This restriction does not apply to the extent that such expenses reduce the income of the same taxpayer that is subject to both domestic taxation and, as can be demonstrated, actual taxation in the other country.

This rule is designed to prevent a “double dip” where a foreign partner’s expenses could reduce taxable income both in Germany and abroad, particularly in partnership structures involving foreign group companies

Background

A Dutch C-B.V. held a 100% limited partnership interest in the plaintiff, a GmbH & Co. KG with its registered office in Germany. F-B.V. held a 100% interest in C-B.V. C-B.V. and the F-B. V. established a group for income tax purposes (known as a “fiscale eenheid”) in the Netherlands. F-B.V. granted several loans to C-B.V who in turn paid monthly interest on the loans to F-B.V. The plaintiff recorded the liabilities arising from the loans granted by F-B.V. in a separate balance sheet and claimed C-B.V.’s interest expenses as special business expenses.

The tax office treated the loan interest paid by C-B.V. as special business expenses which are disallowed under Section 4i Sentence 1 ITA.

Decision

The Supreme Tax Court confirmed the view of the tax office. The non-deductibility under Section 4i Sentence 1 ITA only applies to partnerships, since special business expenses, as expenses incurred by a partner, are an integral part of the two-step profit determination process for a partnership. The interest at issue in this case - on a loan taken out by a partner to finance his contribution to a partnership - also qualifies as special business expense, since, according to established case law of the Supreme Tax Court, such loans are held as **Special Business Assets II**.

Note: *Necessary* ***Special Business Assets II*** *will be assumed if assets of the partner are utilized to establish or strengthen his interest in the partnership whereas* ***Special Business Assets I*** *are suited and intended to serve the business of the partnership.*

The partner as co-entrepreneur may be a taxpayer subject to unlimited or limited income tax or corporate tax liability in Germany. In the present case, the Supreme Tax Court concluded that the interest would also have reduced the tax base in the Netherlands. Consequently, the prohibition to deduct the interest under Section 4i Sentence 1 ITA applied. The exception to the non-deductibility as set forth in Section 4i Sentence 2 ITA did not come into play in the case at hand, as was also not in dispute between the parties involved. Therefore, the Supreme Tax Court refrained from further explanations.

The Supreme Tax Court went on to say that the example of application cited in the legislative materials does not indicate the intention to limit the scope of application of Section 4i Sentence 1 ITA solely to cases involving a formal double deduction of business expenses. On the contrary, the Supreme Tax Court is convinced that the tax base abroad is to be reduced according to Section 4i Sentence 1 even if the expenses (special business expenses) are deducted from the corresponding income of another taxpayer. In the example mentioned, a foreign limited partnership (limited partner) had financed its capital contribution to a domestic GmbH & Co. KG through a (group) loan. The limited partner’s expenses were recognized as business expenses abroad, and the parent company’s income corresponding to those expenses was also regularly recorded as business income abroad.

Finally, the Supreme Tax Court notes that the prohibition of deductions under Section 4i ITA does not violate the fundamental right for freedom of establishment with respect to co-partners resident in other EU countries.

Source:

Supreme Tax Court, judgment of 11 June 2026 (IV R 36/23) published on 6 August 2026.

Schlagwörter

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