By PwC Deutschland | 25 May 2011

Loss offset limitation 1999-2003 only applies to notional losses

The Supreme Tax Court has held that the 1999-2003 “minimum taxation” rules apply to “paper” losses, but not to those borne with true economic effect.

“Minimum taxation” rules were introduced in 1999 for the first time, largely in response to a plethora of commercially touted tax-saving schemes based on investments in loss-making partnerships. The investors were ranked as “active partners” so that they could offset their partnership loss allocations against their other income. Needless to say, they never actually had to cover a loss in cash, although they did run a risk of losing their investment. The authorities tolerated this practice for many years, mostly because of the progressive rate scale which generally led to the recovery of the loss (or its disappearance on insolvency of the partnership) being taxed at more than the benefit gained from the offset. However, in 1997/1998 matters came to a head, forcing the government to take action to curb an increasingly wide-spread abuse (and also to protect the public). The method chosen was to continue to allow unrestricted loss deduction against income from the same type of activity, but to restrict the deduction from other types of income to the first DM 100,000 plus one-half of the excess. However, the system was complicated and the wording of the statue was unclear. In particular, there was (and still is) an unresolved dispute as to whether the first DM 100,000 applied to the total of losses from all sources or to each type of loss separately.

The Supreme Tax Court has not settled all aspects of the dispute, although it has now taken a lot of the heat out of the argument by holding that the rules only apply to losses that will not have to be met in cash. Other, „real” losses continue to be deductible against income from other activities without limitation. Thus, a married couple was entitled to set its entire rental income against its still higher trading loss. The court argued that the wording of the statute was unclear. Various interpretations were possible, but none led to a particularly logical or satisfactory result. It therefore chose to revert to the legislative intention as evidenced in the official explanation to the bill published as background material for the parliamentary debate, and to the changes made to the text in the course of enactment. Thus, it could not follow the originally planned distinction between active and passive income, as this had been dropped from the final text. On the other hand, it could follow the intended object of the legislation – to limit the relief available on losses that were not a real burden – particularly in view of the list of “unreal” types of loss published at the time. This took its present case out of the “minimum taxation” net altogether.

This judgment is not relevant to the “minimum taxation” provisions from 2004.

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