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Interest paid by foreign partner deductible also in case of two-tier partnership

In a decision published in March 2017 the Supreme Tax Court held that - in the case of a two-tier partnership structure – the interest expense of the Dutch partner holding only an indirect share in a German limited partnership is nevertheless tax deductible when computing his limited German tax liability resulting from his investment in the German partnership.

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Specifics of the taxation principles of German partnerships

Assets assigned by a partner to the partnership are referred to as “assigned business assets I” (*Sonderbetriebsvermögen I*). Income directly derived from these assets and expenses incurred in direct connection therewith are similarly classified. On the other hand, assets and liabilities remaining in the possession of a partner, but used by him in connection with his share in the partnership are also attributed for tax purposes to the assets of the partnership “assigned business assets II” (*Sonderbetriebsvermögen II*). The same applies to the related items of income and expense. These income and expense items are included in the results of the partnership, but are then allocated to the partner concerned as prior profit shares or charges.

The case before the Supreme Tax Court involved a Dutch BV who was the sole limited partner of a German limited partnership (a GmbH & Co. KG). The BV took a loan from its Dutch parent in order to finance its investment in the German partnership. Later the BV contributed its share in the German partnership to a Dutch partnership (CV) thus holding only an indirect interest in the German KG via the Dutch CV (the upper-tier partnership). The question arose whether the interest expense of the BV would still be tax deductible when calculating the taxable income attributable to it and emanating from its share in the KG. The German tax office refused, pointing out that –as a result of the sale to CV - the loan financing of BV could no longer be viewed to be in connection with its share in the German (lower-tier) partnership.

Upper-tier partnership as co-entrepreneur of lower-tier partnership

The Supreme Tax Court sided with the appellant (i. e. the German partnership) and considered the loan as still being connected with the investment of the BV in the German partnership and thus the interest to be deductible from the German tax basis of the BV. The Court’s reasoning was that - also in the case of a two-tier partnership – the BV as a partner in the upper-tier partnership (CV) may nevertheless claim “assigned business assets II” on the level of the German (lower-tier) partnership and thus deduct the interest paid in connection with the loan financing. The income received by BV from its investment in the German partnership (business) is treated as income from a trade or business for which a permanent establishment is maintained in Germany and subject to limited tax liability in Germany. It follows that the related interest expense thus reduces the German taxable income of the Dutch BV.

Supreme Tax Court judgment I R 92/12 of October 12, 2016 published on March 8, 2017

Keywords

Two-Tier Partnerships, limited partnership, loan financing