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By PwC Deutschland | 01 August 2019

Restrictions to the “tainting effect” of trading partnership income for trade tax purposes

For income tax purposes, income of a partnership from leasing and letting or from capital assets is to be reclassified as trading income where the partnership also receives a negligible amount of income from a participation in a trading partnership; however, such “tainted” income is not subject to trade tax.

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This was decided by the Supreme Tax Court in its ruling of 6 June 2019, published on 1 August 2019.

Background

In the case, a limited partnership ("the KG") generated income predominantly from leasing and letting and from capital assets. In addition, a very small amount of (negative) trading income from its participations in other partnerships was attributed to it.

In particular situations, the Income Tax Act (ITA) treats the non-trading income of a partnership as trading income. This is referred to as the "tainting effect" ("Abfärbewirkung"); it applies where a partnership has income from its an own trading activity (Section 15 (3) No. 1 **Alternative 1** ITA) and where it receives income from a participation in a trading partnership (Section 15 (3) No. 1 **Alternative 2** ITA).

Decision

The Supreme Tax Court had previously decided that non-trading income would not become tainted where only negligible amounts of trading income from an entity's own trading activities (Section 15 (3) No. 1 Alternative 1 ITA) were received in addition to non-commercial income. In the instant case, the KG argued that such a de minimis ruling should also apply to its income from its participation in a trading partnership. It contended that in view of the negligible amount, such a tainting of non-trading income from trading partnership income under Section 15 (3) No. 1 Alternative 2 ITA would be disproportionate.

The Supreme Tax Court, however, took a different view: for income tax purposes, income from the participation in a trading partnership always gives rise to a requalification of non-commercial income regardless of the amount. This was a fundamentally permissible standardisation, according to which one type of income is to be classified as another type of income. Depending upon the circumstances of each individual case, this reclassification could also lead to tax advantages for the taxpayer, such as the recognition of losses or the creation of reserves.

For trade tax purposes, however, the effect of a tainting from the trading partnership income under Section 15 (3) No. 1 Alternative 2 ITA) – as opposed to the effect of a tainting from an own trading activity under Section 15 (3) No. 1 Alternative 1 ITA -- can only be constitutional if the tainted income is not subject to trade tax. This would be the only way to avoid putting a partnership in a worse position than a sole proprietorship, which would be unconstitutional.

In its judgment, the Supreme Tax Court referred to the protection of trade tax revenue as a ratio legis. The tainting effect of income from an own trading activity prevented trading income from being excluded from the trade tax base due to the difficulties in differentiating between the separate activities of the entity. This danger does not exist in the case of income from the participation in a trading partnership, so that there is no need to taint. Furthermore, the income from the participation in a trading partnership, which gives rise to the tainting of the non-trading income of the parent entity (here the KG) for income tax purposes, would not in any event be subject to trade tax due to the trade tax deduction.

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