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By PwC Deutschland | 25 October 2021

Loss utilisation restriction (Section 2a (1) Sentence 1 No. 5 Income Tax Act) does not apply to the loss of a silent partner's contribution

According to a decision of the Supreme Tax Court published on 21 October 2021, the loss of a silent partner's contribution, which is reflected as a partial write-down for tax purposes, does not fall within the scope of the loss utilisation restriction under Section 2a (1) Sentence 1 No. 5 in conjunction with Sentence 2 Income Tax Act (ITA).

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"Profit reductions" within the meaning of Sec. 2a (1) Sentence 2 ITA are only those profit reductions that result from transaction-based private withdrawals or partial write-downs and which do not lead to negative income, for example, because they only reduce higher positive income.

Background

The plaintiff is the universal successor of her husband (E), who died in 2005. Among various other activities, E operated a sole trader enterprise.

E made a contribution to B GmbH, a limited liability company based in Kazakhstan, as a silent partner and held the investment as part of the business assets of his sole trader enterprise. The interest was based on various agreements between E and his Kazakhstani business partner, S.. The contractual partners initially wanted to set up a company either under the law of the Republic of Kazakhstan or under German law. Since liquid funds were required immediately, E was initially to provide S with a loan, which was to be transferred to the company later as a share capital contribution. E then transferred the agreed loan amount to the GmbH on June 25, 2002. Later, E and S concluded another agreement because S had not used the funds provided as a loan in the manner originally agreed. E then waived his right to a transfer of 50% of the shares in B GmbH. Instead, S was to grant him a silent partnership interest in the GmbH with retroactive effect from 01.07.2002.

S also died in 2005. Thereupon, the plaintiff's son went to Kazakhstan. His efforts to obtain documents or to obtain repayment of the contribution from S's heirs were unsuccessful. According to the plaintiff, the limited liability company was liquidated in 2006. The plaintiff then booked the loss of the investment against profit as of December 31, 2006.

In her income tax return for 2006 (year in dispute), the plaintiff declared, inter alia, income from business operations after a deduction/write-off of the loss on the investment.

After the tax office had initially followed the plaintiff's returns, an external audit came to the conclusion that the loss of the investment was not to be taken into account pursuant to § 2a (1) Sentence 1 No. 5 ITA in the version applicable in the year in dispute .

The action before the lower tax court was unsuccessful.

Decision

The Supreme Tax Court allowed the appeal and overturned the decision of the lower court.

The lower court first correctly assumed that the plaintiff's investment in the GmbH was to be assessed as a typical silent partnership, which as such is subject to Sec. 2a (1) Sentence 1 No. 5 ITA.

Germany’s right to tax was not excluded by the Double Tax Treaty with Kazakhstan (DTT). At any rate, it was not apparent from the provisions of the DTT-Kazakhstan that the right to tax could be withdrawn from Germany as the state of residence.

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Contrary to the view of the tax court, however, the loss of a silent partner's contribution, which was shown for tax purposes as a write-down to the going-concern value, did not fall within the scope of Section 2a (1) Sentence 1 No. 5 ITA.

According to the wording of Section 2a (1) Sentence 2 ITA, the term "profit reduction" does indeed also cover profit reductions resulting from partial write-downs to the going-concern value of an investment. However, the legislator (according to the explanatory notes to the provision) included Section 2a (1) Sentence 2 ITA in the law in order to "allocate profit reductions resulting in particular from write-downs to the going concern value to negative income within the meaning of Section 2a ITA".

As a result, the term "profit reductions" should only refer to those profit reductions which result from a transaction-based private withdrawal or partial write-down and do not lead to negative income because they only reduce higher positive income. Only such cases are to be excluded from deduction by Section 2a (1) Sentence 2 ITA.

Source

Supreme Tax Court judgment of 09 June 2021 (I R 35/18), published on 21 October 2021.

Keywords

curtailment of loss relief, investment write-down, silent partnership