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Scope of dual consolidated loss rules broadened

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The scope of Germany's dual consolidated loss (DCL) rule has been expanded to apply to any situation in which the losses of either a group parent or subsidiary are taken into account in a foreign jurisdiction. The new rule may affect both inbound and outbound structures.

The changes to the DCL rule were included in the Act on the Modification and Simplification of Business Taxation and of the Taxation of Travel Expenses, which was passed by the upper house of parliament on 11 February 2013. The president signed the act on 20 February and it became effective on 26 February.

Content of new rule

The wording of the new DCL rule is as follows:

"*Losses of a controlling entity or a controlled entity in a German tax consolidated group are disallowed for German tax purposes to the extent such losses are taken into account for foreign tax purposes at the level of the controlling entity, the controlled entity or any other person.*"

The amended wording leads to a significant extension of the rule. Under the old DCL rule, the use of losses at the level of the controlling entity was disallowed only where the losses were taken into account in a foreign jurisdiction by the controlling entity under a regime similar to the German tax consolidated group regime. As a result, the rule was of limited practical relevance.

While the original intent of both the old and the amended DCL rules was to disallow the simultaneous use of losses for German and foreign tax purposes by dual resident companies that are part of a German tax group, this intent is not expressed in the wording of either version of the rules.

Scope of amended DCL rule

The amended version of the DCL rule applies to both controlling entities and controlled entities in a German tax consolidated group, whereas the old rule applied only to controlling entities in such a group. The original intent of the legislator to target double dip structures where dual resident companies are used is not included in the final amended version of the DCL rule. According to the legislative history of the amendment, the wording of the rule changed several times during the legislative process and, while the limitation of the application of the rule to dual resident companies has been eliminated from the final wording, it seems doubtful whether the original intent of the legislator can be used by taxpayers to argue that the amended DCL rule applies only to dual resident companies.

The amended wording of the rule includes a different technical description of the term “losses” (“negative *Einkuenfte*” instead of “negative *Einkommen*” in the original version), which may lead to the result that the rule applies where the controlling entity is in a loss position on a stand-alone basis, i.e. profits transferred under a profit and loss pooling agreement from the controlling entity’s subsidiaries cannot be taken into account. The same applies for a controlled entity, i.e. whether the controlled entity is in a loss position must be analyzed on a stand-alone basis. Specific expenses at the level of the controlling entity/controlled entity that are taken into account in a foreign jurisdiction for tax purposes should not fall within the scope of the rule as long as the controlling entity/controlled entity is in a profit position (on a stand-alone basis).

Losses of the controlling entity or a controlled entity are disallowed for German tax purposes only to the extent they are taken into account for foreign tax purposes.

It is worth noting that the treatment of the controlling entity (and in certain cases the treatment of the controlled entity) in a German tax group as a flow-through /disregarded entity for US tax purposes may trigger the amended DCL rule if losses of one of the German entities are recognized for US tax purposes.

It is unclear whether the rules also apply where expenses for German tax purposes at the level of the controlling entity do not give rise to corresponding income at the level of the recipient for foreign tax purposes (i.e. where the relevant income stream is disregarded). Such situations would need to be analyzed carefully.

Finally, there is some discussion as to whether the new DCL rule would apply to a partnership that is a controlling entity in a tax group (a partnership can never be a controlled entity in a tax group). If so, this could affect structures where financing expenses in connection with the acquisition of the partnership interest are deducted at the level of the foreign partner and at the level of the German partnership under the special business expenses concept under German law.

Consequences of amended DCL rule

As a result of the application of the amended DCL rule, losses are disallowed for German tax purposes and losses so disallowed cannot be carried forward.

It is unclear whether the disallowance of losses would apply only for corporate income tax purposes or also for trade tax purposes. Prevailing opinion under the old rules was that the disallowance did not apply for trade tax purposes, but whether the same arguments can be used under the new rule is questionable.

Based on the actual wording of the law, the new DCL rule will apply to all open tax years and, therefore, may affect prior years, although it is questionable whether retroactive application of the rules for years before 2012 is in line with the German constitution.

It also is questionable whether either version of the DCL rules is in line with the EU freedom of establishment principle following the decision of the Court of Justice of the European Union in the *Philips Electronics* case, in which the court held that a restriction under the UK group relief rules, under which a loss could be transferred only if it was not utilized abroad, whether by the same person or a different person, constituted an infringement of the freedom of establishment.

Comments

Apart from the wording of the law and the legislative history, no additional guidance currently is available on the application of the amended DCL rule. It is unclear whether the German tax authorities will issue such guidance and if so, when it will be issued.

Taxpayers should analyze their structures and the potential impact of the amended DCL rule. US investors in Germany that have checked their German subsidiaries as disregarded entities, in particular, should review their structures and closely monitor future developments in Germany.