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German Tax and Legal News

MOF issues guidance on guaranteed minimum dividend payments to minority shareholders in tax consolidated group

Circumstances clarified where variable compensation payments to shareholders are not harmful to existence of tax group.

In a decree issued by the federal Ministry of Finance (MOF) dated 4 March 2020 and published on 5 March 2020, the German tax authorities provide guidance on “compensation payments” made by controlled fiscal unity subsidiaries to minority shareholders (also referred to as guaranteed dividends/payments or “*Ausgleichszahlungen*”) and describe under what conditions compensation payments that include a variable component are not considered harmful to the existence of the tax group (“*Organschaft*”).

Under a profit and loss transfer agreement ((PLTA), a valid legal agreement that is the basis for the German tax group concept), a controlled subsidiary in a tax group must transfer its entire profit to its controlling parent entity even if the parent entity does not own 100% of the shares in the controlled subsidiary (the majority of the voting rights is sufficient to set up a tax group). If the parent entity owns less than 100% of the shares in the controlled subsidiary, under certain circumstances a minority shareholder in the subsidiary is entitled to compensation payments by the controlled subsidiary or the controlling parent entity because the minority shareholder no longer participates in the profit of the controlled subsidiary as a result of the conclusion of the PLTA. Such compensation payments are mandatory under the Stock Corporation Act, and in practice also are common in cases where the controlled subsidiary is a corporation with the legal form of a GmbH.

It has been uncontroversial that compensation payments to minority shareholders that are based on an annual fixed amount (calculated at the time the tax group is set up, based on the average profits of the controlled subsidiary in the past and its expected profits in the future) do not impact the validity of the tax group. However, there has been controversy regarding the impact of compensation payments that provide for a variable component (based on the actual profits of the controlled subsidiary during the existence of the tax group).

In the past, based on the wording of the relevant law, the German tax authorities generally took the position that a compensation payment to a minority shareholder must be a fixed payment; however, the tax authorities did not consider a payment with a variable component that did not exceed certain (limited) thresholds to be harmful to the existence of the tax group. However, in a decision dated 10 May 2017, the federal tax court held (to the disadvantage of the taxpayer) that any compensation payment that includes a variable component is harmful and prevents the recognition of the German tax group. In response to the decision, the tax law was amended with retroactive effect (for all open years) and a new provision was introduced, under which a minority shareholder may receive a variable payment in addition to a fixed minimum compensation amount. Based on the amended law, however, the entire compensation payment must not exceed the pro rata share of the controlled subsidiary's income that would be allocable to the minority shareholder in a scenario where no tax group existed. In addition, to discourage tax planning arrangements, the variable portion of the payment must be economically justified.

The MOF's March 2020 decree provides further guidance, clarifies how the relevant thresholds must be calculated, and describes the economic analysis for a variable portion of the compensation payment. The decree provides that the maximum amount of a compensation payment must be determined based on the pro rata share of the minority shareholder. This applies even in cases where the parties agreed on a disproportionate profit distribution in the PLTA or where the compensation payment is determined on the basis of profits of only certain divisions of the controlled subsidiary (based on tracking stock, etc.). In addition, the decree clarifies that the purpose of the economic analysis is to prevent purely tax-motivated variable compensation payments and that, therefore, the test should

not be applicable in cases where the compensation payments are made to third-party minority shareholders, but only where they are made to related party minority shareholders.

The decree provides additional guidance on compensation payments made by controlled fiscal unity subsidiaries to minority shareholders and on the conditions under which compensation payments that include a variable component are not considered harmful to the existence of the tax group. Taxpayers that may consider starting to make compensation payments that include a variable component should carefully analyze the decree and the guidance provided by the tax authorities.

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