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German Tax and Legal News

No retroactive taxation of upstream merger involving tainted shares

An upstream merger does not fulfill all of the criteria of a disposal due to lack of consideration from the perspective of the transferring entity

A and B that each held 50% of the shares in C GmbH and D GmbH. In 2011, A and B decided on a share capital increase for D GmbH, with both A and B contributing their shares in C GmbH to D GmbH in return for new shares. In accordance with the Reorganization Tax Act (RTA), the contribution was made at tax book value. In 2012, C GmbH was merged upstream into D GmbH. Based on guidance issued by the tax authorities in 2011 on the application of the RTA, the competent tax office took the position that the holding period of the shares in C GmbH was tainted because of the upstream merger. As a result, the built-in gains in C GmbH's shares available at the time of the contribution had to be taxed on a retroactive basis. The taxpayer appealed the decision of the tax authorities to the court.

Under the RTA, reorganizations generally are possible on a no gain/no loss basis if certain conditions are satisfied. The RTA requires the shares received to be held for a period of seven years after a tax-neutral contribution of shares by an individual (in this case, the contribution of the shares in C GmbH). If the shares are disposed of during the seven-year period, the built-in gains existing as of the date of the contribution will be taxed on a retroactive basis, with the taxable gain reduced by one-seventh per year from the date of the contribution. According to the tax authorities' guidance on the application of the RTA, a disposal includes contributions and restructurings (including mergers).

The lower court of Hamburg did not entirely agree with the tax authorities' position. The court confirmed that the term disposal as a transfer of ownership to another party for consideration generally can be applied to reorganizations, even if they are executed at tax book value. However, an upstream merger does not fulfill all criteria of a disposal from the transferring entities' side because it does not receive any consideration for the transfer of its assets. Instead, the transferring entity (C GmbH) is dissolved without liquidation. Hence, the shares in C GmbH can no longer be transferred to a third party.

The court also held that an upstream merger is not contemplated in the purpose of the law. The law aims to ensure the taxation of the built-in gains at the level of the contributing party following a tax-neutral reorganization. In an upstream merger, the taxation of the built-in gains is secured in two ways: at the level of the party that receives the transferred assets and at the level of the shareholders by the increase of value of the shares.

The decision has been appealed and now is pending before the Federal Fiscal Court (I R 48/15).

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