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BFH rules merger gain is tax exempt in upstream merger into controlled fiscal unity subsidiary

BFH disallows 5% inclusion of deemed nondeductible business expenses.

In a decision dated 26 September 2018 and published on 27 March 2019, Germany's Federal Tax Court (BFH) ruled on the application of the domestic participation exemption in fiscal unity cases. The BFH held that the general 5% add-back rule, under which 5% of gains on a merger are deemed to be nondeductible business expenses for German tax purposes, will not apply in fiscal unity cases where an entity is merged upstream into a controlled subsidiary in a fiscal unity. The court reached this conclusion because the fiscal unity rules do not allow an add-back at the level of the controlled fiscal unity subsidiary or at the level of the controlling fiscal unity parent. Consequently, the BFH held that the merger gain was 100% tax exempt for German corporate income and trade tax purposes instead of only 95% tax exempt.

The taxpayer in the case had treated the merger gain triggered by the upstream merger of its third-tier subsidiary into its second-tier subsidiary, where both entities were part of a fiscal unity with a common parent, as fully tax exempt. The tax authorities challenged the tax treatment of the merger gain and the taxpayer filed an objection against amended tax assessment notices issued following a tax audit. The German tax authorities rejected the taxpayer's objection against the amended tax assessment notices and appealed the taxpayer-favorable decision of the lower tax court to the federal tax court.

In accordance with its decision dated 17 December 2014 (see GTLN dated 24 March 2015), the BFH held that, in light of fiscal unity principles and the mechanics of the tax rules applicable to fiscal unities, a 5% add-back may be applied only in cases where German tax law specifically provides for an add-back either at the level of the controlling fiscal unity parent or at the level of the controlled fiscal unity subsidiary. If such a provision is not available for a particular type of income, no add-back may be applied and the income should be fully tax exempt. In its 2014 decision, the BFH ruled on the tax exemption of dividends received by a German controlled fiscal unity subsidiary from its foreign subsidiary and concluded that, since German tax law does not provide for an add-back of 5% of the dividend income for trade tax purposes in fiscal unity cases, the dividends should be fully exempt from trade tax. The trade tax law subsequently was amended to provide that dividends received by a controlled fiscal unity subsidiary are effectively 95% tax exempt for both German corporate income tax and trade tax purposes as from FY17.

It currently is unclear whether German tax law will be further revised based on the BFH's recent decision. However, in light of the court's 2014 decision and the subsequent amendment to the trade tax rules, it is possible that the tax law will be amended to conform to the BFH's latest decision.

Affected taxpayers that were subject to a 5% add-back in connection with a merger gain triggered at the fiscal unity subsidiary level should consider filing an objection against the relevant assessments and claiming a 100% tax exemption for any merger gain based on the BFH's decision.

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