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German Tax and Legal News

Federal tax court rules downstream mergers with foreign shareholders are taxable

Long-standing dispute about tax consequences of down-stream merger of a company with foreign shareholders decided in favor of the tax authorities.

Germany's federal tax court (BFH) issued a decision on 21 November 2018 on the tax consequences of a downstream merger of a German corporation with foreign shareholders, confirming the position of the tax authorities that such a merger generally triggers a 5% taxable capital gain. The BFH overruled the decision of the lower tax court and is contrary to the position taken by most tax professionals—it put an end to a long-standing discussion in the tax literature.
The case before the BFH involved a German GmbH that was the sole shareholder of a Luxembourg Sarl. The shares in the GmbH were held by a US resident corporation. The GmbH was merged downstream into the Luxembourg Sarl, and as a result of the merger, the shares in the Luxembourg Sarl were transferred from the GmbH to the US corporation. In its final tax return, the GmbH claimed tax neutral rollover relief for the merger based on the provisions of the German Reorganization Tax Code (RTC) and did not claim a capital gain with regard to its assets. The tax authorities disagreed, referencing their position taken in the RTC decree (recital 11.19 in the decree dated 11 November 2011).

Under section 11 of the RTC, a merger generally must be carried out at fair market value (and therefore triggering a capital gain) with regard to the assets of the transferring entity that are transferred to the recipient entity. Tax neutral treatment of a merger is available upon request provided the following conditions are fulfilled: (i) the assets transferred are subject to German taxation at the level of the receiving entity; and (ii) future German taxation of the capital gains from the sale of the assets at the level of the receiving entity is not restricted or limited.

The taxpayer and the lower tax court were of the opinion that the above conditions for tax neutral treatment apply only to assets that are transferred from the entity that is merged out of existence to the surviving entity. Since the shares in the subsidiary in a downstream merger are not transferred to the surviving entity but to the shareholders of the entity that is merged out of existence, the restrictive conditions for tax neutral treatment do not apply.

The BFH disagreed, and clarified in its opinion that the assets referenced in the RTA include not only the assets that are transferred to the surviving entity but all assets transferred as a result of the merger. This would include the assets that are transferred to the shareholders of the entity that is merged out of existence.
In the case before the BFH, the shares in the Luxembourg Sarl were transferred to the US corporation, so the shares are no longer allocated to a German permanent establishment and, therefore, Germany loses its right to tax future capital gains arising from a sale of the shares (article 13(5) of the Germany-US tax treaty allocates taxing rights to capital gains from the sale of shares to the country where the shareholder is resident). Because the conditions for tax neutral treatment of the merger are not fulfilled, the downstream merger triggers German capital gains taxation with regard to the shares in the surviving entity, under which such gains should be 95% tax-exempt, with the remaining 5% subject to the general approximate 30% corporate income tax and trade tax rate.

The BFH also concluded that there was no violation of the nondiscrimination clause (article 24(4) of the Germany-US treaty or the EU merger directive. The BFH did not explicitly opine on whether the EU freedom of movement of capital or freedom of establishment principles were violated because any such violation would be justified by general EU taxation principles as described in recent jurisprudence of the Court of Justice of the European Union.
The BFH decision—while disappointing for taxpayers—should not come as a surprise. The court signaled during the oral hearings in May 2018 that it was leaning in favor of the tax authorities. Taxpayers that are planning to carry out a downstream merger of German

entities that are held by foreign shareholders (e.g. the top German holding company) will need to take the BFH decision into account before moving forward with the merger.

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