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Lower Tax Court of Nuremberg (1 K 483/17): Termination and Non-Performance of a Profit Transfer Agreement in the Event of Insolvency

Pursuant to § 14 (1) sent. 1 no. 3 of the German Corporate Tax Act [KStG], a profit transfer agreement must be concluded for at least five years and performed throughout its entire period of validity. Early termination of the contract by giving notice is not detrimental if an important reason justifies the termination. Early termination and non-performance of a profit transfer agreement due to insolvency is considered an important reason within that meaning according to the Lower Tax Court of Nuremberg.

In the decided case, A-Holding GmbH (hereafter 'Holding') was the sole holder and controlling entity of A-GmbH (hereafter 'GmbH') since 2006. The Holding and the GmbH were integrated into a so-called 'cash pooling' system together with A-Group. A cash pool was maintained at Bank X. The Holding was the holder of the primary target accounts. At the end of each day (midnight), the bank transferred the account balance of the GmbH account to the account of the Holding as instructed and agreed, so that the GmbH's account balance was EUR 0.00 (physical cash pool). Insolvency proceedings were initiated in 2009 regarding the Holding and GmbH assets – before the financial statements of the GmbH for 2008 could be formally adopted.

The question in dispute was to what extent early termination and non-performance of the profit transfer agreement due to insolvency during the minimum term is detrimental to the assumption of a corporate tax (and trade tax) group taxation. In its conclusion, the Lower Tax Court upheld the opinion of the tax office. The profit transfer agreement between the Holding and the GmbH ends under civil law with the initiation of insolvency proceedings regarding the assets of the Holding or GmbH in 2009 without requiring termination. The initiation of insolvency proceedings in 2009 constitutes an important reason for early termination of the profit transfer agreement from a tax perspective pursuant to § 14 (1) sent. 1 no. 3 sent. 2 KStG and accordingly is not detrimental.

Content

Lower Tax Court of Nuremberg (1 K 483/17): Termination and Non-Performance of a Profit Transfer Agreement in the Event of Insolvency

Lower Tax Court of Hesse (4 K 412/19): Financial Integration in the Event of Merger during the Year

Federal Ministry of Finance Guidance on Tax Exemption of Gains on Foreign Currency Hedges

State Decrees on Application of the Group Exemption Provision for Real Estate Transfer Tax Purposes

It is indisputable that the profit transfer agreement was actually performed in the years under dispute (2006 and 2007). The transferred profit was first recognised as profit/loss of the GmbH at the Holding through entry in the GmbH clearing account and the revenue accounts. Further transfers from the clearing account to the 'cash clearing account GmbH' also occurred. For the year under dispute (2008) as well, the profit transfer agreement was performed at GmbH by way of entry, known to Holding, in the 'profit transfer' expense account of GmbH and the clearing account of Holding. Lack of performance could be justified neither by non-adoption of the 2008 financial statements of GmbH and/or those of Holding as at 31 December 2008 nor disagreement between the tax authorities and the GmbH regarding the recognition or valuation of balance sheet items.

Profit transfer did not occur through actual payment but through entry in the 'GmbH/Holding' clearing account. This entry with the objective of clearing was known to the Holding and the latter was able to dispose of this amount. Further transfer from the clearing account to the cash clearing account, which is equivalent to actual payment, is not imperative in the opinion of the court. Also, actual payment is not required based on case law. Adoption of the financial statements is not necessary for performing the profit transfer or the entitlement to profit transfer. The Lower Tax Court furthermore explained that the tax group would not become invalid with retroactive effect from inception of the tax group due to the lack of performance (of the agreement) for 2008. In fact, the provision of § 14 (1) sent. 1 no. 3 sent. 2 KStG should be interpreted as meaning that even non-performance of the profit transfer agreement arising from the initiation of insolvency proceedings for an important reason is not detrimental to recognition of the tax group for the previous years (2006 and 2007) in which the tax group was actually implemented.

The appeal was allowed (file ref. I R 29/19), as there is no decision so far by the highest court on the performance of a profit transfer agreement in the event of initiation of insolvency proceedings. There also are no administrative pronouncements in this regard. The safest option is to continue entering the profit transfer obligation in the accounts and actually pay it.

Lower Tax Court of Hesse (4 K 412/19): Financial Integration in the Event of Merger during the Year

In its judgment of 14 May 2020 (4 K 412/19), the Lower Tax Court of Hesse ruled on financial integration of a controlled entity into a new controlling entity (acquiring legal entity) in the event of merger during the year of the (former) controlling entity, on the allocation of the controlled entity's income and on procedural issues concerning the tax group.

In the case under dispute, the plaintiff and limited liability company B (B-GmbH) had a tax pooling arrangement since 2010 (tax group). The former controlling entity (B-GmbH) was merged in 2015 during the year with retrospective tax effect from 1 April 2015 into the general partnership A (A OHG). A OHG was to operate as the plaintiff's new controlling entity already for 2015. It was in dispute in particular whether for the year under dispute (2015) there was uninterrupted financial integration into A OHG from the beginning of the financial year of the controlled entity. There was previously no indirect financial integration into A OHG.

The Lower Tax Court of Hesse ruled that uninterrupted financial integration into the new controlling entity from the beginning of the financial year of the controlled entity also applies in the event of merger during the year of the former controlling entity into the new controlling entity. In the opinion of the Lower Tax Court, with regard to financial integration, the general rule applies that financial integration of the transferring controlling entity which already existed on the transfer date is attributed to the acquiring legal entity, if there was already a tax group in place with the transferring legal entity on the transfer date, because in that case the acquiring legal entity as universal successor comprehensively assumes the legal position of the transferring controlling entity. This is also in line with the view taken by the tax authorities (German Tax Decree on Transformations, marginal ref. Org.02). However, the tax authorities restrict this rule to cases in which the transfer date for tax purposes coincides with the start of the controlled entity's financial year. The Lower Tax Court of Hesse rejects this narrow interpretation due to a lack of legal basis. Contrary to Org.02 of the German Tax Decree on Transformations, the Lower Tax Court has affirmed financial integration into the new controlling entity from the beginning of the financial year of the controlled entity also in the event of merger during the year, with reference to the German Federal Tax Court judgment on the so-called "footprint theory" (Fußstapfentheorie).

In the event of merger during the year, the income generated by the controlled entity would have to be allocated to the former and the new controlling entity (contrary to Org. 19 of the German Tax Decree on Transformations, according to which the income generated prior to the transformation date is also to be attributed to the new controlling entity). The controlled entity would have to prepare interim financial statements for that purpose.

From the perspective of procedural law, the Lower Tax Court ruled that for a tax group, in a uniform and separate assessment (§ 14 (5) Corporate Income Tax Act [KStG]), a decision needs to be made not only on the allocation of income but also on the existence of a tax group as such as the reason for income allocation.

The judgment of the Lower Tax Court of Hesse is still subject to appeal; the appeal is pending before the German Federal Tax Court under file number I R 21/20.

Federal Ministry of Finance Guidance on Tax Exemption of Gains on Foreign Currency Hedges

In its judgment of 10 April 2019 (I R 20/16), the German Federal Tax Court ruled that gains on foreign currency hedges undertaken exclusively to exclude or reduce the currency risk of a specifically planned sale of shares denominated in foreign currency must be taken into account as part of the selling price when determining tax-exempt capital gains pursuant to § 8b (2) sent. 1 of the German Corporate Tax Act [KStG]. The currency hedging transaction must occur in the context of the sale transaction.

According to this judgment, in "anticipatory" hedge constellations, the required context however only arises if the hedge from the perspective of the future seller solely serves the purpose of minimising currency risk with regard to the specifically anticipated proceeds from the sale (micro hedges). Non-specific global hedges of the currency risk of numerous hedged items (macro or portfolio hedges) do not need to be considered.

In its guidance of 5 October 2020, the German Federal Ministry of Finance comments on application of these principles. The specific decision on allocation of the hedge must be evident externally based on objective circumstances. Thus, the taxable entity is required to provide unambiguous and subsequently unalterable documentation of this intended allocation. It must also be possible to demonstrate a verifiable and plausible link between the hedged item and hedging instrument in terms of amount. If on conclusion of the foreign currency hedge the required context did not arise, lack of this requirement cannot retroactively be remedied by subsequent amendment or adjustment of the hedging transaction and thus demonstrating a specific intent to sell for the first time on the basis of external characteristics. If subsequent modification or change of the hedge occurs without realising the foreign currency exchange differences that have arisen until that date, the context required for tax exemption should not exist overall.

If tax-exempt gains on foreign currency hedges arise in part or in full in a financial year prior to the sale of shares, these gains are to be taken into account in the tax assessment for the assessment period in which the financial year ends in which they have occurred. Off-balance sheet adjustment of the gains on foreign currency hedges that have arisen prior to the financial year in which the shares were sold is not necessary until after the sale of shares takes effect.

Losses on foreign currency hedges undertaken exclusively to exclude or reduce the currency risk of a specifically planned sale of shares denominated in foreign currency reduce the (tax-exempt) capital gains as part of the costs to sell as defined by § 8b (2) sent. 2 KStG or increase a loss on sale not to be considered in the determination of income pursuant to § 8b (3) sent. 3 KStG.

State Decrees on Application of the Group Exemption Provision for Real Estate Transfer Tax Purposes

Following the CJEU's judgment of 19 December 2018 in the 'A-Brauerei' case (C-374/17) that the group exemption for real estate transfer tax purposes pursuant to § 6a of the German Real Estate Transfer Tax Act [GrEStG] (group exemption provision) does not constitute prohibited state aid within the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), the German Federal Tax Court (BFH) was able to provide an opinion on the national interpretation of the group exemption provision in seven decisions (file ref. II R 15/19 to II R 21/19 of 21 August and 22 August 2019). In view of these BFH judgments, the decrees issued by the highest tax authorities of the federal states on application of the group exemption provision were revised as at 22 September 2020 (decree).

The decree provides guidance on general requirements for the application of the group exemption provision, beneficiary transactions, the personal scope of application and the pre- and post-transaction holding periods.

The decree explicitly clarifies that all restructurings specified in § 1 no. 1 to 3 of the German Reorganization Act (UmwG) may be eligible, e.g. merger and demerger (split-up, spin-off. This applies regardless of the direction of the restructuring process. A change of legal form – since not explicitly specified in the group exemption provision – continues to be not tax-exempt. The additional criterion of a so-called affiliated group (“*Konzernverbund*”) before and after the restructuring is explicitly abandoned by the tax authorities. Merger with the controlling company as well as merger of the controlling company with a controlled company is therefore possible in principle.

The guidance regarding the controlling company is in general consistent with the fundamental principles of the BFH judgments. Furthermore, the decree explains that the controlling company participates in the market through investment in a controlled company (cf. BFH, decision of 31 May 2017, II R 62/14, marginal ref. 29). From this, the tax authorities have derived the additional requirement that for economic activity at least one controlled company involved in the restructuring process must be economically active in the market. Companies that are not economically active are, for example, shelf companies or those operating exclusively as holding companies. In any event, this additional criterion cannot be specifically inferred from the BFH judgments. Furthermore, in accordance with the changed interpretation of the term 'controlling company', the decree provides for steps to determine the controlling company.

The pre- and post-transaction holding periods must – in line with the BFH judgments - only be observed to the extent that they can be adhered to on the basis of a tax-exempt restructuring process. Consequently, a pre-transaction holding period is unnecessary for newly established companies. For demergers (restructurings) below the controlling company, the decree clarifies that the pre-transaction holding period must be adhered to at least by the transferring legal entity. Adherence to the post-transaction holding period is irrelevant with regard to the transferring legal entity, if this is not possible under reorganization law. For restructurings below the controlling company, the decree clarifies that the five-year post-transaction holding period must be adhered to at least by the acquiring legal entity. This assessment is also consistent with the BFH judgments. Any detrimental change in the controlling interests must be reported – as also specified in the decree – within the post-transaction holding period. The taxable entities are required to report such changes.

The new decree of 22 September 2020 replaces the former decrees of the highest tax authorities of the federal states and shall apply in all open cases.

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