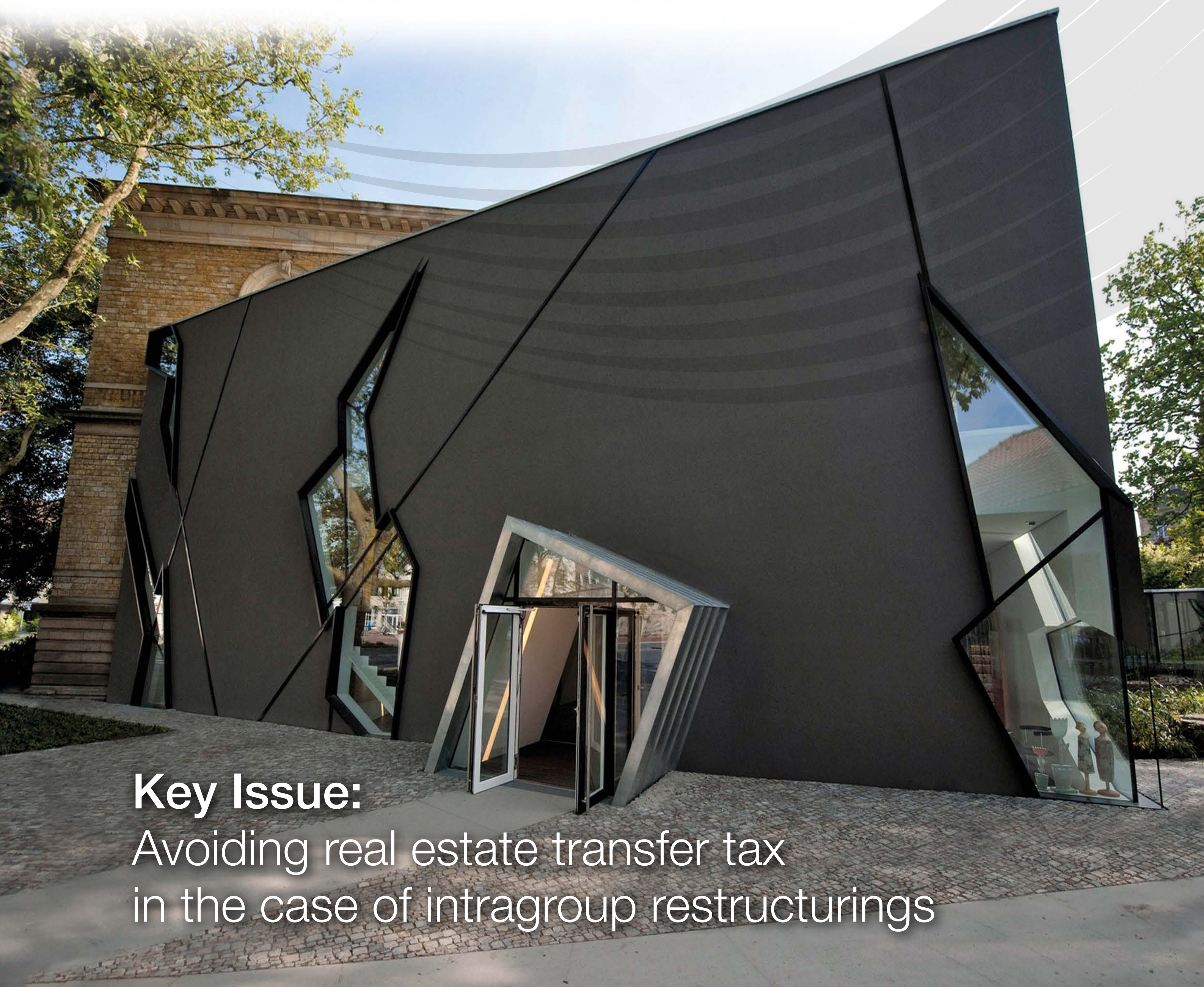
PKF

Newsletter



Key Issue:
Avoiding real estate transfer tax
in the case of intragroup restructurings

11|21

Dear Readers,

In the Key Issue section of this November edition of the PKF newsletter, we summarise the administrative opinion on which **intragroup restructurings** will be able to obtain an **exemption from real estate transfer tax**. This is of particular importance because, since the middle of 2021, there has been a tightening of the conditions under which a transfer of shares can also trigger real estate transfer tax.

We then continue our series of reports on selected aspects of the new **option model for partnerships** with an examination of **special business assets**. In the first draft, of 30.9.2021, of a letter on the application of the German Act on the Modernisation of Corporation Tax Law, the fiscal administration has stated its opinion in a way that would appear to assign **high tax risks to nearly all structures** unless the entire special business assets have been contributed to the company that has elected to exercise the option. In many cases, however, it is unlikely that this would be desirable.

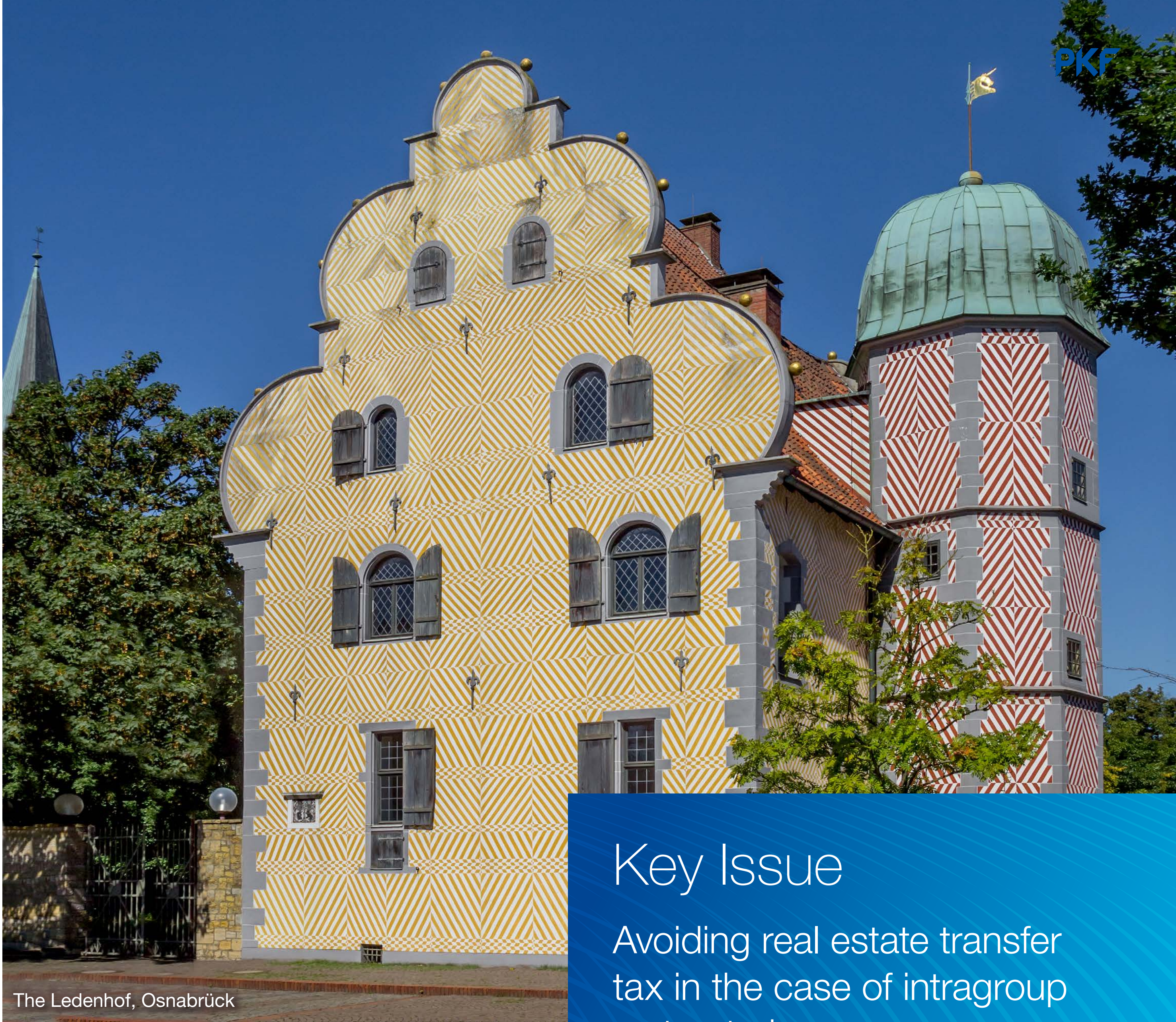
In our third report, we present a **tax planning arrangement for generating new potential for depreciation** that has been found to be acceptable by the Federal Fiscal Court. This arrangement involves, first of all, contributing private real estate into a set of business assets and, subsequently, privatising them again. Next up, we have a summary report on the applications that need to made where property is held as private assets so that the **income derived from power generated by means of solar systems** on that property can be **free of tax,** potentially, even retroactively.

The last main contribution will be of importance for corporate transactions where a so-called **earn-out** will be agreed for the purchase price. A recent ruling shows that what matters here is the wording of the purchase agreement – **in the event of a business disposal there would potentially be a risk that the concessionary tax rate for the disposal gain would be refused.**

Moreover, we continue our journey around the PKF locations in Germany through the illustrations that break up the reports from our experts - this time we visit Osnabrück.

With our best wishes for an interesting read.

Your Team at PKF



The Ledenhof, Osnabrück

Front cover photo: Entrance to Felix Nussbaum House

Key Issue

Avoiding real estate transfer tax in the case of intragroup restructurings

Contents

TAX

StB [German tax consultant] Steffen Zipperling

Avoiding real estate transfer tax in the case of intragroup restructurings

With regard to the application of the so-called 'corporate group reservation' clause *(Konzernvorbehalt)* under Section 6a of the Real Estate Transfer Tax Act *(Grunderwerbsteuergesetz, GrEStG)*, recently, the German fiscal administration has taken a very much more generous view, when compared with its previous interpretation, of the possibility of exempting specific intragroup restructurings from real estate transfer tax (RETT). In practice, this requires a careful weighing up of the structuring options.

1. Recent changes to regulations

In its latest ruling – which was published together with the identical decrees of the highest fiscal authorities of the Länder [Federal States], of 22.9.2020, (Federal Tax Gazette *[Bundessteuerblatt, BStBl.]* 2020 I p. 960) – the fiscal administration has fortunately followed, to a large extent, the most recent wide-ranging ruling of the Federal Fiscal Court *(Bundesfinanzhof, BFH)* of August 2019. Here, in seven rulings, the BFH took a position against the previous restrictive administrative opinion. We already reported on this in the PKF newsletter 06/2020.

The very much broader interpretation of the RETT 'corporate group clause' – which, from now on, will thus also be recommended by the tax administration – has become more important especially because, with effect from 1.7.2021, the scope of the so-called 'supplemental taxable events' *(Ergänzungstatbestände)* under the GrEStG was widened and the respective requirements were also tightened. For example, in the context of share deals (thus, sales where the real estate itself is not transferred but rather shares in property-owning corporations), the critical shareholding threshold level has been lowered from 95% down to down 90%. Furthermore, for transfers that involve partnerships, the prior and subsequent holding periods were extended from five years to ten years and fifteen years respectively. These changes to the law – which we discussed in the PKF newsletter 05/2021 – were implemented through the legislation to amend the GrEStG, of 12.5.2021.

These recent developments mean that, in the future, from a RETT perspective, it could be very much more advantageous to carry out restructurings within the scope of a reorganisation rather than through the simple transfer of a shareholding. The advantages that can be derived from the targeted use of the corporate group clause have been outlined below in examples of upstream and downstream mergers.

Example of a structure In a parent/subsidiary/lower-tier subsidiary company structure, where the parent holds all the shares in the subsidiary and the subsidiary holds all the shares in the lower-tier subsidiary, we have assumed that both the subsidiary as well as the lower-tier subsidiary are property-owning companies. Moreover, we have assumed that this structure has existed for more than five years.

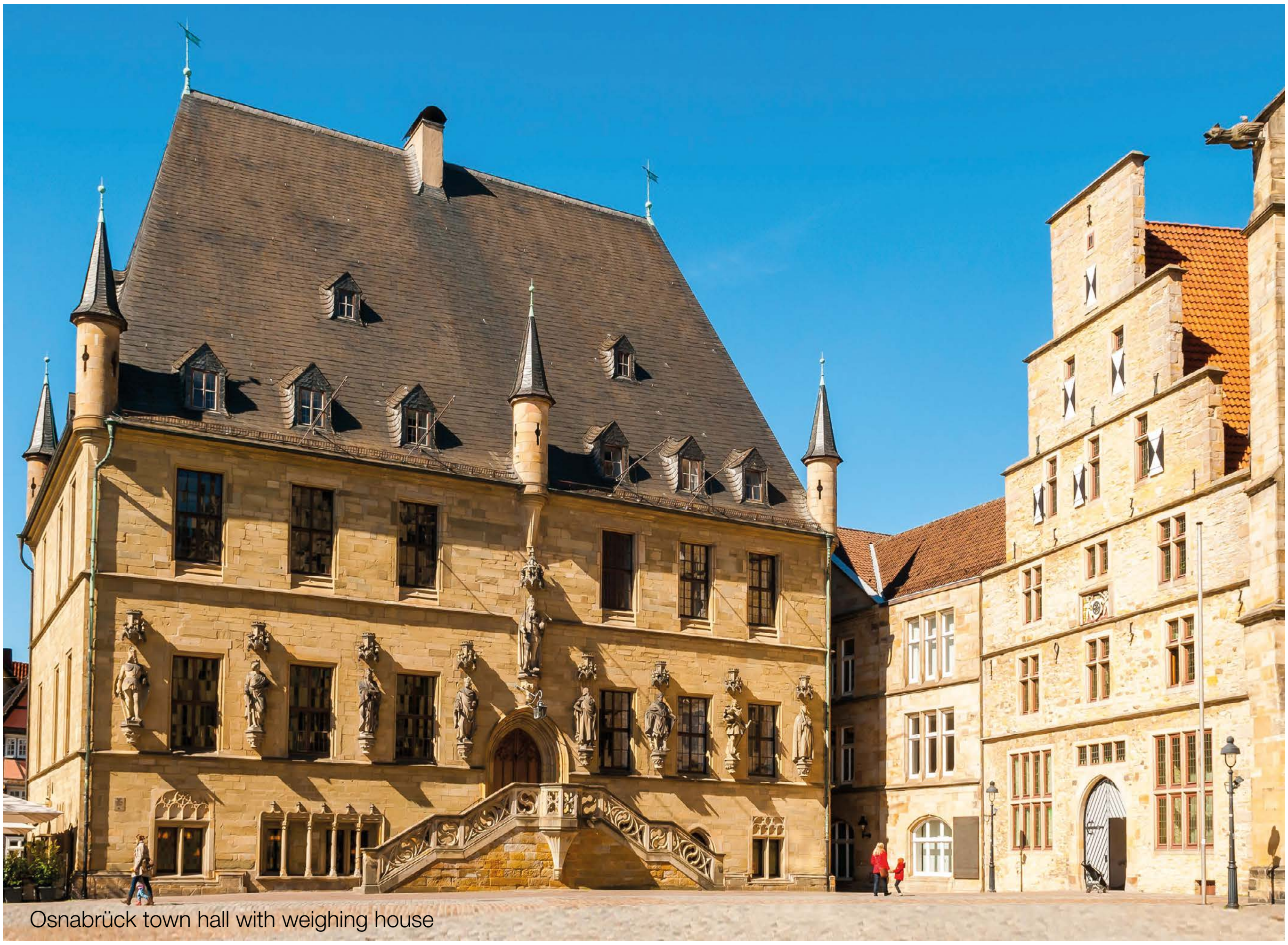
2. Analysis of advantages for upstream and downstream mergers

2.1 Upstream merger

If the lower-tier subsidiary is merged into the subsidiary then, from a RETT perspective, the following would arise as a result.

(1) For the subsidiary – In the course of the merger, the subsidiary will also acquire the real estate of the lower-tier subsidiary since its assets will be transferred in their entirety to the subsidiary. The acquisition of this real estate will initially be liable to RETT. Under Section 6a GrEStG, the RETT for this acquisition will not have to be paid because the requirements for the application of the corporate group clause have been met.

- This constitutes a legal transaction within the scope of a reorganisation (merger).
- Two dependent companies (the subsidiary and the lower-tier subsidiary) of the parent (as the controlling company) were involved in the merger. The criterion of 'control' has been met here since the parent holds at least 95% of the shares in the subsidiary and the subsidiary holds at least 95% of the shares in the lower-tier subsidiary.


Osnabrück town hall with weighing house

- The shareholdings had existed for five years already prior to the merger.
- The five-year subsequent holding period requirement relating to the lower-tier subsidiary cannot be met because the lower-tier subsidiary ceased to exist as a result of the merger. Under the fiscal administration's earlier strict interpretation, this impossibility of complying with the subsequent holding period would have resulted in the corporate group clause not being applicable; this would have meant that RETT would have had to be paid on the lower-tier subsidiary's real estate portfolio. However, from now on, case law and the fiscal administration will be of the same opinion that the impossibility of complying with holding periods under the German Reorganisation Tax Act should not lead to denying the application of the corporate group clause.
- Although, in order to preserve the tax exemption due to the corporate group clause, the parent company will have to hold the shares in the subsidiary for another five years.

For the real estate that the subsidiary itself holds there will be no RETT consequences for the subsidiary arising out of the merger because the real estate is still in the possession of the subsidiary.

(2) For the parent – For the real estate that the subsidiary holds there will likewise be no RETT consequences for the parent company because prior to as well as subsequent to the merger the parent will directly hold shares in the subsidiary.

As regards the lower-tier subsidiary's real estate, the merger will result in the parent company's existing indirect unification of shares being transformed into a direct unification of shares. This so-called bolstering of an already existing unification of shares does not once more fulfil the supplemental tax event of the unification of shares. Therefore, as a result of the merger of the lower-tier subsidiary into the subsidiary, all in all, the parent company does not incur RETT either.

2.2 Downstream merger

If the subsidiary is merged into the lower-tier subsidiary then, from a RETT perspective, the following would arise as a result.

(1) For the lower-tier subsidiary – In the course of the merger, the lower-tier subsidiary will also acquire the real estate of the subsidiary as its assets will be transferred in their entirety to the lower-tier subsidiary. The acquisition of this real estate will be liable to RETT and, as in the case of the merger in the opposite direction, likewise exempted from RETT under Section 6a GrEStG. The requirements for the application of the corporate group clause, described above, have likewise been met here. In particular, it does not matter (any more) that it is no longer possible to comply with the subsequent holding period (thus continuous ownership of the subsidiary by the parent) because the subsidiary has ceased to exist. Although, in this case, too, the parent company will have to hold the shares in the absorbing company – thus, here, in the lower-tier subsidiary – for another five years.

For the real estate that the lower-tier subsidiary itself holds there will be no RETT consequences for the lower-tier subsidiary arising out of the merger because this is still in the possession of the lower-tier subsidiary.

(2) For the parent – A merger in this direction (downstream merger) is likewise not deemed to be a supplemental taxable event – such as a unification of shares, for instance – at the level of the parent company. As regards the lower-tier subsidiary's real estate, the shareholding is merely bolstered by becoming a direct shareholding instead of an indirect one. In terms of the subsidiary's real estate, which has been transferred to the lower-tier subsidiary as a result of the merger, the parent company still has a direct shareholding in this respect

Conclusion

The widening of the scope of supplemental taxable events, with effect from 1.7.2021, has once again considerably increased the complexity of real estate transfer tax legislation. In future, it will be necessary to monitor supplemental taxable events in parallel under the old as well as the new legislation. Thus, the old shareholding threshold of 95% will also remain relevant if, for example, after 30.6.2021 a shareholder had not yet breached that tax triggering point of 95% under the old legislation but had already reached the shareholding threshold of at least 90%.

StB/WP [German tax consultant/public auditor] Dr. Matthias Heinrich / RAin [German lawyer] Lena Wagner

New option model for partnerships – Part III Will exercising the option founder over special business assets ?

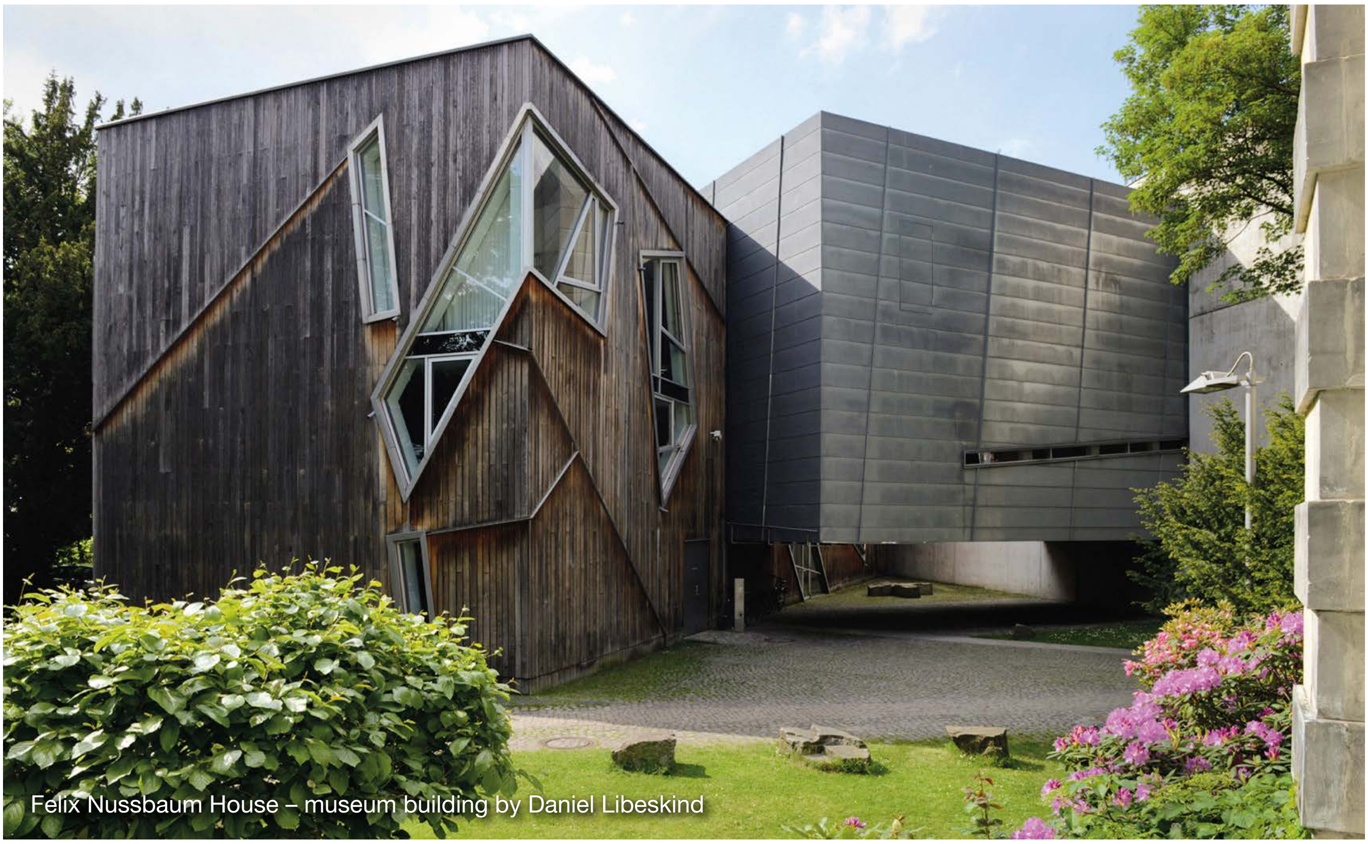
Last time, in Part II of our series of detailed explanations of the German Act on the Modernisation of Corporation Tax Law, we discussed the effects of the notional change of legal form on special business assets. In this issue of our newsletter, we have taken the Federal Ministry of Finance's *(Bundesministerium der Finanzen, BMF)* draft on the option to be treated as a corporation for tax purposes (Section 1a of the Corporation Tax Act *[Körperschaftsteuergesetz, KStG]),* of 30.9.2021, as the basis for our examination of the effects of withholding special business assets.

1. The BMF draft on the option to be treated as a corporation for tax purposes (Section 1a KStG)

The German Act on the Modernisation of Corporation Tax Law, 25.6.2021, introduced, among other things, the option to be treated as a corporation for tax purposes pursuant to Section 1a KStG. The BMF, in its draft circular on the option to be treated as a corporation for tax purposes (Section 1a KStG), addressed a series of questions of interpretation. The BMF's opinion on dealing with special business assets deserves particular attention because, in individual cases, this could materially affect the decision for or against exercising the option.

2. The basis for the option

According to Section 1a(2) sentence 1 KStG, exercising the option constitutes a notional change of legal form within the meaning of Section 1(3) no. 3 of the Reorganisation Tax Act *(Umwandlungssteuergesetz,* UmwStG). Consequently, for tax purposes, the notional change of legal form is treated in the same way as a genuine change of legal form of a partnership into a corporation so that Sections 1 and 25 UmwStG have to be applied accordingly; moreover, pursuant to Section 20(2) UmwStG, each shareholder has the right to elect to separately recognise assets at book value or a higher value but, at most, at their fair market value.



Felix Nussbaum House – museum building by Daniel Libeskind

3. The contribution

A tax-neutral contribution of company shares at book value, pursuant to Section 20(2) sentence 2 UmwStG, requires all the economic assets that are essential for operations for the entire shareholding to be contributed to the company that has elected to exercise the option. A contribution at book value would be precluded if economic assets that are essential for operations but are held as special business assets were withheld. These economic assets would be deemed to have been withdrawn if, at the start of the financial year when the option is activated, they form a part of another set of business assets.

Recommendation: Therefore, particular caution is required if shareholders do not want to transfer economic assets that are essential for operations but are held as special business assets to the company that has elected to exercise the option because, in such a case, there would be a risk that the measurement option would be disallowed and the hidden reserves realised.

4. Withholding economic assets
4.1 Withholding special business assets

If a shareholder keeps back economic assets that are essential for operations that they hold as special business assets (e.g., a piece of real estate) then, pursuant to Section 20(2) sentence 2 UmwStG, the shareholding in the company transferred by the shareholder will be precluded from being recognised at book value because the entire shareholding will not have been transferred to the company that has elected to exercise the option. In such cases, the respective share in the company will be deemed to have been relinquished. The hidden reserves in the shareholding and the special business assets would have to be realised.

4.2 Withholding an equity interest

According to the BMF's draft circular, if a shareholder of the company that has elected to exercise the option does not transfer to the company that has elected to exercise the option their equity interest in the general partner GmbH [a German limited liability company] whose function as general partner company is limited to the management at the company that has elected to exercise the option and which, in view of the circumstances of the individual case, should be classified as business assets that are essential for operations then this would preclude a transfer of assets at book value.

4.3 Retaining special business assets in the parent company's business assets

If economic assets that are essential for operations that are held as special business assets remain in the parent company's business assets, then these would have to continue to be carried at book value. However, according to the BMF's draft circular, there is a risk that the entire hidden reserves of the share in the company would have to be realised.

Please note: The current situation means that keeping back a shareholder loan would indeed be harmful for a transfer at book value even though such a loan would not have any hidden reserves.

4.4 A transfer in advance to an affiliated company

If a shareholder does not transfer economic assets that are essential for operations that are held as special business assets to the business assets of the company that has elected to exercise the option but, instead, transfers them to another set of business assets then, according to the BMF's draft circular, margin no. 20.07 of the German Reorganisation Tax Decree would apply to the notional change of legal form under Section 1a KStG.

Therefore, to determine the applicability of Section 20(2) sentence 2 UmwStG it will be necessary to review the requirements under the 'step transaction rules'.

The series of steps within the meaning of the case law of the Federal Fiscal Court (Bundesfinanzhof, BFH) is a single set of commercial circumstances that because of a plan that is made in advance are 'artificially' dissected; here, the individual steps will be assumed to be significant only insofar as they facilitate the attainment of the final state. Normally, the artificial dissection is supposed to achieve more favourable taxation. In the case of sale transactions that are subject to tax the aim is to reduce the assessment base. If a 'sell-off plan' involves several steps then all of these steps have to be conceptually bracketed together and considered to be a single transaction.

Consequently, there is a risk that, e.g., an advance transfer, at book value, of the economic assets that are essential for operations but held as special business assets to an affiliated GmbH & Co. KG *[German limited partnership with a limited liability company as a general partner]*, where the transfer is commercially related to and occurs at the same time as the exercise of the option by a company, will constitute an artificial dissection of a single set of circumstances to achieve favourable taxation. In the opinion of the fiscal administration, the above situation could preclude the transfer of the remaining company shares at book value.

Conclusion and Outlook

The BMF's draft circular will probably mean that, for many companies, the exercise of the option will founder over the strict requirements for the transfer of economic assets that are essential for operations but are held as special business assets as well as over the 'step transaction rules'. It remains to be seen whether the BMF will publish this draft without any amendments, particularly with respect to the treatment of special business assets, or whether it will abandon its view on the transfer of special business assets as well as the application of step transaction rules and make the path to exercising the option significantly easier and more practical.

StB [German tax consultant] Steffen Heft / StB [German tax consultant] Dr. Maximilian Bannes

In the case of properties, do step up models constitute a form of abusive structuring?

Frequently, in the case of property that is rented out and held as taxable assets, the tax depreciation volume has been used up, or the amount of depreciation is low because the property was acquired a long time ago. So-called 'tax depreciation refreshing models' or 'step up models' can generate new depreciation potential or depreciation amounts on the basis of current market prices. One alternative consists in transferring the property to a commercial partnership. A possible solution to the major disadvantage this entails – namely, that the hidden reserves that arise in the future would then generally be permanently subject to tax as there would be no speculation period in this case – is a subsequent change in the status of the partnership that causes it to become dormant for tax purposes [referred to in German as Entprägung]. The Federal Fiscal Court *(Bundesfinanzhof, BFH)* recently had to rule on such a case and this has provided interesting pointers on the issue of whether or not the above alternative constitutes an inadmissible and abusive structure.

Krahnstraße and Hegerstraße

1. Facts of the case and the ruling by the BFH

The following is a simplified overview of the facts of the case that formed the basis of the BFH ruling of 22.2.2021 (case reference IX R 13/19). Various properties that formed a part of the taxable private assets had been rented out. The properties here were held by an asset management partnership. This partnership then became commercially active for tax purposes so that the properties consequently became business assets. After three years the partnership ultimately became dormant for tax purposes and, therefore, the properties were transferred again from the business assets into the taxable private assets. A particular feature in the case in question was that, during the three-year period of being classified as a business, no hidden reserves had arisen for the properties and, thus, no taxable gains from the transfer had accrued. The taxpayer and the local tax office were now unable to agree on the amount that could be depreciated following the deactivation of the partnership's business.

The BFH decided that the fair market value on the date when the change in status occurred had to be used as the assessment base for future depreciation.

2. Can this model be used as a structuring instrument?

Ultimately, activating the commercial nature of the partnership and, subsequently, changing its status to inactive meant that it was possible to generate new potential for depreciation; moreover, after the end of the speculation period pursuant to Section 23 of the German Income Tax Act, which was triggered by the withdrawal of the assets, it was nevertheless possible to sell the properties tax-free. Two aspects are particularly relevant here for practical tax planning.

(1) First of all, changing the status of the partnership will result in a taxable gain from relinquishment, i.e., the hidden reserves that arose during the 'period of commercial activity' will have to be taxed. At the present time especially, with property prices seemingly going in one direction only, the hidden reserves that would arise during several years of the properties being held as business assets could, potentially, be of a not insignificant magnitude. In the short term, this could therefore result in an additional tax charge.

(2) Secondly, – and for tax planning this would normally have to be considered – hanging over such a structure is the Sword of Damocles of abusive use pursuant to Section 42 of the German Fiscal Code. This was also the situation in the case in question where the local tax office (Finanzamt, FA), at least in the alternative, had contended before the tax court that there were was no economic rationale behind the structure and, in fact, the paramount goal had been solely tax optimisation and the taxpayer should be put in such a position that would have existed if the structure had been omitted.

However, the BFH ruled that the FA had not adequately countered the taxpayer's narrative and their arguments with respect to the non-tax-related reasons for the structure. In the statement setting out its grounds, while the BFH assigned the issue of abusive use merely to a margin number, it is nevertheless all the more important to evaluate this. This is because the Munich-based judges, at least, provided pointers as to the reasons for a change in status to inactive that would be deemed to be sufficiently weighty and economically justifiable.

Please note

Even if, from our present point of view, the structure would have surely been, in part, different, nevertheless the ruling shows that 'bold' planning can certainly lead to success. However, the planning needs to be well thought through because, as always, what matters here are the details of the regulations as they will determine tax success.

StB [German tax consultant] Dennis Brügge

Operate photovoltaic systems and combined heat and power units free of tax charges

Many private residential properties have had small photovoltaic systems (PV systems) installed. Moreover, some people also operate small combined heat and power units (CHP unit). A simplification rule issued by the fiscal administration means that, upon application, profits will no longer be taxed. This even applies for previous years insofar as this is still procedurally possible. The Federal Ministry of Finance *(Bundesministerium der Finanzen, BMF)* has issued a separate circular concerning this.

1. Generally a commercial activity

By feeding self-generated electricity into the public grids as a result of operating a PV system / CHP unit, , normally, taxpayers generate income from commercial operations. The income has to be declared in the personal tax return. This frequently leads to disputes with the fiscal administration, particularly in the case of small systems, because, given the absence of any intention to generate a profit, the initial losses are not recognised.

2. A situation of *Liebhaberei* upon request

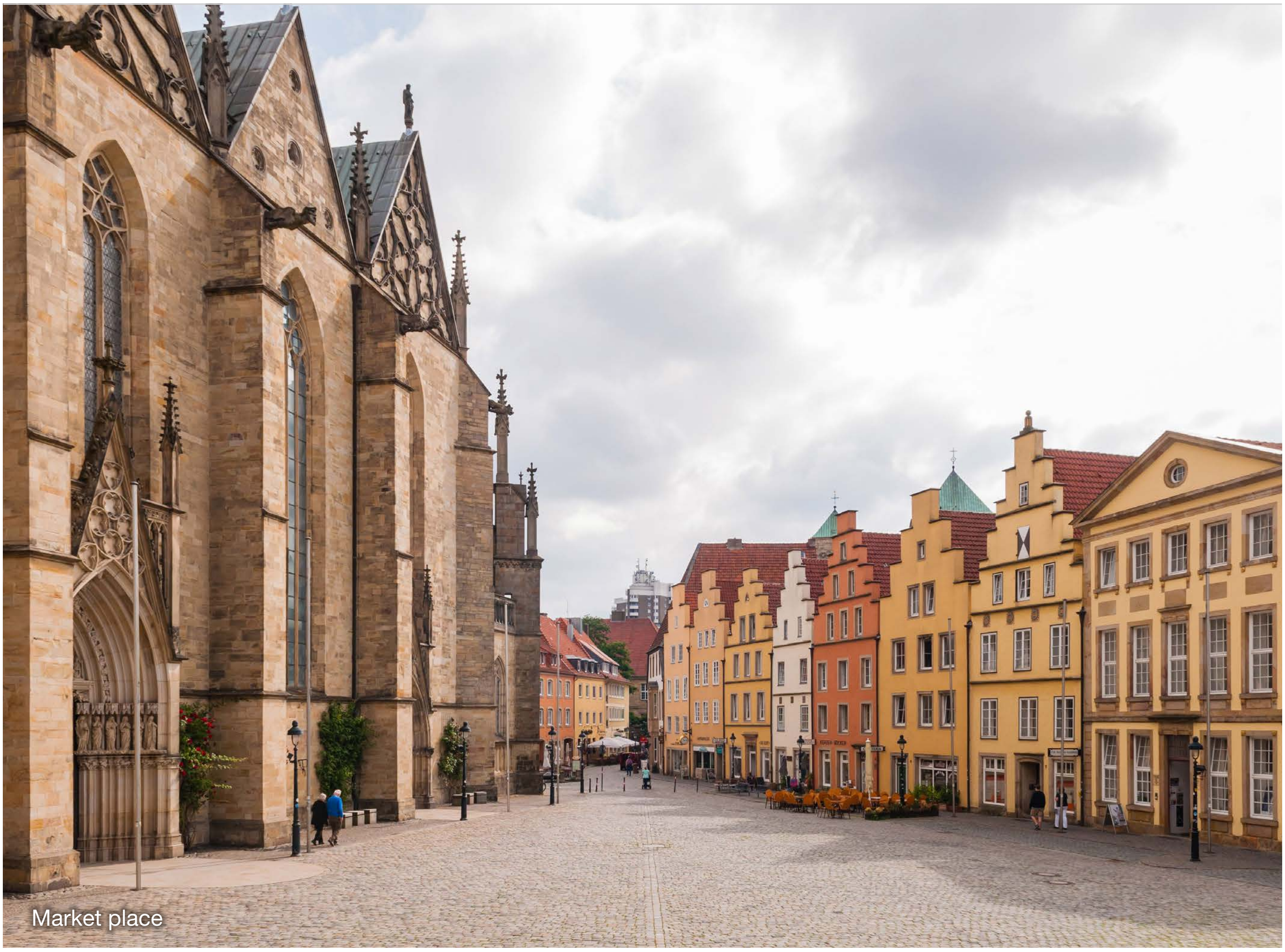
With a view to preventing such arguments, on the basis of the BMF circular of 2.6.2021 (reference: IV C 6 – S 2240/19/10006:006), the fiscal administration now permits, upon a written application, a wholesale situation of Liebhaberei [a German tax term that refers to a situation where the taxpayer performs an activity without the intention to realise (taxable) profits]; taxpayers will simply have to declare that they have no intention of generating a profit through their activities. This will give rise to a situation of Liebhaberei that is not relevant for tax purposes even if, demonstrably, the aim is to generate profits. Other inspection measures of the local tax office will cease to apply. The possibility to file an application will apply to all tax assessment periods that are not yet final and unappealable.

3. The affected systems

The regulations apply to PV systems with installed capacity of up to 10 kilowatts that have been installed on owner-used one-family and two-family house sites, including on outside facilities (e.g., garages), and that were put into operation after 31.12.2003. For the analysis of whether or not the property is an owner-used one-family or two-family house, the potential presence of a home office would not be relevant. CHP units with an installed capacity of up to 2.5 kilowatts that meet the same conditions would be treated in the same way.

4. Effect of the application

After the application has been filed, the (previous) commercial operations will be deemed to be a situation of Liebhaberei that is not relevant for tax purposes – and, indeed, for subsequent years as well as for periods that have already elapsed. In those years, neither taxable profits nor losses will arise. This applies to any future hidden reserves. Although, if tax assessment notices have already been issued for years that have been assessed then this would only apply insofar as amendments to the year are still procedurally possible. Profits or losses will likewise continue to be upheld only if they have already been taken into account in a tax assessment notice where amendments are no longer possible.


Market place

5. Who would benefit from making an application?

Filing an application would benefit all systems that are actually generating profits. By making an application the rate of return generated from a system would increase because the tax payable would no longer be charged. This would be particularly interesting when, due to depreciation, losses are available in tax assessment notices that are already final and unappealable. In such cases, the losses will be preserved and, after an application has been made, future profits will no longer be taken into account.

Recommendation: However, in the case of comparatively recently installed systems, where losses are still expected to be generated during the next few years, you should initially refrain from making an application. In such a case, first of all, you should try to claim a deduction of the losses against tax. If these losses are incontestably recognised by the local tax office, then, once the system achieves profitability, you should file an application for a situation of Liebhaberei.

Moreover, an application will reduce your tax declaration obligations. In this respect, there will no longer be any need to enter data in appendix G of your tax return. In particular, it will also mean that preparing the calculation of taxable profit will be unnecessary. The same will apply to the statement illustrating the determination of the bases for the tax assessment in the case of a PV system of a GbR (the acronym for *Gesellschaft bürgerlichen Rechts,* a partnership under German civil law).

Please note

You should bear in mind that the application will essentially have no effect on other types of tax such as, in particular, VAT. Accordingly, advance VAT returns and annual declarations will basically still have to be submitted. Submitting these would be unnecessary only if the small business exemption were applied. However, this normally only makes sense for older systems. In the case of more recently installed systems, there could be negative consequences as the input tax deduction, in particular, from the purchase would otherwise be refused.

RA/StB [German lawyer/tax consultant] Reinhard Ewert

Taxation of earn-out payments

In the course of M&A transactions, subsequent purchase price payments are frequently agreed. The aim of such so-called earn-out payments is either to share uncertainties and risks of the future development of the business between the contracting parties, or additional compensation based on the economic successes of an enterprise paid to the selling business owner. It is not always easy to make a distinction between the one and the other aspect and there is enormous potential for disputes to develop, in particular with respect to the different tax consequences, as a recent ruling from 2021 by the Rhineland-Palatinate tax court has demonstrated.

1. Issue – A purchase price with a variable component

The case in question involved the sale of a GmbH & Co. KG [German limited partnership with a limited liability company as a general partner]. Besides a fixed purchase price, the contracting parties agreed additional variable compensation based on the gross margin achieved by the company in relation to the net sales in the three subsequent financial years subsequent to the sale.

Following an external tax audit at the company of the respective years, the local tax office *(Finanzamt, FA)* held the view that this was a customary variable purchase price component that constituted compensation for the economic risk arising from the future development of the business that took the development of the company's sales into consideration (i.e., in principle, a fixed purchase price less a risk premium). Consequently, the FA increased the capital gain attributable to the vendor by the earn-out amounts that had been subsequently paid. As a result, instead of the capital loss that had been claimed by the vendor, a substantial capital gain was (retroactively) allocated to him.

The vendor filed an appeal against this while making reference to the particular feature in the agreed provision on the subsequent purchase price payment that comprised solely profit and sales components. Unlike the classic earn-out provisions, where the payment of a variable component depends on achieving specific future parameters, the case in question involved a share of the company's future profits or sales and, therefore, purchase price claims subject to a condition precedent that would only legally be 'realised' on materialisation of the condition precedent and, thus, would not cause a retroactive adjustment to the purchase price.

2. Tax court ruling on sales-related or profit-related purchase price agreements

In its ruling of 30.3.2021 (case reference: 5 K 2442/17, EFG 2021 p. 1199), the Rhineland-Palatinate tax court accepted the taxpayer's arguments and found that, in the purchase price provision at issue, there was a profit-related or sales-related purchase price payment that, in contrast to the general principles, had to be determined not on the date of the sale (as at the closing date) but, instead, only when realised on the date of the accrual.

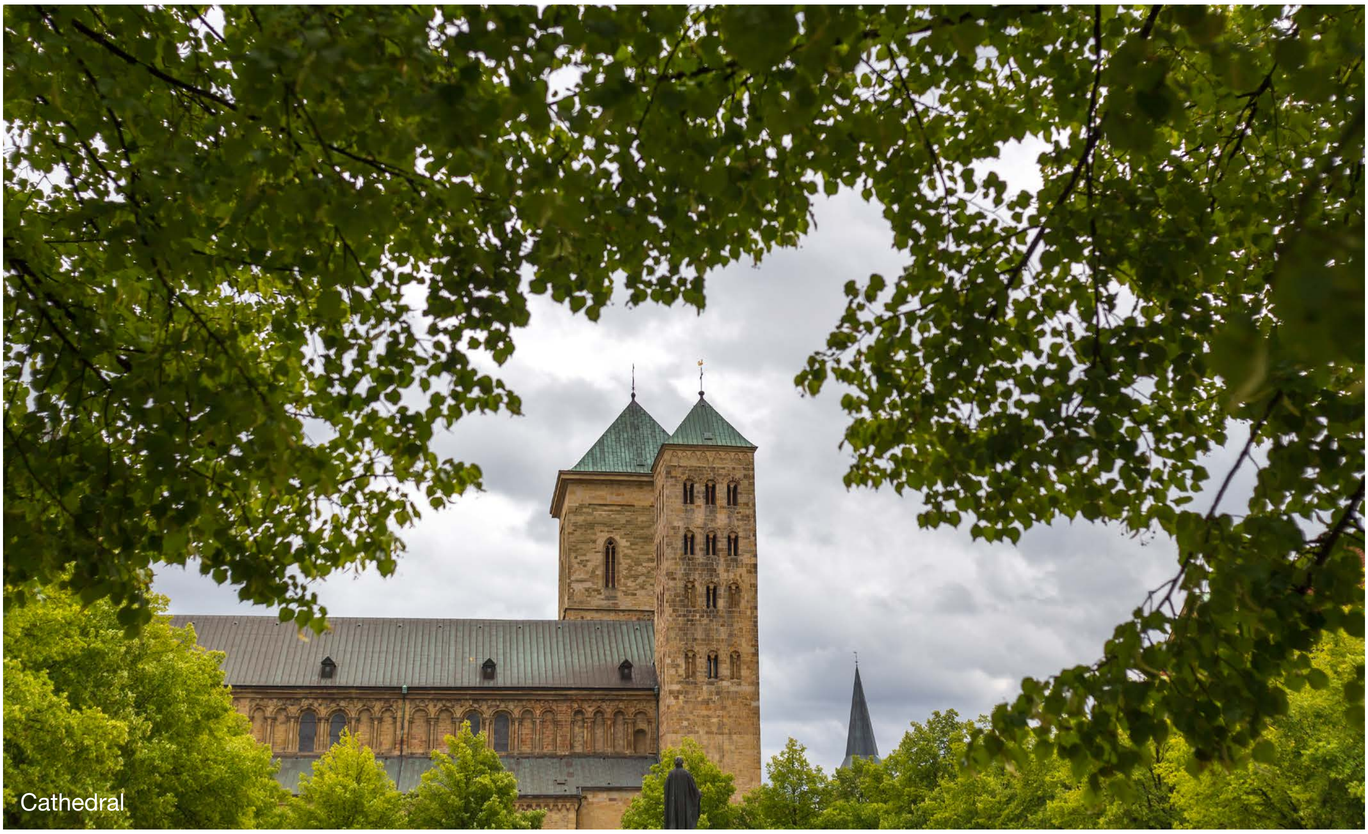
The tax court thus followed the previous line of the Federal Fiscal Court *(Bundesfinanzhof, BFH)* that – in both the area of the sale of businesses pursuant to Sections 16 and 17 of the German Income Tax Act (business disposals) as well as the sale of equity participations pursuant to Section 8b of the German Corporation Tax Act (cf. most recently BFH of 19.12.2018, case reference: I R 71/16) – held the view that sales-related or profit-related purchase price agreements, in contrast to the general principle of a closing date-based approach, are only realised on the date of the respective accrual and, moreover, may only then be subject to tax.

The tax court permitted an appeal due its fundamental importance in view of the fact that the supreme court has not yet conclusively clarified the legal position with respect to specific earn-out clauses. The appeal of the fiscal administration is currently pending before the BFH under case reference: IV R 9/16.

3. Putting the ruling into context

The tax court's ruling once again shows how difficult it can be to actually achieve an economic intention and how important it is to precisely formulate the provisions in each individual case. Even if earn-out payments constitute a common pricing structure in M&A practice, nevertheless, it can be of crucial importance for the tax consequences whether these involve

» subsequent purchase price payments with a retroactive effect on the sales price or capital gain, or
» claims for payment of the purchase price subject to a condition precedent that, in each case, are only realised on the due date of an accrual.


Cathedral

In some cases, there can be considerable effects, for example, in the case that went before the court here – if the BFH confirms the tax court's ruling – none of the extraordinary income that is subject to reduced taxation would have been available on the date of the sale but, instead, regular income that would have had to have been taxed at the normal rate but in the respective assessment period. As the arguments by the fiscal administration in the case in question emphatically demonstrate, by linking the payments to the future sales development or to profits for both variants it is possible to achieve the following.

» Firstly, this would be a sales transaction with a fixed price and a purchase price component where solely the amount is variable.
» Secondly, this would be a purchase price and, in addition, compensation for subsequent sales and/ or profits generated from the enterprise that has been sold.

Which of the two variants would be more favourable for the parties involved in terms of tax would, in turn, have to be determined on the basis of the specific circumstances.

4. Specifically formulated provisions in the compensation agreement are crucial

To assess a case in question it will be crucial to perform an appraisal of the specific wording of the agreement that relates to the variable compensation. The wording of the provision ("In addition to the purchase price...shall receive...an additional purchase price in the form of a variable compensation...') would, first of all, support the view of the local tax office and not that of the fiscal administration. In the statement setting out its grounds for the decision on the objection, which was reproduced in the ruling, in the light of supreme court case law, the fiscal administration likewise made a distinction between

» classic earn-out provisions on the basis of specific performance indicators (preliminary purchase price with subsequent adjustments = an event with retroactive effect) and
» an agreement for variable purchase price payments in the sense of compensation from future profits and/or sales (= condition precedent).

According to this, in the case in question, it was the interpretation of individual clauses, in particular, that was disputed and less so the tax consequences.

Outlook

In this respect, in the interest of legal certainty, it would be desirable if, in its appeal decision, the BFH would express its opinion on the indicators for one or the other form of compensation provision and not merely consider the disputed clause.

IN BRIEF

Employers may order employees to stop working from home

While for some people working from home during the pandemic was a nightmare, others certainly came to appreciate it. A case before the state labour court *(Landesarbeitsgericht, LAG)* of Munich, of 26.8.2021 (case reference: 3 221 13/ 21), showed what can happen when an employer changes its instruction to work from home again and wishes its employees to be back on site.

The staff member was employed as a graphic designer and worked in the employer's workplace. From December 2020, the employees who otherwise worked in the office then worked from home with the permission of the managing director. Only the secretariat had to be present to a limited extent in the Munich office. However, the managing director then instructed the graphic designer to perform his work once again in the office in Munich. The employee moved for a summary judgement against this through the labour courts. He believed that he should continue to be allowed to work from home.

The LAG took a different view. An employer that allows its employee to perform his work as a graphic designer from home is generally entitled to change its instruction. This applies especially if, subsequently, operational reasons for not carrying out the work at home come to light. The German Coronavirus Occupational Health and Safety Regulation likewise does not grant a subjective right to work from home. Even the general risk of contracting the coronavirus on the way to work as well as the risk of infection in the workplace do not preclude the obligation to show up at the office.

Please note: An employer's right to issue instructions is frequently more wide-ranging than some employees would suppose. An employer may specify, at its reasonable discretion, the work to be performed in terms of its content, place and time. However, this only applies if these working conditions have not been determined by an employment contract, works agreement, a collective agreement, or by law.

VAT – Reduction in the charge in cases of 0% financing deals

The offer of so-called 0% financing that is frequently used when selling goods does not lead to any reduction in the VAT assessment base (see PKF newsletter 03/2020). This has now also been confirmed by the Federal Fiscal Court *(Bundesfinanzhof, BFH)* in a new ruling of 8.7.2021.

Company K was offering its customers so-called 0% financing for their goods purchases. On the invoices, apart from the purchase price that was shown as an overall amount with the VAT disclosed separately, it was pointed out that the interest charged by the financing bank would be granted as a 'discount'. In the VAT returns, the VATable revenues from the sale of goods were reduced by the amount of the financing fees (so-called subsidies) that were paid to the bank.

Following on from the local tax office and the court of first instance, the BFH then also took the view that the assessment base may not be reduced by the bank 'subsidies' that were withheld (case reference: XI R 15/19). In fact, the financial services provided by the bank constitute a different and separate business transaction that does not affect the VAT assessment base of the purchase agreement between the claimant and the customer. This was demonstrated, in particular, by the fact that the customer owed Company K the unreduced cash payment amount.

Please note: If the financing bank is part of the seller's group of companies (e.g., so-called automotive banks) and the bank grants the customer a loan at below the customary market interest rate where the retailer has to make an additional payment in order to compensate for this then, according to the fiscal administration, the manufacturer's/retailer's additional payment has to be regarded as other services. For banks that are not affiliated, the act of granting a loan should be oriented towards the customer – no other services are provided by the bank for the retailer and that is why this does not result in any reduction of the VAT assessment base.

A deviating profit distribution formula is not a determinant for inheritance tax

If parents wish to transfer assets to their children, then it is frequently advisable to make a gift already during the donor's lifetime. A parent could thus, for example, conclude a gift agreement with their children for specific objects and, together with the children, set up a GbR [the acronym for *Gesellschaft bürgerlichen Rechts,* a partnership under German civil law] for distributing the profits. The profit distribution formula here may also deviate from the ownership shares of the assets. The Münster tax court recently provided an answer to the question of how, in such a case, the assets have to be divided up following the death of the parent.

In the case in question, a mother had transferred her assets to her two children through gifting (real estate, shares in a GmbH [German limited liability company], cash in the bank, securities and horses). In addition to that, together with the children, she had set up a GbR in which she had a 5% stake and the children each had a 47.5% stake. According to the partnership agreement, the profits were shared out on a deviating basis, namely, the mother's share of the profits was 90% and the children each got 5%. When the managing director position of the mother came to an end the children were supposed to be entitled to the share of the profits that corresponded to their share of the assets. The deviating profit distribution was regarded as a right to use that was similar to a usufructuary right. Following the death of the mother, the local tax office (Finanzamt, FA) determined her share of the business assets. When valuing the testator's share, the local tax office took the deviating profit distribution formula in the partnership agreement into account. Therefore, in the view of the FA, after deducting the capital accounts, 90% of the residual value of the business assets were attributable to the testator's share and not 5%.

The tax court, in its ruling of 15.4.2021 (case reference: 3 K 3911/18 F) considered the action challenging this to be well founded. Under the law, the value of the share of the business assets has to be separately assessed if this value is of significance for inheritance tax. This was the case due to the death of the mother. When calculating the fair market value of the share of the business assets, first of all, the capital accounts from the aggregated financial accounts have to be included; the remaining amount has to be divided up on the basis of the profit distribution formula. In the case in question, when valuing the share of the GbR that had been held by the testator and after deducting the respective capital accounts, the only point of disagreement between the parties related to the profit distribution formula that should be applicable for dividing up the residual joint assets. However, the deviating profit distribution ceased to apply upon the death of the testator. It was the testator's personal right to have the profits distributed in this way and it was not possible to pass this on to her children.

If a tenant fails to move out then the landlord can claim high loss of use compensation

If a tenant fails to move out after the tenancy has expired then they run the risk of having to pay more than the rent that they have hitherto owed.

On that point, on 16.6.2021, the Local Court of Brandenburg delivered a decision in a case (case reference: 31 C 51/20) where the tenants had given notice of the termination of their rental agreement in September with effect from 31.12. Then, however, they changed their minds and sent the landlords a letter where they withdrew their notice of termination. They thus thought that their notice of termination had been rescinded and also did not move out on 31.12., but only did so in June of the following year instead. For the period from January to June the landlord then claimed compensation for use in an amount equivalent to the average market rent for the local area – and this was more than the rent that had been agreed. It was decided that it was only possible to 'withdraw' a notice of termination by mutual agreement. The landlord was able to claim compensation for use and instead of collecting the rent that had previously been agreed, in this case, they applied the average market rent for the local area, which could be achieved in the case of a new rental.

Please note: In cases of doubt, the specific amount of this 'market rent' may be determined by the court using estimates. The rent would then be determined on the basis of the rent index for the local area and, a 10% premium would commonly be added.

AND FINALLY...

“Pragmatism is not the opposite of perfection but rather the path to get to it.”

Uğur Şahin, together with his wife Özlem Türeci, Founder and Chief Executive Officer of BioNTech, at the presentation of the Knight Commander’s Cross of the Order of Merit of the Federal Republic of Germany, in March 2021.

Legal Notice

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