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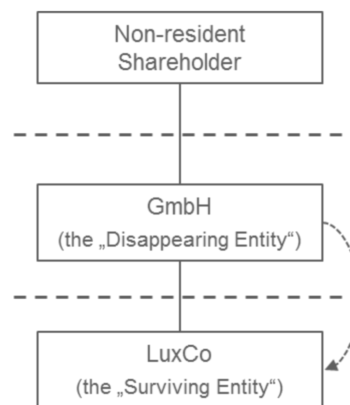
Tax-neutral downstream merger with non-German shareholders

In its recently published decision dated April 22, 2016, the Fiscal Court Dusseldorf ruled that, contrary to the German tax authorities' view, the downstream merger of a German corporation (the "Disappearing Entity") with non-resident shareholders into its corporate subsidiary (the "Surviving Entity") does not result in the realization of the undisclosed reserves in the shares of the Surviving Entity, even if Germany is deprived of its taxation right with respect to the shares in the Surviving Entity as a result of the merger.



German tax authorities' view

According to the decree issued by the Federal Ministry of Finance on November 11, 2011, concerning the application of the German Transformation Tax Act, the downstream merger of a German corporation does not result in the realization of the undisclosed reserves in the shares of the Surviving Entity if, among other requirements, it is ensured that Germany maintains its full taxation right with respect to any capital gains realized from the sale of the shares in the Surviving Entity after the merger. Generally, this requirement cannot be met if the Disappearing Entity has non-resident shareholders and if there is a Double Tax Treaty ("DTT") in force between Germany and the state of residence of the non-resident shareholders allocating the right to tax capital gains realized from the sale of shares to the state of residence in accordance with the OECD Model Convention. In such case, according to the German tax authorities' view, the shares in the Surviving Entity must be capitalized at fair market value in the closing tax balance sheet of the Disappearing Entity, thus triggering a capital gain. Capital gains resulting thereof are subject to taxation in accordance with the general rules. According to these rules, capital gains realized by a corporation from the sale of shares in another corporation are generally exempt for corporate income and trade

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tax purposes; however, 5% of the realized capital gain is treated as non-deductible business expenses subject to corporate income tax and trade tax at a rate of approx. 30%.

The Decision of the Fiscal Court Dusseldorf

The Fiscal Court Dusseldorf ruled that the German tax authorities' view as stated above is not in line with the wording of the law, based on the following arguments:

- The German tax administration takes the view that the treatment of the shares in the Surviving Entity is governed by Sec. 11 (2) sentence 1 no. 1 and 2 of the German Transformation Tax Act and that the requirements for a book value transfer as stipulated in Sec. 11 (2) sentence 1 no. 1 and 2 of the German Transformation Tax Act are not fulfilled with respect to the shares in the Surviving Entity, if the shareholders of the Disappearing Entity are residents of a DTT country.

- Sec. 11 (2) sentence 1 no. 1 and 2 of the German Transformation Tax Act provide *inter alia* that the transferring assets can only be recorded at book value in the closing balance sheet of the Disappearing Entity to the extent that (i) Germany maintains its full taxation right with respect to any capital gains realized from the sale of such assets; and (ii) the assets are subject to corporate income tax at the level of the Surviving Entity.

- In the case of a downstream merger, however, the shares in the Surviving Entity transfer directly to the shareholders of the Disappearing Entity. As a consequence, the shares in the Surviving Entity cannot be subject to corporate income tax at the level of the Surviving Entity and the requirements as stipulated in Sec. 11 (2) sentence 1 no. 1 and 2 of the German Transformation Tax Act can never be fulfilled in the case of a downstream merger, irrespective of whether the shareholder of the Disappearing Entity is a tax resident of Germany or a tax resident of a DTT country.

- On this basis, the court concluded that Sec. 11 (2) sentence 1 no. 1 and 2 of the German Transformation Tax Act are overruled by Sec. 11 (2) sentence 2 of the German Transformation Tax Act, which in the court's view provides for a special and exhaustive valuation rule with respect to shares of the Surviving Entity held by the Disappearing Entity. Pursuant to this rule, the shares in the Surviving Entity are to be capitalized in the closing balance sheet at their book value, increased by write-downs as well as by deductions pursuant to Section 6b Income Tax Act and similar deductions with tax effect in earlier years, but not exceeding the fair market value. According to the court, the application of Sec. 11 (2) sentence 2 of the German Transformation Tax Act is independent of the fulfillment of the requirements as stipulated in Sec. 11 (2) sentence 1 no. 1 and 2 of the German Transformation Tax Act.

Relevance of the decision for taxpayers

It should be noted that the decision of the Fiscal Court Dusseldorf has no binding effect beyond the individual case in question as court decisions apply *inter partes* only. Furthermore, it should be noted that the Fiscal Court Dusseldorf has permitted appeal against its decision with the Federal Tax Court (Sec. 115 para. 2

of the German Code of Procedure of Fiscal Courts). It is to be expected that the German tax authorities will in fact challenge the decision. Accordingly, the Federal Tax Court will most likely have to deal with the question at issue, and it remains to be seen whether the Federal Tax Court will ultimately agree to the view of the Fiscal Court Dusseldorf.

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