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Pension promises to owner/managers of companies

The Supreme Tax Court has handed down four judgments on pension promises to managing directors who are also majority shareholders specifying rules for distinguishing allowable business expenses from disallowable “hidden distributions”.

Pensions promised or paid to company owner/managers (majority shareholders who also hold the position of managing director) remain a recurrent bone of contention with the tax office. The director claims the benefits to have been earned as part of his arm's length salary package and the costs to the company to be allowable as acceptable business expenses. Tax offices often respond with claims that the promises would not have been given in the form under review to third parties as directors and that the expense was affected by the shareholding relationship. Accordingly, it was disallowable as a "hidden distribution" of profits to be treated by the recipient as a dividend. The Supreme Tax Court has published a further four judgments on the distinction.

All four judgments see the pension promise as initially agreed as binding for the future. Attempts to change, or ignore, it therefore easily lead to findings of "hidden distribution". Despite the legal definition of "hidden distribution" as "... excessive expense or prevention of income ...", any "hidden distribution" resulting from a payment is taken at the gross amount paid without regard to the positive effect on the P&L from the release of the provision. The cases under review all see a pension as provision for retirement, thus their payment will be seen as a hidden distribution if the managing director continues in office. More specifically, the court held that:

- The lump sum settlement of the future pension liability at its actuarially calculated present value to an owner/manager prior to retirement was a "hidden distribution" for lack of any indication in the pension promise of the possibility of such a settlement. It was not disputed that the amounts involved were reasonable or that the settlement was in the best interests of the company. The promise was for a pension on retirement at the age of 65 or later and the settlement was made on the occasion of the transfer of the majority holding from father to son when the former was 52. However, the father continued in office as (joint) managing director after the transfer. Judgment I R 28/13 of September 11, 2013
- A pension is paid to provide for retirement and is therefore incompatible with continuing employment in the same company. This also applies to a managing director who reduced his activities and accepted a commensurate salary cut, but without relinquishing the title. Perhaps not entirely consistently, the court noted that he could have continued to work for the company as a part-time consultant, or could have taken another job altogether, without compromising his pension's status. The court also noted that he could have delayed the incidence of the pension against an increase in the amount when finally paid. Judgment I R 60/12 of October 23, 2013
- A company covered its pension liability to its owner manager with an insurance policy. The promise was based on retirement at 60 or later and the policy fell due on that date. The company paid the proceeds from the insurance company to the managing director when received in full settlement of all remaining pension obligations. However, the managing director continued in office. This fact was sufficient for the court to treat the payment as a "hidden distribution". Judgment I R 89/12
- A 25% shareholder as junior partner in a tax consultancy GmbH held a pension promise due on

retirement at 60. The propriety of this arrangement was not originally in dispute. However, he rose to the position of senior partner with a 60% share. The tax office then maintained that 60 was too early a retiring age for a tax consultant and that the provision should be recalculated on the basis of retirement at 65. This position had the support of the corporation tax guidelines. The lower tax court held that the provision should be frozen in the first year still open after the senior partner's promotion, and that future provisions should be based on retirement age 65. The Supreme Tax Court upheld the lower tax court's judgment on the basis that there was nothing in law setting a minimum retiring age and that the original agreement remained acceptable. Accordingly, there was no scope for an accounting adjustment based on a recalculation of the existing provision. It seemed to suggest that there might also have been no scope for an adjustment of future provisions, although it was unable to rule on this point as the senior partner had confined his appeal to the position at the time of his promotion. Supreme Tax Court judgment I R 72/12 of September 11, 2013

These four judgments were all published on March 26, 2014.

Schlagwörter

hidden distributions, owner/manager, pension promises