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By PwC Deutschland | 10. November 2017

Tax Consolidation Groups (“Organschaft”) for income tax purposes: Compensation payments to minority shareholders; failure to amend to “old agreements” of a GmbH following Section 302 (4) Stock Corporation Act.

According to a decision of the Supreme Tax Court published on 9 November 2017 a profit pooling agreement will not be recognised for tax purposes where the compensation agreement with the external shareholder contains both the right to a variable compensation payment calculated on the basis of the profits of the subsidiary/controlled company/"Organgesellschaft" (“subsidiary”) and a fixed amount.

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This also applies to subsidiaries in the form of a GmbH (i.e. limited companies as well as to public limited/stock companies (AGs)). The Supreme Tax Court also ruled that the requirement of Section 17 2nd Sentence No. 2 Corporation Tax Act (old version), according to which the assumption of losses was to be expressly agreed in the profit pooling agreement of a GmbH in accordance with Section 302 (4) Stock Corporation Act, was not only to be complied with at the time of conclusion of the agreement but also in each of the following years. It followed that those parts of the Section 302 regulation which had not entered into force at the time of the conclusion of the contract were also to be taken into consideration. Thus where a loss assumption agreement is not inserted into an "old" profit pooling agreement, (i.e. one concluded prior to the entry into force of Section 302 (4) Stock Corporation Act), in order to meet the requirements of the amended section and where this omission was not subsequently redressed under the amnesty rule, the Organschaft was no longer to be recognised for income tax purposes.

The case turned on the question whether an Organschaft relationship had been established between the appellant, a GmbH, and another GmbH "WB". The object of the appellant is the supply of gas and water to the town of B and the disposal of sewage for the towns of B and H.

Background

Initially the town B held 51% of the share capital of the appellant directly. The municipality then spun its swimming pool operations off into the newly established WB and also transferred to it its majority shareholding. During the period under review the 49% share in the appellant was held by A GmbH; this company also carried out the business of the appellant. The articles of association provided that A GmbH should receive a fixed dividend from the annual profits in advance. The remaining profits were then to be distributed according to the percentage of the shareholdings.

On 30 November 2004 the appellant concluded a profit pooling agreement with WB in order to establish an Organschaft for income tax purposes. According to the agreement the appellant agreed to transfer its whole profit and WB agreed to assume any annual losses. The agreement provided for the application of Section 302 (1) and (3) Stock Corporation Act for the loss assumption as appropriate. A short time later the new subsection 4 of Section 302 Stock Corporation Act was introduced; the new subsection was to have effect from 15 December 2004. This subsection contained imposed a limit on the time in which a subsidiary entity could claim the assumption of losses. The parties failed to amend the agreement in relation to the clause relating to the assumption of losses, both at the time or at a later date.

Furthermore the profit pooling agreement contained provision for compensation payments to A GmbH as the external shareholder. According to this provision, for each complete financial year, WB guaranteed A GmbH a fixed compensation payment calculated on the basis of the par value of A GmbH's shareholding. In addition to this fixed compensation payment WB agreed to pay annually a variable additional premium. This premium was calculated by applying the percentage of A GmbH's shareholding to the appellant's profits after the deduction of actual and fictitious tax and the fixed compensation payment but before the surrender of the profits under the profit pooling agreement. Accordingly A GmbH, as an external shareholder, received both fixed and variable compensation payments.

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Following a tax audit, the tax office came to the conclusion that, for the years 2004 to 2007 WB had not transferred the whole of its profit to the appellant. As a result both the fixed and the variable compensation payments were treated as hidden profit distributions. The administrative appeal and the court (first instance) appeal were unsuccessful. The lower tax court considered the variable compensation payment (i.e. the one based on the profits of the subsidiary) as harmful. The lower court also objected to the clause in the profit pooling agreement regulating the assumption of losses because there was no reference to Section 302 (4) Stock Corporation Act. In the decision published this week the Supreme Tax Court confirmed the lower court's findings.

Linkage of compensation payment to results of the subsidiary before the deduction of profit surrender is harmful for tax purposes

The Supreme Tax Court took the view that, through the linkage of compensation payment to results of the subsidiary before the deduction of profit surrender, the actual execution of the profit surrender was called into question. In a 2009 decision (decision of 4 March 2009, I R 1/08) relating to an AG (public limited company) as subsidiary, the Supreme Tax Court decided that a surrender of the full profit could not have been made under any circumstances, in a situation where, as a result of a compensation payment, the external shareholder received the same share in the profits of the subsidiary as he would have received without the profit pooling agreement. The Supreme Tax Court confirmed its earlier decision and expressly extended its application to subsidiaries in the form of a GmbH (limited company). The Court did not regard it necessary to consider whether or not an AG has the discretion to agree rules on compensation payments which go beyond the minimum requirements of Section 304 (2) 1st Sentence Stock Corporation Act or whether or not, considering the absence of a specific provision, a GmbH has any contractual freedom under company law vis-à-vis the agreement of compensation payments. This is because, the actual surrender of the full profit according to the agreement is to considered on the facts pertaining to the Organschaft applying tax law criteria. Furthermore Section 17 1st Sentence Corporation Tax Act (CTA) - which provides for the application to a GmbH of the rules in Sections 14-16 CTA applicable to AGs, KGaAs and SEs as subsidiaries - speaks against a "free" determination of a compensation payment which should generally be acceptable for tax purposes in the case of a GmbH as a subsidiary. This means, in the view of the Court that the Organschaft rules on compensation payments applying to AGs should apply equally to a GmbH as subsidiary. Section 304 Stock Corporation Act simply requires a fixed compensation or a variable compensation based upon the results of the controlling company(the "Organträger") but not compensation calculated on the basis of the (variable) profit of the subsidiary. For tax purposes the only compensation agreements which will be recognised will be those which meet the requirements of Section 304 Stock Corporation Act; this applies to AGs and GmbHs alike.

Agreements on the assumption of losses of a GmbH – failure to amend after introduction of Section 302 (4) Stock Corporation Act considered harmful

The second part of the judgment related to Section 17 2nd Sentence CTA (old version), according to which the profit pooling agreement of a GmbH can only form the basis for a Organschaft, if the assumption of

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losses is agreed in accordance with Section 302 Stock Corporation Act. In contrast to the new version of Section 17 (1) 2nd Sentence No. 2 CTA, which applies to contracts entered into or amended after 23 February 2013, the old version Section 17 2nd Sentence No. 2 CTA does not provide for a “dynamic” reference to Section 302 Stock Corporation Act in “its currently applicable version” ("in seiner jeweiliger Fassung"). Even a “static” reference to the provisions of Section 302 Stock Corporation Act or a word-for-word rendition of the section would generally have been recognised. Until the special time bar for making claims for the assumption of losses came into force under Subsection 4 on 15 December 2004, Subsections 302 (1) and (3) Stock Corporation Act were obligatory parts of the agreement for the Organschaft. In a 2013 decision (decision of 24 July 2013, I R 40/12), the Supreme Tax Court had already ruled, that the profit pooling agreement of a GmbH concluded in 2005 could only establish an Organschaft, if its loss assumption agreement also included Section 302 (4) Stock Corporation Act (which came into force in December 2004). In the instant case the question was whether a loss assumption agreement which contained all elements of Section 302 Stock Corporation Act existing at the time of its conclusion had to be amended after Section 302 (4) Stock Corporation Act subsequently came into force in order for the profit pooling agreement to go on being recognised for tax purposes.

With the decision published this week, the Supreme Tax Court answered the question in the affirmative. In its reasoning the Court stated that the analogous application of Section 14 CTA to GmbH Groups provided for in Section 17 1st Sentence CTA also applied to the requirements for the beginning and the end of the effectiveness of the profit pooling agreement. The requirements in Section 14 (1) 1st Sentence No. 3 1st Sentence CTA that the profit pooling agreement be concluded for a period of a least 5 years and must be implemented during the entire period, apply - in accordance with Section 17 2nd Sentence No. 2 CTA (old version) - equally to inclusion of the loss assumption according to the provisions of Section 302 Stock Corporation Act. Furthermore the phrase “is agreed” ("vereinbart wird")used in Section 17 2nd Sentence No. 2 CTA (old version) does not mean that it only applies to the version of Section 302 Stock Corporation Act applicable on the date on which the agreement was concluded. Both the principle of “section taxation” and the aim of Section 17 CTA - namely to achieve an approximation of the conditions applicable to a GmbH-Organschaft to those applicable to an AG-Organschaft – contradict this proposition; Section 302 (4) Stock Corporation Act had to applied by AGs as soon as it came into force.

The Supreme Tax Court did not recognise the profit pooling agreement for the purposes of an Organschaft in the instant case, because the option provided by the so-called “Organschaft mini-reform” – which, up until 31 December 2014, provided the opportunity to retrospectively redress any inadequate loss assumption agreement through the inclusion of a reference (“dynamic reference”) to a loss assumption according to Section 17 (1) 2nd Sentence No. 2 CTA (old version) – was not utilised. Likewise a recognition of the agreement covered by the application of Section 302 (4) Stock Corporation Act on the basis of the circular of the Federal Ministry of Finance dated 16 December 2005 (Federal Gazette/BStBl I 2006 Pg. 12) is not possible. This circular applies to situations where the tax office made no objection to the omission of a reference to Section 302 (4) Stock Corporation Act in a profit pooling agreement concluded before 1 January 2006. Following the principles set down by the Court in 2013, the appellant was not entitled to rely

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on the circular during the proceedings before the lower court, because the circular does not bind the courts legally. Even if the circular could be viewed factually as equitable relief under Section 163 of the General Tax Code, there was no evidence that the relief had actually been knowingly applied in this case by the tax office.

Source:

Supreme Tax Court decision of 10 May 2017 (I R 93/15), published on 8 November 2017.

Schlagwörter

Corporation tax, Organschaft, compensation payment, fiscal unity, minority shareholder, tax consolidation group, tax group