Downloaded from Blogs on 03.11.2026 06:13

By PwC Deutschland | 23 January 2014

German rule on taxation of hidden reserves on contribution of business for shares upheld

The ECJ has upheld a German rule providing for immediate taxation (but with a deferral option) of the capital gain inherent in the excess of the market over the book value of a business transferred to a corporation in exchange for shares where as a result of the transaction Germany would lose the right to tax the gain on any subsequent sale of the shares.

Downloaded from Blogs on 03.11.2026 06:13

The Reconstructions Tax Act allows the owner of a self-contained business unit, or of a partnership share, to transfer the asset to a corporation at its book value as a contribution in kind in exchange for newly issued shares. One of the conditions is that Germany should retain the right to tax a capital gain on any subsequent sale of the newly issued shares. If she does not, the asset is transferred at market value and the transferor is required to tax the deemed gain without waiting for realisation. However, at the time of the case, this tax liability could be spread interest-free over the following five years, provided collection was assured. Two Austrian companies jointly owning a German partnership contributed their partnership shares to a German company as a contribution in kind. They objected to taxation, even on deferred payment terms, as discriminatory, given that German partners could have made the same contribution tax-free and would not have been concerned with any form of taxation on a capital gain, until the gain was actually made.

The ECJ has now agreed that the German provisions are a discriminatory hindrance on the free movement of capital (they apply regardless of size or proportion of the partnership holding), but sees them as justified in the overriding public interest. Under the German/Austrian double tax treaty, gains on the sale of shares in a corporation are taxable in the country of residence of the seller. However, sales of partnership shares are taxable as business income of the partners in the country of the partnership. Thus the contribution effectively removed the taxation right from Germany. Since Germany had no other way of protecting her tax interest, the immediate taxation requirement was legitimate. The five-year spread option was adequate to relieve the hardship of immediate taxation. The only proviso made by the court was that the condition for the spread, that collection be assured, was not applied in an unduly burdensome manner, without regard to the actual risk (or lack of it) of default.

n.b. The Reconstructions Tax Act was revised in 2006 and the five-year spread option is no longer available. However, there are other provisions to alleviate hardship or apparently unfair taxation, and these might be sufficient for a court to hold that the German rules continued to be within the limits necessary to achieve a legitimate object.

The ECJ case reference is C-169/12 *DMC* judgment of January 23, 2014.

Keywords

Reconstructions Tax Act, capital gain, contribution in kind, hidden reserves