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By PwC Deutschland | 08 June 2021

Abuse of legal forms in the case of merger

According to the decision of the Supreme Tax Court the offset of losses in case of an upstream merger with the profits of the transferring company accrued during the period of retrospective application was not abusive and in accordance with the legal (tax) provisions in force in the year of dispute (2008).

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Background

Towards the end of 2008, the plaintiff (a GmbH) was experiencing operational losses with imminent threat of insolvency. The usual options for boosting liquidity were not immediately available. On 23 February 2009, the plaintiff acquired D GmbH which had substantial profits stemming from financial transactions in 2008 and 2009. Immediately thereafter, on 24 February, D GmbH was merged into the plaintiff (upstream merger). In the course of a tax audit the tax office came to the conclusion that the profit-making company (D-GmbH) was itself liable to tax on its income earned in the retroactive period because the merger was not effective for tax purposes pursuant to the anti-abuse provisions in Sec. 42 Fiscal Code. The Lower (district) Tax Court of Hesse granted the appeal.

Decision

The decision of the tax court of Hesse was upheld by the Supreme Tax Court. The acquisition of the shares in D GmbH and their subsequent retroactive upstream merger into the plaintiff does not constitute an abuse of legal forms within the meaning of Sec. 42 (2) Fiscal Code.

In essence, the main issue at hand was the interaction of individual tax laws, namely the Reconstructions Tax Act 2006 (RTA), Corporation Tax Act (CTA) and Section 42 Fiscal Code. The merger of a "profitable company" into a "loss company" and the subsequent offset of income from the "profit company" against its own previous losses from the retroactive period preceding the merger does not constitute an abuse of legal forms as far as the year 2008 is concerned. The Supreme Tax Court went on to say, that this would also apply if the "profit company" had already distributed the profits of the retroactive period to its former parent company.

As distinct from 2008, the current version of Section 42 Fiscal Code contains an explicit provision on the relationship of individual tax law anti-abuse provisions vis-à-vis the abuse clause in the Fiscal Code (Current Sec. 42 Paragraph 1 Sentence 2 and 3 reads as follows: "*If the object of a rule in a tax act for the prevention of tax avoidance is fulfilled, the consequences shall follow as provided therein. In other cases, the tax liability following an abuse within the meaning of sub-section 2 shall be as would have arisen from a legal form appropriate to the business transaction*"). Thus, individual tax statutes designed to prevent tax evasion and which are not relevant to the case, do not exclude the application of the general anti abuse provisions of § 42 Fiscal Code. In the case of dispute the provisions of Sec. 12 (3) Sentence 2 in conjunction with Sec. 4 (2) Sentence 2 RTA and Sec. 8c Sentence 2 CTA with respect to the curtailment of loss relief on changes of shareholder are applicable. Sec. 4 (2) Sentence 2 RTA and Sec. 8c Sentence 2 CTA, however, are not relevant in terms of the facts of the case because they stipulate the exclusion of the transfer of loss carryforwards by means of a merger by absorption of **a loss-making company** or regulate the acquisition of shares in such a company. In the present case, however, the object of the share acquisition and subsequent merger is D GmbH as **a profit-making company**.

Therefore, the Supreme Tax Court summarizes its conclusions as follows: Under the anti-abuse rules of

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Sec. 42 Fiscal Code, legal structures enabling the taxpayer to use losses have not generally been deemed to be abusive. Here, the main purpose of the merger was to use the loss carryforward of the plaintiff because of the lack of economic success and thus also to minimize taxes. D GmbH still had a certain economic substance and the plaintiff, on the other hand, while faced with pending insolvency was primarily interested in utilizing the loss it had generated for tax purposes.

Source:

Supreme Tax Court decision of 17 November 2020 (case ref.: I R 2/18), published on 4 June 2021.

Keywords

Loss utilisation, Upstream merger, abuse of legal forms, anti-abuse