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By PwC Deutschland | 01 September 2021

Sale of property after gratuitous transfer to children no abuse

If the taxpayer has arranged for the sale of a property to a third party, there is generally no abuse of tax law (abuse of legal forms) if the property was initially transferred to the children free of charge and subsequently sold by the children to the ultimate buyer. According to the decision of the Supreme Tax Court the capital gain is subject to income tax in the hands of the children based on their individual income tax situation.

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Legal background and facts of the case

The parties are in dispute on the taxation of the capital gain resulting from a private sale of property pursuant to Sec. 23 (1) Sentence 1 No. 1 of the German Income Tax Act (ITA) and the question whether the arrangement leads to an abuse (circumvention) of tax law pursuant to Sec. 42 (1) Fiscal Code (*Abgabenordnung - AO*).

An abuse of tax law is generally assumed where an inappropriate legal option is selected which, in comparison with an appropriate option, leads to tax advantages unintended by law for the taxpayer. This shall not apply where the taxpayer provides evidence of non-tax reasons for the selected option which are relevant when viewed from an overall perspective; Sec. 42(2) Fiscal Code.

Sec. 23 ITA deals with the taxation of private sales. In the case of an acquisition free of charge Sec. 23(1) Sent. 3 provides that “the acquisition or transfer of the asset to private assets by the predecessor shall be attributed to the sole successor for the purposes of this provision”.

The plaintiff acquired a piece of land in 2011 and - in 2012 - transferred ownership of said property free of charge to her grown up son and daughter. By notarized agreement of the same date, the children sold the property to a third party. Half of the sales price was paid to each of the children which substantially reduced the overall capital gains tax payable on the sale. The sales negotiations and arrangements with the ultimate buyer were handled solely by the plaintiff.

The tax office considered the gift to the son and daughter to be an abuse within the meaning of Sec. 42 Fiscal Code; the capital gain was thus fully attributed to the plaintiff. The Regional Tax Court rejected the claim of the plaintiff and upheld the assessment of the tax office.

Final decision

The Supreme Tax Court granted the appeal and overturned the first-instance decision of the Regional Tax Court for the following reasons.

The plaintiff did not, as a matter of fact, sell the property herself, rather she transferred it to her two children in 2012 free of charge. Based on the regional court's previous factual findings, the Supreme Tax Court first of all was not in a position to hold that the (arm’s length) criteria for transactions between related parties would preclude the assumption of a gratuitous transfer in the case of dispute.

Sec. 23 (1) Sent.3 ITA deals with the taxation of a capital gain in the case of a preceding gratuitous acquisition and in this respect is a specific anti-abuse provision which complements the general rule in Sec. 42 (1) Sentence 2 Fiscal Code. Thus, if the prerequisites of a more specific anti-abuse provision - in this case Section 23 (1) sent. 3 ITA - are met, the more general rules of Section 42 (1) sentence 2, (2) AO cannot be applied.

The gratuitous transfer of the property to another party who subsequently sells the property within the taxable period (of ten years) is precisely dealt with in Sec. 23 (1) Sent.3 ITA and therefore cannot be subject

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to anti-abuse restrictions, irrespective of the short time span between the gratuitous transfer and the ultimate sale. The plaintiff and her children have thus followed and adhered to the prevailing tax laws, i.e., Sec. 23 ITA which led to one half of the capital gain being subject to income tax for each of the children.

While looking at further aspects of the case the Supreme Tax Court identified yet other reasons why the assumption of abuse could not be upheld. It was not in any way evident from the earlier fact findings of the Regional Tax Court that the contract regarding the gratuitous transfer of the property to the children and its subsequent sale contained any inappropriate or unreasonable provisions. The children were free to dispose of the endowed property after the transfer. They were not committed to finally sell to the ultimate buyer with whom the plaintiff alone had been negotiating the sale. The children were also not under any obligation to transfer the proceeds of the sale to the plaintiff.

The further fact that the capital gain is taxed at a lower rate for the children than for the plaintiff does not foster the assumption of an abuse. A taxpayer is - as such - not barred from structuring the legal circumstances in such a way to minimize his tax liability. The intention to save taxes does not in itself disqualify an arrangement as being unreasonable.

Source:

Supreme Tax Court decision of 23 April 2021 (case ref.: IX R 8/20), published on 26 August 2021.

Keywords

Capital gains taxation, abuse of legal forms, gratuitous transfer, private sale