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By PwC Deutschland | 26 August 2024

Exit tax upon transfer of Germanys right for taxation under double tax treaty

In a case where Germany lost the right to tax the investment in a Spanish corporation the Supreme Tax Court - in contrast to the opinion held by the tax administration - decided that the German exit taxation pursuant to Section 6 para. 1 sentence 1 Foreign Tax Act applies to the year in which the German unlimited income tax liability ends and not at the later point in time when the limited tax liability arises.

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The legal situation:

Germany is obliged to tax built-in gains, if an asset or a business is transferred to another jurisdiction (i.e., exit taxation). According to Section 6 (1) of the Foreign Tax Act (FTA), where a taxpayer's unlimited tax liability ceases through the taxpayer giving up his German residence/habitual abode, any material shareholdings held in his private property will be deemed as disposed of even without a sale and any capital gain on the deemed disposal will be taxable under Section 17 (1) of the Income Tax Act (ITA). Section 6 (3) FTA provides for this so-called exit tax to be subsequently waived in certain circumstances.

The background:

The case of dispute dealt with the taxation of unrealized gains inherent in an investment in a Spanish corporation following an amendment to the double tax treaty with Spain as regards the right of taxation.

The plaintiff was shareholder of a Spanish corporation which owned a property. On 1 January 2013, Art. 13 para. 2 of the double tax treaty with Spain was amended to the effect that the right of taxation for corporations with more than 50% real estate assets no longer belonged to the Federal Republic of Germany, but to Spain. The dispute was whether the hidden reserves (built-in gains) of the investment were subject to exit tax in 2013 (year of dispute).

The tax court of first instance upheld the claim of the plaintiff.

Here is what the Supreme Tax Court had to say:

The Supreme Tax Court agreed with the decision of the lower court and considered the tax office's appeal as being unfounded. There were no legal grounds for taking into account a profit of the built-in gain as income from business operations for the 2013 tax year.

The exit tax pursuant to Section 6 para. 1 sentence 1 Foreign Tax Act arises in the year in which the German unlimited income tax liability ends. This contrasts with the opinion held by the tax administration. The exit taxation is associated and goes in line with the unlimited tax liability of the person moving away and does not arise at a later point in time, e. g., with the first day of the limited tax liability.

Although theSupreme Tax Court does not share the view of the lower tax court that the exit taxation for the year in dispute violates both EU and constitutional law, taxation of the taxable built-in gain regarding the investment in the Spanish corporation should in any case have not been subject to tax in the year in dispute but would have rather been taxable already in the previous 2012 tax assessment period.

The Supreme Tax Court states that nothing to the contrary applies to the alternative provision in Section 6 para. 1 sentence 2 no. 4 Foreign Tax Act under which the exclusion or restriction of Germany's right of taxation be treated as being equivalent to the termination of unlimited income tax liability.

The built-in gain must therefore be recognized and taxed at the time Germany last had the (unlimited) right to tax the capital gain under the tax treaty.

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Source:

Supreme Tax Court, decision of 16 April 2024 (IX R 38/21) – published on 16 August 2024.

Keywords

exit tax