Germany:
Tax group denied in case of atypical silent partnership at level of group subsidiary

Germany’s Federal Tax Court (BFH) ruled in a recently published decision that the transfer of the profits of a controlled entity in a tax group, except for a portion of the profits remitted to an atypical silent partner, is not sufficient to meet the requirement that all of the subsidiary’s profits be transferred to the parent company to qualify as a tax group.

A German GmbH concluded an agreement to establish an atypical silent partnership with a non-shareholder (a third party) and agreed to transfer a specific share of its profits to that third party. The profit share was defined as the profits earned by the sole foreign permanent establishment (PE) of the GmbH. A couple of years after the agreement was entered into, the GmbH concluded a profit and loss pooling agreement (PLPA) with its sole shareholder, a German corporation, in order to enter into a tax group. Under the PLPA, the GmbH committed to surrender its entire profit to its shareholder and the shareholder agreed to compensate the GmbH for any losses incurred by the GmbH.

The BFH concluded that the tax group was invalid because the GmbH only transferred the profits remaining after a portion of its profits had been paid to the atypical silent partner – it failed to meet the requirement that the entire profit be transferred. According to the BFH, it is irrelevant whether or not the profits generated by the PE are exempt from German tax under a tax treaty because the exemption does not reduce the actual profits of the subsidiary. Consequently, the effects of the tax group were denied so that the profit transfers were recharacterized as constructive dividends and the compensation of losses recharacterized as hidden contributions.

Taxpayers should ensure that the subsidiary in a tax group transfers its entire profit both from a contractual and a factual perspective. Any profit-participating partnership-type instruments at the level of a subsidiary in a tax group should be reviewed carefully before they are implemented to determine whether they may adversely affect the effectiveness of the tax group.

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