



Federal Fiscal Court extends possibilities for tax-neutral departures from partnerships

The current judgment goes beyond the previous practice of the tax authorities

Partners shall be able to leave the partnership to a greater extent without disclosing hidden reserves.

December 2017, Dr. Alexander Wolf

Background:

The partner leaving a partnership generally has a claim for compensation against the company. Since this compensation claim can put the company in considerable liquidity difficulties, the partner is often compensated with real assets.

The division of separable parts of a business operation, co-entrepreneurial shares or individual assets may be a **tax-neutral physical division** (that is, the split of an enterprise avoiding disclosure of hidden reserves to the tax authorities). In this case, hidden reserves are not revealed in the transfer of assets. The case law concerning the tax treatment of real asset compensation as a physical division is therefore of particular practical importance under German tax law.

Since tax authorities and case law allowed for a tax-based physical division only in the event of a complete **dissolution and termination** of the co-entrepreneurship (this is what partnerships are called under German tax law terminology), the Federal Fiscal Court (BFH) expanded the scope of application of physical division to include the **departure of partners** against real asset compensation with its judgment dated Sept. 17, 2015. According to the BFH, the departure of a co-entrepreneur for the assumption

of a separable part of business operations constitutes physical division, provided that the transferred part of the business **remains** in the business assets of the departing co-entrepreneur and the co-entrepreneurship is **continued** by the remaining partners. The tax authorities followed this ruling in a statutory notice dated December 20, 2016.

In its latest **judgment dated March 30, 2017**, the BFH has yet again **expanded the possibilities** of applying physical division. It goes **beyond the practices** approved of by the tax authorities (BMF statutory notice of December 20, 2016).

The Decision of the BFH:

The BFH has established the following guiding principle:

Upon the departure of a co-entrepreneur from the co-entrepreneurship against real asset compensation from the co-entrepreneurial assets, the **principles of physical division apply** even if compensation is paid (...) by means of **transfer of single** assets.

The BFH clarifies: Not only in the case of real asset compensation **with separable parts of a business operation or co-entrepreneurial shares, but in all cases of asset-based compensation**, the departure of the co-entrepreneur is to be treated as a function of his co-entrepreneurial share if the departing co-entrepreneur **continues to hold single assets received as a part of his active business** venture.

Recommendations:

The BFH **favors the continuation of the entrepreneurial commitment of the departing shareholder** with the extension of tax-neutral real asset compensation. It is important to take advantage of these new options.

However, it remains to be seen whether the tax authorities will follow the case law of the Federal Fiscal Court. Only with the publication in the Federal Tax Gazette – which has not yet occurred – will the judgment dated March 30, 2017 be binding for the tax authorities.

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