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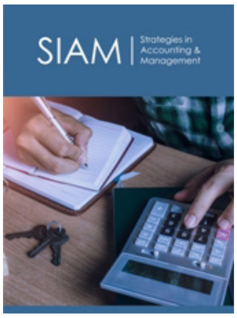

The Accounting and Tax Treatment of Pension Liabilities in M&A-Transactions with Special Consideration to the Corporate Income Tax Option in Germany

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Abstract

After exercising the corporate income tax option, the opting company, such as a German commercial partnership or partnership company, is fictitiously treated by tax authorities as if it were a limited liability corporation in terms of its income and trade tax. Mergers and acquisitions between opting partnerships and corporations are generally tax neutral, but further conditions regarding the transfer of pension liabilities must be met. If a pension commitment is invalid under civil law, pension provisions must be dissolved on the balance sheet, which possibly leads to a tax profit correction.

Keywords: Corporate income tax option; Mergers and acquisitions; Pension liability

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Introduction

In the year 2021 the German legislator enacted the German Corporate Income Tax Modernization Act and therein introduced an option for domestic and foreign commercial partnerships and partnership companies to be treated like a German limited liability corporation for income tax purposes. [1]Currently, the German federal government discusses a draft law to promote growth opportunities, investment and innovation as well as to simplify and promote fairness in taxation, which also includes provisions to increase the attractiveness of the corporate income tax option under Section 1a of the German Corporate Income Tax Act. [2]After exercising the corporate income tax option, the opting company, such as a German commercial partnership or partnership company, is fictitiously treated by tax authorities as if it were a limited liability corporation in terms of its income and trade tax. [3]In particular, this means that personally liable partners of opting partnerships are regarded by the tax authorities as non-personally liable shareholders as in limited liability corporations. Exercising the option reduces tax burdens, if compensations, direct pension commitments or bonuses are subject to an average tax rate of more than 30 percent. The option is also open to companies with foreign legal forms that are comparable to German commercial partnerships or partnership

[1]German Corporate Income Tax Modernization Act (Law to modernize corporate tax law), Federal Law Gazette 2021, Teil I Nr.37, Bonn, June 30th 2021.

[2]Article 20, Nr. 1, draft law to promote growth opportunities, investment and innovation as well as to simplify taxation and promote fairness in taxation (Growth Opportunities Act), German federal government, August 29th 2023.

[3]Section 1a, Corporate Income Tax Act, Section 2, German Trade Tax Act.

[4]Section 34, 1a, German Corporate Income Tax Act.

companies and are subject to unlimited corporation tax in Germany. The option can be exercised for the first time for fiscal years starting after December 31st, 2021. [4]An application for the option can be submitted to the tax authorities at any time. However, the application must be turned in to the responsible tax authority no later than one month before the start of the fiscal year, in which the option should take effect. The above-mentioned draft law to promote growth opportunities in Germany now proposes to relax this application period for start-up companies and entities that change their legal forms to partnerships. Hence, given the increased attractiveness to apply for the corporate income tax option, it is of particular interest to analyze the accounting treatment of pension liabilities in M&A-transactions between opting partnerships and limited liability corporations, as well as the subsequent taxation of these entities, which is based thereupon [1-7].

Accounting Treatment of Direct Pension Commitments under Generally Accepted Accounting Principles in Germany (German-GAAP)

A direct pension commitment represents the base case of a pension liability, which is hereafter used to discuss the principle accounting treatment in limited liability corporations. Pension provisions must generally be passivated according to section 249, paragraph 1 of the German Commercial Code. However, Article 28, paragraph 1 of the Introductory Act to the German Commercial Code specifies two exceptions of this passivation requirement. For a current pension or a direct pension commitment entitled to an employee before January 1st, 1987, as well as for an old claim that increases after December 31st, 1986, the employer has the right to choose not to passivate these liabilities as pension provisions. However, limited liability corporations must indicate the respective pension liability in the explanatory notes to their consolidated financial statement. In addition, when accounting for direct pension liabilities, special issues arise, because netting pension liabilities against specific cover assets on the balance sheet is possible if certain criteria are met. To this end, section 246, paragraph 2 of the German Commercial Code stipulates that cover assets must be capitalizable, earmarked and withdrawn from the access of further creditors.

Tax Treatment of Direct Pension Commitments in M&A Transactions in Germany

In commercial partnerships and partnership companies, pension commitments must be passivated on the company balance sheet and are inversely activated as special business assets in the complementary tax balance sheet of the individual partners. Direct pension commitments between a partnership company exercising the corporate income tax option and its shareholders - respectively partners - are treated comparably to pension liabilities in limited liability corporations. They are passivated based on book values on a continuing basis. Furthermore, current pension payments backed by special business assets in partnership companies are considered as if the fictitious corporation had entitled its shareholder to a benefit. Pensions in current payment as well as insurance premiums for pension liabilities are generally deductible against a corporation's taxable profits. [5]If a whole business, business division or partner shares are acquired by a corporation, the acquiring corporation must generally value these assets at its fair value. [6]If a partnership exercising the corporate income tax option is merged with a limited liability corporation, this is generally in a tax-neutral transaction. [7]An actual change of the legal form of the opting partnership company into a limited liability corporation therefore does not constitute a taxable sales transaction. However, regarding the transfer of pension liabilities, there are additional conditions that need to be met. For example, the direct pension commitment to be transferred must be effective under civil law. If a pension commitment is invalid under civil law, the pension provision must be dissolved on the balance sheet. In addition, it must be examined, whether the requirements and regulations of section 6a, German Income Tax Act are met and have been followed correctly. If there were a violation of a norm in section 6a, German Income Tax Act, the balance sheet would have to be corrected, which can result in a tax profit correction. [8]Also, it must be examined whether the creation of a pension liability represents a hidden profit distribution to the shareholder[9].

Conclusion

After exercising the corporate income tax option, the opting company, such as a German commercial partnership or partnership company, is fictitiously treated by tax authorities as if it were a limited liability corporation in terms of its income and trade tax. Given an increased attractiveness to apply for the corporate income tax option based on the German draft law to promote growth opportunities, investment and innovation as well as to simplify and promote fairness in taxation, this review analyzed the accounting and tax treatment of pension liabilities in M&A-transactions between opting partnerships and limited liability corporations. Pension provisions must generally be passivated according to section 249, paragraph 1 of the German Commercial Code. Pensions in current payment as well as insurance premiums for pension liabilities are generally deductible against a corporation's

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[5]IDW position paper on the occasion of the introduction into a neutral taxation of legal forms (option model), November 13th 2019, IDW Düsseldorf, Germany, p. 6.

[6]Section 20, paragraph 2, German Conversion Tax Act.

[7]Sections 11 et seqq., German Conversion Tax Act.

[8]Section 4, paragraph 2 German Income Tax Act.

[9]Guideline 8.7, German Corporate Tax Guidelines.

taxable profits, whereas the merger of a partnership exercising the corporate income tax option with a corporation is generally a tax-neutral transaction.

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