



Business Gains on Sale

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I. General

When an enterprise is sold or discontinued, all the hidden reserves created during the course of business operations are released. They count as sales profits, and in the year of disposal their effect is to generate taxable income.

In the special situation arising when a business is disposed of, tax relief is provided to reduce taxes on earnings.

The term "gains on sale" denotes the difference between the price at which an asset is sold or withdrawn, and its book value determined for tax purposes on the date of its disposal.

The gains on sale accumulated on the disposal of a business are calculated as follows:

$$\begin{array}{l} \text{Sales price} \\ - \text{book value of the asset} \\ - \text{sales costs} \\ + \text{market value of assets transferred to private property} \\ - \text{debts not assumed by purchaser} \\ \hline = \text{gains on sale} \end{array}$$

A disposal can be made either for valuable consideration or gratuitously.

Disposing of a business for valuable consideration includes for example selling or exchanging it, effecting a transfer to pay off liabilities, or making a contribution in kind to a corporation or partnership in return for being granted partner's rights.

A gratuitous transfer can be brought about by making a gift. In this case no sales profits are created that are liable to income tax, but it has to be remembered that inheritance tax or gift tax may be incurred.

Note on trade tax

If the gains on sale are acquired by a private individual, then they are not liable to trade tax. However, if a partner's share is sold which for tax purposes is held indirectly through a corporation or a partnership, then trade tax has to be paid on the profit attained on selling it.

II. Disposal of an entire enterprise

II.1. **Disposal of a business/business segment (Teilbetrieb)** **(Income Tax Law, Sect. 16 Para. 1 No. 1)**

The profits attained on disposing of an enterprise count as taxable income. If an entire enterprise or a business segment is disposed of or discontinued, then a tax relief is granted for the sales profit. One condition having to be met if a tax relief is to be granted is that all the essential elements of the business or business segment are transferred to the acquirer in a single transaction. The entire business or business segment must still exist on the date of transfer, and it must be such that it can be continued by the acquirer.

Business segment is the term used for a division of an overall business which could exist on its own and be independent. Features indicative of a business segment are if it keeps its own accounts, has its own established clientele, decides its own prices, has its own fixed assets, conducts separate operations (as compared to the main business), and has its own staff.

Example: a newspaper publisher's print shop

The essential elements of a business include plant or fittings and fixtures which are indispensable to the continuation of the business or cannot be replaced at random, as well as real estate and intangible assets, such as intellectual property rights or established clientele.

II.2 **Disposal of a 100% share in a corporation** **(Income Tax Law, Sect. 16 Para. 1 No. 1 Clause 2)**

If the business assets belonging to a sole trader or a partnership include a one hundred percent shareholding in a corporation, and if the entire shares in this corporation are sold off during a single financial year, then this counts as the disposal of a fictitious business segment.

II.3 **Disposal of a partner's entire shareholding** **(Income Tax Law, Sect. 16 Para. 1 No. 1 + 3)**

Tax relief are also granted on the disposal of a partner's entire shareholding in a partnership, such as e.g. an open trading partnership or a limited partnership, and on the disposal or relinquishment of the entire shareholding in a limited partnership on shares [KGaA] that is held by a personally liable partner.

II.4 **Discontinuation of a business**

The discontinuation of a business and the relinquishment of a co-proprietor's share or of a shareholding in a limited partnership on shares [KGaA] that is held by a personally liable partner also count as a disposal for which tax relief may be granted.

The discontinuation of a business is when the entrepreneur finally ceases the operations done there, and disposes of the essential elements of the business over a brief period, either by selling or transferring them to third parties, or by withdrawing them for inclusion in his or her private property, or by using them in any other manner effectively winding up the business.

III. Tax relief

III.1 Reduced tax rate (Income Tax Law, Sect. 34 Para. 1)

The profits attained on disposing of an entire enterprise or a business segment count as extraordinary earnings, and a reduced tax rate applies in accordance with Income Tax Law, Sect. 34 Para. 1.

The progressive tax rate can effectively be mitigated by distributing earnings which count as gains on sale over a five-year period for accounting purposes (this is known as the “fifths arrangement” - Fünftel-Regelung).

Reducing the tax rate in this manner is not allowed for gains on sale which are made on disposing of a share in a corporation, if the share is among the business assets. This is because under the part-income method (Teileinkünfteverfahren), the entrepreneur only has to pay tax on 60 per cent of these gains anyway.

III.2 One-time tax relief on disposing of an enterprise for age or health reasons (Income Tax Law, Sect. 16 Para. 4, Sect. 34 Para. 3)

Special tax relief can be applied for when disposals are made after the age of 55, or in cases of occupational disability as defined in social security law.