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German Tax and Legal News

BFH rules capital gains from sale of shares by non-treaty-protected shareholder are 100% exempt from tax

Germany's federal tax court (BFH) issued a decision on May 31, 2017 (and published on October 25, 2017), in which it held that capital gains from the sale of shares by a foreign corporate shareholder with limited German tax liability is 100% exempt from German tax. In other words, the normal add-back of 5% deemed nondeductible business expenses does not apply to a limited liability taxpayer/non-treaty protected foreign shareholder. In reaching its decision, the BFH overruled the decision of the lower tax court of Hesse, which had ruled for the tax authorities. The BFH decision puts an end to a long running dispute between tax practitioners and the tax authorities.

Based on the German participation exemption and the section 8b of the corporate income tax code, capital gains from the sale of shares generally are 100% tax exempt for corporate shareholders. However, deemed nondeductible business expenses equal to 5% are applied, which effectively limits the benefit of the participation exemption to 95%. Foreign shareholders are subject to limited German tax liability if they owned, directly or indirectly, at least 1% of the capital of a German corporation within the five-year period before the sale.

In the case decided by the BFH, a Bermuda resident corporation owned approximately 11% of the shares in a German corporation through a Bermuda resident partnership. The partnership sold the shares in the German corporation and the German tax authorities assessed a 5% taxable gain for the Bermuda corporate shareholder for corporate income tax purposes.

Since the Bermuda resident corporation indirectly owned more than 1% of the shares in the German corporation, it was treated as being subject to limited German tax liability (the Bermuda partnership is considered transparent for German tax purposes) with regard to the capital gains from the sale of the shares. Germany does not have a tax treaty with Bermuda that would provide protection to a Bermuda resident corporate shareholder. The German tax authorities assessed a 5% taxable gain and imposed corporate income tax and the solidarity surcharge at the general rate of 15.825%.

The commonly accepted view (also shared by the tax authorities) in the context of the trade tax is that capital gains derived by a foreign resident shareholder from the sale of shares should not be taxable (in the absence of a German permanent establishment (PE)). The BFH now has confirmed the same rule should apply for corporate income tax purposes. The add-back of the deemed nondeductible 5% business expenses for corporate income tax purposes would require the existence of a German PE or dependent agent. The BFH also denied the application of an economic view since the method chosen by the legislature to arrive at an effective 5% taxation must be taken into account.

The consequences of the BFH decision should apply to the capital gains tax treatment of all non-treaty-protected foreign corporate shareholders that are subject to limited German tax liability. This includes corporate taxpayers that are resident in non-treaty countries or in countries where the relevant treaty allocates the taxing rights to Germany. In the latter case, this also should cover shareholdings in German real-estate rich companies, since Germany's treaties typically allocate the right to tax capital gains from the sale of shares to Germany in such cases.

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