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German Tax and Legal News

BFH rules on possibility of tax-free repayment of capital by non-EU subsidiary

Repayment of capital by US subsidiary to its German corporate shareholder was fully tax exempt

In a decision dated 10 April 2019 and published on 12 September 2019, Germany's federal tax court (BFH) considered the possibility of a tax-free repayment of capital by a non-EU subsidiary and ruled that the payment received by the German corporate shareholder could be treated as a 100% tax-exempt repayment of capital.

Under German domestic tax law, dividends and liquidation proceeds received from a domestic or foreign subsidiary generally are 95% tax-exempt at the level of the German corporate shareholder, with the remaining 5% being subject to the general corporate tax rate of approximately 30% (including the solidarity surcharge and trade tax, resulting in an effective tax rate of approximately 1.5%). The 5% that is taxable is deemed to represent nondeductible business expenses under the "5% addback rule." To the extent dividends or liquidation proceeds qualify as a repayment of capital, the payment is considered nontaxable and, therefore, 100% tax exempt at the level of the corporate shareholder. To qualify for a 100% tax exemption, it is necessary to provide proof that the payment is not funded from current and/or prior-year profits (retained earnings, earnings and profits (E&P)), but rather is funded from the tax "contribution account." Based on an ordering rule in the German tax law, dividends generally are deemed to be funded out of E&P first, i.e. a company generally must distribute all of its E&P before a repayment of capital can take place.

To be able to treat a payment as a tax-free repayment of capital in a wholly domestic situation, the German distributing subsidiary must maintain a separate contribution account for German tax purposes to record the amount of equity contributed to the company. Where a payment is made by an EU subsidiary ("EU cases"), German tax law contains a formal application procedure. Under the procedure, the EU subsidiary must apply to the German tax authorities for a certificate of approval to treat a payment as a tax-free repayment of capital. If such approval is granted and the shareholder is in the possession of the relevant certificate, the payment may be treated as a tax-free repayment of capital and the income treated as 100% tax exempt at the level of the German corporate shareholder. If the approval procedure has not been completed, the payment is deemed a taxable dividend and is subject to tax at the level of the German corporate shareholder under the general 5% addback rule.

German domestic tax law does not specifically address the treatment of a repayment of capital by a non-EU subsidiary to a German corporate shareholder. Accordingly, it has been questionable whether any repayment of capital (including stated share capital and share premium) made by a non-EU subsidiary could qualify as a tax-free repayment of capital at the level of the German corporate shareholder. The German tax authorities took the position that, in the absence of a formal application procedure for non-EU cases, a repayment of capital made by a non-EU subsidiary would be treated as a taxable dividend subject to the 5% add-back rule, regardless of the treatment of the payment under foreign accounting and corporate law principles (see also GTLN, dated 28 January 2015).

In the case before the BFH, the German taxpayer treated the repayment of capital made by its wholly owned US subsidiary as fully tax exempt. The German tax authorities challenged the tax treatment of the repayment, arguing that a tax-free repayment of capital would require formal approval, which is available only in EU cases. The taxpayer filed an objection against tax assessment notices issued by the tax authorities. The tax authorities rejected the taxpayer's objection and appealed a taxpayer-favorable decision of the lower tax court to the BFH.
In accordance with the lower tax court's decision, as well as its decision dated 13 July 2016, the BFH held that the absence of a formal approval procedure for non-EU cases (such as the

case at hand) may not be interpreted as prohibiting tax-free cross-border repayments of capital in non-EU cases. Rather, since German tax law does not specifically provide for such a formal procedure in non-EU cases, general principles should apply and any questions that might arise in connection with the determination of the repayment of capital should be addressed within the shareholder's ordinary assessment procedure. Upon consideration of the treatment of the repayment of capital under foreign accounting and corporate law principles and the German ordering rules for such types of income, the BFH held that the repayment was 100% tax exempt for German corporate income tax and trade tax purposes, instead of only 95% tax exempt.

It currently is unclear whether the German tax rules potentially may be revised based on the BFH's decision. However, in light of the court's decision, it is possible that the tax law could be amended, and that a formal approval procedure also could be introduced for non-EU cases. Alternatively, the formal procedure that currently is mandatory for EU cases could be abolished, with the result that any such cross-border repayments of capital could be deemed taxable dividends in the future and be subject to the 5% add-back rule for German tax purposes.

Affected taxpayers that were subject to a 5% add-back in connection with a repayment of capital made by a non-EU subsidiary should carefully revist the facts of their case and consider filing an objection against the relevant assessments and claiming a 100% tax exemption for any repayment of capital, based on the BFH's decision.

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