

BFH rules on tax treatment of incongruent dividend distributions

BFH provides clarification on the application of GAAR rules on incongruent dividend distributions.

In a decision dated 28 September 2021 and published on 27 January 2022, Germany's Federal Tax Court (BFH) ruled that an arrangement where disproportionate dividend distributions were made to multiple minority shareholders, but the majority shareholder's profits remained in the company and were allocated to specific profit reserves related to the majority shareholder for future distribution (i.e., a situation involving "incongruent" dividend distributions), was not abusive in terms of the general anti-abuse rule (GAAR). Furthermore, the BFH ruled that such arrangements did not trigger (deemed) dividend income to the majority shareholder.

Background

The case involved several German limited liability companies (GmbHs) with one majority shareholder and multiple minority shareholders. The GmbHs' articles of association (which were all identical) generally provided for dividend distributions based on the shareholding percentages.

The articles of association also allowed for dividend distributions to only selected shareholders (i.e., disproportionate dividend distributions), if such distributions were pursuant to a resolution passed in a shareholders' meeting by a simple majority of votes. In the event of such a distribution, the profits allocated to non-participating shareholders would be booked into the profit reserves of the respective company on accounts specifically allocated to the non-participating shareholders and available for future distributions to such shareholders. In the case at hand, a resolution was passed to distribute dividends only to the minority shareholders, with profits allocated to the majority shareholder transferred to such shareholder's specific profit reserves.

The tax authorities considered the disproportionate dividend distributions generally to be valid for tax purposes but took the position that the transfer of the profits attributable to the majority shareholder and their booking into the shareholder's specific profit reserves qualified as (deemed) dividend distributions followed by (deemed) contributions back into the GmbHs. Based on the view of the tax authorities, the distributions triggered taxable dividend income at the level of the majority shareholder in the year of the distributions. The lower tax court followed the opinion of the tax authorities, and the case was appealed to the BFH.

BFH decision

In accordance with recent jurisprudence, the BFH clarified that a disproportionate dividend distribution that is legally valid (i.e., based on a resolution effective under civil law) must be recognized for tax purposes, provided there is no abuse of law based on the GAAR that would allow for a recharacterization of such an arrangement for tax purposes.

In the case at hand, the BFH denied an abuse of law, as the partial profit retention could serve the purpose of internal funding of the companies, which would be a valid economic reason for such an arrangement. Furthermore, the BFH pointed out that it would neither be atypical nor unreasonable that shareholders have different interests with regard to profit distributions and that within a shareholders' meeting, the shareholders may decide that only certain shareholders receive distributions, while the rest of the profit is retained in the company.

The BFH further ruled that (deemed) dividend income was not triggered for the majority shareholder since the transfer of profits to the shareholder's specific profit reserves retains the

profits at the level of the GmbHs and makes such profits available for future distributions to the majority shareholder. Consequently, and in line with general principles, dividend income for the majority shareholder would be triggered in the future when the dividends are actually distributed to the majority shareholder.

Comments

In practice, existing shareholders often want to retain their profit share for use in internal financing, whereas new shareholders may need the funds to service their acquisition debt. The BFH decision solidifies that disproportionate dividend distributions generally are respected for tax purposes, but the decision also upholds that for each specific situation, the abuse of law test based on the GAAR must be met.

Given that the BFH has repeatedly applied the GAAR in cases of disproportionate dividend distributions where an arrangement was primarily based on tax considerations rather than valid economic reasons, it should be carefully examined in each case whether valid economic reasons justify a disproportionate distribution. This might be questionable if, e.g., a disproportionate dividend distribution is used to manage potentially disadvantageous tax consequences of a regular distribution (e.g., dividend withholding tax in the case of foreign shareholders).

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