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German Tax and Legal News

MoF publishes long awaited decree on conditions for tax-free repayment of capital by non-EU subsidiaries

Decree follows principles as established by past decisions of the federal tax court.

In a long-awaited decree dated 21 April 2022, the German Ministry of Finance (MoF) outlined the tax authority's position regarding the tax-free repayment of capital by a non-EU subsidiary to its German corporate shareholder. The decree is a response to several federal tax court (BFH) decisions from 2010, 2016, and 2019 (see GTLN dated 19 September 2019), which generally aligns with the principles established by the BFH in the decisions.

Background

Under German tax law, dividends and liquidation proceeds received from a domestic or foreign subsidiary generally are 95% exempt from tax at the level of the German corporate shareholder. The remaining 5% is subject to the general corporate tax rate of approximately 30% (including the solidarity surcharge and trade tax), which is due to the 5% being treated as a nondeductible business expense and added back to taxable income (the "5% add-back rule"). This results in an effective tax rate of approximately 1.5%.

To the extent dividends or liquidation proceeds qualify as a repayment of capital, the payment is considered nontaxable and, therefore, fully exempt from tax at the level of the German corporate shareholder. To qualify for the full tax exemption, the payment must not have been funded from either current or prior-year profits (i.e., retained earnings or earnings and profits (E&P)). Based on an ordering rule under 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.

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 (i.e., a "contribution account" for tax purposes) in order to treat the payment as a tax-free repayment of capital. However, where a payment is made by an EU subsidiary, 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 German corporate shareholder is in possession of the relevant certificate, the payment will be treated as a tax-free repayment of capital and fully tax exempt at the level of the shareholder. If the approval procedure was not completed, the payment would be deemed a taxable dividend and subject to tax at the level of the German corporate shareholder under the 5% add-back rule.

German 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. Before the 2016 federal tax court decision, the German tax authorities took the position that, in the absence of a formal application procedure in the law, a repayment of capital made by a non-EU subsidiary is 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).

Decree overview

The MoF decree has confirmed the possibility of a tax-free repayment of capital by a non-EU company to its German corporate shareholders and establishes the principles summarized below.

Companies outside of the EU/EEA area

For companies that are resident in a country
outside of the EU/EEA area, a repayment of stated share capital (as a result of a share capital decrease) does not result in taxable income to the German corporate shareholder, provided that the repayment takes place at least five years after the new shares were issued (section 7(2) *KapErhStG*). Although there is no formal procedure required, the non-EU/EEA company must provide appropriate documentation to the German tax authorities as proof that a repayment of stated share capital occurred (in particular, a shareholder resolution regarding the share capital decrease and the repayment of capital). For a repayment of stated share capital the ordering rule as described above does not apply, i.e., even if there is E&P in the company a tax-free repyamet of capital can be made.

In order for a capital repayment out of the share premium or capital reserves (i.e., not from a decrease of the stated share capital) to qualify as a tax-free payment at the level of the German corporate shareholder, the balance sheet of the non-EU/EEA company may be used to demonstrate such repayment even if it is based on foreign GAAP (i.e., neither German GAAP nor a reconciliation with German GAAP is required). Based on the already mentioned ordering rule under German tax law, E&P is deemed to be distributed first before a repayment of capital can be made. The decree also describes what documents must be provided to the German tax authorities in order to prove the repayment of capital character in such a situation.

EEA companies

The decree confirms that the formal application procedure (as described in section 27 (8) CITC) for EU companies generally is applied also to EEA companies. If an application was not filed by the EEA company, then the same principles as described above for non-EU/EEA companies should apply to EEA companies. This is likely to be welcomed by affected taxpayers as many foreign subsidiaries often fail to file a formal application or do not file an application in a timely manner.

EU companies

There is no statement regarding EU subsidiaries in the decree because the rules applying to EU subsidiaries on the tax-free repayment of capital have been established since 2006 (section 27(8) CITC) and such rules were not addressed in or affected by the BFH decisions.

Comments

The decree has been long awaited by tax practitioners and confirms the acceptance of the principles by the tax authorities as established by the BFH. This is a welcome development for taxpayers. The BFH decisions from 2010, 2016, and 2019 will be published soon in the federal tax gazette, which will mark the official recognition of these decisions by the tax authorities.

Even though the decree is a favorable development, taxpayers should not underestimate the potential complexities and documentation requirements when it comes to the tax-free character of a repayment of capital by a foreign subsidiary (irrespective of whether the subsidiary is resident in the EU, an EEA country, or outside of the EU/EEA).