GERMAN SUPREME TAX COURT RULES IN FAVOR OF TAXPAYER – U.S.-GERMAN REPATRIATION NON-TAXABLE

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Tags
Distributions
Germany
Tax-Free Transfer

In upholding a lower tax court's decision, the German Federal Tax Court (Bundesfinanzhof or "B.F.H.")[1] held that repayment of capital by a U.S. subsidiary to its German parent company would be non-taxable under German tax law. This decision is in line with a prior, similarly taxpayer-favorable decision by the same court.[2] However, the importance of this decision extends beyond prior jurisprudence. More specifically, the B.F.H. clarifies that domestic rules apply in determining to what extent a distribution by a non-E.U. subsidiary to the German parent company is made from profits versus capital (the so-called ordering rule).

The distinction is critical – distributions of profits would be subject to German tax for the German parent, whereas a repayment of capital would, under certain conditions, not be taxable. If the non-E.U. subsidiary does not have any earnings and profits ("E&P"), this decision is clear on the non-taxable event for the German recipient parent company. When the subsidiary does have E&P, however, the tax implications are less distinct.

The following describes the case and decision as well as potential discrepancies arising for cross-border repatriations. As will be shown, taken a step further, this decision is exemplary for the mismatch of rules and concepts under civil law and common law as well as corporate and tax law.

THE CASE

The case dealt with a German-resident corporation ("German Parent" or also referred to as the "Taxpayer") that was a 100% shareholder of a U.S. subsidiary ("U.S. Sub" or "B Inc."). From 2004 onwards, German Parent made capital contributions to B Inc. Importantly in this context, the contributions were not made to U.S. Sub's nominal capital.[3] In 2008, the year at issue, U.S. Sub made a distribution to German Parent. At that time, U.S. Sub did not have accumulated earnings, profit carryforwards, or capital reserves from prior year profits. Accordingly, the distribution was

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1 B.F.H. dated April 10, 2019, I R 15/16, issued on September 12, 2019. The B.F.H. is the supreme court in tax and customs matters within German jurisdiction. It is one of the five Federal supreme courts, established according to Article 95 of the *Grundgesetz* (constitutional law promulgated for historic reasons as German Fundamental Law) and has its seat in Munich.

2 B.F.H. dated July 13, 2016, VIII R 47/13.

3 Tax-free treatment of repayments from nominal capital (decrease of capital) has been unequivocal, see B.F.H. dated October 21, 2014, IR 31/13. For E.U.-based subsidiaries, this is set forth by law; absent an explicit rule for non-E.U. subsidiaries, this follows decisions by the B.F.H. (B.F.H. dated July 13, 2016, VIII R 47/13, BFHE 254, 390; VIII R 73/13, BFHE 254, 404; B.F.H. dated October 20, 2010, I R 117/08, BFHE 232, 15), referenced in the decision.

treated as a non-taxable return of capital[4] for U.S. tax purposes. U.S. Sub's tax return, which reflected this tax position, was not challenged by the I.R.S. German Parent treated the distribution as a non-taxable repayment of capital under German tax law.

The German tax authorities contested the Taxpayer's tax return position and classified this payment as a taxable dividend assessing additional tax on 5% deemed non-deductible business expenses (so-called deemed add-back (*Steuerhinzurechnung*)). The German tax authorities argued that a tax-free repayment of capital would require formal approval, which, under German tax law, is available only for subsidiaries based within the E.U.

THE LAW – GERMAN TAXATION OF DIVIDENDS V. REPAYMENT OF CAPITAL

The German dividend exemption applies to dividends received from domestic and foreign participations.[5] For corporate tax purposes, no minimum holding period is set forth. However, the dividend exemption applies only if the corporation holds a minimum participation of 10%.[6] Below that threshold, the entire dividend payment is subject to tax at a rate of about 30%.[7]

The German dividend exemption is, however, limited to 95% of the dividend received. This is achieved by means of an add-back of deemed business expenses (*Hinzurechnungsbesteuerung*).[8] More specifically, 5% of the tax-exempt gross dividends received are treated as non-deductible expenses. In principle, this applies regardless of the amount of effective business expenses related to the dividend.[9] In comparison, payments relating to the tax capital contribution account (*steuerliches Einlagekonto*), *i.e.*, a tax-specific account that evidences contributions by the shareholder for German tax purposes, are excluded from the term "tax-exempt income" for purposes of the dividend exemption. Thus, they are not subject to the 5% deemed business expenses add-back and can be received tax-free by the German parent company.

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4 The term typically used in a U.S. tax context "return of capital" is equivalent to "repayment of capital" and will be used throughout this article interchangeably.

5 *Körperschaftsteuergesetz* ("KStG," or the German Corporation Tax Act), §8b, ¶1. *Cf.* Dr. Wolf-Georg von Rechenberg, "Germany," 2019 Holding Companies of Europe, pp. 282, 284, and 285.

6 KStG, §8b, ¶4. The minimum shareholding must be met at the beginning of the calendar year.

7 The dividend exemption also applies for trade tax purposes. Depending on the subsidiary's jurisdiction, thresholds vary. In the case of non-E.U. foreign dividends received, a participation of at least 15% is required for an uninterrupted period since the beginning of the tax year and the foreign company must pass an activity test. For participations in E.U. subsidiaries, a participation of 10% qualifies for the dividend exemption and no activity test is required.

8 While draft legislation on the implementation of the E.U. Anti-Tax Avoidance Directive (A.T.A.D.) ("*A.T.A.D. Umsetzungsgesetz*") provides for changes to transfer pricing provisions, it maintains the concept of add-back tax, with modifications mainly relating to tiered structures. The draft law was released by the German Ministry on December 10, 2019, and is pending parliamentary approval.

9 Dr. Wolf-Georg von Rechenberg, "Germany," p. 284.

In accordance with an ordering rule under German tax law, dividends generally are deemed to be first funded out of E&P.[10] In other words, a company generally must distribute all of its E&P before a repayment of capital can take place. The starting point for this determination is the tax balance sheet for the recipient parent company, prepared in accordance with German tax rules. Differences between accounting and tax rules are taken care of by additions and subtractions, *e.g.*, relating to differences of periods for amortization and depreciation and timing differences in realization of income.[11] While this ordering rule is set forth under German tax law for domestic and E.U.-based subsidiaries,[12] no rule exists for non-E.U. subsidiaries in the German tax code.

"The complex and time-consuming procedure for determinations in the context of repayment of capital, which is applicable to repatriations made by E.U. corporations (including the cut-off period), is not applicable to repatriations by non-E.U. subsidiaries."

THE B.F.H. DECISION

The B.F.H. disagreed with the German tax authorities' view. Notwithstanding the absence of a tax capital contribution account (*Einlagekonto*), the repayment of capital by non-E.U. subsidiaries should be eligible for non-taxable treatment.

While, in a first instance, the determination of distributable profits by the subsidiary should follow local accounting or corporate law,[13] the ordering rules under German tax law should subsequently apply. Accordingly, a non-E.U. subsidiary should be allowed to provide evidence on repayment of capital (other than from nominal capital). Otherwise, this would constitute an infringement of the freedom of capital which extends to non-E.U. corporations under Article 56 E.G. (Treaty on the European Union) (now Article 63 A.E.U.V. (Treaty on the Functioning of the European Union)).[14]

In the case at issue, this is further supported by the U.S.-German income tax treaty (the "Treaty"), which provides for comprehensive exchange of information between the tax authorities of the contracting states under Article 26(1).

According to the B.F.H., repatriation payments qualify as non-taxable income, if two conditions are met:

- The determination of the repatriated amount is based on the domestic accounting or corporate law of the country of residence of the non-E.U. distributing subsidiary.
- Pursuant to ordering rules under German tax law, no profit is available to be distributed by the non-E.U.-resident subsidiary.

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10 KStG, §27(1) 3rd sentence; applicable to E.U.-based subsidiaries under certain circumstances in KStG, §27(8) introduced in 2006.

11 Hence, while the terms differ, conceptually the determination of E&P in Germany does not deviate from U.S. principles.

12 *Id.* E.U. subsidiaries are subject to a formal approval procedure prior to applying this rule on treatment as (tax free) repayment of capital.

13 In line with B.F.H. dated October 20, 2010, I R 117/08, BFHE 232, 15; B.F.H. dated July 13, 2016, VIII R 73/13, BFHE 254, 404. Note that the term used by the B.F.H. was "*Handelsrecht/Gesellschaftsrecht*," literally translated as Commercial Law or Company Law. In Germany (and likewise in other civil law countries such as Austria), this includes accounting rules.

14 *Cf.* BFHE 254, 390; European Court of Justice, C-685/16, EU: C: 2018: 743, BStBl II 2019, 111 (September 20, 2018).

Further, the court held that the complex and time-consuming procedure for determinations in the context of repayment of capital, which is applicable to repatriations made by E.U. corporations (including the cut-off period), is not applicable to repatriations by non-E.U. subsidiaries.

The B.F.H. decision confirms the decision by the tax court of first instance (*Finanzgericht Muenster* ("F.G.")). Note that in the case at issue, the F.G. pointed out that (i) the repayment related to contributions that were not made towards nominal capital; (ii) U.S. Sub did not have distributable profits, profit carryforwards, or capital reserves from profits; (iii) under U.S. tax law the classification as dividend is subject and limited to the company's E&P; and (iv) the payment was declared as "repayment of capital" and 100% non-taxable in U.S. Sub's tax return, which was not challenged by the I.R.S.

IMMEDIATE IMPLICATIONS

It is unclear whether the B.F.H.'s decision may trigger a revision of the German tax rules. However, in light of the court's decision, it is possible that the tax law could be amended and that a formal approval procedure could be introduced for non-E.U. cases. Alternatively, albeit less likely, the formal procedure that currently is mandatory for E.U. cases could be abolished, with the result that 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-E.U. subsidiary should carefully revisit the facts of their case. They may consider filing an objection against the assessments, claiming a non-taxable repayment of capital, based on the B.F.H.'s decision.

FURTHER PROSPECTS – THE U.S. PERSPECTIVE

Notably, for determining whether a distribution constitutes a repayment of capital the B.F.H. deferred to accounting or corporate law under the non-E.U. subsidiary's jurisdiction before applying the German ordering rule. In the case that the non-E.U. subsidiary has E&P, two questions arise: How does one deal with mismatches between the term "E&P" under accounting or corporate law as compared to tax law; and would a differing tax treatment under local tax law impact the treatment for German tax purposes? In the specific case of a U.S. subsidiary of a German parent company, the answers from a U.S. perspective present themselves as described in the following.

Determination of Distributable Profits Under U.S. Law

Capital rules including rules on amounts allowed for distribution are set forth under corporate law. Corporate law in the U.S. is state law.[15] There is no general Federal corporate law and no Federal common law.[16] Thus, contrary to German (civil) law, while common accounting standards under U.S. Generally Accepted Accounting Principles ("G.A.A.P.") exist, capital rules vary widely between states. Some states require a formal balance sheet conforming to U.S. G.A.A.P. and limit payments of

15 See Richard A. Booth, Capital Requirements in United States Corporation Law.

16 *Id.*

dividends to either retained earnings or certain threshold of assets (*e.g.*, California), whereas other states permit dividends without reference to a balance sheet (*e.g.*, Delaware).[17] Hence, reference by the B.F.H. to accounting or corporate law rules under the non-E.U. subsidiary's local law relates to differing standards and sets of rules. From a practical point of view, it appears reasonable to interpret the B.F.H. deferring to contributions and, more specifically, the determination of distributable profits according to the balance sheet prepared in accordance with U.S. G.A.A.P. or similar accepted accounting standards such as I.F.R.S. (International Financial Reporting Standards). One advantage of this approach is that minority shareholders of U.S. subsidiaries would be in a position to provide evidence in this regard based on publicly available information.[18]

Ordering Rules – U.S. Taxation of Dividends

Together with other passive type income, dividends are treated as fixed or determinable, annual or periodic payments (also commonly referred to as F.D.A.P.) which are subject to 30% withholding tax. This tax is levied on the gross amount. For dividends, that income is considered to arise from U.S. sources because of the tax residence of the payer. Under certain conditions, this tax may be reduced or eliminated under an applicable income tax treaty. Note that under U.S. income tax treaties in general and the Treaty in particular, this, in addition, requires that residency[19] and one of the tests under the limitation on benefits ("L.O.B.") article[20] are met.

However, for U.S. tax purposes, not all amounts of distributions received by a person in its capacity as shareholder constitute dividends. The Code sets forth the following ordering rule:

1. A distribution constitutes a dividend to the extent of available current-year or accumulated E&P.[21]

2. The amount in excess of those earnings reduces the shareholder's basis in the stock.[22] This is also referred to as return of capital. Note that this amount does not necessarily correlate to the capital under accounting standards.

3. The amount in excess of basis, if any, is treated as a gain from the sale or exchange of property and is taxable as such.[23]

In principle, the U.S. tax rules are thus comparable to the German ordering rule. A difference may result from the specific provisions on determining E&P for U.S. tax

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17 Delaware allows dividends to the extent that going concern value exceeds long-term debt and stated capital. *Id.*

18 Roland Wacker, Repayment of Capital by Non-E.U. Companies According to B.F.H.-Decision Dated April 10, 2019 – I R 15/16, FR 2019, 907 ("*Einlagenrueckgewaehr durch Drittstaatengesellschaften nach dem B.F.H.-Urteil v. 10.4.2019* – I R 15/16, FR 2019, 907") in FR 21/2019, 979 (989).

19 Article 4 of the U.S.-German income tax treaty.

20 Article 28 of the U.S.-German income tax treaty.

21 Code §301(c)(1). A distribution will be treated as a dividend to the extent of a corporation's current-year E&P, even if the corporation has an accumulated E&P deficit.

22 Code §301(c)(2).

23 Code §301(c)(3).

purposes as compared to the tax balance sheet in accordance with German domestic tax rules. Taxpayers should consult with their U.S. and German tax counsels to determine the deviations, if any.

Though referenced in various sections, E&P is not defined in the Code. Essentially, it can be described as a company's economic ability to pay dividends to its shareholders without returning paid-in capital. In broad terms, current E&P is approximately equal to the corporate taxable income minus the Federal income tax assessed on it with certain statutory adjustments.[24] These statutory adjustments include deductions that reduce taxable income but do not reduce the corporation's ability to pay dividends or vice versa. Any amounts retained by the corporation increase accumulated E&P, which is the earnings and profits that have been retained by the corporation from previous tax years. Accumulated E&P is a tax term for what, under financial accounting, would be referred to as retained earnings with certain adjustments for tax purposes. Hence, in a U.S. context, E&P is a tax concept that is not similar to profits determined under financial accounting and capital rules.

U.S. Tax Treatment of Repayment (Return) of Capital

To the extent a distribution is a return of capital, it is not gross income as defined under Code §61. Consequently, it is not F.D.A.P.[25] and as such not subject to 30% U.S. withholding tax on F.D.A.P.

Based on the foregoing, because accounting standards deviate from tax rules, the subsequent determination of the extent of a (taxable) dividend and (non-taxable) return of capital that follows tax law may result in differing amounts. In addition, because the latter will be based on German tax rules, this may lead to further discrepancies between the U.S. and German tax. This mismatch will, however, only be relevant for shareholders that do not meet the criteria for exemption from U.S. dividend withholding tax under Article 10, paragraph 3 (direct ownership of 80% or more of voting rights for a 12-month period meeting certain tests under the L.O.B. article) of the Treaty.

CONCLUSION

The takeaway of this decision is twofold: In light of the foregoing, taxpayers should be able to succeed in claiming a non-taxable repayment of capital as long as the aforementioned circumstances, in particular a lack of E&P by the distributing non-E.U. subsidiary, are met. However, in view of the German tax authorities' position special attention should be applied in scenarios that are deviating, in particular if the distributing non-E.U. subsidiary has E&P.

Notwithstanding the clear view the B.F.H. expressed in this decision on the treatment of a distribution by a non-E.U. subsidiary that is not profitable to its German parent as non-taxable repayment of capital, legislative changes may follow. In any event, it will be interesting to see what the future holds for German parent companies with profitable U.S. subsidiaries in otherwise similar circumstances.

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24 *E.g.*, Code §§301, 312, and 316 and regulations promulgated thereunder. Examples include depreciation and tax-exempt income.

25 Preamble to Prop. Treas. Reg. 140206-06.