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Good things come… –
German Federal Ministry of Finance recognizes case law on the treatment of return of capital and repayments of share capital by non-EU corporations

May 5, 2022

On April 21, 2022, the German Federal Ministry of Finance (Bundesfinanzministerium) published the long-awaited Circular on the treatment of repayments of share capital and equity contributions not made to the share capital by third country (non-EU) corporations. The Ministry thus recognizes the long-established case law of the German Federal Fiscal Court (Bundesfinanzhof, or "BFH") that a tax-neutral return of capital and repayment of share capital is also possible in the case of non-EU corporations. As a result, it should now be possible to finally settle tax proceedings that have been ongoing for years throughout Germany.

Background

Since the change from the tax credit method to the partial income method in the corporate income tax system, domestic (German) corporations are required to maintain a special tax-specific capital contribution account according to Section 27 of the German Corporate Income Tax Act (Körperschaftsteuergesetz, or "KStG"). Contributions not made to the share capital are to be recorded in this account. Payments from this special tax-specific capital contribution account can be received by shareholders in a tax-neutral manner. In contrast, returns of share capital of the distributing corporation are always to be treated as a withdrawal, which is independent of profits or loss, and thus as a distribution of assets, which must be deducted from the book value of the assets at the level of the shareholder in its balance sheet. Although both payments - from the share capital and from the additional paid-in capital - represent repayments of corporate capital and are therefore reductions in the book value of the assets that do not affect income for the shareholder under commercial law, tax law makes a distinction and requires special proof for repayments from the additional paid-in capital in the form of a tax-specific capital contribution account. Whereas under commercial law, a distribution of reserves only leads to the recognition of income from investments if previously retained profits are transferred to the shareholder, under tax law a payment from the additional paid-in capital can also be treated as income from investments, taking into account the so-called sequence of appropriation (Verwendungsreihenfolge) for tax purposes.

Equity	Liabilities
A. Assets	A. Sharesholders‘ equity
	I. Share Capital
	II. Additional paid-in capital
	III. Retained profits
	IV. Profits carried forward / Losses carried forward
	V. Net profits for the year / Net losses for the year
	B. Debts

While the process for the repayment of equity contributions not made to the share capital from domestic corporations is governed by Section 27 (1) to (7) KStG, and Section 27 (8) KStG provides for a special filing procedure for a return of capital application for payments from EU companies, it has long been a matter of dispute how such payments from third-country (non-EU) corporations are to be treated. Such third countries are, for example, the USA, Singapore or, since Brexit, also Great Britain.

However, the German Federal Fiscal Court has confirmed in a series of decisions that third country (non-EU) corporations can also repay share capital and equity contributions not made to the share capital to their shareholders in a tax-neutral manner (see e.g. BFH Decision dated July 13, 2016, VIII R 47/13 and our beinformed dated October 20, 2016, as well as BFH Decision dated April 10, 2019, I R 15/16). As yet, however, the German tax authorities have so far not recognized these decisions and have qualified all payments from third country (non-EU) corporations as taxable dividends.

Payment from additional paid-in capital according to Section 27 KStG

Domestic	EU	Third country (non-EU)
-Distributing corporation is obligated to maintain tax-specific capital contribution account -Year-end balance is determined separately by tax assessment notice	-Distributing corporation may file an application for separate determination of the amount of capital returned -Deadline for application: at the latest in the calendar year following the payment	-Not regulated

Circular dated April 21, 2022

With the Circular published on April 21, 2022, the German tax authorities now follow the case law of the highest court and also allow tax-neutral repayment of share capital and return of contributions in the case of third country (non-EU) corporations.

In detail, in the opinion of the German tax authorities, share capital repayments are to be treated in accordance with Section 7 (2) of the Law on Tax Measures to Increase Share Capital from Corporate Funds (Gesetz über steuerrechtliche Maßnahmen bei Erhöhung des Nennkapitals aus Gesellschaftsmitteln, or "KapErhG"). According to Section 7 (2) KapErhG, tax-neutral repayments of share capital are permissible only five years after the corresponding share capital increase. However, this presupposes that a share capital increase resulting from the conversion of reserves into share capital has taken place prior thereto in the first place (Section 1 KapErhG). The German Federal Ministry of Finance does not make any statement on share capital repayments that do not result from the conversion of reserves. In our opinion, however, these should be treated as tax-neutral without a five-year time limit (see e.g. Decision of the Düsseldorf Tax Court dated August 24, 2018 - 14 K 564/16 E, rkr., DStR 2019, 809). The actual occurrence of a share capital reduction and repayment must be proven by appropriate documents, in particular the resolutions on a share capital increase and reduction can be considered as proof.

In the case of equity contributions not made to the share capital, the sequence of appropriation of Section 27 (1) Sentence 3 and Sentence 5 KStG must be observed in accordance with the case law of the German Federal Fiscal Court. Accordingly, there can be a tax-neutral return of capital - as in the domestic case – only if the payment is made from the tax-specific capital contribution account and it is not out of distributable profit. Direct access to the reserves is thus not possible in the case of a non-EU country either. Thankfully, the tax authorities do not require a reconciliation to German tax accounting principles pursuant to Section 60 (2) of the Income Tax Implementing Regulation (Einkommenssteuer-Durchführungsverordnung). Foreign commercial law is decisive for the sequence of appropriation. In the past, this issue had repeatedly led to discussions with the German tax administration. For the determination of the return of capital, proof must be provided, among other things, of the unlimited tax liability of the distributing corporation, the amount of the shareholder's investment, distribution resolutions or capital reduction resolutions, as well as the balance sheet of the paying third country (non-EU) corporation. In addition, actual proof of payment must be submitted.

Finally, the Ministry clarifies that the application filing procedure for benefits from EU corporations under Section 27 (8) KStG also applies to corporations in the EEA. In the past, this was the prevailing view in the literature. However, if no application has been filed for EEA companies, then the principles for third country (non-EU) companies are applicable.

The Circular is applicable in all cases that remain unresolved to date.

… to those who wait?

The reaction of the German tax authorities to the case law of the German Federal Fiscal Court was long overdue and had been awaited for years. In some cases, tax audits and tax assessment notices have now been ongoing for periods of more than ten years. It remains to be seen what requirements the tax authorities will impose (retrospectively) on the proof required in these old cases.

However, the Circular finally gives taxpayers more legal certainty for the future. The German tax authorities do not require a separate tax assessment procedure or application procedure for benefits from third country (non-EU) corporations. The tax-neutral treatment of corporate payments is to be

decided when filing the tax returns of the shareholders. The shareholders are well advised to provide the proof required by the German tax authorities and to demand such proof from the distributing companies. In the context of fund structures, German investors should have this information assured to them in side letter agreements. We will be happy to support you in this!

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