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Repatriation of Contributed Capital Is Nontaxable, Court Rules

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Repatriation of Contributed Capital Is Nontaxable, Court Rules

Germany's Fiscal Court of Nuremberg recently published an important decision[1] affecting individuals investing in non-EU corporations.

The plaintiffs, tax residents of Germany, owned shares in a publicly traded U.S. corporation (T). In 2008 the board of directors of T decided to carry out a spinoff, transferring 100 percent of the business to a subsidiary (M1) owned solely by T. The spinoff was not based on a formal profit distribution resolution.

After consultation with the U.S. tax authorities, the spinoff was treated as tax exempt in the United States. As a result of the spinoff, the plaintiffs received one share in M1 for every share they had owned in T. The plaintiffs filed their annual 2008 German tax return, providing the relevant banking documents, but did not declare the noncash capital gains that resulted from the spinoff and that appeared in the banking documents.

Under German tax law, repayments of capital contributions that are not paid into the share capital (nominal capital) of EU corporations are, under certain circumstances, tax neutral, whereas profit distributions are treated as taxable dividends (at rates as high as 30 percent).

Against that backdrop, the local tax office recognized the noncash capital gains as a deemed profit distribution. The tax office classified the plaintiffs' newly acquired M1 shares as a dividend amounting to capital income, and not a tax-neutral repayment of contributions, because the German Corporate Income Tax Act (CITA)[2] refers to the tax exemption only in relation to shareholders of domestic and EU corporations, not shareholders of a non-EU corporation, such as T.

Upon reviewing the evidence, the fiscal court rejected the tax office's decision, holding that the transfer of shares that resulted from the spinoff qualified as a tax-neutral capital repayment. The plaintiffs' newly acquired shares in M1 had ''no tax-relevant meaning,'' the court said.

Referring to past communications between T and its shareholders, the court said the outcome for the shareholders in the United States was a tax-free return of capital, and not a dividend.

The plaintiffs were able to strengthen their case by providing documentation demonstrating that the profit and loss accounts were not affected but that the equity capital was affected by the financial outsourcing that resulted from the spinoff. This suggested that there was no profit or dividend of any kind, the court said. In its decision, the court compared the spinoff process to the changing of a €100 banknote to two €50 banknotes.

Under German tax law, EU corporations must file a tax return in Germany in compliance with the verification procedures set forth in section 27, paragraph 8 of the CITA. Because section 27, paragraph 8 does not address the tax-neutral return of capital contributions for non-EU corporations, the German fiscal authorities have thus far denied the tax-neutral benefit to those investors.

In its decision, the fiscal court stated that the lack of mention of the treatment of a return of capital by non-EU corporations does not necessarily lead to the conclusion that they are barred from a tax-neutral return of capital to their investors. In fact, the court further held that a tax-neutral return of capital contributions is possible, provided that the foreign commercial and corporate law allows for this treatment and that eligibility for the treatment is properly documented.

Non-EU portfolio companies (particularly in the United States) of closed-end private equity funds are often funded with a minimum payment into the nominal capital and with a high percentage invested into the capital reserves. Based on the court's recent decision,

[1]Judgment 5 K 1552/11 of June 12, 2013 (first published in April 2014).

[2]Section 27, paragraph 8.

German investors in non-EU corporations could receive the same tax-neutral return of capital as investors who invest in domestic or EU corporations.

If the Federal Fiscal Court upholds the Nuremberg court's decision, investors in non-EU portfolio companies would be well advised to immediately begin obtaining documentation demonstrating their repayments from equity contributions into the capital reserve, confirming their eligibility for the tax-neutral return of capital. ◆

♦ *Lutz M. Boxberger and Rachael Bazinski, Weitnauer attorneys at law & tax advisers, Munich*