YPOG Briefing:
Ministry of Finance clarifies possibility of tax-neutral return of capital contributions and repayment of nominal capital

Berlin, June 03, 2022 | Carl Sieger

In a decree dated 21 April 2022, the Federal Ministry of Finance (BMF) commented on the possibility of a tax-neutral return of capital contributions and repayment of nominal capital of companies that are not subject to unlimited tax liability in Germany or the European Union and European Economic Area (EEA) (so-called "third-country companies").

The practical tax treatment of return of capital contributions is important, especially when foreign investments are financed through equity capital by the domestic shareholder company and the capital contributions are later returned by the foreign company to the domestic shareholder. For German companies and companies with unlimited tax liability in the European Union, section 27 of the Corporate Income Tax Act (KStG) provides a legal framework for this purpose. However, this does not apply to third-country companies. Consequently, there has been some controversy between the judiciary and the tax authorities as to whether third-country companies may also make non-taxable returns of capital contributions. The judiciary allows this, and the tax authorities have recently aligned with the BMF's decree.

For German companies, contributions outside the nominal capital are to be recorded in the so-called "tax contribution account". This is separately determined on an annual basis. The return of these contributions is not taxable (section 20(1) no. 1 sentence 3 of the Income Tax Act (EStG)). This is systematically correct, since the return of these contributions do not refer to the profit of the corporate entity. However, by law, (taxable) profits must be distributed first and (non-taxable) contributions second (so-called "sequence of use", section 27(1) sentence 3 of the KStG). These regulations are applicable (accordingly) to EU and EEA companies. Although section 27 of the KStG is not applicable to third-country companies, the Federal Fiscal Court (BFH), with reference to the general principle of equal treatment and a possible violation of the free movement of capital,[1] also allows a tax-neutral return of capital contributions in the case of third-country companies.

Decree clarifications

The decree has clarified numerous grey areas:

- the return of contributions is possible in principle – the tax authorities explicitly accept the possibility of return of capital contributions for third-country companies. Even in the absence of a statutory provision, a return of capital contributions must be possible for shareholders of third-country companies according to the ability-to-pay principle. Otherwise, domestic shareholders would be taxed on their assets contrarily to the principle of equality;

[1] (1) Ruling of 12 July 2016, VIII R 47/13 and 10 April 2019, I R 15/16.

- sequence of use – the BMF, according to the jurisdiction of the BFH, also intends to apply the sequence of use for third-country companies. The principle that contributions may only be returned tax-neutrally to the extent that the payments exceed the "distributable profit" of the previous fiscal year also applies to third-country companies. The distributable profit is calculated from the tax balance sheet equity reduced by the subscribed capital and the contributions that have not been included in the nominal capital;

- determination of positions of the sequence of use – the BMF has now decided not to use a tax balance sheet (or a reconciled (foreign) commercial balance sheet) to determine equity as a basis for calculating the distributable profit; instead, the foreign commercial balance sheet is taken as a sufficient basis for determining equity. This is a welcome change. As a result, the BMF has removed any remaining uncertainties from the ruling of the BFH's first senate. Moreover, the tax authorities are generous in comparison with EU and EEA companies. These companies are still required to carry out elaborate transitional accounting under German tax law;

- evidence and procedure – in contrast to German and EU companies, there is no separate determination procedure for third-country companies in the absence of a statutory provision. The question of the return of contributions is shifted to the respective assessment procedure by the shareholder. The requirement to provide evidence is also a welcome development. The decree sets out the possible types of evidence as:

  - proof of the unlimited tax liability of the third-country company;
  - the amount of the domestic shareholder's participation;
  - resolutions and evidence of distributions made; and
  - the foreign commercial balance sheet;

  The development of the different components of equity does not need to be presented. This is different for EU and EEA companies and, at least for older companies, a considerable difficulty in practice. In addition, no special application is required within the short period of section 27(8) of the KStG, as is the case for EU companies;

- nominal capital – repayments of nominal capital are not subject to the sequence of use, even in the case of third-country companies. Therefore, repayments of nominal capital can be made tax-free in compliance with section 7(2) of the Capital Increase Tax Act. According to this legislation, the return of nominal capital is deemed to be income from capital assets if it originates from a capital increase from company funds that took place less than five years before the return; and

- EEA companies – German shareholders of EEA companies can celebrate. In the past, the regulations on EU companies applied to these companies analogously to section 27(8) of the KStG. This will continue to apply in the future. However, if EEA companies do not submit an effective application, they will be treated as third-country companies. This results in a kind of option and relieves the EEA company from the special procedure requirements of section 27(8) of the KStG. Strictly speaking, this would also end the need for the transitional accounting under German tax law.