German 2022 Annual Tax Act - Tax-Neutral Capital Repayments from Non-EU Companies Available Only by Filing an Application with the German Tax Authorities

April 4, 2023

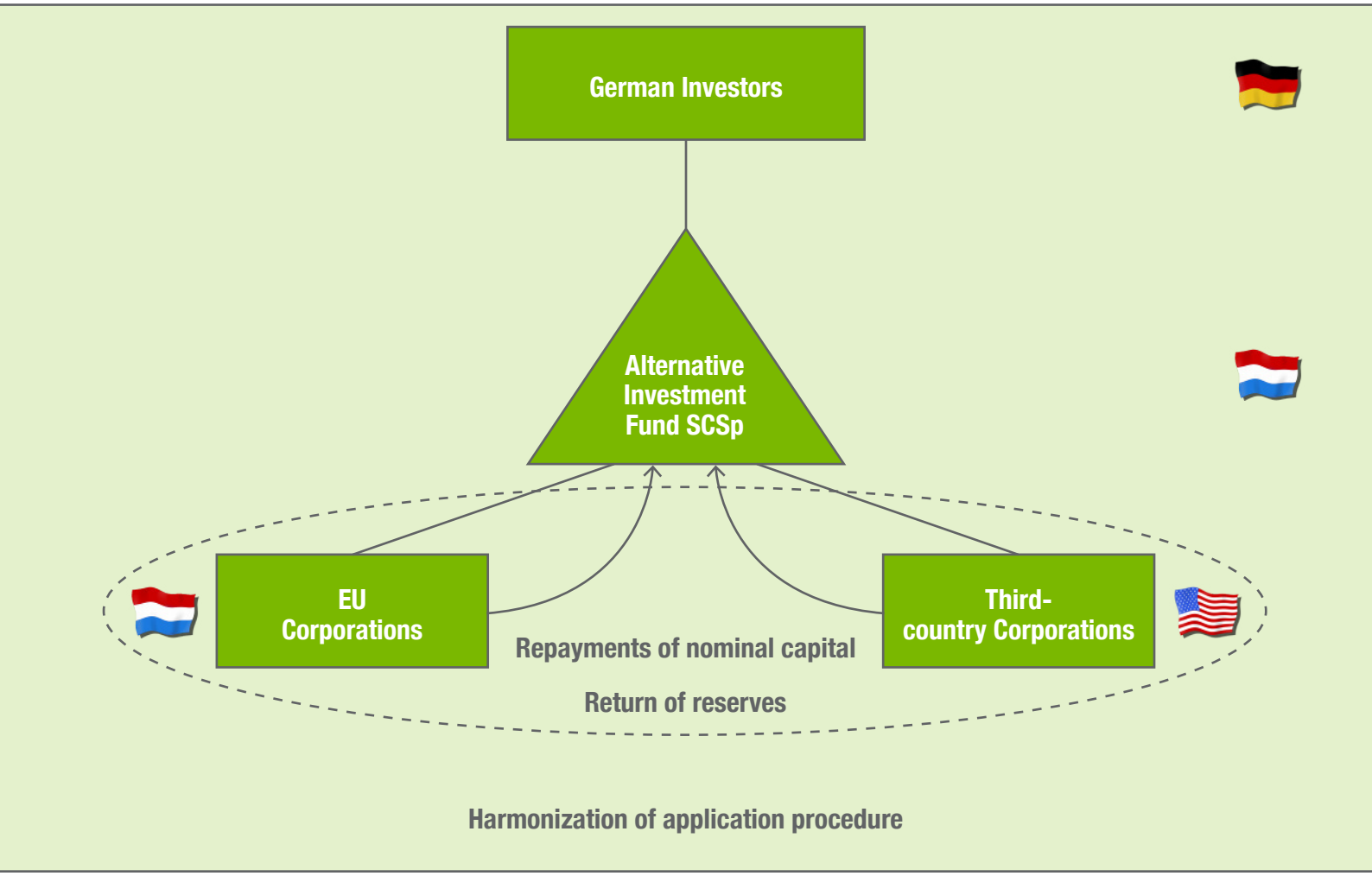
The German 2022 Annual Tax Act will again result in changes for companies that are neither domiciled in Germany nor in the EU if they wish to repay capital to their shareholders in a tax-neutral manner. While the German Federal Ministry of Finance (Bundesfinanzministerium, or "BMF") had just acknowledged the long-standing case law of the German Federal Fiscal Court (Bundesfinanzhof) in its Circular dated April 21, 2022, stating that these so-called third-country (non-EU) capital companies can also repay capital reserves and nominal capital in a tax-neutral manner, and under which conditions this is accepted by the German tax administration, the amendment to the law again gives rise to new questions for the legal practitioner. Particularly for investors in alternative investment funds, the now established statutory application requirement represents a practical hurdle that is difficult to overcome.

The Good News First

Section 27 (8) of the German Corporate Income Tax Act (Körperschaftsteuergesetz) was amended by the 2022 Annual Tax Act. According to the amendment, companies not subject to unlimited tax liability in Germany can now repay their capital reserves or their nominal capital in a tax-neutral (non-taxable) manner. It is to be welcomed that this creates legal certainty and a level playing field for all foreign companies. The previous uncertainties regarding the scope of application to companies not resident in the EU have thus been eliminated. It is also now clarified that Section 27 (8) of the German Corporate Income Tax Act also applies to repayments of nominal capital. The application of this provision to repayments of nominal capital did not previously follow from the law. Now, however, all foreign companies, and not only EU companies, must undertake an application procedure in Germany in order to make a tax-neutral repayment of capital. If such application is not filed with the German authorities, the payment is deemed to be taxable as dividend income in the hands of the German shareholder.

Documents to beinformed:

- beinformed dated May 5, 2022



As Always, the Devil Is in the Details

Until now, a tax-neutral return of capital from third-country (non-EU) corporations was not regulated by law. However, with the BMF Circular dated April 21, 2022 (cf. our beinformed dated May 5, 2022), the tax authorities acknowledged the long-standing case law of the German Federal Fiscal Court and also permitted a tax-neutral return of reserves for third-country corporations. According to such Circular, a tax-neutral return of reserves from third-country corporations is possible without a separate application procedure by the distributing corporation but was possible within the German tax assessment of the shareholder providing evidence within the context of shareholder's tax assessment. However, the new regulation now leads to a formal assessment procedure with an application obligation on the part of the company making the payment (Section 27 (8) Sentence 3 of the German Corporate Income Tax Act as amended by the 2022 Annual Tax Act).

This application is subject to a filing deadline. This is a statutory limitation period which cannot be extended. It must be submitted by the end of the twelfth month following the end of the fiscal year in which the payment was made (Section 27 (8) Sentence 4 of the German Corporate Income Tax Act as amended by the 2022 Annual Tax Act). The fiscal year of the paying foreign company is to be taken into account. Whereas the previous version of Section 27 (8) referred to the end of the calendar year following the calendar year in which the payment was made, the new version refers to a

12-month period based on the fiscal year of the company making the payment. Whereas in the past (for EU companies) all applications had to be submitted by December 31st of the following year, a continuous application procedure is now required within this 12-month period if the repayments are not to be treated as dividend income. Especially in the case of investments in alternative investment funds with a large number of holding and portfolio companies, it is now necessary to keep track of when the financial years of the individual companies end in order to monitor the expiry of this 12-month period as part of a deadline management.

Another practical problem is that the application must be made by the company itself. Especially in fund structures, it is not always ensured that the German shareholder has sufficient influence on the paying company. In any case, the possibility of proving the tax neutrality of the return of capital in the shareholder‘s own tax assessment is no longer permissible under the new law. Until now, previously negotiated side letters demanded that only the EU subsidiaries of the funds were regularly required to conduct an application procedure for the purpose to ensure the tax neutrality of the return of contributions. In new side letter negotiations, the clauses for EU and non-EU companies should be harmonized from now on.

In addition, the amendment applies not only to payments from reserves, but also to repayments of nominal capital. Whereas under the BMF Circular dated April 21, 2022, only nominal capital repayments resulting from the conversion of reserves and thus falling under Section 7 (2) of the German Act on Tax Measures to Increase Share Capital from Corporate Funds (Gesetz über steuerrechtliche Maßnahmen bei Erhöhung des Nennkapitals aus Gesellschaftsmitteln, or “KapErhG”) were covered, the amendment now applies to all nominal capital repayments, irrespective of whether they result from the conversion of reserves or not. As a parallel measure to the new provisions of Section 27 (8) of the Corporation Tax Act, Section 7 (2) KapErhG has been repealed as of 2023.

Finally, the question as to what evidence must now be provided for tax neutrality is of considerable practical relevance. Section 27 (8) Sentence 7 of the German Corporate Income Tax Act was not amended by the 2022 Annual Tax Act. It continues to state that the circumstances required for the calculation of the return of contributions must be presented in the application. The BMF Circular dated April 21, 2022, provided for a significant relief for third-country corporations, as it did not require a reconciliation to German tax accounting principles pursuant to Section 60 (2) of the German Income Tax Implemention Regulation for these third-country corporations. Instead, foreign commercial law was decisive when determining whether the payment qualifies as return of capital or dividend distribution. In addition, resolutions and evidence of the payments made were sufficient. However, the administrative practice under Section 27 (8) Sentence 7 of the German Corporate Income Tax Act requires a reconciliation of foreign commercial law with German tax accounting principles. In addition, according to the previous administrative practice regarding Section 27 (8) Sentence 7 of the German Corporate Income Tax Act, a complete development of the capital contribution account for tax purposes (steuerlicher Einlagenbestand) is required. This could necessitate a reappraisal of the history of the paying company over a period of years. In practice, this will simply be impossible in some cases.

Conclusion

The procedural hurdles of the new Section 27 (8) of the German Corporate Income Tax Act are high and do not affect only third-country corporations. Moreover, the change in the deadline calculation may also result in changes in the application procedure for EU corporations.

According to the explanatory Memorandum to the 2022 Annual Tax Act, the filing deadline for the application was changed in order to shorten the previous processing times on the administrative side and to avoid peak loads on the December 31st deadline. However, we do not believe that this will ease the administrative burden. Whereas applications have so far „only“ concerned other European countries, the German Federal Central Tax Office will in future have to deal with financial statements and foreign legal systems around the globe. As the procedures currently already take several years, it remains to be seen whether these periods will be shortened.

If a foreign company's application to the relevant German tax office fails, for example, because it was not submitted by the foreign company in due time, or if it is rejected because the evidence cannot be sufficiently provided, the payment is treated as dividend income by the German tax authorities. For investors in alternative investment funds these dividends are regularly not tax-exempt. Since the individual investor usually holds less than 10 percent of the paying company, the so-called “participation exemption” and thus the tax exemption for dividend income under Section 8b (1) of the German Corporate Income Tax Act does not apply. Although a possible capital gain from the dissolution of the company is reduced upon exit, as the reduction in acquisition costs of the shareholding by denying the tax-neutrality of the return of capital does not apply, however, this capital gain is tax-exempt under the participation exemption set forth in Section 8b (2) of the German Corporate Income Tax Act. For regularly taxed corporations as investors, there is a risk of taxation of the substance. It is advisable to review existing side letter clauses and adapt them to the amended wording of the law. We will be happy to support you in this!

be in touch: Any questions? Please do not hesitate to contact us!

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