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Foreign dividend capital repayment if so classified in home country

The Supreme Tax Court has held that a US distribution of shares in a former subsidiary is a tax-free capital repayment to a German resident shareholder if so classified under US law.

A US company spun-off a subsidiary, by distributing its shares in kind to its own shareholders. A German resident recipient saw this distribution as a tax-free capital repayment; the tax office saw it as a dividend in kind, taxable at the market value of the shares received. The tax office' main argument was that the company had not reduced its nominal share capital as a result of the distribution, hence it must have funded the dividend from revenue reserves. The taxpayer replied that the distribution had diluted his investment, hence he had received a capital repayment.

The Supreme Tax Court has now held that the question can only be decided on the basis of the foreign law in force at the time. If US law treated the distribution as a capital repayment (from capital reserve), it should be exempted as such in the hands of a German shareholder. If the US saw it as a distribution of income, it should be seen as such in Germany. If the recipient of income was a shareholder at the time the legal claim to the dividend arose (e.g. shareholders' resolution), the receipt should be taxed as investment income. If he only became a shareholder later, the receipt was tax-free as a partial repayment of his investment. If there was no legal act founding the claim before the distribution took place, the relevant cut-off date was the date of the distribution.

Supreme Tax Court judgment I R 117/08 of October 20, 2010 published on February 23, 2011

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