

By PwC Deutschland | 16. September 2024

Saved expenses deemed to be hidden profit distribution

The Supreme Tax Court decided that a hidden profit distribution may be assumed if the shareholder saves own expenses. Such cost savings can also be the result of a waiver of an agreement for reimbursement or compensation claims. The tax court of first instance must now determine whether the economic embargo in the customer's home country and the ensuing compensation payments had legal consequences for the GmbH or whether the breach of contract was solely made at the instruction of the parent company.

Background

The plaintiff is a limited liability company (GmbH), its parent company (X) is domiciled in the USA. Due to an economic embargo imposed by the USA the plaintiff was instructed by X to no longer provide services to a client in Venezuela (Y), the country affected by the economic embargo. Y then brought an action against the plaintiff for failure to carry out the orders and asserted claims for damages. In light of this, the plaintiff initiated arbitration proceedings before the International Chamber of Commerce in Paris, after which it was obliged to pay damages, claims for unwarranted enrichment and pro rata procedural costs on the condition that V withdrew the action.

In the opinion of the tax office, the payment by the plaintiff of the procedural costs and the amount of damages as well as the costs incurred in connection with the execution of the order and the loss of profit due to the discontinuance of the orders were to be qualified as hidden profit distribution. The orders were canceled solely in the interests of the US parent company. A third party as prudent and conscientious manager would not have been prepared to bear the costs of a cancellation of a contract initiated solely in the interests of the parent, nor would he have waived any future profits resulting from the execution of the order.

The lower tax court of Schleswig-Holstein upheld the claim and found that the hidden distribution had been wrongly applied.

Decision

The Supreme Tax Court set aside the judgment of first instance and referred the matter to the tax court for the following reasons.

The concept of a hidden distribution of profits is commonly defined as a loss or thwarted increase of assets (net worth) resulting from relations with the shareholders and affecting the level of income, and that is not the consequence of an ordinary profit resolution under the rules of company law. A loss or thwarted increase of assets from shareholder relations is to be seen against the yardstick of the dealings with third parties.

A benefit in the case of a hidden distribution through a thwarted increase in assets could also result from the fact that the shareholder saves own expenses. The savings in expenses could also arise from the waiver of the agreement on a reimbursement or compensation claim. The case of dispute involves such a cost saving scenario.

By waiving a commitment by its US parent company to assume a risk of loss associated with the breach of contract and be adequately compensated, the plaintiff had incurred a thwarted loss of assets, which it ought to have been taken into account at the time when the forborne pecuniary benefit should have been recognized in its balance sheet.

If the plaintiff had taken a prior commitment by its parent to assume the damage as a precondition for the breach of contract, its profit for tax purposes in the year in dispute would have been higher.

In the second instance, the Schleswig-Holstein Tax Court must now clarify the following three main issues before rendering its final judgment while observing the above explanations of the Supreme Tax Court.

- It must determine whether the thwarted increase in assets on the part of the plaintiff resulted from relations with the shareholder.
- In addition, the tax court is required to further assess the terms of the US embargo. The breach of contract would not have been (partly) caused by the shareholder relationship if a corresponding obligation of the plaintiff had already arisen from the embargo as such.
- Finally, it must also be determined whether X caused or contributed to the plaintiff's breach of contract when issuing the instructions to cut further business and services with Y. The breach of contract would not have been (partly) caused by the shareholder relationship if a prudent and conscientious manager by himself would have opted to breach the contract due to the potential negative economic consequences in the future.

Source:

Supreme Tax Court, decision of 22 May 2024 (I R 2/21) – published on 12 September 2024.

Schlagwörter

hidden distributions