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Disposals of shares by limited taxpayers: no add-back of fictitious business expenses without domestic branch

The Supreme Tax Court has ruled that where a limited taxpayer has no permanent establishment (branch/permanent representative) located in Germany, the add-back of fictitious business expenses cannot be applied.

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Background

Gains arising from the sale of shares in a company are exempt from tax where the seller is a company. However, 5% of the gain is to be added back as a fictitious non-deductible business expense. The question before the Court was whether this fictitious non-deductible business expense could also be attributed to a foreign company as a limited taxpayer, where that foreign company had no permanent establishment (i.e. no branch or permanent representative) located in Germany.

The appellant, a limited company, was tax resident of Bermuda and thus did not benefit from a tax treaty. The appellant argued that the rule concerning fictitious non-deductible business expenses could only be applied where the taxpayer actually carried on a business in Germany or at least had a domestic permanent establishment (i.e. to have business expenses you should have a domestic business). The Tax Court Hessen had refused the appeal, following the tax office's argument that the sale of shares (with a shareholding of more than 1%) in a German resident company gives rise in principle to a limited obligation to pay tax. If the limited taxpayer is a company, the gain on disposal is tax free and correspondingly 5% of the gain on disposal is a non-deductible fictitious business expense.

Judgment

The fiction of lump-sum business expenses cannot apply in this situation because the appellant, due to fact it does not operate a domestic branch nor does it have permanent representative in Germany, does not earn any domestic income which such business expense could be set off against. Whilst the relevant provision creates a fictitious business expense and directs its non-deductibility, it does not provide the German tax authorities with a mechanism to tax the fictitious business expense. This mechanism would therefore have to be provided for in other tax provisions. The appellant realised domestic income from a deemed business. To determine this "business income" however no calculation of profits allowing for a deduction of the business expense needed to be carried out. The appellant's limited obligation to pay tax arose exclusively from the gain on the disposal. The difference between the disposal proceeds and the acquisition costs including any costs of sale was qualified as "business income" by virtue of a statutory fiction so that to this extent neither an accrual basis accounting nor a cash base accounting became necessary.

Source:

Supreme Tax Court judgment of 31 May 2017 (I R 37/15), published on 25 October 2017.

Keywords

Corporation tax, Share disposal, exempt disposal, fictitious non-deductible business expense, foreign company, limited taxpayer