By PwC Deutschland | 01 December 2021

Dividend exemption under double tax treaty or abuse of legal forms?

The distribution of profits by a Luxembourg subsidiary (in the legal form of a SARL) to its German parent company (a partnership limited by shares – KGaA) may be an abuse of legal forms where the KGaA provided SARL with a loan and shortly thereafter waived repayment, thereby putting SARL in a position to actually make the profit distribution. Even more when the losses arising from the impairment of the value of SARL because of the distribution are to be used by the shareholders in a tax-effective manner.

Background

A German partnership (plaintiff) held 99% of the shares in a KGaA, which in turn held 100% of the shares in a Luxembourg SARL. The question to be answered by the courts is whether the dividend of SARL to the KGaA, which itself was exempt from tax in Luxembourg, is also tax free in Germany as intercompany dividends under Art. 20 Abs. 2 sentence 3 of the 1958 German-Luxembourg double tax agreement (DTA) which was in force in the years of dispute (2011 and 2012). SARL could effectively pay the dividend only because of the waiver of KGaA for repayment of two loans which were granted to SARL a short time before. SARL itself did not generate earnings (profits) from a genuine business activity on the market. The tax office held that a tax-effective dividend could only be assumed where the foreign company makes profit distributions from own income generated on the market.

Decision

The regional tax court took a different view and confirmed that a dividend as stated in the relevant DTA existed. However, it dismissed the appeal on grounds of the anti-abuse provisions in Sec. 42 Fiscal Code.

Although dividend qualifies for intercompany exemption…

The distributions made by SARL to KGaA are generally subject to the dividend (intercompany) exemption pursuant to Art. 13 (2) in conjunction with Art. 20 (2) sentences 1, 3 DTA and which provided relief for dividends on significant holdings, i. e. dividends paid by a corporation to another corporation, if the shareholding is at least 25%. The SARL is a corporation within the meaning of Article 20(2) sentence 3 DTA. In the absence of an explicit definition or other references in the 1958 DTA, the definition whether a corporation exists is subject to the interpretation of Germany as the country applying the treaty in the case of dispute. As far as foreign companies are concerned, it needs to be determined, when applying a comparison of types, if they corresponded to a German corporation. This question was answered in the affirmative by the tax court.

… the chosen structure is an abuse of legal forms

The regional tax court held that the entire arrangement was abusive as it effectively was aimed at utilizing losses generated from the dividend-related reduction of the value of SARL in a most tax-effective, but economically unreasonable manner. The intention of the parties was to create tax benefits without there being business or other good reasons for the structure chosen. Even more so since the transactions were concluded in a short time and in close chronological order and the pursuit of an economic purpose could not be identified by the court or proven by the claimant.

In the years in dispute, the plaintiff was the sole shareholder in the KGaA and - as general partner of the KGaA - was able to direct and control the business of the KGaA and thus had a controlling influence. The same applies to the KGaA which held a 100% interest in SARL.

The loan agreements from 2011 and 2012 are contradictory. The loan agreement was valid for an indefinite period without the lender having a right of termination. Further, the agreement did not provide for interest.

Judging by the contents of the loan agreement, the court has doubts as to whether a loan agreement was intended between the parties from the outset. This follows from further explanations in the addendum to the loan contract, according to which the economic character of the transfer of capital as equity is to be ensured.

Note: The decision of the regional tax court of Schleswig-Holstein concerns the years 2011 and 2012 and, in this respect, still refers to the old DTA from 1958. In the meantime, Germany and Luxembourg have concluded a new DTA, which has been in force since 2014. This agreement contains a subject-to-tax clause, where income from Luxembourg is only tax-exempt in Germany if actually taxed in Luxembourg.

Source:

Regional tax court of Schleswig-Holstein, decision of 10 February 2021 (5 K 199/18); according to reports, an appeal has been filed and the case is now pending before the Supreme Tax Court (case ref. I R 14/21).

Keywords

abuse of legal forms, dividend exemption, intercompany exemption