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By PwC Deutschland | 20 December 2022

Tax treatment of incongruent advance distributions

A civil law resolution for a selective incongruent advance distribution to only one of two shareholders contravening the articles of association but passed unanimously by the shareholders' meeting is also tax effective. Thus, the “left-out” shareholder does not realize taxable income by way of a hidden distribution.

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Background

In the past, albeit there are several court decisions to the contrary, the tax authorities tend to treat deviating resolutions for disproportionate distribution of profits as an abuse of legal forms (Section 42 German Fiscal Code). With its most current decision (see below) the Supreme Tax Court once more stated that there is no general legal principle according to which incongruent profit distributions are abusive. On the contrary, civil law explicitly recognizes such distributions as permissible under Sec. 29 (3) Limited Liability Companies Act (GmbHG). Therefore, there are no general reservations following this principle also from a tax point of view.

Case of dispute

In the years 2012 to 2015, the plaintiff held a 50% interest in GmbH 1. The remaining 50% shareholder was held by GmbH 2, whose sole shareholder was the plaintiff. In the years in dispute, both shareholders of GmbH 1 unanimously passed advance distribution resolutions whereby the advance profits were to be distributed only to GmbH 2. The articles of association of GmbH 1 did not contain any regulations with respect to the distribution of profits. These were therefore to be distributed in accordance with the shareholding ratios (Sec. 29 (3) Sentence 1 GmbHG). The local tax office considered the distribution resolutions to be void under civil law due to the incongruent distribution of the advance profits and taxed the plaintiff's part of the distribution amounts as hidden profit distributions pursuant to Sec. 20 (1) No. 1 Sentence 2 Income Tax Act.

Decision

The Federal Ministry of Finance had joined the proceedings in support of the tax office.

The Supreme Tax Court ruled in favor of the plaintiff. the distribution resolved in the year in dispute was attributable solely to G-GmbH for tax purposes.

The unanimously approved distribution resolutions which were set up in accordance with civil law are also to be recognized for tax purposes. Therefore, the dividends in question are ordinary open profit distributions from GmbH 1 to GmbH 2, with no distributions to be attributed to the plaintiff. An allocation of one half of the distribution amounts to the plaintiff on the basis of an abuse of legal forms pursuant to Sec. 42 of the German Fiscal Code was ruled out by the Supreme Tax Court. An abuse is to be assumed where an inappropriate legal form is chosen that leads to a tax advantage that the law does not foresee for a reasonable form according to Sec.42 (2) Sent. 1 Fiscal Code. Incongruent distributions validly resolved under civil law must be also accepted for tax purposes. In the given circumstance the plaintiff did not obtain a tax advantage not provided for by law.

It must be considered that almost every hidden profit distribution also represents a disproportionate distribution. These are attributed to only one and not all shareholders. Following this, the Supreme Tax Court sees no reason to treat open and hidden profit distributions differently from the outset.

The resolutions adopted unanimously by the shareholders of GmbH 1 regarding the incongruent advance profit distributions are, as an individual measure, only temporarily in breach of the Articles of Association

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and in this respect did not have a (harmful) permanent effect as it is not binding for future dividend resolutions.

Source

Supreme Tax Court judgment of 28 September 2022, case VIII R 20/20 published on 15 December 2022

Keywords

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