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No gift tax on increase in shareholder’s value by way of disproportionate contribution

In a recent ruling, the (lower) Tax Court of Hamburg decided that the disproportionate contribution to the free capital reserve of a partnership limited by shares is not a transaction that is subject to gift tax.

Background

The plaintiff and his father founded a partnership limited by shares – (*KGaA*). The share capital was taken over in full by the plaintiff's father as the sole limited partner. The plaintiff has made a capital contribution to the *KGaA* as general partner. According to the articles of association of the *KGaA*, the partners participate in the profits and reserves of the *KGaA* in proportion to their capital accounts and the total capital, which is made up of the share capital and the capital contribution. In the present case, the ratio was 90% to 10% in favor of the plaintiff. Shortly after the registration of the *KGaA* in the trade register, the father made a contribution of several million Euros to the unrestricted capital reserve of the *KGaA* which, according to the Articles of Association, is not part of the capital accounts (disproportionate contribution).

The tax office considered this to be a transaction subject to gift tax pursuant to Sec. 7 (8) Sentence 1 of the German Inheritance and Gift Tax Act (IGTA) and issued a corresponding gift tax assessment notice to the plaintiff. The objection of the plaintiff was dismissed by the tax office.

Decision

The appeal before the Hamburg Tax Court was successful.

The case of dispute mainly revolved on the interpretation of Sec. 7 (8) IGTA which provides that „*a taxable gift between living persons also includes an increase in the value of shares in a corporation which a natural person or foundation holding a direct or indirect interest in the corporation (the recipient) receives through the contribution of another person (the donor) to the corporation*“.

The tax court found that the *KGaA* was indeed a corporation and that the value of the plaintiff's shareholding had increased as a result of the disproportionate contribution made by the father. However, the plaintiff's shareholding was not a "*share in a corporation*" within the meaning of Sec. 7 (8) because he did not participate in the share capital of the *KGaA*.

The court pointed out that a distinction had already been made elsewhere in the Inheritance Tax Act between the share of a general partner in a KGaA on the one hand and the share in a corporation on the other, even before the introduction of Sec. 7 (8) IGTA. Moreover, the same distinction is also made in certain provisions of the German Income Tax Act and the German Valuation Act.

The official explanatory memorandum to the amended provision of Sec. 7 (8) IGTA at the time is not at all conclusive and clear to the court. It does neither specifically deal with the question of how the term "*share in a corporation*" should be interpreted nor whether this also includes the contribution made by a general partner of a KGaA which has no participation in the share capital.

Finally, the court noted, that although the legislator had intended to close the legal loopholes in cases of disproportionate contributions with the provision of Sec. 7 (8) IGTA, a gap in the law - as used by the plaintiff - had remained. This gap is not for the tax authorities and courts to close, but rather a matter for the legislator.

Source:

Tax Court of Hamburg, decision of 11 July 2023 (3 K 188/21). - The appeal is currently pending before the Supreme Tax Court (case ref. II R 23/23).

Keywords

capital contribution, gift tax