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No further application requirements after option for half-income method

Certain type of capital investment income may be taxed under the partial income method (so called half-income method) upon application of the taxpayer and is valid for another 4 years following the year in which the application was made. According to the Supreme Tax Court, the specific preconditions laid down in Section 32d (2) Income Tax Act, e.g. for minimum ownership, only have to be met in the first year of application; a failure to meet the requirements in the following four assessment periods is not harmful.

Background

According to Section 32d (1) Sentence 1 Income Tax Act (ITA) capital investment income is subject to tax at a rate of 25%. Upon application, taxpayers may opt for the partial income method for 5 years, according to which 40% of the dividends are tax exempt if they hold at least 25% of the company's shares in the assessment period in which the application is first made (Section 32d (2) No. 3a ITA. Under the half-income method 60% of the dividends received or capital gains realized is charged to income tax. Correspondingly, 60% of related expenditure and capital losses are deductible.

The plaintiff in the case of dispute continuously held a one-third interest in the capital of K-GmbH until the sale of his share. He had financed the acquisition of the investment in the amount of € 430,000 with external debt. In 2010, the plaintiff sold his share in K-GmbH with the interest-bearing loan still outstanding. Thus, interest was payable in 2010 and in the years 2011 through 2014 (years in dispute). Upon the sale of the shareholding in K-GmbH the plaintiffs incurred losses of some € 215,000 and in their joint income tax return for 2010 applied for the half income method in accordance with Section 32d (2) no. 3 ITA and the deduction of the subsequent debt interest as income-related expenses.

Due to the sale of the shareholding, the tax office no longer considered the application requirements pursuant to Section 32d para. 2 no. 3 sentence 1 letter a ITA to be fulfilled and denied the deduction of income-related expenses in 2011 through 2014. It was of the opinion that the partial income method may no longer be applied within the five-year period from the date on which the taxpayer ceased to be a shareholder.

Decision

The Supreme Tax Court did not follow the position of the tax administration and upheld the appeal of the plaintiffs.

An application pursuant to Section 32d (2) no. 3 sentence 4 in connection with Section 32d (2) no. 3 sentence 1 letter a ITA can be submitted for the assessment period in which an investment is sold as the first year of application if the applicant has held a sufficient interest in the corporation at any time during this assessment period until the sale. It is not necessary to generate investment income pursuant to Section 20 (1) nos. 1 and 2 ITA (i.a. dividends, other compensations from shares, profit participations rights) in this assessment period. In the four subsequent assessment periods the standard individual income tax rate must therefore be applied under the partial income method taking into account income-related expenses even if the requirements of the option are no longer met.

According to established case law of the Supreme Tax Court, debt interest for financing the acquisition of a significant shareholding held as private assets and payable after the termination (sale) of the shareholding is generally deductible if it is economically connected to the previous investment income from the shareholding. The subsequent interest is still payable here because the debt was taken with the intention to generate income from capital investment. It is therefore deductible if (as in the case of dispute) the debt cannot be repaid from the proceeds of the sale or termination of the investment.

The application relating to the shareholding in K-GmbH was submitted by the plaintiff in time with the submission of the income tax return for the 2010 assessment period. As long as the application is not withdrawn it is also valid for the following four assessment periods without any further restrictions and it need not to be substantiated if the requirements are still met. In the 2010 assessment period the plaintiff was the owner (by a sufficient share of one third) of the investment in K-GmbH under civil law until the sale of his share. He was also the economic owner for tax purposes in accordance with Section 39 (1) Fiscal Code. The eventual sale of the shareholding during the year has no adverse effect.

Source:

Supreme Tax Court, decision of 17 July 2024 (VIII R 37/23) – published on 19 September 2024.

Keywords

half-income system, investment income