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By PwC Deutschland | 01 March 2026

No increase of taxable income pursuant to Section 8 (3) Corporation Tax Act in the case of hidden capital contribution

The failure to tax the deemed capital gain under Section 17 (1) Sentence 2 Income Tax Act at the level of the shareholder in the case of a hidden contribution of shares in a corporation is not a reduction in income as provided in Section 8 (3) Sentence 4 Corporation Tax Act which would otherwise result in an increase in taxable income. This was decided by the Supreme Tax Court in a recently published judgment.

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Background

Section 8 (3) Sentence 4 Corporation Tax Act (CTA) states that "the (taxable) income is increased to the extent a hidden capital contribution has reduced the income of the shareholder."

According to Section 17 (1) Sentences 1 and 2 Income Tax Act (ITA) “income from business operations also includes profits from the sale of shares in a corporation (if the seller has held at least 1 percent of the company's capital, either directly or indirectly, within the last five years). The hidden contribution of shares in a corporation into a corporation is equivalent to the sale of the shares”.

L was the sole shareholder and managing director of a limited liability company (A GmbH). Later, he set up another GmbH together with the plaintiff and became its sole shareholder. L also transferred 100% of his shares in A GmbH to the plaintiff free of charge.

The transfer of shares in the limited liability company was recorded as follows: In the annual financial statements as of 31 December 2010, the shares were not included and only the nominal capital was shown in the balance sheet. As of 31 December 2011, shares in affiliated companies were recorded as fixed assets and as corresponding entry in capital reserves. As of 31 December 2012, shares in affiliated companies and a capital reserve (amount of the share capital of the limited liability company) were recorded.

In its tax assessment for the year in dispute (2012) the tax office increased the plaintiff's income. It maintained that L had contributed his shares in A-GmbH to the plaintiff and that the contribution should be valued at its gong-concern value but not exceeding its fair market value. The appeal against this decision was rejected in the first instance.

Decision

Following the plaintiff's appeal, the judges at the Supreme Tax Court overturned the decision of the former tax court and upheld the claim brought by the plaintiff.

Pursuant to Section 17 (1) sentence 2 ITA, the hidden contribution of shares is equivalent to the sale of the shares at shareholder level. Under certain circumstances, the profit from the sale of such shares is considered income from business operations pursuant to Section 17 (1) sentence 1 ITA.

The Supreme Tax Court went on to explain that the statutory definition in Section 8 (3) Sentence 4 CTA of a “reduction in the shareholder's income” is to be interpreted as a reduction in the basis of assessment for income tax purposes. This would be the case if the hidden contribution had been taken into account as income-related expenses or business expenses for the shareholder. Since this was not the case and taxation pursuant to Section 17 (1) Sentence 2 ITA did not take place (in the final income tax assessment of L for 2011) no such "reduction of income" had occurred. Under Section 17 (1) Sentence 2

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ITA, the hidden contribution of such shares to a corporation is treated as equivalent to a sale at market value (Section 17 para.2 Sentence 2 ITA). As a result of the failure to apply Section 17(1) sentence 2 ITA, however, there has been no reduction in the shareholder's income but merely a “non-recognition of a (notional) increase in income.”

While the hidden reserves remain with the acquirer as a result of the hidden contribution there is no risk of a loss of tax revenue (shortfall of tax) due to the fictitious capital gain that was inadvertently not recognized in accordance with Section 17 (1) Sentence 2 ITA because taxation is deferred and can be recovered later in the event of the genuine sale of the shares, the Supreme Tax Court said.

Finally, the Supreme Tax Court clarified that Section 8 (3) Sentence 4 CTA does not restrict the scope of application of the provision to corporate shareholders; natural persons as shareholders are also covered by the provision.

As could be seen from the above, the case prompted the Supreme Tax Court to perform some real legal juggling. But in the end, and as the saying goes, “legal awareness facilitates the search for a solution”.

Source:

Supreme Tax Court, judgment of 19 November 2025 (I R 40/23) published on 26 February 2026.

Keywords

Capital gains taxation, capital contribution