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Shareholders of US S corporation are entitled to full refund of withholding tax

Shareholders of a U.S.-based S corporation are eligible for a full refund of the withholding tax on dividends paid by a German-based subsidiary. This was decided by the Supreme Tax Court in a recently published judgment.

Background

The issue in dispute concerned the interpretation of Section 50d (1) Sentence 11 of the Income Tax Act (ITA) in the version applicable in 2013, the year in dispute. Does this provision constitute a substantive legal assignment of the right for a refund to the shareholders of the U.S. S corporation or is it merely of a procedural nature?

The choice to establish a S corporation is optional, the corporation itself is not subject to corporate income tax. Instead, its income is taxed directly at the level of the shareholders who are U.S. residents. The shareholders of the S corporation in the case at hand are exclusively individuals resident in the United States as well as US trusts whose beneficiaries are, in turn, exclusively also individuals resident in the United States.

The Federal Central Tax Office assumed a remaining withholding tax rate of 15% given that the treaty eligibility of the plaintiff's shareholders must be taken into account. The Cologne Tax Court (lower tax court) granted the appeal and held in favor of the plaintiffs.

Decision

The Supreme Tax Court upheld the lower court's decision and dismissed the appeal of the Federal Central Tax Office.

Section 50d (1) Sentence 11 ITA (currently: Section 50d (11a) ITA) reads as follows: If the recipient of the capital investment income is a person to whom the income is not attributed under this Act or under the tax laws of the other Contracting State, the right to full or partial refund of the tax withheld from the investment income is granted only to the person pursuant to a DTA to whom the capital income is attributed under the tax laws of the other Contracting State.

"S corporation" (the plaintiff) does not meet the requirements for residency in the United States within the meaning of Article 4 (1) Sentence 1 of the U.S.-German Double Taxation Agreement (DTA) because it is not itself subject to U.S. income tax under U.S. law. Although the dividend payments made by the German subsidiary to the S corporation are not taxable in the U.S. under U.S. law, they are deemed to be taxable to the extent they are ultimately attributed as income or profits to U.S. residents. This is valid for

the shareholders of the S corporation (who joined the proceedings as co-plaintiffs). The legal fiction of the treaty-based allocation of income or profits under Article 1 (7) DTA ensures that these individuals enjoy treaty protection with respect to the relevant income or profits.

The Supreme Tax Court considers Section 50d (1) Sentence 11 ITA to be a “procedural” provision resulting in the S-corporation’s claim for a refund being transferred pro rata to the shareholders in the United States. Since the S-corporation made these claims on behalf of its shareholders, it was entitled to these claims. These individuals are therefore eligible to treaty protection with respect to the relevant income. They are thus entitled to a full refund of withholding tax plus the solidarity surcharge.

The legislative explanation at the time regarding Section 50d (1) Sentence 11 ITA explicitly states that the claims are transferred “for the purpose of asserting them.” It does not, however, establish the accrual of the claim itself on the part of the shareholder. The application of this provision to distributions made to the S-corporation implies that it is not the S-corporation itself but rather its shareholders who must assert their claim vis-à-vis the Federal Central Tax Office for a refund of the tax withheld and paid.

Source: Supreme Tax Court, judgment of 11 March 2026 (I R 13/23) published on 28 May 2026.

Keywords

S corporation, withholding tax refund