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German Tax and Legal News

BFH rules on application of 5% addback on dividend distributions from CFCs

The addback applies regardless of whether dividend distributions are tax-exempt as previously taxed CFC income.

In a decision dated April 26, 2017 and published on September 14, 2017, Germany's Federal Tax Court (BFH) ruled that the lump-sum addback of 5% of the amount of dividends received (which is deemed to represent nondeductible business expenses) applies on dividend distributions from a foreign subsidiary, which are tax-exempt to the extent the taxpayer recognized taxable income from the subsidiary under Germany's controlled foreign company (CFC) rules in the same business year or in the previous seven business years. The decision is of interest because it is contrary to the prevailing opinion of commentators that has been expressed in tax literature.

In the case before the BFH, the taxpayer had taxable CFC income in fiscal years (FYs) 2006 – 2009 from its participation in a Swiss subsidiary. In FY 2009, the Swiss subsidiary made a dividend distribution. Based on section 8(1) of Germany's corporate income tax code (CITC) (which provides a general tax exemption for dividends received by German corporations), the taxpayer treated the dividend distribution not exceeding the previously taxed CFC income as tax-exempt, and applied the 5% lump-sum addback (as set forth in section 8b(5) of the CITC), leading to a 95% tax exemption for the dividend distribution. The tax authorities assessed the tax accordingly. In the course of a subsequent amendment to the tax assessment, the taxpayer applied for the dividend distribution to be treated as tax-exempt under section 3(41a) of the income tax code (ITC) (which provides a tax exemption for distributed dividends previously taxed under the CFC rules), and for the 5% lump-sum addback not to apply. The tax office agreed that the application of section 3(41a) of the ITC, in conjunction with section 8b(1) of the CITC, allowed the dividends to be treated as tax exempt, but insisted on the application of the 5% lump-sum addback. The lower tax court of Bremen agreed with the taxpayer, and the tax office appealed the decision to the BFH.

The BFH partially disagreed with the tax authorities. The BFH left open whether dividend distributions from previously taxed CFC income are tax-exempt under section 3(41a) of the ITC or under section 8b(1) of the CITC. The BFH held that, based on the wording of the law, the 5% lump-sum addback applies to dividend distributions that are tax-exempt under section 3(41a) of the ITC, since the provision on the addback (section 8b(5) of the CITC) refers to income *in the sense of* section 8b(1) of the CITC, as opposed to income that is tax-exempt *under* that section. The court opined that there are no sustainable reasons not to apply the lump-sum addback to dividend distributions of CFC income. The BFH further stated that section 3(41a) of the ITC cannot be seen as a correction to section 8b of the CITC or as a case where a specific law trumps a more general law—in cases where dividends are distributed to corporations, section 8b of the CITC prevails towards section 8(1) of the CITC which opens the application of section 3(41a) of the ITC.

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