CAPITAL GAINS 100% TAX-EXEMPT INSTEAD OF ONLY 95% FOR FOREIGN CORPORATE SHAREHOLDERS

In a decision dated 31 May 2017 (I R 37/15), which has been released on 25 October 2017, the German Federal Fiscal Court (*Bundesfinanzhof*) ruled in favour of foreign shareholders selling shares in a German corporation.

As a rule, capital gains realised upon sale of shares in a corporation are tax-exempt pursuant to section 8b para 2 sentence 1 of the German Corporate Income Tax Act. However, pursuant to para 3 sentence 1 of the same section, 5% of such capital gains are considered as non-deductible business expenses (so-called 5% taxation), resulting in an effective tax-exemption of 95% only.

The court had to decide whether this 5% taxation rule also applies to non-resident shareholders without domestic operations. While the lower fiscal court ruled against the foreign shareholder, the Federal Fiscal Court had a different point of view.

Pursuant to the Federal Fiscal Court, the 5% taxation rule does not apply as long as the relevant non-resident shareholder has neither a permanent establishment nor a permanent representative in Germany. Accordingly, where the 5% taxation rule does not apply, capital gains should be 100% tax-exempt in Germany.

The new decision is, in particular, relevant for non-resident entities holding shares, directly or indirectly through partnerships which do not have a German permanent establishment or permanent representative, in German resident real estate companies where the applicable double tax treaty entitles Germany to impose a tax on capital gains realised upon sale of shares in real estate companies (e.g. as pursuant to Art. 13 para 2 of the double tax treaty between Germany and Luxembourg or other double tax treaties following Art. 13 para 4 of the OECD Model Convention). The same holds true for holding entities being resident in a jurisdiction which has not entered into a double tax treaty with Germany.

We note that the court's argumentation is very technical, and the court has indicated that there might be other ways to limit the tax-exemption to effectively 95%, which might then also affect non-resident shareholders. Accordingly, it could well be that the German legislator amends the law in the future. For the time being, capital

Key issues

- Capital gains realised upon sale of shares in a German resident corporation by non-resident corporate shareholders should be 100% tax-exempt irrespective of the existence of or the provisions in a double tax treaty
- Relevant for, in particular, holding entities in the real estate sector and holding entities in jurisdictions without a double tax treaty

gains realised by non-resident corporate shareholders upon sale of shares in a German resident corporation should be 100% tax-exempt irrespective of the existence of a double tax treaty (except for non-resident banks selling shares belonging to their trading books, for non-resident life- and health insurance companies and for certain other cases). It should also no longer be admissible for the German tax authorities to issue orders to withhold German tax from the purchase price for shares in real estate companies pursuant to section 50a para 7 German Income Tax Act.

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