

Caption: Notwithstanding an earlier statement, the Federal Fiscal Court decided in three rulings that excessive payments of remuneration by a limited liability company to an affiliated person of a shareholder are to be recorded for income but not for gift tax purposes. Nevertheless, a double tax burden cannot be ruled out, since the BFH does not exclude a generous donation in the relationship between the shareholder and his affiliated person.

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NOTWITHSTANDING AN EARLIER STATEMENT, THE FEDERAL FISCAL COURT [BUNDESFINANZHOF - BFH] DECIDED IN THREE RULINGS THAT EXCESSIVE PAYMENTS OF REMUNERATION BY A LIMITED LIABILITY COMPANY [GESELLSCHAFT MIT BESCHRÄNKTER HAFTUNG - GMBH] TO AN AFFILIATED PERSON OF A SHAREHOLDER ARE TO BE RECORDED FOR INCOME BUT NOT FOR GIFT TAX PURPOSES. NEVERTHELESS, A DOUBLE TAX BURDEN CANNOT BE RULED OUT, SINCE THE BFH DOES NOT EXCLUDE A GENEROUS DONATION IN THE RELATIONSHIP BETWEEN THE SHAREHOLDER AND HIS AFFILIATED PERSON. [/av_textblock] [/av_two_third][av_two_third first min_height='' vertical_alignment='' space='' custom_margin='' margin='0px' padding='0px' border='' border_color='' radius='0px' background_color='' src='' background_position='top left' background_repeat='no-repeat' animation='' av_uid='av-8mss86'] [av_textblock size='' font_color='' color='' av-medium-font-size='' av-small-font-size='' av-mini-font-size='' av_uid='av-k0c4pany' id='' custom_class='' admin_preview_bg='']

I. Tax registration of asset transfers involving a corporation

Due to the independence of a GmbH under civil law, the question arises as to the tax effects of asset transfers from corporations to their shareholders, which take place outside of ordinary profit distributions. The assessment of such constellations has regularly engaged the fiscal courts in recent years. Topic of the discussion is the open offence of Section 7 para. 1 sentence 1 no. 1 German Inheritance Tax Act [*Erbchaftsteuergesetz - ErbStG*] and the question, whether the generosity of a donation lapses if it was issued because of reasons under company law. In earlier rulings the BFH had denied the “generous donation”, thereby denying the incurrence of gift taxes in cases of a contribution of a GmbH to its shareholder with the same argument. On the contrary, the taxation of asset transfers by a GmbH to an affiliated person of a shareholder have not been subject to judicial review. The BFH has now addressed this issue within several rulings.

II. Taxation of excessive remuneration payments by a GmbH to a shareholder's affiliated person

The BFH has been dealing with the issue of excessive remuneration payments within three legal proceedings (decisions dated 13 September 2017, II R 32/16, II R 54/15 und II R 42/16), each case treating a payment made by a GmbH to an affiliated person of a shareholder. In two of the three cases, a GmbH had rented property (and machinery) from the spouse of the (sole) shareholder, with the rent of said property (and machinery) being too high. The third case dealt with a GmbH, which paid an excessive acquisition price for company shares to the brother of the parent company's controlling shareholder. In each and every case, the (sole) shareholder of the GmbH had been involved in the draw ups of the underlying contracts. The BFH now generally contemplates whether excessive remuneration payments made by a GmbH to an affiliated person of a shareholder not only trigger a profit tax, but a gift tax as well.

1. Profit Tax

Excessive payments of a GmbH to a shareholder constitutes a hidden profit distribution [*verdeckte Gewinnausschüttung* - vGA]. This also applies if the profit is not distributed to the shareholder directly, but to an affiliated person of the shareholder. This is regarded as an indirect hidden profit distribution (indirect vGA). It thereby makes no difference whether the relation between the shareholder and the affiliated person are due to family ties, company or contractual law, as well as of a pure actual relationship. Concerning the three cases ruled by the BFH, all requirements of a hidden profit distribution were met, making the respective income tax recordings concerning the excessive part of the remuneration indisputable. The GmbH rectified the unreasonably high part of the remuneration by adding through an off-balance sheet revenue (Section 8 para. 3 Sentence 2 German Corporate Income Tax Act [*Körperschaftsteuergesetz* - KStG]). The respective shareholder received relevant income from capital assets (Section 20 para. 1 sentence 1 clause 2 German Income Tax Act [*Einkommenssteuergesetz* - EStG]).

2. Gift Tax

Regarding the assessment of gift tax, the BFH firstly screened the fundamental requirements of a donation according to Section 7 para. 1 Sentence 1 ErbStG. As far as the beneficiary will gain a benefit at the donors' expense, this benefit is recognized as „generous donation“. Objectively, the donation must be free of charge and subjectively the donor's will for generosity is required. Based on this, the following ruling by the BFH is of significance: Through excessive payments a property transfer with regard to the corporate relationship occurs, even though these payments are not made with a shareholder as beneficiary and there is neither a direct nor an indirect relationship under company law between the respective GmbH and the affiliated person. In any case, this applies, whenever the respective shareholder has been involved in the process of drawing up the contract between the GmbH and the affiliated person. As the excessive payments can be traced back to the business relationship, however, a donation does not occur, because the necessary provision of generosity, is missing. In the end, within such combinations the shareholder thus provides the affiliated person with a pecuniary advantage, but not the GmbH itself. Regarding this presented triangular relationship GmbH – shareholder – affiliated person, an abbreviated payment path can be assumed, whereby a donation by the GmbH is excluded, but a donation among the natural persons is indicated.

3. (Non-)Conformity of a hidden profit distribution with a generous donation

According to the BFH, in the cases concerned, there is no generous donation in combination with the hidden profit distribution between the GmbH and the affiliated person, at least, as far as the respective shareholder had been involved in the draw-up of the underlying

contract(s). The involvement of the shareholder in the contractual negotiations means that he acts as managing director of the GmbH e.g. by signing the contract, giving appropriate instructions or expressing his consent to the conclusion of the contract. Consequently, hidden profit distribution and donations in this constellation are mutually exclusive, meaning that the hidden profit distribution for income tax purposes supersedes the gift tax related circumstance of a generous donation.

III. Acknowledgement of the BFH rulings

1. The BFH's change in direction

With the above mentioned rulings, the BFH has renounced its previous notion. In its ruling of 2007 (judgment of November 7, 2007, II R 28/06) the BFH hinted that payments of excessive remuneration can actually be generous donations of a GmbH to an affiliated person. As the Argument can be made that there is no legal foundation backing the BFH's perspective and this perspective cannot be explained by general principles, the BFH had been subject – for good reason – of strong criticism and its ruling had also been the subject of numerous discussions in literature. This was compounded by the fact that the disputed statement by the BFH had not been relevant to the circumstances of that case (so-called obiter dictum). All the more astonishing was the fact that not only the tax authority quoted that statement made by the BFH in its identical Decree of the Federal States (Decree BStBl. I 2012, 331 of 14 March 2012), but also the legislature apparently referred to this when introducing its tariff regulation Section 15 para. 4 ErbStG, concerning the inheritance and gift tax. The BFH's present shift concerning this matter is to be welcomed. In its current rulings, the BFH attaches great value to transparency. Particularly in terms of the systematics of the tax regime the BFH stringently outlines that there is a non-conformity of taxable income through hidden profit distribution and generous donations between a GmbH and an affiliated person of a shareholder.

2. Possible double burden of income and gift tax

The outcome of abovementioned BFH rulings, however, does not necessarily rule out a double taxation. All contributions must be fiscally recognized. The BFH addresses, almost in passing through another obiter dictum, the relationship between the shareholder and the affiliated person and does not rule out a generous donation between them which might trigger gift tax. Due to the lack of relevance to the respective ruling, the BFH decided to waive any further statements.

IV. Consequences

The BFH provided clarification with its three rulings regarding the much debated issue of gift taxation on hidden profit distributions in relation between a GmbH and an affiliated person and thus ensures a certain degree of legal certainty. Now, following the rulings of the BFH, when working on cases with similar circumstances attention should be paid especially to the persons who were involved in the process of drawing up the contract. However, with these three BFH rulings, only the relationship of the GmbH with the shareholder and the affiliated person has been sorted out. In the triangular relationship GmbH – shareholder – affiliated person, therefore remains a possibility of a generous donation between the shareholder and the affiliated person, which can overall result in a double burden of income tax (hidden profit distribution) and gift tax. The Tax Authority implemented the rulings of the BFH with the identical Decree of the Federal States, GLE of April 20, 2018, and, at the same time, lifted its previous rulings and incorporated the obiter dictum of the BFH as well. According to that, in such cases mostly no generous donation occurs between the GmbH and the affiliated person of the shareholder with regard to Section 7 para 1 Sentence 1 ErbStG, but there is one between the shareholder and his affiliated person. If the gift could have been made by more than one shareholder (e.g. father and uncle of the beneficiary), also a proportionate contribution can be presumed. As an exception, there is no generous donation between the shareholder and the affiliated person, if, regarding the legal relation be-

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