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*German Tax and Legal News*

## **Lower tax court denies full participation exemption for dividends under tax treaty**

Lower tax court confirms the tax authorities approach of only granting a 95% participation exemption for dividends under a DTT

The lower tax court of Saarland issued a decision dated 24 March 2015, in which it confirmed the position of the German tax authorities that, where a German corporation receives dividends from a foreign subsidiary and an applicable tax treaty provides that the dividends are tax-exempt at the level of the German recipient, 5% of the dividends are deemed to be nondeductible business expenses under domestic rules and can be added back to taxable income. As a result, dividends paid to a German corporate shareholder are only 95% exempt.

In the case decided by the lower tax court, a German corporation received dividends from its subsidiaries in China and Turkey and it treated the dividends as 100% tax exempt in its German corporate income tax return. The German taxpayer argued that a full exemption applied to the dividends under the treaties, and that the domestic 5% add-back should not apply because this effectively would constitute an override of the treaties and would contradict the treaty provisions. A treaty override would violate German constitutional principles. The taxpayer also argued that a treaty has priority where domestic tax law contains contradicting provisions.

The lower tax court disagreed and upheld the position of the tax authorities. The tax court argued that the 5% addback of deemed nondeductible business expenses does not constitute a treaty override. Technically, the full participation exemption, as provided in a treaty, is not affected or changed by the addback. The 100% exemption and the 5% addback are effected in two separate steps, and the 5% addback has to be considered separately. The 5% addback is a standard rule that clarifies the general principle in German income tax law that business expenses related to tax-exempt income cannot be deducted for tax purposes. The lower tax court also rejected the arguments that the addback violates constitutional principles.

The decision of the lower tax court of Saarland is not surprising, even though the issue is interesting from a theoretical perspective.

The taxpayer has appealed the decision to the federal tax court, where it currently is pending.

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