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German Tax and Legal News

Lower tax court rules on trade tax treatment of dividends under tax group rules

The lower tax court of Muenster has issued a taxpayer-favorable decision on the trade tax treatment of dividends distributed by a nonresident subsidiary to its German parent company that is a controlled company in a German tax group.

The lower court of Muenster issued a taxpayer-favorable decision on 14 May 2014 (reference: 10 K 1007/13 G) that deals with the trade tax treatment of dividends distributed by a nonresident subsidiary to its German parent company that is a controlled entity in a German tax group. The court held that the dividends are exempt from trade tax (in the case, the requirements for application of the “trade tax participation exemption” were met by all entities involved), and as explained below, adding back 5% of the distributed dividends as deemed expenses to the trade income at the level of the controlling entity is not possible under the special provisions in German tax law for determining the taxable income of a German tax group.

Background

Under German tax law, a corporation’s income generally is subject to both corporate income tax and trade tax. Trade tax is based on taxable income as calculated for corporate income tax purposes, but with several income adjustments (addbacks and deductions). Dividends paid between corporations generally are excluded from corporate income, although 5% of the distributed amount is added back to income as representing nondeductible business expenses, resulting in an effective exemption of 95% of the distribution. If the parent company holds at least 15% of the subsidiary at the beginning of the trade tax levy period (usually the calendar year), there is no addback for purposes of calculating trade tax income (“trade tax participation exemption”). Thus, under the trade tax participation exemption, the effective 95% corporate tax exemption also applies for trade tax purposes and only 5% of the dividends are subject to trade tax.

The situation is different where a tax group for corporate and trade tax purposes is involved. In this case, a controlled entity’s income for corporate income tax and trade tax purposes will be attributed to the group’s controlling entity. For both corporate income and trade tax purposes, a controlled entity’s income is calculated separately at the level of the controlled entity before it is attributed to the controlling entity. German tax law, however, requires certain adjustments to be made in determining taxable income in the context of a tax group. The 95% exemption from corporate income tax for dividends received by a controlled entity is not applied at the level of that entity; instead, it is applied at the level of the controlling entity. As a result, the full amount of the dividend distribution will be included in the income of the controlled entity as calculated for corporate income tax purposes. For trade tax purposes, the controlled entity’s income is determined based on the previously determined corporate taxable income and will be adjusted in accordance with the special rules in the Trade Tax Act. One of the adjustments permitted under that act is a deduction equal to the amount of the dividend distribution included in the corporate income if the requirements for the trade tax participation exemption are met and no expenses are directly associated with the dividend distribution (if there are such expenses, only the excess of the distribution over those expenses may be deducted). The controlled entity’s income for trade tax purposes (with the dividend income excluded) is then attributed to the controlling entity.

The case

The case before the lower court of Muenster involved a nonresident subsidiary that distributed dividends to its German shareholder, a controlled entity in a German tax group. The requirements for application of the trade tax participation exemption were met by all entities involved. The German tax authorities treated 5% of the dividend distribution as income for

corporate income and trade tax purposes at the level of the group controlling entity.

The court, however, concluded that German tax law does not provide for an addback of 5% of dividend income at the level of the controlling entity for trade tax purposes. Because the trade tax income attributed to the controlling entity in a tax group does not include any dividend income, there is no basis for applying at the level of the controlling entity the provision that adds back 5% of the dividend income as deemed nondeductible business expenses.

Comments

At first glance, this decision may seem surprising because it treats dividends distributed to a controlled entity within a German tax group differently from dividends distributed directly to the controlling entity in the group (in the latter case, 5% of the dividends would be subject to trade tax). However, the lower court of Muenster held that this difference in treatment could not justify the imposition of the 5% addback to trade tax income where dividends are distributed to a controlled entity because the German legislature would have been aware of this difference in treatment when it made other amendments to the rules, but apparently chose not to change the treatment of such dividend distributions.

Although the case involved dividend distributions from a nonresident corporation to a German controlled entity, the principles of the decision should be applicable to distributions by a German corporation to a controlled entity within a German tax group provided the requirements for the participation exemptions are met. However, it should be noted that the lower tax court has permitted an appeal of its decision to the federal tax court.

Expenses that are directly associated with the dividend distribution reduce the amount of the dividend that can be deducted from the trade tax income of the controlled entity where the trade tax participation exemption requirements are met. This becomes relevant, for example, where the controlled entity has debt-financed the participation in its dividend distributing subsidiary. In such a case, the amount of the dividends to be deducted for trade tax purposes must be reduced by the interest paid to finance the participation (up to the amount of the dividend distribution).

This result may be avoided by equity financing the acquisition of the subsidiary, which can be achieved if the controlling entity obtains the loan and provides the funds to the controlled entity as equity to use for the acquisition of the participation in its subsidiary. Because the deduction for dividend income in the Trade Tax Act is applied at the level of the controlled entity in determining the trade income attributable to the controlling entity, interest paid by the controlling entity should not be taken into account in determining the trade income of the controlled entity and, thus, in applying the deduction provision.

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