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No Exemption From Trade Tax for Dividends Received From Subsidiaries Operating Hospitals, Nursing Homes and Similar Institutions

Dividends received from corporate subsidiaries are generally 95 percent tax exempt at the level of the parent company. This is not only true for corporate income tax purposes, but also for trade tax purposes provided that the parent holds at least 15 percent of the shares in the subsidiary at the beginning of the fiscal year (participation exemption). Moreover, the subsidiary must qualify as a "domestic corporate entity that is not exempt from taxation" which in this context has the meaning of not being exempt from trade tax. This additional requirement reflects the objective of the trade tax exemption for dividends which is to mitigate a double taxation of profits both at the level of the subsidiary and (when being distributed) at the level of the parent company.

"Beneficial trade tax regime not applicable to dividends."

Against this background the Federal Fiscal Court ruled in a recently published decision dated January 24, 2012 (I B 34/11) that the participation exemption does not apply for trade tax purposes if the distributing company is exempted from taxation due to its operations. In the case at hand the subsidiary operated nursing homes which qualifies as an activity that is exempted from trade tax according to § 3 no. 20 lit. c) Trade Tax Act. The taxpayer had argued that the participation exemption would apply to the dividends received from its subsidiary regardless of the fact that such subsidiary did fall within the scope of the trade tax exemption. The Federal Fiscal Court did not share this view and denied the application of the participation exemption in accordance with the view of the tax authorities. As a result, the dividends were made fully subject to trade tax.

In its ruling the Federal Fiscal Court accepts that in light of the objective underlying the trade tax exemption provided for in § 3 no. 20 Trade Tax Act (i) to improve the treatment of ill people as well as people in need of care and (ii) to grant financial relief to social insurance carriers the application of the participation exemption for trade tax purposes could be justified if the amounts received as distributions were used to fund other participations falling within the scope of the beneficial trade tax regime. However, the Federal Fiscal Court rejects such an approach due to the wording of the law.

In practice, this means that double- or multi-tier structures should be avoided not only for minority participations. This is not only true for nursing homes, but also for carriers of hospitals and similar institutions the operations of which are (at least partially) exempted from trade tax.

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A potential strategy to mitigate the trade tax burden on distributions could be the formation of a fiscal unity. In such a case, profits would not be up-streamed by way of dividend, but by way of profit pooling. However, the formation of a fiscal unity requires the conclusion of a profit and loss pooling agreement which could prove quite burdensome in some cases given the formal prerequisites to be met (e.g. the minimum term of five years). In addition, it should be noted that so far the Federal Fiscal Court has not given a clear answer as to the question whether an entity that falls within the scope of the trade tax exemption set forth in § 3 no. 20 Trade Tax Act qualifies as eligible entity to form a trade tax fiscal unity. Moreover, in particular in a scenario where other shareholders hold (minority) participations in the subsidiary the formation of a fiscal unity might not provide for a viable route due to the requirement to agree on the payment of a guarantee dividend under these circumstances.

However, given that expenses which have an economic nexus with the distribution can be deducted for trade tax purposes there might be alternative mitigation strategies available since on this basis eventually the net dividend will be subject to trade tax at the level of the parent company only. Therefore, in particular an efficient financing structure could provide for a possible approach to mitigate a potential trade tax leakage.

In addition, ballooning concepts can be used to mitigate negative trade tax implications. This is because, as a general rule, capital gains from the disposal of shares are — other than distributions — 95 percent tax exempt regardless of the trade tax treatment of the operating business of the subsidiary.

Which structure provides for the most efficient mitigation strategy eventually depends on the facts and circumstances of each individual case. If it turns out that a domestic structure cannot be implemented in a trade tax efficient manner the implementation of a cross-border structure could be considered. However, in this regard, among other things, withholding taxes have to be taken into account. Particularly in a scenario where the prerequisites of the EU Parent/Subsidiary-Directive or a double tax treaty are met a cross-border structure could provide for a feasible solution to mitigate negative trade tax implications.

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