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ECJ to rule on foreign tax credit limitation

The Supreme Tax Court has filed a preliminary question with the ECJ on the calculation of the German income tax attributable to foreign source income as the maximum amount of the foreign tax credit.

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All German double tax treaties provide for income tax in the state of residence on the investment income of private persons from their foreign portfolios against a credit for the tax already borne abroad. Usually, this is the foreign withholding tax at the treaty rate. The credit is limited to the amount of German income tax attributable to the foreign source income, but the treaties are generally silent on the calculation formula. The Income Tax Act provides for an apportionment – the total income tax due on the worldwide income before credit should be apportioned *pro rata* over the various sources. A couple with foreign investment income have appealed against this apportionment, claiming that the maximum credit should be the marginal tax, that is the additional amount of income tax assessed by reason of the foreign source income. In their view, the apportionment leads to further German taxation on the foreign income by restricting the foreign tax credit to less than the relevant German tax payable and is therefore a hindrance on the free movement of capital inasmuch as investing abroad becomes taxwise less attractive than investing at home.

The Supreme Tax Court sees sufficient merit in this argument to refer the question to the ECJ. In its resolution, it explains that the effect of the apportionment is to apportion personal allowances and reliefs between home and foreign source income. This is not only contrary to the concept of the primary responsibility of the state of residence to grant relief for personal circumstances, but is also inconsistent with other provisions in the Income Tax Act. Thus, a foreign resident cannot usually claim German personal allowances against his incidental German source income, and a German resident receives a full credit for all German taxation withheld at source.

The Supreme Tax Court does not explicitly mention the effect of the progressive rate scale on the apportionment, but, presumably, the same considerations apply. This is borne out by the court's statement of the relevance of its question: if the ECJ rules that the personal reliefs must be set against the domestic income in their entirety, the taxpayers' appeal must be granted. If the ECJ denies the attribution, the appeal must be dismissed.

Supreme Tax Court decision I R 71/10 of February 9, 2011 published on April 13

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