By PwC Deutschland | 22. November 2022

Accrual of foreign source income and foreign tax credit

Part of the fee payable by the foreign client which is initially retained in anticipation of a potential foreign withholding tax liability of the German self-employed contractor is not immediately subject to income tax in the hands of the latter. According to a ruling of the Supreme Tax Court, the fee withheld is only subject to German income tax if the foreign customer settles the foreign (withholding)tax liability incurred on the total amount of the agreed fees.

Background

The case of dispute concerns the amount of taxable business income of a female disc-jockey (plaintiff) with performances in other EU countries and who declared her taxable income by using the so called “surplus income”-method (which is computed on a cash basis by deducting expenses and other allowances or personal deductions from the income / revenues - *Überschusseinkünfte*) as provided in Section 4 (3) of the German Income Tax Act (ITA). She had not received the agreed fees in full; rather, the foreign clients had withheld a portion thereof to settle the prospective (withholding)tax payments incurred abroad. The plaintiff was able to provide "tax certificates" for part of these tax payments. To the extent she was unable to produce certificates, the tax office took the full amount as income..

The Tax Court of Berlin-Brandenburg rejected the appeal brought by the claimant. Among other things, the court stated that an accrual of taxable income also occurs where a payment is not made directly to the taxpayer but is applied elsewhere on his or her behalf to settle other liabilities. The tax court treated the fee retained to settle the tax liability as non-deductible because taxes on income are expressly defined in Section 12 No. 3 ITA as non-deductible items.

Decision

The Supreme Tax Court upheld the appeal but at the same time referred the matter back to the lower tax court. In the opinion of the Supreme Tax Court, the court of first instance had erred insofar as it had recognized operating income in the amount of the fees for which a proper documentation for payment of foreign taxes could not be furnished by the claimant.

With regard to the partially retained fees: According to the Supreme Tax Court, an accrual also takes place if - in agreement with the taxpayer - payment is made to a third party (here: the foreign revenue office) on the taxpayer's behalf and thus actually settles a debt of the taxpayer (so-called abridged payment method). The findings of the lower tax court were not sufficient to establish beyond doubt that the specified criteria for a recognition as taxable income were met. Furthermore, there are no reliable conclusions as to what was agreed between the plaintiff and her clients.

In its ruling, the Supreme Tax Court also **examined** in more detail **further aspects** of the case as follows:

The **calculation of the maximum tax credit amount** pursuant to Sec. 34c (1) Sentence 2 ITA in accordance with the Supreme Tax Court judgment of 18 December 2013 - I R 71/10: In this decision the Supreme Tax Court followed an ECJ judgment from 28 February 2013, C-168/11 "*Beker and Beker* " and held that the maximum foreign tax credit had to be based on the total German tax payable on the foreign income as calculated on the assumption that personal allowances and reliefs are first set against the domestic income. The Supreme Tax Court also held the “per country” limitation to be in accordance with community law (more details on judgment C-168/11, "*Beker and Beker*" to be found in our **blog post of 2 April 2014**).

The **documentation requirements** imposed in Section 68b of the Income Tax Implementation Ordinance

on the amount of foreign income and taxes are justified under EU law for overriding reasons of general interest due to the effectiveness of tax supervision and do not go beyond what is necessary to achieve this objective, because the provision is not exhaustive and allows further documents as evidence beyond tax assessment notices and tax receipts.

Source

Supreme Tax Court judgment of 16 March 2022 (I R 10/18) published on 17 November 2022

Schlagwörter

accruall, foreign tax credit, foreign withholding tax