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By PwC Deutschland | 01. Februar 2023

Future expenses not to be included when calculating maximum foreign tax credit

When determining the amount of foreign withholding tax credit against German income or corporation tax, expenses for future earnings are not to be included in the calculation, which - in the case of dispute before the Supreme Tax Court- improved the plaintiffs tax credit potential. This decision of the Supreme Tax Court contrasts with the view held by the tax authorities.

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Background

The case in dispute concerns the credit of Chinese withholding tax against German corporate income tax. - The plaintiff is a limited liability company (GmbH) and holds 100% of the shares in X in the People's Republic of China, in addition to other shareholdings. The development of a new product can be produced abroad at the request of the customer. In this case, the plaintiff transfers the results of the development research to the respective foreign subsidiary for use in return for payment of a one-time amount which is determined by applying the so-called cost-plus method. These payments were subject to withholding tax abroad.

In the year in dispute, the plaintiff generated license income from the development results transferred to X, upon which a tax of 10% was withheld in China. In addition to the operating expenses in the year in dispute, further expenses had already been incurred in that year for ongoing and not yet completed development work, which in later years led to the granting of licenses and license income from China. These were capitalized in the year of dispute as future expenses.

The tax office took the view that, for the purpose of calculating the maximum amount of foreign credit, it was necessary to consider all operating expenses which were incurred in the year in dispute from the same source of income, namely income from licenses with China. These also included the capitalized future expenses. As a result of this approach, a credit of the Chinese withholding tax against the German corporate income tax was no longer possible. The Muenster Tax Court agreed with the plaintiff and granted the appeal.

Decision

The Supreme Tax Court confirmed the view of the court of first instance and dismissed the view of the tax office as unfounded. Expenses for future earnings are not to be included in the calculation of the maximum amount of foreign tax credit.

Article 24 of the Double Tax Agreement (DTA) with China explicitly refers to the application of domestic law to calculate the amount of withholding tax credit. According to Sec. 34c(1) Sentence 4 Income Tax Act (ITA), which specifies the foreign tax credit parameters, the foreign tax shall be credited against the German income tax attributable to the income from that state. This is to be determined in such a way that the overall German tax assessed is allocated in proportion of the foreign income to the total taxable income.

From this follows that the foreign taxes are to be credited only insofar as they are attributable to the income received in the relevant assessment period. Business expenses and other reductions in operating assets are only to be taken into account when calculating the maximum amount of tax to be credited if they are economically connected with the relevant foreign source income.

The Supreme Tax Court further pointed out that business expenses can only be deducted if they are specifically and economically connected with the foreign source income. The term "economic connection" as used in the statute is not further defined. According to the case law of the Supreme Tax Court, it is based on

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the general principle of cause. This limits the deduction of operating expenses and other deductions both in material terms and time.

Source

Supreme Tax Court, decision of 17 August 2022 (I R 14/19), published on 26 January 2023.

Schlagwörter

foreign tax credit