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Subject to tax rules in treaties

The finance ministry has issued a decree on the application of subject to tax rules in treaties where taxation in the state of source is not immediate or full.

It is increasingly common practice for Germany to agree in her double tax treaties that she will only exempt the foreign income of her residents if they show that it has been taxed in the state of source or activity. If the income has not been taxed abroad – expect, perhaps by withholding – it becomes taxable in the state of residence with a credit for any withholding tax actually paid. Other treaties stipulate that income will be deemed to have arisen in the state of resident unless taxation in the state of source is proven. The Supreme Tax Court at one time took the view that this stipulation was not the equivalent of a subject-to-tax condition of exemption, although it has since revised its opinion and now sees the two concepts as identical. Finally, a few German treaties – especially with countries with British tax traditions – make taxation in the state of residence conditional on the income having been paid out or remitted there (“remittance basis”). The finance ministry has issued a decree explaining its understanding of the meaning of actual taxation in borderline cases.

In principle actual taxation is to be demonstrated with the notice of assessment and the bank payment voucher. However, if the foreign country does not issue assessment notices because it operates a self-assessment system, the tax authorities will accept a copy of the tax return as evidence that the income has been declared. The bank voucher will still be needed, though, as proof of payment.

An income item will be treated as having been taxed in the other state if it has been taken into account in the computation of taxable income. Thus, it will be seen as “subject to tax” in the other state, even if it is offset against allowances or losses, or where it benefits from exemption under the treaty itself or EU directive, as may be the case with dividends on significant shareholdings. Taxation will also be assumed where the actual burden is deferred, e.g. by offset of the income against provisions or depreciation beyond the German limits, or where there is an offset against expenses that would be disallowed under German law. However, taxation will not be assumed if the income is exempt under local law by its nature, if the owner is exempt as a taxpayer, where the income was concealed from the local authorities, or where it does not rank in the other state as being of local source. The examples quoted in the decree are royalty income earned in the USA by a foreigner from licences abroad that is exempt in the US as being unconnected with a local trade or business and interest income earned from loans to US local community authorities.

The decree emphasises that remittance-based taxation is dependent upon actual payment. Questions as to where the income was actually earned are unimportant, although regard will have to be had to the actual wording of the treaty provision.

Keywords

state of residence, state of source, subject to tax