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By PwC Deutschland | 25 October 2023

Taxation of foreign passive income in case of potential doubts under constitutional and EU law

Pursuant to the claim for interim relief in the form of a suspension from payment the Supreme Tax Court decided that the taxation of foreign passive income pursuant to Secs. 7 et seq. Foreign Tax Act of a corporation domiciled in Hong Kong is not in serious doubt with respect to the free movement of capital and under constitutional law.

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Facts of the case (in brief)

German residents (the appellants) each held a 1/3 interest in a Hong Kong-based Ltd. The Ltd. generated income from the provision of services which was not taxed in Hong Kong. A specific assessment declaration pursuant to Sec. 18 Foreign Tax Act (FTA) was not submitted by the plaintiffs. The tax office issued an assessment notice for 2016 and estimated the attribution amount within the meaning of Sec. 10 (1) FTA. A complaint was filed by the plaintiffs for interim relief in the form of a suspension from execution, which was rejected by the tax office.

Decision

The Supreme Tax Court agreed with the decision of the court of first instance (the Muenster Tax Court) and rejected the complaint as unfounded.

Even if, after summary examination, there are doubts under constitutional and EU law on the taxation of passive foreign income where the low tax threshold of 25% is higher than the lowest national total income tax rate/ tax burden for unlimited taxpayers (22.825%, including trade tax), a successful court action (appeal) would be impossible if it can be excluded that the applicants, in view of a "zero taxation" of the disputed income abroad, would benefit from a more favorable legal situation once the infringement of constitutional or EU law is eliminated.

However, in the opinion of the Supreme Tax Court, the doubts expressed in the professional literature so far are substantial, since a low tax threshold that is significantly higher than the lowest total tax burden for unlimited taxpayers in Germany can obviously no longer be justified with the "achievement of unreasonable tax advantages" due to the absence of "a compensating foreign taxation" or the securing of a "necessary prior burden on low-taxed profits of foreign companies".

In this context, it is correctly pointed out that adherence to this low-tax threshold is likely to change the "character of attribution of sheltered passive foreign income" / attribution of foreign passive income from a measure to combat profit shifting to low-taxed territories to the direction of a general imputation system in which all foreign income concerned is to be subject to domestic taxation. This is particularly the case if the attribution amount (already taxed abroad) is allocated to a domestic corporation (which is therefore also subject to trade tax), thus resulting in a shortfalls of tax credit (loss of tax credit potentials).

The applicants' complaint nevertheless cannot succeed. Although the constitutional doubts could be removed in such a way that the low tax threshold be lowered to 22.825% (taking into account the trade tax) or 15.825% (without trade tax). However, in view of the "zero taxation" of the income of the intermediate company in Hong Kong, the applicants could not benefit from this. For the Supreme Tax Court, it is simply impossible that the lawmakers will introduce a new legislation favoring the applicants in the dispute.

The same applies to the alleged doubts under EU law. After all, it would not lead to the complete inapplicability or invalidity of the national provisions regarding the taxation of the attribution amounts if the European Court of Justice (CJEU) were to recognize an infringement of Union law.

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