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Reimbursement of tax on loss of earnings is subject to income tax

In a most recent decision, the Supreme Tax Court held that the income tax payable on the compensation for loss of earnings which was subsequently reimbursed by the tortfeasor (injuring party) is subject to income tax in the hands of the injured party.

Background

The plaintiff had to give up her job due to a serious medical error. She received annual compensation for her loss of earnings from the injuring party's insurance company. She had to pay tax on the payments as this was a compensation for lost wages pursuant to Section 24 no. 1 letter a Income Tax Act („*compensation for lost income or expected loss of income*“). In the years of dispute, the insurance company complied with its statutory obligation to reimburse the income tax for the compensation payments received in previous years. The tax office and the tax court of first instance were of the opinion that these reimbursements were themselves subject to income tax. The plaintiff, on the other hand, believed this was a loss of taxes, and its reimbursements did not again trigger any tax.

Decision

The Supreme Tax Court rejected the plaintiff's appeal. Taxable compensation included not only the loss of net earnings initially paid but also the ensuing tax which is subsequently reimbursed by the tortfeasor. In this respect, the Supreme Tax Court relied on the principles under civil law under which the injuring party or its insurance company is obliged to also pay the tax due on the loss of earnings. The net loss of earnings and the tax due are each part of a uniform claim for damages which were just paid at different times. Both nevertheless serve to compensate the injured party for lost income.

The Supreme Tax Court ruled out the possibility of taxing the tax refunds at a reduced income tax rate. This was particularly because the plaintiff did not receive compensation for her entire loss of earnings (including the resulting tax burdens) in one year.

The distribution of the payments over several years also deprived the compensation of the “extraordinary nature” which is required for a reduced taxation in accordance with Section 34 Income Tax Act.

Source:

Supreme Tax Court, decision of 15 October 2024 (IX R 5/23) – published on 9 January 2025.

Keywords

compensation payment, extraordinary income, wages & salaries