

Tax credit for foreign withholding tax on investment income against German trade tax

DECISION OF THE FISCAL COURT OF HESSE DATED 26 AUGUST 2020 – 8 K 1860/16

Executive summary

- In its decision of 26 August 2020, the Fiscal Court of Hesse held that foreign withholding tax can be credited against domestic trade tax.
- Despite the absence of an explicit tax credit provision under trade tax law, the entitlement to a tax credit is provided for under the double taxation agreement (DTA) in conjunction with the application of corporate income tax and income tax crediting provisions.
- The amount of the tax credit should be determined by the tax authorities by means of a so-called supplementary assessment notice if the trade tax assessment notice has already become final and binding.
- It would be advisable to carry out a thorough analysis of the relevant facts and, where appropriate, submit a timely application for a supplementary assessment notice regarding the tax credit for the withholding tax.

History and legal background

Prior to the decision of the Fiscal Court of Hesse, foreign withholding tax levied at the level of German resident corporations could not be credited against the German trade tax. In the period under dispute, according to section 8b (1) of the German Corporation Tax Act (CTA), the payment of a portfolio dividend (shareholding in the distributing company of less than 10%) was not included in the determination of income for corporation tax purposes. For trade tax purposes, however, it was added back to the tax base pursuant to section 8 (5) sentence 1 of the German Trade Tax Act (TTA) (the trade tax reduction provisions of section 9 nos. 2a and 7 TTA do not apply to portfolio

dividends). The (portfolio) dividend was thus included in the taxable trade income.

Due to the DTA-compliant tax deduction by the source state with the concurrent taxation right of the residence state (i.e. Germany) with regard to the dividends, juridical double taxation arose.

Juridical double taxation is generally avoided by granting a tax credit for German (corporation) tax purposes. Depending on the individual DTA, there are three possible foreign tax credit mechanisms:

1. Tax credit for income tax and corporation tax purposes, i.e. *'from German income tax and corporation tax'*;
2. Tax credit not expressly granted for trade tax purposes, i.e. *'from that part of the German tax (with the exception of trade tax)'* (cf. article 24 (1) no. 2 DBA-Switzerland);
3. Tax credit for German tax purposes, i.e. *'from the German tax on income in compliance with the provisions of German tax law on the credit of foreign taxes.'*

Probably the most common is scenario number three, which can also be found in the OECD Model Tax Convention. The issue of a possible trade tax credit becomes economically relevant in particular if, despite the use of a tax credit for corporation tax purposes, a tax credit remains unused, for example, because the German tax resident taxpayer cannot credit the withholding tax for corporate tax purposes (e.g. in the event of a loss or where, due to different tax bases, the foreign (withholding) tax exceeds the domestic corporate tax due on such foreign source



income). In this case, the taxpayer would request crediting the surplus amount – which in principle cannot be carried over to another assessment period – to the respective assessment period for trade tax purposes to prevent the tax credit from being wasted or forfeited.

However, the Trade Tax Act (TTA) does not include any such (explicit) tax credit provision, which means that as a general rule trade tax credits are not accepted by the German tax authorities, despite critical voices in the academic literature. The decision of the Fiscal Court of Hesse dated 26 August 2020 and the proceedings currently pending before the Federal Fiscal Court (BFH) could provide clarity with respect to eliminating de facto double taxation or unequal treatment.

Decision of the Fiscal Court of Hesse dated 26 August 2020 – 8 K 1860/16

The question in dispute was whether – and, if so, how – the tax office is required to accept a trade tax credit with regard to Canadian withholding tax paid on dividends. In its judgement dated 26 August 2020 – 8 K 1860/16, the Fiscal Court of Hesse upheld that a trade tax credit could be granted.

According to the view held by the fiscal court of Hesse, the deduction of Canadian withholding tax gives rise to double taxation since Germany and Canada levy a similar tax on the same taxpayer in respect of the same taxable item and for the same period. While there is no tax credit provision under the Trade Tax Act, the DTA directly provides for such a tax credit. Notwithstanding the absence of an explicit provision for trade tax, the fiscal court of Hesse holds the view that the allowance of the tax credit under the DTA (article 23 (2) (B) (aa) and article 10 DTA Germany-Canada) must therefore be applied mutatis mutandis in the context of the application of the German domestic corporate income tax and income tax provisions (section 26 (1) sentence 1 CTA and section 34c (6) sentence 2 of the German Income Tax Act). The Fiscal Court of Hesse further ruled that the tax credit, both in terms of its merits and the amount, should be determined by the

tax office as part of the trade tax assessment notice. The trade tax assessment notice issued in the case at hand was final, but according to the court, also incomplete or insufficient, which is why the tax credit amount could be assessed in a separate supplementary assessment notice, regardless of the legal validity of the original trade tax assessment notice.

Conclusion and outlook

The case is currently pending before the German Federal Fiscal Court (I R 8/21). It therefore remains to be seen what position the German Federal Fiscal Court takes on this issue and whether it follows the decision of the fiscal court of Hesse. If it were to do so, the specific feature of the procedure for a supplementary assessment notice could have a greater impact than might appear at first sight. If the issue of supplementary assessment notices is permitted in all cases for which the statute of limitations has not yet expired, the subsequent allowance of a tax credit (i.e. refund) could potentially lead to substantial refunds for international group structures.

On this basis, it is advisable to check past (dividend) events and, depending on the situation, submit applications to the competent tax authority for the issue of supplementary assessment notices, and to keep these open under procedural law in order to benefit from unused trade tax credits.

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