German Federal Constitutional Court confirms tax treaty overrides are permissible under the constitution

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The issue of tax treaty overrides as an instrument to safeguard Germany's right to tax, contrary to existing double tax treaties, has been under debate for several years. The discussion has been fueled by the German Federal Tax Court voicing substantial doubts about the constitutionality of such mechanisms. Now, the Federal Constitutional Court has – against all expectations – confirmed that tax treaty overrides are constitutional.

Treaty overriding, i.e. the unilateral nullification of provisions contained in double tax treaties (DTTs), has been widely used by the German legislature in recent years. Most of these provisions are contained in the German Income Tax Act (Einkommensteuergesetz) and the Corporate Income Tax Act (Körperschaftsteuergesetz), and they typically constitute 'switch-over' clauses. To this end, the German legislature provides for the application of income exemption – pursuant to the relevant treaty provisions – only if the income is (in its view) taxed sufficiently in the source state; otherwise the tax credit method rather than the exemption method is applied.

The case recently considered by the German Federal Constitutional Court (ref. no. 2 BvL 1/12 of December 15, 2015) centered on the DTT between Germany and Turkey. According to a previous version of this DTT, income from employment earned in Turkey by people with full tax liability in Germany was exempt from German taxes, and did therefore not count toward the German tax assessment base. In contrast to the obligations agreed on in this treaty, Sec. 50d(8) of the German Income Tax Act states that, irrespective of the applicable DTT, exemption from German taxation of employment income can be granted only if the citizen liable for taxation proves that the state entitled under the treaty to exercise the right of taxation has waived this right or that the taxes assessed by this state on the basis of the income in question have been paid.

The German Federal Tax Court (ref. no. I R 66/09) originally took the view that Sec. 50d (8) of the German Income Tax Act was unconstitutional. In particular, the provision was assumed to constitute an unreasonable breach of international treaty law, infringing the plaintiff's fundamental right of respect for the constitutional order and the rule of law. The court referred the case to Germany's Federal Constitutional Court, which has now confirmed the constitutionality of the provision – and, therefore, tax treaty overrides. According to the court, unconstitutionality cannot be justified because of a (potential) breach of international treaty law or a breach of the principle of equal treatment. The German Federal Constitutional Court held that international tax treaties possess the same rank as statutory federal law and can thus be superseded by later federal statutes that contradict them. As a consequence, further cases concerning treaty overrides that the Federal Tax Court has referred to the Federal Constitutional Court may be expected to be judged similarly.

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The recent court decision has potentially enormous ramifications, although at the moment it is difficult to assess them in their entirety. Most importantly, it does not seem to provide a basis for double taxation. Sec. 50d(8) of the German Income Tax Act, the legal provision scrutinised in the case at hand, is in fact designed to avoid double non-taxation; it stipulates that, if taxes on employment income have been paid in the other state, Germany will exempt this income from German income taxation. Otherwise, the tax credit method is applied so that in either case double taxation does not arise. However, in contrast to the present case, other provisions in which tax treaty overrides have been installed may possibly result in double taxation. In particular, this includes the tax treatment of payments (such as remuneration for management services, the granting of loans, or licensing of tangible or intangible assets) by a German-based partnership to its partner's resident abroad. Under the existing DTTs, such payments are usually classified as income from employment, interest or license fees for which the right to tax lies with the partner's state of residence, while Germany is at most granted a right to impose withholding taxes. However, Sec. 50d(10) of the German Income Tax Act unilaterally treats such payments as business profits for the purposes of treaty law that are fully taxable in Germany. Therefore, it will be interesting to observe whether the German Federal Constitutional Court will extend its decision to such cases as well (ref. no. 2 BvL 15/14).

Assuming the Federal Constitutional Court reaches the same conclusion in those cases, it is still uncertain how to deal with the potential double taxation stemming from tax treaty overrides. Generally, the OECD Model Convention (OECD MC) provides under Art. 25 for a mutual agreement procedure (MAP) if taxation is not in accordance with the treaty provisions in place, i.e. in the case of looming double taxation. The relevant competent authorities must first endeavour to resolve the case. If they cannot reach agreement, any unresolved issues arising from the case can then be referred for arbitration on request. However, given that a treaty override may result in double taxation while expressly disregarding the applicable DTT, it seems uncertain whether a MAP can be requested under the applicable DTT. Even if a MAP is initiated, its potential result seems unpromising. Given that in this case Germany will exert its right to tax in violation of the DTT, the MAP could result only in the other state being allocated the right to tax. However, if the Germany competent authority then waives its right to tax, it breaches statutory federal law.

In view of the Federal Constitutional Court's decision, we expect the German legislature to increasingly unilaterally insert treaty override provisions in the future. This may also affect the German transfer pricing provisions laid down in Sec. 1 of the German Foreign Tax Act (Außensteuergesetz) that were recently found not to be entirely in line with the arm's length principle under Art. 9 of the OECD MC. To this end, the court's decision reduces legal certainty in that taxpayers (potentially) doing business in Germany cannot simply trust in the provisions of existing DTTs but instead need to seek specialised tax advice in order to analyse whether German domestic tax law provides for a different view in their case.

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