Germany:
Federal Tax Court queries constitutionality of treaty override

In a recently published decision, Germany’s Federal Tax Court (BFH) expressed doubts as to whether the tax treaty override, under which the credit method is substituted for the exemption method provided for under a tax treaty, is in line with the principles of the German constitution. If not, the domestic legislation overriding a treaty would be void.

The treaty override provision in section 50d paragraph 8 of the Income Tax Act allows Germany to impose tax (despite provisions to the contrary in an applicable tax treaty) on the employment income of a German tax resident if the individual is unable to demonstrate that the employment income was actually taxed in the contracting state or that the other state specifically waived its taxation rights.

In the case before the BFH, a German resident taxpayer had earned income from employment in Turkey during FY 2004. The Germany-Turkey tax treaty in effect at the time (i.e. the 1985 treaty) provided that the employment income was taxable in Turkey and exempt in Germany. The German tax authorities denied the exemption because the taxpayer failed to show that any tax was paid to the Turkish tax authorities or that Turkey had waived its rights to tax the income in Turkey.

The BFH held that the treaty override provision regarding employment income violates the principles of the German constitution, namely, the general preference for the application of international law over domestic law in the Law of Nations and the nondiscrimination principle. According to the court, the law infringes the equal treatment clause in two ways: (1) taxpayers without the ability to document the tax treatment in the contracting state (in this case, Turkey) are treated differently from taxpayers who are in a position to provide the information; and (2) taxpayers earning employment income are treated worse than taxpayers with income other than employment income.

In previous cases the BFH had ruled that treaty law and domestic law are separate and distinct legal areas that do not interfere with each other and that any breach of treaty provisions was merely unfortunate, but it does not bestow any rights on the taxpayer. The court has now taken a very different position as it gives priority to the treaty and requires a justification for a treaty override. The prevention of double non-taxation, in and of itself, would not be sufficient to justify the breach of an agreement between nations. The legislator could renegotiate or even terminate the treaty. In this case, instead of enacting the treaty override in 2003, Germany would have been in a position to terminate the treaty with Turkey with six months’ notice in 2004. Germany also could have renegotiated the provision on income from employment in the new 2011 treaty (e.g. by implementing a subject-to-tax clause), but it did not.

The BFH has referred the case to the Constitutional Court, which has the sole authority to determine whether domestic law contradicts the constitutional principles. A decision by that court that the rule is unconstitutional would affect all open cases where the tax authorities have applied section 50d paragraph 8 of the Income Tax Act. Other comparable treaty overrides also could be deemed unconstitutional, e.g. section 50d paragraph 9 of the Income Tax Act, which gives Germany the right to tax a German resident where a diverging interpretation of treaty provisions results in double non-taxation.

Affected taxpayers should keep their tax assessments open and monitor developments closely.

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