Germany: 
BFH refers treaty override provision issue to Federal Constitutional Court

The Federal Tax Court (BFH) has referred a case involving a tax treaty override provision to the Federal Constitutional Court, asking the court to determine whether the provision is in line with German constitutional law. A conclusion by the Constitutional Court that the provision is unconstitutional likely would have a significant impact on the German legislature’s practice of introducing treaty override provisions that aim to secure German taxation rights, despite tax treaty provisions to the contrary.

For a tax treaty to become applicable in Germany, the treaty must be transposed into German domestic law (that is, a treaty is not "self-executing"), which requires the consent of both the upper and lower houses of parliament. Once transposed, a tax treaty has equal status with “ordinary” domestic tax law – a treaty will not supersede ordinary domestic law, or vice versa. Because of this equality of status, the prevailing opinion has been that the German legislature subsequently can enact rules that override the provisions in Germany’s existing tax treaties.

The BFH is of the opinion that the interaction between tax treaty law and German domestic tax law needs to be refined. According to the court, although a tax treaty and German domestic law are ranked equally, the negotiated provisions in a treaty limit the legislature’s latitude to introduce measures that deviate from the treaty.

The case referred to the Federal Constitutional Court involves a situation where a German trading partnership with a permanent establishment (PE) in Germany paid interest to one of its individual partners who was a tax resident of Italy.

According to German domestic tax principles, a partnership is treated as transparent and its partners are taxed on their share of the business profits of the partnership. A PE of a German partnership is considered a PE of the partners. In addition, interest paid by a partnership to its partners is considered to be a part of the partners’ business income allocated to the partnership PE and, therefore, taxable in Germany under domestic income tax principles.

By contrast, under a tax treaty, such interest income typically will not qualify as business income allocable to a PE of a partnership; instead, it will be considered ordinary interest income of the partners. Under a treaty, the primary right to tax ordinary interest income is allocated to the state in which the recipient of the interest is resident (in this case, Italy).

The BFH confirmed this understanding of the treaty provision in previous cases that prompted the German legislature to amend the tax law to secure German taxation rights, even where provisions of an applicable tax treaty allocate the taxing rights differently. Broadly speaking, the treaty override introduced a few years ago provides that such interest income is deemed to be business income allocable to the German PE that is taxable in the hands of the relevant partner, even where a tax treaty applies.

In the current case, on the basis of the treaty override, the German tax authorities applied the business profits article of the Germany-Italy tax treaty, which allocated the right to tax the partner’s share of the business income realized by/through the partnership to the state where the PE was located (i.e. Germany). The application of the treaty override triggered double taxation of the interest income: it was taxed in Italy as interest income and in Germany as business income allocable to the German PE.

The BFH not only acknowledged the potential risk of double taxation under the treaty override provision, but went so far as to question whether the provision was constitutional. Since the BFH lacks the authority to rule on the constitutionality of a law, it referred the case to the Federal Constitutional Court.

The case could result in the Constitutional Court handing down a landmark decision redefining the interaction of tax treaty law and ordinary German domestic law. Considering the number of treaty override provisions introduced by the German legislature in recent years (e.g. the anti-treaty shopping rule in section 50d(3) of the Income Tax Code also is considered a treaty override provision), potentially affected taxpayers should monitor future developments closely and any ongoing cases should be kept open (e.g. by appealing tax assessments and referencing the pending court decision).

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