



Tax Alert

Treaty-Overriding is consistent with German Constitution

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Recently the Federal Constitutional Court decided that Treaty Overriding is consistent with the German Constitution.

As a result the legislator is allowed to enact a law that overrules legal consequences Germany has agreed on with other states in bilateral double tax treaties.

The Case

The case decided dealt with the old double tax treaty between Germany and Turkey. In 2004 a German engineer worked temporarily in Turkey. Due to the double tax treaty the income from employment could only be taxed in Turkey. Germany was obliged to exempt the income irrespective of an effective taxation in Turkey. In 2003 the German Federal Parliament passed a law which requires an employee to bring further evidence in order to benefit from the exemption method agreed in most double tax treaties for income from employment. The taxpayer must prove that the income from employment is or deliberately isn't taxed abroad. If the taxpayer cannot provide evidence as requested Germany switches from the exemption towards the credit method. As a result the income from employment will be taxed in Germany. In the case decided the engineer wasn't able to provide the requested evidence. Germany taxed his employment income.

To make it very clear: According to the double tax treaty Germany wasn't allowed to tax the income from employment. However, due to local law the legal consequences of the double tax

treaty were overruled and Germany finally taxed the employment income.

The judgement

According to the Federal Constitutional Court the so called treaty overriding is in line with the German constitution. The Court justified its decision with the fact that the regulations of double tax treaties and the local law have equal priority. Hence, it is possible that double tax treaty provisions are overruled by local law if according to conflict-of-law rules the local law is prevailing. That can be the case if the local law comes into force later than the double tax treaty (*Jus posterior derogat legi priori*) or is more specific (*Jus specialis derogat legi generali*).

What does the judgement mean for Grant Thornton?

The judgement legitimates all treaty overrides in German Tax Law. This will lead to an even more complicated tax treatment of international activities as comprehensive knowledge of double tax treaties will no longer be sufficient when dealing with international clients. A detailed analysis of the German tax law is inevitable when it comes to clients with tax liability in Germany.

Germany has a wide range of treaty overrides. All of them have in common that they address a real or imagined abuse of double tax treaties. In the following we have summarized the most popular treaty overrides in German tax law.

- Reduction of withholding taxes in Germany (mainly for dividend and license payments). According to local German tax law the foreign entity receiving the payment must fulfil certain criteria with regards to itself as well as the shareholders in order to keep the lower withholding tax rates stated in the double tax treaty.
- Germany switches from the exemption towards the credit method if qualification conflicts due to a different qualification of either the entity itself or the attribution of profits, provided the different qualification leads to untaxed income or a taxation lower than it would have been without the conflict.
- The exemption of profits allocated to a permanent establishment abroad depends on the quality of the income generating activity. German tax law knows a very complex distinction between active (qualifies for the exemption method) and passive (doesn't qualify for the exemption method) activities and hence income.

For the Grant Thornton network it is absolutely crucial to understand the tremendous importance of the decision of the German Federal Constitutional Court and the consequences when dealing with international clients. Please reach out to us whenever you are advising a client with tax liability in Germany. We are more than happy to help and demonstrate that we have a capable and strong network.

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