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By PwC Deutschland | 22 May 2012

Constitutional Court to rule on treaty override

The Supreme Tax Court has laid its doubts on the constitutional propriety of the treaty override switch over provision in respect of employment income not taxed in a foreign state with the taxing right under a treaty.

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As a rule, German double tax treaties exempt the employment income of residents where the right to tax falls to the other state, but take the amount exempted into account in calculating the rate to be applied to the other, non-exempt income. However, the Income Tax Act contains a treaty override provision substituting the credit method for the exemption method of avoiding double taxation where the employee earning the income cannot show either that the foreign state has actually taxed the income in question, or that it has waived its treaty right to do so. A case has been brought before the Supreme Tax Court by a resident claiming exemption of employment income earned whilst working on a nine-month temporary assignment to Turkey. Under the German/Turkish double tax treaty, this income was taxable in Turkey and exempt in Germany. However the taxpayer produced no evidence of Turkish taxation, so the German tax office applied the treaty override provision and refused to exempt the amount claimed.

The Supreme Tax Court sees two constitutional conflicts in the override provision. The first lies in a conflict with the provision defining the “general rules of international law” as part of Federal law with priority over federal statutes, and the second is a breach of the equal treatment provision in that the override at issue applies to employment income only, rather than to income of all sources. Accordingly, it has stayed its case, laying its doubts before the Constitutional Court.

The double tax treaty with Turkey in the version valid up to December 31, 2010 contained no “switch-over” or other clause transferring a taxing right to the state of residence in the event of non-collection in the state of activity. There is thus no authority under the treaty for application of a domestic law override. The “general rules” of international law require, however, adherence to international agreements – pacta sunt servanda (pacts are to be respected) – and the agreement here in question allocates the taxing right to Turkey and supports this provision with an information exchange clause and other measures designed to make evasion more difficult. A claim justifying the override as a measure against evasion is, in the view of the court, only plausible if Germany were to forward the amount collected to the Turkish authorities. This, though, was not the legislative intention. Anti-avoidance or anti-evasion considerations could not justify a unilateral appropriation of a taxing right by Germany for levy at German rates and for the benefit of the German treasury. That the effect of the override provision is arbitrary is also evident from the consideration that it would not apply if the taxpayer could show actual taxation abroad at a very low rate of even as low as 1%.

The Supreme Tax Court’s view of the equal treatment breach is based on the consideration that the override applies to employment income only, but not to other forms of income taxable in the other state, such as trading profits, fees for independent personal services, or income from property. These forms of income are also potentially exposed to evasion by non-residents through failure to file tax returns or to meet other compliance obligations, particularly if their ties to Turkey are only temporary. There is also no evidence to suggest in general terms that employees tend more towards tax deceit than other taxpayers.

The Supreme Tax Court has already suggested several times that it harbours grave constitutional doubts on the treaty override. However, in all cases up to now, the court was able to disapply it for other reasons; thus

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there was no occasion to seek the verdict of the Constitutional Court.

Supreme Tax Court decision I R 66/09 of January 10, 2012 published on May 9

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