

March 17, 2016  
2016-039

**Germany – Constitutional Court Comes to Decision about Treaty Override**

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## flash Alert

A Publication for Global Mobility and Tax Professionals by KPMG's Global Mobility Services Practice

In a February 12, 2016 press release,<sup>1</sup> the German Constitutional Court announced its decision<sup>2</sup> that the so-called “treaty override” by national statutory law is permissible under the German Constitution.

The underlying decision solely affects the German treatment of income from employment in double taxation treaty scenarios. The German government is allowed to impose German income tax on individuals who do not provide evidence of actual taxation abroad (“proof of foreign taxation”), although this approach might violate double taxation treaty rulings.

### Why This Matters

If a specific double taxation treaty stipulates that Germany should exempt employment income from domestic taxation, this tax exemption is not automatically granted by the German tax authorities in the annual tax assessment. In accordance with the law, a German tax exemption is generally only granted if individuals provide evidence of actual taxation abroad (“proof of foreign taxation”).

If the aforementioned proof of foreign taxation is not provided to the German tax authorities, the underlying employment income would be subject to German income tax regardless of whether the particular double taxation treaty actually stipulates a tax exemption in Germany (“treaty override”).

In practice, this treaty override often causes additional administrative work (e.g., for translation/explanation of non-German income tax returns and/or tax assessment notices) for taxpayers, employers, and tax advisers in both home and host countries. This time-consuming approach has now – indirectly – been affirmed by the German Constitutional Court.

### Background

In the vast majority of cases, Germany has concluded double taxation treaties with other countries that, amongst other matters, determine the primary right of taxation of income derived from employment. In cross-border scenarios where Germany is to be regarded as the country of residence for double taxation treaty purposes,<sup>3</sup> potential double taxation is often prevented by the tax exemption method applied should the other contracting state have – as the state of source<sup>4</sup> – the primary right of taxation.

However, this approach might lead to a scenario where income from employment remains inadvertently exempt from taxation when taxpayers simply do not comply with foreign tax legislation. For that reason, the German legislature introduced a statutory law that came into effect on January 1, 2004.<sup>5</sup>

As a consequence, since then, Germany has only provided a tax exemption on foreign income from employment if taxpayers are able to provide evidence that:

- a) the employment income was actually subject to income tax in the contracting state (state of source); or
- b) the other contracting state has actually waived its right of taxation (e.g., general tax relief in that state).

If the aforementioned conditions are not met, Germany imposes income tax on foreign income from employment, which contradicts the rulings of double taxation treaties.

In the underlying case, the plaintiff received income from employment in Turkey and applied for tax exemption in Germany pursuant to the double taxation treaty with Turkey of 1985 ("DTT Turkey 1985"). As he was neither able to provide evidence that the Turkish sourced income was subject to income tax in Turkey nor that it was exempt from Turkish income tax, the German tax office treated the entire income as taxable in Germany – contrary to the DTT Turkey 1985 ("treaty override").

The German Constitutional Court decided that unilateral treaty overrides are not unconstitutional. The Court held that double taxation treaties have the same rank as statutory federal law and do not rank above it. Furthermore, the legislature is not bound by statutory law and is allowed to rescind or alter acts of assent to double taxation treaties of previous legislatures. In other words, double taxation treaties (here, DTT Turkey 1985) can be superseded by later federal statutes (here, act of 2004) that are in contradiction to them.

#### **KPMG Note**

In cases where double taxation treaties were concluded prior to January 1, 2004, a treaty override by imposing German income taxes on foreign employment income irrespective of the specific double taxation treaty is constitutional, according to the ruling of the German Constitutional Court. However, taking into account the reasons given for the judgement, it is still questionable whether a treaty override could be constitutional if the specific double taxation treaty was concluded after the act of 2004 (see footnote 5). This remains to be seen, and relates to double taxation treaties concluded after 2004 such as those between Germany and Spain, Luxemburg, Ireland, or the Netherlands.

It is recommended that in all relevant cases, documents showing the actual taxation outside Germany be provided to the German tax authorities in order to avoid German taxation "through the back door."

In cases where the foreign tax assessment can only be finalized and proven after the German tax authorities have imposed income tax on the foreign income (treaty override), the German tax assessment can be amended with the aim of exempting the income from German income tax retroactively.

*Footnotes:*

- 1 Press Release No. 9/2016, see:  
<http://www.bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2016/bvg16-009.html> .
- 2 Order of December 15, 2015 (file number 2 BvL 1/12); for detailed reasons for the judgement, see (in German):  
[http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2015/12/ls20151215\\_2bvl000112.html](http://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/DE/2015/12/ls20151215_2bvl000112.html) .
- 3 Based on article 4 of the OECD Model Tax Convention.
- 4 Based on article 15 of the OECD Model Tax Convention.
- 5 § 50d sec. 8 sentence 1 German Income Tax Act (*Bundesgesetzblatt* (Federal Law Gazette), December 19, 2003, page 2651, see (in German):  
[http://www.bgbl.de/xaver/bgbl/start.xav?startbk=Bundesanzeiger\\_BGBl&jumpTo=bgbl103s2645.pdf](http://www.bgbl.de/xaver/bgbl/start.xav?startbk=Bundesanzeiger_BGBl&jumpTo=bgbl103s2645.pdf)) .

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